FINANCIAL LIBERALIZATION

DARWISH
FINANCIAL LIBERALIZATION AND REPRESSION
(LESSONS FOR LEBANON)

by

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To the memory of my father...
CHAPTER ONE

INTRODUCTION

Economic theory acknowledges the importance of financial liberalization in many developing countries in order to improve the efficiency of existing financial markets and to develop new markets to enable the financial system to serve better the needs of the real economy, thus contributing to economic development.

The purpose of this project is to assess the process of financial development or financial deepening in a selection of East Asian and Latin American economies and try to learn from the experiences of the successful and unsuccessful ones, in order to implement policies aimed at deepening of the Lebanese financial market.

The study is divided into five chapters. Chapter two defines the state of financial deepening versus shallow finance; then it reviews the conditions necessary for promoting the development of deep financial markets. These include an environment of macroeconomic stability accompanied with adequate prudential regulation and a strong legal and supervisory frameworks. This chapter exposes the role of repressive measures and excessive regulations in undermining the process of financial deepening.

Chapter three provides an overview of the experiences of many developing countries in East Asia and Latin America. The first part of this chapter studies the
macroeconomic environment of the high performing East Asian economies and the policies adopted to guide and foster the deepening of their financial sector. The second part of chapter three reviews the experiences of three Latin American countries - Mexico, Argentina and Chile - in restructuring their financial systems after the major financial crises of the early 1980s. Special reference is given to Chile for its success in promoting the deepest financial markets in Latin America.

Chapter four examines the Lebanese experience building on the experience gained from the study of the above countries. It is divided into three parts. The first part gives an overview of the Lebanese economy during the period of war (1975-1990). It includes an assessment of the major macroeconomic indicators and the state of the banking sector. The second part examines the factors contributing to financial deepening in Lebanon by drawing parallels and trying to learn from the experiences of the above developing countries. The third part suggests reform options for the Lebanese financial sector.

Chapter five summarizes the study and provides some concluding remarks and recommendations.
CHAPTER TWO

A THEORETICAL REVIEW

2.1. Financial Deepening Versus Shallow Finance:

The term “financial deepening” was first introduced by Edward Shaw in 1973 in his work “Financial Deepening and Economic Development”. Financial deepening means that financial assets and institutions grow rapidly relative to GNP and that the development of financial markets and institutions stimulates economic development. (Horch p.4)

In most countries, as incomes rise and economies grow and diversify, financial institutions expand to provide a wider range of services associated with the mobilization and allocation of resources. These services must be offered to savers and investors through a wide range of financial instruments whose characteristics are sufficiently attractive in terms of yield, liquidity, maturity and risk. (Zank p.9).

Traditional leading institutions, such as commercial banks attract primarily short-term deposits and provide only short-term, highly collateralized credit since they are not prepared to meet all the needs of long-term and higher-risk financing (Horch, p.2). Therefore, countries need to develop other financial institutions whose services compete with and complement those of commercial banks.
Nonbank financial intermediaries, such as development banks, insurance companies and pension funds are potentially important sources of long-term finance. The growth of the nonbank financial intermediaries constitutes an important factor in the process of financial deepening. As specialized financial intermediaries develop, especially those concerned with contractual savings plans such as pension funds, many household sector savers tend to hold larger proportions of indirect financial assets.

Securities markets, including markets for stocks and bonds, constitute a major component of capital markets. The primary role of securities markets is to offer "risk capital through the issuance of stocks and shares, and long-term debt-financing through the issuance of long-term bonds for investments in long-term assets" (Ibid p.1). Therefore, deep financial markets should be based both on short-term lending and longer term financing and risk capital.

The ultimate function of financial markets development or financial deepening is to increase financial resources and to improve the efficiency of the allocation of these resources towards the highest productive investments (Popiel p.2). Financial assets with attractive yield, liquidity and risk characteristics encourage saving in financial form. By diversifying the range of financial instruments available to investors, financial development contributes to "increased competition and helps to channel resources towards the highest return investments for a given degree of risk" (Horst p.1-2). This in turn improves the
efficiency and solvency of the financial system, and thus, its ability to contribute to economic growth.

Moreover, the depth of the financial system is an important determinant of its strength (Zank p.17). Deep financial markets show flexibility in adjusting to internal and external changes and absorbing shocks. This can be explained by the fact that "money and capital markets represent the deep end of the financial system, and the deeper the system, the greater its stability and resilience" (Popiel p.1).

Yet in spite of the importance of financial markets, many developing countries suffer from shallow finance: Financial institutions such as insurance companies and pension funds are underdeveloped, and the growth of capital markets is constrained. Few people have access to such markets, and the range of available financial instruments is limited. Savers and investors who often have no access to formal institutions tend to rely on informal financial markets which are characterized by wide spreads, high risks and tax evasion. Professional and nonprofessional money lenders, friends and relatives are the main sources of external finance in such markets. Private financial savings tend to be invested in non-financial assets such as gold or real estate (Zank p.17-23).

Moreover, shallow formal financial markets are more fragile than deep ones in that they do not adjust well to external shocks without collapsing or showing excessive fluctuations. This proved to be correct during the world economic recession of the early 1980s when, as a result of the shocks of the
1970s, financial institutions in many developing countries suffered from large losses as many borrowers were unable to service their loans (Horch p.2).

Shaw's argument is that "developing countries typically suffer from a condition of financial repression which keeps finance "shallow" and restricts economic growth" (Kitchen p.14). As provided by McKinnon (1973) and Shaw (1973), financial repression is characterized by interest rate controls, overvalued exchange rate, high reserve requirements, directed credit allocation programs and many other excessive measures that tend to distort domestic capital markets (Gibson p.583-584). In developing countries, government's efforts to promote economic growth by undertaking repressive measures and excessive regulations have undermined financial deepening. Financial policies must be based on market forces rather than government directives in order to promote efficient allocation of resources. However, market-based financial systems can be unstable and susceptible to fraudulent practices. This underlines the importance that liberalization of the financial system be accompanied by measures to strengthen the regulatory and supervisory frameworks. Therefore, a combination of sound macroeconomic, sectoral and regulatory policies is crucial to lay the foundation of well-functioning financial markets that can stimulate long-term development.

2.2. Prerequisites for Financial Deepening

2.2.1. Macroeconomic Stability
By achieving macroeconomic stability through implementing positive real interest rates, maintaining low inflation, controlling budget deficits and encouraging a competitive exchange rate, governments will create an environment conducive to financial deepening by encouraging saving and productive investment (Zank p.2).

In most countries, the key problem to macroeconomic stability is governments' excessive spending resulting in large budget deficits. To meet their financing needs, governments resort to several measures that can lead to macroeconomic destabilization. Governments' large domestic borrowing crowds out private borrowing by absorbing the majority of liquidity from the system in the form of government securities, thereby reducing the access of private borrowers to finance their productive investments. Excessive monetary financing of deficits through printing new currency and expanding the money supply leads to inflation. Heavy external financing of deficits results in debt crises. (Ibid p.42-43). To avoid these macroeconomic ills which inhibit financial development, governments must seek to keep the deficit within the limits that could be financed without incurring destabilizing effects.

High inflation reduces levels of confidence in the financial system and introduces uncertainty and risk, especially to medium and long-term lending practices. Instead of going into financial assets, available domestic savings either are invested in nonproductive physical assets such as gold and real estate, or are leaked from the economy in the form of capital flight (Ibid p.42). Therefore,
maintaining moderate to low inflation is crucial for the accumulation and efficient allocation of resources.

Market-determined interest rates reflecting the true cost and value of money lead to the suppression of inflation and deepening of financial markets. Positive real interest rates favor financial over nonfinancial savings, leading to greater financial intermediation which in turn ensures that resources are channeled into the most productive investments. Therefore, positive real interest rates stimulate economic development by "promoting financial deepening and improving the productivity of investments". (Tsang p.5). The conventional belief that low or negative interest rates are necessary to contain inflation and stimulate investment and growth has proved to be incorrect. Interest rates below market equilibrium levels lead to capital flight and encourage speculation in real estate and other physical assets rather than investments in domestic financial assets. As demonstrated by McKinnon(1973) and Shaw(1973), insufficient levels of savings will be mobilized to finance the higher demand for investment at low interest rates, and therefore, actual investment will be reduced (Leite p.736).

Other barriers to macroeconomic stability, and subsequently, to financial development include the maintenance of foreign exchange policies that reduce competitiveness, and the imposition of controls that distort prices and output. In countries with financially repressed economies, currency is typically overvalued which leads to distorted lending decisions, reduces incentives to export and encourages capital flight. Maintaining stable and realistic exchange rates at
competitive levels by adjusting them. For inflation is crucial for domestic macroeconomic stability and efficient allocation of resources. Moreover, the price of goods and services must be allowed to reflect their true opportunity costs and not be distorted by government controls and discriminatory policies.

2.2.2. Adequate Prudential Regulation and Supervision

Financial regulation and supervision consists of the rules and policies regulating the operations of financial institutions and directing their development. The ultimate goals of financial regulation and supervision are to achieve efficiency, stability and safety in the financial sector which is conducive to the deepening of the financial markets and the economy as a whole (Vittas p.62).

While inadequate or insufficient regulation and supervision leads to financial distress and crises, excessive regulation, on the other hand, inhibits capital formation and reduces the ability of the financial markets to contribute to economic growth. Therefore, a financial system based on an appropriate degree of adequate prudential regulation and supervision, as opposed to excessive or insufficient regulation, must be implemented. This system is based on the following:

2.2.2.1. Removal of Interest Rate Ceilings

In financially repressed economies, interest rate ceilings are often imposed by governments to protect borrowers and encourage investment. Ceilings often result in negative real interest rates which discourage savers from holding domestic financial assets and encourage borrowers by reducing the cost
of funds, thus, encouraging debt financing at the expense of equity financing. However, as previously mentioned, imposing interest rate ceilings often leads to reductions, not increases, in the amount of funds available for debt financing. Therefore, the removal of credit ceilings is beneficial for financial development since it eliminates these biases against capital markets' deepening, and for the accumulation and efficient allocation of resources. (Zank p.48-49).

2.2.2.2. Reducing Excessive Reserve Requirements

Reserve requirements are imposed by governments as an instrument for controlling the money supply growth, and for managing the liquidity of banks. However, in most developing countries, excessive reserve requirements are held with government agencies for the purpose of financing government deficits. These high reserve requirements have a negative impact on financial development since they tend to reduce banks' profitability and decrease the flow of funds to productive enterprises. When no interest or low interest is paid on high reserve requirements, they serve as an implicit tax on commercial banks that tend to increase the cost of intermediation, which inhibits financial development (Tseng p.4).

2.2.2.3. Elimination of Credit Allocation Schemes

Governments in many developing countries tend to target credit (often at subsidized rates) directly at priority activities that they believe promise high yields in economic development terms. Directed-credit programs often result in investments with low rates of return, which burden banks with large
nonperforming loans. These programs usually fail because funds are not necessarily utilized for the purpose for which they were allocated. In order to succeed, credit allocation schemes must be based on the “achievement of overall macroeconomic stability and the development of quite effective monitoring systems” (Vittas p.65). Therefore, excessive measures to direct credit contrary to market forces can lead to the “misallocation of scarce investment resources, undermining the strength and viability of credit institutions and retarding the growth of financial assets” (Zank p.50). In the contrary, making credit available to needs fosters the development of financial markets because “it leaves them free to respond to the unconstrained demand for their products” (Popiel p.8).

2.2.2.4. Limiting Structural Controls

The financial systems of many developing countries are characterized by a high degree of fragmentation and segmentation. Entry of new foreign or domestic institutions into particular segments of the financial system is restricted. Existing financial institutions are constrained in their liberty to increase the range of financial services. These restrictions limit competition in the financial system, impede improvements and innovations in financial intermediation, and consequently, hinder financial deepening.

Competition in financial intermediation tends to limit the spreads between borrowing and lending rates, which in turn increases the efficiency of resource allocation by raising the volume of investment that can be supported by a given level of saving. (Zank p.49-51). Therefore, measures must be undertaken to
reduce barriers to competition and market segmentation by allowing greater freedom of entry and expanding the range of permissible activities for different types of financial institutions (Tseng p.9).

Relaxing or removing the above excessive controls is crucial for the development of money and capital markets, but it does not ensure that financial systems will develop as intended. This must be complemented with the strengthening of prudential controls and the establishment of a better legal, accounting and supervisory frameworks to support the operations of financial markets.

1.2.2.5. Enhancing Prudential Controls

Prudential controls aim "to preserve the safety and soundness of individual financial institutions and sustain public confidence in the stability of the financial system as a whole" (Vitas p.63). They include the following set of requirements:

- Ensuring minimum capital requirements.
-Limiting large exposures by diversifying risks.
- Provision of an adequate supply of professional management and trained personnel.
- Adopting generally accepted accounting standards for public reporting of financial information.
- Establishing a strong and independent auditing profession.
2.2.2.6. The Legal and Supervisory Frameworks

The legal framework needs to be both cohesive and comprehensive in order to enhance the development of financial markets. Laws concerning collateral, foreclosure, lenders and borrowers rights must be strongly enforced. This is due to the existence of asymmetric information between the suppliers and users of financial services. Lenders often lack adequate information on the behavior of borrowers. For this reason, they are unwilling to enter into certain types of financial contracts. To encourage long-term loans and other types of financing, governments deal with asymmetric information by enforcing fuller disclosure of financial information and, by defining contracts that impose restrictions on behavior and differentiate between high and low risk borrowers (Vittas p.67).

To discourage fraudulent practices by lenders, it is equally important for governments to supervise financial markets and institutions. Traditionally, supervisors spent too much efforts ensuring compliance with the various controls and credit allocations, but recently greater attention is focused on ensuring the quality of investments and the adoption of prudent practices (Ibid p.69). The basic objective in establishing a supervisory system is for financial institutions to disclose all relevant information to supervisors. Information disclosures required by supervisors must be more relevant and reliable than those made to the public because losses and insolvencies may be hard to detect in standard audited financial statements. External auditors must be commissioned by governments to
conduct independent audits of financial institutions. Moreover, legal procedures for dealing with insolvent financial institutions must be clearly defined.

2.3. Measures of Financial Deepening

One of the practical methods to measure the level of financial deepening in any country is the ratio of M2 (currency + demand deposits + savings deposits + time deposits) to GDP. This ratio is often used in developing countries where banks are playing a major role in financial markets and most of the financial assets are held in deposits with banks. The ratio of M3 (financial liabilities of banks and nonbank financial institutions) to GDP gives a broader measure of financial deepening by taking into account the presence of financial assets in the nonbank financial sector. This ratio of M2 to GDP is given for various developed and developing countries in Table 2.1. While there is large difference among countries, the ratio for developed countries which are characterized by their deep financial markets is about twice that for the developing countries.
Table 2.1. Ratio of M2 to GDP

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<tr>
<td>Japan</td>
<td>0.84</td>
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<td>0.94</td>
<td>0.98</td>
<td>1.1</td>
<td>1.17</td>
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<td>Germany</td>
<td>0.56</td>
<td>0.56</td>
<td>0.56</td>
<td>0.58</td>
<td>0.59</td>
<td>0.61</td>
<td>0.66</td>
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<tr>
<td>United States</td>
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CHAPTER THREE
FINANCIAL DEVELOPMENT: EXPERIENCES OF EAST ASIA AND LATIN AMERICA

A general view of financial development experiences of many developing countries in East Asia and Latin America is given in this chapter. In recent years, a dramatic contrast has been drawn between the marked growth performance of many East Asian nations on the one hand and the generalized economic stagnation of many Latin American countries on the other hand. This difference is determined basically by East Asia’s high record of financial stability as a basis for long-term growth, whereas the history of Latin America reveals a continuous cycle of financial instability and external indebtedness. The experience of Chile, which is an exception in Latin America, is studied carefully in this chapter for its importance in financial development.

3.1. East Asia

During the past three decades, East Asia grew faster than any other region in the world. Most of this growth is attributed to its eight high performing economies (HPAEs): Japan, Korea, Singapore, Hong-Kong, Taiwan, Indonesia, Malaysia and Thailand. Most of these countries deregulated their financial systems during the 1980s (except Japan in the 1970s). This process of financial
reform has been gradual, phased and was implemented in an environment of macroeconomic stability combined with solid prudential regulation and supervision of financial institutions. Financial sector policies in these economies were designed to promote savings and efficient investment and to deepen financial markets. In addition to the market-oriented policies and strong prudential regulation, more interventionist policies were implemented by the government in most of these countries. The most controversial thing is that these selective interventions aimed at promoting financial development have succeeded in some of the East Asian economies while they have ended in failure in many other Asian and non-Asian developing countries. These policies would not have succeeded without the unusual macroeconomic stability accompanied with the strong institutional capability which characterized some of the successful Asian economies and enabled them to establish clear performance criteria and monitoring. (The East Asian Miracle p.242).

3.1.1. Macroeconomic Stability

The successful East Asian economies were characterized by a much greater macroeconomic stability than most other developing economies. This superior macroeconomic performance encouraged long-term planning and provided the necessary framework for financial deepening by promoting financial savings and highly productive investments. Fiscal deficits were kept under prudent control in most of the East Asian economies. While some countries have run substantial budget deficits such as Malaysia and Thailand during the 1980s,
none have resorted to inflationary or destabilizing financing. These countries were able to deal prudently with higher levels of monetary, domestic and external financing due to their unusual high levels of domestic financial assets and low initial debt ratios. (Ibid p.106-110). As a result, the successful Asian countries were able to maintain low to moderate inflation rates and to keep internal and external debt under prudent management. This in turn provides a favorable environment for long-term growth by ensuring stable real interest and exchange rates. Indonesia and Korea have higher inflation than the other HPAEs, but still they fall under the moderately low-inflation countries as compared to the high-inflationary Latin American countries. The East Asian Economies succeeded in maintaining realistic exchange rates by avoiding the severe overvaluation which characterizes most of the financially repressed economies. During the 1970s, most of the East Asian economies maintained fixed exchange rate arrangements, usually by pegging to the US dollar, such as in Taiwan, Thailand, Indonesia and Korea. During the 1980s, there was a movement toward more flexible exchange rate regimes. Thus, "most moved from long-term fixed-rate regimes, to fixed-but-adjustable rate regimes with occasional steep devaluations, to managed floating rate regimes" (Ibid p.115). Moreover, adhering to macroeconomic fundamentals helped the East Asian economies to have rapid and flexible responses to macroeconomic shocks and changing economic circumstances.

3.1.2. Financial Development in East Asia

3.1.2.1. Interest Rate Policy
As mentioned in the last section, maintaining low to moderate inflation resulted in stable real interest rates which encouraged financial savings by giving people the confidence to save. Most of the successful Asian countries liberalized their interest rates during the 1980s. Interest rates were fully deregulated in Indonesia in the early 1980s. Korea, Malaysia, and Thailand “relaxed controls by more frequent adjustments in rates, wider bands for regulated rates, and the removal of some interest rate ceilings” (Tseng P.5). Thailand freed interest rates on time deposits with a maturity of more than one year in 1989, then eliminated interest rate ceilings on all time deposits in 1990, and in early 1992, removed ceilings on savings deposit rates. This gradual approach to interest rate liberalization, which was undertaken in an environment of responsible macroeconomic management, prudent regulation and improved supervision, resulted in positive real interest rates, which in turn contributed to financial deepening in most of these countries. The monetization ratio (M2/GDP) rose in most of the East Asian countries during the 1980s. Growth in financial assets was particularly rapid in Malaysia, Singapore and Thailand where the ratio reached 66-90% in 1989 (Charts 3.1 & 3.2). In Indonesia, the ratio of M2 to GDP increased from about 20 percent in 1983 to about 46 percent in 1992 (Chart 3.3). In Korea, the ratio of M2 to GDP was unusually lower than the ratios in many other economies with similar levels of income growth (Chart 3.4). However, the ratio of M3 (including nonbank financial assets) to GDP rose sharply during the 1980s due to large increases in the assets of nonbank financial institutions which
accompanied rapid income growth in Korea since the 1970s (The East Asian Miracle p.274-275).

3.1.2.2. The Impact of Directed Credit Programs

In most developing countries, efforts to direct the allocation of credit have usually suffered from the abuse of credit programs and misuse of funds, which involved a decline in financial discipline by resulting in low repayment rates and undermining the growth of financial assets. Yet the experiences of the HPAEs, in particular those of Korea and Japan, have demonstrated that directed credit programs can improve investment provided countries maintain strong macroeconomic stability and emphasize effective monitoring and appraisal of projects. (Vittas p.10).

Most of the allocation in the East Asian economies has been to promote exporters since export performance was easy to measure and therefore to monitor. Moreover, directing credit either to specific industries or to exporters was supported by effective communication and consultation between the public and private sectors. Yet not all attempts to direct credit in the East Asian economies have met their objectives. Directed credit programs without strong appraisal and monitoring, as in Indonesia, Malaysia and Thailand, have either been abandoned or ended with failure. However, limiting interest rate subsidies for directed credit programs and having small shares of directed credit relative to the size of total credit in the financial system, have limited financial market
distortions in the East Asian economies. In addition, these economies focused on directing credit to the private sector and not to loss-making public enterprises as in other developing countries (The East Asian Miracle p.280-289). Today, directed credit programs are becoming less important in most developing economies following the major financial liberalizations of the 1980s and early 1990s.

3.1.2.3. Financial Regulation and Supervision

East Asian governments have directed great efforts to achieving efficiency and stability in the financial system and maintaining public's confidence in financial institutions. Prudential regulations have been improved in most of the East Asian countries, such as adhering to international capital adequacy requirements as stipulated in the Basle agreement. Other important prudential regulations included provisions concerning legal lending limits and maintenance of adequate reserves to cover risk assets. Portfolio requirements to encourage prudent lending such as restrictions on lending to real estate projects and other speculative activities were adopted following the 1980's real estate speculation boom in Hong-Kong, Japan, Korea, Malaysia and Thailand. During times of financial crises, East Asian governments have been quick in responding by implementing whatever necessary to cope with failing financial institutions. They have been able to maintain confidence by acting as implicit insurers without incurring excessive fiscal costs due to their increasing levels of savings brought about by public confidence in the financial system. (Ibid p.212-220).
Supervision has been strengthened in most of the East Asian economies by maintaining close contact between supervisors and financial institutions based on fuller disclosure of financial information. However, financial policies in the HIPAEs "have gone beyond prudential regulations to include protecting banks from competition to increase the financial strength of banking institutions" (Ibid p.212). Many East Asian countries have had rigid restrictions on the range of financial institutions and instruments. These restrictions aimed at protecting depositors and maintaining confidence in the stability of the financial system. While protection from competition can inhibit financial intermediation by increasing the average spread between lending and borrowing rates, most East Asian economies "have at times simultaneously regulated deposit and lending rates and consequently the spreads of financial institutions" (Ibid p.217). Thus, balancing the need to enhance bank solvency with the need to promote the efficient use of savings, followed by the gradual liberalization of entry restrictions and interest rates during the 1980s have contributed to East Asia's deepening of financial institutions as compared to other developing economies.

3.1.2.4. The Development of Money and Capital Markets

Money and capital markets were generally underdeveloped prior to the 1980s and played a minor role in financial intermediation and capital allocation. Financial systems were typically dominated by banks: bank deposits constituted the most important form of household savings, and short to medium-term bank loans were the most important source of external finance for corporations. Bond
and equity markets for long term debt-financing and risk capital were of marginal importance. Firms often found difficulties in financing their long term needs since they have to turn to informal financial markets with high cost of funds. In order to fill the perceived gaps resulting from failures in long-term capital markets, many East Asian governments have created development banks for long-term industrial lending, as well as specialized institutions providing credit to agriculture and small and medium-size enterprises. Due to their high performance criteria in selecting and monitoring projects and firms, development banks have been successful in many East Asian economies especially in Japan, Korea, and Taiwan where they accounted for a large share of the assets of the financial system. In contrast, development banks in many other developing economies have ended with failure brought about by political pressures to finance bad projects and poor capabilities to screen and monitor projects. (The East Asian Miracle p. 226-227).

As the East Asian economies have matured following the major financial reforms of the 1980s, more attention has been directed to the creation and improvement of money and capital markets. The development of new financial instruments—such as central bank and government securities, certificates of deposit, commercial papers and repurchase agreements—have promoted the development of money markets in many of these countries. This in turn stipulated competition among financial institutions and provided a flexible means for liquidity management through open market operations. (Tseng p.10).
Financial institutions for longer-term finance, particularly development finance companies, insurance companies and pension funds have also expanded rapidly. This was fostered by a more relaxed regulatory framework than that applied to the banking sector and the development of new financial instruments. By the late 1980s, nonbank financial institutions in Korea accounted for much of the growth of the total assets of the financial sector.

Moreover, several measures have been undertaken to support the development of bond and equity markets which became increasingly important in a number of East Asian countries. Rating and regulatory agencies in Thailand, Indonesia and Hong-Kong have been strengthened, while laws discriminating against corporate bonds in Japan have been relaxed. As for equity markets, growth has been promoted by simplifying listing procedures, strengthening protection against fraud, and requiring correct and full disclosure of information prior to any public offering. The Korean government has encouraged firms to turn toward bond and equity markets by maintaining tighter regulation on domestic credit of the banking sector. Thus, while bond and equity markets have not been important in financing East Asia’s success, “they are likely to play an increasing role in its financial future” (The East Asian Miracle 1994 p.225).

3.2. Latin America

Over the past 15 years, the history of Latin America has been characterized by deep macroeconomic mismanagement and financial instability. Rates of
growth in output were depressingly low, rates of inflation were unusually high, interest and exchange rates were largely volatile and, the external current account deficits were large relatively to national income. Long-term planning was almost impossible in this environment. Heavy borrowing by governments has spurred inflation and reduced overall savings. In turn, high inflation and the unstable environment it has caused have contributed to capital flight, thus resulting in lower domestic savings rates. Moreover, the financial markets and institutions through which savings are transformed into investments have been depressingly weak and banks have been subject to continuous government interference.

Three Latin American countries - Mexico, Argentina and Chile - are studied in the next section for their divergent experiences in financial restructuring. All three countries have faced banking difficulties following the early 1980s debt crisis. Only Chile has been able to restore confidence in the financial system contributing to the deepest capital markets in the region.

3.2.1. Overview of Financial Development in Latin America

During the 1980s, banks constituted the main source of finance in Latin America. Due to severe economic difficulties faced during the decade, short-term financing was the only kind of resource that financial institutions would mobilize (Rojas-Suarez p.4). Politically driven lending, usually to finance government budget deficits, was very common in many Latin American countries. Moreover, making money from inflation and allowing high spreads in the absence of appropriate bank supervision resulted in distorted financial markets which
contributed to inefficiencies in financial intermediation. Financial deepening, as measured by the ratio of M2 to GDP, was low as compared to the high-performing East Asian economies.

3.2.1.1. Financial Distress in Mexico and Argentina

At the beginning of the international debt crisis, the banking systems in Argentina and Mexico were already suffering from severe credit crisis. Prior to 1978, the banking system in Argentina has been subject to interest rate ceilings, credit controls and high reserve requirements. These repressive measures were rapidly removed in 1978 and government supervision over the banking sector was relaxed. Moreover, full and free deposit insurance was provided by the government. (Ibid p.17). This rapid deregulation of the financial system which was implemented in an unstable macroeconomic environment accompanied with loose banking supervision has created incentives for destabilizing behavior. As a result, non-performing loans have rapidly developed and many firms have been forced into bankruptcy. The central bank responded to the crisis by reimposing interest rate ceilings on deposits which resulted in negative real interest rates on deposits and permitted banks to help defaulting borrowers by reducing interest rates on loans. In addition, the central bank reimposed high reserve requirements which provided resources to lead to the most troubled institutions.

In Mexico and in Argentina, the Central Bank responded to the banking crisis by reducing the real burden of borrower debt and forcing depositors to accept a depreciation of their deposits in real terms. (Ibid p.17). An additional
problem confronting the banking systems in Argentina and Mexico was the fast expansion of credit to the central government in the mid 1980s. The central bank again financed most of this credit expansion through high reserve requirements imposed on banks. In both countries, credit expansion resulted in hyperinflation as the public realized that the credit extended could not be repaid in real terms. Hyperinflation was accompanied by a deterioration in the exchange rate (Ibid. p.23). In addition, extreme negative real interest rates on domestic currency deposits led to severe financial disintermediation as measured by the ratio of M2 to GDP. In Argentina, the ratio fell from about 19% in the early 1980s to less than 12% during the early 1990s (Chart 3.5). In Mexico, the ratio fell from about 30% in the early 1980s to less than 12% in 1988 (Chart 3.6). Thus, the experiences of the two countries reflected their inability to deal with the banking crisis in the early 1980s in a manner that would restore confidence in the banking system. "As a direct lender and a supervisor, the central bank was faced with a conflict of interest that undermined sound bank supervision" (Ibid. p.17).

By the early 1990s, banking crisis in the two countries had come to an end, and comprehensive efforts were implemented to liberalize financial markets and strengthen bank supervision.

3.2.1.2. The Chilean Experience

3.2.1.2.1. Liberalization and Financial Distress

In 1973, the Chilean financial system was highly repressed. Banks were under government control and they were subject to large reserve requirements.
Interest rate controls resulted in negative real rates for saving and borrowing. Targeted credit programs channelled investment funds to state-owned companies and high-priority government projects. The liberalization of the financial system which was initiated in 1974 aimed at stimulating economic growth by creating a market system of financial intermediation. This was based on the idea that "positive real interest rates would increase savings, and market-based allocation would improve the quality of investment" (Faruqi p.114). During 1974-1975, commercial banks were reprivatized (sold to large local conglomerates), reserve requirements were lowered, interest rates were freed, and a new class of private savings and loan institutions was allowed to operate (Gibson p.599). Financial intermediation grew rapidly during the liberalization period, where the ratio of M2 to GDP rose from 15% in 1975 to 40% in 1982 (chart 3.7). While the liberalization measures resulted in an important development of the financial system and deepening of financial institutions, it appears that many of the institutions were unprepared to operate in the unrestricted environment. Thus, the financial deepening process was interrupted by the emergence of a financial crisis in the early 1980s. A widespread failure of financial institutions resulted when the economy entered a recessionary period in the early 1980s. The first signs of distress began during the period 1975-1978, with the collapse of the whole savings and loan systems, followed by the failure of several unregulated financial institutions and one medium-sized bank (Ibid p.37). Financial crisis returned during the period 1981-1982 when a number of the large Chilean-owned business.
conglomerates and hence banks who had lent heavily to them get into severe difficulties (Ibid p.599). The crisis reached its peak by January 1983, when almost all private sector banks had become insolvent and had been taken over by the authorities (Faruqi p.115).

The interaction between inappropriate macroeconomic policies on the one hand and significant structural weaknesses in the financial sector on the other hand had led to the crisis of the early 1980s (Ibid p.40-41). When the liberalization process began, inflation continued to be high and variable resulting in variable and too high real interest rates which in turn contributed to the growing non-performing loans in banks portfolios. The peso was devalued against the dollar and in 1978, the exchange rate was fixed by the government. All these factors, accompanied with a liberalization of capital flows in the early 1980s, led to large capital inflows, which in turn resulted in large real appreciation of the peso. As argued by McKinnon (1985), this serious macroeconomic imbalance between interest rates and exchange rates was responsible for the 1981-1983 crisis. (Gibson p.600-601). As for the financial sector origins of the problem, they can be referred to the lack of adequate prudential regulation and supervision which contributed to the risky behavior of market participants and hindered the solvency of banks (Faruqi p.41).

3.2.1.2.2. Crisis Resolution

In dealing with the crisis, the Chilean authorities chose to “socialize losses and defer them over time through a debt restructuring process financed by
the central bank” (Ibid p.118). The central bank bought the bad loan bank portfolios at par in exchange for central bank promissory notes, thus improving the asset portfolio quality of banks and making them attractive investments to new private shareholders. Banks were required to repurchase their loan portfolios using their own future profits. (Ibid p.39).

However, two implicit subsidies were included in the portfolio purchase program. First, the central bank subsidized the interest rates on promissory notes by offering a higher rate than the cost incurred at the moment they were issued. Second, bank profits with which the portfolio was to be repurchased were subject to a discount rate. In addition, the rescue program was accompanied by a sustained real currency depreciation that started in 1982 and increased the real value of foreign debt. In order to help foreign currency borrowers, the central bank offered them favorable exchange rates, which further increased losses at the central bank. (Ibid p.121).

Despite the severe costs borne by the central bank, the management of the banking crisis in Chile minimized distortions in the financial system relative to those incurred in other Latin American countries. In contrast to Mexico and Argentina, the Chilean authorities attempted to focus responsibility for banking crisis on the shareholders of the most distressed banks rather than on the financial system as a whole (Rojas-Suarez p.21-22).

3.2.1.2.3. Strengthening the Regulatory and Supervisory Framework
Because the lack of appropriate banking regulations has strongly contributed to the Chilean crisis, the establishment of a new framework of banking legislation in 1986 has been crucial to the reform process. The new legislation gave great importance to the regulation of banking activities, such as including provisioning rules, limits on loans to individual borrowers, limits on foreign currencies' positions, limits on lending to related parties, limits on mortgage financing, and many other regulations. The 1986 law also allowed banks to participate in non-traditional activities in the areas of securities intermediation and financial services through bank subsidiaries (Faruqi p.123).

In addition, the new legislation emphasized bank supervision by requiring fuller disclosure of detailed information on the financial conditions of each banking institution. As a result of the experiences during the crisis, the supervisory framework in Chile has become the most comprehensive in Latin America.

3.2.1.3. The Development of Capital Markets in Latin America

Since the late 1980s, a number of factors, both domestic, including financial sector reform programs and privatization programs, and external, specifically low interest rates in the United States, have contributed to the expansion of bond and equity markets in Latin America.

Many of Latin America's liberalizing reforms have been aimed directly at developing capital markets based on the idea that healthy capital markets are crucial to improving the efficiency with which savings are transformed into investment, thus contributing to financial deepening. As a result, foreigners have
been allowed to invest in domestic equity markets, heavy regulatory requirements have been relaxed and securities supervision has been improved (The Economist p.9).

Capital markets have also benefited indirectly from other reforms, such as privatization programs. The sale of state assets has played a very important role in raising capital in many Latin American countries. In Mexico, for example, the privatization of Telmex (Telefonos de Mexico) in 1991 has brought a dramatic increase in the supply of new tradable securities (Ibid p.6). The decline of interest rates in the United States in the early 1990s encouraged foreign investors to look to new emerging markets for higher yields, which led them to Latin America's capital markets.

As a result, market capitalization expanded dramatically during the period 1991-1993 in many Latin American countries after its contraction during the early and mid 1980s (Rojas-Suarez p.6). Mexico's stock market capitalization, for instance, increased from $23 billion at the end of 1989 to over $200 billion at the end of 1993, while in Argentina, market capitalization rose from $4 billion to more than $40 billion over the same period (The Economist p.9). However, "foreign investment has all too often substituted for, rather than supplemented, the development of a domestic investor base" for both bond and equity markets in Latin America (Ibid p.9). Moreover, in spite of the tremendous growth in market capitalization, equity finance in Latin America is still limited to the
largest corporations and has not yet become a significant competitor for bank finance for the corporate sector as a whole (Rejas-Suarez p.6).

As for Latin America’s domestic debt market, it is almost dominated by government paper. This is a direct consequence to Latin America’s history of high inflation and government heavy borrowing which crowded out private borrowing. The control of inflation and reduction in government borrowing brought about by recent macroeconomic reforms in many Latin American countries should contribute to the development of long-term corporate bond markets. Moreover, the need for infrastructure finance through the bond market will also play a role in the development of long-term debt markets in Latin America. However, both debt and equity markets in Latin America still suffer from the shortage of domestic institutional investors. Chile, with its stable equity market based mostly on domestically raised capital and its active long-term corporate bond market, is an exception. (The Economist p.10).

One of the major developments in Chile’s financial markets in the last decade has been the privatization of its public pension fund system and its replacement with a privately funded capitalization system (Faruqi p.126). Since 1981, all workers had to channel 10% of their pre-tax income to private pension fund agencies. In this new system, private savings are no longer misallocated through government unproductive uses usually motivated by political considerations. Instead, they are entrusted to professional managers who seek-cut the highest returns by investing these funds in various instruments including bank
deposits, privately issued bonds and stocks, and government securities. Moreover, competition among pension fund managers has led to more efficient use of capital. As a result, private pension fund agencies in Chile have been able to accumulate a large pool of domestic institutional savings that have been very important in the deepening of the Chilean financial markets. Pension funds and insurance companies in Chile are the main holders of long-term financial instruments, which contributed to a deep long-term capital market, unlike other Latin American countries (Ibid p.128).

Thus, due to its high levels of domestic saving (close to those of many East Asian economies), responsible management in the face of financial crisis, and its strong regulatory and supervisory framework, Chile's reforms have been the most advanced in Latin America contributing to the deepest capital markets in the region.
Chart 3.2. Thailand: Monetization Ratio (M2/GDP)
CHAPTER FOUR

FINANCIAL DEEPENING IN LEBANON

This chapter examines the process of financial deepening in Lebanon based on the experiences of East Asian and Latin American economies which were assessed in the previous chapter.

As noted above, the process of financial deepening was successful in the East Asian economies due to their long history of financial stability accompanied with solid prudential regulation and supervision. Low to moderate inflation and stable real interest and exchange rates have encouraged long term planning, thus promoting financial savings and highly productive investments. High levels of growth and saving enabled the East Asian economies to keep their budget deficits as well as their external and internal debt under prudent management.

In contrast, the Latin American countries were more fragile in the face of financial crises which led to severe financial distortions especially in Mexico and Argentina. Due to their high levels of inflation, large volatility in interest and exchange rates, and loose banking supervision, these countries were unable to deal prudently with financial crisis which hindered the process of financial deepening. Chile, with its large domestic savings and improved prudential regulation and supervision, succeeded in dealing with the crisis and deepening its financial markets.
This chapter examines the Lebanese experience building on the experience gained from the study of the above countries. It is divided into three parts. The first part gives an overview of the Lebanese economy during the period of war (1975-1990). It includes an assessment of the major macroeconomic indicators and the state of the banking sector. The second part examines the factors contributing to financial deepening in Lebanon by drawing parallels and trying to learn from the experiences of the above developing countries. The third part suggests reform options for the Lebanese financial sector.

4.1. The Lebanese Economy (1975-1990)

4.1.1. The Macroeconomic Environment

Prior to the beginning of the civil war in 1975, Lebanon experienced high economic growth accompanied by relative price stability, a sound national currency and a favorable banking and financial sector. This was fostered by its geographical location, highly open economy, favorable regulatory environment, government's limited intervention in economic affairs, and the political and economic developments in the countries surrounding it. This rapid process of economic growth and financial development was largely hindered by the onset of wars starting in 1975 and continuing for a decade and a half. This resulted in a severe destruction of the infrastructure and the financial center, a substantial decline in real income growth, high and rising government's budget deficits and recession of economic activities.
Table 4.1 gives the main macroeconomic indicators for Lebanon as well as for a selection of Latin American and high performing East Asian countries for which the relevant information is available. These are: Korea, Singapore, Malaysia, Indonesia, Chile, Mexico and Argentina. The indicators under scrutiny are: inflation rates, nominal and real interest rates, budget deficit, money supply and public debt relative to GDP.

4.1.1.1. Large Budget Deficits

The major macroeconomic problem resulting from the war was the soaring budget deficit which mainly contributed to high inflation rates and rapid depreciation of the Lebanese pound. Since the early 1980s, the government's budget deficit has deteriorated substantially (Chart 4.1). Due to war, the government lost the capability to collect its revenues while it continued its spending on non-productive sectors. In order to finance the deficit, the government resorted to printing new currency and the issuance of treasury bills. The Central Bank's direct lending to the government or its subscription in treasury bills through printing new currency resulted in a rapid expansion of the money supply which in turn led to a surge in inflation rates. Government's borrowing from commercial banks through the issuance of treasury bills was less inflationary than printing money, but still it involved an increase in the money supply, and crowded out private borrowing (Saidi 1995, p.62).

4.1.1.2. High Inflation and Unstable Exchange Rates
The other two major macroeconomic consequences of the war were the rising inflation and the rapid depreciation of the Lebanese pound which characterized the Lebanese economy during the 1980s and early 1990s. The uncertainty brought about by these two factors has undermined medium to long term planning and resulted in a deterioration of the financial sector. The inflation rate rose tremendously during the years of war where it moved from a low level of 10% in 1975 to 69% in 1985 and then reached its peak at 487% in 1987. However, nominal interest rates were almost constant during the 1980s moving within a narrow range of 12 to 22% (IMF). This resulted in severely negative real interest rates especially during the period 1986-1988 (chart 4.2). People lost confidence in the Lebanese pound which led to a dollarization of the economy as people shifted to the use of the dollar in most of their economic activities. Bank deposits in foreign exchange have increased substantially at the expense of Lebanese pound deposits and bank loans to the private sector were increasingly granted in foreign exchange rather than in Lebanese pounds. Dollarization reached its peak in 1987 when foreign currency deposits constituted 92.29% of total deposits (Iskandar p. 39).

4.1.2. The Banking Sector

Since the early 1980s, the banking sector became tightly regulated due to a number of restrictive monetary measures such as the compulsory subscriptions to treasury bills, high legal reserve requirements, and credit limitations in domestic currency. Thus, the banking sector's role in intermediating funds had diminished
gradually since 1984 and bankers had lost control over significant portions of the sector's financial assets (Ibid, p.37-38). Banking resources to finance private sector's investment activities were largely crowded out by the public sector since they were directed to the financing of rising and unproductive budget deficits.

Moreover, the banking sector was largely affected by the political and security disturbances when a number of banks went into severe difficulties. Since the emergence of Al-Mashrek bank crisis in 1989, a number of non-resident Lebanese banks began facing serious problems either in their liquidity or in the structure of their assets and liabilities. These problems, mainly caused by mismanagement, resulted in the failure of banks which affected their position inside Lebanon. The banking sector's crisis worsened with the increase in the number of failing banks which reached 13 in the early 1990s (The Bankers Association of Lebanon 1992, p.11).

4.2. Factors Contributing to Financial Deepening

4.2.1. Restoring Macroeconomic Stability

Experiences of the successful East Asian economies have demonstrated that maintaining a stable macroeconomic framework is crucial for the process of financial development. However, the experience of Lebanon during the period of war was similar to Mexico and Argentina in terms of macroeconomic instability, restrictive monetary measures and banking crisis. Thus, the implementation of macroeconomic stabilization program would serve as a first step in the process of financial deepening.
Since the end of the civil war in 1990, the Lebanese economy has recovered substantially with the major macroeconomic indicators moving in the right direction. GDP growth was estimated at 30% in 1991, 5% in 1992 and 7 to 9% in 1993 (Saidi 1995, p.29). Following the appointment of the new government in October 1992, an exchange rate stabilization policy has been implemented accompanied with a restrictive monetary policy. As a result, inflation rates have decreased substantially from over 120% in 1992 to a range of 8 to 9.5% during 1993-1994 (Saidi April 1996, p.5). The Lebanese pound has also appreciated gradually since 1992 where the exchange rate to the dollar declined from LL 1838 at the end of 1992 to LL 1711 and LL 1647 at the end of 1993 and 1994 respectively (BDL). Moreover, the substantial reduction in inflation rates in 1993 resulted in positive real interest rates which in turn led to a reduction in the dollarization of deposits. According to IMF estimates of the inflation rate and as shown in chart 1b, real interest rates were slightly negative in 1993. As in the case of Lebanon, both Mexico and Argentina implemented comprehensive efforts to reduce the inflation rate in the early 1990s which resulted in a period of stability accompanied by positive real interest rates.

Concerning the budget deficit of the government, it continued its deterioration at an amplified rate during the early 1990s but it improved slightly since 1994 (chart 4.1) due to the fiscal policy implemented by the government since 1993. This policy aimed at reducing expenditures in real terms and increasing revenues. It was accompanied by an improvement in tax
administration and collection, and a tax reform which reduced the income tax rate to 10%. Real improvement in the budget deficit will take time due to the current need for government financing of the reconstruction projects and the building of the infrastructure. However, the ratio of public debt to GDP is still very high where it exceeded 50% in 1993 (Table 4.1). The financing of this large debt will lead to further deterioration in the budget deficit which will result in a vicious circle of unsustainable budget deficits.

The monetization ratio (M2/GDP), which is used to measure the level of financial deepening, is unusually high in Lebanon (Table 4.1) where it exceeded two and even three during the period of war (chart 4.3). As shown in chapter three, this ratio is less than one in all the countries under study. Even in developed countries with the deepest financial markets, the monetization ratio is still less than one or around one (Table 2.1). This unusually high ratio in Lebanon is due to the fact that M2 was growing at an accelerating rate while the average growth rate of real GDP turned to be negative during the period of war. Thus, this high ratio is not an indicator for high potentials in Lebanon. Since the early 1990s, the ratio of M2 to GDP decreased substantially as a result of the growth experienced in real GDP (chart 4.3 & table 4.1).

Above all, the restoration of political stability starting in 1990 along with the implementation of economic stabilization measures resulted in improved macroeconomic conditions. These conditions should persist in the long run in order to renew confidence in the future of the Lebanese financial sector.
4.2.2. Development of a Sound Banking Sector

During the years of war, the deteriorating conditions of the Lebanese banking sector were very similar to those experienced in Mexico and Argentina during the 1980s. In all three countries, Commercial banks were forced to finance the credit expansion of the government through high reserve requirements imposed by the Central Bank. This led to hyperinflation which was accompanied by a severe deterioration of the exchange rate and negative real interest rates. Charts 4.4 and 4.2 show respectively the severe negative real interest rates experienced in Mexico and Lebanon, especially during the period 1986-1988. As a result, the real burden of borrower debt was reduced while depositors were forced to accept a depreciation of their deposits in real terms due to the inflation tax. Moreover, the Central Bank was confronted with a conflict of interest between ensuring the financing of the government and stopping the depreciation of the national currency. In contrast to Mexico and Argentina, the Central Bank of Lebanon has been able to reinforce its role by preserving and gradually improving the parity of the Lebanese pound since 1992. However, credit allocation of Lebanese pounds to the central government through compulsory subscriptions to treasury bills should be abolished, as the credit allocation schemes were reduced in most of the developing countries. One measure undertaken by the Central Bank was the reduction in the required subscription in treasury bills from 60% to 40% according to a circular issued in 1994 (The Bankers Association of Lebanon 1994, p.18).
In order to protect depositors and maintain confidence in the stability of the banking sector, Lebanon pursues prudential regulations similar to those adopted in the high performing East Asian economies and in Chile after the banking reform. As of March 1995, commercial banks in Lebanon have been able to meet the solvency ratio of 8% as required internationally by the Basle agreement (Saidi April 1996, p.5). The Central Bank is currently discussing with the Bankers association of Lebanon the issue of increasing the minimum acceptable capital of commercial banks from LL 2 billion to LL 10 billion in order to activate the Lebanese Banking operations and facilitate competition in the regional and international banking market (Eco, May 1996, p.1). This step will take some time, but it will bring the capital base of small banks in line with larger ones.

In dealing with the crisis of bank failures which started in 1989, the parliament issued a new banking reform law in November 1991. This law stipulated the establishment of a special banking court to decide whether a bank is able to resume its operations or not, and it specified the procedures to follow in bank closures and self-liquidation. This law also permitted the increase of the deposit insurance from LL 1 million to LL 5 million. (iskandar p.34).

Thus, the implementation of macroeconomic stabilization measures in the early 1990s along with the strengthening of prudential regulation and supervision should restore confidence in the Lebanese banking sector.

4.2.3. Development of a Deep Financial Market
During the period of war, Lebanon suffered from a severe deterioration in the financial sector. Financial institutions were underdeveloped, the stock market was destroyed and eliminated, and the range of financial instruments was very limited. In Lebanon, banks dominate the financial system where the main source of lending is short term bank lending mostly in the form of callable overdraft facilities. Due to the high level of uncertainty brought about by political and macroeconomic instability during the period 1975-1990, long term planning was very risky which resulted in a severe shortage of medium and long term finance.

Now, as confidence has been restored in the Lebanese economy, the availability of efficient financial markets becomes critical to finance the reconstruction projects as well as the rapid economic growth expected to occur. Lebanon needs to build its capital stock through intensive investment programmes to increase production and quickly recapture the 1974 real growth levels.

In order to mobilize domestic as well as foreign resources in financial form, Lebanon needs to develop a variety of financial instruments whose characteristics are sufficiently attractive in terms of yield, liquidity, maturity and risk. These financial instruments should be provided through healthy money and capital markets in order to improve the efficiency with which savings are transformed into investments, thus contributing to long term economic development.
A recovery of real growth levels and an increase in production will require a substantial increase in private investment resources in addition to the increase in public sector investment. As shown in the East Asian experience, domestic savings are crucial for the growth of the economy’s real sector. The change in the saving behavior of the private sector in Lebanon during the early 1990s is shown in Table 4.2. Banking deposits of residents increased steadily during the period 1990-1994. These deposits rose to L.L 20,981 billion at the end of 1994 making an increase of 469% over their 1990 value in L.L. Even if the figures are converted to US$ at closing rates, the 1990 deposits amounted to $4.371 million as compared to 1994 of $12,739 million, making an increase of 191%. Moreover, individuals in Lebanon hold an important portfolio in treasury bills. Treasury bills holding by the public increased by 267% during 1991, 25% during 1992, 19% during 1993 and 51% during 1994. Thus, as political and macroeconomic conditions have been improved, domestic savings should play an increasing role in financing the productive sector of the Lebanese economy.

Table 4.2 - Lebanon: Change in Saving Behavior

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<tbody>
<tr>
<td>Banking Deposits</td>
<td>5,681</td>
<td>5,947</td>
<td>12,403</td>
<td>15,786</td>
<td>20,981</td>
</tr>
<tr>
<td>The holding by the public</td>
<td>177</td>
<td>690</td>
<td>814</td>
<td>970</td>
<td>1,464</td>
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Source: BDL Annual Report and Bilanbarques, various issues.

In order to fill the perceived gap in the provision of medium to long term credit and finance, Lebanon needs to promote the development of financial
institutions which are well adapted to the provision of medium and longer term credit and finance. The services offered by these financial institutions should complement the role of commercial banks which attract retail sources of funds and provide commercial and short term credit.

As mentioned in Chapter three, the successful East Asian economies have fostered the development of financial institutions for medium and longer term finance by establishing a more relaxed regulatory framework than that applied to the banking sector, and by developing new financial instruments. As in East Asia, the Central Bank in Lebanon has recently promoted the establishment and the development of specialized banks and financial institutions through a series of new measures and regulations. One of these regulations stipulated that specialized investment banks should not be subject to legal reserve requirements on their deposits on condition that they offer medium to long term finance to the private sector. Commercial banks can benefit from these same exemptions on condition that they provide medium to long term finance to productive investments. (Sadri, April 1996, p.1). Moreover, tight credit regulations on the Lebanese banking sector -namely credit limitations in domestic currency and credit ceilings in foreign currency- aim indirectly at encouraging other forms of medium and long term finance. The credit ceiling in foreign currency has been recently raised from 55 % to 60 % and then to 70 % because a good number of Lebanese banks have either reached or exceeded the limit (ibid p.6). Therefore, people need to satisfy their demand through other forms of financial institutions.
which are better adapted to provide medium and long term credit and finance. Thus, as in the experience of Chile with its private pension funds, specialized banks and financial institutions are supposed to play an increasingly important role in the deepening of the Lebanese capital market.

Along with enhancing the role of specialized banks and financial institutions, it is equally important to have available new credit and investment instruments. The money market in Lebanon is currently dominated by treasury bills and other new financial instruments such as certificates of deposit and repurchase agreements. The fact that people in Lebanon already have an important portfolio in treasury bills shows their willingness to invest in a more diversified portfolio including different types of financial instruments such as stocks and corporate private or public bonds.

Recently, a new law was passed by the Lebanese Parliament allowing commercial banks to offer 30% of their stock to the public on organized financial markets (Eco, May 1996, p.7). Such markets have already developed with the listing of Solidere shares in the secondary market in 1994, then with the revitalization of the Beirut Stock Market which became fully operational in January 1996. However, the volume of trading in the Beirut Stock Market is still very limited due to the lack of local listings. Small-sized and family-owned companies in Lebanon are "averse to dilution of ownership and disclosure" (Saidi 1995, p.356).
Thus, in order to encourage trading and ensure the efficient functioning of the stock market, the Lebanese government must resort to several measures similar to those implemented in East Asia. This include establishing a modern accounting and auditing system based on international standards, introducing laws to protect investors and ensure the transparency of market operations, adopting modern trading systems based on new technology, imposing full disclosure of accurate information about the companies whose stocks and bonds are traded, and establishing an independent regulatory authority for the licensing and supervision of the market (Ibid. p.23).

Privatization in Latin America have played a very important role in the expansion of stock markets. Thus, the development of the Lebanese stock market would also be promoted by the privatization of public utilities such as electricity, water and telecommunications. The sale of these public sector enterprises will increase the number of tradable securities in the market which will be very helpful in the revival of the Beirut Stock Market. Moreover, privatization will offer the government a means for improving its financial position by raising capital in the stock market. Raising funds through privatization is no different in principle from selling government bonds in the debt market. The issuance of government bonds to finance the reconstruction projects can play an important role in the development of a long term debt market. Actually, the Lebanese government has issued high-yield bills in foreign currency denomination and sold
them in foreign markets, thus attracting foreign funds to help financing the reconstruction projects.

Based on the main findings drawn from the experiences of a selection of East Asian and Latin American countries in chapter three and the experience of Lebanon in this chapter, tables 4.1, 4.3 and 4.4 help in providing the following concluding remarks:

1- While Korea, Singapore, Malaysia and Indonesia are characterized by a long history of macroeconomic stability as demonstrated by their favorable macroeconomic indicators, Lebanon, Mexico and Argentina are on the right track in improving their macroeconomic conditions (table 4.1). According to Dr. Saidi’s estimates, inflation has been controlled in Lebanon since 1993 resulting in positive real interest rates (table 4.3). According to IMF estimates of the inflation rate, real interest rates in Lebanon were slightly negative in 1993 (table 4.1) and they became positive in 1995. Inflation rates were also controlled in Mexico and Argentina since the early 1990s (tables 4.1 and 4.3). However, Lebanon and Mexico still suffer from large budget deficits (table 4.3) which could have negative effects in the process of financial deepening if they persist for a long period of time.

2- While credit allocation schemes have become less important in Korea, Indonesia, Chile and Mexico following the major financial liberalizations of the 1980s and early 1990s, Lebanon still allocates credit to the central government
through compulsory subscriptions to treasury bills imposed on commercial banks (table 4.3). This can undermine financial development by restricting the channelling of funds towards high-productive investments.

3.- Interest rates were gradually liberalized or completely freed in most of the developing economies such as Korea, Indonesia, Chile and Mexico (table 4.3). In Lebanon, interest rates are dominated by treasury bills’ rates through the treasury bills’ subscription requirement. Although the prices or discount rates are determined by theoretically free auctions since 1993, but these rates were distorted between 1993 and 1994 by having the rates of the two year treasury bills excluded from the auctions and determined exogenously by the Lebanese Treasury. Between 1994 and 1995, although the two year bills rates were also freed, but the process of auction distorted the free pricing of treasury bills. This distortion was the result of the central bank interfering in the auction by accepting orders at variance with the Treasury’s weekly borrowing requirements. Interest rates should be based on market forces in order to ensure the efficient accumulation and allocation of resources, which in turn contribute to long term economic development.

4.- Strong prudential regulation and supervision have contributed to financial deepening in most of the successful East Asian economies such as Korea and Indonesia (table 4.4). These measures have been strengthened in Chile in 1986 after the banking crisis of the early 1980s. In Mexico as well as in Lebanon, prudential regulation and supervision have been strengthened in the
early 1990s (table 4.4). This constitutes an essential factor in the process of financial deepening, especially after the financial crises experienced in Latin America and Lebanon during the 1980s.

5- Bond and equity markets are becoming increasingly important in the successful East Asian economies such as in Korea and Indonesia (table 4.3). In Latin America, stock market capitalization expanded dramatically during the early 1990s. However, stock markets in Latin America such as Mexico still suffer from the lack of domestic institutional investors. Chile has the deepest capital market in Latin America based mostly on domestically raised capital (table 4.3). In Lebanon, the stock market is still at an early stage of development. Recent regulations, similar to those implemented in Korea and Chile, have been undertaken by the Lebanese authorities in order to promote the development of efficient bond and equity markets. The stock market in Lebanon can also benefit from the experiences of privatization in Latin America which have played an important role in the expansion of stock markets.

C. Reform Options.

Based on the above concluding remarks, Lebanon is following the right trend in improving the conditions conducive to financial development. However, Lebanon still suffer from the presence of huge government deficit and debt which are hindering the process of financial development. Thus, along with the economic stabilization measures implemented by the government since 1992, the following reform steps would be recommended:
1- First, the implementation of a privatization program should be effected over the next few years. The public sector in Lebanon includes the following public utilities: electricity, water, post and telecommunications and transport. As the Beirut Stock Market has been revitalized, the privatization of public sector enterprises can take the form of a public offering of shares to be subscribed by the general public. Several measures and regulations must be provided to avoid monopoly control and ownership, and ensure the efficient functioning of the privatized utilities.

The sale of these public enterprises should help in reviving the Beirut Stock Market through an expansion in the potential supply of local listings. More important is the role of privatization in improving the fiscal condition of the government and alleviating the potential debt service burden arising from a large accumulation of debt. Thus, this privatization program, along with the fiscal adjustment in the flow of expenditures and revenues through tight fiscal policy, should play an effective role in achieving a persistent and permanent reduction in the government budget deficit.

2- A gradual reduction in LL interest rates should go in line with the reduction in government budget deficit. This should help to eventually allow the market forces to determine the rates. As a result, the differential between LL and USS interest rates will be reduced, thus encouraging the utilization of the Lebanese pound in the credit and capital markets. As people become encouraged to issue LL-denominated securities, a market for private securities would develop.
after being crowded out by government securities to finance large budget deficits.

3. A third step in the reform program would be the elimination of the 40% compulsory subscription to treasury bills. Given the lower yields in LL achieved in step 2, this step would be effective in transferring large resources from unproductive investments in treasury bills towards high-productive investments.

4. Finally, at a later stage, the government should consider the elimination of the 3% invested in special treasury bills and the 10% legal reserve requirements.

The last 2 steps should be accompanied with further strengthening of banking prudential regulations and supervision.

At this stage of development, financial distortions would be eliminated and financial deepening would be promoted. People will be well adapted to hold financial assets other than the highly-liquid bank deposits and treasury bills.
<table>
<thead>
<tr>
<th>Country</th>
<th>Inflation Rate(%)</th>
<th>Nominal Interest Rates(%)</th>
<th>Real Interest Rates(%)</th>
<th>Budget Deficit/GDP (%)</th>
<th>M2/GDP (%)</th>
<th>Public Debt/GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Korea</td>
<td>2.4 4.8</td>
<td>5 5 2.5 0.2</td>
<td>-1.1 0.6</td>
<td>34.8 42</td>
<td>15.5 6.7</td>
<td></td>
</tr>
<tr>
<td>Singapore</td>
<td>0.4 2</td>
<td>4.99 2.3</td>
<td>4.59 0.3</td>
<td>2 N.A</td>
<td>72 92.3</td>
<td>86.2 N.A</td>
</tr>
<tr>
<td>Malaysia</td>
<td>0.3 3.7</td>
<td>4.13 5.07</td>
<td>3.83 1.37</td>
<td>-7.3 -5</td>
<td>65 89.9</td>
<td>82.3 56.6</td>
</tr>
<tr>
<td>Indonesia</td>
<td>4.8 9</td>
<td>18 17</td>
<td>13.2 8</td>
<td>-0.9 0.6</td>
<td>24 47</td>
<td>32.2 37.5</td>
</tr>
<tr>
<td>Chile</td>
<td>28 12</td>
<td>31.9 18.24</td>
<td>3.9 6.24</td>
<td>-2.3 1.9</td>
<td>40 39</td>
<td>N.A. N.A.</td>
</tr>
<tr>
<td>Mexico</td>
<td>57.5 8.6</td>
<td>56.07 18.56</td>
<td>-1.63 9.96</td>
<td>-8.4 N.A</td>
<td>25 30.7</td>
<td>N.A. N.A.</td>
</tr>
<tr>
<td>Argentina</td>
<td>627 10.6</td>
<td>630 11</td>
<td>3 1.6</td>
<td>-5.5 N.A</td>
<td>17.3 17.8</td>
<td>N.A. N.A.</td>
</tr>
<tr>
<td>Lebanon</td>
<td>69.4 29</td>
<td>19.7 20.22</td>
<td>-49.7 -8.8</td>
<td>-35.8 -10.2</td>
<td>200 119</td>
<td>97.1 52.8</td>
</tr>
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</table>

<table>
<thead>
<tr>
<th>Country</th>
<th>Interest Rate Policy</th>
<th>Foreign Exchange Policy</th>
<th>Control of Budget Deficit</th>
<th>Control of Inflation</th>
<th>Credit Allocation Scheme</th>
</tr>
</thead>
<tbody>
<tr>
<td>Korea</td>
<td>Gradual liberalization (since 1982)</td>
<td>Managed-floating (since early 1980s)</td>
<td>Yes</td>
<td>Yes</td>
<td>Largely reduced, eventually successful</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Free (since early 1950s)</td>
<td>Managed-floating (since early 1980s)</td>
<td>Yes</td>
<td>Yes</td>
<td>Largely reduced</td>
</tr>
<tr>
<td>Chile</td>
<td>Free (since 1975)</td>
<td>Managed-floating (1990s)</td>
<td>Yes</td>
<td>Yes</td>
<td>reduced</td>
</tr>
<tr>
<td>Mexico</td>
<td>Free (since 1980)</td>
<td>Fully Flexible (1990s)</td>
<td>No large budget deficit in 1994</td>
<td>Yes (in the 1990s)</td>
<td>reduced</td>
</tr>
<tr>
<td>Lebanon</td>
<td>Not completely free</td>
<td>Managed-floating</td>
<td>No significant budget deficits in the 1980s</td>
<td>Yes (in 1993)</td>
<td>LL at commercial banks directed to finance government deficit</td>
</tr>
<tr>
<td></td>
<td>Market Segmentation</td>
<td>Prudential Regulation and Supervision</td>
<td>Stock Market Performance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>----------------</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Korea</td>
<td>Restrictions on entry (more freedom during the 1980s)</td>
<td>Strong</td>
<td>Recently promoted.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>Freedom of entry</td>
<td>Strong</td>
<td>Recently promoted.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chile</td>
<td>Freedom of entry</td>
<td>Strengthened after the 1986 banking reform</td>
<td>Good (many domestic institutional investors).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>Freedom of entry</td>
<td>Strengthened in the 1990s</td>
<td>Lack of domestic institutional investors. Many foreign investors which is risky.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lebanon</td>
<td>Restrictions on entry (recent measures allowing more freedom)</td>
<td>Strengthened in the 1990s</td>
<td>Still at an early stage of development.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

This study was conducted to present the importance of financial deepening and its beneficial effects in stimulating economic development.

The ultimate objective of financial deepening is to increase savings in financial form and to improve the efficiency of channeling resources towards optimal productive investments, which in turn stimulates economic growth. Thus, financial markets and institutions should expand to provide savers and investors with the wider range of services associated with the mobilization and allocation of resources.

The process of financial deepening was successful in the high performing East Asian economies due to their long history of financial stability accompanied with adequate prudential regulation and strong supervision. Financial policies in these economies were designed to promote financial savings and efficient investments, and to deepen financial markets.

In contrast, the history of Latin America reveals a continuous cycle of macroeconomic mismanagement and financial instability. This led to severe financial distortions, which in the absence of adequate prudential regulation and supervision, undermined the process of financial deepening. While Mexico and Argentina were unable to deal prudently with financial crises, Chile succeeded in deepening its financial markets due to its larger domestic savings, responsible
macroeconomic management, and improved prudential regulation and supervision.

The experience of Lebanon during the years of war was similar to Mexico and Argentina in terms of macroeconomic instability and financial distortions. In the early 1990s, all three countries implemented macroeconomic stabilization measures and improved prudential regulation and supervision.

As confidence has been restored in the Lebanese economy, Lebanon adopted comprehensive measures to promote the development of its financial markets, as in the successful East Asian economies and Chile. Thus, Lebanon is on the right track in the process of financial deepening. However, Lebanon still suffers from the presence of many financial distortions which are hindering the efficient functioning of the financial system.

Based on the experience gained from the study of the above developing countries, the following lessons are recommended for implementation in order to deepen the Lebanese financial market:

- Maintaining low to moderate inflation;
- Reducing the budget deficit and keeping it under prudent management;
- Allowing interest rates to be determined freely by market forces;
- Eliminating the compulsory subscriptions to treasury bills;
- Enhancing the role of domestic savings in financing the growth of the productive sector;
- privatizing public sector enterprises such as water, electricity and post;
- promoting the development of specialized banks and financial institutions;
- encouraging the introduction and trading in new financial instruments;
- enhancing strong supervision of financial markets and institutions;
- and finally, promoting the development of the Beirut Stock Market by insuring the implementation of a modern accounting and auditing system, introducing laws to protect investors, and imposing full disclosure of accurate information prior to any public offering.
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