WORLD BANK OPERATIONS EVALUATION DEPARTMENT

OED

Financial Sector Reform

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
AFR	Africa
APL	Adaptable Program Loan
ARPP	Annual Review of Portfolio Performance
BCEAO	West African Central Bank
BSP	Bangko Sentral ng Pilipinas
CAMEL	Capital adequacy, Asset quality, Management efficiency, Earnings and Liquidity
CAR	Capital Asset Ratio
CAS	Country Assistance Strategy
CBV	Central Bank
CBP	Central Bank of the Philippines
CODE	Committee on Development Effectiveness
DBPC	Deposit Bank Credit to the Private Sector
DDSR	Debt and Debt Service Reduction
DFC	Development Finance Corporation
DFI	Development Finance Institution
DOF	Department of Finance
DYB	Devlet Yatirim Bankasi
EAP	East Asia and Pacific
ECA	Europe and Central Asia
EDI	Economic Development Institute
EIB	European Investment Bank
ERL	Economic Reconstruction Loan
ESAF	Enhanced Structural Adjustment Facility
ESW	Economic Sector Work
FI	Financial Institution
FIL	Financial Intermediary Loan
FDI	Foreign Direct Investment
FERIS	Foreign Exchange Risk Insurance Scheme
FFI	Financial Fragility Index
FML	Financial Markets Loan
FOGADE	Deposit Insurance Fund
FSAC	Financial Sector Adjustment Credit
FSAL	Financial Sector Adjustment Loan
FSL	Financial Sector Adjustment Related Loan
FSRL	Financial Sector Restructuring Loan
FSU	Former Soviet Union Republics
FTAL	Financial Sector Technical Assistance Loan
FY	Fiscal Year
GDI	Gross Domestic Investment
GDP	Gross Domestic Product
GDS	Gross Domestic Savings
IBRD	International Bank of Reconstruction and Development
ICICI	Industrial Credit and Investment Corporation of India
ICR	Implementation Completion Report
IDA	International Development Association
IDBP	Industrial Development Bank of Pakistan
ID	Institutional Development
IFC	International Finance Corporation
IFS	International Financial Statistics
IIC	Industrial Investment Credit
IMF	International Monetary Fund
IPRs	Initial Project Reviews
ITPA	Industrial and Trade Policy Adjustment
LAC	Latin America and the Caribbean
MAFI	Macro Fragility Indicator
MIFI	Micro-Institutional Fragility Indicator
MIS	Management Information System
MNA	Middle East and North Africa
NBFI	Non-Bank Financial Intermediary
NCB	National Commercial Bank
NDB	National Development Bank
NPAs	Non-Performing Assets
OD	Operational Directive
OED	Operations Evaluation Department
OMS	Operational Manual Statement
OP	Operational Policy
OPRIS	Operations Policy Research Information System
PAR	Performance Audit Report
PCR	Project Completion Report
PDIC	Procedures and the strengthening of deposit insurance
PFI	Participating Financial Institution
PFP	Policy Framework Paper
PICIC	Pakistan Industrial Credit and Investment Corporation
PIR	Performance Indicators Rating
PR	President's Report
PSDL	Private Sector Development Loan
QAG	Quality Assistance Group
SAD	Sector Adjustment Loan
SAL	Structural Adjustment Loan
SAP	Structural Adjustment Program
SAR	Staff Appraisal Report
SAS	South Asia
SECAL	Sector Adjustment Loan
SIL	Specific Investment Loan
SIM	Specific Investment and Maintenance Loan
SME	Small and Medium-size Enterprises
SOE	State-Owned Enterprises
SPO	State Planning Organization
SSI	Small-scale Industry
TA	Technical Assistance
TAL	Technical Assistance Loan
TKSB	Turkiye Sinai Bankasi
UEMOA	Union Economique et Monétaire Ouest Africaine (since January 10, 1994)
UMOA	Union Monétaire Ouest Africaine (until January 10, 1994)
WDI	World Development Indicators

W O R L D   B A N K   O P E R A T I O N S   E V A L U A T I O N   D E P A R T M E N T

Financial Sector Reform:

A Review of World Bank Assistance

Nicolas Mathieu

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FOREWORD

This study analyzes the role of the Bank in helping client countries to implement financial sector reforms. It focuses on the country as the unit of analysis, rather than on individual loans, and on performance indicators in the financial and real sectors. Even without full incorporation of lessons still to be drawn from recent East Asia crises, this study finds a satisfactory outcome in only 12 of the 23 countries that it examines. Initial conditions appear to be significant in determining the outcome of reforms, and prior sector work is important for ensuring that policy reforms in Bank loans reflect a country's initial conditions.

In general, adjustment loans are more successful and more sustainable in promoting institutional development than are financial intermediation loans; this may reflect the relative ease of introducing prudential regulations compared to strengthening specific financial institutions. The study develops financial fragility indicators and applies them to three countries that experienced financial crises in the early 1990s (Mexico, the Philippines and Venezuela), to demonstrate their use as well as their limitations in evaluating financial sectors. The conclusions reaffirm the idea that financial sector adjustment is a complex, long-term process.

The main recommendations of the study are that the internal guidelines on financial sector operations (OD 8.30) provide a valid framework for preparing operations in support of financial sector reforms. The Bank should go beyond these guidelines, however, by incorporating best practice on both substantive issues and Bank processes, after sufficient time has elapsed to evaluate

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PREFACIO

En este estudio se analiza el papel del Banco Mundial para ayudar a los países miembros a aplicar reformas en el sector financiero. El estudio se centra en los países como unidades de análisis, no en cada uno de los préstamos, y en los indicadores del desempeño en el sector financiero y el sector productivo de la economía. Si bien no se han incorporado plenamente las enseñanzas que podrán extraerse de las recientes crisis en Asia oriental, se concluye que sólo en 12 de los 23 países examinados en el estudio se han obtenido resultados satisfactorios. Al parecer, las condiciones iniciales son importantes para determinar el resultado de los reformas y los estudios sectoriales previos ayudan a garantizar que las reformas de política incluidas en los préstamos del Banco reflejen las condiciones iniciales del país.

En general, los préstamos para fines de ajuste son más eficaces para promover el desarrollo institucional que los préstamos de intermediación financiera, además de ser más sostenibles; esto podría deberse a que es relativamente más fácil incorporar normas prudenciales que fortalecer determinadas instituciones financieras. En el estudio se proponen algunos indicadores de la fragilidad financiera y se aplican a tres países que sufrieron crisis a comienzos de la década de 1990 (México, Filipinas y Venezuela), a fin de demostrar su utilidad y sus limitaciones para la evaluación del sector. Las conclusiones del estudio reafirman la idea de que el ajuste del sector financiero es un proceso complejo y a largo plazo.

La conclusión más importante del estudio es que las directrices internas sobre operaciones en el sec-

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PRÉFACE

La présente étude analyse le rôle joué par la Banque pour aider ses clients à entreprendre des réformes au niveau de leur secteur financier. Elle porte sur les pays eux-mêmes, plutôt que sur tel ou tel prêt, et sur les indicateurs de performance au niveau du secteur financier et du secteur réel de l'économie. Même si les enseignements restant à tirer des crises qui ont récemment frappé l'Asie de l'Est n'y sont pas totalement pris en compte, l'étude fait état de résultats satisfaisants dans 12 des 23 pays examinés seulement. Il apparaît que les conditions de départ ont une influence déterminante sur l'issue des réformes, et des études sectorielles préalables contribuent fortement à ce que les réformes de politique générale prévues dans les prêts de la Banque reflètent bien la situation initiale d'un pays.

En général, les prêts à l'ajustement contribuent de façon plus positive et plus durable au développement institutionnel des pays que les prêts d'intermédiation financière ; cela témoigne peut-être du fait qu'il est relativement plus facile d'introduire des réglementations prudentielles que de renforcer des établissements financiers donnés. Des indicateurs de fragilité financière sont définis dans cette étude, et leur application au cas de trois pays qui ont connu des crises financières au début des années 90 (Mexique, Philippines et Venezuela) permet d'en démontrer à la fois l'utilité et les limites comme outils d'évaluation des secteurs financiers. Les conclusions viennent réaffirmer l'idée selon laquelle l'ajustement du secteur financier est un processus complexe et de longue haleine.

Selon les principales recomman-

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and learn from the recent developments in East Asia.

Substantive recommendations include:

- better sequencing of reforms (macrostability is critical, interest rate deregulation and bank recapitalization should be preceded by a number of conditions); some measures to limit damage can be taken while waiting for those conditions to be in place;
- more attention to the implications of systemic governance factors and to the prudential framework for financial institutions, including development of adequate skills to ensure they are effective; and to the independence and solvency of the central bank;
- greater focus on promoting competition; and
- investing more resources in collecting information on risk exposure and governance of financial sectors.

On processes:

- realistic assessment of long-term commitment to reform is critical;
- use of a wide range of lending and non-lending instruments should be encouraged, including the new adaptable program loan;
- financial intermediary loans should be used only in the context of an improved macro- and financial environment;
- good sector work is important for appropriate design of operations;
- better coordination with the IMF and the IFC is necessary; and

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tor financiero (OD 8.30) ofrecen un enfoque válido para la preparación de operaciones en respaldo de las reformas del sector. Sin embargo, la labor del Banco debería trascender estas directrices e incorporar prácticas óptimas tanto en las áreas fundamentales como en sus procedimientos, una vez que haya transcurrido el tiempo necesario para evaluar los recientes acontecimientos de Asia oriental y extraer las enseñanzas pertinentes.

Las siguientes son algunas de las recomendaciones más importantes del estudio:

- debe mejorarse la secuencia de las reformas (la estabilidad macroeconómica es fundamental; antes de la desreglamentación de las tasas de interés y la recapitalización de los bancos deben cumplirse varias condiciones); algunas de las medidas destinadas a limitar los daños pueden adoptarse mientras se espera que se cumplan dichas condiciones;
- debe prestarse mayor atención a las consecuencias de los factores sistémicos de la función de gestión y a las normas de disciplina y control de las instituciones financieras, incluido el desarrollo de la capacidad necesaria para garantizar su eficacia, así como a la independencia y solvencia del banco central;
- debe hacerse un mayor esfuerzo por promover la competencia, y
- deben destinarse mayores recursos a la recolección de información sobre el riego y la gestión del sector financiero.

En lo que respecta a los procedimientos, en el estudio se señala lo siguiente:

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dations de l'étude, les directives internes régissant les opérations de la Banque dans le secteur financier (DO 8.30) constituent un cadre adéquat pour la préparation de projets à l'appui des réformes dans ce secteur. Cependant, la Banque doit aller au-delà de ces directives en incorporant les pratiques optimales pour ce qui concerne aussi bien les questions de fond que ses propres procédures, une fois qu'elle aura eu assez de temps pour évaluer les récents événements d'Asie de l'Est et en tirer les leçons.

Sur les questions de fond, les recommandations sont les suivantes :

- mieux échelonner les réformes (la stabilité macroéconomique est d'une importance capitale, et un certain nombre de conditions doivent précéder la déréglementation des taux d'intérêt et la recapitalisation des banques, certaines mesures palliatives pouvant être prises en attendant que ces conditions soient réunies) ;
- prêter davantage attention aux implications des facteurs systémiques de gouvernance et au cadre prudentiel applicable aux établissements financiers, y compris à l'établissement de compétences adéquates pour en garantir l'efficacité, ainsi qu'à la question de l'indépendance et de la solvabilité des banques centrales ;
- mettre plus l'accent sur des mesures propres à encourager la concurrence ; et
- investir davantage de ressources dans la collecte d'informations sur l'exposition aux risques et l'aspect gouvernance des secteurs financiers.

Les procédures font l'objet des recommandations suivantes :

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- the Bank has a key role to play in helping to convince groups within borrowing countries of the importance of financial reform.

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- es fundamental hacer una evaluación realista del compromiso a largo plazo con la reforma;
- debería alentarse el uso de una amplia gama de instrumentos crediticios y no crediticios, incluidos los nuevos préstamos adaptables para programas;
- los préstamos a intermediarios financieros deberían otorgarse solamente en el contexto de un clima macroeconómico y financiero más favorable;
- los estudios sectoriales de calidad son importantes para el diseño adecuado de las operaciones;
- es necesario mejorar la coordinación con el FMI y la CFI, y
- al Banco le corresponde la tarea fundamental de ayudar a convencer a los diversos grupos en los países prestatarios sobre la importancia de la reforma financiera.

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- une évaluation réaliste de l'adhésion à long terme d'un pays au processus de réforme est d'une importance capitale ;
- il faut encourager l'utilisation d'un large éventail d'instruments de prêt et hors prêt, y compris les nouveaux prêts à des programmes évolutifs ;
- les prêts d'intermédiation financière doivent être utilisés uniquement dans le contexte d'une situation macroéconomique et financière assainie ;
- des études sectorielles de qualité sont importantes pour la conception appropriée des opérations ;
- il convient d'assurer une meilleure coordination avec le FMI et la SFI ; et
- la Banque a un rôle clé à jouer pour aider à convaincre les groupes concernés, dans ses pays emprunteurs, de l'importance des réformes financières.

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EXECUTIVE SUMMARY

The globalization of the world's financial markets has created a new world environment, full of opportunities, but fraught with dangers and unexpected shocks, highlighted most recently in the countries of East Asia. Resource flows from developed to developing countries have increased eight-fold in the last decade, and growth in many developing countries has reached the highest level in many years. At the same time, the promises of this new financial environment are clearly not without problems. Since globalization began, more than 80 countries—both developed and developing—have had banking sector crises, and in many countries the crises have been of unprecedented scale.

The World Bank's support for the financial sector has exhibited similarly contrasting patterns. On the one hand, many of the financial sector loans made in the late 1980s and 1990s have played a key role in restoring growth with equity. At the same time, however, the average outcome of Bank support for the financial sector has sharply deteriorated from being one of the best performing sectors before globalization to currently being one of the weakest. In addition, the composition and level of Bank support for the financial sector has changed in basic ways, focusing more on adjustment lending and less on financial intermediary lending, particularly following the Bank's 1992 establishment of a new framework governing financial sector operations—known as Operational Directive (OD) 8.30. Finally, in the past year the Bank has committed to a renewed emphasis on support-

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RESUMEN

La globalización de los mercados financieros mundiales ha creado un nuevo contexto internacional pleno de oportunidades que, no obstante, está plagado de riesgos y crisis inesperadas, como quedó demostrado recientemente en los países de Asia oriental. En la última década, los flujos de recursos de los países desarrollados a los países en desarrollo se han incrementado ocho veces, y muchos países en desarrollo han registrado los índices de crecimiento más altos en muchos años. Al mismo tiempo, este nuevo ambiente financiero, si bien prometedor, no está exento de problemas. Desde el inicio del proceso de globalización más de 80 países tanto desarrollados como en desarrollo han sufrido crisis bancarias, muchas de ellas de una magnitud sin precedentes.

El respaldo del Banco Mundial al sector financiero ha tenido contrastes similares. Por un lado, muchos de los préstamos otorgados a ese sector a fines de los años ochenta y en la década de 1990 han sido cruciales para restablecer el crecimiento con equidad. Al mismo tiempo, sin embargo, los resultados medios logrados con el apoyo del Banco al sector financiero han empeorado acusadamente; en efecto, antes de la globalización dicho sector era uno de los que obtenía mejores resultados, pero en la actualidad su desempeño es uno de los más deficientes. Además, la composición y el nivel del respaldo del Banco al sector financiero han sufrido cambios fundamentales, atribuyéndose menos importancia a los préstamos a intermediarios financieros para concentrarse en préstamos con

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RÉSUMÉ ANALYTIQUE

L'intégration des marchés financiers à l'échelon mondial a créé un nouvel environnement porteur d'innombrables opportunités mais également source de risques et de chocs imprévus, comme en témoignent les récents événements d'Asie de l'Est. Au cours de la dernière décennie, les apports de ressources des pays développés aux pays en développement ont été multipliés par huit et beaucoup de pays en développement ont vu la croissance atteindre des niveaux jamais observés depuis bien longtemps. Mais en dépit de ces promesses, le nouveau contexte financier n'est manifestement pas dénué de problèmes. Depuis l'amorce du processus de mondialisation, plus de 80 pays, développés et en développement, ont connu des crises bancaires qui ont été, pour beaucoup, d'une ampleur sans précédent.

L'appui fourni par la Banque mondiale au secteur financier présente un bilan tout aussi contrasté. D'un côté, une bonne partie des prêts accordés dans ce domaine à la fin des années 80 et dans les années 90 a fortement contribué à rétablir une croissance soucieuse d'équité. De l'autre, les résultats obtenus en la matière se sont, en moyenne, nettement dégradés, au point que cette partie du portefeuille de prêts de la Banque, qui était l'une des plus performantes avant la mondialisation, est aujourd'hui parmi celles dont les résultats laissent le plus à désirer. Il faut ajouter à cela une modification fondamentale du niveau et des composantes de l'appui de la Banque, qui a fini par mettre l'accent sur les opérations d'ajustement

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ing the financial sector, and in 1997 it announced a new financial sector strategy.

This study examines the Bank's performance in the financial sector in this evolving environment. It examines the results on the ground of the Bank's performance over this period of change and turbulence. It analyzes financial sector operations through the prism of the 1992 financial operational directive, and traces the effects that these operations had on country economic performance. These results, in turn, provide insights into whether countries assisted by the Bank improve overall economic performance when they follow the financial policies recommended by the Bank. In effect, these results provide support for the metaphor, often used by President Wolfensohn, that the finance sector is, in many respects, the lifeblood of the economy and financial sector reform is akin to heart surgery.

This study, for the first time, brings together an analysis of the outcomes of financial sector adjustment lending and in particular, the Bank's treatment of financial crises. The question addressed is whether the Bank gave adequate attention in these operations, to the fragility of financial systems, and, indeed, whether financial sector fragility is measurable in ways that can help avoid future problems? Finally, the study examines how firmly grounded the Bank's new financial sector strategy is in the Bank's experience—does the new strategy build on the lessons learned by the Bank? For example, does this experience support the argument that a longer-term perspective on the financial sector is necessary—that

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fines de ajuste, especialmente tras el establecimiento por parte del Banco, en 1992, de un nuevo marco normativo para las operaciones en el sector financiero conocido como la directriz operacional 8.30 (OD 8.30). Finalmente, durante el último año el Banco ha dado renovada importancia a su labor de respaldo al sector y en 1997 anunció la adopción de una nueva estrategia al respecto.

En este estudio se examina el desempeño del Banco en el sector financiero en este contexto en evolución. Se analizan los resultados en el terreno obtenidos por la institución durante este período de cambios y turbulencias. También se pasa revista a las operaciones en el sector financiero a la luz de la directriz operacional de 1992 antes mencionada y se identifican los efectos de estas operaciones en el desempeño económico de los países. Esos resultados, a su vez, ayudan a determinar si los países que reciben asistencia del Banco logran mejorar el desempeño general de su economía cuando adoptan las políticas financieras recomendadas por la institución. En efecto, estos resultados dan credibilidad a la metáfora que el Presidente del Banco, James Wolfensohn, usa frecuentemente al señalar que el sector financiero es, en muchos aspectos, el órgano vital de la economía y que la reforma en dicho sector es una verdadera cirugía al corazón.

Este estudio constituye el primer análisis de los resultados de los préstamos para ajuste del sector financiero y, en particular, de las medidas adoptadas por el Banco para hacer frente a las crisis financieras. Se procura determinar

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plutôt que sur les prêts d'intermédiation financière, notamment après l'adoption en 1992 du nouveau cadre régissant ses opérations dans le secteur financier (Directive opérationnelle 8.30). Pour finir, la Banque s'est engagée, durant l'année écoulée, à redonner un nouvel élan à ses activités en faveur du secteur financier, et a annoncé en 1997 une nouvelle stratégie dans ce domaine.

C'est dans ce contexte mouvant que la présente étude dresse le bilan de l'action de la Banque dans le secteur financier. Elle évalue les résultats obtenus sur le terrain durant cette période de changements et de turbulences. Elle analyse l'action de la Banque au regard de sa directive opérationnelle de 1992, et cerne les effets de cette action sur les performances économiques des pays. À partir de là, il est possible de déterminer si les pays bénéficiant de l'aide de la Banque obtiennent généralement de meilleurs résultats économiques quand ils appliquent les politiques recommandées par celle-ci dans le domaine financier. En fait, toutes ces données viennent confirmer l'idée souvent exprimée par le Président Wolfensohn au moyen de la métaphore selon laquelle le secteur financier est, à bien des égards, le coeur de l'économie, et la réforme de ce secteur tient de la chirurgie cardiaque.

Cette étude fait, pour la première fois, la synthèse des résultats des prêts à l'ajustement du secteur financier, en examinant en particulier la réponse apportée aux crises financières par la Banque. La question traitée est de savoir si celle-ci, dans les opérations en question, a prêté l'attention qu'il fallait à la

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financial reform is best seen as a process rather than a project? Similarly, has policy advice and sector work had an appreciable effect on financial sector lending? In short, how well have financial sector operations emphasized creating incentives for prudent banking practices?

The study's main finding is that the new financial sector strategy is indeed informed by the Bank's complex and turbulent experience in the financial sector. Its new strategy is based on the lessons learned during one of the most volatile financial periods in history. But, the Bank's learning process has been a very slow one, and serious concerns remain. Indeed, these concerns have intensified. Financial sector issues are at the core of the recent crises in East Asia and the international machinery to foresee, prevent and manage such crises is under stress. The discussion of a potential financial sector role for the Bank, beyond its current country focus, lies outside the scope of this report.

Setting aside these basic qualifications, the main message is positive. First, the study shows that the Bank's experience is consistent with the growing conventional wisdom that an effective financial sector policy is at the heart of the processes which generate and nurture growth. As a result, the study implies that well-designed financial policies can be expected to contribute to greater growth. Second, the study indicates that the Bank's new financial sector strategy, its increased emphasis on the need for a richer set of indicators to judge performance, and finally, its new lending instruments, such as

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si en estas operaciones el Banco tomó debidamente en cuenta la fragilidad de los sistemas financieros y si, de hecho, es posible evaluar dicha fragilidad de manera que se puedan evitar problemas en el futuro. Finalmente, se examina hasta qué punto la nueva estrategia del Banco para el sector financiero se basa en la experiencia previa de la institución: ¿se aprovecharon en la formulación de esta nueva estrategia las enseñanzas recogidas? Por ejemplo, ¿confirma esta experiencia el argumento de que para el sector financiero es necesario adoptar una estrategia a largo plazo y de que la reforma financiera debe considerarse más bien un proceso y no un proyecto? Igualmente, ¿han tenido el asesoramiento en materia de políticas y los estudios sectoriales un efecto apreciable en las operaciones crediticias para el sector financiero? En resumen, ¿en qué medida se ha atribuido suficiente importancia en las operaciones en el sector financiero a la creación de incentivos para la adopción de prácticas bancarias prudentes?

La conclusión más importante del estudio es que en la nueva estrategia ha influido ciertamente la compleja y turbulenta experiencia del Banco en el sector financiero. La nueva estrategia está basada en las enseñanzas recogidas durante uno de los períodos de mayor inestabilidad en la historia. Sin embargo, el proceso de aprendizaje del Banco ha sido muy lento y aún existen graves problemas. De hecho, estos problemas se han intensificado. La problemática del sector financiero es un aspecto fundamental de las recientes crisis en Asia oriental y los mecanismos

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fragilité des systèmes financiers, et si, d'ailleurs, la fragilité d'un secteur financier peut se mesurer d'une manière qui permette d'éviter des problèmes ultérieurs. Enfin, l'étude examine à quel point la nouvelle stratégie de la Banque pour le secteur financier est ancrée dans sa propre expérience, et prend appui sur les enseignements qu'elle en a tirés. Il s'agit de savoir, par exemple, si cette expérience confirme l'argument selon lequel une perspective à plus long terme s'impose à l'égard du secteur financier, une réforme financière étant à considérer de préférence comme un processus et non comme un simple projet, ou encore si les avis de politique générale et les études sectorielles ont eu un effet appréciable sur les prêts au secteur financier. Bref, dans quelle mesure les opérations dans le secteur financier se sont-elles attachées à promouvoir des règles de saine gestion dans le domaine bancaire ?

La principale conclusion qui ressort de l'étude est que la nouvelle stratégie de la Banque dans le secteur financier est effectivement le fruit de l'expérience complexe et mouvementée qui a été la sienne dans ce secteur, et qu'elle s'appuie sur les leçons tirées d'une des périodes les plus instables que l'histoire ait connues au plan financier. Cela dit, le processus d'apprentissage de la Banque a été très lent, et de sérieux motifs de préoccupation subsistent. Ils se sont même accrus. Les questions relatives au secteur financier sont en effet au coeur même des crises récemment survenues en l'Asie de l'Est, et les mécanismes internationaux permettant de prévoir, de prévenir et d'endiguer ces crises sont mis à

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Adaptable Lending, are firmly rooted in the Bank's experience. Consequently, assuming that the generic weaknesses of the global system are addressed, the new strategy should improve the Bank's impact. These favorable financial sector effects should, in turn, help the countries achieve higher, more stable rates of growth.

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internacionales para pronosticar, prevenir y hacer frente a estas crisis están sujetos a fuertes presiones. El análisis de una posible actuación del Banco Mundial en el sector financiero, además de su actual énfasis en los países, escapa al alcance de este informe.

Con excepción de estos problemas básicos, la evaluación fundamental del informe es positiva. Primero, se indica que la experiencia del Banco confirma la opinión generalmente aceptada y cada vez más difundida de que para generar y fomentar el crecimiento es indispensable una política financiera eficaz. Por consiguiente, del informe se desprende que las políticas financieras bien diseñadas deberían contribuir a lograr un mayor crecimiento. Segundo, en el estudio se señala que la nueva estrategia del Banco para el sector financiero, la mayor insistencia de la institución en la necesidad de contar con un conjunto más amplio de indicadores para evaluar los resultados y, finalmente, sus nuevos instrumentos crediticios, como los préstamos adaptables, están sólidamente cimentados en la experiencia previa del Banco. Por lo tanto, suponiendo que se abordarán las deficiencias genéricas del sistema financiero mundial, la nueva estrategia debería incrementar el impacto de la labor del Banco. A su vez, este efecto favorable en el sector financiero debería ayudar a los países a aumentar y estabilizar sus tasas de crecimiento.

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mal. Mais la question du rôle que la Banque pourrait être amenée à jouer dans le secteur financier, au-delà de son action actuelle à l'échelon des pays, déborde du cadre de ce rapport.

Mis à part ces réserves fondamentales, le message essentiel est positif. D'une part, l'étude montre que l'expérience de la Banque va dans le sens de l'idée de plus en plus communément admise selon laquelle une politique rationnelle pour le secteur financier est un élément central des processus propres à engendrer et entretenir la croissance. L'implication de ce constat est que l'on peut s'attendre à ce que des politiques financières bien conçues contribuent à une croissance plus soutenue. D'autre part, selon l'étude, la nouvelle stratégie que la Banque applique dans le secteur financier, l'importance accrue qu'elle attache à la nécessité d'une série plus fournie d'indicateurs pour l'évaluation des performances et, en définitive, ses nouveaux instruments de prêt, tels que les prêts évolutifs, sont tous des éléments fermement ancrés dans l'expérience de la Banque. De ce fait, dans l'hypothèse où des mesures sont prises pour remédier aux carences génériques du système en place à l'échelon mondial, la nouvelle stratégie devrait améliorer l'impact de la Banque, et ces effets favorables pour le secteur financier devraient à leur tour aider les pays à atteindre des taux de croissance plus élevés et plus stables.

The Evaluation Framework

In the past 15 years the world has experienced one of the most volatile periods in financial history. An international debt crisis, high and variable inflation and real interest rates, and banking crises created costly financial problems throughout the world and particularly in developing countries. As dramatically illustrated in recent weeks, even the East Asian countries with fiscal surpluses, high saving and investment rates, and some of the highest trade-to-GDP ratios in the world, were not immune to financial turbulence (Claessens and Glaessner 1997).

The past 15 years saw the emergence of new financial instruments and new types of institutions. To facilitate the development of financial institutions, restrictions on lenders were eliminated, and innovative ways of doing business were adopted. Financial deregulation and liberalization were attempted in parallel. Technological change made the global financial environment a very different place. It helped the volume of private international capital flows to grow at unprecedented rates.

Like other multilateral financial institutions, the World Bank has had to adapt its financial operations to adjust to the changes. It developed a comprehensive approach on financial sector issues in developing countries and incorporated its findings in the Bank's operational manual. The financial sector Operational Directive (OD) 8.30 (World Bank 1992), which is now being recast as Operational Policy (OP) 8.30, includes major elements of sector development strategy and recommendations on the use of lending instruments for both adjustment and financial intermediary lending. Recent developments in East Asia confirm the wisdom of a prudent and comprehensive approach to financial sector reform. However, the severity and breadth of the crisis and its complex antecedents call for a special review of issues such as, economic governance, industrial policy, interlocking ownership of enterprises and banks, foreign investment regulations and debt management. This study makes no such attempt.

Financial sector reform is defined as a set of actions aimed at reducing or eliminating distortions in financial markets, deepening the financial sector, and strengthening financial institutions. This study assesses the Bank's operations relating to financial sector reform, the development of financial institutions, and the management of financial crises in countries that approach it for financial, technical, or advisory support. Bank-supported operations comprise two elements: financial sector liberalization (improving market structure and competition by removing price and quantity distortions) and institutional infrastructure development (strengthening individual financial institutions and prudential regulation and supervision). The balance between these two has become a major issue in light of the growing number of financial crises in developing countries.

This study evaluates the result of a series of reforms supported by the Bank over the past decade (FY85–FY96). Since the Bank's support of financial sector reforms is relatively recent, many reform programs are ongoing, and their outcomes are assessed for the most recent years of implementation. The analysis begins with

a country's initial conditions, comparing stated reform objectives with the conceptual framework. It then follows the implementation of reforms, comparing their outcome and impact with program objectives, using OD 8.30 categories and related indicators as monitoring devices.

Another key objective of the Bank's financial sector operations is to prevent major financial crises and to mitigate their impact when they do occur. The study assesses the effectiveness of the Bank in this by examining its contribution in preventing or attenuating the recent crises in Mexico, Venezuela, and the Philippines. Discussion of a potential financial sector role for the Bank beyond its current country focus, however, lies outside the scope of this study.

The Conceptual Framework

The framework of the Bank's operations relating to the financial sector has been dictated by the ferment of ideas in the academic literature, as modified by experience in the countries that undertook financial reforms over the past two decades. The basic premise of financial reform—indeed, of all economic reform—is that government intervention should not prevent market signals from directing the allocation of resources. Voluntary, market-based decisionmaking is facilitated by an efficient financial system. Until the 1980s, however, the development and efficiency of financial systems were severely undermined by government efforts to promote economic development through interest rate controls, directed (and subsidized) credit programs, and heavy fiscal burdens. The result was more distorted financial sectors, suboptimal saving rates, and misallocation of investment. Empirical research shows a negative correlation between financial repression and the real rate of growth. The financial reforms articulated by such intellectual pioneers as McKinnon (1973) and Shaw (1973) included sweeping away interest rate ceilings and directed credit programs, and making markets more competitive.

Empirical research shows a negative correlation between financial repression and the real rate of growth.

Increasing experience with financial reform, by itself, and as part of general economic reform, has brought profound changes in operational modes and in approaches to financial liberalization. The new perspective is affected by differences in the economic and institutional environment in which financial liberalization has been initiated and implemented, the instrumentality and interpretation of financial deregulation, and the relationship between fiscal deficits and financial reform. In the past, interest ceilings were dismantled in several developing countries without regard to the state of the economy, the state of the banking system, the liability structure of borrowing firms, and a host of other conditions. Macroeconomic stability and reasonably sound banks are now viewed as prerequisites for financial reform. Similarly, experts realize that financial liberalization may not improve financial institutions' allocation of resources if price distortions arising from protection and price controls persist. Policymakers now know that fiscal deficits must be reined-in before financial liberalization can be fully implemented (Caprio and others 1994; Cho and Khatkhate 1989; Khatkhate 1996).

Recent academic forays into financial liberalization have highlighted problems in evaluating the effectiveness of financial reform. Until recently, the credit markets that prevailed before government intervention were assumed to be perfect. But the market under reform should be compared not with a perfect one, but with the distorted one that existed before reform (Gertler and Rose 1994). A rise in interest rates following financial liberalization causes borrowers' net worth to fall because of the declining value of collateralizable assets and the discounted value of future income streams. An erosion of borrowers' net worth raises the premium on external finance, reducing investment below the optimum. Since borrowers' net worth links the financial system and the real sector, financial liberalization tends to bring about a shrinking of economic activity if proper precautions are not taken. Such insights affect not only how to evaluate the effectiveness of financial reform but how to sequence reforms (Caprio and others 1994).

The analytical underpinnings of the Bank's evolving normative framework have been supported by operational guidelines on prudential control and bank supervision, included in the core principles of the Basle Committee on Banking Supervision. Drawing on worldwide experience, 25 principles were formulated, covering the prerequisites for effective banking supervision, licensing, and structure; prudential requirements; methods of bank supervision; information requirements; and cross-border banking. Since 1997 these have been a valuable reference, as is the IMF's recent publication "Towards a Framework For Financial Stability," which takes the blueprint for action further.

The Bank's Approach to Financial Sector Operations

The Bank's approach has evolved, absorbing ideas from the academic literature and modifying them in the light of experience in developing countries particularly and industrial countries generally. The principle governing the Bank's policy has been that financial sector reform must be viewed in the context of a country's overall economic reform.

In the 1960s, when the Bank first became involved in financial sector operations, the focal point for financial sector lending was often stable interest rates in the credit and development institutions, (mostly government-owned or government-dominated). Over time, the Bank broadened its focus, recognizing that a more volatile world financial environment created pressures to liberalize the financial sector, but that financial deregulation had to take into account the country context. Stable macroeconomic conditions and strong regulations were prerequisites for launching financial liberalization. Drawing from experience, the Bank supported market-based lending undertaken by competing financial institutions, the phasing-out of subsidized and targeted credit programs, and the strengthening of policy, regulatory, and institutional infrastructure. This was predicated on providing an incentive framework through which the financial sector could gradually respond to market signals. In brief, the Bank's policy until the late 1980s was to support:

Over time, the Bank broadened its focus, recognizing that a more volatile world financial environment created pressures to liberalize the financial sector, but that financial deregulation had to take into account the country context.

- Specific policy reforms to make the financial system more efficient.
- The creation or strengthening of financial institutions.
- The promotion of finance to microenterprises (World Bank 1989a).

As experience with financial operations accumulated, the Bank came to recognize the constraints of a purely market-based approach. Developing countries often lacked the staff, management skills, and legal framework needed for a viable banking system; they needed "properly designed administrative intervention to eliminate the existing barriers to market development" (World Bank 1989a). To deal with these constraints, the Bank revised its policy in the early 1990s to combine policy reform with support to specific institutions. It took a systemic approach to financial sector interventions. Explicit directions based on this approach are embodied in OD 8.30 (World Bank 1992) which defined "financial sector operations as structural and sectoral adjustment loans and technical assistance loans in support of financial sector reforms, as well as technical assistance and all investment loans through financial intermediaries in the borrowing countries." It "put together a policy perspective that concentrates on financial liberalization and macro linkages, with an institutional perspective that concentrates on lending instruments and institutional development for the financial sector." Thus OD 8.30 articulated directives to link the policy-based approach aimed at reducing financial sector distortions with the institutional approach aimed at achieving specific objectives in the financial and real sectors. One result was to discourage directed credit—with a consequent dramatic decrease in lending aimed at small and micro-enterprises. The Bank has recently redrafted this directive to provide greater flexibility for targeting intermediation lending (March 1997), clarified its approach to current financial sector issues (April 1997), and strengthened its capacity to intervene rapidly in case of financial crises (December 1997).

The Bank's new view is that a well-functioning financial system is an ongoing process, not an event. Such a system requires a long-term view. In addition, the design of financial sector operations must be based on thorough economic and sector work (ESW), which clearly articulates an economic environment in which a financial sector can grow efficiently. The Bank now fully acknowledges the importance of reducing financial fragility. The Bank's new strategy emphasizes the need to establish appropriate incentives in the client countries for prudent banking and to sequence adjustment policies towards the ultimate success of the reform program.

The Bank's Financial Lending Instruments

The Bank uses six types of lending instruments for financial sector development. Five are aimed directly at the sector level: structural adjustment loans (SALs), sector adjustment loans (SADs), technical assistance loans (TALs), and, occasionally, specific investment and maintenance loans (SIMs) and specific investment loans (SILs). A sixth type, financial intermediary loans (FILs), supports reform through operations handled by individual financial institutions. At times, FILs include a sector reform program with a policy letter attached.

The Bank has made extensive use of financial sector adjustment loan/credits (FSAL/C) to characterize loans whose primary objective is to promote financial sector reform.[1] These are mainly—but not exclusively—SADs. FSALs, which acquired prominence in the 1980s, are designed to remove policy and institutional impediments to financial sector development. Their main objective is to bring about financial deepening and to make the financial sector more efficient and more responsive to market forces. They cover the full spectrum of financial sector issues, including bank restructuring, development of human resource skills, encouragement of competition, and strengthening of financial infrastructure. They emphasize the importance of macroeconomic stability to sustain development of the financial system.

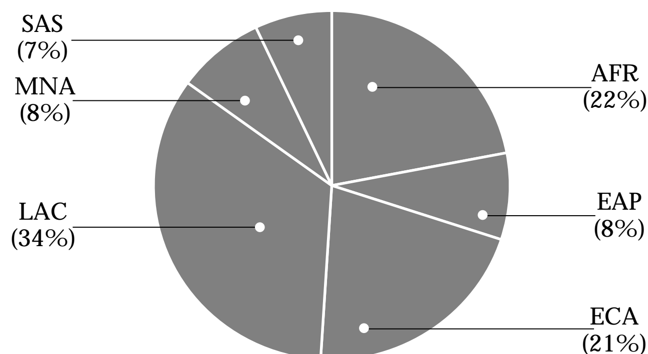
SALs have broader policy objectives. Even when they do not address financial sector issues directly through large financial sector policy components with features similar to FSALs, they still have an indirect effect on financial sector development, often including conditionalities on two key relative prices—exchange rates and interest rates.

TALs have more limited but sharply-defined objectives: building the institutional capacity to manage a liberalized, market-based system and to sustain the positive effects of reform. Lending for technical assistance can be either stand-alone (TAL) or part of a SAL, SAD, or FIL.

From FY85 to FY96 the Bank supported financial sector reform through 26 SALs for 21 countries, 33 SADs (with strong financial components) for 28 countries, 10 FILs for 10 countries, 8 TALs for 8 countries, 2 SIMs for 2 countries, and 8 SILs for 8 countries.

As for regional distribution, the 88 adjustment-related operations show some concentration in Latin America and the Caribbean (LAC) (more than 30 percent of the world total), followed by Africa, and Europe and Central Asia (ECA) (figure 1.1). About 40 percent of all adjustment-related operations are in SALs and 30 percent are in SADs, which include FSALs (see Annex Table 1.1). The adjustment operations are almost equally divided between ongoing and completed operations.

FIGURE 1.1: REGIONAL DISTRIBUTION OF ADJUSTMENT-RELATED OPERATIONS IN THE FINANCIAL SECTOR, FY85–96



AFR = Africa
EAP = East Asia and Pacific
ECA = Europe and Central Asia
LAC = Latin America and the Caribbean
MNA = Middle East and North Africa
SAS = South Asia

Source: World Bank projects database

The Bank's Non-lending Instruments for Financial Sector Reform

The Bank has prepared ESW reports analyzing many issues bearing on the financial sector, taking into account the macroeconomic settings. ESW reports may help countries to develop a perspective on their problems with financial sector development and to design appropriate strategies to deal with those problems. Although ESW is supposed to precede financial sector projects, more often than not the reports follow project preparation and often even project implementation. The Bank issued 109 financial sector-related ESWs for 70 countries between FY81 and FY95 (see Annex Table 1.2).

Sample Coverage and Methodology

The sample used for the study varies depending on the availability and comparability of data and their quality. For evaluating the projects' effects on the financial system and the real economy, and for evaluating the appropriateness of project design, a sample of 23 countries was chosen (out of 58) with 43 financial sector adjustment-related loans (out of 88). These loans, called FSLs in this study, include mainly SADs, SALs, and TALs, and some FILs with large financial sector policy components, as well as a few SIMs and SILs. The sample included 29 completed and 14 ongoing projects approved between FY85 and FY96 (see Annex Table 2.1).[2] For assessing the Bank's policies in the financial

sector, this sample is considered sufficiently representative of the universe of countries in which the Bank had financial sector operations.[3] The sample used for analyzing institutional development includes 28 countries with 21 completed FSLs[4] and 52 completed FILs. Admittedly, this sample is larger than the first; this is because the accent in this sample is on qualitative rather than quantitative indicators, and qualitative indicators are less demanding in time-series data. Varying the sample size according to what is targeted for assessment should not introduce biases in conclusions, as a broad preliminary examination of the Bank's financial sector operations has shown that overall performance among borrowing countries differs only at the margin, if not in specific details.

We used the first sample to assess the effects of Bank assistance to reform the financial sector through adjustment lending. The methodology used (detailed in Box 1.1 and in Table 1.1) traces Bank intervention at the country level, measuring stated objectives and instruments employed against the implementation record (outcome and impact). Bank-supported objectives include improving market structure, enhancing competition, and strengthening the financial system. The instruments used to achieve those objectives were policies, regulations, and institutional reform (see Annex Table 2.2). "Outcome" means the direct effects of the policy instruments used on the financial sector; "impact" means the final effects on the real economy. Both outcome and impact are measured by quantifiable indicators, such as the level of real interest rates, the spread between domestic lending and deposit rates, investment and saving ratios, the GDP growth rate, and the ratio of monetary assets to GDP. These indicators are constructed on the basis of Bank research and experience from several financial sector operations over the years, as reflected in OD 8.30.[5] Indicators measure outcome and impact at the end of the reform period against of objectives set earlier. The rating scale adopted is binary, with "1" indicating satisfactory and "0" indicating unsatisfactory. The ratings for various indicators are aggregated and averaged out to assign an overall rating to a reform program. An overall rating equal to or below 0.5 is considered unsatisfactory.

Bank-supported objectives include improving market structure, enhancing competition, and strengthening the financial system.

We used the second sample to evaluate FSLs and FILs for institutional development (ID), so the indicators are qualitative, not quantitative (see methodology in Box 3.1). Designed to assess performance in institutional development, they are based on findings in staff appraisal reports (SARs), project/implementation completion reports (PCR/ICRs), and project performance audit reports (PARs). We devised a "score card" (see sample in Annex Table 3.1), which includes components or instruments, common to institutional development, giving equal weight to each instrument. Achievement under each instrument is also scored using a binary system. The instruments include bank restructuring, improving financial infrastructure, and improving portfolio quality. One-by-one, 24 FSL (excluding 12 ongoing FSLs) and 58 FIL operations were scored. The scores were then aggregated and averaged.

To assess financial crises, we used the case study method for three countries(Mexico, the Philippines, and Venezuela.[6] The assumption in using case studies was that experience in dealing with those crises was more useful than pure statistical indicators. We formulated various financial indicators suited to the diagnosis and monitoring of financial crises, and used these to construct a financial fragility index (FFI).

Data Limitations

These were significant. Comparing countries was difficult because statistical variables used were not comparable, so measures of outcome and impact should be taken more as broad estimates of performance than as precise measures of how things went right or wrong.

Major limitations include:

- Most adjustment programs in the sample are relatively recent, so it is difficult to measure outcome or impact. Liberalization programs can be viewed as successful only when the reform is sustained.
- The macroeconomic indicators emphasized in the study are generally useful for a long-term perspective, but they are more reliable if supported by a microeconomic analysis, such as an examination of how the allocation of credit changes after reform. The Bank has made some attempts in this area, but these were limited by the absence of firm-level data (Schrantarelli and others 1994). The Bank is carrying out research to develop and refine the methodology for measuring the impact of reform on resource allocation.

BOX 1.1: METHODOLOGY USED TO ASSESS FINANCIAL SECTOR REFORMS

The methodology in this study is similar to the one OED uses to evaluate projects in general. We begin by assessing initial conditions, then project relevance, outcome with respect to relevant objectives, and the longer-term impact. In this study, however, we put more emphasis on the use of performance indicators, and we apply the methodology to both completed and ongoing projects. We focus more on performance at the country level for a series of reforms supported by the Bank rather than on a single batch of reforms supported by one Bank operation. Toward this end, we use the word "program" instead of "project" to discuss our findings.

- By ***initial conditions***, we understand the state of macroeconomic and financial sector variables in the time before approval of a program's first project. This time is usually up to a few years ahead of the first project approval.
- *By program objectives*, we understand a series of objectives over time that governments established to reform their financial sectors and for which they asked Bank support.
- *Program outcome* refers to changes that occur in outcome indicators relative to their values at the initial conditions stage, as well as measurement of outcomes with respect to the original objectives.
- The *real sector impact* refers to changes that occur in impact indicators relative to their values at the initial conditions stage. These are longer-run effects of the financial sector on the real sector. Changes in impact indicators are expected to be positively correlated with changes in program outcomes.

The performance indicators to evaluate financial sector reform components are continuous time-series that follow initial conditions, outcome, and impact of a particular aspect of the reform. In this way financial sector reform is monitored as an ongoing process and not as a one-time event (Sheng 1996).

In the rating of initial conditions, outcome, and impact of a reform component, we use a binary scale to interpret our results. For instance, take a reform program whose *objective* is to attain positive real interest rates. If the real deposit rate in a country is negative and has been so for a few years before approval of the program's first project, we score the relevant indicator (real deposit rates) as "0" or unsatisfactory, *as an initial condition*. However, after the first project is approved and implementation is in progress, if the real deposit rate begins turning positive (even if it is still very low), we score it as a "1" or satisfactory, *as an outcome* of one component of the reform program. Performance indicators for all reform components are scored in this manner.

The reform components and the performance indicators monitoring them are classified according to the general financial sector objectives provided in OD 8.30: (1) macrostability policies, (2) financial sector policies, (3) soundness of the banking system, and (4) impact on the real sector.

- Overall program outcome ratings at the country level are obtained by calculating a simple average of performance indicators of macrostability policies, financial sector policies, and soundness of the banking system.
- Overall impact ratings are obtained by calculating a simple average of performance indicators in the real sector category only.

If the average score for outcome indicators is more than 0.5, we rate the outcome as satisfactory. If the average is less than or equal to 0.5, we rate the outcome as unsatisfactory. Impact ratings are derived in the same way.

TABLE 1.1: PERFORMANCE INDICATORS FOR THE FINANCIAL SECTOR

OBJECTIVES OF ADJUSTMENT PROGRAMS	POLICY INSTRUMENTS	POLICY IMPLEMENTATION RECORD	PERFORMANCE INDICATORS OF OUTCOME	PERFORMANCE INDICATORS OF IMPACT ON REAL SECTOR
Remove interest rate and credit distortions	• Interest rate liberalization • Move to indirect instruments of monetary control • Dismantling of directed credit • Opening capital account	• Number and categories of interest rates liberalized • Treasury bill rate, interest rate on reserves • Directed credit as share of total credit • Level of foreign exchange controls	Real positive interest rates, term structure of interest rates M2/GDP	
Remove impediments to competition	• Privatization of banks • Entry/exit laws • Removal of differential taxation of banks and other financial intermediaries • Foreign ownership laws	• Private assets as share of total assets • Number of new banks, concentration ratio • New/old tax structure of banks • Assets of foreign bank as share of total assets	Banking system financial ratios, lending/deposit spread	GDP growth
Strengthen financial sector infrastructure	• Legal framework for central bank • Legal framework for banks • Regulatory framework for non-banking sector • Identification of rights and obligations of financial agents	• Central bank law • Prudential regulations, banking company law • Non-bank assets/total financial sector assets, number of listed companies in stock exchange • Liquidation and bankruptcy rules, payment systems, accounting and auditing standards	Banking system and central bank financial ratios market capitalization	GDS/GDP,[a] GDI/GDP[b]
Strengthen institutions	• Strengthening of banking supervision • Bank restructuring • Bank institutional reforms	• Capacity and authority to supervise, licensing criteria, supervision systems • Capital replenishment, asset liquidation, independence and capacity of board, MIS, human resource development programs	Individual bank financial ratios	Level of direct foreign investment
Stable macroeconomic environment	• Low inflation • Reduced current account deficit • Reduced fiscal deficit • Equilibrium of exchange rate			

[a] GDS = gross domestic savings.
[b] GDI = gross domestic investment.

- Judgments of the health of banking systems are made using indicators such as capital adequacy, but these indicators do not throw light on what needs to be done to make banks sounder. For that, forward-looking indicators must be formulated. This can be accomplished only through sophisticated statistical techniques of "stress testing" or "dynamic solvency testing" that can show how banks withstand various shocks and how the risks they face are correlated. The models based on these techniques focus attention on how banks make decisions about portfolio assets and liabilities, avoiding the trap of universally prescribed ratios for different risk positions. So the evaluations of banking health are suggestive rather than definitive.
- The performance indicators used in the analysis are difficult to update even for inflation and M2/GDP (financial depth), variables for which good historical information is generally available. These performance indicators rely on both central bank and national accounts data, which are updated at different times. The banking sector presents the most problems. Data for indicators like asset quality (loans in arrears/total loans) and management efficiency (expenses per unit of profit) are often not available.

The Plan of the Study

In chapter 2 we evaluate the overall outcome and impact of financial sector reforms that the Bank supported through FSLs. For this evaluation, which includes many ongoing loans, we use performance indicators derived from the OD 8.30 conceptual framework (see Table 1.1). Chapter 3 focuses on institutional development, with a larger sample including both FSL and FIL operations, and a more detailed institutional "score card," also derived from OD 8.30. Chapter 4 evaluates the outcome and impact of Bank intervention in financial crises, with a modified set of performance indicators (fragility indicators) better adapted to identify crises and to monitor recovery. In chapter 5 we evaluate Bank performance in identifying and analyzing sector issues through ESW; preparing and implementing lending operations, as well as overall sequencing issues in lending strategies; and (3) coordinating the IBRD, IFC, and IMF in providing financial sector services to client countries. In chapter 6 we conclude how the Bank fared when we use the operational directive OD 8.30 as a benchmark, and what is needed beyond the directive to keep improving support to financial sector reforms.

Financial Sector Reform Operations

This chapter focuses on lending operations—mainly SALs, SADs, and TALs—that support reform of the financial sector and sectorwide institutional changes. The only FILs discussed in this section are those that included a sector reform program with a policy letter.

After sketching the economies of the sample countries, we examine whether Bank operations dealing with financial sector reform were appropriately or inadequately designed (considering the initial conditions and the types of policies required to improve efficiency), to see how well they achieved their objectives over FY85–FY96. Then we analyze the projects' results over the same period.

Characteristics of Financial Systems in Sample Countries

Of the 23 countries in the sample, most had liberalized interest rates before undertaking financial reform, and they had positive real deposit rates. In most countries positive real interest rates were sustained over a period up to and including the time when financial operations were implemented, except in Mexico, Venezuela, and possibly India. Some countries had introduced other types of liberalization—for example, the use of indirect monetary instruments, a reduction in subsidized credits, and the easing of entry conditions for foreign or private banks (Indonesia, Malaysia, the Philippines). In many countries (including Chile, Ghana, Indonesia, Mexico, the Philippines, and Turkey) previous adjustment programs had included liberalization of the capital account.

Banking systems in many of the sample countries were highly concentrated. Banks were generally publicly-owned (in China, Ghana, Indonesia, the Republic of Korea, Tanzania, and the South Asian countries), though there were some private banks as well (in Chile, Mexico, Turkey, and Venezuela). The oligopolistic and conglomerate structure prevailing in many banking sectors prevented competition. A systematic review of the Bank President's Reports (PRs) and SARs for the sample countries indicates that at the beginning of the adjustment program only 17 percent of the countries had satisfactory competition in the financial sector (see Table 2.1).

Banks in several sample countries (such as India, Mexico, Pakistan, Poland, and Turkey) were initially close to insolvency. Capital adequacy fell far short of Basle standards. Banks were also inefficient and were unable to meet the economy's long-term resource needs. Publicly-owned banks, in particular, fell into this category.

The depth of the financial system, as measured by the ratio of M2 to GDP, averaged close to 30 percent for sample countries on the eve of operations.[1] Two-thirds of this was accounted for by quasi-money and the rest by narrow money (M1). The M2-to-GDP ratio was highest for India (50 percent), followed by Pakistan and Chile (40 percent), Turkey and Tanzania (around 37 percent), Venezuela (33 percent), Bangladesh and the Philippines (30 percent), Indonesia (27 percent), and Mexico and Ghana (15 percent). Deposit rates were substantially negative in Mexico and Venezuela (below -50 percent), and were also negative for Ghana (-22 percent)

TABLE 2.1: INITIAL FINANCIAL SECTOR CONDITIONS IN COUNTRIES STUDIED

COUNTRY (*Fiscal year of first financial sector operation*)	DISTORTIONS	DEGREE OF COMPETITION	STATE OF FINANCIAL SECTOR INFRASTRUCTURE	FINANCIAL STRENGTH OF INSTITUTIONS
Bangladesh (1990)	0	0	0	0
Bolivia (1987)	0	0	0	0
Chile (1986)	1	1	1	1
China (1993)	0	0	1	0
Côte d'Ivoire (1992)	0	0	0	0
Egypt (1992)	0	0	0	0
Ghana (1988)	1	0	0	0
India (1995)	0	0	0	0
Indonesia (1988)	0	0	0	0
Kenya (1989)	0	0	1	0
Korea (1985)	0	1	1	0
Malawi (1991)	0	0	0	1
Malaysia (1987)	1	1	0	0
Mexico (1989)	0	0	0	0
Morocco (1986)	0	0	1	0
Pakistan (1989)	0	0	0	0
Philippines (1989)	1	1	1	0
Poland (1991)	0	0	0	0
Senegal (1987)	0	0	0	0
Tanzania (1992)	0	0	0	0
Tunisia (1988)	0	0	1	0
Turkey (1986)	0	0	0	1
Venezuela (1990)	0	0	0	0
Percent satisfactory	**17**	**17**	**30**	**13**

Note: "1" is satisfactory on balance at time of appraisal, "0" is unsatisfactory.
Source: PRs, SARs, and OED estimates based on time-series from World Development Indicators 1997 and International Financial Statistics (IFS).

and Tanzania (-9 percent). The domestic spreads in Bangladesh, Indonesia and the Philippines were reasonable—4 to 5 percentage points—but they were high in Chile, Ghana, India, and Tanzania (7 to 16 percentage points), and negative in China (-14 percentage points) and Venezuela (-6 percentage points).

The Situation in the Real Sector

Annual real GDP growth rates in all the sample countries were positive before reform, the average being 4.5 percent. Bangladesh, Tanzania, and Venezuela stood at the low end, with growth rates declining to zero in Bangladesh and to -2 percent in Venezuela. At the high end, Turkey was growing at 8 percent a year, followed by the Philippines at about 6 percent. Gross domestic saving and investment rates were mixed. Tanzania's saving rate was almost zero and those of Bangladesh and Ghana were barely more than 2 percent and 5 percent of GDP, respectively. But the saving rates in China and Indonesia stood at 30 percent, followed by 25 percent for Venezuela, and 22 percent for India. Chile, Mexico, the Philippines, and Turkey all had saving rates between 15 and 20 percent at the beginning of reform, but saving rates were falling in Mexico and the Philippines, and rising in Chile and Turkey. In general, there was an imbalance between domestic savings and investment in most of the sample countries, with gross domestic investment exceeding gross domestic savings.

Despite previous attempts at adjustment and stabilization, many countries launched their financial reform operations in an unstable macroeconomic environment. Mexico, Turkey, and Venezuela had been suffering from chronically high inflation. On the other hand, macroeconomic stability prevailed in Ghana, Indonesia (Box 2.1), and Chile (Box 2.2).

Program Design

Initial Conditions in the Financial Sector

The overall assessment of Bank programs begins by examining initial conditions (see Box 1.1). To measure how much initial conditions changed, or were modified by reform, we used performance indicators correspond-

BOX 2.1: INDONESIA AND THE SEQUENCING OF REFORM

Initial conditions. Financial adjustment operations in Indonesia were undertaken within the framework of Bank support for a broader structural adjustment program. Following a drop in oil prices in the early 1980s and their collapse in 1986, Indonesia began a program that included a major depreciation of the rupiah, a reduction in public spending, measures to stimulate exports and encourage foreign investment, improvements to industrial efficiency by opening up the economy, basic financial reform, and a long-term strategy to diversify the economy away from an overdependence on oil. This program entailed significant relaxation of the system of close regulation that had characterized the Indonesian economy.

Bank initiatives. Lending support for adjustment was provided after the fact, endorsing actions that were judged to conform with the Bank's assessment of Indonesia's economic priorities. Initial support in the form of two trade policy loans in 1987–88 was followed by two private sector development loans (PSDLs) in 1989–90, all with financial sector components, and a financial sector development project in 1993. During this period the Bank also approved six FILs. The Bank's operations have supported the evolution of Indonesia's financial system from a state-dominated one, with fixed interest rates and administered credit, to a liberalized, competitive, and increasingly privately-owned network, with market-determined interest rates. This has meant developing an indirect means of monetary control and strengthening the central bank's supervisory framework and enforcement capabilities.

Outcome. The heart of the government's adjustment effort in the second half of the 1980s and the early 1990s was to restore external equilibrium through real depreciation of the exchange rate, bringing public accounts into better balance, opening the economy gradually to increased competition. In the financial sector the liberalization of interest rates introduced under the trade policy adjustment loans, coupled with increased public confidence in the banking system, has led to substantial financial deepening. The measures introduced under the PSDLs—especially permitting the entry of foreign banks—increased competition in the banking sector to some extent. The overall structural adjustment program has been successful in generating high rates of saving and investment, and realizing rapid economic growth: but it did not succeed in reducing substantially the fragility of the banking system, which in 1997 became vulnerable to the effects of the currency crisis.

Assessment. After oil prices collapsed, Indonesia's immediate need was to depreciate its currency to restore external equilibrium and to cut public spending because of the decline in government revenues and borrowing prospects. But to restore rapid growth from non-oil sources required fundamental structural adjustment. Initiating structural adjustment after implementing the basic measures needed to restore macroeconomic stability was entirely appropriate. The early initiation of financial sector reform was also appropriate. But liberalizing the financial sector without first ensuring that adequate legal, regulatory, and supervisory infrastructure was in place led to the proliferation of weak banks and to a number of bank failures, as clearly shown during the currency crisis of 1997.

Lessons of experience. The audit report for the PDSLs draws a number of important conclusions about the correct sequencing of reforms. First, the legal, regulatory, and supervisory environment of the financial sector must be strengthened before or at the same time as entry is liberalized. Second, establishing a strong legal infrastructure for banking activities should have priority from the start, rather than be one item on the continuing agenda. This would have sent a clearer signal to the private sector that the government was irrevocably committed to a fundamental change in relationships. Only in November 1997, did the Bank approve a technical assistance loan to directly strengthen the structure and improve the soundness of the banking system.

BOX 2.2: CHILE: A SUCCESS STORY THE SECOND TIME AROUND

Initial conditions. Chile was especially vulnerable to the 1982 debt crisis. After several years of strong growth in the late 1970s, its currency was highly overvalued, its domestic saving rate was low, supervision of the financial system was lax, and foreign indebtedness had risen sharply. The rise in interest rates and the abrupt termination of foreign lending in 1982 led to Chile's worst economic crisis since the Great Depression. Economic growth then resumed, buoyed by the sustained real exchange rate devaluation, reduced imports, declining public spending, and rising private investment. After 1985, following the adoption of a longer-term program of structural adjustment, imports were further liberalized, export earnings improved, and the debt-GDP ratio declined rapidly. Since 1988 Chile's economic growth has been rapid, averaging more than 7 percent a year.

Bank initiatives. The Bank strongly supported Chile's growth-enhancing post-1984 strategy with three SALs (FY86–FY89), two industrial finance projects (FY86–FY91), a small- and medium-sized industry project (FY86–FY93), and a financial markets loan (FY91–FY93). The first two SALs supported the government's structural adjustment program (SAP) for 1985–87, the initial goals of which were to accelerate and diversify exports, correct Chile's savings/investment disequilibrium, and reduce the amount of stress in the financial system. The second phase of the SAP, starting in late 1986, focused on recapitalizing banks and corporations, and sought a substantial increase in public savings, a reduced but more efficient export-supportive public investment program, strengthened export incentives, and improved social security. The SAP thus incorporated simultaneous and mutually-reinforcing financial and real policy reforms.

The Bank's Financial Markets Loan (FML) was a hybrid loan with two broad objectives: to support policy changes aimed mainly at deepening the securities markets and to provide term funds to the equipment-leasing sector. The policy component's objectives were to ensure profitable investment opportunities for the increasing assets of the pension funds and the life insurance companies, to strengthen the banks, to support Chile's balance of payments, to develop CORFO (the state development bank) as a second-tier lender to the leas-

ing to OD 8.30's five broad categories of financial sector reforms: stability of the macroeconomic environment, extent of distortions in the financial system (such as negative interest rates and the existence of directed credit), degree of competition, level of development of financial infrastructure, and strength of the financial institutions. Initial conditions were assessed by studying SARs of financial sector operations in our sample countries (see Annex Table 2.1). Initial conditions were characterized as either satisfactory "1" or unsatisfactory "0" in all four categories (Table 2.1).

About 30 percent of the 23 sample countries had favorable initial conditions in development of their financial sector infrastructure. About 17 percent were considered to have acceptable levels of financial distortions. Only 17 percent of the countries began reform with a high degree of competition, and only 13 percent had financially-sound banks.

There were, of course, variations in initial conditions. Chile had satisfactory initial conditions in all four areas; the Philippines had favorable initial conditions in three areas. Korea and Malaysia had good initial conditions in two areas. Bangladesh, Bolivia,[2] Egypt, India, Indonesia (Box 2.1), Mexico, Pakistan, Poland, Senegal, and Tanzania had the worst overall initial positions.

The Presence and Relevance of Bank Policies

The policies included in the country programs varied:

- Liberalization of interest rates was one of the formal loan conditions in: Ghana, Mexico, Tanzania, Turkey, Venezuela, and the South Asian countries. Ghana, Mexico, and Turkey complied with this condition at least partially, but neither Tanzania nor Venezuela complied at all. Compliance in Bangladesh was admittedly formal. Although the degree and quality of compliance in Pakistan had

BOX 2.2: CHILE (CONTINUED)

ing companies, and to strengthen the government's capacity to supervise the financial sector.

Outcome. Chile's structural adjustment program was remarkably successful and in most respects stands as a model for other countries facing similar initial problems. Chile's growth performance over most of the past decade has been the best in Latin America. It considerably exceeded expectations. Imports grew more slowly in 1985–88 than in 1982–84, exports grew more quickly, consumption and investment rose, savings grew rapidly, inflation declined, the fiscal deficit fell sharply, foreign debt dropped, and unemployment declined sharply. Because Chile has focused on getting the economic fundamentals right, including dramatically raising the domestic saving rate, its good economic performance appears fully sustainable.

The FML was successful in promoting substantial development of Chile's capital markets. The loan facilitated a considerable increase in the volume of domestic share issues, high pension fund and life insurance company returns, and a large increase in stock prices. In addition to the development of the capital markets, securities market infrastructure was improved, with the introduction of competitive computerized trading, improvements in risk assessment services, and the establishment of a centralized securities depository. The leasing component of the FML was an unqualified success. Another positive feature of the loan was that the regulatory changes it supported have increasingly corrected the market failure that justified the Bank's directed lending to leasing companies, thus rendering future lending of this type unnecessary. Finally, technical assistance provided under the loan was unusually well-managed and successful. The institutional objectives of the loan were met, and CORFO has emerged as a successful second-tier lending institution.

Lessons of Experience. A highly complex financial sector project can be successful provided: (1) the macroeconomic, financial and industrial framework is sound; (2) the government is fully committed to the project; and (3) the Bank and the government are able to draw upon a sound base of sectoral and institutional knowledge.

not been explicitly reported, references to high interest rates suggested interest rate liberalization.

- Credit reform was part of financial reform operations in Bangladesh, Indonesia, Mexico, Pakistan, the Philippines, and Turkey. Indonesia had already started phasing-out liquidity credits from the central bank before reform, but that requirement was still included as part of conditionality. In the Philippines, directed credit schemes were transferred from the government to a development bank slated for privatization. Under Pakistan's only FSAL and Turkey's second, directed credit was curtailed to an extent satisfactory to the Bank; this was not the case with Mexico. In Bangladesh the directed program of lending to priority sectors through concessional refinancing from the central bank was formally abolished.
- Indirect monetary instruments stressed by the IMF were introduced as part of reform operations in Bangladesh, Ghana, Indonesia, Tanzania, and Turkey. In all five of these countries, open market operations were initiated, but their effectiveness in controlling the money supply was uncertain. In Ghana, for example, the central bank had to be convinced that it should use open market operations as a monetary control instrument rather than as a means of financing the fiscal deficit, though both uses of open market operations are not mutually exclusive.
- Bank privatization was part of reform operations in Chile (Box 2.2), India (1995), Indonesia, Mexico, Tanzania, and Venezuela.
- In Indonesia, measures to enhance competition included reducing differentiation between public and private banks by allowing state enterprises to

make deposits with either, and between banks and non-banks by reducing reserve requirements (Box 2.1). A measure similar in intent was the ceiling on taxes on deposits in the Philippines and opening of the banking system to foreign banks in Tanzania.

The important question is whether policies incorporated in project designs were relevant to initial conditions. Bangladesh, Indonesia, Mexico, Pakistan, and Poland were the only five countries in which Bank programs had provided policy instruments to improve initial conditions in all four reform areas (Table 2.2). In India, Morocco, Senegal, and Tanzania, programs had policy instruments to alleviate problems in three areas. In Malawi and Venezuela, only one area incorporated appropriate policy instruments. For Egypt and Malaysia, none of the required policies was incorporated in program design.

We identified matches or mismatches between initial conditions and the Bank's policy package. If that package was well-designed for improving initial conditions, it was called a "hit." If the program policies were unsuited to improving poor initial conditions, it was defined a "miss." And if the policies prescribed were unnecessary because initial conditions were relatively good or did not need major improvement, they were considered to be "overkill" (Table 2.3).[3]

Hits averaged 64 percent, misses 25 percent, and overkills 11 percent. Using our threshold of 50 percent for satisfactory performance, the Bank's diagnosis appears marginally satisfactory. Removing distortions and strengthening institutions showed the most hits with 78 percent. Bangladesh, Indonesia, Korea, Mexico, Pakistan, and Poland fared best, with hits in all four areas. Egypt, however, scored misses in all four areas.

Competition policies had fewest hits.[4] In some countries the Bank took a perfunctory approach to competition *within* the banking system and sidestepped

TABLE 2.2: RELEVANCE OF BANK-SUPPORTED POLICY PACKAGES

COUNTRY *(Fiscal year of first financial sector operation)*	REMOVAL OF DISTORTIONS	INCREASE IN COMPETITION	DEVELOPMENT OF FINANCIAL SECTOR INFRASTRUCTURE	STRENGTHENING OF INSTITUTIONS
Bangladesh (1990)	X (u)	X (u)	X (u)	X (u)
Bolivia (1987)	X (u)	(u)	X (u)	X (u)
Chile (1986)			X	X
China (1993)	(u)	(u)	X	X (u)
Côte d'Ivoire (1992)	(u)	(u)	X (u)	X (u)
Egypt (1992)	(u)	(u)	(u)	(u)
Ghana (1988)	X	(u)	X (u)	X (u)
India (1995)	X (u)	X (u)	(u)	X (u)
Indonesia (1988)	X (u)	X (u)	X (u)	X (u)
Kenya (1989)	X (u)	(u)	X	X (u)
Korea (1985)	X (u)			X (u)
Malawi (1991)	(u)	X (u)	(u)	
Malaysia (1987)			(u)	(u)
Mexico (1989)	X (u)	X (u)	X (u)	X (u)
Morocco (1986)	X (u)	X (u)	X	X (u)
Pakistan (1989)	X (u)	X (u)	X (u)	X (u)
Philippines (1989)		X	X	X (u)
Poland (1991)	X (u)	X (u)	X (u)	X (u)
Senegal (1987)	X (u)	(u)	X (u)	X (u)
Tanzania (1992)	X (u)	(u)	X (u)	X (u)
Tunisia (1988)	X (u)	(u)	X	X (u)
Turkey (1986)	X (u)	(u)	X (u)	X
Venezuela (1990)	X (u)	(u)	(u)	(u)

Note: "X" indicates the presence of a policy instrument; (u) indicates unsatisfactory initial conditions in a particular reform area.
Source: PRs and SARs.

TABLE 2.3: HITS, MISSES, AND OVERKILLS

COUNTRY *(Fiscal year of first financial sector operation)*	REMOVING DISTORTIONS	PROMOTING COMPETITION	DEVELOPING FINANCIAL SECTOR INFRASTRUCTURE	STRENGTHENING INSTITUTIONS
Bangladesh (1990)	Hit	Hit	Hit	Hit
Bolivia (1987)	Hit	Miss	Hit	Hit
Chile (1986)	Hit	Hit	Overkill	Overkill
China (1993)	Miss	Miss	Overkill	Hit
Côte d'Ivoire (1992)	Miss	Miss	Hit	Hit
Egypt (1992)	Miss	Miss	Miss	Miss
Ghana (1988)	Overkill	Miss	Hit	Hit
India (1995)	Hit	Hit	Miss	Hit
Indonesia (1988)	Hit	Hit	Hit	Hit
Kenya (1989)	Hit	Miss	Overkill	Hit
Korea (1985)	Hit	Hit	Hit	Hit
Malawi (1991)	Miss	Hit	Miss	Hit
Malaysia (1987)	Hit	Hit	Miss	Miss
Mexico (1989)	Hit	Hit	Hit	Hit
Morocco (1986)	Hit	Hit	Overkill	Hit
Pakistan (1989)	Hit	Hit	Hit	Hit
Philippines (1989)	Hit	Overkill	Overkill	Hit
Poland (1991)	Hit	Hit	Hit	Hit
Senegal (1987)	Hit	Miss	Hit	Hit
Tanzania (1992)	Hit	Miss	Hit	Hit
Tunisia (1988)	Hit	Miss	Overkill	Hit
Turkey (1986)	Hit	Miss	Hit	Overkill
Venezuela (1990)	Hit	Miss	Miss	Miss
Percentage of:				
Hits (64)	78	48	52	78
Overkills (11)	4	4	26	9
Misses (25)	17	48	22	13

Note: Figures in parenthesis indicate average "hits," "overkills" or "misses" in percentages.
Source: PRs, SARs, ICRs, PCRs and PARs.

competition *between* banks and non-bank financial intermediaries (NBFIs) altogether. In some countries the government used NBFIs to introduce more outside competition, but neither the Bank nor the government was prepared to take substantive action regarding competition within the banking system. Generally, competition policies seem to be either absent from or superficially designed in most Bank projects. Future projects need to focus more on promoting competition and strengthening institutions.

Policy implementation under financial sector operations also varied (Table 2.4).

Admittedly, implementation performance can be judged only if the policies are included in a project. Of the 16 countries whose programs included policy prescriptions to remove distortions, 10 countries implemented reforms. Only three of the nine countries whose programs contained policy prescriptions to increase competition carried out the expected reforms. Of the 17 countries for which development of financial sector infrastructure was an objective, 12 were able to implement the required policies. And of the 19 countries whose programs contained policy prescriptions for institutional strengthening, only 8 implemented them satisfactorily according to the objectives of the reform program.

In only four countries—Chile, Côte d'Ivoire (post-1994), Mexico, and Senegal—was implementation successful in all areas covered by the policy reform packages. On the other hand, Bangladesh, India, Korea,

TABLE 2.4: POLICY IMPLEMENTATION

COUNTRY *(Fiscal year of first financial sector operation)*	REMOVAL OF DISTORTIONS	INCREASE IN COMPETITION	DEVELOPMENT OF FINANCIAL SECTOR INFRASTRUCTURE	STRENGTHENING OF INSTITUTIONS
Bangladesh (1990)	X			
Bolivia (1987)			X	X
Chile (1986)			X	X
China (1993)				
Côte d'Ivoire (1992)			X	X
Egypt (1992)				
Ghana (1988)	X		X	
India (1995)				
Indonesia (1988)	X	X		X
Kenya (1989)	X		X	
Korea (1985)				
Malawi (1991)				
Malaysia (1987)				
Mexico (1989)	X	X	X	X
Morocco (1986)	X			
Pakistan (1989)	X	X	X	
Philippines (1989)			X	X
Poland (1991)			X	X
Senegal (1987)	X		X	X
Tanzania (1992)			X	
Tunisia (1988)	X		X	
Turkey (1986)	X			
Venezuela (1990)				

Note: 'X' indicates the satisfactory implementation of a policy instrument in a particular reform area.
Source: PCRs, ICRs, and PARs.

Morocco, Turkey and Venezuela had poor implementation records.[5]

The Outcome as Measured by Performance Indicators

How did the Bank's adjustment operations do in our sample of 23 countries? To assess program outcomes, we use 16 performance indicators derived from the OD 8.30 conceptual framework (these are outlined in Table 1.1). Unfortunately the availability of data on these indicators varies from country to country (Table 2.5). As assessed by our PIR methodology (see Box 1.1) applied to 29 completed and 13 ongoing projects, financial sector reform supported by the Bank yielded satisfactory outcomes in 12 countries—52 percent of the total (Table 2.5), for the period of adjustment programs examined (FY85–96). The macroeconomic dimension was well understood by the Borrower, and results are generally good, with a satisfactory rating of 74 percent. Still, countries remain vulnerable to exogenous shocks. The sector dimension, however, achieved a satisfactory rating of only 52 percent. The Bank actively—and at times successfully—supported policies to remove distortions and to develop financial infrastructure. Competition policies, however, were either missing or not well-implemented. The poor results are in soundness of banking systems, with an average satisfactory rating of 35 percent—indicating that in most cases reforms did not reach the core of the financial system. But data are relatively scarce in this area, and results may thus differ when more information becomes available.

Program outcomes vary considerably across elements of the financial system in all countries. More than two-thirds of the countries were rated as having a satisfactory outcome in M2-GDP ratio, whereas only one-third was rated satisfactory in bank profits. Although the capitalization of commercial banks improved in two-thirds of the countries, only in about one-fourth did central banks have satisfactory capital adequacy ratios. Financial repression generally declined as a result of financial sector operations, but bank restructuring

remained a problem in many countries. These outcomes, however, do not take account of the recent effects of the 1997 crisis in East Asia, e.g. Korea, Indonesia[6] and the Philippines. The recent financial crises in Korea and Indonesia clearly indicate that strong macroeconomic performance can temporarily cover the weak underlying condition of the financial system. Actually, the weakness of the banking system was already identified for both countries with our rating methodology applied to pre-crisis information (Table 2.5).

It is interesting to compare outcome assessments based on PIRs with those in PCRs and ICRs, PARs, the Annual Review of Portfolio Performance (ARPP) for projects under implementation, and the report of the Quality Assistance Group (QAG) on FILs.[7] One can make such a comparison only for outcomes (effect on the financial system), since PCRs, PARs, and the ARPP do not rate projects for impact (effect on the real sector). And even a comparison of outcomes is difficult because the project samples are not the same. The ARPP covers the Bank's portfolio of projects that are being implemented, while PCR/PAR ratings are normally for completed projects only. Furthermore, PCR/PAR ratings are available for only 19 of our sample countries.

Using PCR/PAR methodology on the full sample of 23 countries, we find that 58 percent show satisfactory performance; using ARPP methodology, 78 percent are satisfactory. But only 52 percent of the countries show satisfactory performance using the PIR methodology (Table 2.6). Eleven countries had higher satisfactory ratings under the PCR/PAR system than under the PIR system. The same 11 countries also had higher satisfactory ratings in the ARPP system. Eighteen countries had satisfactory ratings under the ARPP, compared with only 12 in PIR. One plausible reason for fewer satisfactory ratings in this study may be that the PIR indicators give greater weight to conditions in the banking system. In China, India, Pakistan, the Philippines, Senegal, and Tunisia the banking systems have either stagnated or deteriorated according to the assessment of performance indicators.

The discrepancy in the satisfactory ratings between the PIR and the other Bank rating systems could reflect disparate sample sizes. To remove this sample bias, we compared performance results for a subset of 19 countries out of the 23, retaining only those for which all the rating methodologies have been systematically applied.[8] Even in the adjusted sample, the PIRs show that project outcomes are less satisfactory (Table 2.7).

Reasons for Mixed Outcomes

From the results obtained so far (Table 2.5), the outcomes of Bank-supported reforms, though not uniformly unsatisfactory, have been below program objectives. We focus here on possible reasons for those outcomes, drawing on OD 8.30 and academic studies on the role of the real economy, the fiscal factor, and, more generally, the responsibility of governments.

Government Policies

Financial sector operations should be viewed as part of the structural transformation of an economy. If real sectors lag in reform, they hinder the growth of the financial sector. And without enterprise restructuring, there will be few good opportunities for banks to lend. If banks are restructured but enterprises are not, bank restructuring will only have to be repeated, at a much higher cost each time, as experience in Africa and Latin America suggests. In Central Africa one bank was restructured three times. In Mauritania recapitalized banks generated losses for the state amounting to 50 to 60 percent of GDP. The Chilean experiment underscores the lesson that highly-leveraged, undercapitalized, and weak enterprises tend to unravel a banking system. So, financial sector operations should fit neatly with the restructuring of the enterprise sector (Khatkhate 1993; World Bank 1995a; Caprio and Klingebiel 1996).

Fiscal policy is important because there is a close link between the fiscal deficit and financial saving and the banking systems. A larger fiscal deficit makes it difficult to fully liberalize interest rates because of raising the cost of government debt. It therefore hinders financial savings. But the impact of the fiscal deficit on financial intermediaries cuts both ways. While a larger fiscal deficit represses financial intermediaries in that it does not permit the government to abandon interest rate regulation or directed credit, as in India, it helps the financial sector to appropriate a substantial part of inflation tax resulting from the fiscal deficit, as in Chile during the first half of the 1980s. The result depends on whether the benefit of inflation exceeds or falls short of the costs imposed by the fiscal deficit.

Financial intermediaries focus on their own and their borrowers' net worth, which makes the timing of financial liberalization crucial. If, for example, the real economy is in a cyclical downturn because of an external shock, such as adverse terms of trade or high interest rates transmitted from abroad, borrowers' net worth declines and hence the cost of the external finance they

TABLE 2.5: OUTCOMES: FINANCIAL SECTOR PERFORMANCE INDICATORS

	MACROSTABILITY							FINANCIAL STRUCTURE					
COUNTRY	INDICATORS	INFLATION	FISCAL DEFICIT/ GDP	CURRENT ACCOUNT BALANCE/ GDP	REAL EXCHANGE RATES	DEPTH M2/ GDP	AVERAGE	REAL DEPOSIT RATES	DOMESTIC SPREAD	FOREIGN SPREAD	MONEY MARKET RATE	IFC'S GLOBAL CAPITAL MARKET INDEX	AVERAGE
Bangladesh	14	1		1	1	1	**1.0**	1	0	1	0		**0.5**
Bolivia	13	1	1	0	1	1	**0.8**	1	0	0			**0.3**
Chile	15	1	1	1	1	1	**1.0**	1	1	1		1	**1.0**
China	18	0	1	1	1	1	**0.8**	0	1	0	0	0	**0.2**
Côte d'Ivoire	10	0		0	1	1	**0.5**		1				**1.0**
Egypt	15	0	1	1	0	1	**0.6**	0	1	0	0	1	**0.4**
Ghana	13	1	1	0	1	0	**0.6**	1			1	1	**1.0**
India	10	1				1	**1.0**	1	1	0	1		**0.8**
Indonesia	15	1	1	0	1	1	**0.8**	1	1	1	1	0	**0.8**
Kenya	12	1	0	1	0	1	**0.6**	1	0	0	1		**0.5**
Korea	15	1	1	1	0	1	**0.8**	1	1	1	1		**1.0**
Malawi	13	0		1	1	0	**0.5**	0	1	0	0		**0.3**
Malaysia	16	0	1	0	1	1	**0.6**	1	1	1	1	0	**0.8**
Mexico	13	1	1	0	1	1	**0.8**	1			1	1	**1.0**
Morocco	14	0	1	1	0	1	**0.6**	1	0	1	1		**0.8**
Pakistan	13	0	0	0	1	1	**0.4**				0	0	**0.0**
Philippines	18	1	0	0	1	1	**0.6**	1	0	1	1	0	**0.6**
Poland	18	1	1	1	0	1	**0.8**	0	0	0	1	0	**0.2**
Senegal	12	1		0	0	0	**0.3**	1	0	0	1		**0.5**
Tanzania	13	1	0	0	1	1	**0.6**	0	0	1			**0.3**
Tunisia	12	0	0	0	0	0	**0.0**				1		**1.0**
Turkey	17	0	0	1	1	0	**0.4**	0		0	1	0	**0.3**
Venezuela	17	0	1	1	1	0	**0.6**	1	1	1	1	0	**0.8**
Percent satisfactory							**74**						**52**

Note:
1. "1" means satisfactory, "0" means unsatisfactory; an average rating greater than 0.5 is "satisfactory," an average rating of 0.5 or less is "unsatisfactory.
2. This table includes macroeconomic variables even when Bank programs are often narrowly based because the reform of the sector depends critically on the macroeconomic environment.
   If the latter is not conducive, the sector concerned would not show improvement despite a well-conceived program and its satisfactory implementation.
3. "S" means satisfactory, "U" means unsatisfactory.

Source: International Financial Statistics (IFS), World Development Indicators 1997.

need rises. As a result, real investment falls, leading to a drop in the net worth of the financial institutions. This link between financial reform and the net worth of borrowers and lenders means that governments should move aggressively on financial reform in good times and more slowly in bad times (Caprio and others 1994). Latin American countries ignored the critical importance of timing financial reform, and their experiments were unsuccessful. Korea had the opposite experience. The Korean Government initiated financial liberalization measures only after a significant deceleration of inflation and abatement of recessionary tendencies. Doing so ensured a realistic set of relative prices and a profitable corporate sector (Cho and Khatkhate 1989).

The Bank's operations may be seen as less successful than expected partly because the Bank expects results in two to three years. But meaningful results from interventions in the financial sector may take a long time to emerge (Sheng 1996)—as long as 8 to 10 years for Bank-supported structural reforms. Because of the Bank's high expectations, it tends to urge governments to take quick action, such as completely deregu-

TABLE 2.5: OUTCOMES (CONTINUED)

	BANKING SYSTEM						OVERALL RATING		
	BANKS' CAPITAL ADEQUACY	BANKS' ASSET QUALITY	BANKS' MANAGEMENT	BANK'S EARNINGS	COMMERCIAL BANKS' LIQUIDITY	CENTRAL BANK CAPITAL ADEQUACY	AVERAGE	AVERAGE RATING[3]	
Bangladesh	0			0	0	0	**0.0**	0.50	U
Bolivia	1				0	1	**0.7**	0.64	S
Chile	1			0	1	1	**0.8**	0.92	S
China	0	0	0	0	1	0	**0.2**	0.38	U
Côte d'Ivoire	1				1	1	**1.0**	0.75	S
Egypt	1				0	0	**0.3**	0.46	U
Ghana	1				0	0	**0.3**	0.64	S
India					0	0	**0.0**	0.63	S
Indonesia	1				0	0	**0.3**	0.69	S
Kenya						0	**0.0**	0.50	U
Korea	1			1	0	0	**0.5**	0.77	S
Malawi	1				1	0	**0.7**	0.45	U
Malaysia	0			0	0	0	**0.0**	0.50	U
Mexico	0				0	0	**0.0**	0.64	S
Morocco	1				0	1	**0.7**	0.67	S
Pakistan	0			0	1	0	**0.3**	0.27	U
Philippines	1	1	1	1	1	1	**1.0**	0.75	S
Poland	1	0	0	0	1	0	**0.3**	0.44	U
Senegal	1				0		**0.5**	0.40	U
Tanzania	1				1	0	**0.7**	0.55	S
Tunisia	1			1	0	0	**0.5**	0.30	U
Turkey	0	1	1	1	1	1	**0.8**	0.53	S
Venezuela	0	0		0	0	0	**0.0**	0.47	U
Percent satisfactory							**35**		**52**

lating interest rates, and privatizing and recapitalizing banks, though such measures are not so well thought-out. These recommendations create more problems than solutions in the long-term.

The Political Economy of Reform

OED's definition of ownership (Johnson 1993) is particularly apt in financial sector work. It calls for joint identification of program goals, consensus within the government leadership, upfront actions to demonstrate intellectual conviction and broad outreach regarding reform goals within the body politic. It is especially difficult to secure genuine commitment to financial sector reform, because these sectors are often characterized by concentrated ownership, where the owners and those with political power are closely connected. The question is often raised: is financial sector reform more likely to be successful if borrowers take more ownership of reform? Clearly, any reform that a country does not accept stands very little chance of success. The urge for reform must come from within the country. All that an outside agency, like the Bank, can do is to nudge the

country through offers of financial assistance and technical advice (see Box 2.3). The question is, when is a country willing to embark on financial sector and other reforms? Experiences over the past decade show that countries embrace reform when the following three conditions prevail (Williamson 1994):

- The political party changes and the party in power develops a new program. Or, the party in power may change its stance on reforms when the country finds itself in a serious crisis.
- Either the bureaucracy through which a ruling party implements its program changes when the political party changes, or it is persuaded to accept new policies.
- Citizens change their perception of reform.

Clearly, none of these three conditions is easily met unless reforms are seen to be unavoidable and therefore desirable, or unless the fruits of reform are seen quickly and are credible. After the debt and oil crises, a wave of reforms in several developing countries in Latin America and Asia accelerated. In Chile, ownership of reform came with a change of regime. Reform also took place when centrally-planned regimes collapsed. India initiated reform only when it faced a dire economic crisis in 1991.

Accepting ownership of reform at a political level, however, does not always ensure smooth sailing. It has been a universal experience in transition and developing countries that the bureaucracy stalls reform even when it is announced by the party in power. At the same time the bureaucracy is impelled to change its attitude if the leadership persists with reform and results become visible. Reform means upsetting vested interests. But their resistance can be overcome if the ultimate beneficiaries of reforms—investors, producers, and wage earners—gain from reform, or lose less than they expected. When reform succeeds, both bureaucrats and politicians feel pressure from below and find it difficult to retreat (Williamson 1994). Ownership of reform can also be

TABLE 2.6: A DETAILED COMPARISON OF OUTCOME RATINGS FOR 23 COUNTRIES

COUNTRY *(Fiscal year of first financial sector operation)*	PERFORMANCE INDICATORS *(PIRS)*	PROJECT COMPLETION/ AUDIT REPORTS *(PCRS/PARS)*	DIFFERENCES BETWEEN PIR AND PCR/PAR RATINGS	ANNUAL REVIEW OF PORTFOLIO PERFORMANCE *(ARPP)*	PIR-ARPP DISCONNECT
Bangladesh (1990)	0.50	0.00	0.50	1.00	-0.50
Bolivia (1987)	0.64	1.00	-0.36	1.00	-0.36
Chile (1986)	0.92	1.00	-0.08	1.00	-0.08
China (1993)	0.38			1.00	-0.62
Côte d'Ivoire (1992)	0.75	1.00	-0.25	1.00	-0.25
Egypt (1992)	0.46			0.00	0.46
Ghana (1988)	0.64	1.00	-0.36	1.00	-0.36
India (1995)	0.63			1.00	-0.37
Indonesia (1988)	0.69	1.00	-0.31	0.00	-0.31
Kenya (1989)	0.50	0.00	0.50	1.00	0.50
Korea (1985)	0.77	0.00	0.77	1.00	-0.23
Malawi (1991)	0.45			1.00	-0.55
Malaysia (1987)	0.50	0.00	0.50	1.00	-0.50
Mexico (1989)	0.64	1.00	-0.36	1.00	-0.36
Morocco (1986)	0.67	1.00	-0.33	1.00	-0.34
Pakistan (1989)	0.27	1.00	-0.73	1.00	-0.73
Philippines (1989)	0.75	0.00	0.25	1.00	-0.26
Poland (1991)	0.44	1.00	-0.81	1.00	-0.81
Senegal (1987)	0.40	1.00	-0.60	1.00	-0.60
Tanzania (1992)	0.55	0.00	0.55	0.00	0.66
Tunisia (1988)	0.30	1.00	-0.70	1.00	-0.67
Turkey (1986)	0.53	0.00	0.53	0.00	0.53
Venezuela (1990)	0.47	0.00	0.47	0.00	0.47
Number of countries	23	19	19	23	23
Satisfactory	12	11		18	
Unsatisfactory	11	8		5	
Success rate (%)	52	58	-6	78	-26

Source: PCRs, ICRs, PARs, ARPP, and OED estimates based on time-series from Central Bank Annual Reports, IFS, and WDI.

TABLE 2.7: A COMPARISON OF OUTCOME RATINGS FOR NINETEEN COUNTRIES

	OED STUDY (PIR)	PCR/ PAR	ARPP	QAG[a]
Satisfactory rating (%)	58	58	79	60

[a] QAG ratings are not strictly comparable, as the QAG rating reflects the concept of "project at risk," rather than "satisfactory outcome," and is applied only to the current portfolio of FILs. For the purpose of comparison, however, we call the portion of the QAG portfolio that is not "at risk" (60 percent of FILs) "satisfactory."
Source: IFS, WDI, PCRs, PARs, OPRIS.

assured if it is accelerated so that it becomes irreversible. This has happened both in transition economies, such as Poland, and in developing countries, such as India.

Against this background some generalizations can be made. Most distortions in the financial sector are perpetuated by the government's close association with the banking system. If an arm's-length relationship can be built between the banking system and the government, reform is likely to take on greater urgency. This may mean fiscal reform, which will prevent governments from taxing financial systems; privatization of publicly-owned banks, which will neutralize the influence of an entrenched bureaucracy; establishment of independent central banks, which will take a more detached view of how the financial system functions; and creation of an incentive-compatible system under which all involved have stakes in maintaining an efficient financial sector.

Program Design

The design of adjustment operations also greatly influences outcomes, as the percentage of "hits" in Table 2.4 suggests. By and large, adjustment operations yielded good outcomes when projects were well-designed and policy instruments well-coordinated. But good project design alone is not enough. Six of the sample countries—Bangladesh, Indonesia, Korea, Mexico, Pakistan, and Poland—had hits in all four policy areas, suggesting satisfactory project designs, but only Indonesia, Korea and Mexico showed satisfactory outcome rating for the period under review (up to FY96). On the other hand, of ten countries with more than two hits but fewer than four, only eight—Chile, Côte d'Ivoire, Ghana, India, Morocco, the Philippines, Tanzania, and Turkey—had satisfactory outcomes. Project failure in countries with well-designed projects—or project success in countries with moderately relevant designs—may be attributed to other determinants of performance, such as the external environment, other policies, or real sector performance. It may also be explained by the fact that outcome and impact depend on how much the authorities are willing to implement broad-based programs rather than narrower or more specifically targeted programs.

Determinants of Performance

Since financial sector operations are relatively new and many of them are not completed, performance data are relatively limited. Nevertheless, we attempt to identify the determinants of project performance through statistical and econometric analysis.[9]

To explore why financial sector loans perform differently in different countries, we compare changes in key outcome variables three years after FSLs are approved. A country's outcomes are separated into three groups (Table 2.8) according to two categories of initial conditions—one macroeconomic, the degree of inflation, and the other microeconomic, deposit bank credit to private enterprises (DBPC) as a share of GDP. These initial conditions are then linked to changes in the ratios

TABLE 2.8: CONTROLLING FOR INITIAL CONDITIONS IN THE MACROECONOMY AND THE FINANCIAL SECTOR

	INITIAL CONDITIONS		
INDICATOR	I INFLATION<25%; DEPOSIT BANK PRIVATE CREDITS <20% OF GDP	II INFLATION>25%; DEPOSIT BANK PRIVATE CREDITS <20% OF GDP	III INFLATION<25%; DEPOSIT BANK PRIVATE CREDITS >20% OF GDP
Change 3 years after initial conditions:		(percentage points)	
M2/GDP	+8.22	+4.64	-0.23
DBPC/GDP	+5.69	+2.33	-0.70

Source: IFS database

BOX 2.3: TURKEY: THE "OWNERSHIP" ISSUE

Initial conditions. The central problem with Turkey's financial system in the mid-1980s was the banks' poor financial condition, reflecting the difficulties of their clients, especially the public enterprises. These difficulties were exacerbated by macroeconomic instability and very high real interest rates resulting from excessive public borrowing. Clearly, the success of the financial reform program was contingent on bringing public spending under much better control. Other financial policy problems had to be dealt with as well as such institutional problems as inadequate accounting procedures and unsatisfactory prudential supervision of financial institutions.

FSAL objectives. The objectives of the first FSAL, approved in 1986, were to reform financial policies, strengthen the banking system, and develop capital markets. FSAL II, a follow-up project approved in 1988, focused on filling-in the gaps under the same headings. In addition, more explicit emphasis was placed on improving macroeconomic conditions than under FSAL I. FSAL I and FSAL II both provided technical assistance oriented toward institution-building, training the staff of banking institutions, preparing related studies, and automating information systems.

FSAL outcome. The envisaged reforms were only partially completed. On the positive side, a banking crisis was averted and prudential regulation, external auditing, and off-site monitoring of banks and capital market institutions were brought up to international standards. The capital base of the banking sector was strengthened, and nonperforming loans were appropriately classified and provided for. The size of the public banking sector was reduced both relatively and absolutely. The relative size of preferential credits declined, and subsidized credit programs were curtailed. However, government borrowing continued to drive-up real interest rates, and crowd-out private sector borrowing, and public overspending helped generate macroeconomic instability, reversing or jeopardizing some sectoral reforms.

Assessment. The PAR, noting that public overspending was partly the result of public enterprise deficits and that the problems of the financial sector were also closely linked to questionable loans to the same public enterprises, asked why a common solution to macroeconomic and financial sector problems was not sought directly in public enterprise reform. This suggests that the Bank failed to come fully to grips in its adjustment lending strategy with one of the most critical economic issues in Turkey. This unwillingness to insist on the fulfillment of key macroeconomic conditions undermined the effectiveness of the first FSAL. The Bank imposed tougher conditions on FSAL II and showed much greater willingness to insist on these being met.

Lessons of experience. Experience from the two FSALs indicates incomplete government ownership of the reform program, partly because of lack of a political consensus, a reflection of continued political opposition to some of its measures by entrenched groups. The Bank was also responsible for not having asked for ownership of the most critical components of the reform.

TABLE 2.9: CHANGES IN THE REAL ECONOMY MEASURED WITH PERFORMANCE INDICATORS

COUNTRY *(Fiscal year of first financial sector operation)*	GDP GROWTH	GDS[a]/GDP	GDI[b]/GDP	NET FOREIGN DIRECT INVESTMENT	AVERAGE	OVERALL RATING (*Satisfactory/ unsatisfactory*)
Bangladesh (1990)	1	0	1	0	0.50	Unsatisfactory
Bolivia (1987)	1	0	0	1	0.50	Unsatisfactory
Chile (1986)	1	1	1	1	1.00	Satisfactory
China (1993)	1	1	1	1	1.00	Satisfactory
Côte d'Ivoire (1992)	1	1	0	1	0.75	Satisfactory
Egypt (1992)	0	0	0	1	0.25	Unsatisfactory
Ghana (1988)	1	0	1	1	0.75	Satisfactory
India (1995)					n.a.	n.a.
Indonesia (1988)	1	1	1	1	1.00	Satisfactory
Kenya (1989)	1	0	1	0	0.50	Unsatisfactory
Korea (1985)	1	1	1	0	0.75	Satisfactory
Malawi (1991)	0	0	1	0	0.25	Unsatisfactory
Malaysia (1987)	1	1	1	1	1.00	Satisfactory
Mexico (1989)	1	0	1	1	0.75	Satisfactory
Morocco (1986)	1	0	1	1	0.75	Satisfactory
Pakistan (1989)	0	1	1	1	0.75	Satisfactory
Philippines (1989)	1	0	1	1	0.75	Satisfactory
Poland (1991)	1	0	1	1	0.75	Satisfactory
Senegal (1987)	1	0	1	0	0.50	Unsatisfactory
Tanzania (1992)	1	0	1	1	0.75	Satisfactory
Tunisia (1988)	1	0	0	0	0.25	Unsatisfactory
Turkey (1986)	1	1	1	1	1.00	Satisfactory
Venezuela (1990)	0	0	0	1	0.25	Unsatisfactory
Percent satisfactory						**64**

Note: "1" indicates satisfactory; "0" indicates unsatisfactory.
[a] GDS: gross domestic savings.
[b] GDI: gross domestic investment.
Source: OED estimates based on time-series from World Development Indicators 1997.

of M2 and DBPC to GDP three years after the latest loan approval. Data were not available for several countries, so a smaller sample of 18 countries was used.[10] The statistical results still remain significant.

The comparison shows that changes in financial depth (measured as M2/GDP) are highly sensitive to initial conditions. Improvements under FSLs were greatest in countries with low inflation and low bank credit to the private sector.[11] In countries starting with inflation below 25 percent and DBPCs of less than 20 percent of GDP, for example, M2/GDP improved by an average of 8.22 percentage points, and DBPC ratios improved by an average of 5.69 percentage points. On the other hand, in countries with inflation lower than 25 percent and a DBPC higher than 20 percent of GDP, the reform's effect on both ratios was disappointing. Thus both macroeconomic and microeconomic initial conditions appear to be key determinants of a reform project's impact on the financial system.

Other factors that affect outcome include policies on prudential regulation. Econometric analysis (Cull 1997) shows that attempts to improve prudential controls have an important bearing on the outcome of the Bank's interventions in the financial sector. As in the previous analysis of initial conditions, firmer conclusions could be derived from larger samples. (see Annex 2.2).

The Real Sector

We also use the performance indicators to assess the probable effect of financial sector reform on the economy. The indicators are macroeconomic structural variables and the level of foreign direct investment. Generally, the impact of the Bank's interventions on the real economy has been satisfactory in more than half of our 23 sample countries (see Table 2.9). Bank interventions have had a satisfactory impact on net direct foreign investment in 16 countries, on the gross domestic investment ratio in 17 countries, and on the GDP growth rate in 18 countries. In general, the impact in each country differs, depending on the scores for each component of the macroeconomy.

TABLE 2.10: COMPARISON OF FINANCIAL SECTOR OUTCOME WITH REAL ECONOMY IMPACT

COUNTRY *(Fiscal year of first financial sector operation)*	**SATISFACTORY OUTCOME**	**UNSATISFACTORY OUTCOME**	**SATISFACTORY REAL SECTOR PERFORMANCE**	**UNSATISFACTORY REAL SECTOR PERFORMANCE**
Bangladesh (1990)		X		X
Bolivia (1987)	X			X
Chile (1986)	X		X	
China (1993)		X	X	
Côte d'Ivoire (1992)	X		X	
Egypt (1992)		X		X
India (1995)	X		n.a.	
Indonesia (1988)	X		X	
Kenya (1989)		X		X
Korea (1985)	X		X	
Malawi (1991)		X		X
Malaysia (1987)		X	X	
Mexico (1989)	X		X	
Morocco (1986)	X		X	
Pakistan (1989)		X	X	
Philippines (1989)	X		X	
Poland (1991)		X	X	
Senegal (1987)		X		X
Tanzania (1992)	X		X	
Tunisia (1988)		X		X
Turkey (1986)	X		X	
Venezuela (1990)		X		X
Percent satisfactory	**52**	**48**	**64**	**36**

Note: "Outcome" refers to effect on the financial system; "impact" refers to effect on the real economy.
Source: OED estimates based on time-series from International Financial Statistics and World Development Indicators 1997.

Finance and Development

Among the 23 sample countries the proportion with a satisfactory real sector performance was higher than that with satisfactory financial sector outcomes—64 percent compared with 52 percent (see Table 2.10). Note that in 10 of the 23 countries programs were satisfactory in both areas. And in 7 countries performance was unsatisfactory in both the real and financial sectors. This suggests a close link between reform of the financial sector and development of the real economy, as found in recent academic and Bank studies (Levine 1997). Nevertheless, a strong macroeconomic performance can temporarily cover the weak underlying condition of the financial system.

As presented in detail by Levine (1997), the nature of the link between finance and development is ambiguous at both theoretical and empirical levels. In this study, for example, the financial sector outcome was unsatisfactory for four countries, but the real sector performance was satisfactory. Why? These countries might have benefited from other reforms, such as trade liberalization, the removal of price controls, and deregulation of the industrial sector. They may have also benefited from favorable exogenous events, such as changes in international trade and prices.[12]

3 Institutional Development

The two major aspects of institutional development are: strengthening financial sector infrastructure and strengthening individual institutions. Strengthening financial infrastructure usually involves developing a legal framework for the central bank, the banking system, and non-bank financial institutions, as well as laws and regulations defining the rights and obligations of financial agents. Strengthening individual financial institutions requires better bank supervision, the restructuring and privatization of banks, and organizational and managerial changes within banks. Institutional development is critical to financial reform because without high-quality technical capabilities and general institutional efficiency, resource mobilization and efficient allocation remain weak.[1]

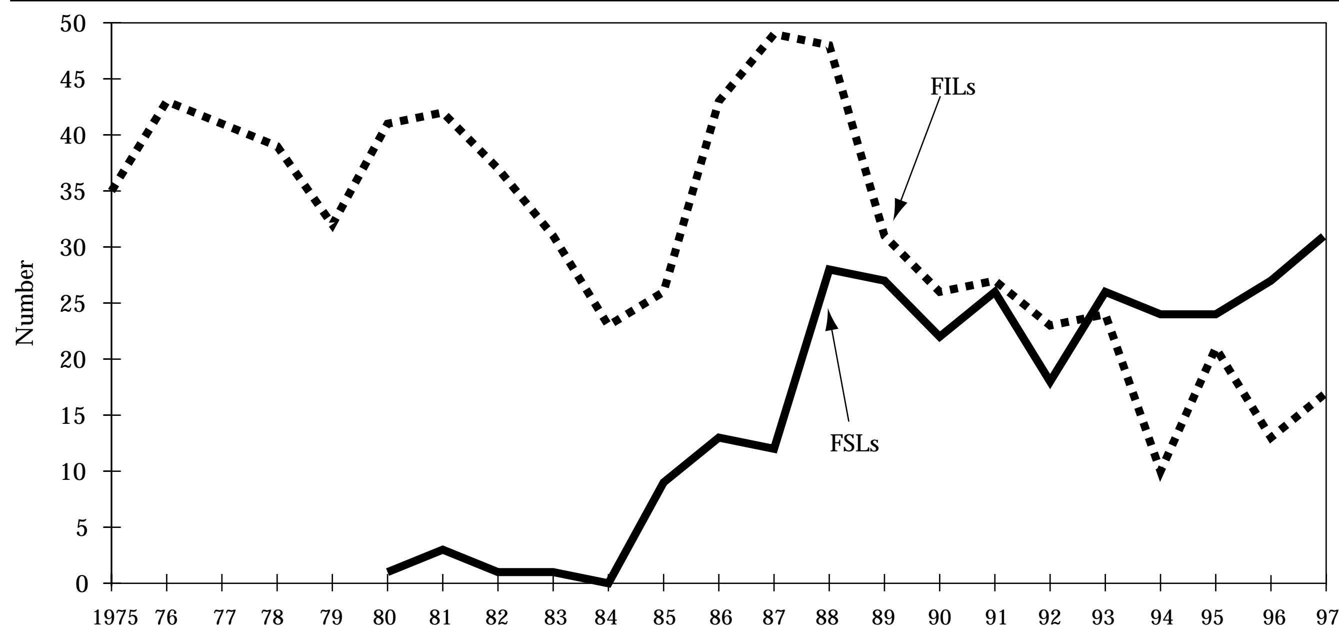
To support institutional development in the financial sector, the Bank relies on SADs, other loans related to sectoral adjustment (financial sector components in SALs and TALs), and FILs. The difference between sector-related loans (SADs, SALs, and TALs) and FILs in institutional development is large. Financial sector loans are policy-based lending instruments. They support changes in a whole range of financial infrastructure, including laws, regulations, and administrative practices to strengthen capital markets and to improve the soundness of banking systems. In FILs institutional development has a narrower focus (it refers to the viability of the institution itself, as reflected in its governance, management, technical capability, resources, portfolio, and profitability).

From the late 1960s to the late 1980s, FILs were a favored lending device. But in 1979, when the second oil shock translated into rising inflation and falling investment, FILs began to decline. Except for a temporary increase in 1986–88—especially in LAC countries following an investment boom in the Western Hemisphere—FILs have shown a steady decline, offset somewhat by a corresponding rise in FSLs (Figure 3.1).

This section reviews institutional development in FSLs[2] and FILs made to 24 countries.[3] Institutional development components in FSLs (Annex Table 3.2) include measures to strengthen financial infrastructure and institutions (such as the restructuring and privatization of banks). Twenty-four completed FSLs and fifty-eight completed FILs (Annex Table 3.3) were reviewed (approved between FY82 and FY92).[4] The selected institutional components were portfolio quality, resource mobilization, financial performance, and technical capability. In assessing institutional development (see methodology in Box 3.1), we characterize initial conditions of financial institutions and the regulatory framework, and then observe progress under Bank-supported programs. We also evaluate Bank performance.

Initial conditions (prevailing before FSLs were approved) were weak, but institutional performance improved significantly, especially after FSLs supported measures that strengthened financial infrastructure (Table 3.1). Initial conditions for FILs were better than those for FSLs, but progress under FIL programs was marginal after measures were taken to improve the institutional capacity of individual banks (Table 3.1). At the

FIGURE 3.1: NUMBER OF FSLs AND FILs APPROVED 1975–97



FSLs include SADs, SALs, and TALs with financial sector components.
Source: Operations Information System, World Bank

TABLE 3.1: THE CONSOLIDATED RESULTS

	INITIAL CONDITIONS	IMPLEMENTATION RECORD	OUTCOME	SUSTAINABILITY[a]
FSLs				
Strengthening financial infrastructure	0.21	0.93	0.80	0.71
Strengthening institutions, of which	0.17	0.71	0.62	0.75
Bank restructuring	0.12	0.67	0.50	0.67
FSLs[b]				
Portfolio quality	0.52	0.42	0.40	0.30
Resource mobilization	0.28	0.37	0.31	0.33
Financial performance	0.63	0.42	0.41	0.47
Technical capability	0.58	0.65	0.59	0.63
Overall rating	0.38	0.44	0.42	0.42

Notes: Methodology is given in Box 3.1.
(a) Sustainability is defined here as the probability of maintaining the project achievements in the institutional area.
(b) FIL scores relate strictly to the financial institutions' performance and do not cover the enterprise sector.
Source: PRs, SARs, and OED estimates

BOX 3.1: SAMPLE AND METHODOLOGY TO ASSESS INSTITUTIONAL DEVELOPMENT

The assessment is based on findings in SARs, PCR/ICRs, and PARs. We use a sample of 24 FSLs and 58 FILs for 24 countries.

The methodology to assess institutional development follows the same approach as that for Bank's interventions in financial sector liberalization (Chapter 2). We evaluate initial conditions, implementation, and outcome with respect to program objectives. Then we look at the impact or sustainability of the reform program. Because of the specificity of institutional development, there are a few differences. The methodology for institutional development uses loan instrument categories (FSLs compared with FILs) as the focus of assessment, unlike the methodology for liberalization, which supports a country focus. Another difference lies in the types of indicators used. To assess financial liberalization, we used quantitative indicators; for institutional development, we used qualitative indicators.

In practice we devised a "score card" (Annex Table 3.1) listing the two main objectives of institutional development and distinguishing them according to whether they are more likely to be supported by a FSL or by a FIL. The two main institutional development objectives are to (1) strengthen financial sector infrastructure; and (2) strengthen individual institutions.

These objectives are achieved by using regulatory and institutional reform measures at the level of individual banks. Financial sector infrastructure measures mainly supported by FSLs include, but are not limited to, changes in central bank law, capital and money market regulations and supervision practices of central banks. Institutional reform measures for individual banks under FILs include, but are not limited to, improving governance, management, and portfolio quality of the banks.

Using a binary system, performance indicators were constructed to monitor performance under each reform measure for initial conditions, the policy implementation record, outcomes, and sustainability. Satisfactory scores were rated as "1" and unsatisfactory ones were rated as "0". Each indicator was given the same weight in the scoring system.

The scores under each subcategory of initial conditions, implementation progress, outcome, and sustainability were aggregated and averaged for FSLs and FILs separately. In addition, we derived aggregated results by regions, level of per capita GDP, and intensity of Bank lending.

end of FIL operations, performance scores for both outcome and sustainability remained more or less at the same level as they had been initially. Thus, FSLs seem to have been a more effective lending instrument than FILs for meeting objectives.

Improving the legal system is relatively easy, but restructuring the banking system takes a long time.

Notable progress was made in strengthening financial infrastructure under FSLs, but outcomes by bank restructuring and institutional-strengthening were generally weak. This was not surprising, as improving the legal system is relatively easy, but restructuring the banking system takes a long time. If the period covered were longer, the scores for restructuring might improve. The narrow gap between initial conditions and outcomes for the components of institutional development in FILs could be attributed to the time constraint. Institutional development may be greater over the long-haul than in the short-run, because it requires skill development, which is a long, drawn-out process.

Institutional development programs were rated by country groups, broken down by level of income (Table 3.2). Initial conditions were better in middle-income countries than in low-income countries for both types of instruments. Outcomes were also better in middle-income countries under both FSLs and FILs. But improvements with respect to initial conditions in low-income countries were substantial for FSLs. Although it is difficult in general to achieve good results in low-income countries, FSLs appear to be a relatively efficient instrument for institutional development.

Initial conditions were better for countries with greater loan frequency (four or more loans), and outcomes were better too (Table 3.3). This may be because

TABLE 3.2: RESULTS IN LOW- AND MIDDLE-INCOME COUNTRIES

	INITIAL CONDITIONS		IMPLEMENTATION RECORD		OUTCOME		SUSTAINABILITY	
	LOW	MIDDLE	LOW	MIDDLE	LOW	MIDDLE	LOW	MIDDLE
FSLs								
Strengthening financial infrastructure	0.13	0.30	0.94	0.95	0.82	0.82	0.66	0.83
Strengthening institutions:	0.08	0.22	0.67	0.73	0.47	0.68	0.65	0.80
a. Central bank supervision practices	0.17	0.25	0.67	0.79	0.60	0.79	0.80	0.86
b. Restructuring of banks	0.00	0.18	0.67	0.67	0.33	0.58	0.50	0.75
FSLs								
Portfolio quality	0.31	0.60	0.36	0.45	0.36	0.42	0.21	0.39
Technical capability	0.46	0.63	0.58	0.68	0.50	0.64	0.58	0.68
Resource mobilization	0.18	0.32	0.20	0.44	0.20	0.36	0.10	0.48
Financial performance	0.55	0.65	0.57	0.35	0.50	0.38	0.43	0.48

Source: PRs, SARs, and OED estimates

countries seeking Bank loans more often made a greater effort to improve performance so that they could continue receiving loans. It may also be because of the Bank's more effective monitoring of loan implementation (or those who execute a country's program may develop expertise as time goes by and more loans come in). Certainly, portfolio quality and resource mobilization show better outcomes in countries with high loan frequency. We find at the institutional level an echo of what was identified in the conceptual framework, and observed more generally in adjustment operations, that reform in the financial sector is a process, not an event.

Key Factors Affecting Institutional Development

Different components of institutional development are influenced by different factors. Whether financial infrastructure is improved, for example, depends on how determined governments are to put through and implement the necessary legislation. The same is true for restructuring banks (the whole system as well as individ-

TABLE 3.3: RELATIVE SUCCESS IN COUNTRIES WITH HIGH LOAN FREQUENCY (4 OR MORE LOANS, FSLs PLUS FILs) AND LOW LOAN FREQUENCY (1–3 LOANS)

	INITIAL CONDITIONS FREQUENCY		IMPLEMENTATION RECORD FREQUENCY		OUTCOME FREQUENCY		SUSTAINABILITY FREQUENCY	
	HIGH	LOW	HIGH	LOW	HIGH	LOW	HIGH	LOW
FSLs								
Strengthening financial infrastructure	0.29	0.17	0.92	0.89	0.94	0.70	0.83	0.61
Strengthening institutions including	0.34	0.08	0.79	0.63	0.78	0.51	0.68	0.77
Bank restructuring	0.40	0.00	0.80	0.62	0.80	0.38	0.60	0.69
FSLs								
Portfolio quality	0.52	0.47	0.47	0.21	0.43	0.21	0.40	0.15
Technical capability	0.53	0.62	0.67	0.55	0.62	0.45	0.71	0.45
Resource mobilization	0.32	0.21	0.46	0.11	0.38	0.11	0.50	0.11
Financial performance	0.66	0.50	0.45	0.36	0.50	0.29	0.52	0.36

Source: PRs, SARs, and OED estimates

ual banks) and for central banks' exercising supervision. The quality of the macroeconomic environment appears to have little or no impact on outcomes in those areas. But other components of institutional development, such as portfolio quality, resource mobilization, and financial performance, depend heavily on macroeconomic stability and the creditworthiness of bank clientele—two factors bank managements cannot control.

In this context it is not surprising that outcomes in institutional development under FSLs have been uniformly better than those under FILs(with the exception of improving technical ability (whose outcome is better than that of portfolio quality, resource mobilization, and financial performance). Macroeconomic failures such as inflation militated against banks' efforts to improve their institutional profile. This was exacerbated by the weak financial position of state enterprises, core borrowers who invariably reneged on their loans. Many countries also had to contend with overbearing government interventions, government micromanagement of bank operations, and inadequate margin spreads. Development banks in particular, the main participants under FILs, are generally prohibited from accepting domestic deposits, making them financially dependent on the government or on multilateral institutions.

Two conjectures arise from the preceding observations. First, macroeconomic stability should be ensured when institutional development programs are initiated. FSLs may include instruments to achieve that state; FILs do not. That is the principal reason why FSLs have grown at the expense of FILs in recent years. Second, since neither FSLs nor FILs are designed to directly address enterprise restructuring, there is no automatic linkage between financial intermediary reforms and financial reform in the productive sector.[5] Without such a link, the "evergreening" of bad bank loans may continue.

More generally, the Bank has been closely involved in restructuring and privatizing state enterprises, but may not have coordinated its separate programs directed at the real and financial sectors. A recent Bank study (Pohl and others 1997) shows that in countries that privatized rapidly, the privatized firms improved their profitability relatively quickly, making government intervention in banks (and Bank support) unnecessary. By contrast, in countries with slow privatization, loan portfolios of commercial banks' were even worse than expected. Rapid privatization in the industrial sector is therefore an important precondition for Bank intervention in the financial sector. But we must add a caveat here. Privatization, though necessary, does not succeed unless an appropriate, transparent regulatory mechanism is in place or the ground work is assiduously prepared to find the buyers of equity in privatized banks. Mexican bank privatization failed to prevent collapse of banks, because care was not taken to choose buyers on the basis of their records and because bank supervision was inadequate to prevent deterioration of banks' loan quality. Monetary authorities were lax in controlling expansion of bank credit. In Ghana, potential buyers were scarce because of the obstacles placed in the way of allowing foreigners to own bank stocks.

The Sustainability of Institutional Components

To gauge the success of adjustment-related operations such as FSLs and FILs, it is not enough to look at outcomes. It is also important to know whether program benefits are sustainable for both the borrowing countries and the Bank. Sustainability is vital if countries' overall development programs are to be maintained. Without sustainability, they must start projects all over again, using scarce human resources. The Bank's task managers must scrutinize programs with a view to removing loopholes in their designs or implementation so that Bank interventions can be more efficient in the long-run.

It is striking that institutional development is far more sustainable under FSLs than under FILs (Table 3.1 and Box 3.2). The record on sustainability has also been uniformly higher in middle-income countries under both FSLs and FILs (Table 3.2). The same holds true, but not as strongly, for countries with higher loan frequencies (Table 3.3).

FSLs and FILs differ in sustainability, partly because of structural factors that directly affect institutional development (Box 3.2). For FSLs inadequate attention was given to the payments system, accounting and auditing standards, collateral laws and regulations, and education programs in accounting and banking that are critical to sustainability. For FILs performance was lower because of uneven professionalism in banking, limited on-site training of staff, and inadequate improvements in the quality of banks' portfolios.

BOX 3.2: PAKISTAN: THE LONG, DIFFICULT ROAD TOWARD SUSTAINABILITY OF FINANCIAL INSTITUTIONS

The Bank's involvement in lending through financial intermediaries to support private industrial development and to strengthen lending institutions in Pakistan started in the late 1950s. Bank lending focused for a long time on individual development finance institutions and national commercial banks.

The Pakistan Industrial Credit and Investment Corporation (PICIC) project, approved in 1980, was the Bank's eleventh loan to that institution. The Industrial Development Bank of Pakistan (IDBP) project, approved in FY82, focused on lending to small and medium-size enterprises (SMEs). With the Industrial Investment Credit (IIC) project (FY84), the Bank adopted a multi-institutional approach, lending to PICIC, IDBP, and the national commercial banks (NCBs). Two more IIC projects followed (FY86 and FY89). Finally, the Bank was involved in lending to small-scale industry (SSI) with three SSI projects (FY81, FY84, and FY87).

Outcome. Most of the Bank's credit operations, although accomplishing their basic task of transferring Bank resources to finance investment, were not successful at financing viable projects through efficient, financially-sound institutions. And implementation of their technical assistance components was decidedly mixed. Despite the Bank's long involvement with PICIC, the recurrence of fundamental problems suggests that trying to transform an inefficient, nominally private but partly state-owned, government-controlled institution into a vigorous and financially-sound intermediary was at best a herculean task and at worst a forlorn hope. IDBP continued to suffer from inadequate recoveries, low profitability, failure to mobilize domestic resources, and failure to keep abreast of change. It made some progress in diversifying its portfolio and areas of business, but was unsuccessful in its arrears recovery program. The poor results of the (first) IIC are ascribed to a number of external factors and deficiencies in appraisal and project selection. The financial performance of PICIC and IDBP declined after 1987, as portfolios and loan collection rates worsened. Their financial positions were adversely affected by the government's repression of the banking system. Under the second IIC project, 92 percent of the subloan commitments were made to the textile sector. This lack of diversification contributed to

BOX 3.2: PAKISTAN (CONTINUED)

deterioration in the participating financial institutions' (PFIs') balance sheets. Most of the PFIs experienced collection and portfolio problems, there was considerable management turnover, and the government's interference in management adversely affected PFI performance.

In the first SSI project, lending through the commercial banks proved satisfactory, the banks built up their subproject lending capabilities, and sound projects were financed, although technical assistance was not quite as successful. The second SSI project included a line of credit through IDBP, acting as an apex institution, to finance subprojects through the commercial banks and a technical assistance component. Unfortunately, IDBP turned out to be an inefficient apex agency and did not supervise the national commercial banks (NCBs) properly. The NCBs did not adequately appraise and monitor the subloans and as a result had major recovery problems. In fact, during implementation of the third SSI project, the Bank was obliged to declare four out of five NCBs ineligible to further participate in the project. This was intended to force them to take remedial actions. Three of them failed to participate for the remaining years of the project life.

Lessons of experience. An important lesson from Pakistan is the need to maintain the presence, analysis, and dialogue on the sector and to follow-up with regular operations, preferably adjustment-type, to reinforce whatever progress is made under one operation. The Bank has had a stop-and-go approach to the financial sector in Pakistan; essentially the Bank backed-off when it should have continued. The Bank made one financial sector adjustment loan in FY89 and nine years later approved another, the Banking Sector Adjustment Loan. Pakistan would have benefited from much earlier introduction of financial sector reform, particularly reform aimed at establishing uniform and transparent accounting, developing legal, regulatory, and enforcement infrastructure; and strengthening the banking system. Institution-building through FILs is more time-consuming and vulnerable to political intervention than the policy-based components of SADs, which provide for market-based determination of interest rates and improvements in institutional infrastructure.

4

Liberalization and Financial Crises

Policies for financial sector reform must take into account the likelihood of financial crises, because banking systems are often in financial distress on the eve of reform.[1] Indeed, financial crises emerge from reform policies or are magnified by them, depending on how the reform policies are conceived, adapted to initial conditions, and sequenced. The distress of banks, especially of publicly-owned banks, is caused both by interventionist government policies and by weak internal bank management which results in poor credit evaluation procedures, undiversified loan portfolios, and departures from standard commercial banking practices. The regulatory apparatus that oversees bank operations is usually inadequate because of regulatory authorities' limited capacities. Governments undertake financial liberalization to eliminate or reduce quantitative controls on banks' assets and liabilities (Goldstein and Turner 1996; Khatkhate 1993; Sunderarajan and Balino 1991).

A delayed policy response to macroeconomic imbalances that emerge in more financially integrated economies precipitates financial crises, because the margin for policy error is small. This was well-illustrated by the 1997 Thailand crisis. Despite evidence that the baht was appreciating in real terms because of the drop in exports, the large current account deficit, and the appreciation of the U.S. dollar relative to the yen, the monetary authority maintained the fixed baht-dollar parity. To defend it, domestic interest rates were raised. As a result banks' nonperforming assets increased sharply, leading to the bankruptcy of some financial institutions (Box 4.1). The 1997 Korea crisis is also a case of macroeconomic imbalances revealing deep structural weaknesses in the financial sector (Box 4.2).

When a financial system is fragile, it is vulnerable to economic shocks; fragility is a measure of susceptibility to crises. Policy measures that reduce a financial system's fragility tend to increase its ability to withstand shocks. In this chapter we develop a simple framework for quantifying this measure—a financial fragility index (FFI)—based on a set of fragility indicators.

> Policy measures that reduce a financial system's fragility tend to increase its ability to withstand shocks.

The financial reform strategy embodied in the Bank's adjustment operations has three dimensions: (1) reducing government interventions that distort the banking system, (2) restructuring and revitalizing banks in distress because of bad loans carried over from before the reforms set in improving supervision and prudential control of banks, privatizing state-owned banks, and (3) establishing modern accounting and prudential norms. This strategy minimizes the likelihood of financial crises.

Financial crises are common in financial systems all over the world but have been especially severe in developing countries. In about a dozen countries, including four studied here, estimated losses from resolving financial crises exceeded 10 percent of GDP or more (Caprio and Klingebiel 1996; Lindgren and Saal 1996). Some fac-

BOX 4.1: THAILAND'S 1997 FINANCIAL CRISIS—WHAT DID THE BANK DO?

The genesis of a crisis. Recent events indicate that the 1997 crisis was precipitated by a delay in policy response to emerging macroeconomic imbalances. Export growth, vibrant and sustained until 1996, slowed under the pressure of heavy competition from China and Vietnam in labor-intensive products. Given Thailand's reliance on foreign capital to finance domestic investment, the current account deficit rose to around 8 percent in 1996. Despite the evidence that the baht was appreciating in real terms, the fixed exchange rate was maintained. When the macroeconomic imbalance reached critical levels, foreign capital inflows shriveled, and foreign banks started to withdraw their loans from businesses and domestic banks, despite their commitment to rolling them over. Eventually, the authorities were left no alternative than to float the baht.

The ensuing devaluation revealed the fragility of the Thai banking system. Banks were already saddled with large non-performing assets, amounting to 9 to 10 percent of total bank loans. Their financial position worsened further when the burden of banks' and their customers' repayment of foreign currency liabilities in domestic currency ballooned. The Ministry of Finance and the Bank of Thailand extended liquidity to banks to tide them over the pressure on their resources. But the loans to corporate customers, groaning under the repayment burden, became non-performing, further aggravating the banks' financial position.

The currency crisis would have affected the banking system less if the system had been sufficiently resilient to adverse macroeconomic fluctuations and asset price gyrations. Commercial banks and non-bank financial institutions did not have the capability to efficiently manage their portfolio risks, and the authorities did not have in place an adequate framework of prudential control and supervision. Loans were not made on strict business standards, because political influences interfered with bank management. Above all, the readiness of the authorities to bail-out financial institutions in distress, either because of their own management difficulties or because the consequences of exchange

tors causing banking crises are macroeconomic and exogenous to the financial system: others are endogenous. Exogenous factors include fluctuations in terms of trade, relative prices, international interest rates, exchange rates, and inflation. But the factor most relevant to adjustment operations and associated policies is endogenous: inadequate preparation for financial liberalization. Financial reforms often generate new risks for banks that, without proper precautions, can precipitate a financial crisis. Interest rate liberalization deprives banks of the protection they previously enjoyed. Paradoxically, credit expands quickly, despite higher real interest rates. Bank managers accustomed to controlled interest rates are neither skilled nor experienced enough to evaluate new sources of risk, including credit, interest rate, exchange rate, and other market risks. Lacking the skills to evaluate loans and faced with new competition, both foreign and domestic banks may make poor credit decisions.

Bank adjustment operations can help prevent endogenous financial crises if they are attuned to specific country circumstances and balance the components of reform, such as removing distortions, improving accounting standards, instituting prudential controls and bank supervision, and correctly sequencing reform policies (Goldstein and Turner 1996; Khatkhate 1996; Sunderarajan and Balino 1991). The reforms also create stronger financial systems that can better weather exogenous shocks. In this section we examine how effectively the Bank's financial sector operations and interventions deal with financial crises. We rely on case studies, which allow us to identify the precise nature of interventions in specific types of financial crises. Case studies also allow us to identify common patterns among crises by examining different factors.

The case studies focus on financial crises in Mexico, the Philippines, and Venezuela—each presents a different perspective on Bank intervention. Mexico's first financial crisis occurred in 1987, before the approval of a financial sector adjustment program. The second occurred after Bank operations began. The financial crisis in the Philip-

BOX 4.1: THAILAND (CONTINUED)

rate changes created serious moral hazard problems for the banking system.

World Bank's Involvement. Although the World Bank's borrowing program has been modest during the decade beginning in 1987, the Bank has been a close observer of the Thai financial system through various studies it carried out. A major work was undertaken to analyze Thai macroeconomic policy in the 1970s and the 1980s as a part of a global study, but it barely touched on the Thai financial sector. This work was followed by a comprehensive report in 1990 on the Thai financial sector carried out with the concurrence of the Thai authorities. The report, while recognizing the vigorous growth of the Thai economy, and its other favorable aspects, did spotlight, albeit cautiously, some of the features of the financial sector that caused concern. The report, however, overplayed the strengths of bank supervisors, suggesting that they were efficient and that the skills of individual examiners were high. The Bank used the report to understand the Thai financial system but did not use policy dialogue to bring the portents of future trouble to the attention of the authorities. Another Bank study, prepared in the Bank's Country Economics Department in 1990, expressed the same apprehension about the Thai financial sector, but again with a lack of urgency.

The Country Assistance Strategy prepared in 1994 had generally euphoric overtones. In some places, however, the report mentioned the difficulties in maintaining external balance in the face of large saving and investment imbalances. In proposing new ESW programs, it suggested that more attention should be focused on financial sector reform and domestic savings mobilization. But none of those suggestions were implemented. At the first sign of macroeconomic imbalances emerging and export growth slowing, the financial crisis gathered speed and intensity, prompting in September 1997 the approval of a Bank TA loan to strengthen financial infrastructure. Another Bank loan to support the restructuring of finance companies was approved in December 1997 for the amount of US$ 350 million. Both loans were prepared without the benefit of recent ESW.

pines took place after approval of the Bank's financial sector operations; the crisis in Venezuela occurred after approval.

A low-fragility system is sound, stable, and well-functioning. Here, we use well-known indicators to develop an aggregate view of system fragility. From an assessment of their contribution to financial fragility, two sets of indicators, macroeconomic and microeconomic, are scored on a scale of 1 to 3, with 1 denoting low fragility and 3 high fragility. A simple average of these scores for each set generates a macroeconomic and microeconomic FFIs.[2] The macroeconomic fragility index is an aggregate of 14 macroeconomic indicators covering internal and external balances, real interest rate levels, real sector growth, Brady bond spreads, stock market prices, capital flows, debt, credit growth, and terms of trade exposure (see Annex Table 4.1). The microeconomic index is an aggregate of 18 indicators, including market structure of the banking sector, financial soundness of the banking sector, and central bank, and progress in enterprise restructuring (Annex Table 4.2).

Mexico

The Bank had two financial sector operations in Mexico in the period under study: one in 1989 (L3085), which was completed in 1993 and one in 1995 (L3911), scheduled for completion in 1998. During the first financial sector operation (1989–93) the macroeconomic FFI declined slightly, from 1.7 to 1.6, reflecting a negligible improvement in Mexico's overall financial position. Moreover, the microeconomic FFI increased from 1.8 to 2.1, revealing the banking system's growing fragility. Between the two programs the country's overall financial position worsened. Both FFIs increased sharply between 1993 and 1994, the first year of the second Bank-supported program, indicating that even the limited effects of the first program could not be sustained. Then between 1994 and the first quarter of 1995, both FFIs increased again, suggesting the possibility of trouble (Figures 4.1a and 4.1b).

BOX 4.2: KOREA'S 1997 FINANCIAL CRISIS: WHAT WENT WRONG WITH THE MIRACLE ECONOMY?

Korea's striking and sustained economic growth since the 1970s was brought about by the government's interventionist policies, which conformed to a market system because of Korea's peculiar institutional characteristics. The Korean economic system comprised two subsystems: a public system committed to developmental goals and a private system pursuing profit motives. Under this double system the government, the financial sector, and private producers worked together efficiently for a long period. But in the past five years the Korean economy reached near full employment, and wage pressure mounted. Korean industries faced growing competition in labor-intensive exports from China and Vietnam. Once the disciplining force of exports lost momentum, Korea's GDP growth started to decline. And in such an environment the weaknesses of both the corporate sector and the financial system, which had been covered by the country's high growth rate, came to the surface. Corporate bankruptcies increased, and, consequently, the banking system's non-performing assets, which were already high and had been masked by weak accounting standards, ballooned. The Korean authorities continued to direct the financial system to lend to the loss-making corporate sector. The government then compensated the financial system through central bank assistance. When the financial crisis erupted in Thailand in July 1997, it echoed in neighboring East Asian countries, including Korea, leading to a loss of foreign investor confidence. Even when there were clear signals of impending trouble, the Korean authorities tried to avert the crisis by using the same interventionist policies. This time, however, these efforts could not be sustained, and the financial sector as well as the real economy fell into a major economic crisis.

The World Bank's Involvement. The Bank was aware of serious weaknesses in Korea's financial sector, as evidenced in its reports. Four 1993 OED audit reports on Korea's industrial finance and financial intermediary projects specifically indicated that competition between banks had not been introduced, interest rate liberalization was limited, and the supervision and prudential control of financial intermediaries had not been changed. A 1993 Bank financial sector study gave a similar report, emphasizing the growing amount of nonperforming assets and the weakness of accounting standards. The study argued that government controls had led to financial market segmentation resulting in inefficient lending policies and nonperforming assets. The latter posed a serious problem for the financial sector, and a lack of transparency in accounting standards underestimated the size of these assets. The report suggested total abolition of directed credit. As a follow-up to the financial sector study, the Bank cooperated with Korean authorities to design a blueprint for a phased program of complete financial deregulation beginning in 1994. But implementation was halfhearted, and whatever was achieved was driven more by the government's attempt to qualify for OECD status (and as a result of pressure from the US government) than it was by Korean conviction. Though the Bank could diagnose the ills of the Korean financial system, it could not persuade the country to undertake substantial reforms, because of the limited leverage it had with Korea. The 1997 crisis prompted the Korean authorities to adopt a new attitude towards the structural problems of the financial sector. In December 1997 the Bank approved a US$ 3 billion economic reconstruction loan upon strong declarations from the new government that Korea was willing to embark on serious structural reforms.

FIGURE 4.1a: FSAL AND FINANCIAL FRAGILITY IN MEXICO: MACROECONOMIC LEVEL

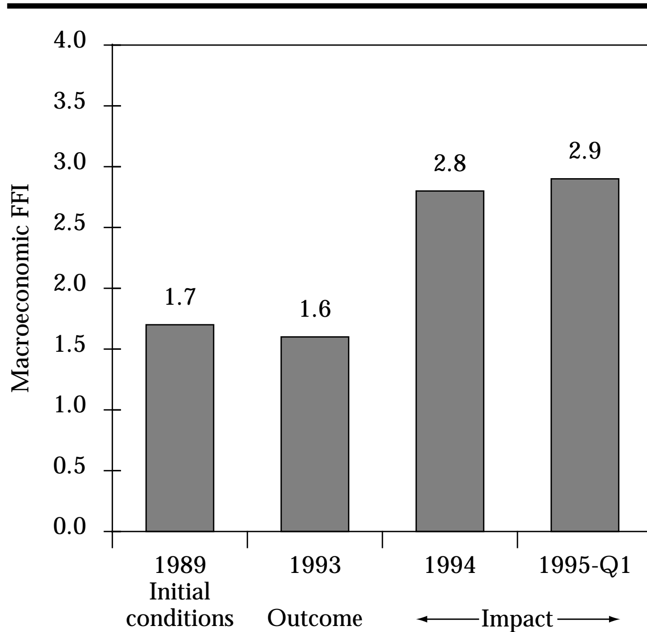
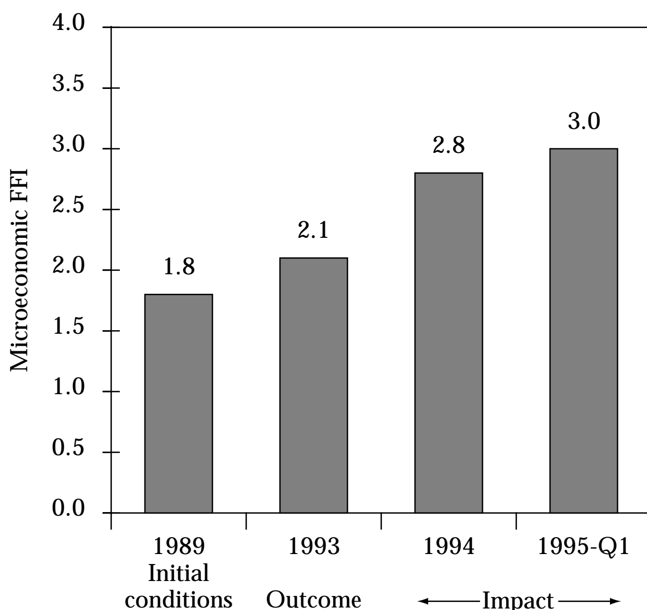


FIGURE 4.1b: FSAL AND FINANCIAL FRAGILITY IN MEXICO: MICROECONOMIC INSTITUTIONAL LEVEL



Source: OED estimates

The message from the FFIs can be compared with the conclusions reached in the PCR (No. 11638) and the PAR (No. 12077). Both reports describe the outcomes of the adjustment program as "highly satisfactory" and express few doubts about their sustainability. Although both reports were issued in 1993 (the PCR in February and the PAR in June), the picture they provide is misleading. By early 1993, and certainly by the middle of that year, there were clear signs of a significant increase in financial fragility and a reversal of many program outcomes. Given how rapidly the Mexican economy was changing in early 1993, the PAR could have relied on more current data to better evaluate project performance and the prospects for sustainability.

In formulating the FSAL, the Bank committed errors of both commission and omission. The FSAL program was put together quickly in an attempt to respond to the immediate needs of the Mexican financial sector. Thus, the quality of project preparation and design may have suffered. Without undertaking economic and sector work, the Bank had little direct knowledge of bank regulation and supervision, and of development banks. As a result, there was too much pressure on local institutional capacity to properly implement reforms. Furthermore, the project relied on action plans for institutional development, rather than on concrete measures and appropriate incentives, and there was little Bank follow-up to implement those plans. The action plans on bank regulation and supervision were either not implemented or poorly implemented, mainly because of limitations in local capacity.

A major flaw of the FSAL, which might have contributed to increased microeconomic fragility, was the absence of any conditionality for the loan portfolios of commercial banks. A recent Bank study concluded that a heavy concentration of consumer loans in the banking system's portfolio may have been a major cause—more than the devaluation of the peso itself—of the banking crisis in 1994–95 (Wilson, Caprio, and Sanders, 1997). Further, dominance by large financial groups of the banks (as well as their misleading accounting and auditing standards) did not disclose the actual deterioration of asset quality. This deterioration went undetected because of regulatory forbearance that allowed bank owners to recoup their losses.

The sustainability of the FSAL was undermined largely by a combination of government policies and external and domestic shocks which led to the crisis in late December 1994. The financial sector reforms dictated under the FSAL were neither comprehensive nor deep enough to strengthen the financial system to withstand such shocks. Regardless of the optimistic assessments of the PCR and PAR, the Mexican financial sys-

tem was extremely fragile at the end of 1993. It collapsed under the shocks of 1994. A major cause of that collapse was the weak system of prudential oversight and supervision instituted for newly-privatized banks.

The Mexican macroeconomy and banking system were very weak when the Bank provided a financial sector reconstruction loan (FSRL) in early 1995 (Figures 4.2a and 4.2b). One objective of that loan was to help the Mexican government contain the crisis. A longer-term goal was to help Mexico restructure its financial system to prevent the recurrence of systemic crises. A distinguishing feature of the FSRL was that it directly and effectively addressed the fragility of the financial system at the microeconomic and macroeconomic levels. As a result both measures of financial fragility declined sharply. The macroeconomic FFI declined from 2.9 in the first quarter of 1995 to 1.7 in the first quarter of 1996, reflecting mainly lower inflation, fiscal and current account deficits, real interest rates and domestic credit growth. During the same period the microeconomic FFI declined from 3 to 2.7, indicating some improvement of the banks' financial position and a slightly more competitive environment.

The positive effects of the FRSL reforms persisted until early 1997 (Figures 4.2a and 4.2b). The macroeconomic fragility index decreased slightly from 1996-Q1 to 1997-Q1, mainly as a result of lower inflation. The microeconomic index also declined, as the public became more confident in keeping deposits in commercial banks, and the central bank's financial position strengthened. The quality of commercial bank supervision improved as a result of more intensive technical assistance programs. The level of the microeconomic FFI, however, remained above 2 in the first quarter of 1997, indicating that the financial sector was still fragile and vulnerable to crises. Effective technical assistance may help improve supervision, but policies to provide adequate staff and financing and to ensure autonomy of the supervisors are more important.

FIGURE 4.2a: FSRL AND FINANCIAL FRAGILITY IN MEXICO: MACROECONOMIC LEVEL

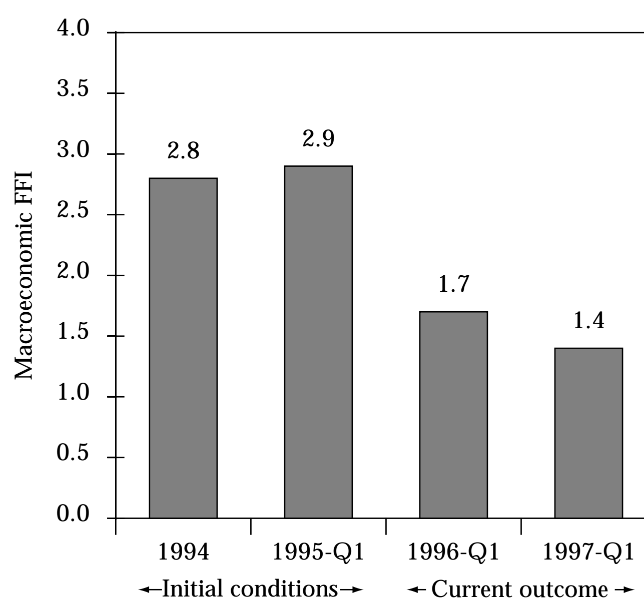
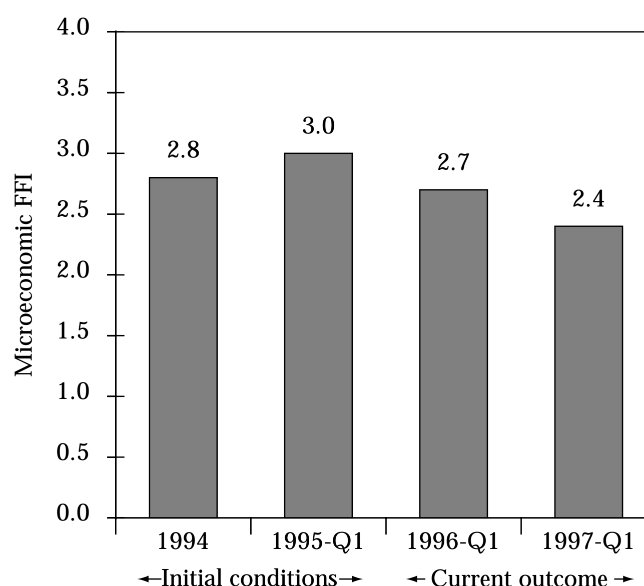


FIGURE 4.2b: FSRL AND FINANCIAL FRAGILITY IN MEXICO: MICROECONOMIC INSTITUTIONAL LEVEL



Source: OED estimates

Venezuela

Venezuela enjoyed the highest per capita income in Latin America during the early 1970s. Following the 1973 oil boom, however, the economy was increasingly mismanaged, governed by a set of highly complex regulations, subsidies, direct state interventions, inadequate social sector policies, and excessive reliance on petroleum revenues. Eventually, the economic and social problems of the country reached crisis by 1988. A new administration took office in 1989 and almost immediately began a sweeping economic stabilization and reform. As a consequence Venezuela became eligible for a Brady Plan program of debt and debt service reduction (DDSR). In July 1989 the government proposed a program of new bor-

rowing and DDSR to its external creditors, consistent with the Brady Plan announced earlier that year. The FSAL operation (Loan 3224-VE) approved by the Bank in 1990 and later evaluated by OED should be viewed against this background (see World Bank 1995g).

The FSAL supported a program of further interest rate liberalization and bank privatization. It also aimed to enhance competition and strengthen both the regulatory framework and individual financial institutions. Bank studies completed in 1988–89 showed the necessity of correcting insolvency problems as early as possible. At that time the financial system was oligopolistic in structure, and there were close links between major borrowers and banks. Venezuela was particularly vulnerable to financial crises. The FSAL proposals were not commensurate with the magnitude of Venezuela's financial problems.

Indeed, the macroeconomic fragility index for Venezuela, relatively low in 1990, increased substantially during program implementation (Figure 4.3a). The deregulation of interest rates, began as early as 1989, became dangerously destabilizing because the market structure remained oligopolistic and poorly-regulated. In addition, the macroeconomic environment became increasingly unstable. Two military coup attempts in February and November 1992 challenged implementation of the stabilization-cum-adjustment program initiated in 1989. Then oil prices declined substantially in 1993. Macroeconomic management deteriorated substantially in 1993 and 1994—the fiscal deficit grew from 3.9 percent of GDP to 14.5 percent, the exchange rate became overvalued, and domestic credit rose sharply.

The microeconomic fragility indicator which was high in 1990 (Figure 4.3b), declined only slightly and remained high during and after implementation. This index was high to begin with because the banking system was highly oligopolistic and insolvent. Fragility remained high throughout because measures to restructure commercial banks, strengthen the supervisory function of the superintendency of Banks and Financial Institutions, and reduce bank fraud were not taken. The government did not approve the new banking law before 1993, even though it had already liberalized interest rates. After the law was approved, authorities' actions to deal with the financial crisis were not consistent with the procedures set by the law regarding intervention and liquidation of financial institutions.

The outcome of the FSAL was unsatisfactory mainly because the program it supported did not deal with solvency problems as quickly as was required and because the government liberalized interest rates without implementing a regulatory and supervisory framework. Further, the Bank program did not include appropriate policy instruments to increase competition, develop financial infrastructure, and strengthen financial institutions.

FIGURE 4.3a: FSAL AND FINANCIAL FRAGILITY IN VENEZUELA: MACROECONOMIC LEVEL

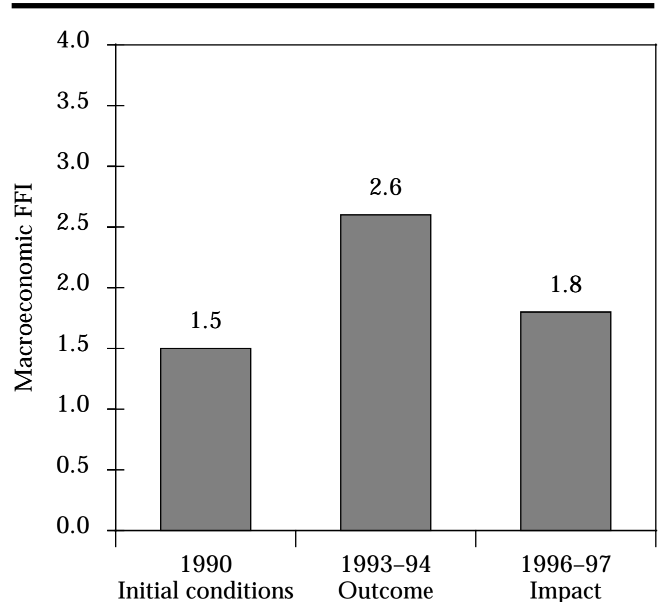
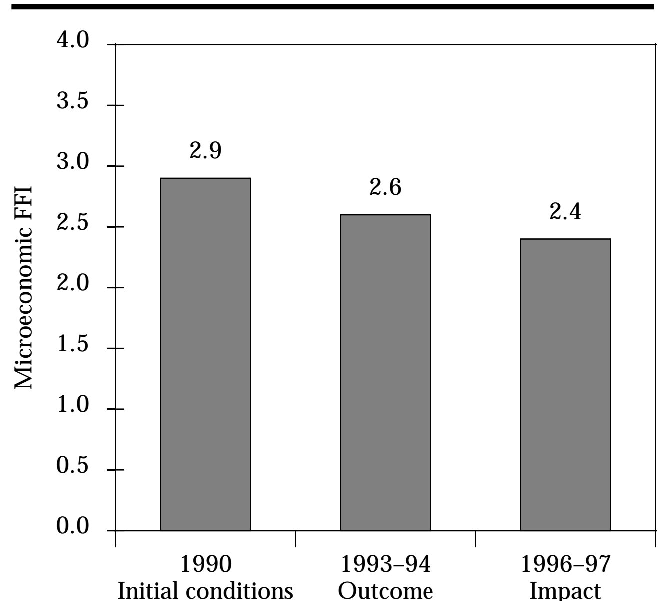


FIGURE 4.3b: FSAL AND FINANCIAL FRAGILITY IN VENEZUELA: MICROECONOMIC INSTITUTIONAL LEVEL



Source: OED estimates

The Philippines

In 1987 the Bank carried out a study of the financial sector in the Philippines. It identified five problem areas: bank supervision, the protection of depositors, the cost of intermediation, poor savings mobilization, and the delivery of long-term credit. These problem areas became the starting point of a dialogue with the government for the preparation of a FSAL (Loan 3049-PH) in late 1988. At that time the financial soundness of the central bank was not considered to be an issue.

Overall, the FSAL was successful in reducing the fragility of the financial sector (see World Bank 1996b). The macroeconomic fragility index was 1.8 to start with and declined while the stabilization policies were effective during the period 1994–96. The index, however, substantially increased in 1997 (Figure 4.4a), reflecting the effects of the turmoil in East Asia capital markets and a relatively large trade deficit. The microeconomic fragility index fell after 1989 as a result of a continuous effort to strengthen the central bank's supervisory functions, but increased in 1997, although not as fast as the macro index (Figure 4.4b).

A serious central bank crisis, however, occurred during project implementation. The financial fragility of the central bank had grown over the years to the point that it became bankrupt in 1993. Central bank deficits calculated on a cash basis appeared in the mid-1980s and increased substantially in the early 1990s. Cumulative losses from 1983 until 1993 (the year the central bank was recapitalized) amounted to 180 billion pesos (12.2 percent of GDP).

Since the crisis was confined to the central bank and did not spread throughout the financial system, the indicators, which are systemic in nature do not trace what happened to the central bank. Therefore, we added a central bank fragility index to follow ex post the intensity of the crisis. This fragility index is an average of five indicators related to profitability and solvency ratios as well as to quality of governance and short-term treasury bill rates (Annex table 4.3). Because the crisis was built up over several years, the fragility index reflects high losses and insolvency in 1992 and earlier (Figure 4.4c).

In 1993 the central bank was completely restructured—and thus strengthened, as shown by the substantial decrease of the fragility indicator. The process was successful but costly, partly because the intervention came so late and partly because the entire institution was fully restructured. Earlier diagnosis of the central bank's financial difficulties and earlier application of remedies might have averted the need for drastic restructuring and reduced the cost of adjustment.

FIGURE 4.4a: FSAL AND FINANCIAL FRAGILITY IN THE PHILIPPINES: MACROECONOMIC LEVEL

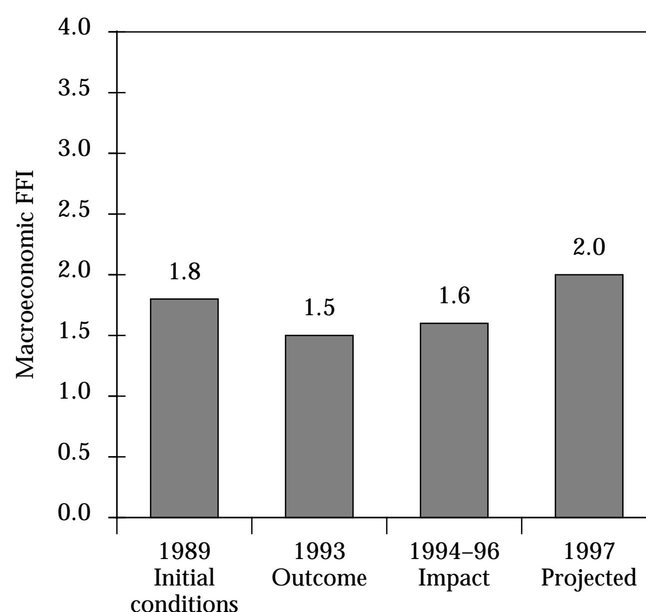
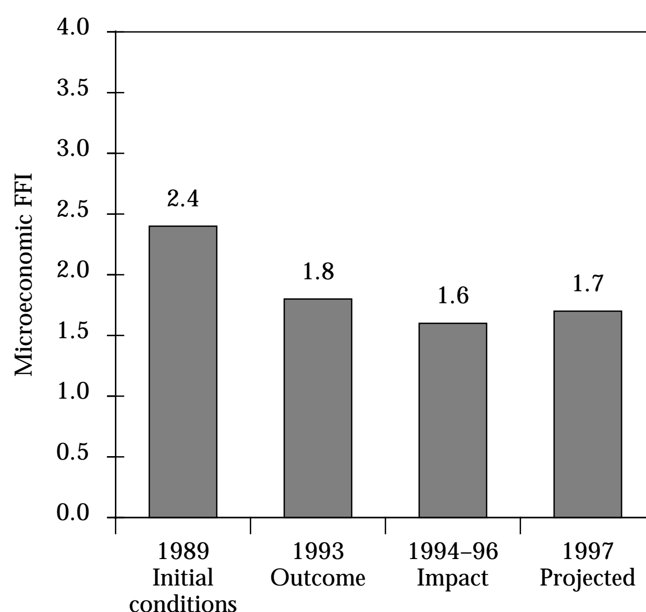
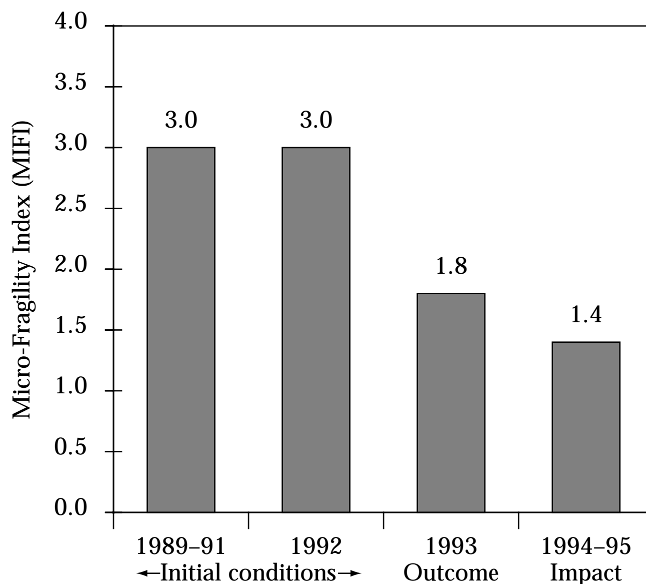


FIGURE 4.4b: FSAL AND FINANCIAL FRAGILITY IN THE PHILIPPINES: MICROECONOMIC INSTITUTIONAL LEVEL



Source: OED estimates

FIGURE 4.4c: CENTRAL BANK FRAGILITY—THE PHILIPPINES (1989–1996)



Source: OED estimates

Conclusions and Lessons

All three countries began with a high microeconomic fragility index. It was reduced in the Philippines, and (after a second loan) in Mexico. It did not decline in Venezuela. The main difference in performance is attributable to the rapidity and effectiveness of interventions that improved the financial position of the central bank and the soundness of the banking system. The macroeconomic indexes show better results in the short-term, as expected, since it is relatively easier to stabilize aggregates than to change institutions.

The point of this fragility indicator analysis is not to suggest that the FFIs can predict crises with any degree of precision. It is to show that far too little data on financial sector performance has been collected, processed, and analyzed in a systematic way and that more rigorous surveillance of financial sectors is necessary. As the recent crisis in East Asia makes dramatically clear, lack of regular and reliable monitoring information on financial system risk exposures can have serious consequences.

Some broad conclusions may be drawn from these experiences:

- The standard indicators (those derived from OD 8.30 guidelines) used to assess outcomes in the financial sector under Bank-supported programs are not sufficient for assessing the fragility of a financial system.
- The costs of financial crises can be enormous: the additional costs of assessing fragility should be seen in this light. A set of reasonably simple indicators can be developed to provide insights into financial fragility. In addition, the Bank should pursue its recent initiative to systematically analyze the determinants of banking crises in view of estimating the probability of occurrence (see Demirgüç-Kunt and Detragiache 1997). More attention should be given to this kind of analysis and to the development of evaluative measures at the onset of a project.
- The Bank should continue to monitor financial systems long after financial sector operations are concluded (Mexico). It might be useful for the Bank to seek feedback from, and to coordinate activities with, the IMF in its efforts to identify potential crises, since the IMF has key surveillance responsibilities in regard to the financial sector (see Chapter 6).
- Financial sector reform is not sustainable unless it is comprehensive and penetrates down to the institutional level (Mexico). This is possible only if solid ESW is completed before operations and only if technical assistance components are part of the package.
- Effective prudential regulation and supervision are vitally important to the soundness of the financial system (Mexico, Venezuela).
- Deregulating interest rates can be dangerously destabilizing if done when macroeconomic conditions are unstable, financial markets are oligopolistic, many borrowers show serious financial distress, connected lending is common, banks are in a fragile financial condition, banking supervision is incompetent, and banking legislation and regulations are weak (Venezuela) (see World Bank 1995d).
- In preparing financial sector studies, the Bank should pay more attention to the financial performance of the central bank and, as much as possible, review off-balance sheet items, especially guarantees and derivatives operations (the Philippines).

Bank Performance

For an adjustment project to succeed, the Bank must take a comprehensive view, drawing on its own and outside knowledge and resources. Bank staff must have a complete picture of the economy. Even a well-designed project may be affected by adverse macroeconomic conditions, such as high and rising inflation or overvalued exchange rates, or by microeconomic distortions, such as price controls, subsidies, lack of competition, or restricted trade regimes.

ESW should precede the preparation of an adjustment operation, placing the Bank's project work securely in the context of broad macroeconomic policy and strategy imperatives. This work should then be supplemented by consultation with the IMF, which has a different (but not fundamentally divergent) focus on issues, and with the IFC, which has expertise in private sector issues. The Bank's performance can be judged by how well it designs projects to suit a particular country situation. In this chapter we assess Bank performance with institutional development, sequencing of adjustment strategies, and cooperation and coordination with the IMF and the IFC.

Economic and Sector Work

Much ESW was, in fact, prepared before OD 8.30 (World Bank 1992) and did not always cover the items specified there. Reports in the 1980s generally dealt with the macroeconomic setting and structure of the financial system. Now, as specified in OD 8.30, other factors, especially resource mobilization, interest rate liberalization, and directed credit are also examined. Some attention was paid to the strengthening of financial institutions and the importance of the informal financial sector in the 1980s. Reports in the early 1990s cover these and other OD issues more systematically, placing more emphasis on regulatory reform.

The extent to which ESW was attached to the project cycle and the impact on project outcome give a measure of the complementarity between ESW and project lending. A 1995 Bank study (Schneider 1995) found that less than half of Bank projects had been preceded by ESW in the three years before project approval. When considering the entire set of the 88 FSLs in this study, and extending the period of presence (or absence) of ESW to five years preceding project approval, we found that no ESW was done for an even higher percentage of projects (55 percent). This has certainly deprived the potential borrower of the benefit of in-depth background information and a well-argued long-term strategy to develop the sector (Box 5.1). But ESW was completed for the financial sector in countries (Botswana, Burundi, Colombia, Lesotho, Mauritius, Nigeria, Rwanda, Thailand, and former Yugoslavia) for which there was no Bank lending for financial sector adjustment. This might suggest that ESW was considered as a substitute for lending.

Turning to our sample of 23 countries we also observe a large proportion of projects not preceded by ESW within five years (47%). When using the PIR methodology of Chapter 2 to measure the performance of Bank-supported reforms at country level, we find that

BOX 5.1: THE IMPACT OF PAKISTAN'S ESW ON LENDING OPERATIONS

Bank Operations. Pakistan's economic reform program began in 1977 when the government embarked on a new investment strategy, emphasizing a leading role for the private sector. The results were strongly positive: real private investment in large- and medium-scale industrial projects grew at 13 percent a year in 1977–82, and real GDP growth averaged 6.7 percent over 1977–83. The Bank supported the strategy with adjustment lending. A SAL (FY82) addressed structural imbalances and an Export Development Loan (FY86) supported the introduction of a more open trade regime. An FSAL to strengthen monetary management, the prudential framework, and the banking sector was approved in FY89. Financial sector reform was initiated, and Bank support came, although fairly late in the reform process. Bank assistance to the real sector and the strengthening of financial institutions through FILs, however, dates back to the late 1950s (Box 3.2).

ESW. The first comprehensive financial sector review was carried out in 1987 and identified several structural weaknesses, including over-regulation of the monetary system, inadequate supervision of financial institutions, an unstable strategy for government borrowing , and inefficient institutional credit markets. In response, the government drew up a financial sector adjustment program. The program included measures to remedy the weaknesses identified in the Bank review, but did not address directly reforms of development finance institutions (DFIs), insurance, or the stock market, nor did it address the basic question of the sequencing of reforms. The FSAL supported program implementation. Although progress was made on the institutional front, some objectives of financial reform(increased resource mobilization, greater investment, more efficient allocation, and higher output growth—were not reached. In retrospect it is clear that the FSAL should have gone further, placing more emphasis on fiscal reform, greater independence for the central bank, and more transparency in the central bank's operations.

Another Bank study, *Restructuring the Financial System: Building on Financial Reform in Pakistan*, distributed in April 1993, four years after approval of the FSAL, again drew attention to persistent deficiencies in the financial system. These include weak and inefficient financial institutions, with weak portfolios, poor debt recovery, excessive credit concentration, and inadequate capitalization; inadequate prudential regulation and lax enforcement: inadequate central bank supervisory capacity; a poor framework for loan recovery; the need for further bank privatization; and the need to restructure the DFIs. There were also many unresolved policy issues. Evidently, financial decisionmaking must be freed from government interference, and financial institutions like NCBs must be prepared for and subjected to stronger competition. Selected issues, but not the most fundamental, were supposed to be addressed by the Financial Sector Deepening and Intermediation Project, but the conditionality remains unfulfilled, funds undisbursed, and the Bank is planning to cancel the loan.

Lessons of Experience. It is very difficult to mount successful loans to be channeled by DFIs, through unreformed, or only partly-reformed state banks in a heavily distorted financial sector. It is also very difficult to achieve the objectives of financial sector reform in a macroeconomic environment characterized by public overspending, inflation, and high real interest rates. ESW certainly deepened the knowledge of the sector and identified major structural issues. But ESW alone is not enough to develop a timely and clear financial sector strategy with an appropriate sequencing of policy measures.

TABLE 5.1: PROJECTS FOR WHICH ADVANCE ECONOMIC AND SECTOR WORK WAS DONE

NUMBER OF ESW REPORTS PRECEDING A PROJECT	0	1	2	
Project status				**Total**
Active	19	14	5	38
Completed	29	19	2	50
Total number of projects	48	33	7	88
Percentage	55	37	8	100

Note: This table tallies the number of ESW reports done in the 5-year period preceding each project.
Source: Operations Information System, World Bank.

only one-third of the countries with no previous ESW have a satisfactory outcome, while two-thirds of the countries with at least one ESW before project approval have a satisfactory outcome (Table 5.2). In addition, when using the "hits and misses" methodology of Chapter 2 as a proxy for good project design, we find a positive influence of ESW: in those countries where the Bank carried out ESW on the financial sector no more than five years before at least one of the adjustment-related loans in the financial sector, there were fewer "misses", while in countries where the Bank had not carried out such ESW, there were more likely to be more "misses" (Table 5.2).

These results suggest a link between ESW and developing successful Bank financial sector operations from design to outcome for the period examined (FY85–96).[1] The design of the adjustment loans for Bolivia, Indonesia, and Morocco were built on knowledge acquired through in-depth Bank studies on the financial sector. Chile's successful financial market operation benefited from a preceding Bank report on industrial finance. ESW, however, is not a guarantee of successful lending. Substantial ESW was prepared for Bangladesh and Kenya and delivered before project preparation, but the program outcomes were unsatisfactory, because reforms were not properly sequenced.

Lending Operations

To assess the Bank's performance in lending, we adopt two different perspectives: (1) lending operations emphasizing financial sector liberalization; and (2) operations emphasizing institutional development.

It is necessary to point out that our evaluation method is constrained. A more complete evaluation would rely on enterprise-level data in the borrowing countries, which would enable us to see how reform changes the financing patterns and the allocation of resources at the enterprise level, and thus to assess whether the efficiency gains from reform outweigh losses from post-reform crises.[2] The implication is that

TABLE 5.2: ESW AND FINANCIAL SECTOR PROGRAM DESIGN AND OUTCOME (FY85–96)

	PROGRAM DESIGN		PROGRAM OUTCOME	
	≥ 2 MISSES	0–1 MISS	UNSATISFACTORY	SATISFACTORY
No ESW	Côte d'Ivoire Malawi Malaysia Venezuela	Poland Senegal Tanzania	Malawi Malaysia Poland Senegal Venezuela	Côte d'Ivoire Tanzania
At least one ESW	China Egypt	Bangladesh Bolivia Chile Ghana India Indonesia Kenya Korea Morocco Mexico Pakistan The Philippines Tunisia Turkey	Bangladesh China Egypt Kenya Pakistan Tunisia	Bolivia Chile Ghana India Indonesia Korea Mexico Morocco The Philippines Turkey

Source: Tables 2.3 and 2.5 and Annex Tables 1.1 and 1.2.

OED, QAG, and DEC should insist that the Bank collects firm-level data before project preparation.

Operations Focusing on Market Reforms
For the 17 countries in our 23-country sample for which Bank performance data on adjustment-related operations are available, there is a strong positive relationship between Bank performance and project performance. In cases in which Bank performance was strong,[3] 88 percent of the project outcomes were satisfactory. Eighty-one percent of the project outcomes were probably sustainable, and, 69 percent led to substantial institutional development.

Lending for Institutional Development
In general, Bank adjustment operations and financial intermediary loans tend to succeed when the borrower is committed to reform, and Bank involvement and problem-solving are intense and continuous. Bank performance is better under FSLs than under FILs (Table 5.3), partly for reasons outside the Bank's control. Program implementation is difficult under FILs when a country's macroeconomic conditions deteriorate, because those conditions deeply affect portfolio quality and bank profitability. In five of nine countries FILs failed partly because of exchange rate fluctuations or an upsurge in inflation, and partly because of government interference and inadequate appraisal of borrowers' capabilities. OED's Annual Review provides supporting evidence that Bank performance in the financial sector for FILs closed between 1988 and 1995 was poor (the Bank was too optimistic about portfolio management). When the Bank stays involved, combining close monitoring with assistance, institutional development is boosted. But when Bank support lessens, institutional development tends to slump.

Weak Bank performance in institutional development under FILs was inevitable since FILs concentrated largely on DFIs which have often been required to make high-risk loans at low interest rates to projects with high economic rates of return but not necessarily with high financial rates of return. This often translated into heavy losses. DFIs' difficulties were exacerbated by the foreign exchange risks involved with Bank lending. Thus, it has been a Herculean task to make DFIs viable, competitive, and sustainable—unless they were allowed to operate in a liberalized financial and economic environment where loans were priced on the basis of risk.[4]

TABLE 5.3: BANK PERFORMANCE IN SUPPORTING INSTITUTIONAL DEVELOPMENT

	QUALITY AT ENTRY	PROJECT SUPERVISION
	(*percent satisfactory*)	
FSLs[a]	74	90
FILs	53	49

Note: [a] The FSLs include SADs, SALs, and TALs focusing on financial reform. Quality at entry includes identification/preparation and appraisal processes.
Source: PRs, SARs, ICRs, and PCRs and OED PARs.

Adjustment Strategies and Sequencing
In analyzing the effectiveness of the Bank's adjustment strategy, the question is often asked whether the outcome of financial sector operations is vitiated by the wrong sequencing of financial reforms. This issue arose in Bank experiences in Chile, Indonesia, and Turkey, all of which are in our sample. In the early 1980s the financial sector did not perform well if deregulation was initiated in the midst of macroeconomic instability in countries with little or no prudential control and supervision. Toward the end of the 1980s, when the same countries had developed sound macroeconomies and well-designed regulatory mechanisms, financial reforms succeeded. In Indonesia, which had fairly stable macroeconomic conditions but weak regulations, financial reform fared well, but only up to a point. Reform would have been more successful if strong regulations had been in place. The same was true of Chile in the late 1980s. Turkey's financial liberalization was launched in a good macroeconomic setting in the mid-1980s, but began to unravel as the macroeconomy deteriorated.

Sequencing is extremely important and should be given prominence in Bank adjustment operations. Given the enormous heterogeneity of country circumstances and institutions, it may be difficult, if not impossible, to outline a cast-iron formula for sequencing. Still, country studies and other Bank resources suggest some broad, empirically tested guidelines for a practical approach.

Sequencing of financial reform is multidimensional:

- First, it is dictated by the state of the economy—whether it is in a cyclical upswing or downswing—which in turn determines the borrower's net worth. This net worth rises in good times and declines in bad times, so that lending institutions reduce the premium for debt finance in good times and raise it in bad times. Financial reform should thus proceed faster when the borrowers' net worth is rising and slower (World Bank experience

1996a). This has been well supported by experience in the sample countries. For instance, Caprio and Klingebiel (1996) point out that, "Malaysian authorities followed this strategy, re-controlling interest rates when the economy was experiencing financial distress in the mid-1980s, and resuming decontrol as net worth improved. Korean and Indonesian authorities also profited from early positive shocks."

- Second, the pace of reform must be adjusted according to initial conditions. "If banks have limited skills, do not have reliable financial information on which to base credit decisions, are not motivated to make prudent lending and risk-taking decisions, reforms can go awry" (World Bank 1996a). Likewise, if directed credit is predominant before reforms, its removal or phasing-out depends on the quality of supervision, which can ensure prudent risk-taking. If supervision is poor, the abrupt ending of directed credit can lead to financing of real estate, generating an asset price bubble (World Bank 1996a).
- Third, macroeconomic stability is important—sometimes vital—to the success of a structural adjustment program. The most crucial element is probably an appropriate exchange rate. Senegal and Indonesia pose contrasting examples. In Senegal financial sector reform stalled because of an overvalued exchange rate. But reform gathered momentum after a depreciation. Indonesia, on the other hand, depreciated its exchange rate at the beginning of financial reform, reduced inflation, and curbed public expenditures (Johnson 1997; Khatkhate 1993; Villanueva and Mirakhor 1990).
- Fourth, financial sector reform has close links with real sector reform. The real sector must function properly. Both public and private enterprises are often inefficient and unprofitable. As long as these inefficiencies continue, the financial sector will be less effective, as we have seen in Africa and Latin America, where restructured banks became immediately unviable because their borrowers were unprofitable (mostly public) enterprises. The same happened in Eastern Europe (see Pohl and others 1997; Johnson 1997; Khatkhate 1993; Villanueva and Mirakhor 1990). However, financial sector reforms should not necessarily be postponed until the real sector is restructured.

It should be noted that an optimal sequence of reforms, though theoretically appealing, is difficult to design: one can proceed only by trial and error.

- Policymakers must consider macroeconomic stability and the building of financial infrastructure basic to reform. The main pillar of macroeconomic stability is the country's fiscal situation. While financial repression is detrimental to financial system development, its sudden easing would enlarge the fiscal deficit unless the government can develop other sources of revenue. Thus the government should be cautious in eliminating at a stroke its reliance on the financial institutions for resources.

Policymakers must consider macroeconomic stability and the building of financial infrastructure basic to reform.

- Financial infrastructure should be built at the start of reform. It should include developing skills, information, and appropriate incentive systems; improving accounting and auditing systems; establishing a regulatory system with properly-trained regulators; and devising modern financial sector legislation. This is a very time-consuming task, but once started governments should not retreat, even when conditions may warrant slowing other reforms. For example, Malaysian authorities re-controlled interest rates for some time (G. Caprio and Klingebiel 1996).
- Introducing bank recapitalization and vigorous competition should come after a sustained effort has been made to improve the incentive system for banks. Incentives refer to the effort that banks and their regulators devote to ensuring that their institutions are sound; they include high capital requirements, liability on bank owners, and adequate debt-collecting procedures (World Bank 1995a). Once the right incentives are in place, recapitalization will be rewarded. There will be little risk of banks falling back into a situation where their net worth is negative because they will employ newly-infused capital more efficiently. And the banks will be able to face competition from new entrants more confidently.

The sequencing strategy outlined here should not be interpreted rigidly except in regard to what is central to

BOX 5.2: SEQUENCING REFORMS IN SENEGAL AND THE UNION MONETAIRE OUEST AFRICAINE

Initial Conditions. Like many African countries, Senegal has suffered chronically from a severely limited physical and human resource base, a high population growth rate that hinders economic advancement, frequent droughts, increasing desertification, and major swings in terms of trade. In the early post-Independence years these economic problems were exacerbated by, among other things, excessive industrial protection, government overspending, inefficient public enterprises, excessive market regulation, rigidities in the labor market, and an inadequately-regulated and inefficient banking system. By the late 1970s, Senegal's economic stagnation and declining per capita income impelled the government to seek IMF and Bank assistance.

Bank and IMF initiatives. The IMF responded with an Extended Fund Facility in 1980. In addition, beginning in 1980, the Bank initiated a series of SALs aimed at alleviating some of the problems. SAL III included a financial sector reform component. Later, in conjunction with SAL IV, the Bank mounted a separate FSAL. The FSAL was preceded by regional financial reforms announced by the Union Monetaire Ouest Africaine (UMOA) in August 1989. These reforms included eliminating the sectoral allocation of credit, partially liberalizing interest rates, eliminating preferential rates, implementing a new system of crop-financing, introducing a new system for determining borrower creditworthiness, and revising bank-by-bank credit ceilings.

Financial Sector Adjustment. The FSAL, intended to complement and extend the UMOA reforms, was a comprehensive project covering all four areas typically part of the Bank's financial sector reform: removing distortions, strengthening the financial system, strengthening individual financial institutions, and enhancing competition. Specifically, the FSAL embraced monetary and credit reform, bank regulation and supervision reform, bank restructuring and liquidation, government divestiture of bank shares, provisions for the recovery of bad debts, provisions for government payment of annual liabilities arising

reforms. There should be enough room to shift and shape some elements depending on the overall position of the economy.

Partnerships with the IMF and IFC

Coordination with the IMF

Country studies provided evidence that collaboration among the Bank, the IMF, and bilateral donors in mounting reform operations was usually close and jointly beneficial. For example, in Chile the two institutions supported mutually reinforcing policy measures, and cooperated closely in securing private sector financing for Chile's reform program and facilitated commercial bank and Paris Club debt restructuring. In Turkey the IMF, although not directly involved in the country at that time, collaborated with the Bank in preparing a shadow IMF program in conjunction with FSAL 2. The Bank also played an important role in mobilizing Japanese cofinancing. In Pakistan, the Bank and the IMF jointly designed the medium-term economic program and worked closely on the preparation of the FSAL and the Policy Framework Paper (PFP).

Bank-IMF coordination in carrying out financial sector operations improved after formal arrangements between them were strengthened and clarified in 1989. Still, there is potential for improving collaboration. IMF staff noted that in many countries most of the easy reforms have already been undertaken under ESAFs and SALs. But financial sectors often remain fragile, sometimes dangerously so. The IMF increasingly sees the strengthening of financial systems as pivotal to the continued success of adjustment and reform efforts. In dealing with fragile banking systems, the IMF recognized the need to draw on Bank resources. IMF staff interviewed acknowledged that the Bank's extensive involvement with country commercial banking systems has given its staff a distinct comparative advantage in dealing with such institutional problems. IMF staff would welcome far more Bank support in this area, particularly in countries where the Bank is not

BOX 5.2: SEQUENCING (CONTINUED)

from bank restructuring, and a program to establish "grass-roots" banks. The Bank also approved three loans and an IDA credit to create and support a state development bank, SOFISEDIT, to promote and support industrial development.

Outcome. Although considerable progress was made, the overall result of the SALs was disappointing, partly because of external factors, such as overvaluation of the CFA franc during much of the period, and partly because of internal factors, including entrenched political opposition to change; incomplete government ownership of, and commitment to, the reform process; and weak supply responses to the improved incentives. In the financial sector, the Bank underestimated the severity of the problems. By 1989, after three SAL operations, the banking system was still in severe crisis. The FSAL finally succeeded in reforming the financial sector and restructuring and recapitalizing the banking system, once more fundamental reforms to the role of the regional central bank (BCEAO), initiated by the Fund and agreed to by UMOA, were in place.

Assessment. Senegal's experience clearly demonstrates that proper sequencing of elements in an economic adjustment and structural reform program is vital. With regard to the sequencing of financial versus real reforms, the PAR on the FSAL argues that financial reform paved the way for a successful devaluation, the typically adverse effects of which were surmounted with relative ease by the strengthened banking system. The beneficial economic impact of the 1994 exchange rate depreciation, reinforced by structural adjustment, further strengthened the financial system. As far as the sequencing of financial sector reforms is concerned, the basic UMOA reforms clearly had to be in place before the Senegalese financial system could be reformed.

Lessons of Experience. A lesson to be derived from the Bank's overall experience in Senegal is that the Bank needs to place considerably more emphasis on "getting it right" in the first place, be it with regard to the basics of the country's economic situation, its sectoral reform requirements, or the need for individual institutions or particular forms of lending.

directly engaged in financial sector operations. It was suggested that annual Bank-IMF consultations, possibly along the lines of present annual public expenditure review consultations, might be useful for identifying priority countries and areas for the Bank's institutional analysis.

There are many examples of close cooperation between the two institutions in designing successful financial reform programs, providing technical assistance, and providing complementary loans. Inevitably, at a working level, staff of the two institutions do not always agree on specific diagnoses and recommendations. There is room for improving the sharing of information and analysis, reducing the scope for duplication of efforts and avoiding the rapid escalation of disagreements to the senior management of both institutions. A paper on "Bank-Fund Collaboration in Strengthening Financial Sectors," was discussed by both Boards in mid-1997. This paper sets out a broad division of responsibilities, as well as procedures for collaboration. The Fund will be mainly concerned with bilateral and multilateral surveillance of banking and the broader financial sector. It will emphasize, to a greater extent than in the past, identifying vulnerabilities in financial systems that could have major macroeconomic implications. It will also suggest corrective policies. The Bank will continue to help develop member's countries financial sectors, in the context of its ESW and lending programs. There are overlaps in the responsibilities between the two institutions, notably banking supervision and regulation and legislation. Detailed consultation procedures have been mapped-out. More needs to be done, however, to ensure full and timely exchange of information and early coordination between the Bank and the IMF for immediate response to financial crises.

Bank-IFC Coordination

From the outset the World Bank Group recognized that the IFC was to be the focal point for development work in financial markets. Until fairly recently the Bank had little involvement in securities market development. In

the past decade, however, the number of IFC technical assistance projects undertaken in coordination with the Bank has escalated sharply. There were only six joint projects in 1971–79, and only four in 1980–85. Between 1986 and 1990 the number rose to 79, and in 1991–95 it climbed to 90. In 1971–95 overall, 24 percent of IFC technical assistance projects were undertaken in conjunction with the Bank. These joint projects tended to be more successful in persuading governments to undertake needed reforms. In the financial sector, (mostly the banking sector) Bank-IFC collaboration has been even closer: the 82 joint projects undertaken in the financial and banking sectors represented 47 percent of IFC's technical assistance operations in those sectors.

IFC officials interviewed for this study confirmed that there is a complete exchange of documents between the two institutions, ensuring that each is kept formally aware of the other's operations. As with the IMF, a sense of joint mission has often been the cement for close cooperation. Reporting on Bank-IFC coordination in developing Hungary's capital markets, an IFC study noted that, "a sense of higher mission and the excitement of working on the first official stirrings of capitalism in the Communist bloc overcame any natural feelings of territoriality." The report also noted mutual respect for each institution's areas of skill. Still, there is a risk of possible conflict of interest between the IFC, as a shareholder in financial institutions, and the Bank and Fund, given their roles in restructuring.

The potential for differences between the two institutions is inherent in the IFC's instinctive search for private sector solutions to problems with financial sector development (for example, setting-up a market for bank bonds and notes where none existed before) as opposed to the Bank's working with governments and requiring sovereign guarantees. The Bank's orientation has sometimes led to proposals for government involvement in what are, in most industrial countries, mainly private arrangements. Although the machinery currently used for exchanging information and views is generally satisfactory for resolving such issues, some problems remain.

First, the two institutions differ greatly in size. The scope and complexity of Bank operations means that coordinating with the Bank imposes a very heavy load on IFC staff. And because the IFC is smaller, some Bank staff are not fully aware of the technical assistance it can provide and do not feel compelled to coordinate with it. Informal contacts and good will resolve most of these problems, but IFC personnel are sometimes frustrated. And while the Bank and the IFC exchange preliminary project documents, such as summaries of investment enquiries (SIQs) and initial project reviews (IPRs) the IFC staff would welcome even earlier notification about impending projects, so that they have a better opportunity to influence their design.

According to IFC staff, a continuing difference of views had surfaced in a number of countries about the Bank's channeling of IDA funds at low-interest rates through apex institutions to private financial intermediaries. In some countries (such as Zambia) the Bank was contemplating making IDA funds available to financial intermediaries at interest rates below LIBOR—substantially less than rates that the IFC would charge. This appeared to conflict with the Bank's own stated principle of discouraging subsidized lending operations. IFC officials noted that competition from the European Investment Bank (EIB) and African Development Bank (AfDB), which also provided subsidized funding, pressured the Bank to do likewise. Although compromises on IDA lending were reached in particular cases, the need for a generic mechanism to resolve issues of pricing within the World Bank Group was noted both by the IFC and QAG.

Conclusions on IMF and IFC Coordination

Some broad conclusions may be drawn about the Bank's strategy with regard to IMF and IFC partnerships. The first priority is to recognize that financial reform is a long, drawn-out process. Instead of thinking in terms of two-or three-year lending operations, the Bank must develop long-term strategies, which must be included in a CAS. But this requirement should not be an excuse for lethargy in pushing through financial sector reform. That strategy should incorporate all instruments, especially non-lending services, to help effect the desired changes. Ten years or more may be required to complete financial reform in a country, and far more emphasis must be placed on financial infrastructure. Still, there may be occasions to hasten financial sector reforms to ensure macroeconomic stabilization.

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This long-term strategy should be shared with all interested parties, both inside and outside the Bank Group. The Bank would support the development of the framework within which private financial intermediaries can function effectively, while the IFC would help establish or privatize financial intermediaries, which can then serve as models. The strategy should also include interaction and agreement with the IMF on monetary policies, banking supervision, taxation of the financial system, and the like. Collaboration at that level was formally discussed by the Board members of the Bank in August 1997, in which they further clarified the division of responsibilities between the Bank and the Fund (5.19). It is important for the regional multilateral development banks, bilateral donors, and other parties to sign on to a common financial development strategy.

Conclusions and Recommendations

The performance of Bank assistance in financial sector reform has not been strong. It was not until the late 1980s that the Bank started to emphasize the need for financial sector adjustment lending; it was in 1992 that the Bank's financial sector operations began to take a systematic perspective of macroeconomic and financial sector issues with the Operational Directive (OD) 8.30. It was only in 1997 that the Bank articulated the importance of a long-term perspective and the importance of economic sector work in policy advice. The East Asia crisis has provided fresh evidence of the Bank's tendency to underrate the seriousness of financial sector dysfunctions.

Main Findings

According to OD 8.30, the Bank's policy instruments for sector liberalization and institutional development include: (1) deregulation of interest rates and elimination of directed credit; (2) privatization of banks to enhance competition; (3) improvement of regulatory regimes; and (4) strengthening of financial institutions. The major findings of this study are:

- In only 4 of 23 sample countries did Bank programs provide policy instruments to improve conditions in all four areas of reform. In some areas the Bank policy package was deemed inappropriate given the country's economic situation. A large proportion (78 percent) of policy packages matched initial conditions in the categories of institution-building, and elimination of distortions. Reform aimed at encouraging competition scored the fewest matches.
- Project implementation was weakest in enhancing competition. Strengthening individual institutions also remained weak, with the implementation rate less than 50 percent. Policies relating to financial infrastructure improvements had the best implementation record: 71 percent.
- In 10 of 23 countries both program outcome (the effect on the financial sector) and impact (the effect on the real sector) were satisfactory. In 7 countries outcome and impact were unsatisfactory. This suggests close links between financial sector reform and the growth of the real economy.
- The ratings used in the study are on average similar to PAR/PCR ratings, and are lower than ARPP ratings. The discrepancies between the evaluations here and the ARPP evaluation arise in countries where the performance of the banking system has stagnated or deteriorated. This aspect of financial sector soundness, well-referenced in OD 8.30, has not always received the attention needed to achieve satisfactory results in Bank operations.
- Initial conditions greatly influence outcomes. These were best in countries with low inflation and low levels of bank credit to the private sector. Outcomes were also greatly affected by non-bank financial regulation and prudential control, as well as by the design of adjustment operations.

- Both FSLs and FILs support institutional development, but their specific objectives are not the same. FSL objectives are related to financial infrastructure, while FILs seek to strengthen financial institutions more directly. Initial conditions under FSLs were very weak, but improved greatly after the loans were made. By contrast, initial conditions were better under FILs, but hardly changed as a result of FIL operations.
- Outcomes in low and middle-income countries showed improvement over initial conditions under FSLs and FILs. But the performance of both groups of countries has been consistently better under FSLs than under FILs.
- Institutional development is much more sustainable under FSLs than under FILs. It has been much more consistently so in middle-income countries than in low-income countries. Critical to sustainability are good payments systems and higher accounting and auditing standards.

Case studies of financial crises in Mexico, the Philippines, and Venezuela suggest that:

- The set of standard indicators used to assess financial sector outcomes under Bank-supported programs is not adequate for assessing the fragility of a financial system.
- Financial sector reform is not sustainable unless it is comprehensive and penetrates to the institutional level. Operations must include ESW and technical assistance components. Effective prudential regulation and supervision are vital to the soundness of a financial system.
- Deregulating interest rates can be destabilizing if macroeconomic conditions are unstable, financial markets are oligopolistic, borrowers are in serious financial distress, connected lending is common, the financial condition of banks is fragile, banking supervision is ineffective, and regulatory banking legislation is weak.
- In preparing financial sector studies, the Bank should pay more attention to the financial performance of the central bank and, as much as possible, should review off-balance sheet items, especially guarantees and derivatives operations.

Reasons for Mixed Outcomes

It is clear from this study that the outcomes of the Bank's adjustment operations, though not uniformly unsatisfactory, were below what was expected. We focus here on possible reasons for those poor outcomes, drawing on the Bank's OD 8.30 and academic studies on the role of the real economy, the fiscal factor, and, more generally, the responsibility of governments:

- Financial sector operations should be viewed as part of the structural transformation of an economy. Without restructuring enterprises, there will be few good opportunities for banks to lend, and even if banks are restructured, that restructuring will only have to be repeated, at a much higher cost. Fiscal policy is important because there is a close link between fiscal deficits and the banking system.
- Financial intermediaries focus on their own and their borrowers' net worth, which makes the timing of financial liberalization crucial. This link implies that governments should move aggressively on financial reform in good times and more slowly when borrowers' net worth has been reduced by negative shocks, such as recessions or losses from terms of trade (Caprio and others 1994).
- In borrowing countries political ownership of reform does not always ensure smooth sailing (Williamson 1994). The bureaucracy must change its ways and attitudes, and implement reforms quickly so that the results become visible. Any reform requires upsetting vested interests, but their resistance can be overcome if the ultimate beneficiaries—investors, producers, and wage earners—gain.[1]
- The Bank's operations may be seen as less successful than expected, partly because the Bank expects results in two to three years. But meaningful results from interventions in the financial sector may take eight to ten years. Thus, outcomes should be evaluated over a longer perspective.

The bureaucracy must change its ways and attitudes, and implement reforms quickly so that the results become visible.

Recommendations

The OD 8.30 guidelines and their revised (draft) version in OP 8.30 are comprehensive, consistent with past Bank experience, and relevant to current financial sector issues. They reflect recent academic findings on financial

liberalization and institution-building. By definition, however, both documents have limitations. They are general guidelines, not intended to recommend a particular strategy. For that reason they do not automatically generate good practice. To improve Bank support of financial reforms in future, the first recommendation is to go back to the guidelines as a general reference for comprehensive reform. Then the recommendations is to focus on the five main aspects of financial sector strategy where weaknesses were identified.

Recommendation 1: Returning to the Operational Policies Directive

The Bank should aim at a more integrated approach to financial sector development. When the Bank incorporates financial sector development strategies into CAS documents it should also ensure that sooner or later (this is a matter of sequencing) all major relevant aspects of the financial sector, as described in OD 8.30, especially competition, are dealt with in a systematic way. In addition, the Bank should occasionally initiate and support regional reforms (as in West African Central Bank reforms).

Recommendation 2: Going Beyond the Operational Policy and Toward Good Practice

OD 8.30 is now being revised. The directive clarified and formalized the Bank's position on the financial sector, which it slowly built over the years from conceptual work and lending experience. OD 8.30 has anchored many good practices and has been recently updated to further clarify current issues, such as directed credit and restructuring of financial intermediaries. Beyond the recommendation to use the directive as a fundamental reference for establishing complete sector strategies and sound lending, this study points out additional areas that still need attention.

Program Design

Recommendation 2.1: Proper Sequencing of Reforms

The general strategy should be to first initiate reform only if the macroeconomy is stable, ensuring specifically that the fiscal situation is good. Second, a financial infrastructure, which includes the formation of skills, development of information, setting of an appropriate incentive system for banks, improvement of accounting and auditing standards, and establishment of regulatory markets and legislation, should be in place. Both parts should be taken as central to financial reform and should not be stalled, even when other reforms, such as interest rate liberalization or phasing-out of directed credit, must be slowed or held in abeyance because of unexpected events. If the proper incentives are offered, it is possible to advance reforms such as, easing entry of new banks and liberalizing the capital account. The pace of reforms will vary depending on the institutional strengths and ownership of the major players. The East Asia crisis will be rich in additional lessons.

Recommendation 2.2: Emphasizing Competition and Financial Infrastructure

Financial liberalization is incomplete without well-conceived measures for introducing competition. Reforms should be designed to have long-term effects always keeping in mind the ultimate objective of establishing a competitive environment. Conventional instruments of enhancing competition within banking systems—such as bank privatization, legal changes in company laws, banking laws, foreign ownership laws, bankruptcy laws, and regulatory changes to remove different treatment of different banks—should constitute the basis of a policy to enhance competition. But these conditions are necessary, not sufficient. Authorities must create an environment, through regulation, to prevent collusive behavior among banks and conglomerate relationships between banks and nonfinancial groups (Denizer 1997).

A major lesson from the financial crises in Mexico, Venezuela, and the Philippines is that financial sector reform is not sustainable unless it is comprehensive and penetrates to the institutional level. Strengthening financial infrastructure requires, first, analysis of the central bank's governance, independence, skill level, capacity and incentives to supervise. Second, attention must be given to the payments system, accounting and auditing standards, collateral laws, and regulations in client countries. Third, professionalism in banking and accounting is often neglected. Training programs in these areas should firmly anchor the reform process. All FSLs should address these important developmental issues.

Bank Processes

Recommendation 2.3: Timely ESW and Continuous Monitoring

OD 8.30 states clearly that lending should be based on ESW. But many financial sector operations were carried out without ESW. Analysis suggests that previous ESW strengthens the design of financial sector operations and

contributes to their success. In-depth, policy-oriented economic and institutional analysis should invariably precede project initiation to ensure that the critical issues are clearly defined from the outset and that a macroeconomic environment conducive to reform is maintained.

The Bank should monitor and evaluate more continuously and more systematically achievements of countries' financial sector adjustment programs, with performance indicators focusing on structural changes and relevant to the objectives of these programs. Increased coordination with the IMF, who regularly reviews and appraises macro and financial sector policies (Article IV Consultation) and IFC, who monitors capital markets, would reduce duplication of effort and sharpen the diagnosis. In the context of financial sector adjustment programs supported by the Bank, performance indicators should be carefully selected and continuously monitored by the Bank and the government authorities. The indicators should be relevant to the specific objectives of the adjustment program and should focus on structural changes in the financial system. Changes in these indicators should be used to evaluate the relevance and efficacy of the adjustment program.

The Bank's relevant policy documentation should be updated to ensure that specific financial sector indicators are included in reform operations. Financial reform operations must use appropriate and generally acceptable banking indicators, which are essential for ascertaining the weaknesses in a system and for monitoring progress or deterioration.

Recommendation 2.4: Judicious Use of Classical and New Lending Instruments

The Bank already has a considerable number of instruments to support reforms in the financial sector (SALs, SADs, FILs, SIMs, TALs) and has used them all. Each lending instrument, however has its own relative advantage: SALs for macroeconomic stability and structural adjustments, SADs (also called FSALs) for financial sector liberalization and development of financial infrastructure, and TALs for strengthening financial systems, and individual financial institutions.

The optimal sequence of instruments should reflect the optimal sequence of reforms. In general, SALs should pave the way for SADs, and FILs should be used in a reform framework supported by SADs. A TAL can be used at all times, but its content will differ at various stages of the reform program, emphasizing system-wide weaknesses at the beginning and individual financial institutions later. Since institution-building is a slow process, the new instrument, adaptable program loans (APLs) which disburse according to the pace of institutional progress, could become essential in supporting financial reforms. But the prospect of a financial crisis in a country could generate a loss of confidence among foreign creditors and require up-front disbursements of large amounts from the Bank and other multilateral organizations to compensate the short-term capital outflows. Provided the country has good long-term repayment capabilities and is willing to embark on a major long-term reform program, the Bank could decide to make such a loan (ERL), as evidenced in Korea recently.

Financial intermediation projects, and the health of financial institutions they help maintain, are vulnerable to the effects of recessions and abrupt changes in government policy. In general, Bank lending through FILs for institution-strengthening has not been successful. The Bank should focus first on establishing an environment in which FIs can become profitable and competitive. Lending to FIs for institution-strengthening should be undertaken within a phased financial sector reform program, in which the government has credibly established that it will maintain good policies. The proposed evolution of FIs within a financial sector program should be made explicit. If the Bank is to increase its support of private sector development, this aspect of Bank performance must be improved on.

While the Bank intends to develop technical assistance programs and loans, there are very few completed "stand-alone" projects in the financial sector on which to base conclusions for future loans. Case studies of technical assistance incorporated in Bank loans show that the Bank should commit itself to providing technical assistance only under the following conditions: (1) the need is clearly established (as opposed to being only perceived); (2) the Bank has the resources to design and supervise assistance effectively; and (3) the government is committed to specific actions that will ensure the effectiveness of assistance.

Recommendation 2.5: More Effective Partnerships with the IMF, IFC, and EDI

The first priority is to recognize that financial reform is a long, drawn-out process. This long-term view should be shared with all interested parties, inside and outside the Bank Group. The strategy should include interaction and agreement with the IMF on monetary policies,

banking supervision, taxation of the financial system, and the like. In August 1997 the Board of the Bank, formally discussed further clarifying the division of responsibilities between the Bank and the Fund. It is important that regional multilateral development banks, bilateral donors, and other parties sign on to a common development strategy.

The scope and complexity of Bank operations means that coordinating with the Bank imposes a heavy load on IFC staff. While the Bank and the IFC now exchange preliminary project documents, such as summaries of investment inquires (SIQs) and initial project reviews (IPRs), Bank staff should give IFC staff even earlier notification about impending projects, so that they have more opportunity to influence project design.

The Economic Development Institute (EDI) of the World Bank trains decisionmakers to help promote financial sector development through its banking and finance program. This has led to successful outcomes in countries of the Former Soviet Union during the last five years. EDI should be encouraged and given appropriate resources to further develop its banking and finance training program in sound bank management, banking policy, regulatory issues, and bank failures.

Recommendation 2.6: Better Partnerships with Institutions in Borrowing Countries

The Bank should support a consensus among parties involved in project design and implementation in client countries. This is part of promoting borrower "ownership," a prerequisite for project success. Country case studies suggest that Bank support of financial sector adjustment operations is more successful when the key parties are convinced of the need for reform than when it is trying to persuade reluctant counterparts with different priorities. To ensure continuity of reform, it is critical for the Bank to maintain a close liaison with borrower governments, even in adverse political circumstances. As an outside, objective analyst of the financial sector, the Bank should bring lessons of experience from other countries and disseminate these to focus early attention on reform needs.

ENDNOTES

Chapter 1

1. OD 8.30 (World Bank 1992: 12) defines FSALs as instruments "for simultaneously supporting a broad range of policy and institutional reforms to improve the functioning of financial markets and to strengthen the ability of financial institutions to mobilize and allocate financial resources."

2. Relatively few projects were undertaken in the financial sector in the mid-1980s. The number of projects increased only at the end of the decade and in the early 1990s, with a growing number of SADs, also called FSALs, focusing on the financial sector, which, the Bank believed, should complement, through their targeted sector reform, the overall reform in SALs. Another reason for increasing recourse to FSALs was the Bank's realization of the limits of FILs as the main tool to promote development of the financial sector.

3. Among economies in transition, China and Poland were selected because the Bank has had a longer experience of supporting financial sector reforms in these countries.

4. FSLs include SALs, SADs, and TALs with financial sector components.

5. See "Financial Systems and Development" in World Bank (1989b); "Financial Sector Operations" in World Bank (1992); World Bank 1993b; World Bank 1995e; and World Bank 1995f.

6. Among countries that had financial crises, Mexico, the Philippines, and Venezuela were chosen because OED had done the most PARs of Bank financial sector operations for these countries.

Chapter 2

1. M2 stands for broad money. It is measured as the sum of money (IFS line 34) and quasi-money (IFS line 35).

2. Although Bolivia eliminated many interest rate distortions in August 1985, our performance indicators show that interest rates were erratic and mostly negative before the approval of the Public Financial Management Operations I (C1809-BO). Interest rate spreads were also high at that time, which is consistent with a lack of competition within the banking system (World Bank Report No. 6765-BO).

3. Overkill may be too strong a word in the sense that every country needs continuous improvement in all these areas, as well as others not specifically targeted. But given the limited financial and human resources in each country, policy packages must be selective and tailored to initial conditions. A redundant policy prescription may hamper proper implementation of the program.

4. In Venezuela, although reform policies included measures to promote competition, the audit report observed that competition policies were included as a mere formality and stipulated relatively weak conditionality.

5. Some explanation about Korea and India is necessary because although their implementation records were poor, their outcomes were satisfactory (see Table 2.5). In Korea implementation of banks' interest rate liberalization was poor, but it was offset by the rapid growth of non-bank financial intermediaries, with freedom to set interest rates, which competed with banks. In India the reason for the discrepancy between poor program implementation and a good outcome seems to lie in the extreme financial repression present on the eve of the program, so that even a poorly-implemented program could yield positive results.

6. Performance indicators for Indonesia showed on balance satisfactory outcomes up to 1996 for all the financial sector components, except the banking system, which even then was unsatisfactory. In 1997, a year after our sample, almost all the other performance indicators deteriorated sharply, to the point that the overall outcome for Indonesia would have been unsatisfactory. The 1997 crisis was generated by an illiquid banking system which became rapidly insolvent, together with a pegged exchange rate policy. The weakness of the banking system is clearly revealed by micro fragility indicators (CAMEL). Our analysis of the Bank response to financial crisis (see Chapter 4) gives more emphasis to micro fragility indicators, and the role the lack of of financial sector soundness can play in financial crises.

7. In 1996 the QAG commissioned a review of the Bank's portfolio financial intermediary loans as part of its portfolio investment program. The FIL portfolio was chosen as it was found to have a higher ratio of projects at risk than the portfolios of other instruments of lending. As of June 1996 the Bank's portfolio included 52 ongoing FILs. Of these, 15 FILs are formally rated as having a problem (that is, their rating is "unsatisfactory" for development objectives or implementation progress or both). In addition, six projects are classified as potential problem projects. These 21 FILs are classified "at risk" and make up 40 percent of all FILs in the portfolio. See World Bank (1997c).

8. The 19 countries are: Bangladesh, Bolivia, Chile, Côte d'Ivoire, Ghana, Indonesia, Kenya, Korea, Malaysia, Mexico, Morocco, Pakistan, the Philippines, Poland, Senegal, Tanzania, Tunisia, Turkey, and Venezuela.

9. This section draws on Cull (1997). Here, we consider only the last Bank financial sector operation in each country.

10. The five countries taken out of the original sample are: China, India, Indonesia, Poland, and Tanzania.

11. The rationale for a negative relationship between inflation and DBPC and M2/GDP is as follows: Gertler and Rose (1994) find an empirically-strong positive relationship between higher per capita income and depth of the financial system as measured by DBPC/GDP. On the basis of this, it is presumed that if DBPC/GDP ratio is initially low, that is, the financial system is underdeveloped, then M2/GDP should rise if a FSL program is implemented successfully. There will be a negative relationship between the initial condition of DBPC/GDP and M2/GDP after three years of FSL. The negative relationship between low inflation as an initial condition and high M2/GDP after a successful FSL is self-explanatory. For details, see R. Cull (1997).

12. In one country (Bolivia) the outcome of the reform program was satisfactory, while the performance of the real sector remained unsatisfactory. The gains from financial sector reform might have been transmitted to the real economy with a time-lag longer than the period under review because of institutional inertia or financial institutions' failure to respond rapidly to market signals.

Chapter 3

1. This theme is reflected in the Bank's Operational Manual Statement (OMS 3.73), which applied to FILs approved before February 1992, when OD 8.30 was issued. The SADs follow OD 8.30, even those approved before its issue.

2. FSLs include SADs, as well as large financial sector components in SALs and TALs.

3. In carrying out this analysis, we referred to SARs and subsequent audit documents (PCRs, ICRs, PARs) and to the relevant ESW. Financial sector issues are also occasionally raised in structural adjustment and sector adjustment loan reports.

4. One FIL began a few months before 1982 and nine FSLs after 1992. The nine FSLs, as ongoing cases, are excluded from this analysis.

5. SALs, however, may include both public enterprise and financial sector reforms.

Chapter 4

1. For the purposes of this chapter a *financial crisis* is defined as a situation in which a significant proportion of financial institutions have their liabilities exceeding the market value of their assets, leading to runs, the collapse of some financial firms, and government intervention. A financial crisis, then, is a situation in which an increase in the share of nonperforming loans, mounting losses (because of foreign exchange exposure, interest rate mismatch, contingent liabilities), and a decline in the value of assets cause systemic solvency problems in a financial system and lead to liquidations, mergers, or restructuring.

2. A caveat: the aggregated index is an unweighted sum of indicators, and several of the indicators are not independent of each other, so the FFI has limitations. Demirgüç-Kunt and Detragiache (1997) developed a more selective approach, using an econometric model to estimate the probability of a banking crisis in which real interest rates and inflation are highly significant in all specifications. But the exchange rate does not have an independent effect once inflation and terms of trade are controlled for. The fiscal surplus is also not significant. Although we fully acknowledge the merits of this approach for predicting financial crises, we prefer to rely upon a more extensive set of macroeconomic and microeconomic indicators for assessing ex post the impact of Bank intervention.

Chapter 5

1. More general results on the positive impact of ESW on the quality of Bank projects can be found in a recent study by Klaus Deininger, Lyn Squire, and Swati Basu (1997).

2. The work carried out in the Bank by Caprio, Hanson and Associates (1994) showed that in general financial reform has positive efficiency effects on firms.

3. Strong Bank performance is defined here as satisfactory performance at project identification, appraisal, and implementation. Criteria to assess Bank performance are (1) at identification/preparation, the degree of involvement of the government and beneficiaries, the project's consistency with the Bank's country strategy, the extent to which the project is grounded in economic and sector work; (2) at appraisal, the quality of technical, financial, and institutional capacities analysis; the incorporation of lessons learned; the readiness of implementation; and the suitability of the lending instrument; and (3) for supervision, the quality of reporting on the progress of project implementation, the capacity to assess implementation problems, the quality of advice given to the implementing agency, the degree of enforcement of loan covenants, and the flexibility in suggesting modifications.

4. Although the cases of ICICI in India and NDB in Sri Lanka suggest that it can be done.

Chapter 6

1. World Bank (1995b) adds three more dimensions to the political economy: political acceptability, feasibility, and credibility of reforms.

Notes

1. This section draws on Cull (1997). In this section only the latest Bank financial sector operation in each country is considered for the statistical and econometric analysis. For reasons of data availability, five countries have been taken out of the original sample (China, India, Indonesia, Poland, and Tanzania).

2. Robust growth results, the focus of Levine and Renelt (1992), are also found in the institutional work of Knack and Keefer (1995).

3. Other policy variables achieved significance with the predicted sign (recapitalization, strengthening of bank supervision practices) when entered in the regressions one-by-one (Cull 1997).

4. Additional conclusions from regressions and data analysis not included here are found in Cull (1997).

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ANNEX TABLE 1.1: LIST OF 88 FINANCIAL SECTOR ADJUSTMENT-RELATED PROJECTS (FSLs): FY85–FY96

LOAN/ CREDIT NUMBER	PROJECT ID	COUNTRY	REGION	PROJECT NAME	FISCAL YEAR	PROJECT STATUS	MAJOR LENDING INSTRU-MENT	LOAN AMOUNT (Million)
C22830	110	Benin	AFR	Structural Adjustment Loan II	1991	Completed	SAL	55
C24720	289	Burkina Faso	AFR	Private Sector Assistance	1993	Active	SIL	7
C23030	1199	Côte d'Ivoire	AFR	Financial Sector Adjustment Program	1992	Completed	SAD	200
C19110	892	Ghana	AFR	Financial Sector Adjustment Credit I	1988	Completed	SAD	100
C23180	911	Ghana	AFR	Financial Sector Adjustment Credit II	1992	Active	SAD	100
C21480	1050	Guinea	AFR	Private Sector Promotion	1990	Completed	SAD	50
C26530	1078	Guinea	AFR	Financial Sector Operation	1995	Active	SAL	23
C17980	983	Guinea Bissau	AFR	Structural Adjustment Loan	1987	Completed	SAL	15
C20490	1310	Kenya	AFR	Financial Sector Operation	1989	Completed	SAD	120
C18340	1511	Madagascar	AFR	Industry and Trade Policy Adjustment Credit	1987	Completed	SAD	83
C21040	1540	Madagascar	AFR	Financial Sector and Private Enterprise Development Proj.	1990	Active	SIM	48
C22210	1655	Malawi	AFR	Financial Sector and Enterprise Development Project	1991	Active	FIL	32
C27260	1866	Mauritania	AFR	Private Sector Development Program	1995	Active	SAD	30
C26070	1811	Mozambique	AFR	Financial Sector Capacity-building Project	1994	Active	TAL	9
C18020	2340	Senegal	AFR	Structural Adjustment Loan III	1987	Completed	SAL	93
C20770	2355	Senegal	AFR	Financial Sector Adjustment Program	1990	Completed	SAD	45
C23080	2809	Tanzania	AFR	Financial Sector Adjustment Credit	1992	Completed	SAD	200
C27710	35620	Tanzania	AFR	Financial Institutions Development Project	1996	Active	SIL	10.9
C24960	2962	Uganda	AFR	Financial Sector Adjustment Credit	1993	Active	SAD	100
C24230	3623	China	EAP	Financial Sector Technical Assistance Project	1993	Active	TAL	60
L29370	3962	Indonesia	EAP	Second Trade Policy Adjustment Loan	1988	Completed	SAD	300
L30800	3974	Indonesia	EAP	Private Sector Development Loan	1989	Completed	SAL	350
L32670	3994	Indonesia	EAP	Private Sector Development Loan II	1991	Completed	SAL	250
L35260	3970	Indonesia	EAP	Financial Sector Development Project	1993	Active	FIL	307
L2571	4120	Korea	EAP	Industrial Finance Project II	1985	Completed	SAD	222
C20370	4199	Lao, PDR	EAP	Structural Adjustment Credit	1989	Completed	SAL	40
L2770/1	4281	Malaysia	EAP	Development Finance Project	1987	Completed	SIL	65
L30490	4517	Philippines	EAP	Financial Sector Adjustment Loan	1989	Completed	SAD	300
L35850	8278	Armenia	ECA	Institution-building Loan	1993	Active	TAL	12
L33970	8308	Bulgaria	ECA	Structural Adjustment Loan I	1992	Completed	SAL	250
L38030	8401	Estonia	ECA	Financial Institutions Development Project	1995	Active	FIL	10
L31910	8478	Hungary	ECA	Financial Systems Modernization Project	1990	Active	SIM	66
L33470	8492	Hungary	ECA	Structural Adjustment Loan II	1991	Completed	SAL	250
L38670	8508	Kazakstan	ECA	Finance and Enterprise Development Project	1995	Active	SIL	62
L37950	8527	Latvia	ECA	Enterprise and Financial Sector Restructuring Project	1994	Active	SIL	25

ANNEX TABLE 1.1: (CONTINUED)

LOAN/ CREDIT NUMBER	PROJECT ID	COUNTRY	REGION	PROJECT NAME	FISCAL YEAR	PROJECT STATUS	MAJOR LENDING INSTRU-MENT	LOAN AMOUNT (Million)
L3695	8529	Latvia	ECA	Agricultural Development Project	1995	Active	FIL	35
L38660	8536	Lithuania	ECA	Enterprise and Financial Sector Assistance Project	1995	Active	FIL	25
C27210	8409	Macedonia	ECA	Financial and Enterprise Sector Adjustment Credit	1995	Active	SAD	85
L32470	8585	Poland	ECA	Financial Institutions Development Project	1991	Active	SAD	200
L33410	8588	Poland	ECA	Structural Adjustment Loan I	1991	Completed	SAL	300
L35990	8589	Poland	ECA	Enterprise and Financial Sector Adjustment Loan	1993	Active	SAL	450
L37340	8828	Russia	ECA	Financial Institutions Development Project	1994	Completed	SIL	200
L36660	8848	Slovak Republic	ECA	Economic Recovery Loan	1994	Completed	SAL	80
L36360	8854	Slovenia	ECA	Enterprise and Financial Sector Adjustment Loan	1994	Active	SAD	80
L27140	8962	Turkey	ECA	Financial Sector Adjustment Loan	1986	Completed	SAD	300
L29640	8987	Turkey	ECA	Financial Sector Adjustment Loan II	1988	Completed	SAD	400
L35580	6047	Argentina	LAC	Financial Sector Adjustment Loan	1993	Completed	SAL	400
L37090	5988	Argentina	LAC	Capital Market Development Project	1994	Active	FIL	500
L37100	6062	Argentina	LAC	Capital Market Technical Assistance Project	1994	Active	TAL	8.5
L3926	40904	Argentina	LAC	Bank Reform Loan	1996	Active	SAD	500
C18090	6160	Bolivia	LAC	Public Financial Management Operation I	1987	Completed	TAL	11.5
C19250	6159	Bolivia	LAC	Financial Sector Adjustment Project	1988	Completed	SAD	70
C22980	6184	Bolivia	LAC	Structural Adjustment Program	1992	Completed	SAL	40
L26250	6627	Chile	LAC	Structural Adjustment Loan	1986	Completed	SAL	250
L27670	6628	Chile	LAC	Structural Adjustment Loan II	1987	Completed	SAL	250
L28920	6633	Chile	LAC	Structural Adjustment Loan III	1988	Completed	SAL	250
L31430	6634	Chile	LAC	Financial Markets Operation	1990	Completed	FIL	130
L25180	6923	Costa Rica	LAC	Structural Adjustment Loan I	1985	Completed	SAL	80
L28970	7103	Ecuador	LAC	Financial Sector Adjustment Operation	1988	Completed	SAD	100
L36090	7098	Ecuador	LAC	Private Sector Development Project	1993	Completed	FIL	75
L35330	7210	Guatemala	LAC	Economic Modernization Loan	1993	Completed	SAL	120
C26690	7259	Guyana	LAC	Financial Sector and Business Environment Project	1995	Active	SAD	15.5
C27460	34605	Guyana	LAC	Private Sector Development Adjustment Credit	1995	Active	TAL	3.5
L29900	7383	Honduras	LAC	Structural Adjustment Loan I	1989	Completed	SAL	50
L28480	7445	Jamaica	LAC	Trade and Financial Sector Adjustment Operation I	1987	Completed	SAD	40
L33030	7469	Jamaica	LAC	Trade and Financial Sector Adjustment Operation II	1991	Completed	SAD	30
L30850	7691	Mexico	LAC	Financial Sector Adjustment Loan	1989	Completed	SAD	500
L38380	40497	Mexico	LAC	Financial Sector Technical Assistance Project	1995	Active	SAD	1,000
L39110	34161	Mexico	LAC	Financial Sector Restructuring Adjustment Program	1995	Active	TAL	23.6
C23020	7781	Nicaragua	LAC	Economic Recovery Credit	1992	Completed	SAL	110

ANNEX TABLE 1.1: (CONTINUED)

L37740	7917	Paraguay	LAC	Private Sector Development Project	1995	Active	SIL	50
L34890	8050	Peru	LAC	Financial Sector Adjustment Loan	1992	Active	SAD	400
L30810	8145	Uruguay	LAC	Structural Adjustment Loan II	1989	Completed	SAL	140
L32240	8208	Venezuela	LAC	Financial Sector Adjustment Loan	1990	Completed	SAD	300
L33520	4963	Algeria	MNA	Enterprise and Financial Sector Adjustment Loan	1991	Completed	SAD	350
L38340	35704	Algeria	MNA	Economic Rehabilitation Support Loan	1995	Active	SAL	150
C24020	5167	Egypt	MNA	Technical Assistance Project for Privatization and Enterprise and Banking Sector Reforms	1992	Active	TAL	9
L26040	5414	Morocco	MNA	Industrial Trade Policy Adjustment Loan	1986	Completed	SAD	200
L33650	5495	Morocco	MNA	Financial Sector Development Project	1991	Active	SAD	235
L39280	5522	Morocco	MNA	Financial Sector Development Project	1996	Active	SAD	250
L29620	5718	Tunisia	MNA	Structural Adjustment Loan I	1988	Completed	SAL	150
L34240	5742	Tunisia	MNA	Economic and Financial Reforms Support Loan	1992	Completed	SAL	250
C21520	9528	Bangladesh	SAS	Financial Sector Adjustment Credit	1990	Completed	SAD	175
L38560	10563	India	SAS	Financial Sector Development Project	1995	Active	FIL	700
C20460	10334	Nepal	SAS	Structural Adjustment Credit II	1989	Completed	SAL	60
L30290	10327	Pakistan	SAS	Financial Sector Adjustment Loan	1989	Completed	SAD	150
L38080	10470	Pakistan	SAS	Financial Sector Deepening and Intermediation Project	1995	Active	FIL	216
C24840	10419	Sri Lanka	SAS	Private Finance Development Project	1993	Active	SIL	60

ANNEX TABLE 1.2: BANK ESW RELATED TO FINANCIAL SECTOR REFORM: FY81–FY95

REPORT NO.	REGION	COUNTRY	TITLE	TYPE	DATE
7690	AFR	Botswana	Financial Policies for Diversified Growth	SR	8/1/89
10978	AFR	Burundi	A Financial Sector Review	SR	7/1/92
4066	AFR	Burundi	Financial Sector Report	SR	7/1/82
6028	AFR	Cameroon	Financial Sector Report	SR	6/1/86
3113	AFR	Côte D'Ivoire	Finance in the Development of the Ivory Coast	ER	12/1/81
9427	AFR	Ethopia	Financial Sector Review	SR	6/1/91
4766	AFR	Gambia	Financial Sector Review	SR	10/1/83
13423	AFR	Ghana	Financial Sector Review: Bringing Savers and Investors Together	SR	12/29/94
8911	AFR	Ghana	Towards a Dynamic Investment Reponse	SR	10/1/90
9809	AFR	Guinea Bissau	Private Sector Development Study	SR	12/1/91
11438	AFR	Kenya	Tapping Kenya's Potential: A PSD Strategy	SR	12/1/92
5619	AFR	Kenya	Agricultural Credit Policy Review	SR	8/1/85
5246	AFR	Kenya	Industrial Finance	SR	4/1/85
8021	AFR	Lesotho	Financial Sector Review	SR	4/1/90
9817	AFR	Madagascar	Financial Policies for Diversified Growth	SR	3/1/92
10057	AFR	Madagascar	Rural Finance Sector Review	SR	2/1/92
9009	AFR	Malawi	Financial Policies for Sustainable Growth	SR	2/19/92
10443	AFR	Mauritius	Financial Sector Review	SR	6/1/92
10269	AFR	Mozambique	Financial Sector Study	SR	9/1/92
13911	AFR	Nigeria	The Nigerian Rural Financial System: Assessment and Recommendations	SR	1/26/95
12781	AFR	Nigeria	The Nigerian Banking System: Financial Assessment and Key Issues for Distress Resolution	SR	3/16/94
9864	AFR	Nigeria	The Financial Sector: Issues and Options	SR	10/1/91
4051	AFR	Nigeria	Financial Intermediation	SR	2/1/83
8934	AFR	Rwanda	Financial Sector Review	SR	5/1/91
4457	AFR	Sierra Leone	Financial Sector Study	SR	2/1/84
9099	AFR	Uganda	Financial Sector Review	SR	5/7/91
8498	AFR	Zaire	Private Sector Incentives: Current Policies and Proposals for Reform	ER	3/1/90
12387	AFR	Zambia	Financial Sector Development	SR	10/1/93
13492	EAP	China	Financial Sector Reforms: Current Status and Issues	SR	9/6/94
8415	EAP	China	Financial Sector Review: Financial Policies and Institutional Development	ER	6/29/90
13112	EAP	Indonesia	Non-bank Financial Sector Study	SR	6/7/94
9498	EAP	Indonesia	Developing Private Enterprise	SR	5/9/91
8159	EAP	Indonesia	Financial Sector Report	SR	5/1/90
5501	EAP	Indonesia	Policies and Prospects for Long-term Financial Development	ER	7/1/85

ANNEX TABLE 1.2: (CONTINUED)

4566	EAP	Indonesia	Rural Credit Study	SR	6/1/83
11373	EAP	Korea	Financial Sector Study	SR	7/1/93
3288	EAP	Korea	Financial Sector Report	SR	11/1/80
6530	EAP	Malaysia	A Study of Development Finance Institutions	SR	1/1/87
10053	EAP	Philippines	Capital Market Study	ER	2/1/92
7177	EAP	Philippines	Financial Sector Study	SR	8/1/88
8403	EAP	Thailand	Financial Sector Study	SR	5/25/90
4085	EAP	Thailand	Perspectives for Financial Reform	SR	7/1/83
13153	EAP	Vietnam	Financial Sector Review: An Agenda for Financial Sector Development	SR	3/1/95
9223	EAP	Vietnam	Transforming A State-owned Financial System: A Financial Sector Study	SR	4/15/91
6941	ECA	Hungary	Development and Reform of Financial Markets	SR	6/1/89
11818	ECA	Russia	The Banking System in the Transition	SR	9/1/93
4459	ECA	Turkey	Special Economic Report: Policies for the Financial Sector	ER	9/1/83
7869	ECA	Yugoslavia	Financial Sector Restructuring: Policies and Priorities	SR	11/1/89
12963	LAC	Argentina	Capital Market Study	SR	12/21/94
11673	LAC	Argentina	Financial Sector Review	SR	11/1/89
7176	LAC	Argentina	Securities Markets and Main Non-bank Financial Institutions	SR	3/1/88
6418	LAC	Argentina	Banking Sector: The Need for Reform	SR	12/1/86
13873	LAC	Bolivia	How Legal Restrictions on Collateral Limit Access to Credit in Bolivia	SR	12/1/94
11075	LAC	Bolivia	Restructuring for Growth: The Remaining Agenda for PE Reform and PSD	ER	9/1/92
6765	LAC	Bolivia	Banking Sector Study	SR	11/1/88
11581	LAC	Brazil	The Development of the Brazilian Capital Market	SR	10/7/94
9458	LAC	Brazil	Capital Markets Issues	SR	3/1/91
7725	LAC	Brazil	Selected Issues of the Financial Sector	SR	3/1/90
8247	LAC	Brazil	The Dilemma of Brazil's State Banking System	SR	1/1/90
2790	LAC	Brazil	Financial Systems Review	SR	11/1/80
7737	LAC	Chile	Industrial Finance: Sector Report	SR	1/1/89
11724	LAC	Colombia	Financial Sector Reform	SR	6/1/93
8276	LAC	Colombia	Financial Sector Strategy Paper	SR	12/1/89
6337	LAC	Colombia	Commercial and Development Banks	SR	3/1/86
4274	LAC	Colombia	The Colombian Investment Banking Sector and Related Financial Sector Issues	SR	8/1/83
6821	LAC	Costa Rica	Selected Financial Sector Issues	SR	3/1/88
8601	LAC	Dominican Republic	Financial Sector Strategy	ER	4/1/90
5270	LAC	Ecuador	Brief Review of the Financial Sector	SR	4/1/85
7819	LAC	Guatemala	Financial Sector Report	ER	7/1/90

ANNEX TABLE 1.2: (CONTINUED)

REPORT NO.	REGION	COUNTRY	TITLE	TYPE	DATE
11705	LAC	Guyana	Private Sector Development	SR	6/1/93
10307	LAC	Guyana	From Economic Recovery to Sustained Growth	ER	4/1/92
7363	LAC	Honduras	Financial Sector Survey	ER	7/1/88
11823	LAC	Mexico	Country Economic Memorandum	ER	5/16/94
9198	LAC	Mexico	Development Banks Issues: A Framework of Analysis and Suggested Bank Strategy	SR	12/1/90
4316	LAC	Peru	Brief Review of the Financial Sector	SR	2/1/83
9373	LAC	Trinidad and Tobago	Financial Sector Study	SR	5/1/91
8899	LAC	Uruguay	Financial Sector Development and Restructuring Issues	ER	6/1/90
10393	LAC	Venezuela	Term Financing and Capital Markets Development	SR	2/1/92
11940	MNA	Algeria	Capital Markets Study	ER	6/1/93
7241	MNA	Algeria	The Algerian Financial System	SR	5/1/88
2981	MNA	Algeria	Le Financement Des Enterprises Et Le Systeme Bancaire	SR	4/10/80
10790	MNA	Egypt	Financial Policy for Adjustment and Growth	SR	9/1/93
10337	MNA	Egypt	Reform and Development of the Securities Market: Recommendation to the Government	SR	2/1/92
13153	MNA	Iran	Capital Markets and Financial Institutions	SR	9/28/94
13183	MNA	Lebanon	Financial Policy for Stabilization, Reconstruction, and Development	ER	7/27/94
11557	MNA	Morocco	Developing Private Industry in Morocco	SR	7/1/93
4957	MNA	Morocco	Financial Sector Study	SR	12/1/84
5263	MNA	Tunisia	Financial Sector Report	SR	12/1/85
6901	SAS	Bangladesh	A Program for Financial Sector Reform	SR	12/1/87
4098	SAS	Bangladesh	Financial Sector Review	SR	9/1/82
10489	SAS	India	Stabilizing and Reforming the Economy	ER	5/1/92
8264	SAS	India	Financial Sector Report: Consolidation of the Financial System	SR	6/1/90
6661	SAS	India	Credit and Capital Markets Study	SR	2/1/87
11637	SAS	Pakistan	Restructuring the Financial System: Building on Financial Reform	ER	4/1/93
7049	SAS	Pakistan	Financial Sector Review	SR	12/1/87
9339	SAS	Sri Lanka	Financial Institutions Study	SR	2/1/91

ANNEX TABLE 2.1: LIST OF SAMPLE FINANCIAL SECTOR ADJUSTMENT-RELATED OPERATIONS (FSLs) FOR 23 COUNTRIES: FY85–FY96

LOAN/ CREDIT NUMBER	PROJECT ID	COUNTRY	REGION	PROJECT NAME	FISCAL YEAR	PROJECT STATUS	MAJOR LENDING INSTRU-MENT	LOAN AMOUNT (Million)
C23030	1199	Côte d'Ivoire	AFR	Financial Sector Adjustment Program	1992	Completed	SAD	200
C19110	892	Ghana	AFR	Financial Sector Adjustment Credit I	1988	Completed	SAD	100
C23180	911	Ghana	AFR	Financial Sector Adjustment Credit II	1992	Active	SAD	100
C20490	1310	Kenya	AFR	Financial Sector Operation	1989	Completed	SAD	120
C22210	1655	Malawi	AFR	Financial Sector and Enterprise Development Project	1991	Active	FIL	32
C18020	2340	Senegal	AFR	Structural Adjustment Loan III	1987	Completed	SAL	93
C20770	2355	Senegal	AFR	Financial Sector Adjustment Program	1990	Completed	SAD	45
C23080	2809	Tanzania	AFR	Financial Sector Adjustment Credit	1992	Completed	SAD	200
C27710	35620	Tanzania	AFR	Financial Institutions Development Project	1996	Active	SIL	10.9
C24230	3623	China	EAP	Financial Sector Technical Assistance Project	1993	Active	TAL	60
L29370	3962	Indonesia	EAP	Second Trade Policy Adjustment Loan	1988	Completed	SAD	300
L30800	3974	Indonesia	EAP	Private Sector Development Loan I	1989	Completed	SAL	350
L32670	3994	Indonesia	EAP	Private Sector Development Loan II	1991	Completed	SAL	250
L35260	3970	Indonesia	EAP	Financial Sector Development Project	1993	Active	FIL	307
L2571	4120	Korea	EAP	Industrial Finance Project II	1985	Completed	SAD	222
L2770/1	4281	Malaysia	EAP	Development Finance Project	1987	Completed	SIL	65
L30490	4517	Philippines	EAP	Financial Sector Adjustment Loan	1989	Completed	SAD	300
L32470	8585	Poland	ECA	Financial Institutions Development Project	1991	Active	SAD	200
L33410	8588	Poland	ECA	Structural Adjustment Loan I	1991	Completed	SAL	300
L35990	8589	Poland	ECA	Enterprise and Financial Sector Adjustment Loan	1993	Active	SAL	450
L27140	8962	Turkey	ECA	Financial Sector Adjustment Loan	1986	Completed	SAD	300
L29640	8987	Turkey	ECA	Financial Sector Adjustment Loan II	1988	Completed	SAD	400
C18090	6160	Bolivia	LAC	Public Financial Management Operation I	1987	Completed	TAL	11.5
C19250	6159	Bolivia	LAC	Financial Sector Adjustment Project	1988	Completed	SAD	70
C22980	6184	Bolivia	LAC	Structural Adjustment Program	1992	Completed	SAL	40
L26250	6627	Chile	LAC	Structural Adjustment Loan I	1986	Completed	SAL	250
L27670	6628	Chile	LAC	Structural Adjustment Loan II	1987	Completed	SAL	250
L28920	6633	Chile	LAC	Structural Adjustment Loan III	1988	Completed	SAL	250
L31430	6634	Chile	LAC	Financial Markets Operation	1990	Completed	FIL	130
L30850	7691	Mexico	LAC	Financial Sector Adjustment Loan	1989	Completed	SAD	500
L38380	40497	Mexico	LAC	Financial Sector Technical Assistance Project	1995	Active	SAD	1000
L39110	34161	Mexico	LAC	Financial Sector Restructuring Adjustment Program	1995	Active	TAL	23.6
L32240	8208	Venezuela	LAC	Financial Sector Adjustment Loan	1990	Completed	SAD	300
C24020	5167	Egypt	MNA	Technical Assistance Project for Privatization and Enterprise and Banking Sector Reforms	1992	Active	TAL	9
L26040	5414	Morocco	MNA	Industrial Trade Policy Adjustment Loan	1986	Completed	SAD	200
L33650	5495	Morocco	MNA	Financial Sector Development Project	1991	Active	SAD	235
L39280	5522	Morocco	MNA	Financial Sector Development Project	1996	Active	SAD	250
L29620	5718	Tunisia	MNA	Structural Adjustment Loan I	1988	Completed	SAL	150
L34240	5742	Tunisia	MNA	Economic and Financial Reforms Support Loan	1992	Completed	SAL	250
C21520	9528	Bangladesh	SAS	Financial Sector Adjustment Credit	1990	Completed	SAD	175
L38560	10563	India	SAS	Financial Sector Development Project	1995	Active	FIL	700
L30290	10327	Pakistan	SAS	Financial Sector Adjustment Loan	1989	Completed	SAD	150
L38080	10470	Pakistan	SAS	Financial Sector Deepening and Intermediation Project	1995	Active	FIL	216

ANNEX 2.2: DETERMINANTS OF PROJECT PERFORMANCE: THE EMPIRICAL EVIDENCE

An econometric analysis was carried out to identify the main factors affecting outcome. For reasons of data availability, the analysis was limited to a sample of 18 countries. The analysis was applied to a limited number of specific factors, and to only a few outcomes. In spite of these limitations, the analysis provides useful first indications of the relative magnitude of the effects, and paves the way for further quantitative analysis in this complex area.[1]

Regression Analysis

Hypothesis

The purpose of this regression analysis is to control simultaneously for sectoral and macroeconomic initial conditions, and to help identify salient factors affecting outcome. The explanatory variables selected to reflect initial conditions are inflation, to indicate the level of macrostability, and deposit bank credit to the private sector (DBPC) as a percentage of GDP, to reflect the level of financial sector development. The growth literature provides another important candidate for inclusion: international trade, here measured as the ratio of imports to GDP (IMP/GDP).

The economic literature points to initial real per capita GDP as another explanatory variable. But Gertler and Rose (1994) found that countries with high per capita GDP at the time of intervention also had relatively well-developed financial systems, as measured by DBPC/GDP. In the specifications that follow, therefore, we use DBPC/GDP in place of per capita income.

With respect to initial conditions, explanatory variables will include the inflation rate, IMP/GDP, and DBPC/GDP, all measured in the year of the first policy change supported by the FSL. The remaining explanatory variables are also institutional and capture features specific to Bank-supported policies, according to the classifications of the "score card" (Annex Table 3.1). These latter variables (interest rate distortion, non-bank financial regulation and prudential regulation) are entered in the regressions one-by-one to identify their specific contribution to outcome.

Results

Caveat. Given the data limitations and the multiple factors that affect financial sector performance in the years following policy changes, the results are less robust than recent ones from the growth literature. While most of those studies use samples of 50-100 countries, the sample here is much smaller.[2] In the other studies, growth rates and explanatory variables are averaged over long periods. In this analysis many of the policy reforms supported by the Bank were undertaken in 1993-96. Complete sets of IFS data are available through 1995 only, although the benefits of policy changes are expected to operate with at least a two or three-year lag. The potential sample is accordingly cut substantially. With so few degrees of freedom, the results should be interpreted with caution.

As the previous growth analysis indicated, initial financial sector and macroeconomic conditions had implications for the change in outcome (Table 2.8). The regression results essentially restate that countries with relatively underdeveloped financial systems and low inflation experienced the largest postintervention improvements, as measured by M2/GDP.

At least two major policy variables had significant coefficients in the regression exercise; interest rate distortions and bank prudential regulations, with the latter having the largest effect on outcome.[3] The relatively large positive coefficient on the prudential regulations dummy variable and its statistical significance suggest that development of the financial sector has been substantially linked with World Bank support to the strengthening of the regulatory framework.

Overall, the regression analysis indicates that financial deepening, measured as M2/GDP, was positively associated with low inflation and an initially underdeveloped financial sector. Controlling for initial macroeconomic and financial sector conditions, certain reforms, especially strengthening of prudential regulations, were associated with relatively large increases in M2/GDP.[4]

OUTCOME CHANGE IN FINANCIAL DEEPENING (M2/GDP)-REGRESSION RESULTS

EXPLANATORY VARIABLE	MACRO + FINANCIAL + TRADE + INTEREST RATE DISTORTION	MACRO + FINANCIAL + TRADE + NONBANK FINANCIAL REGULATION	MACRO + FINANCIAL + TRADE + PRUDENTIAL REGULATIONS
Constant	0.92	3.27	-1.19
	(0.20)	(0.64)	(0.24)
Group I	9.85	7.87	7.46
	(2.90)	(1.95)	(2.36)
Group II	1.37	3.52	3.14
	(0.38)	(0.94)	(0.96)
IMP/GDP	-0.16	-0.14	-0.8
	(1.06)	(0.83)	(0.55)
Removal of interest	5.13		
Rate distortions	(1.67)		
Non-bank financial regulation		0.40	
		(0.12)	
Prudential regulations			5.26
			(1.93)
Adjusted R-squared	0.293	0.141	0.331
Number of observations	18.000	18.000	18.000

Note: t-statistics in parentheses; group dummies are defined below:
The intercept term for Group III is reflected by the value of the constant term in the regression.
Group I - Inflation < 25 %; Deposit Bank Private Credits < 20 % of GDP
Group II- Inflation >25 %; Deposit Bank Private Credits < 20 % of GDP
Group III- Inflation < 25 %; Deposit Bank Private Credits >20 % of GDP

ANNEX TABLE 3.1: SAMPLE SCORECARD FOR INSTITUTIONAL DEVELOPMENT

COUNTRY: **REGION:** **INCOME LEVEL:**

Bank Program:
Approval year:
Closing year:
Objectives:
Instruments:

INSTITUTIONAL PERFORMANCE	INITIAL CONDITION	IMPLEMENTATION RECORD	OUTCOME	SUSTAINABILITY
I. *Financial System Infrastructure*				
1. Changes in central bank law				
2. Changes in banking law				
3. Changes in laws governing financial (non-bank) institutions				
4. Capital and money market regulations				
5. Accounting and audit standards				
6. Collateral laws and regulations				
7. Payments system				
II. *Strengthen Institutions*				
1. Supervision practices of central bank				
2. Restructuring, privatization, or strengthening of banks or both				
III. *Sustainability of Banks*				
1. Overall rating on sustainability				
a. Governance				
b. Management				
c. Technical capability				
d. Resource mobilization				
e. WB loan disbursement				
f. Portfolio quality				
g. Financial performance				
h. Risk avoidance				
i. Subsidization				
IV. *Technical Assistance*				
Total score				
Rating				
Borrower Performance				
Bank Performance				

ANNEX TABLE 3.2: LIST OF 24 FINANCIAL SECTOR ADJUSTMENT-RELATED PROJECTS (FSLs) FOR INSTITUTIONAL DEVELOPMENT ANALYSIS

LOAN/CREDIT NUMBER	REGION	COUNTRY	TITLE	DATE
L3558	LAC	Argentina	Financial Sector Adjustment Loan	2/16/93
C2152	SAS	Bangladesh	Financial Sector Adjustment Credit	6/5/90
C1809	LAC	Bolivia	Public Financial Management	5/28/87
C1925	LAC	Bolivia	Financial Sector Adjustment Credit	6/16/88
C2298	LAC	Bolivia	Structural Adjustment Loan II	9/17/91
L2625	LAC	Chile	Structural Adjustment Loan	10/22/85
L2767	LAC	Chile	Second Structural Adjustment Loan	11/20/86
L2892	LAC	Chile	Third Structural Adjustment Loan	12/15/87
L3143	LAC	Chile	Financial Markets Project	12/14/89
C2303	AFR	Côte d'Ivoire	Financial Sector Adjustment Credit	10/1/91
L2897	LAC	Ecuador	Financial Sector Adjustment Loan	12/22/87
C1911	AFR	Ghana	Financial Sector Adjustment Credit	5/31/88
C2049	AFR	Kenya	Financial Sector Adjustment Credit	6/27/89
L3085	LAC	Mexico	Financial Sector Adjustment Loan	6/13/89
L3365	MNA	Morocco	Financial Sector Development Project	6/3/91
L3029	SAS	Pakistan	Financial Sector Adjustment Loan	3/28/89
L3049	EAP	Philippines	Financial Sector Adjustment Loan	5/4/89
C1802	AFR	Senegal	Third Structural Adjustment Program	5/21/87
C2077	AFR	Senegal	Financial Sector Adjustment Credit	12/18/89
C2308	AFR	Tanzania	Financial Sector Adjustment Credit	10/17/91
L3424	MNA	Tunisia	Economic and Financial Reforms	12/12/91
L2714	ECA	Turkey	First Financial Sector Adjustment Loan	6/10/86
L2964	ECA	Turkey	Second Financial Sector Adjustment Loan	6/21/88
L3224	LAC	Venezuela	Financial Sector Adjustment Loan	6/12/90

ANNEX TABLE 3.3: LIST OF 58 FINANCIAL INTERMEDIARY LOANS (FILs) FOR INSTITUTIONAL DEVELOPMENT ANALYSIS

LOAN/CREDIT NUMBER	REGION	COUNTRY	TITLE	DATE
L2793	LAC	Argentina	Small and Medium-scale Industrial Credit	11-Jan-95
L2063	LAC	Argentina	Second Industrial Credit Project	01-Dec-81
C1117	SAS	Bangladesh	Second Shilpa Bank Project	03-Dec-90
L2434/C1491	EAP	China	China Investment Bank 2 Project	03-Oct-91
L2226/C1313	EAP	China	China Investment Bank 1 Project	03-Oct-91
L2659/C1663	EAP	China	China Investment Bank 3 Project	03-Oct-91
C1763/L2783	EAP	China	Industrial Credit 4 Project	03-Mar-87
L3075	EAP	China	Industrial Credit 5 Project	30-May-89
L2673	LAC	Ecuador	Small-scale Enterprise Credit III	11-Mar-94
L2672	LAC	Ecuador	Industrial Finance Project	14-Mar-92
L2096	LAC	Ecuador	Fifth Development Banking Project	17-Dec-90
L2221	LAC	Ecuador	Small-scale Enterprise Credit I	29-Jun-89
L1879	LAC	Ecuador	Small-scale Enterprise Credit II	29-Jun-89
L2074	MNA	Egypt	Fifth Development Industrial Bank	03-Oct-91
L1842	MNA	Egypt	Misr Iran Development Bank Project	04-May-90
L1804	MNA	Egypt	Development Finance Company	27-Jun-88
L2051	SAS	India	Thirteenth and Fourteenth Industrial Credit and Investment Corporation Projects	26-Jun-90
L1843	SAS	India	Thirteenth and Fourteenth Industrial Credit and Investment Corporation Projects	26-Jun-90
L2800	EAP	Indonesia	BRI/KUPEDES Small Credit Project	18-Apr-94
L2277	EAP	Indonesia	Fifth Bank Pembangunan Indonesia (BAPINDO) Project	16-Aug-91
L2430	EAP	Indonesia	Third Small-scale Enterprise Development Project	16-Apr-90
L2011	EAP	Indonesia	Small Enterprise Development Project	12-Jun-89
L1817	AFR	Kenya	Fourth Industrial Development Project	31-Dec-92
C1738	AFR	Kenya	Second Kenya Industrial Estates (KIE) Small-scale Industry Credit Project	16-Dec-92
L2309	EAP	Korea	Second Industrial Finance Project	30-Jun-93
L2144	EAP	Korea	Second Citizens National Bank and SME Project	25-Jun-93
L1933	EAP	Korea	Development Bank Project	26-Jun-90
L2004	EAP	Korea	Fourth Small and Medium Industry Bank Project	04-May-90
L1829	EAP	Korea	Citizens National Bank Project	05-Dec-86
L2515	EAP	Korea	Small and Medium Industry Project	16-Apr-85
L2571	EAP	Korea	Second Industrial Finance Project	06-Jun-85
C3221	AFR	Malawi	Financial Sector and Enterprise Development Project	25-Feb-91
L2770	EAP	Malaysia	Development Finance Project	27-Sep-93
L2471	EAP	Malaysia	Small-scale Enterprise Project	06-May-93

ANNEX TABLE 3.3: (CONTINUED)

L2325	LAC	Mexico	Second Small and Medium Enterprise Industry Development Project	30-Jun-94
L1881	LAC	Mexico	Third Small and Medium Enterprise Industry Development Project	30-Jun-94
L2747	LAC	Mexico	Industrial Technology Development Project	30-Jun-94
L2546	LAC	Mexico	Second Small and Medium Mining Development Project	30-Jun-94
L2142	LAC	Mexico	Capital Goods Industries Development Project	25-Sep-90
L1820	LAC	Mexico	Small and Medium Mining Development Project	17-May-90
L2487	MNA	Morocco	Electrical and Mechanical Industries Project	29-Jun-94
L2038	MNA	Morocco	Second Small-scale Industry Project	23-Apr-90
L2037	MNA	Morocco	Ninth Banque Nationale Pour Le Developpement Economique (BNDE) Project	26-Oct-89
L3365	MNA	Morocco	Financial Sector Development Project	03-Jun-91
L2648/C1646	SAS	Pakistan	Second Industrial Investment Project	10-Jun-94
L2380	SAS	Pakistan	Industrial Investment Credit	16-Jun-93
C1186	SAS	Pakistan	Second Industrial Development Bank Project	17-May-89
C1019	SAS	Pakistan	Eleventh Industrial Credit and Investment Corporation Project	01-Dec-86
L3038	EAP	Philippines	Fourth Small and Medium Industries Development Project	15-Mar-95
L3123	EAP	Philippines	Industrial Investment Credit Project	30-Jun-93
L1984	EAP	Philippines	Development Corporations and Small and Medium Industries I	21-Jun-90
L2169	EAP	Philippines	Development Corporations and Small and Medium Industries II	21-Jun-90
C1136	AFR	Senegal	Investment Promotion (Third SOFISEDIT) Project	04-Feb-91
L2522	MNA	Tunisia	Export Industries Project	06-Jan-94
L2647	ECA	Turkey	Small and Medium-scale Industry Project	01-Dec-93
L1998	ECA	Turkey	Industrial Credit Project	04-May-90
L2093	ECA	Turkey	Industrial Development Credit I	29-Jun-89
L1952	ECA	Turkey	Industrial Development Credit II	29-Jun-89

ANNEX TABLE 4.1: MACRO-FRAGILITY INDICATORS

INDICATORS	LINKS TO FINANCIAL FRAGILITY
1. Inflation rate (annual percent change in CPI)	A high and variable inflation environment generally adds to the fragility of the financial system by causing disintermediation and preventing the emergence of long-term debt contracts. A reasonable degree of price stability is essential for a strong and stable financial system. The fragility threshold level of inflation will probably vary from country-to-country and can only be determined by examining country experiences. However, casual observation suggests that inflation rates in excess of 20 percent are damaging to financial stability in most countries.
2. Fiscal balance (percent of GDP)	Large and persistent fiscal deficits create strong incentives for governments to repress the financial system, and often lead to excessively high real interest rates and high levels of nonperforming loans, thus adding to financial fragility. Fiscal deficits are particularly damaging when private saving rates are low.
3. Current account balance (percent of GDP)	Large current account deficits tend to damage the financial system, because they often lead to reserve losses, capital outflows, and excessive domestic and foreign borrowings. Recent evidence suggests that CADs in excess of 8 percent of GDP tend to be highly destabilizing for the economy and the financial systems.
4. Exchange rate position	Over-valued real exchange rates distort price incentives, put upward pressure on real interest rates, and lead to loan defaults. Dual exchange rate regimes. Flexible versus pegged or currency board regimes.
5. Real interest rates: a. Deposits b. Loans	Excessively high real interest rates over extended periods greatly increase the fragility of the financial system and often lead to banking crises. High real deposit rates (in excess of 10 percent) may reflect greater and perhaps imprudent risk-taking by bankers, while high lending rates (in excess of 30 percent) are often caused by "distress borrowing" and may attract destabilizing portfolio capital inflows. On the other hand, negative or very low real interest rates lead to disintermediation and credit mis-allocation, thus weakening the financial system. In addition, very high spreads may indicate serious and damaging incentive problems on the part of bankers (Sheng 1996; Galbis 1993).
6. Gross domestic savings (GDS) (percent of GDP) a. private b. public	Low domestic saving rates (especially private) are found closely correlated with fragility and weakness of financial systems. East Asian economies with very high saving rates generally have stable financial systems. By contrast, LAC countries with very low savings rates (less than 15 percent) have fragile financial systems. The exception is Chile, with a current saving rate around 24 percent (up from 5.4 percent in 1980) and a sound and stable financial system. The Mexican private savings rate, which dropped from 18.8 percent to a low of 9.1 percent in 1994, is widely believed to have aggravated the 1994–95 financial crisis. A GDS rate of 20 percent can perhaps be taken as a reasonable fragility threshold value for this indicator. (The Economist, December 9, 1995).
7. Real GDP growth a. level b. volatility	A stable, growing economy tends to promote sound and strong financial systems, while declines and volatility in economic growth are often associated with increased fragility of the banking sector and proneness to crises (Sheng 1996).
8. Brady bond spreads (spread over US T-bonds)	The fragility threshold for most developing countries: sustained 4–5 percent growth.
9. Stock market prices	The secondary market yields on Brady bonds, commonly measured by spreads over comparable U.S. T-bonds, are a reliable barometer of investor confidence. Sustained high spreads (in excess of 300 basis points) probably indicate a seriously fragile financial situation. For example, Mexican Brady bonds had spreads well in excess of 300 basis points for months preceding the 1994–95 crisis. So did those of Argentina and Venezuela.

ANNEX TABLE 4.1: (CONTINUED)

INDICATORS	LINKS TO FINANCIAL FRAGILITY
10. Capital flows a. FDI b. Portfolio investment	Large and unexpected declines in stock market prices are associated with increased financial fragility. Similarly, rapid growth in the stock market, often fueled by portfolio capital or speculative activity financed by bank credit (stock market bubbles), produces a highly fragile financial system. If not managed properly, large and volatile capital flows (especially portfolio investments or "hot capital") can greatly add to financial fragility, making the system vulnerable to shocks and crises. Large capital inflows tend to overvalue the exchange rate, depress exports, and worsen capital account deficits. Likewise, large and unexpected capital outflows (capital flight, portfolio investments) cause interest rates to rise, leading to increases in loan defaults and banking distress. A steady increase in long-term FDI is usually a stabilizing factor for the financial system. Sustained annual portfolio capital inflows exceeding 10 percent of GDP are probably a reasonable fragility threshold for most developing countries.
11. External debt a. Level b. Maturity structure	Excessive external debt, especially when concentrated at the short end of the maturity structure, tends to increase financial fragility. The fragility threshold will vary with the size and structure of a country's economy.
12. Monetization/Financial Depth (M2 as percent of GDP)	A relatively deep financial system (higher M2) tends to be more resilient and better able to absorb shocks. Financial fragility threshold: 30 percent.
13. Domestic credit growth (in real terms) a. Private sector b. Public sector	Excessive growth in real credit is widely found to increase financial fragility and lead to banking crises (Sundararajan and Balino 1991; Gavin and Hausmann, 1995; Kaminsky and Reinhart 1996). Empirical analysis by Caprio and Klingebiel (1996) finds close association between real credit growth rates in excess of twice real GDP growth rates, and banking crises in many countries. The reason is that rapid credit growth in the banking system often leads to a deterioration of loan quality by hampering effective credit assessment by bankers and supervision, in part because of non-receipt of timely information. Rapid credit growth may also reflect a decline in loan quality as distressed banks resort to extension or rollover of bad loans to cover the extent of the damage of non-performing loans (evergreening). The latter serves as an example of the problems in the real sector spilling into and weakening the financial sector.
14. Terms-of-trade exposure (trend and variance of Terms-of-Trade)	Bank lending over-concentrated (more than 30 percent) in sectors subject to frequent and substantial changes in terms of trade (TOT Exposure) can greatly increase banking fragility and lead to banking crises. (Sheng 1996). TOT changes may arise from exogenous price declines or as a result of trade or exchange rate policy reforms, often as part of SAL programs. Examples include the Chilean financial crisis (copper price declines, 1974–87), the Malaysian banking crisis (tin, rubber, and oil price declines, 1983–86), the farm financial crisis in the US Mid-West (farm exports decline brought on by the over-valued U.S. dollar), and Texas bank failures (energy price declines in the mid-1980s). Moreover, volatility in terms of trade appears to be particularly detrimental to the banking sector in the presence of shallow financial markets (Caprio 1996).

Note: Indicators 1–4 define the macroeconomic environment in which a banking or a financial system operates. Establishing a strong and stable macroeconomic environment is essential to reducing financial fragility and promoting a strong financial/banking system.

ANNEX TABLE 4.2: MICROECONOMIC/INSTITUTIONAL FRAGILITY INDICATORS

INDICATORS	LINKS TO FINANCIAL FRAGILITY
1. Banking market structure	Competitive market structure probably provides the optimal mix of low fragility and high efficiency; oligopolistic or cartelized market structures can be less fragile but are also less efficient and tend to undercut the financial liberalization and development process. For example, even though Mexico shared the same debt crisis in the early 1980s as other heavily-indebted countries, it avoided a banking crisis because of nationalization, although at a high cost in the form of inefficient credit allocation by state-owned banks.
2. Capital adequacy (Banks' capital/total assets)	Inadequate capital to cushion loan losses is a key determinant of fragility in the banking sector. The minimum risk-weighted capital-asset ratio of 8 percent required by the Basle Committee is probably too low for most developing countries. Fragility threshold: 8 percent.
3. Deposit insurance schemes	A well-designed and fully-funded deposit insurance sector can promote financial stability, especially when accompanied by an effective supervision system. On the other hand, deposit insurance without effective supervision invariably leads to a highly fragile banking system because of moral hazard problems.
4. Asset quality (NPLs/total loans)	A key determinant of financial fragility. As a rule of thumb, non-performing loans in excess of about 10 percent greatly weaken the banking system and often lead to banking crises. (Sheng 1996; Caprio 1996).
5. Loan-to-deposit ratio	Higher values (in excess of 100 percent) suggest a banking system that may be over-reaching its resources; may reflect excessive reliance on interbank money markets or foreign borrowings, both leading to increased fragility. Very low values (less than 30 percent) indicate a banking system with a weak franchise, implying greater credit risks and fragility (Corrigan 1991; Rojas-Suarez and Weisbrod 1995).
6. Maturity profile of the deposit base in the banking system	A very short maturity structure of bank deposits reflect a general loss of confidence and hence increased fragility in the banking system. During the period leading up to the Argentine bank crisis in 1989, most of the deposit base had only seven days' maturity.
7. Currency/deposit ratio	An excessively high currency/deposit ratio may often reflect a lack of public confidence in the banking system, leading to dis-intermediation and increased financial fragility.
8. Loan portfolio concentration	Sectoral or geographical concentration of loan portfolios permits insufficient diversification of risks, leaving the banking system vulnerable to shocks and crises.
9. Enterprise/firm indebtedness (debt-to-asset ratio)	The presence of a large number of highly-indebted (especially with a large proportion of short-term debt) or insolvent firms and enterprises often leads to "distress borrowing" and a fragile banking system. Fragility threshold: debt-to-asset ratios exceeding 0.5 for more than one-third of banks.
10. Connected lending (percentage of banks owned by industrial or financial conglomerates)	Excessive lending to related firms under an interlocking system of bank and firm ownership or a conglomerate structure often leads to a highly fragile financial system. Fragility threshold: 25 percent (Sheng 1996).
11. Banks' exposure to real estate (percent of total loans to real estate)	Over-exposure to real estate lending tends to be a significant source of bank fragility because of property booms and speculative bubbles, often leading to banking and financial crises. Fragility threshold: 30 percent (Sheng 1996).
12. Market risk exposure (non-interest income/total income) a. Interest rate risks b. Foreign exchange risks c. Other derivatives/ guarantees	A high share of non-interest income can be taken as indicative of weakness in core business and an over-reliance on risky, often off-balance-sheet, activities involving market risks. Fragility threshold: 30 percent.

ANNEX TABLE 4.2: (CONTINUED)

INDICATORS	LINKS TO FINANCIAL FRAGILITY
13. Previous bank restructuring	The presence of weak banks that have not been properly restructured poses a significant threat to the stability of the financial system.
14. Previous enterprise restructuring	Public or private enterprises carrying a significant portion of nonperforming bank loans must be restructured (with banks) to minimize financial fragility. An improved legal and regulatory framework is essential to facilitate corporate workouts and debt restructuring, and thus to minimize their negative impact on financial stability.
15. DFI solvency/reform	Highly-indebted or insolvent development banks and other Development Finance Institutions (DFIs) often pose a serious threat to the stability of the financial system.
16. Central Bank: a. Capital adequacy b. Foreign exchange reserves c. Off-balance-sheet operations	Adequate levels of capital and foreign exchange reserves are essential for a central bank to effectively discharge its various functions in support of a strong and stable financial system. Using the central bank to finance government budget deficits and undertake other fiscal activities undermines its effectiveness and leads to increased fragility in the financial system. Off-balance-sheet operations by a central bank can greatly increase risks and cause financial instability.
17. Domestic accounting and auditing standards	Poor-quality accounting and auditing systems greatly exacerbate the problem of asymmetric information, thus undermining public confidence in the integrity of the financial system and greatly adding to its fragility.
18. Prudential bank regulation and supervision systems and capacity	Effective prudential regulation and supervision is a key determinant of financial stability. In their absence, financial systems remain dangerously fragile and prone to financial crises, as shown, for example, by the Chilean banking crisis of 1981.

ANNEX TABLE 4.3: CENTRAL BANK FRAGILITY INDICATORS

INDICATORS	MEASUREMENT
1. Central bank profitability	Deficit/surplus from the income statement.
2. Short-term interest rates	91-day Treasury Bill rate.
3. Foreign liability coverage ratio	Ratio of foreign loans payable to international reserves; figures taken from central bank balance sheets.
4. Solvency	Total liablities/total assets; figures taken from central bank balance sheets.
5. Quality of governance	Includes central bank independence, effectiveness of management, and adequacy of its regulatory powers.

ANNEX 5: FINANCIAL SECTOR REFORM: A REVIEW OF WORLD BANK ASSISTANCE/MANAGEMENT RESPONSE

Recommendations	***Management Response***
Financial Sector Strategy 1. OD 8.30 and its associated OP define a framework for financial sector operations. CASs documents should ensure that all major relevant components of the directive, and especially competition, are dealt with in a systematic way.	Agreed, subject to the advice of the Board that the OP should be limited to financial intermediary lending, rather than to the broader financial sector operations covered by the OD. The financial intermediary lending policy content of OD 8.30 (with some refinements and clarifications) is being replaced by OP 8.30, Financial Intermediary Lending. The draft policy, which will be submitted shortly to the Executive Directors for approval, includes a general framework for financial intermediary lending. Such lending: (i) is based in a CAS that discusses the critical developmental importance of the financial sector and the justification and sequencing of Bank interventions; (ii) is considered in a satisfactory macroeconomic and policy environment; (iii) supports appropriate financial infrastructure, including prudential regulations and supervision; (iv) establishes minimum eligibility criteria for participating financial institutions (FIs); and (v) requires appraisal of each operation to cover, inter alia, the strategic sectoral significance of the operation/project, economic justification, and consistency with financial sector development objectives. Efforts are underway to step up financial sector diagnostic work and ensure that CASs systematically draw on such diagnoses and cover financial sector issues, including competition, where they are identified as important.
ESW and Project Preparation 2. The value of in-depth policy-oriented economic and institutional analysis of the financial sector is clear. Much greater emphasis should be given to ESW prior to project initiation to ensure that the critical issues are clearly identified from the outset.	Agreed. The basic principle that relevant ESW should lay a foundation for financial sector operations is well recognized. In January 1998, the Board approved a program to reinforce the Bank's financial sector work, and a special budget for this program. A detailed strategy to implement this program is under preparation. It includes a proposal to conduct financial sector assessments initially for all countries vulnerable to crises and sequentially to expand them to other countries. These assessments will

	review, inter alia, the status and performance of the real/enterprise sector in the context of their impact on the performance of financial institutions and vice versa. In addition, a common diagnostic framework and methodology is being developed which will help improve the quality of ESW.
Performance Indicators. 3. The Bank should allocate more resources to monitor and evaluate countries' financial sector programs, with performance indicators focusing on structural changes and system resiliency.	Agreed. As noted in para. 2, the Board authorized a special budget to reinforce the Bank's financial sector work. An important component of the program will be the development of a monitoring and surveillance mechanism based on key performance indicators, at both the country and project/operation levels.
Lending Instruments and Program Monitoring 4. Financial sector development is a process not an event. Hence, more attention should be given to sustaining this process. In particular, the new lending instrument, adaptable program loans (APLs), which disburse according to the pace of institutional progress, should become important in supporting financial reforms.	Agreed. The Bank approach under the reinforcement program should lead to more sustained attention to financial sector development, particularly in vulnerable countries. APLs allow for flexibility in the design and implementation of diversified Bank interventions in the financial sector. A few such projects are already under preparation. However, additional work is needed to develop new approaches (e.g., more effective ways to develop capital markets and deliver technical assistance) to cater to the needs of the financial sector of client countries.
5. Technical assistance is of the utmost importance to financial sector development. However, TALs have not performed effectively. As a result, the Bank should commit itself to providing technical assistance only under the following conditions: (1) long term commitment is clearly established; (2) the Bank invests sufficient resources to design and supervise the assistance effectively; (3) the government is committed to specific actions that will ensure the effectiveness of assistance; and (4) EDI should be encouraged to further develop its banking and finance training program in the areas of sound	Agreed. In addition to financial sector assessments and detailed diagnoses under the reinforcement program, we will have special TA operations, financed by trust funds and Bank loans. This TA and associated funding will be provided if the country is willing to commit to the agreed programs of reform. Various triggers will be used to gauge this commitment. Also, additional resources are being committed to strengthen supervision, and we are developing new products to better integrate TA with lending. EDI's current work program—its own as well as the programs it has undertaken in partnership

bank management, banking policy, regulatory issues, and bank failures.	with the FPSI Network and other operational units-already encompasses current financial sector issues (including sound bank management, systemic bank crisis management, capital market development, microfinance, etc.). EDI programs continue to evolve to respond to changing client needs.
IMF 6. The Bank's interaction with the IMF and the IFC is of increased importance. The Bank's country strategies should include interaction and agreement with the IMF on full and timely exchange of information and early coordination. Similarly, while the Bank and the IFC exchange preliminary project documents, Bank staff should give IFC staff even earlier notification about impending projects, so that they have more opportunity to influence their design.	Agreed. A framework for "Bank-Fund Collaboration on Strengthening Financial Sectors." prepared jointly by the two institutions, was discussed and endorsed in September 1997 by the Boards of both institutions. Among other things, this framework provides for an exchange of information. Since then, Bank and Fund staff have been working closely together on crisis countries. At present, IFC and the Bank routinely consult each other with respect to their financial sector operations; this collaboration takes place at the project as well as at the sector strategy formulation level. In many countries the Bank and IFC are preparing jointly CASs that include financial sector concerns. The principles of collaboration between the Bank and IFC are also included in the draft OP 8.30.

ANNEX 6: REPORT FROM CODE/COMMITTEE ON DEVELOPMENT EFFECTIVENESS

On May 13, 1998 the committee on Development Effectiveness (CODE) reviewed a report ***Financial Sector Reform: A review of World Bank Assistance*** (SecM98-221) prepared by the Operations Evaluation Department (OED), together with a draft Management response (CODE98-26). The report analyzes the Bank's role in helping client countries to implement financial sector reforms prior to the recent East Asia crisis. It focuses on the country as the unit of analysis, rather than on individual loans, and on performance indications in the financial and real sectors to evaluate outcomes. Thus, it examines results rather than inputs. Even without fully incorporating the lessons still to be drawn from the East Asia crisis, the study finds satisfactory outcome in only 12 (52 percent) of the countries that were examined. In promoting institutional development, adjustment loans were found to be more successful and more sustainable than financial intermediation loans. The report suggests that the East Asia crisis provides new evidence of the Bank's tendency to underrate the seriousness of financial sector dysfunctions.

The report finds that the Bank's new financial sector strategy is firmly grounded in the Bank's experience in the sector and is based on the lessons learned from this experience, although the learning process was slow and serious concerns remain. The report suggests that the internal guidelines on financial sector operations (OD8.30) provide a valid framework for preparing operations in support of financial sector reforms. However, the Bank should go beyond these guidelines and incorporate best practice on substantive issues and Bank process, after sufficient time has elapsed to evaluate and learn from the recent developments in East Asia.

The committee welcomed the opportunity to focus on this timely, relevant, and comprehensive report on the critical issue of financial sector reform, and commended both the OED report and the forward-looking Management response. Committee members appreciated in particular the innovate methodology used in the OED report. They noted that the report will be published with a summary translated into French and Spanish. OED will work closely with the Sector Board to disseminate the evaluation findings.

Committee members noted the report's findings that results were better in those countries where the Bank carried out prior economic and sector work (ESW). This confirmed prior evaluation findings about ESW's positive contribution to the design of reform programs. It was also suggested that short, focused and diagnostic sector notes would be useful. The importance of adequate and timely technical assistance and supervision was also highlighted. Members also commented on the importance of ensuring that CAS's properly address financial sector issues and their links to macro issues and real sectors: realistically assessing ex ante long-term commitment to reform; monitoring and evaluation of progress; using the full range of lending and non-lending instruments, including adaptable program loans (APLs); involving the local institutions; having in place a transparent regulatory mechanism to ensure success of privatization; improving synchronization and sequencing of reforms; and ensuring a long-term, sustained approach to financial reform and viewing it as a long-term process, rather than an event.

The Committee was generally supportive and was encouraged by the Management's constructive and forward-looking response outlining the Bank's efforts to strengthen its ability to help clients address financial concerns. However, members raised a number of issues, including the need to do more analysis and draw lessons from the experience in the sector including in Mexico and East Asia, and assess progress made since the establishment in January of the Special Financial Operations Unit and allocation of incremental authority for work on the financial sector program. Committee members were particularly interested in progress on he recruitment, internal organization, cooperation/coordination with the IMF and IFC, and in whether the Bank has a critical mass including staff skills, knowledge management and instruments to move forward in the very challenging area.

Next Steps: The Committee looks forward to discussions of these important issues in future Board And Committee meetings, and to the forthcoming Financial Sector Strategy Paper.

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