Economic Development Institute
of The World Bank

Macro-Financial Review: Policy and Program Formulation

Tusania: A Case Study and Training Guide

Shakil Faruqi

EDI WORKING PAPERS

REGULATORY REFORM AND PRIVATE ENTERPRISE DIVISION

Macro-Financial Review: Policy and Program Formulation

Tusania: A Case Study and Training Guide

Shakil Faruqi

This case study is intended for those interested in macro-financial management, policy and program formulation. Topics covered include: approaches to macro-financial review; analysis of financial system structure and trends; linkages with economic trends; analysis and aggregates; financial resource mobilization and allocation; domestic and external financial requirements; operations of the central bank and its impact on the banking system, mechanisms and linkages; the regulatory framework and system of control; the role of financial markets; policies and program formulation at the macro-level, and interactions at the sectoral and institutional level.

Economic Development Institute
of The World Bank

FOREWORD

This case study and training guide is one of a series of training materials on banking and financial systems developed at the EDIRP. It is primarily intended for those responsible for macro-financial management, policy and program formulation, and operation of the regulatory and control mechanisms, as well as the practitioners in the financial and banking systems. As a training handbook, the study is also intended for trainers interested in enhancing their understanding of the framework, methodology, and analytical techniques underlying macro-financial review and the formulation of a program of policies and actions. The emphasis is on developing the basic elements of a macro-financial program, and at the same time provide an understanding of the nature of inter-links between the major economic and macro-financial aggregates. The study highlights the type of constraintes operative on the system of regulation and control and the degrees of freedom available to the authorities concerned while charting out and implementing a stabilization package and macro-financial program in a time of economic and financial crisis.

While this case study will suffice for those interested at the macro-level in formulating the framework, the policy regime, bench-marks and broad-based guide posts, it will be inadequate for practitioners whose concerns go beyond policy-making. For them it is critical to have a deeper understanding of how banking and financial systems respond to policy changes and how effective is the mechanism of regulation and control. Therefore, the centerpiece of the case study is the illustration of linkages as feasible, between macro-financial policy bench-marks, and the response of the banking and financial system at the sectoral level, down to the impact at the institutional level.

This case study is primarily based on lessons of experience of the author drawn from country cases and is interspersed by observations in similar situations elsewhere. The framework, analysis, results, and illustrations are forged as a composite of the two country cases. The data set has been stylized to spotlight the nature of interlinks, the control mechanisms, and the behavioral response at the sectoral and institutional level. Since the study spans a period of seven years, this may remind some readers of the parable of seven fat years, followed by seven lean years, yet even a parable must be ensconced in a continuum and a contextual relevance. This is attempted here in this case-study.

Danny Leipziger
Chief
Regulatory Reform and
Private Enterprise Division

ACKNOWLEDGMENT

The manuscript was initially prepared by the author at various stages in several training modules delivered in EDI training programs during 1992-1995. The author would like to thank all those who contributed to this publication. A draft of the manuscript was reviewed and edited by Professor John Crockett of George Mason University. Processing of earlier drafts was done by Elizabeth Crespo, John Yates, Bénédicte Löchen, and Robert McGee. Final processing, copy-editing and preparation for publication was done by Johanna Frontczak with skill and patience.

TABLE OF CONTENTS

TABLES

BOXES

CHARTS

ANNEXES

ABBREVIATIONS

ADBT	Agriculture Development Bank of Tusania
AMLs	Agencies: Multilaterals
CenBank/CBT	Central Bank of Tusania
CDs	certificates of deposit
ComBanks	Commercial Banks
DFIs	development finance institutions
fCDs	foreign currency deposits
FinIns	Financial Institutions
FinSys	Financial System
GDP	gross domestic product
IDBT	Industrial Development of Bank of Tusania
IOUs	financial obligations (I owe you)
LIBOR	London Interbank Offer Rate
M&LT	medium and long-term
MoF	Ministry of Finance
MoI	Ministry of Industries
NBT	National Bank of Tusania
NICT	National Insurance Corporation of Tusania
NTF	National Trust Fund
QRs	Quantitative Restrictions
SBT	Savings Bank of Tusania
SEC	Securities and Exchange Commission
SEs	state (owned) enterprises
SME	small and medium enterprises
ST	Siwat, Tusanian currency
T-bills	treasury bills
TCs	treasury certificate
TNB	Tusanian National Bank
TSE	Tusanian Stock Exchange
Y	year

EDI Document Number: 340/083, Shelf Number: E9258

Shakil Faruqi is principal financial economist in the Regulatory Reform and Private Enterprise Division at the Economic Development Institute of the World Bank.

EDI Working Papers are intended to provide an informal means for the preliminary dissemination of ideas with the World Bank and among EDI's partner institutions and others interested in development issues.

The backlist of EDI training materials and publications is shown in the annual *Catalog of Learning Resources* which is available from:.

Learning Resources Center, Room M-P1-010
Economic Development Institute
The World Bank
1818 H Street NW
Washington, DC 20433, USA

Telephone: (202) 473-6351
Facsimile: (202) 676-1184

CHAPTER I

THE ANALYTICAL FRAMEWORK

The Perspective

1.1 This case study deals with the current economic and macro-financial situation of Tusania, focusing on the problems of the past couple of years which have continued to deteriorate despite attempts to reverse this trend. The main reason was that the corrective measures and policies were inadequate to cope with the underlying structural causes of imbalances in the Tusanian economy. Yet, the focus has to be on the short-term picture within the framework of the government's annual programs since these annual programs are the central mechanism of the implementation of policy packages. Therefore, following a detailed presentation of the operations of the financial system, and analysis of the current situation, this case study proceeds to outline a short-run economic stabilization program and examine the feasibility and consistency of macro-financial package of corrective measures, together with the supportive apparatus necessary to enable Tusania to achieve stability and economic growth. The broad economic trends, stabilization objectives and annualized targets provide the guideposts for the articulation of the macro-financial package, though

these guideposts themselves may be adjusted in iterative fashion during the implementation phase because of the constraints encountered. While the data base for this type of analysis and program formulation is invariably inadequate - especially for the latest years - this does not alter the salient conclusions or the broad direction of the economic and macro-financial program, given that the underlying economic and financial structure, the operations of the financial system, and the initial conditions remained unaltered. As the severity of the current situation varies, the intensity of the corrective measures is modulated -- it is more a matter of degrees rather than broad directions of policy response.

1.2 Since any short-run economic and financial program has to contend with overall resource constraints, both internal and external, one cannot chart out a macro-financial program isolated from a comprehensive program for economic stability and recovery, short-term or otherwise. On the domestic front, this involves ascertaining the domestic resource balance in financial terms, the macro-financial aggregates such as the supply of banking credit within the mechanisms of the financial operations of the banking system borrowings of the public sector and the credit needs of the private sector. However, the most important aspect of the domestic resource balance in Tusania has to do with the fiscal operations of the government and the financial operations of a large quasi-government sector that, together, determine the over-all size of the public sector deficit that must be financed by banking system credit on terms and conditions which may not reflect market-based costs. On the external front, these elements are closely intertwined with the analysis of the balance of payments, capital inflows, and foreign borrowings necessary to support the macro-financial package contained in the stabilization program. The determination of a sustainable level of foreign capital inflows involves first ascertaining the size of the current account deficit based on the trade balance and the underlying levels of imports, exports, and exchange rate movements. This is followed by an assessment of net medium- and long-term capital inflows, disbursements from the existing

pipeline of foreign credits less repayments, the likelihood of new foreign borrowings on official accounts, and the outlook for private capital inflows, all of which are financing items for the balance of payment deficits.

1.3 This focus on the macro-level, both for the analysis of current trends and program formulation, has to be based on the operations at the institutional or unit level, and links have to be established in a direct fashion. How the financial institutions, the businesses, the enterprises, and the households behave in the face of changing economic and financial conditions and how they respond to various policy-led changes need not only be understood, but traced and followed. This traversing between the micro and macro levels is not easy, but is attempted here. The aggregation, however, poses two sets of analytical issues encountered throughout this case study. One set of issues relates to the statistical process of aggregation from the ground up, brick-by-brick, block-by-block, on the basis of financial statements originating at the micro-unit level, leading to the aggregation at the component level, and eventually, at the macro-level. Unless the data recording and reporting system is uniformly adhered to aggregation may not fully capture the subtleties of trends at the micro-level. A second set of issues relates to how faithfully the macro-level trends reflect the behavior of the constituent units, financial institutions, businesses, and enterprises. Quite often the unit level response to a given situation is driven by considerations inconsistent with those observed at the macro-level analysis. This cleavage, which arises especially in times of financial crisis, is sufficiently documented in this case study. Therefore, effort has been made to capture the behavior and functional response at the unit level in its microcosm and to establish analytical links with the outcome at the aggregate level.

1.4 Another major purpose of this case study is to present the underlying methodology and techniques of economic and financial reviews, the articulation of a short-term program, the determination of the size of financial resources needed, both

domestic and external, linkages at the unit level, simulations of feasibility of the program, and sensitivity analysis. This makes it possible to demonstrate the degrees of freedom in calibrating the levers of control and their impact, given the rigidities in the financial system that may render the operations of the control mechanism ineffective. Since these mechanisms have to interface with market-based signals, the central premise of this case study is that the Tusanian economy is fairly open, the basic economic and financial structures are reasonably responsive to market-based signals, and its regulatory system and corrective apparatus are sound and functioning. This may be too much to pretend, yet essential for the purposes of this study.

1.5 This case study presents a medium-term review spanning seven years, Y_1 through Y_7, with focus on the crisis years of Y_5 and Y_7. The seven-year span may remind some readers of the parable of seven fat years followed by seven lean years. Yet, even a parable has to be ensconced in a continuum, therefore, the review presented here for the Y_1-Y_7 years cannot be detached from developments in the years preceding the review period. As the case study demonstrates, the economic and financial trends during the review period are closely intertwined with the structure of the Tusanian economy prevailing before, and were shaped by the policy milieu and attempts at structural change and reform in the years preceding the review period. While the Tusanian economy remained buoyant during the first half of the review period, Y_1 -Y_4, the seeds of economic and financial crisis of the years Y_5-Y_7 were deeply embedded in the long-term past. This became particularly evident when the annual program for Y_8 was formulated as historical trends defined the set of constraints and degree of freedom available to policy formation. This case study, therefore, is not presented as a routine review and short-term stabilization program of a quick-fix variety. Instead, it offers a medium-term perspective with a focus on annual programs, since these are the only delivery mechanism available to the government.

The Issues

1.6 The macro-financial review has to contend with two broad issues. The first is the extent to which the macro-financial policies have been able to strike a balance between stimulating or directing an adequate and self-sustaining flow of financial resources to real sectors of the economy, while preserving confidence and financial strength in the institutions that make up the system. The second is, given that the financial system has undergone substantial changes, whether or not it has accomplished a major change in the pattern of financial resource mobilization and allocation. That is, to what extent have the reforms in the past succeeded? Further, if the distortions still exist, what is the source of these distortions? Do these remaining imperfections have their origin in the financial sector *per se*, in the real sectors, or in the structure of the government policy? The analysis of this element will help to identify distortions at their source, thus avoiding costly and inappropriate interventions. Specifically the review must focus on the following:

1. Issues relating to saving-investment balance, government finance, and public debt, both domestic and foreign; exchange and trade regime and its impact on the financial system; monetary and interest rate policies; and the evolution of money markets for the viability of open market operations and indirect instruments of monetary control for effective management of aggregate money demand. *Simply put, who generates and supplies financial resources, both domestic and foreign? What is the source, composition, and size of financial flows on the supply side?*

2. Issues relating to the allocation and pricing of financial resources, term lending, financing of the priority sectors such as industry and agriculture, and attempts to provide credit to disadvantaged groups; the phenomenon of perverse lending; issues covering development of capital markets to promote vitally needed long-term finance to support investment growth; and massive privatization and commercialization of public sector enterprises (SEs). That is, w*ho uses these resources and at what costs? What is the nature of resource allocation between users and suppliers, and what are the terms of allocation represented by the interest rate structure?*

3. System wide issues related to financial intermediation and its efficiency, the viability and solvency of financial institutions and portfolio quality and management; and the establishment and strengthening of a supervisory and regulatory system capable of enforcing a uniform criteria for participation in the financial system. *What is the mechanism of transfer of these resources between the suppliers and users and how efficient is it?*

1.7 It is not possible in this case study to deal with all of these issues in an exhaustive fashion. Instead, these elements are used as guideposts while outlining the macro-financial program and they are discussed in relevant sections to the extent possible. The data requirements are equally exhaustive. They are summarized at the aggregate level in four major accounts: macro-financial accounts; fiscal accounts; balance of payments accounts; and national accounts. These accounts are spelled out as exhibits in the Chapter Annexes. The exhibits, which provide a system of accounting identities, demonstrate the interlinks between the sub-components of a given account, as well as across the financial system, and their links with the macro-data set. In addition to these major accounts, there are four critical sets of prices: the general price level, the interest rate structure, the wage rate and the exchange rate. Availability of this basic data set, its reliability and quality, are critical to both the diagnostics and calibration of the levers of financial control. As mentioned above, this aggregate data set is built upon unit-based accounts and is constructed in building-block fashion, with progressive aggregation of its major components.

Approaches to Macro-Financial Program and Policy Formulation

1.8 To recapitulate, a macro-financial program has to be a part of the overall program for economic stabilization, recovery, and growth. This has to be achieved in the context of a sustainable domestic resource base, especially the fiscal deficit and its financing, and a sustainable current account deficit within a viable balance of payments. The twin deficits, namely the fiscal deficit and the current account deficit, have to be satisfied in a consistent fashion with broad macro-financial targets, and

with funding from domestic and external borrowings. These interlinks come in to play primarily through the price level, interest rate structure, and the exchange rate, depending on how open the economy is and what the structure of these linkages is.

1.9 The usual approach to the articulation of a short-term program is to start with an evaluation of the size of the domestic resource gap, with some notions of price stability and a sustainable exchange rate consistent with the domestic price level, the interest rate, and viable financial flows through the banking system, as well as their allocation to private and public sectors. Alternatively, one could begin with the external deficit, given the structure of foreign trade, current account balance, and autonomous capital inflows on a net basis, determining the size of the domestic resource gap that will be sustainable with some degree of price stability, and estimating how much of the residual domestic resource gap can be financed by the government through gap-fill borrowings from overseas and multilateral agencies (AMLs). In both cases, the government is under the constraint of keeping the targets of economic growth and inflation in prices and wages at levels politically acceptable to the public. That is, GDP growth, inflation, and the wage level, are somewhat pre-determined - partly within the political and social constraints - and to the degree that they are specified independently of the considerations of technical viability of the resource gap. Herein lie the roots of conflicting policy objectives, posing a dilemma to those in charge of policy formulation and implementation. In any event, the economic stabilization program straddles all the major areas mentioned above and it hinges in a composite manner on both domestic and external resource availability, consistent with stable levels of exchange rates, interest rates, domestic prices, and a target of economic growth acceptable to the public.

1.10 In the first case, if we proceed with the domestic resource gap, defined as the excess demand of resources over and above those available to the government and the private sector, the need is to determine the size of this domestic deficit. The easiest

way is to start with public sector deficit emerging from fiscal operation as well as the quasi-deficit, which is the government-guaranteed deficit of the state economic enterprises (SEs). Having determined this, the next step is then to figure out what level of public sector deficit is sustainable and consistent with price and interest rate stability, with external resource flows and foreign trade, and above all, the exchange rate. The main elements of the macro-financial program, then, have to focus on government budget deficits and their financing together with the availability of financial resources to the private sector through the banking system. In this respect, demand for financial resources by the private sector is treated in an autonomous fashion. That is, reliance is placed on the market mechanism, as long as prices perform the market-clearing function, imperfectly or otherwise.

1.11 In the second case, one could begin with the determination of the size of the external deficit, both on the current account and the capital account of the balance of payments. Then, one would proceed to determine a feasible import capacity, given the present structure and prospects of exports, feasible inflows of external funds – feasible in the sense of generating a financing gap no larger than the likely flows of short-term funds and medium- to long-term capital. This feasible balance of payments alternative will, in turn, determine the short-term investment and output growth possibilities. In this scheme, the corrective actions are spear-headed by foreign trade and balance of payments measures. These steps must be accompanied by policies concerning exchange rate and short-term borrowings. These have to be supported by domestic demand management in the form of controls on money supply and banking credit without which the external balance would not be attainable, thereby jeopardizing the targeted short-term outcome. Thus, the demand management alternatives have to be tailored to the feasible balance of payments, which becomes the overriding concern

1.12 No matter which route is followed, the challenge is to find a convergence of these approaches while articulating the macro-financial program. The main elements

of the macro-financial program concern domestic resource availability which, in financing terms involves: money supply, banking credit and its allocation to government and private sector, i.e. the size and type of deficit financing and the inherent cost of this borrowing. These have to be linked with some normalized level of financial resources needed by the private sector and controlled mainly by the interest rate structure, both on the deposit and lending sides, and the institutional mechanisms employed to affect the allocation of financial resources. The time frame is typically the annual program cycle which, per force, is driven by short-term considerations.

1.13 As the transition is made from the short- to medium-term, structural forces of the economy take over. The balance of payments constraint remains a force to be reckoned with, though its severity is considerably diminished. Growth during the medium-term depends largely upon how quickly the economy is able to invest and accumulate capital and to internalize modern technology in its productive structure. In other words, over the medium term, supply constraints become operative with no major departures from the past growth policy and patterns, except in qualitative terms. For an economy like Tusania, the expansion of the modern industrial sector continues to enjoy priority in its growth policies, along with an increase in proportion of the manufacturing value-added in the GDP. This is accompanied by sufficient agricultural growth to provide for domestic food needs and exportables, mainly primary commodities and a few manufacturing items. The growth strategy during the medium term is envisaged as maintaining the tempo of long-term structural changes, interrupted by slow-downs, but once short-term dislocations have been overcome, the economy resumes its normal growth.

1.14 Given this scenario, the essence of program options lies in demand management accompanied by appropriate measures of resource mobilization with mainly short-term consequences for the balance of payments. It would also affect

medium- to long-term growth. The short-term macro-financial actions and controls are expected to bring monetary and fiscal magnitudes in line with feasible balance of payments and economic growth, decrease inflation, and affect the finances of the government, the Central Bank and the SEs. The medium-term package consists of policies aimed at structural problems and at generating enough public sector resources to keep up with the financial requirements of investment and growth over the medium-term. Therefore, the focus of the stabilization program is to develop a package of internally consistent economic and financial policies, which must be technically feasible within the internal and external constraints of resource availability, as well as within the implementation capacities. Having developed the program, the next step is to evaluate the impact on the economy and to outline a short-run economic outlook, simultaneously ensuring that this economic outlook is "acceptable" in the sociopolitical context.

1.15 The requirement for the success of a program of this complexity and magnitude, is a broad-based consensus among the vital segments of the society, i.e., the lawmakers, the government, the opinion makers and the private sector. More often than not, the program's first impact on a wide segment of the population is negative, and this impact can easily become unbearable in the absence of a social safety-net. Even if the program is dutifully implemented, rather than in a checker-board fashion, there are significant lags in the economic recovery that will prevent any meaningful supplement across-the-board in the the general public's standards of living. So long as the roots of the economic and financial crisis lie in the systemic use of resources beyond what the resource base of the economy can support, and on terms not reflecting economic or opportunity costs, programs of this type will invariably cause severe belt-tightening, voluntary or otherwise. Attempts to circumvent this process will result in a fresh round of even more severe crises. That has been the experience of many countries over the past couple of decades.

1.16 While broad-based consensus is essential for the future direction, the implementation culture and capacity to execute and manage these programs are even more important. It is easy to formulate programs but implementation requires compliance at the institution level. Besides policy packages, authorities need to have a broad array of control levers affecting financial operations at the unit level. The need is not only that these control levers be properly operated and their impact understood, but also that they are applied to achieve the broad objectives of the program, preventing those affected from circumventing, diluting, or compromising the thrust of the program. For example, in times of a severe credit crunch stemming from a deliberate increase in the cost of credit through a general rise in the interest rate, or a straightforward denial of credit through the revamped system of directed credits, it is not uncommon for the SEs to issue quasi-private IOUs for other SEs to maintain their grip on the supplies. In time, these IOUs may begin to circulate in a "secondary market" of their own, thus thwarting any efforts at demand management in the public sector.

In the Case of Tusania ...

1.17 Throughout the review period, the authorities' major concerns were monetary and exchange control to achieve price and interest rate stability, support to priority sectors, and resumption of growth, perhaps in that order. The launching of the structural adjustment program occurred afterwards when the severity of the economic and financial crisis of Y_5-Y_7 years became evident to all parties concerned, domestically and abroad. As the precursor, the government during the crisis years, initiated a system of more efficient financial resource mobilization and allocation through a liberalized interest rate and price structure, a realistic exchange rate and auctions throughout the financial system. However, as events unfolded, monetary stability remained elusive. As the reform measures took hold and protectionist arrangements were weakened, the economy faced increasing exposure to market

forces, both domestically and abroad. The financial system, previously shielded, came under pressure and the weaknesses of a good number of banking institutions became apparent. The authorities were then saddled with diagnostics and damage control, while pursuing economic and monetary stability in parallel.

1.18 Overlapping these objectives were equity, distributional, and indigenization[1] considerations which have been important factors behind various economic and financial policies. To what extent these objectives were achieved remains questionable. Tusania is a low middle-income economy with a per-capita GNP of $742, a level that provides a decent base for sustained growth. While income distribution in Tusania is not known with any precision, the impressions are that it is skewed, and that income disparities have grown over the years. A cardinal feature of the financial policies of successive governments has been the re-allocation of financial resources to disadvantaged groups and priority sectors through interest rates, sectoral credit targets, rural banking, and restrictions on regional deposit bases for bank lending. Similarly, indigenization objectives are likely to remain intact. In a more open and market-based financial system, it remains a challenge to see how these objectives can be accommodated.

1.19 In the future, with the continuation of structural adjustment, the economy is expected to accomplish the shift to a new environment ushered in during the crisis years with prospects for stable and sustained growth. A more efficient industrial sector, a revitalized agriculture sector, and a market-oriented trade regime, are likely to contribute to growth performance, provided there are no reversals in policy. Under these circumstances, the government must continue to emphasize the sustainability of market-based financial flows and the maintenance of a healthy and viable financial

[1] Indigenization refers to policies aimed at enhancing domestic ownership and control of foreign-owned businesses, banks, and companies.

system as the center piece of this mechanism. This brings us to the review of the Tusanian financial system presented in the next chapter.

CHAPTER II

THE TUSANIAN FINANCIAL SYSTEM: STRUCTURE, GROWTH AND RESOURCE MOBILIZATION

2.1 The financial system of Tusania has undergone significant changes and experienced rapid growth over the past years. The basic features of the financial system, however, have remained intact. Periodic slowdowns in the Tusanian economy led the government to maintain the financial commitments of both the public and private sectors at historic levels through a series of interventions in the operations of the financial system. These interventions in the allocation and pricing of financial resources, driven by short-term considerations: prevented the financial system from achieving diversification and strength, increased dependence of major segments of the system on public-sector resources, and discouraged saving mobilization. Attempts were occasionally made to soften this interventionist regime, but these efforts were inadequate to enable the financial system to strengthen its base, increase its competitiveness and provide market-based financing. Moreover, this was done within a policy framework governing the real sectors which sought to maintain the protective structure of production, widespread price controls, and a licensing system on the procurement and allocation of commodities and inputs with unfavorable implications for the clients of the banking system. This policy framework adversely affected production and investment decisions, led to sectoral imbalances, and hurt the growth of the Tusanian economy. The attempt to redress these economic imbalances in later years through monetary, interest rate,

and fiscal policies was partially successful, but also affected the financial system in its primary role of mobilizing domestic savings and allocation of financial resources to the productive sectors of the economy.

A: The Financial System: Structure and Growth

2.2 The Tusanian financial system consists of the Central Bank of Tusania (CBT) at the apex of the banking system, constituting the first tier, as in any other country. The second tier of the banking system consists of 37 commercial banks with more on the way. There are five development finance institutions (DFIs) — the Industrial Development Bank of Tusania (IDBT), the Agricultural Development Bank of Tusania (ADBT), the National Investment Bank of Tusania (NIBT), the Savings Bank of Tusania, (SBT), and the National Bank of Tusania (NBT). Strictly speaking, the SBT and NBT cannot be classified as development-finance institutions. The primary role of the SBT is on the funding side, in that it provides a fairly stable source of funds to the government from its deposit base. Funds are then passed on to the development banks for their lending operations. The NBT, as the commercial bank of the government, provides short-term financing for the operations of the state enterprises, the SEs, and also provides complimentary financing for development banks. Therefore, to keep the presentation simple, both the SBT and NBT are lumped together in the category of DFI. Further, the financial operations of the CBT are reported separately from the rest of the banking system, defined here to consist of commercial banks, which are the dominant part, and the DFIs. This has been done to isolate the CBT share of financial operations from the rest of the banking system, though in a purely technical sense, the term banking system includes both tiers – the central bank and all banking institutions in the formal sector. The formal banking system thus consists of the CBT, the commercial banks, and the DFIs constituting the core of the financial system (*see ANNEX II, Exhibit 1*).

On the banking system's periphery are a host of other small financial establishments which behave like banks in that they raise deposits and provide short-term financing to their clients. These are privately-owned finance and investment companies – of which there are about eighteen. However, these are not licensed banks; instead they are registered and listed under the *Companies Act of Tusania* and fall under the responsibility of the Ministry of Finance (MOF). In addition, there is a small but thriving informal segment engaged in deposit-taking and lending consisting of a large number of thrift societies, community banks, co-operatives, and the ubiquitous money lenders. They have a palpable presence in rural as well as urban areas.

2.3 There are a number of non-bank financial institutions consisting of six insurance companies, several pension funds, and a National Trust Fund (NTF). All were established under the *Companies Act of Tusania* and are registered with their respective government departments, depending on their line of activity. Only the banking institutions are required to report to the CBT and as part of its oversight function, while non-bank financial institutions, such as insurance companies, pension funds, and finance companies, are outside the reporting, regulatory, and supervision framework of the CBT. There is no self-regulation mechanism either.

Financial System Assets and Structure

2.4 The Tusanian financial system grew substantially over the past decade. During the period under review, Y_1 -Y_7, the average growth rate of the assets of the financial system was 17.1 percent per year. A good deal of this growth is owed to the substantial monetary expansion that occurred during the second-half of the review period, Y_5-Y_7, when the rate of growth increased to 21.1 percent per year. There was substantial growth in CBT assets which increased at an annual rate of 18.1 percent during Y_1 -Y_7, while its proportional share in total assets of the financial system, likewise, increased from 31.7 percent in Y_1 to 33.4 percent in Y_7. Much of this

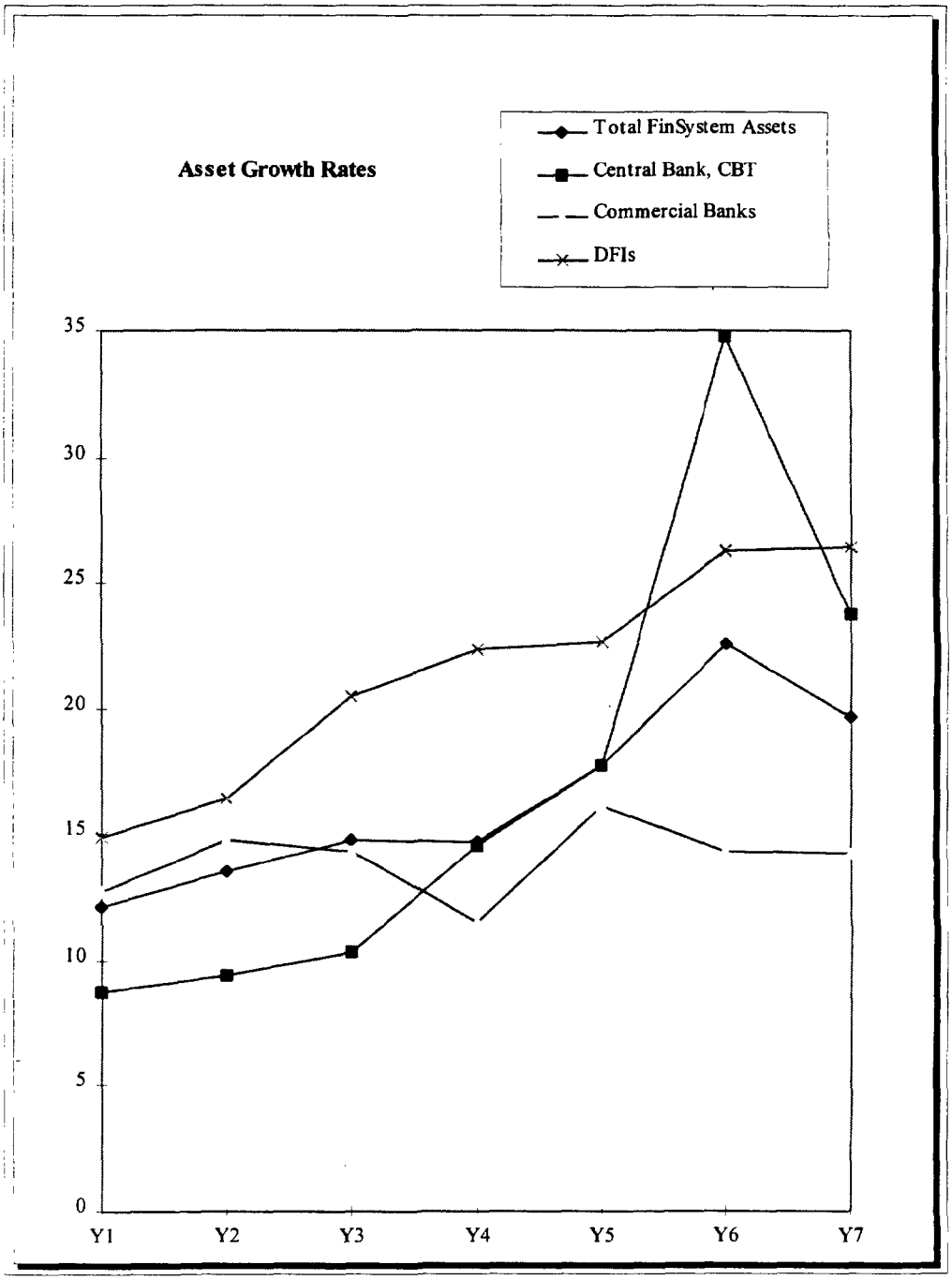
Table 2.1 Assets of Financial System

	Annual Indicators				Average Annual Growth Rates		
	Y_1	Y_4	Y_6	Y_7	Y_1-Y_7	Y_1-Y_4	Y_5-Y_7
	(ST billions)				*(per cent)*		
Total FinSystem Assets	**501**	**749**	**1081**	**1294**	17.1	14.3	21.1
Central Bank, CBT	**159**	**220**	**349**	**432**	18.1	11.4	29.1
Banking System	*304*	*462*	*639*	*752*	16.3	15.0	17.6
ComBanks	237	347	461	527	14.2	13.6	14.4
DFIs	67	115	178	225	22.4	19.7	26.3
Non-Banks	38	67	93	110	19.4	20.8	18.0
Annual Growth Rates (%)							
Total FinSystem Assets	12.1	14.7	22.6	19.7			
Central Bank, CBT	8.7	14.6	34.7	23.8			
Banking System	13.8	14.1	17.5	17.7			
ComBanks	12.7	11.6	14.4	14.3			
DFIs	14.9	22.3	26.2	26.4			
Non-Banks	16.2	19.6	17.7	18.3			
Shares (%)							
Total FinSystem Assets	100.0	100.0	100.0	100.0			
Central Bank, CBT	31.7	29.4	32.3	33.4			
Banking System	60.7	61.7	59.1	58.1			
ComBanks	47.3	46.3	42.6	40.7			
DFIs	13.4	15.4	16.5	17.4			
Non-Banks	7.6	8.9	8.6	8.5			

For details see **Annex II**, Table 2-1

increase, however, occurred during Y_5-Y_7 for reasons discussed in Chapter VI. The assets of the remainder of the banking system also increased, but at a rate lower than the CBT. This is because the banking system is dominated by commercial banks. But the growth of commercial banks' assets was 14.2 percent per year during the

Chart 2-1

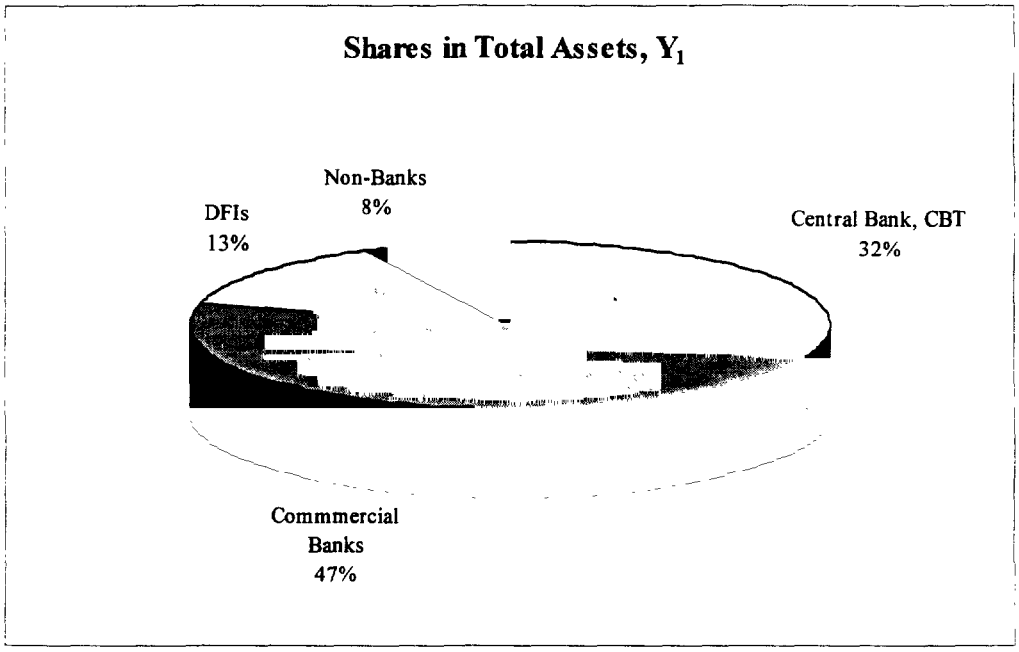

Asset Growth Rates
Total FinSystem Assets
Central Bank, CBT
Commercial Banks
DFIs
35
30
25
20
15
10
5
0
Y1
Y2
Y3
Y4
Y5
Y6
Y7

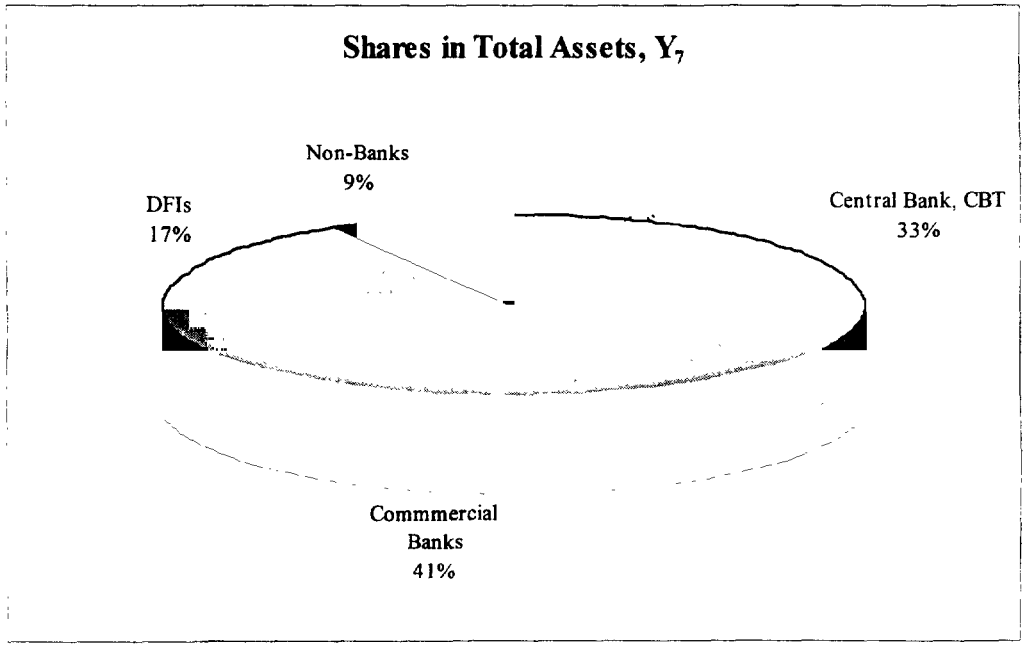
review period, slower than that of the CBT. Further, the growth rate of commercial banks' assets was higher than that of the CBT's assets in the early part of the review years, at 13.6 percent per year during Y_1-Y_4. In later years during Y_5-Y_7, however, the CBT's assets increased 29.1 percent per year as compared to the 14.4 percent growth of assets for commercial banks. Because of this reversal in trends, the commercial banks' share in the total assets of the financial system decreased from 47.3 percent in Y_1 to 40.7 percent in Y_7. The DFIs gained substantially as their assets increased much faster at 22.4 percent per year during the entire period. Likewise, their share in total assets of the system increased from 13.4 percent in Y_1 to 17.4 percent in Y_7. The DFIs and the non-bank financial institutions together currently constitute more than one-fourth of the financial system, and this gain has occurred at the expense of the more market-oriented segment of the financial system - the privately-owned commercial banks - as a group. This noticeable increase in the relative position of the DFIs in the Tusanian financial system is a more stylized event and is specific to this case study, though structural changes like this occur over a longer period.

The Banking System

2.5 The growth of financial assets was not accompanied by significant improvements or diversification in the operations of the banking system, savings mobilization, or financial deepening. Likewise, there was no major improvement in the efficiency of the financial intermediation between savers and investors. This is evident in the analysis of the factors underlying the expansion of the financial system during review years, both at the system and institutional levels. The two major components of the second tier of the banking system, the commercial banks and the DFIs, had substantial growth, but the extent to which this growth was accompanied by qualitative improvements remains obscured and requires an in-depth review of performance indicators at the institutional level. Although, beyond the scope of this study, this is briefly touched upon in Chapter VII.

Chart 2-2 Shares in Total Assets





2.6 The *banking system of Tusania is concentrated* in a handful of large and powerful banks, though it has a variety of institutions offering a reasonable range of financial services. There has been rapid growth in indigenous banking owing to free entry. Though a good number of banks were started as joint ventures with large overseas banks as technical partners, the number of banks has grown quickly, intensifying competition in the system. This rapid growth has not affected the prevailing concentration of banking business in half a dozen large banks with a large share of government ownership. There has been an ongoing debate over what kind of banking system government policies should promote over the long run. Should these policies assist the evolution of universal banks, or maintain the current hybrid system consisting of large mono-banks, the DFIs, and a number of commercial banks mainly for short-term financing, supplemented by small regional banks? That is, should Tusania follow the British, the German, or the Japanese system of banking for its mainstream activities? Should it encourage the DFIs to evolve into investment banks, or should it promote universal banking? To date, this debate is inconclusive.

2.7 Given this structure of the banking system, and significant growth in the CBT's assets during the review period, the CBT has emerged as an even more powerful financial institution. It wields a pervasive influence in the way the financial system mobilizes resources and allocates them among the final users. The CBT, both as the monetary authority and as a regulatory authority, has all the levers of control at its disposal to affect the growth and evolution of the financial system, not just routine operations of its constituent components. Yet the CBT remains beholden to the government in that the CBT lacks a truly autonomous mandate with freedom of independent action. Lately, the CBT has become more assertive, but this does not imply that the CBT now enjoys autonomy and can act independently in critical matters. The debate regarding the exercise of its powers has been ongoing for quite some time, but true autonomy for the CBT is unlikely to occur as it is simply not in the interest of the major power groups – the government, the SEs, the parliamentarians, and, curiously, even the large commercial banks – to have an

independent CBT. Any change in that direction will not come from piecemeal actions; instead, it will require a change in the Central Banking Act. Meanwhile, the CBT continues to perform its traditional roles. As the monetary authority, it is responsible for ensuring public trust in the Tusanian currency, controlling money, credit ,and banking operations of the Tusanian banking system, and is responsible for operating the official foreign exchange system and managing foreign exchange reserves. As the regulatory authority, the CBT is responsible for keeping public confidence in the banking system, maintaining the solvency and health of financial institutions, is the lender of the last resort to banks in trouble, and is the eventual safety net provider.

2.8 Significant growth in the number of commercial banking institutions over the past 10 years has occurred in spite of economic problems, austerity, and in some years, even recession. Today there are 37 commercial banks. The stimulus to this growth has come from various factors. In recent years, the stimulus was partly provided by the foreign exchange allocation system, which conferred upon the banks an economic rent in direct proportion to the differential between the official exchange rate and the parallel market exchange rates. Most of these new and small banks, which opened during the last five years of the review period, are derisively dubbed as backyard foreign exchange traders, unworthy of the banking license, because the major functions of banking such as deposit mobilization and rendering financial services are marginal to their activities. They remain mostly one-branch banks located in the main Tusanian city, and are likely to remain so given competition and slow growth prospects. The total number of banks is likely to grow further as several new banks may be granted licenses, with more applications pending.

2.9 Even with the proliferation of banks, the authorities believe, perhaps justifiably, that the Tusanian economy is under-banked. As of the end of Y_7 , there were about 160,000 people to one commercial bank branch, which is rather low, even though the number of bank branches has increased rapidly over the past years. Most

of the branches are located in urban areas and belong to the major old banks, rather than to the new banks, which are essentially one-branch operations. The distribution of branches is highly skewed. The top five commercial banks have 100 branches or more per bank, and control half of the entire branch network. Clearly, more branches are needed rather than more banks, especially in outlying regions. Government regulations require banks to open branches in outlying regions, but banks regard this rule as a financial and managerial burden. While it does help to extend financial services to the outlying areas, it imposes a net financial cost upon the banks since most of these branches are running at a loss. Whether this requirement increases access to borrowers to the banking system, or promotes greater deposit mobilization, is unclear.

2.10 Because commercial banks are at the core of the financial system, much of this case study is devoted to the analysis of their operations. They are by far the largest financial intermediaries in terms of their assets, loans, advances, and branch networks. Their assets are really half of the of the financial system's total assets, and they have a large share in the total deposit liabilities and the total branch network of the banking system. There is substantial concentration of credit activities in a few large dominant banks which control the bulk of credit and thereby exert strong influence over economic activities. As a result, the significant increase in the total assets of commercial banks during the review years had little to do with the proliferation of banks, mentioned above. Most of the asset growth was concentrated among the large, well-established banks, partly because of their strong links with the private and even the public sector. The assets of the top eight banks increased faster, as these banks held more than two thirds of the entire banking system's total assets at the end of the review period. While the DFIs grew faster, gained in relative share, and enjoyed preferential access as a group, the commercial banks still retained their dominance in the financial system.

Government Policy on Ownership

2.11 An important aspect of Tusania's financial system is the extensive government ownership and control of banking institutions, including commercial banks, development finance institutions (DFIs), and major non-bank financial institutions such as insurance companies. These government-owned institutions *together* control a significant proportion of financial resources. Lately, the government has pursued the policy of indigenization – increasing Tusanian ownership – of the banking system, with significant impact both on the pattern of ownership and management of the banks. The law requires that at least 60 percent of banks' shares must be indigenous. The indigenization policy, however, has led to a significant controlling interest of the government in major banks, as the private sector has lacked sufficient resources to buy the 60 percent. Thus, besides its direct ownership of the DFIs and other financial institutions, the government ended up owning 6 of the 37 commercial banks operating at the end of Y_7. The total assets of these government-owned banks in Y_7 was about half of the assets of the entire commercial banking system. Their loans and advances were even higher – nearly 55 percent of total loans and advances outstanding of the banking system. As the major shareholder, the government nominates the management and board of directors, and therefore has a great deal of impact on the activities of these major banks. Though it has restrained from interfering in their daily operations, the government, by and large, regards these banks as sources of readily-available loan finance to the public sector. This attitude of easy finance has engendered a lack of proper accountability and financial discipline, which in later years turned out to have disastrous results for some of the banks in this group. In addition, the government also has significant controlling shares and ownership in non-bank financial institutions. It wholly owns Tusania's largest insurance company, the National Insurance Corporation of Tusania (NICT), with 38 percent of the premium income of the whole insurance industry. The government also has a strong presence in the money market in that government

papers and instruments, Treasury Bills and Treasury Certificates, dominate money market trading.

2.12 The indigenization policy, therefore, has resulted in a preponderance of government ownership and direct control over financial institutions. Only recently have new, privately-owned banks emerged, but they are fairly small and their operations are yet to have much impact on the conduct of the financial system as a whole. This pattern of indigenization and government ownership of major banks, together with regulatory authority and monetary control through the CBT, has conferred upon the government an unprecedented array of controls over the financial system and its resources. This, in turn, has had serious implications for resource allocation and financial intermediation, as discussed in the relevant chapters of this case study.

2.13 The government, however, recently decided to partially divest its ownership in some of these banks, and is embarking on a program of restructuring state-owned banks in response to their poor operating records. State-owned large commercial banks are generally healthy, but their cost effectiveness is another issue. At the other end, some of the small banks are facing financial distress and need restructuring. Given the number of banks involved, it is not clear how this divestiture and restructuring will proceed, especially at a time when the government is already conducting a major privatization drive of state-owned enterprises (SEs). The sale of these SEs to the public is already beginning to stretch the private sector's capacity to absorb new ventures and ,in any case, it is beyond the ability of the rudimentary capital market in Tusania to mobilize the indigenous equity finance to accommodate the divestiture of state-owned enterprises. On top of this, if a large number of state-owned banks are to be privatized, it is unlikely that the indigenous private sector could afford such a massive capital outlay to acquire public sector assets. For these reasons, the ownership structure of these banks will continue unchanged in the foreseeable future unless the government relaxes the rules of foreign ownership.

Besides, since the present ownership structure has enabled the government to materially impact the allocation of financial resources in the economy through financial, monetary, and economic policies, as well as through a system of control down to the institution level, it is not likely that the state will relinquish its control so easily.

Non-bank Financial Institutions and Informal Sector

2.14 Non-bank financial institutions have grown substantially, as well, over the past few years, but consistent data is unavailable on the size of their operations excepting insurance companies and pension funds. A good number of them, especially the finance companies, are quasi-banking institutions, as mentioned earlier, in the sense that they operate like banks on the credit side. On the deposit side, while legally they are not allowed to take deposits, they circumvent the regulations and 'manage' a good amount of deposits on behalf of their clients for collateralized lending on the deposit base of their clients – just as commercial banks do. These institutions often engage in group-linked activities, have an inside track on large businesses, and often engage in a variety of discriminatory practices. The growth of finance companies is attributable in part to the relatively lenient registering and regulatory rules embodied in the *Companies Act* as compared with the bank licensing system. While the government has strictly-controlled bank licensing, the registration of finance companies provides a medium to bypass these restrictions. Yet these quasi-banking institutions are in effect part of the formal banking system with a dilutive impact on the system of monetary and credit control.

2.15 As regards contractual savings institutions, mainly the insurance companies and pension funds, their assets are included in the category 'non-bank financial institutions' reported here. Among these, as of Y_7, there were 6 insurance companies with assets of about ST52 billion, dominated by a couple of large companies. Among them, NICT is the largest with assets totaling ST22 billion – nearly five times larger

than the assets of the next largest firm, the Tusania Reinsurance Company. NICT is wholly government-owned and has nearly half of Tusania's insurance business. Profitability is poor, however, as its return to asset ratio is one of the lowest in the industry. Some of the mid-size firms seem to be more profitable, with a high return to asset ratio, but most others in this category have a ratio closer to 8 percent. Most insurance companies seem to be sufficiently capitalized as shown by fairly high capital adequacy ratios. Earlier on, all life insurance companies were required by the CBT to invest no more than 25 percent of their funds in government instruments and at least 25 percent of their funds in real estate. The absence of regular financial reporting requirements precludes an accurate assessment of insurance companies' financial status, but major companies for whom data is available are apparently doing quite well. In comparison, the number and size of pension funds is fairly small, and they have a smaller asset base than insurance companies, though it is difficult to accurately determine their holdings. The National Trust Fund (NTF) is the largest among them with total assets estimated at 3.5 billion. It is a compulsory savings scheme for workers which provides cash benefits to their contributing members upon retirement or disability, although the coverage is limited. Both insurance companies and pension funds are outside the supervision and regulatory framework of the CBT. There is a need to strengthen the supervision of the activities of both the pension funds and insurance companies. They could potentially play an enhanced role in the capital market and assist in savings mobilization.

2.16 There is a vibrant informal sector operating in rural areas known as the 'curb-market.' Subsistence farmers and small businesses rely a good deal on this informal sector for their credit needs since while credit societies and cooperatives offer incentives for saving while at the same time providing a form of financial insurance for participants, their costs are prohibitive. Credit societies are essentially a credit club where members collect agreed amounts and loan them at no interest to each other on a rotating basis. No collateral is required since defaults would result in social ostracism. A portion of the contributions is lent to non-members at a nominal

rate of interest. As regards lending, however, money lenders are at the opposite end of the informal sector. The main source of funds for money lenders is the union of money lenders or even loans from commercial banks. Interest charges can amount to 3 to 5 percent per month and the margin between lending and borrowing rates can be very high. Money lenders curiously enough often belong to credit associations; in fact, some credit associations are promoted by local money lenders. However, their activities put a heavy financial burden on the unfortunate borrower.

Laws, Rules and Regulatory Framework

2.17 The legal framework of the Tusanian financial system is fairly well established and an exhaustive discussion of the framework is not intended here. In outline, the Central Bank Act and Currency Act were promulgated at the time of the establishment of the CBT. Since then, there have been substantial changes in the operations of the financial system, which have been managed through periodic enunciation of rules and regulations implemented by the CBT. The system of control as exercised by the CBT is fairly good, as the directives issued by the CBT department concerned, carry significant clout and are binding on the operations of the banking institutions. The system of licensing and entry of banking institutions is governed by the *Banking Act*, which has seen several amendments, rendering it more stringent with regard to the licensing of new banks. These amendments, however, have not prevented the proliferation of banking institutions in spite of increased equity requirements and the adoption of more rigorous 'due diligence' procedures. The DFIs, however, were established through the enunciation of separate laws for each one of them. These laws were enacted by the legislature from time to time, similar to the *Banking Act*, but with special provisions with regard to their status, funding, and mode of operation. The non-bank financial institutions were established under the *Companies Act of Tusania*, are licensed by the Ministry of Finance, and are registered with the Ministry of Commerce. The insurance companies and pension

funds were also established under the *Companies Act*, and are registered with the Ministry of Commerce.

2.18 The legal structure underlying the financial system is fairly comprehensive, but the regulatory system is weak and needs major improvements. The operations of the financial system need strong regulatory control to ensure system-wide stability, financial strength, and solvency. The regulatory and supervision system, as operated by the CBT, is not strong enough nor vigilant enough to spot the emergence of financial distress and deal effectively with troubled financial institutions. There is a need to chart an orderly system of ***exit***, parallel to the system of ***entry*** with due regard to solvency concerns. The CBT does intervene with a body of rules and regulations, but most often these interventions are too little, and too late. The regulatory and supervision system of the CBT has not been effective both because the provisions of the system were loosely chartered to begin with, and because CBT's implementation has been inadequate to cope with the rapidly enlarging banking system. The Banking Supervision Department of the CBT has been understaffed, ill-equipped, and simply too small to carry out meaningful off-site surveillance and on-site examination of the banks. The staff needs to be expanded and trained and the facilities need major improvement.

2.19 A major reason for the lack of effectiveness of the regulatory and supervision system lies in the inadequacy of the reporting and disclosure requirements embedded in the accounting and auditing system currently in practice. The system of reporting, disclosure, accounting, and auditing, needs upgrading to bring it into line with international standards. In particular, an early warning system needs to be installed backed by sufficient financial resources to allow timely action by the authorities to prevent the emergence of financial distress and insolvency at the institutional level. A system of self-regulation by the Banking Association needs to be encouraged to supplement the CBT's regulatory and supervisory activities.

2.20 Given the structure of the Tusanian financial system, its organization, major components, and the legal and regulatory framework governing their operations, let us return, briefly, to the issues of the macro-financial program, policy formulation and implementation, and the system of controls operative on major components of the financial system. In general, the state-owned banks, whether DFIs or commercial banks with majority ownership by the government, were much easier to control through a system of directives, either issued by the CBT or the government department concerned. In these cases, the concerns of financial strength and viability were subservient to over-arching considerations of sustaining the operations of strategic SEs at desired levels. If there was sluggishness in the response behavior of state-owned financial institutions, it had little to do with policy targets, or the control levers of the CBT; rather it had more to do with administrative inefficiencies within the institutions concerned. But the privately-owned segment of the financial system, in particular, the commercial banks, guided by the market tests of profitability and financial solvency, were more difficult to control, though on paper, they did show some compliance with the macro-financial guidelines. The underlying reason for this segmentation in response to policy controls had to do with the client-base of the public sector financial institutions and privately-owned banks. For example, as discussed in Chapters VI and VII, when the government belatedly began its reform program in the late review period, increasing competitiveness and re-aligning interest rates and prices, all coinciding with the liquidity and credit crunch, the state-owned banks could afford to overlook the financial status of their clients, but the privately-owned commercial banks could not. In the first case, the state came to the rescue by keeping the financial flows to the public sector clients intact or enlarged. In the second case, the private commercial banks had to find ways to keep their clients afloat at a financial cost because they could not afford to let their clients go under. These clients had no safety net, as did the public sector clients. Thus, the CBT tried to implement the same type of monetary control across the board with a similar response to controls, but the ***manner*** in which the response was executed by the banking institutions, relative to their client base, was substantially different between

the privately-owned and public-sector banking institutions. An understanding of this dichotomous response is critical to charting out the macro-financial program.

B: Financial System and Savings Mobilization

2.21 The next step is to explore the performance of the financial system in generating financial resources for the Tusanian economy. In particular, how effective has it been at mobilizing financial savings? This issue at the macro level is related to the policies governing consumption and saving behavior in real terms. Given a stable and growing economy, how good has the incentive regime been in stimulating that part of financial savings which is responsive to the interest rate structure given price stability? At the institutional level, the issue is how aggressive have the deposit-taking institutions been in mobilizing deposits, given the economic and macro-financial environment, nexus, the structure and organization of the financial system, the incentive regime, rules and regulations governing the financial operations of the deposit-taking institutions – especially on the funding side – and the financial base of the institutions concerned. That is, one could look at the aggregate savings at the macro-economic level, analyze the trends, tinker with the policy regime, and be done with it. The other alterative would be to step down to the sector level, review the structure and the incentive regime facing the depositors and institutions alike, prescribe the necessary changes in the incentive regime, and stop there. The problem, however, is that both of these 'givens' facing a financial institution describe only the necessary conditions, while the institutional constraints and responses reveal the sufficient conditions governing savings mobilization. Therefore, the need is to step down further to the institutional level and analyze their financial needs and cost structure to review how the institutions secure their financial base through deposit mobilization efforts and then to link it at the sectoral or the macro-financial level. This traversing back and forth at these separate levels is difficult to encapsulate in a base study of this type, but it is attempted here, though in an indicative fashion.

Financial Savings and Trends

2.22 From the vantage point of the financial system, the deposit mobilization efforts of the Tusanian financial system have been fairly respectable, as shown by growth in total deposits during the review period, Y_1-Y_7 . These consist of the deposits of the banking system – by far the largest proportion of the total – while contractual savings institutions are also relevant though marginal to the savings mobilization effort. During Y_1-Y_7, financial savings increased at an annual average rate of 13.9 percent from ST237 billion in Y_1 to ST527 billion in Y_7. The financial savings rate of growth was 14.2 percent per year during Y_1-Y_7 , and increased to 16.2 percent during Y_5-Y_7 . That is, financial savings were not only sustained but increased, and at a significant rate, during the later part of the review period. This could imply that Tusanians began to save more during the period of high inflation, economic crisis, and declining incomes, however, this was not the case because savings in real terms declined. The growth rate of real domestic savings was less then 1 percent to begin with, during Y_1-Y_3, turned negative in Y_4 , and was -2.9 percent in Y_6, and -2.0 percent in Y_7. As a result, the ratio of real domestic savings to real GDP declined from 16.2 percent in Y_1 to 15.1 percent in Y_7 *(see Table 2-2 next page, and for details see Annex II, Table 2-2).*

2.23 Thus, from the macroeconomic perspective, Tusania was already in a deep imbalance with regard to resource generation and resource use, since no country can sustain declining real savings for very long. That the real savings of the public sector declined is abundantly clear from the size of public sector deficits, as discussed in Chapter V, and was significantly negative in real terms. Further, real household savings also declined owing to declining real incomes. Moreover, rapid inflation in Tusania during Y_5-Y_7 may have put downward pressure on the private propensity to save through creating a relative price effect that made current consumption favorable over future savings. Besides, having reached a plateau, real consumption did not decline commensurate to the loss of real income. The macro level policy response

Table 2.2 Institutionalized Financial Savings

	Annual Indicators				Average Annual Growth Rates		
	Y_1	Y_4	Y_6	Y_7	Y_1-Y_7	Y_1-Y_4	Y_6-Y_7
	(ST billions)				*(per cent)*		
Financial Savings	**237**	**330**	**448**	**518**	**13.9**	**11.7**	**16.3**
Total Deposit of FinSystem	**199**	**280**	**398**	**465**	**15.2**	**12.1**	**18.5**
Demand Deposits	135	183	269	320	15.5	10.7	20.9
Time and Savings Deposits	64	97	129	145	14.6	14.9	13.8
Other Savings	**38**	**50**	**50**	**53**	**5.7**	**9.6**	**1.0**
Total BankSys Deposits	**191**	**269**	**384**	**439**	**14.9**	**12.1**	**17.3**
***of this:* ComBank Deposits**	**184**	**255**	**365**	**417**	**14.6**	**11.5**	**16.9**
Demand Deposits	124	165	249	288	15.1	10.0	19.7
Growth Rate (%)	*(per cent)*						
Financial Savings	9.1	13.8	17.0	15.6			
Deposit of FinSys	9.0	14.8	20.2	16.8			
BankSys Deposit	9.8	14.5	20.4	14.3			
ComBanks Deposit	9.5	13.8	19.7	14.2			
DDs of ComBanks	7.8	13.0	23.9	15.7			
Domestic Savings (real)	0.3	2.2	-2.1	-1.6			
Shares, Ratios (%)	100	100	100	100			
Deposits of:							
BankSys / Financial Savings	80.6	81.5	85.7	84.7			
ComBanks/Financial Savings	77.6	77.3	81.5	80.5			
Other Savings/FinSavings	16.0	15.2	11.2	10.2			
DD/ComBank Deposit	67.4	64.7	68.2	69.1			
Savings/ComBank Deposits	12.0	12.9	11.0	10.6			
FinSavings/GDP (nominal)	18.5	18.3	17.2	17.2			

For details see **Annex II**, Table 2-2

called for major adjustments on the resource use side to accommodate the shrinking domestic savings base, but an immediate turn-around was not possible, mainly

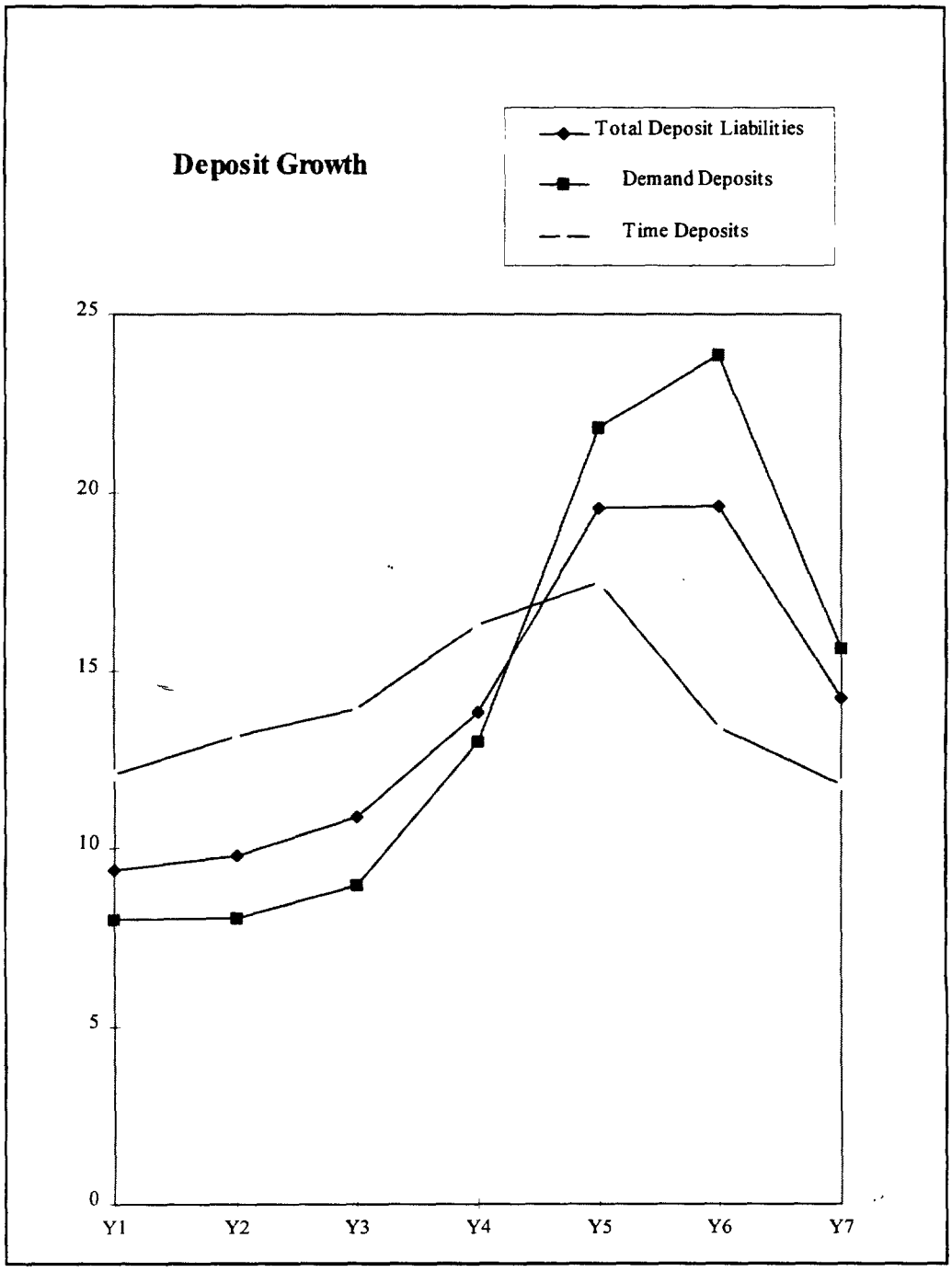
because not much can be done over the short run of a year or two to cause a significant increase in real savings in both the public and private sectors.

2.24 Based on the macro-economic picture, institutionalized financial savings showed a respectable performance because commercial banks continued to mobilize deposits at a rate of about 14.6 percent per year during Y_1-Y_7 . Consequently, the share of commercial bank deposits in total savings increased from 77.6 percent in Y_1 to 80.5 percent in Y_7, at the expense of the contractual savings institutions whose share declined correspondingly. This type of change normally does not occur over such a short period, because underlying saving behavior is fairly complex and does not depend solely on nominal interest rate levels. Rather, it depends on time preference, expectations of real purchasing power, attitudes towards thrift, and expectations.

Banking System and Deposit Mobilization

2.25 Further, whether financial variables affect savings is still open for debate, though the effect of interest rates on the form in which people save is clear. This is partially exemplified by trends in the components of commercial bank deposits. At the aggregate level, commercial bank deposits are nearly three-fourths of total financial savings in Tusania and are dominated by demand deposits – nearly 67 percent of the total – yet demand deposits earn the lowest rate of interest, if any. At the other end, savings deposits of longer maturity at commercial banks have the highest interest rate, yet their proportion is low, and their rate of growth was slower than the demand deposits during Y_1-Y_7. At any rate, as discussed in Chapter VI, real interest rates turned negative during the crisis period, which may have contributed to this trend. Finally, rapid inflation and depreciation of the Siwat may have depressed savings, but they did not cause a switch in asset preferences, and banks had no difficulty in mobilizing savings at a level that they perceived adequate for their funding needs up until the liquidity crunch in Y_7.

Chart 2-3


Deposit Growth
Total Deposit Liabilities
Demand Deposits
Time Deposits
25
20
15
10
5
0
Y1
Y2
Y3
Y4
Y5
Y6
Y7

2.26 That commercial banks have been at the center of the deposit mobilization effort, is quite clear. As mentioned above, their deposits increased from ST184 billion in Y_1 to

ST417 billion in Y_7, an average annual growth rate of 14.6 percent during Y_1-Y_7. In fact, the rate of deposit growth increased from 11.6 percent per year during Y_1-Y_4 to 17.8 percent during Y_5-Y_7 in spite of negative real interest rates, a diversion in profit sources away from traditional to foreign exchange dealings which occupied the attention of bankers, and enough liquidity, at least up to Y_6. As banks had enough funds to lend throughout the period, they did not attempt to aggressively expand the deposit base and, in any case, they could not exceed the annual credit ceilings. Further, given the impact of the financial squeeze on borrowers during Y_5-Y_7, the banks did not want to increase their exposure to a large segment of their clients adversely affected by the crisis. In spite of these factors, which would normally be expected to have put downward pressure on the growth of financial savings, banking deposits posted a fairly respectable gain and were not ***perceived*** as inadequate by the deposit-taking institutions.

2.27 The increase in the number of banking institutions and the increase in their financial operations may also have been a factor in the growth of institutionalized financial savings. The number of banks, their branch networks, access, range of banking services and deposit instruments, all affect banking deposits, even though over the long-run, savings growth depends on income, interest, and expectations and preferences. While there was some diversification in financial instruments available to savers, there was not any particular improvement in their range or attractiveness. About two-thirds of the deposits were demand deposits throughout these years, while savings deposits were 12.0 in Y_1 and dropped to 10.6 percent of total deposits in Y_7. Clearly, commercial banks, as well as the specialized savings banks, mobilize most of their loanable funds from short-term deposits predominantly held by households and small businesses, with a portion of demand deposits held by large businesses and, until Y_7, the public sector SEs, for similar purposes. Time deposits, and more

recently, certificates of deposit with a maturity greater than three months, serve as an instrument for short-term investment by public and private corporations and are preferred by depositors. The CDs, however, constitute a fairly small portion of total deposits mobilized by the banking system.

2.28 Normally, in an uncertain and inflationary environment, households attempt to safeguard their savings against a loss of purchasing power by switching to short-term financial assets and away from longer-term savings instruments by minimizing their contractual savings obligations. If opportunities are available, savers prefer to switch to real assets or 'safe havens' through capital flight abroad. This asset preference, however, may be available only to large and sophisticated savers, not to ordinary household savers, even though they are facing near zero or negative real yields on financial savings. This seems to have been an important factor underlying the preponderance of demand deposits in Tusania. A more rigorous analysis of the major determinants of demand for financial assets by households might be undertaken by estimating demand functions for money, and time and savings deposits. This would help in ascertaining the impacts of nominal yields and the rate of inflation, aside from income levels, on the demand of financial assets. Given the limited choice of financial instruments and the attraction of real assets, including illegally held foreign currency balances, nominal yield is unlikely to be an important factor relative to expectations of inflation in determining the composition of financial assets in savers' portfolios.

2.29 Further, since all of the money market instruments are held by the CBT, private savers or corporations have few satisfactory alternatives to holding their financial balances as cash or deposits with the banking system *(see Chapter VIII for details)*. Besides, the largest proportion of government-backed securities is held by financial institutions in the public sector because private savers will not voluntarily invest in low-yielding government securities. There has been some growth and diversification in the capital market instruments available to private savers, but data is

not available on the holdings of private debentures and equities. However, considering that the securities market has been fairly small, that the growth in active trading has been modest, and that there is little secondary market trading, the combined share of these assets in financial savings is likely to be small, if not negligible.

2.30 Commercial banks have been in the vanguard of financial savings mobilization for the reasons discussed above. Savings mobilization through financial markets, specialized institutions like the Savings Bank of Tusania (SBT), contractual savings institutions, markets for real assets – all are peripheral to the savings effort. The SBT, in particular, did not have any noticeable impact given its client base of government employees. Since the SBT holds the monopoly on payroll disbursements for public service organizations, it has a captive clientele, whose 'savings' are in reality a residual after their routine expenditures, rather than the result of conscious effort on the part of depositors to hold voluntary savings balances. The absence of other alternatives for their balances reinforces this position.

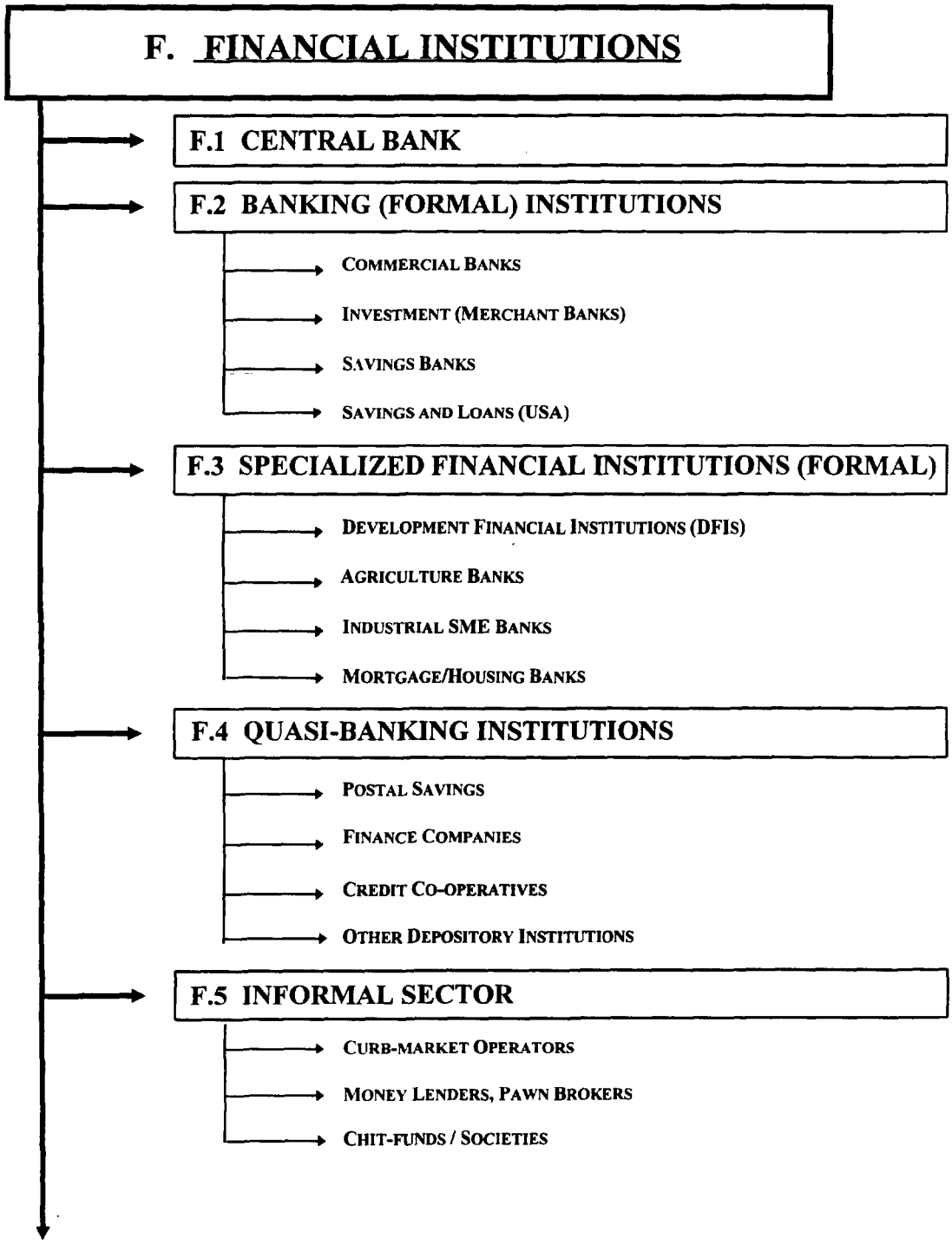
2.31 In summary, given the rapid growth of the deposit base, deposit-taking institutions felt fairly comfortable with their deposit mobilization efforts throughout the review period, except in Y_7 when they faced a liquidity crisis. This behavior of financial institutions was at odds with the macro-level need to expand the savings mobilization effort. Therein lies another major cause of the financial crisis facing Tusania during the Y_5-Y_7 period. The households, likewise, felt no reason to significantly change their savings behavior. In fact, all economic, financial and institutional factors they faced militated against any significant change in their historical savings behavior. In circumstances like these, changes in the incentive regime, incremental at that, could hardly lead to any perceptible improvement in savings performance.

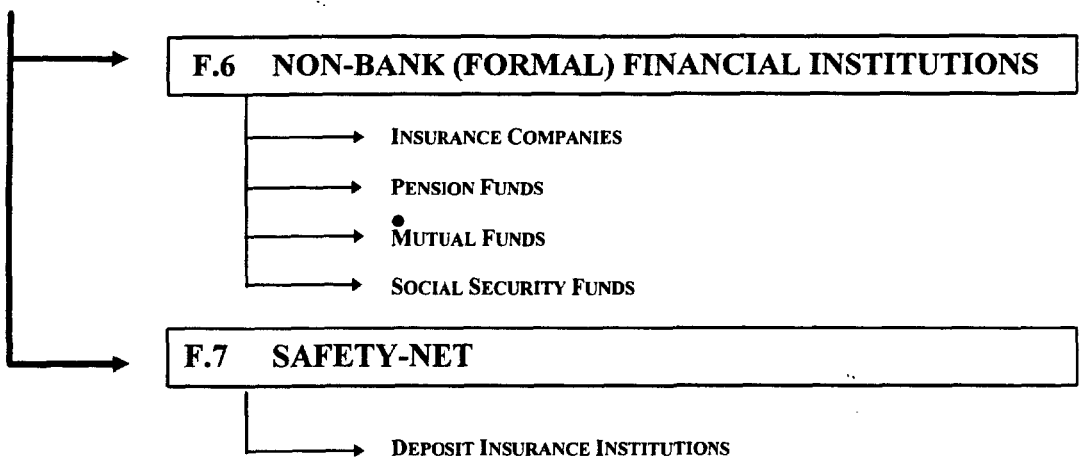
Savings and Financial Intermediation

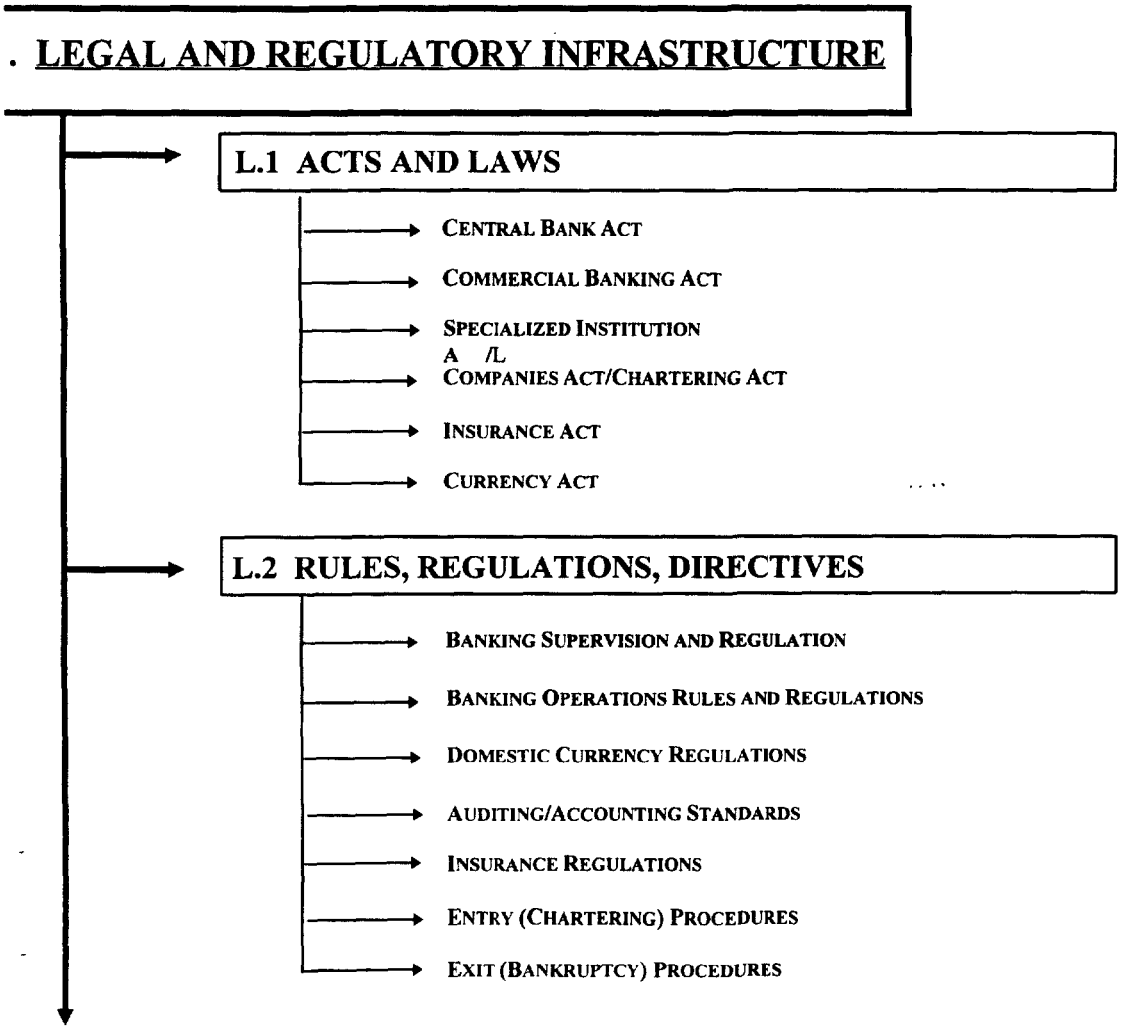
2.32 The pattern of the savings mobilization discussed above suggests that the base for financial intermediation has been reasonably good in spite of unfavorable policies. On the deposit side, these policies, put restraint through managed interest rates until liberalization in later years. On the lending side, the policies constrained the banking system through a rather rigid credit system as discussed in Chapter VII. So long as the banking system could generate substantial earnings on activities other than pure financial intermediation, such as the sale of foreign exchange, inter-bank lending and off-balance sheet activities, the weaknesses of the financial intermediation process remained obscure. Once these profits began to fall as happened during the Y_5-Y_7 period, the banking system found it increasingly hard to maintain its financial strength. This is borne out by a review of the summary accounts of the commercial banks, which demonstrate a substantial growth both in domestic credit and deposit liabilities throughout the review years. The analysis of banking credit in Chapter VII shows that there was a compression in the financial intermediation activities of commercial banks during the crisis years, owing to the drastic controls imposed by the authorities in a bid to stem inflation and speculative activities financed, in part, by the banking credit. But, as a long-term trend, there has been a healthy growth in the deposit liabilities of the commercial banks, even though there was not much diversity in the range of financial instruments available to depositors. This growth provided a reasonably strong base for the banking system to expand its activities.

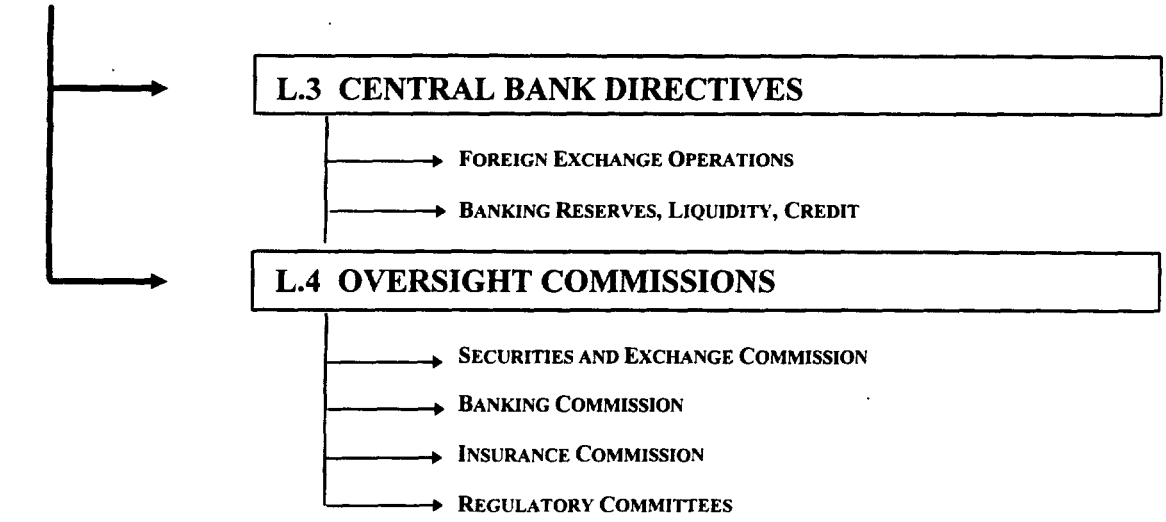
ANNEX II - Exhibit 1

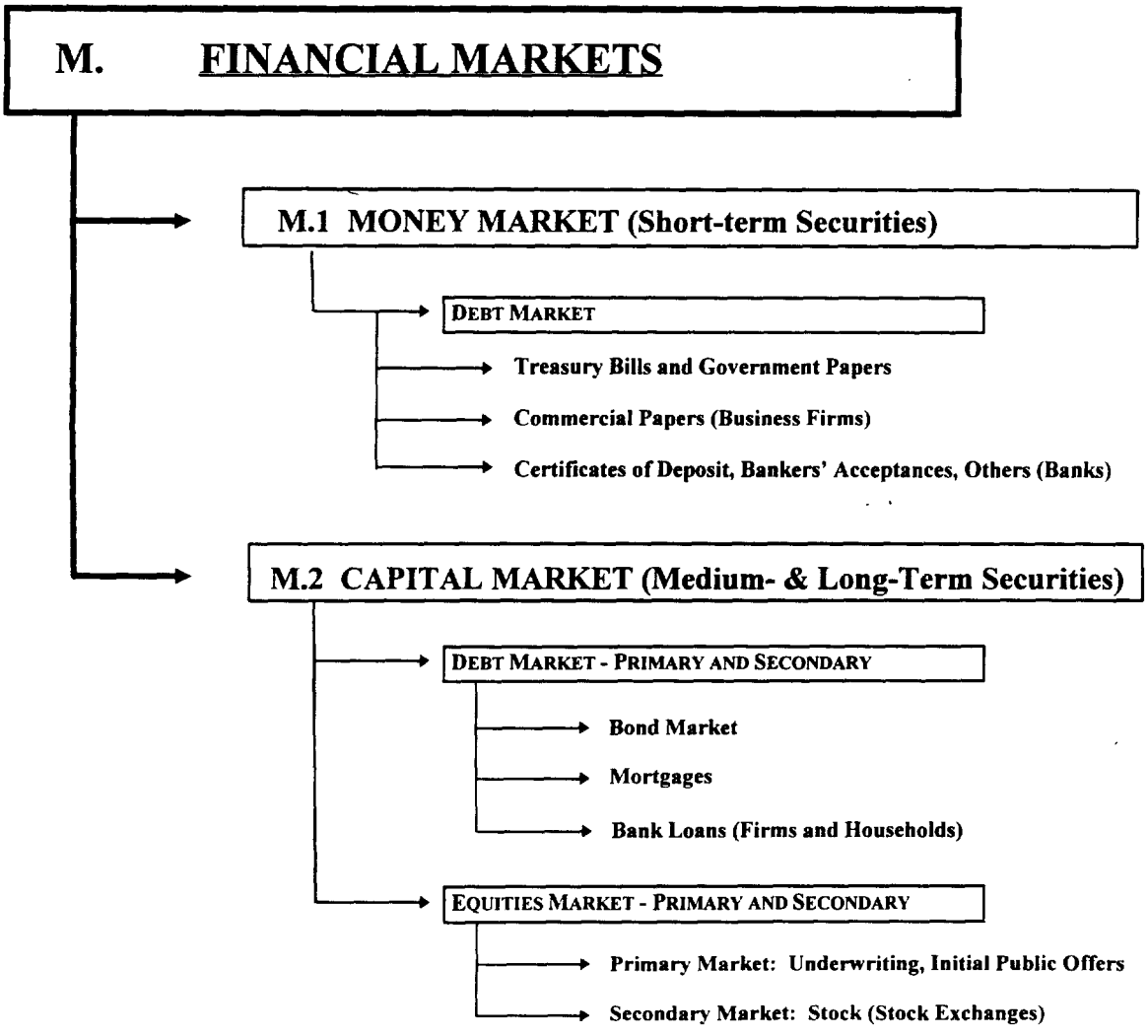
FINANCIAL SYSTEM




F.6 NON-BANK (FORMAL) FINANCIAL INSTITUTIONS
INSURANCE COMPANIES
PENSION FUNDS
MUTUAL FUNDS
SOCIAL SECURITY FUNDS
F.7 SAFETY-NET
DEPOSIT INSURANCE INSTITUTIONS


. LEGAL AND REGULATORY INFRASTRUCTURE
L.1 ACTS AND LAWS
CENTRAL BANK ACT
COMMERCIAL BANKING ACT
SPECIALIZED INSTITUTION
A /L
COMPANIES ACT/CHARTERING ACT
INSURANCE ACT
CURRENCY ACT
L.2 RULES, REGULATIONS, DIRECTIVES
BANKING SUPERVISION AND REGULATION
BANKING OPERATIONS RULES AND REGULATIONS
DOMESTIC CURRENCY REGULATIONS
AUDITING/ACCOUNTING STANDARDS
INSURANCE REGULATIONS
ENTRY (CHARTERING) PROCEDURES
EXIT (BANKRUPTCY) PROCEDURES


L.3 CENTRAL BANK DIRECTIVES
FOREIGN EXCHANGE OPERATIONS
BANKING RESERVES, LIQUIDITY, CREDIT
L.4 OVERSIGHT COMMISSIONS
SECURITIES AND EXCHANGE COMMISSION
BANKING COMMISSION
INSURANCE COMMISSION
REGULATORY COMMITTEES


M. FINANCIAL MARKETS
M.1 MONEY MARKET (Short-term Securities)
DEBT MARKET
Treasury Bills and Government Papers
Commercial Papers (Business Firms)
Certificates of Deposit, Bankers' Acceptances, Others (Banks)
M.2 CAPITAL MARKET (Medium- & Long-Term Securities)
DEBT MARKET - PRIMARY AND SECONDARY
Bond Market
Mortgages
Bank Loans (Firms and Households)
EQUITIES MARKET - PRIMARY AND SECONDARY
Primary Market: Underwriting, Initial Public Offers
Secondary Market: Stock (Stock Exchanges)

ANNEX II - Exhibit 2

ASSETS OF THE FINANCIAL SYSTEM

TOTAL ASSETS (Amounts)

1. Central Bank

2. Banking System
   a. Commercial Banks
   b. Investment Banks
   c. Specialized Banks/Development
   d. Finance Institutions

3. Non-Bank Financial Institutions
   a. Insurance Companies
   b. Finance Companies
   c. Other Institutions

TOTAL ASSETS (Shares, Growth)

1. Central Bank
2. Banking system
3. Non-Bank Financial Institutions

ANNEX II *Table 2-1 Assets of Financial System (1 of 2)*

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Total FinSystem Assets	**501**	**569**	**653**	**749**	**882**	**1081**	**1294**
Central Bank, CBT	**159**	**174**	**192**	**220**	**259**	**349**	**432**
Banking System	*304*	*350*	*405*	*462*	*544*	*639*	*752*
ComBanks	237	272	311	347	403	461	527
DFIs	67	78	94	115	141	178	225
Non-Banks	38	45	56	67	79	93	110
Annual Growth Rates (%)							
Total FinSystem Assets	12.1	13.6	14.8	14.7	17.8	22.6	19.7
Central Bank, CBT	8.7	9.4	10.3	14.6	17.7	34.7	23.8
Banking System	13.8	15.1	15.7	14.1	17.7	17.5	17.7
ComBanks	12.7	14.8	14.3	11.6	16.1	14.4	14.3
DFIs	14.9	16.4	20.5	22.3	22.6	26.2	26.4
Non-Banks	16.2	18.4	24.4	19.6	17.9	17.7	18.3
Shares (%)							
Total FinSystem Assets	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Central Bank, CBT	31.7	30.6	29.4	29.4	29.4	32.3	33.4
Banking System	60.7	61.5	62.0	61.7	61.7	59.1	58.1
ComBanks	47.3	47.8	47.6	46.3	45.7	42.6	40.7
DFIs	13.4	13.7	14.4	15.4	16.0	16.5	17.4
Non-Banks	7.6	7.9	8.6	8.9	9.0	8.6	8.5

Average Annual Growth Rates

	Y_1-Y_7	Y_1-Y_4	Y_4-Y_7	Y_5-Y_7			
Total FinSystem Assets	17.1%	14.3%	20.0%	21.1%			
Central Bank, CBT	18.1%	11.4%	25.2%	29.1%			
Banking System	16.3%	15.0%	17.6%	17.6%			
ComBanks	14.2%	13.6%	14.9%	14.4%			
DFIs	22.4%	19.7%	25.1%	26.3%			
Non-Banks	19.4%	20.8%	18.0%	18.0%			
Total Domestic Credit	16.4%	13.3%	19.6%	21.8%			
Central Bank, CBT	18.7%	9.1%	29.2%	34.6%			
ComBanks	12.6%	13.4%	11.9%	12.4%			
Total Deposits of FinSys	15.2%	12.1%	18.4%	18.5%			
ComBank Deposits	14.6%	11.5%	17.8%	16.9%			

ANNEX II *Table 2-1 Assets of Financial System (2 of 2)*

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
			(ST billions, end of period)				
Total Domestic Credit	**321**	**361**	**410**	**467**	**538**	**665**	**798**
Central Bank, CBT	114	123	134	148	176	255	319
ComBanks	164	187	215	239	265	298	335
Other Financial Institutions	43	51	61	80	97	112	144
Total Deposits of FinSys	**199**	**217**	**244**	**280**	**331**	**398**	**465**
ComBank Deposits	184	202	224	255	305	365	417
Other Financial Institutions	15	15	20	25	26	33	48
ComBank Total Assets	**237**	**272**	**311**	**347**	**403**	**461**	**527**
ComBank Domestic Credit	164	187	215	239	265	298	335
Claims Private Sector	138	156	176	195	215	238	267
Claims Public Sector	26	31	39	44	50	60	68
Total Assets, CBT	**159**	**174**	**192**	**220**	**259**	**349**	**432**
CBT Domestic Credit (Net)	**114**	**123**	**134**	**148**	**176**	**255**	**319**
Public Sector	102	108	112	121	146	236	296
Ratios (%)							
FinSys Deposits/Liabilities	39.7	38.1	37.4	37.4	37.5	36.8	35.9
FinSys Credits/Assets	64.1	63.4	62.8	62.3	61.0	61.5	61.7
ComBank Deposits/Liabilities	77.6	74.3	72.0	73.5	75.7	79.2	79.1
ComBank Credits/Assets	69.2	68.8	69.1	68.9	65.8	64.6	63.6

ANNEX II *Table 2-2 Institutionalized Financial Savings (1 of 2)*

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Financial Savings	**237**	**259**	**290**	**330**	**383**	**448**	**518**
Total Deposit of FinSystem	**199**	**217**	**244**	**280**	**331**	**398**	**465**
Demand deposits	135	145	160	183	219	269	320
Time and Savings deposits	64	72	84	97	112	129	145
Other Savings	**38**	**42**	**46**	**50**	**52**	**50**	**53**
Total BankSys Deposits	**191**	**211**	**235**	**269**	**319**	**384**	**439**
Demand deposits	130	141	154	176	211	260	302
Time and Savings deposits	61	70	81	93	108	124	137
***of this:* ComBank Deposits**	**184**	**202**	**224**	**255**	**305**	**365**	**417**
Demand Deposits	124	134	146	165	201	249	288
Time Deposits	38	43	49	57	67	76	85
Savings Deposits	22	25	29	33	37	40	44
Other Banks	**7**	**9**	**11**	**14**	**14**	**19**	**22**
Nominal GDP	1280	1413	1575	1806	2149	2604	3010
Constant (real) GDP	1280	1321	1362	1400	1434	1451	1454
Constant (real) Savings	207	208	210	209	206	200	196
Annual Growth Rate (%)							
Financial Savings	9.1	9.3	12.0	13.8	16.1	17.0	15.6
Constant (real) Savings	0.7	0.5	1.0	-0.5	-1.4	-2.9	-2.0
Deposit of FinSys	9.0	9.0	12.4	14.8	18.2	20.2	16.8
BankSys Deposit	9.8	10.5	11.4	14.5	18.6	20.4	14.3
ComBanks Deposit	9.5	9.8	10.9	13.8	19.6	19.7	14.2
DDs of ComBanks	7.8	8.1	9.0	13.0	21.8	23.9	15.7
Shares, Ratios (%)							
Financial Savings	100.0	100.0	100.0	100.0	100.0	100.0	100.0
BankSys / Financial Savings	80.6	81.5	81.0	81.5	83.3	85.7	84.7
ComBanks/ Financial Savings	77.6	78.0	77.2	77.3	79.6	81.5	80.5
Other Savings/Financial Savings	16.0	16.2	15.9	15.2	13.6	11.2	10.2
Savings/ComBank Deposits	12.0	12.4	12.9	12.9	12.1	11.0	10.6
Fin Savings/GDP (nominal)	18.5	18.3	18.4	18.3	17.8	17.2	17.2
Dom Savings/GDP (real)	16.2	16.2	16.3	16.2	15.9	15.4	15.1

ANNEX II *Table 2-2 Institutionalized Financial Savings (2 of 2)*

Average Annual Growth Rates

	Y_1-Y_7	Y_1-Y_4	Y_4-Y_7	Y_5-Y_7		
Financial Savings	13.9%	11.7%	16.2%	16.3%		
Real Savings	-0.9%	0.3%	-2.1%	-2.5%		
Total Deposit of FinSystem	15.2%	12.1%	18.4%	18.5%		
Demand deposits	15.5%	10.7%	20.5%	20.9%		
Time and Savings deposits	14.6%	14.9%	14.3%	13.8%		
Other Savings	5.7%	9.6%	2.0%	1.0%		
Total BankSys Deposits	14.9%	12.1%	17.7%	17.3%		
Demand deposits	15.1%	10.6%	19.7%	19.6%		
Time and Savings deposits	14.4%	15.1%	13.8%	12.6%		
of this: ComBank Deposits	14.6%	11.5%	17.8%	16.9%		
Demand Deposits	15.1%	10.0%	20.4%	19.7%		
Time Deposits	14.4%	14.5%	14.2%	12.6%		
Savings Deposits	12.2%	14.5%	10.1%	9.0%		
Other Banks	21.0%	26.0%	16.3%	25.4%		

CHAPTER III

GENESIS OF THE ECONOMIC AND FINANCIAL CRISIS

3.1 Many of Tusania's current economic and financial problems are a legacy of the past. The structure of the economy and operations of the financial system were shaped largely by the policy milieu and the framework of regulations and control mechanisms that have prevailed for a long period of time. Many of the structural imbalances of the Tusanian economy and the systemic weaknesses of the financial system in the past originated in this framework. Tusanian authorities periodically undertook attempts at reforms and adjustments in response to changing economic conditions, but these efforts were inadequate to cope with the magnitude of the changes required. In addition, Tusania embarked upon a major transition from a public-sector dominated command-based economy to a more open, market-based economy. This transition, however, coincided with a severely retrenched domestic resource base, poor export performance, low foreign exchange earnings, and dwindling capital inflows. Since the essence of the adjustments was to instill market discipline, the retrenchment in the resource base had the opposite impact. Major segments of the economy attempted to circumvent instead of operate within these limits, thereby compromising the economic and financial situation facing Tusania. Before long, economic and macro-financial stability became a prime concern, and the government was forced to take drastic measures.

The government resorted to direct controls, which temporarily provided relief, but some of these actions were in contravention of adjustments needed to deal with the underlying structural weaknesses of the Tusanian economy. Since these stopgap measures were grafted upon the surviving shell of an economic framework inherited from the past, the ensuing macro-financial stability proved ephemeral. The efforts to keep the old structure intact made the adjustments and transition more difficult.

3.2 The development strategy of Tusania in the past emphasized rapid modernization that could not be sustained from domestic resources alone, thus enhancing dependence on foreign savings and requiring infusions of imported capital. The drive for modernization was characterized by capital-intensive and domestic market-oriented industrial development, supplemented by large investments in infrastructure, communications, and transport, mostly imported. Development of the agricultural sector provided the backbone for the economy in terms of essential foodstuffs and exportables, but this also contributed to the need for foreign financing to sustain production levels. This led to large import requirements, both capital goods and raw materials, which could not be sustained by the Tusanian structure of foreign trade and its productive base. The culmination was a balance of payments crisis. The government intervened, but short-term stabilization packages provided only temporary relief. Monetary expansion caught up with the real economic base, and structural weaknesses took over. Further, the government erroneously perceived these crises as episodic, as the one occurred during the review period of this case study, occupying much energy and attention and diluting their focus from underlying structural imbalances. The realization was late in coming that the government was facing two sets of overlapping challenges: first, recovery from short-term crises; and second, initiation of structural changes and a transition to a system that would be more responsive to market forces. The resources needed to cope with these two challenges were way beyond the Tusanian economic and financial capacity, and the gap could not be closed with the best of efforts.

3.3 Over the past decade, and prior to the crisis years of Y_5-Y_7, Tusania grew quickly, as compared with other countries similar in size and economic structure, without having to make the major adjustments that many other economies had to make in the face of mounting balance of payment pressures. Despite an increase in import prices and general world inflation, Tusania managed to grow by 4 percent per annum, apparently absorbing the increased burden. There followed increased balance of payment deficits and the development of manageable domestic resource constraints limited to a few sectors. The economy remained buoyant, but steady deterioration of the balance of payments continued and could not be halted by periodic devaluations of the Siwat. In Y_5, Tusania found itself in a serious balance of payments squeeze, combined with rapid inflation, declining real incomes, the erosion of real wages and salaries, and economic instability. This was widely perceived as a short-term financial crisis. The prevailing view was, with some justification, that the Tusanian economy was reasonably diversified, had a good resource base, and had the potential for sustained growth. All that was needed were a few corrective measures over the short-term to ensure stable economic environment, and recovery would follow. That major actions were needed to redress structural imbalances and to usher in a more open and market-based economy was not materially recognized. Attention was devoted to coping with immediate needs and improving responses to the exigencies of the situation at hand. Besides, the government was too preoccupied with surviving the relentless pressures of opposition groups and maintaining its grip on governance. It could not afford to take steps that would further weaken its position. This failure of response proved too costly as the crisis unfolded in later years of the review period.

3.4 In the early review years Y_1-Y_4 , Tusanian growth was reasonable at around 3.0 percent per year, but it began to slow during Y_4 and Y_5. Investment and output growth in real terms in the later years was nearly half of the long-term historical growth rates (*see Table 3.1 below*). The growth of real GDP was 2.4 percent in Y_5, declined to 1.2 percent in Y_6, and to near zero level in Y_7. On the heels of this

decline in output in constant value terms, domestic savings in real terms declined to 0.4 percent in Y_5 and became negative in Y_6 and Y_7. The slowdown of the growth rate in GDP during the Y_4-Y_7 years was largely attributed to a severe compression in imported raw materials and spare parts to maintain industrial production. This does not fully account for the decline in the GDP since the industrial sector contributes about one-third of total output, while the agricultural sector constitutes nearly half of the Tusanian economy.

Table 3.1 GDP - Macro Accounts

	Annual Indicators				Average Annual Growth Rates		
	Y_1	Y_4	Y_6	Y_7	Y_1-Y_7	Y_1-Y_4	Y_5-Y_7
	(ST billions)				*(per cent)*		
Current Values							
GDP	1280	1806	2604	3010	15.3	12.2	18.3
Exports	93	147	199	231	16.4	16.5	13.9
Imports	175	263	352	398	14.7	14.5	14.0
Domestic Savings	207	293	401	455	14.0	12.3	15.3
Constant Values, Y_1=100							
GDP	1280	1400	1451	1454	2.1	3.0	0.7
Exports	93	114	111	112	3.1	7.0	-3.1
Imports	175	204	196	192	1.6	5.2	-2.9
Domestic Savings	207	227	223	220	1.0	3.1	-1.8
Annual Growth Rates	*(per cent)*						
GDP	3.1	2.8	1.2	0.2			
Exports	2.3	8.0	-6.6	0.7			
Imports	1.5	6.6	-3.9	-2.0			
Domestic Savings	3.1	2.2	-2.1	-1.6			
Ratios (%)	***Constant Values, Y_1=100***						
Domestic Savings/GDP	16.2	16.2	15.4	15.1			
Exports / GDP	07.3	7.7	7.6	7.7			
Imports / GDP	13.7	14.0	13.5	13.2			

For details see **Annex III**, Table 3-1

Agricultural output showed a modest growth but was not sufficient to compensate for the decline in industrial output. The agricultural sector also suffered from a drop in fertilizer imports, rising petroleum prices, and a lack of maintenance of farm machinery and equipment. The main negative impact on farm output, however, came from the relative price structure where, with rapid inflation, agricultural prices — especially food items — were kept much lower in relative terms, thus worsening incentives to farmers. Historically, the agriculture sector had faced a repressed price regime, and it was worsened by rapid inflation during Y_5-Y_7. Thus, the roots of an economic crisis were already present, and, as such, were simply reinforced and hastened by rapid shifts in the supply of inputs, availability of foreign liquidity, and external finance.

3.5 For quite a long time, Tusania had pursued a development strategy with emphasis on self-reliance, especially self-sufficiency in food production, development of indigenous industrial capacity, and import-substitution — in short, an autarchic model of growth as pursued by many other countries. In good measure, it succeeded, as Tusania did not have to rely much on foreign capital to sustain its investment program or to finance its domestic resource gap. But Tusania did have to find external finance to cover its foreign trade deficit, which could not be sustained over the long-term. The inflows of foreign capital in the early years of the review period provided a cushion for these foreign trade deficits. With deepening balance of payments problems during Y_5 and Y_6, however, this external financing mechanism collapsed, and foreign trade deficits could no longer be covered in a conventional manner. These aspects are analyzed in Chapter IV in detail. In summary, foreign creditors — banks and suppliers — not only applied the brakes on new exposure, they also began to demand repayment, or at least that Tusania keep their loans current. Tusania increasingly found it difficult to borrow overseas, and in such circumstances it could finance only part of its trade deficit through routine capital inflows. As the external debt burden mounted, with little prospect of repayment, arrears began to build up. Eventually this shut down even the routinely available

foreign financing cover, thus precipitating a balance of payments crisis which could not be resolved through conventional processes.

3.6 On the domestic front, the external financing mechanism generated counterpart domestic liabilities that were lodged with the financial system. As discussed in Chapter VI, to offset these liabilities, financial resources had to be generated domestically in various ways. For example, the holders of financial assets had to be taxed sooner or later through either direct tax or inflation tax. The asset holders could, however, escape the burden through capital flight, for which both the official and the parallel market provided easy mechanisms. The banking system provided easy access to credit to large borrowers at rates of interest that were below market level. This easy access to credit allowed large borrowers to speculate against the Siwat, creating self-fulfilling devaluations in the parallel market. Consequently, this forced devaluations in the official market, as authorities attempted to keep the differential narrow between the two exchange rates. This, in turn, worsened the foreign debt-servicing burden in local currency, thus reinforcing the impact on the financial system.

3.7 At the same time, growing financial difficulties of the banks, owing either to default by borrowers engaged in speculative activities or capital flight, or to the failure of the SEs, imposed a further burden on the financial system. The CBT was forced to provide liquidity to the banking system to prevent banking collapse. At the same time, it tried to control inflation through tight monetary policy, liquidity control and credit expansion by fiat, thereby raising interest rates to levels such that borrowers in the real sector began to fail, leaving the banking system with large losses. For a while, the government tried to sustain the commitments of the public sector by incurring large deficits. Eventually, it began pulling away from its over-extended commitments, thus compounding the financial difficulties of a large number of companies, both state- and privately-owned. Those SEs that were operating on the brink of insolvency, floundered, and their insolvency eventually found its way to

the financial system. The government's claim on the aggregate financial resources increased, since a good portion of financial resources originate through the monetization of net capital inflows. This crowding out occurred at a time when companies needed a cushion to ride out imminent financial failure, adversely affecting their capacity to maintain production and employment, which in turn led to the recession discussed in paragraph 3.4 above.

3.8 This was the genesis of the economic and financial crisis that gripped Tusania during the years of Y_6 and Y_7. The crisis was of domestic origin and was rooted in the way the Tusanian economy and its financial system operated within a policy framework that could no longer cope with the crisis analyzed in the next two chapters. The common refrain was that "the Tusanian balance of payments were in crisis, not the Tusanian economy." The reason for this public perception was that problems of foreign financing received widespread publicity and media coverage both at home and abroad. Foreign banks and creditors stopped lending to Tusania and began demanding repayment. The Siwat came under severe pressure, but devaluations were perceived as a betrayal of confidence, though parallel markets confirmed the weakness of the Siwat. Vital import of items like oil and petroleum, pharmaceuticals, and essential consumer goods, could no longer be financed. Subsequently, the AMLs became involved, and their efforts to ease the crisis of external finances received even greater media coverage. On the extreme, a political frenzy held that this crisis was nothing but the making of the international financial community in consort with the foreign enemies of Tusania and that there was not much wrong with the Tusanian economy or its structure of foreign trade. In other words, the prevailing view was that a fix on the balance of payments through a short-term stabilization package should be sufficient to cope with a situation seen primarily as sparked by a foreign exchange liquidity crisis. Subsequent events proved otherwise.

ANNEX III *Table 3-1 GDP - Macro Accounts*

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Current Values							
GDP	**1280**	**1413**	**1575**	**1806**	**2149**	**2604**	**3010**
Exports	93	109	122	147	178	199	231
Imports	175	198	221	263	306	352	398
Domestic Savings	207	229	257	293	342	401	455
Annual Growth Rates (%)							
GDP	10.0	10.4	11.5	14.6	19.0	21.1	15.6
Exports	11.2	17.2	11.9	20.5	21.1	11.8	16.1
Imports	8.6	13.1	11.6	19.0	16.3	15.0	13.1
Domestic Savings	9.8	10.6	12.2	14.0	16.7	17.3	13.5
Constant Values, Y_1=100							
GDP	1280	1321	1362	1400	1434	1451	1454
Exports	93.0	101.9	105.5	114.0	118.7	110.9	111.6
Imports	175.0	185.0	191.2	203.9	204.1	196.1	192.3
Domestic Savings	207.0	214.0	222.3	227.1	228.2	223.4	219.8
Annual Growth Rates (%)							
GDP	3.1	3.2	3.1	2.8	2.4	1.2	0.2
Exports	2.3	9.5	3.6	8.0	4.2	-6.6	0.7
Imports	1.5	5.7	3.3	6.6	0.1	-3.9	-2.0
Domestic Savings	3.1	3.4	3.9	2.2	0.4	-2.1	-1.6
Ratios (%)	*Constant Values, Y_1=100*						
Domestic Savings / GDP	16.2	16.2	16.3	16.2	15.9	15.4	15.1
Exports / GDP	7.3	7.7	7.7	8.1	8.3	7.6	7.7
Imports / GDP	13.7	14.0	14.0	14.6	14.2	13.5	13.2
GDP deflator index	100.0	107.0	115.6	129.0	149.9	179.5	207.0

Average Annual Growth Rates

	Y_1-Y_7	Y_1-Y_4	Y_4-Y_7	Y_5-Y_7			
Constant Values							
GDP	0.0215	0.0303	0.0127	0.0069			
Imports	1.6%	5.2%	-1.9%	-2.9%			
Domestic Savings	1.0%	3.1%	-1.1%	-1.8%			
Current Values							
GDP	0.1532	0.1216	0.1856	0.1835			
Exports	16.4%	16.5%	16.3%	13.9%			
Imports	14.7%	14.5%	14.8%	14.0%			
Domestic Savings	14.0%	12.3%	15.8%	15.3%			

CHAPTER IV

REQUIREMENTS FOR EXTERNAL FINANCE

4.1. The need for external finance in Tusania emerged from two sources: First, to finance the foreign trade deficit given import levels and export performance; and second, to finance long-term investment needs, i.e. the need for foreign savings to cover the shortfall between domestic savings and investment. Foreign financing of the trade deficit and domestic investment generated two streams of outflows over time: a) the interest obligations of foreign loans and dividends on foreign investments lodged in the services account, and b) amortization and repayments of principal lodged in the capital accounts of the balance of payments. Traditionally, Tusania's capacity to meet these foreign liabilities had been sufficient to prevent a balance of payment crisis, but over time two disturbing trends occurred. First, Tusania's foreign trade deficit kept growing and could no longer be sustained, and second, in order to cover the financing needs of the trade deficit as well as investment needs, Tusania relied on short-term capital inflows which subsequently proved volatile with disastrous consequences.

4.2 ***In summary***, the balance of payments situation of Tusania was fairly manageable during the decade prior to the review period. The overall deficit in the balance of payments historically, and prior to the review period, ranged between $250-$350 million annually. This could easily be financed by foreign borrowings of two types: the medium and long-term borrowings guaranteed by the government (M&LT), and short-term borrowings from international financial markets. Later on,

the government allowed the CBT to attract foreign currency deposits (fCDs) pegged at a premium above the international market interest rates. These were denominated in major foreign currencies, much stronger than the Siwat, with explicit repayment obligations in foreign currencies and implicit government guarantees covering both the credit risk and foreign exchange risk. These fCDs were overseas institutional deposits of short-term maturity placed by nearly 300 foreign banks in the foreign accounts of the CBT. These fCDs were a major source of financing for the overall balance of payment deficits through the early years of the review period. Later on, with the growing current account deficit, a reversal of major proportions took place and net fCD inflows dropped dramatically causing a major foreign liquidity crisis. Within a period of 18 months during Y_4 and Y_5, Tusania found itself with mounting arrears on the fCDs and other short-term obligations which could not be met. Later on, these had to be managed through rescheduling organized by international agencies. In the early phase of the crisis, the loss of foreign liquidity continued to be perceived as a financial phenomenon. It was a classic case of a mismatched maturity structure where long-term funding requirements were financed through short-term inflows that were both volatile and expensive relative to medium- and long-term (M&LT) capital inflows. To begin with, the bulk of foreign financing needs were to cover the trade deficit. Only a small part was used to finance domestic borrowing needs of the public sector apart from investment financing, which were justified as contributing to growth, import substitution, or to export potential. While financing the trade deficit with short-term foreign borrowings through instruments like fCDs, suppliers' credits, or other trade financing instruments, was regarded as imprudent by the government and the CBT; the volatility of fCD inflows did not register until it was too late. The underlying causes of the balance of payment deficit, however, were structural and were rooted in the domestic structure of production, investment, and foreign trade. A related factor was Tusania's need to cover the short-fall in domestic savings through foreign savings to close the savings investment gap, originating from a development strategy that could not be sustained by domestic resources. This

linkage was obscured by fairly steady inflows of foreign finance that appeared to be quite manageable in the early years.

4.3 The external financing requirements can be viewed two ways. The usual approach is to look at the current account deficit and to ascertain how much of that deficit is covered by *autonomous* M&LT capital inflows on a net basis. If these capital inflows (net) are insufficient to cover the current account deficit, the resulting deficit, defined as the *balance of payments deficit,* is usually financed by short-term capital inflows and borrowings from international financial markets. Another approach, followed here, is to take the balance of payments deficit as given, and then focus on the short-term inflows, because that is where the link is forged between the foreign borrowing operations, financial markets, and the banking system. In particular, since the crisis of Y_5-Y_7 in Tusania was perceived largely as a financial crisis spawned by foreign illiquidity, we need to focus on the causes of this liquidity crunch, relate it to both the medium and long-term capital movements, short-term inflows and arrears, and then step back to review the current account deficit emerging from the structure of Tusanian foreign trade.

Balance of Payments Deficit

4.4 The Tusanian balance of payments deficit was a manageable $237 million in Y_1, but rose swiftly to reach $686 million in Y_4, $715 million in Y_5, $876 million in Y_6, and $815 million in Y_7 (*see table below and Annex IV, Table 1 for details*). In later years, a good part of this deficit occurred because of the increase in debt servicing obligations, both interest and amortizations, *as recorded by the CBT and the Treasury,* and not as recorded by the creditors in their books on Tusanian accounts. The deficit began to rise during Y_5 through Y_7 because it could not be financed *above the line* by autonomous capital movements, defined as medium and long-term (M&LT) borrowings of the government and direct foreign investment. The M&LT borrowings on a gross basis were $292 million in Y_1, rising to $414 million in

Table 4.1 Balance of Payments

	Annual Indicators						
	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
			(US$ millions)				
Balance of Payments Deficit	**-237**	**-465**	**-504**	**-686**	**-715**	**-876**	**-815**
Financed by:							
Short-Term Inflows (net)	714	812	919	679	571	497	558
fCDs	527	558	531	267	112	21	8
Arrears Rolled-Over	0	0	114	228	312	357	382
Negotiated Foreign $ Credits	0	0	0	163	251	458	462
Reserves	-266	-194	-231	-42	-12	39	-38
Net errors/omissions	-211	-153	-184	-114	-95	-118	-167
Total Foreign Finance	**237**	**465**	**504**	**686**	**715**	**876**	**815**
Exports	1163	1313	1403	1561	1741	1805	1834
Imports	2188	2388	2537	2793	3000	3196	3118
Trade Balance	*-1025*	*-1075*	*-1134*	*-1232*	*-1259*	*-1391*	*-1284*
Invisibles (Services, net)	629	567	403	315	282	254	220
Current Account Balance	**-396**	**-508**	**-731**	**-917**	**-977**	**-1137**	**-1064**
Capital Movements							
Public M&LT (net)	121	148	178	180	210	207	194
Direct Private Investment	38	43	49	51	52	54	55
Net M&LT Inflows	159	181	227	231	262	261	249
Balance of Payments Deficit	**-237**	**-465**	**-504**	**-686**	**-715**	**-876**	**-815**
Arrears Outstanding	92	169	268	508	657	1013	1236
BoP Deficit --adjusted	**-329**	**-634**	**-772**	**-1194**	**-1372**	**-1889**	**-2051**

For details see **Annex IV**, Table 4-1

Y_4. After the amortization payments, the net M&LT borrowings were $121 million in Y_1, and $180 million in Y_4, rising to about $200 million during the Y_5-Y_7 period. Direct private investment amounted to $35 million in Y_1 and increased to $51 million in Y_4, but then stayed in the range of $52-$55 million during Y_5-Y_7. As a result, total net M&LT flows increased from $159 million in Y_1, to $231 million in Y_4 and then

stagnated around $258 million through Y_7. This stagnation coincided with the rise in the current account deficit and was a contributing factor to the liquidity crisis. M&LT flows are linked with long-term investment trends and are financing items for the domestic savings and investment gap, rather than the trade financing gap or a gap-filler item for short-term foreign financing undertaken by the central bank or the banking system. These short-term inflows were market-based, and were provided by multi-national banks and other financial institutions. These short-term inflows also included the net position with the IMF as year-end balance on purchase and re-purchase operations authorized as balance of payments support within the framework of the annual economic program agreed upon by the Tusanian government.

Emergence of Arrears

4.5 Short-term inflows are recorded as *below the line* (the balance of payments deficit line) financing items for the balance of payment deficit. They consist of short-term borrowings of the banking system and the private sector, such as bankers acceptances and suppliers' credits of typically less than a year in maturity. The central bank may also borrow short-term funds from the financial markets. In the case of Tusania, the CBT borrowed heavily from the financial markets. When these liabilities were not met, they emerged as arrears. Moreover, the arrears acknowledged by the CBT were much smaller than those recorded by creditors overseas. Here is the cleavage between unit-level and aggregate-level reporting on something as volatile and expensive as short-term foreign borrowings in times of rising interest rates and depreciating currency of the borrower. The foreign creditors recorded a higher level of Tusanian liabilities arising out of non-payment of the original obligations, refusal to roll over existing liabilities into new short-term instruments, hence accrued interest and fees; or adverse exchange rate movements between the loan currency and the Siwat. The default led creditors to impose severe penalties and charges, lumped into fresh liabilities against Tusania by creditors, even though these were unconfirmed by the CBT. Routinely, there is always a small

amount of arrears which are bundled almost automatically into new short-term liabilities on creditors' books. But beginning in Y_3, the creditors started to refuse this voluntary roll-over and arrears began to rise swiftly. By the middle of Y_5, Tusania was found in default by its foreign creditors, thus drying up fresh inflows of foreign capital. The CBT took the position that these arrears were "obligations in dispute," or part of the "reporting mismatch" owing to foreign exchange movements and thus were part of external debt accounts, not a part of the balance of payment accounts. The arrears reported here and included in the balance of payments accounts were aggregated from the financial statements of overseas creditors but were not officially recognized, much less resolved, by the borrower — the CBT. The size of the arrears was too large to be ignored, consisting mainly of obligations on fCD accounts, the direct liability of the CBT and the trade financing arrears, mainly the liabilities of the private sector channeled through the banking system.

4.6 In Y_1, total arrears were $92 million, increasing to $382 million by Y_3. In Y_4, the arrears rose to $736 million, consisting primarily of fCD obligations of $468 million and trade financing and other arrears of $268 million. Since Tusania's creditors voluntarily rolled over $228 million of these obligations in Y_4, the net arrears outstanding were $508 million in Y_4, nearly double the $268 million in arrears outstanding in Y_3. This worsening trend intensified and by mid-Y_5 the creditors declared Tusania in default. Thereafter, the total arrears rose swiftly to $1,370 million in Y_6, and in spite of the voluntary rollover of $357 million, arrears outstanding in Y_6 were $1,013 million, nearly twice the level of Y_4 (*see Annex VI, Table 4.1*). In Y_7, total arrears reached $1,618 million, of which $1,028 million were in fCDs and $590 million were in trade financing and other arrears. Again, creditors were obliged to roll over $382 million of these arrears, making arrears outstanding in Y_7 $1,236 million. The rolled-over arrears were short-term obligations of less than one year, hence they appear as financing items in the short-term inflows. As mentioned above, since Tusanian authorities had taken the position that these liabilities were "in dispute," the arrears outstanding were not included in the balance

of payments. But if the adjustment is made for these arrears outstanding, the balance of payments deficit (BoP Deficit -- adjusted) increases dramatically from $329 million in Y_1, to $1,194 million in Y_4, to $1,889 million in Y_6, and to $2,051 million in Y_7, more than twice the deficit reported on official accounts.

Short-Term Inflows

4.7 The net amount of short-term inflows was much larger than the balance of payments deficit in early years (Y_1-Y_3). These were used for the build-up of foreign reserves, as well as to cover net outflows recorded as errors and omissions. The short-term (net) inflow was $714 million in Y_1 and rose to $919 million in Y_3, largely because of the sustained inflows of fCDs to the CBT as overseas deposits. In the early years Y_1-Y_3, fCDs were at historic levels, in the range of $530-$550 million, however, in Y_4, with the growing repayment inability of the CBT, the fCDs inflows dropped by half to $267 million. By Y_7, they had dramatically dropped off to near zero levels. As deposits in the CBT foreign accounts, and thus foreign liabilities of the CBT, the drop-off was a significant *decline* in CBT's recorded liabilities, but in effect, part of the fCDs turned into rolled-over short-term debt on a voluntary basis, while the larger part of the remaining accumulated balance of fCDs turned into foreign arrears (*see Box 4.1: Foreign Currency Deposits, next page*). The rolled over liabilities emerged in Y_3 at $114 million, rising to $357 million in Y_6 and $382 million in Y_7. These rolled over amounts were resolved liabilities and no longer "in dispute," therefore they were recorded as part of short-term inflows. Owing to the drop-off in fCDs, however, the total short-term inflows, inclusive of roll-overs, decreased from $919 million in Y_3 to $679 million in Y_4, to $497 million in Y_6, and to $558 million in Y_7.

4.8 A similar trend was seen in the suppliers' credits extended to Tusanian importers, which typically are *not* the liability of the banking system; and banker's acceptances, which *are* the liability of the banking system. Both these inflows were

Box 4.1 ***Foreign Currency Deposits (fCDs)***

The fCDs were considered by the CBT as a relatively easy instrument for borrowing short-term funds from international banks without going through a lengthy process of documentation, negotiations, and pledging of world class collateral. As the name suggests, these were deposits made by lending banks, in a currency of the borrower's choice, into CBT accounts opened at the lending bank for typically three to six months, and in rare cases up to a year. As it turned out, this was a most expensive form of short-term borrowing for the CBT, and, by the same token, a lucrative lending mechanism for overseas banks. This was because the lending banks charged a hefty loan origination fee up front ranging between two to four percentage points, on top of a lending rate typically 0.75 to 1.00 per cent above LIBOR. Financially, these were the best terms banks could get on their international lending operations. The banks would look at the financial statement of the CBT with sizable foreign reserves fairly clean of any arrears, a good record of sustained foreign exchange earnings as cash inflow, and reasonable foreign liability-structure, though not so much from its traditional exports, rather from regular remittances of overseas Tusanians to support their families and businesses at home. Above all, lending to the CBT through fCDs came with an implicit guarantee of the Tusanian government against risk of default — there was no foreign exchange risk, given that repayments were denominated in the currency of deposits. The loan documentation procedures consisted of a letter of intent tendered by the CBT and a fairly standard loan agreement to allow finalization of processing in a few days, hence direct lending costs for the banks were minimal. All these factors conjured up a powerful incentive for overseas banks to take part in the fCD arrangement. Within a matter of a few months, the average level of the fCDs reached the equivalent of nearly half a billion US$, and as many as 300 banks ended up with deposits as small as $1.5 million on up to $15 million for large banks. As long as the CBT made good on its' payments, the banks felt safe. Therefore, for a single bank looking at its' own net exposure against total foreign exchange inflows, this mechanism of short-term foreign finance was financially viable.

Several things went wrong, however, at the macro-financial level. While for a single bank the exposure was tiny relative to the total foreign exchange earnings of Tusania, the total size of fCD liabilities for the CBT was fairly large. Further, the banks felt fairly secure when comparing their exposure to the total foreign exchange earnings, but they did not realize that the fCD's servicing burden in the aggregate, together with other debt-service obligations, was a fairly large proportion of total foreign exchange earnings. Major issues lurking beneath the structural imbalances of the Tusanian economy were even more obscure to these overseas banks and certainly the banks were not aware of how the foreign trade structure would perform under strain. When the crash came, CBT began to offer even higher upfront fees to pay off previous obligations bringing the fCD system, fairly quickly, into financial insolvency. Several bankers caught in this insolvency felt betrayed by the CBT and the Tusanian government despite the fact that the lack of "due diligence" on their part and the lucrative lending terms induced them to indulge in this type of lending arrangement. As subsequent events confirmed, this was neither the first time, nor would it be the last, that the "hard-nosed bankers" found their noses bloodied in the process. They came out intact, however, even ahead, though it took a few years.

market-based, carried premium rates in international markets, and were of a maturity of one year or less. The suppliers' credits to Tusanian importers were in part guaranteed by overseas export credit guarantee agencies, such as Eximbank, and totaled $115 million in Y_1, rising to $178 million in Y_3. As the foreign liquidity position began to worsen, suppliers' credit began to decline and dropped to $77 million in Y_6. With the resolution of external debt and adoption of a stabilization program in Y_7, there was some turn around, and suppliers' credits stood at $110 million. More or less, the same trend was observed in the case of bankers' acceptances which rose from $72 million in Y_1 to $96 million in Y_3, then dropped off to $42 million in Y_6, with some increase in Y_7 due to the restoration of credit cover in Y_7 by foreign auditors (*see Box 4.2 Financing Imports*).

4.9 Alarmed by this reversal, the CBT, with the government's approval and support, feverishly tried to negotiate several types of bridge financing, including multi-institution syndicated loans with government guarantees. These negotiated foreign credits were first obtained from a group of large private foreign banks and were later supplemented by short-term financing from the AMLs as part of the stabilization program. These negotiated foreign loans increased from $163 million in Y_4 to $458 million in Y_6 and $462 million in Y_7. The AMLs' financing was large and was predicated on implementation of economic programs aimed at curbing the aggregate demand through stringent controls, controls on domestic credit, public sector price reforms, trade liberalization, and exchange rate adjustments. Thus, short- term foreign financing was directly linked with the economic program, with the performance to be monitored and authenticated by the AMLs. As discussed in Chapter IX, these AML agreements in Y_7 for Y_8 became the basis for resolving the overhang of the short-term liabilities of the CBT, the banking system, and private Tusanian borrowers. Prior to the enactment of a stabilization program for Y_8, the Tusanian government was obliged to implement annual economic programs endorsed by the AMLs during Y_5, Y_6, and Y_7. These were seen by foreign creditors as an endorsement of the Tusanian economy by the AMLs — a vote of confidence. On these reassurances, and as part of

Box 4.2 Financing Imports—Suppliers' Credits

Suppliers' credits for Tusanian importers, like in any other country, were almost routinely extended by overseas exporters. These credits were a short-term financing instrument on market terms, typically for one to two years, at interest rates higher than those prevailing in financial markets. For exporters, the incentive was to complete their sales to Tusanian importers, which were extended as a part of a financing package, including financing by banks, but more importantly, with the export credit guarantees by agencies like ECGD (British), Hermes (German), Cofas (French), Saache (Italian), and Eximbank (Japan, U.S., and others). Tusanian foreign exchange regulations do not allow suppliers' credits for import of consumer goods which are financed from foreign exchange purchases from the CBT and may be covered through bankers' acceptances. Suppliers' credits, therefore, were used mainly to import raw materials and spare parts by manufacturing units to maintain their capacity utilization. In some cases, large suppliers' credits were arranged for new plants and machinery, both by the private sector and the SEs.

In any event, suppliers' credits were an important source of short-term financing, but dried up owing to the default and were shut off when the credit guarantee agencies declared Tusania off-cover. The exporters invoked the credit guarantee and were paid off by the covering agency, who ended up as the creditor to Tusania. These credits were then declared in arrears, with attendant penalties and charges, were bundled together at the time of rescheduling negotiations and became the sovereign liability of the Tusanian government with medium-term negotiated interest rates and grace periods. In some cases, Tusanian importers had deposited Siwats with the CBT through their banks to purchase foreign exchange to pay off their liabilities. But the CBT didn't have enough foreign exchange to sell, and in those cases, the suppliers' credit ended up being CBT's liability. Some of these liabilities were cleared but a good part ended up as arrears and eventually as part of the CBT.

a financial assistance package, foreign creditors were co-opted to extend syndicated loans during Y_5-Y_6, in parallel to the financial assistance committed by the AMLs, but almost all of it in short-term funds. That these annual programs for Y_5-Y_7 proved to be ineffective in stemming the crisis, is a separate matter.

4.10 There were two other factors at work, especially in the early years: reserve build-up and capital flight. During Y_1-Y_3, buoyed by short-term fCD inflows and

other financing, both the CBT and the banking system engaged in the net build-up of reserves of $266 million in Y_1, $194 million in Y_2, and $231 million in Y_3. As foreign financing became difficult, this trend reversed and some of the foreign obligations were met by reserves. The private sector, however, continued to engage in capital flight throughout these years for several reasons, though mainly spurred by the exchange rate differential between the official and parallel markets. While the level of capital flight, included in the "net errors and omissions" in the balance of payments accounts, was modest, it contributed to a negative perception of the Tusanian economy, a vote of no-confidence for the Siwat, and the failure of exchange rate management. The reserve build-up dramatically dropped off during Y_4-Y_7, while the errors and omissions item remained a net outflow, though it declined as the shortage of foreign exchange became acute during the crisis years.

4.11 In the preceding paragraphs, an effort has been made to analyze short-term inflows since the shift in these inflows led to Tusanian foreign illiquidity in later years. To begin with, M&LT inflows were inadequate to cover over the balance of payments deficit, much less compensate for the sheer size of the adverse shift in short-term inflows. Consequently, the balance of payments deficits, adjusted for these short-term liabilities, became unmanageably large during Y_5-Y_7. Thus, while a large part of the deficit emerged from the financing side, the foreign trade gap and current account deficits were the initial source of the financial crisis. Let us now turn to these items.

Foreign Trade and Current Account Balance

4.12 The foreign trade balance of Tusania ran at a deficit throughout the period of analysis. During the review period, the trade deficit began in the range of $1.0-$1.2 billion during Y_1-Y_4, rising to $1.4 billion in Y_6, then declining somewhat to about $1.3 billion in Y_7. This increase in the foreign trade deficit occurred in spite of reasonable export performance. Tusanian exports in value terms increased considerably from $1,163 million in Y_1 to $1,834 million in Y_7, growing at an annual average rate of 7.9 percent during these years. Imports increased from $2,118 million

in Y_1 to $3,118 million in Y_7, a slower average annual growth rate of 6.1 percent. All things considered, the trade performance of Tusania was quite reasonable as compared to countries with a similar production base, economic structures, historical trends and stages of economic development. During the early years (Y_1-Y_4), the average rate of growth of exports in US dollars was 10.3 percent and those of imports 8.5 percent; however, the export growth dropped off to 5.5 percent during Y_4-Y_7, and growth of imports dropped off even faster to 3.7 percent, all in US dollar value terms.

4.13 There was an even more disturbing trend in that both exports and imports in constant value terms decreased, the only difference being that imports decreased faster than exports. Much of this decline occurred during Y_5-Y_7. In the early part of review years Y_1-Y_4, exports in real terms increased by 3.1 percent per year, faster than the rate of increase of imports at 1.4 percent per year. But during Y_5-Y_7, exports in real terms decreased at the rate of 2.9 percent per year, while real imports decreased by 3.6 percent per year. This compression in import demand is credited to demand management policies during the crisis years. But a persistent real drop in the quantity of exports and poor export performance pointed to the inadequacy of the foreign trade regime and exchange rate policy pursued by Tusania. The popular view was that given Tusania's reliance on agricultural commodity exports like cotton, wheat, dried fruits; and light manufacturing, such as textiles and leather products, tinkering with the trade regime and exchange rate alone would not lead to a sizable improvement in trade performance. This "export pessimism" is widely shared by primary commodity exporters and is not unique to Tusania.

4.14 As a result of the trends in foreign trading in real terms, export to GDP ratio hovered around 7.7 percent over the review period, while import to GDP ratio stayed around 12 percent over the same period (*for details see Annex IV, Table 4-1*). As regards the composition of trade, on the exports side, agricultural commodities contributed nearly two thirds of export earnings. On the import side, machinery, spares, and industrial raw materials constituted about 38 percent of the total; oil and

petroleum about 24 percent; pharmaceuticals and essential consumer goods about 12 percent, the remainder being miscellaneous items. Imports of luxury consumer items were almost negligible given outright import bans and a steep custom duty structure.

4.15 Given this structure of trade, it is no surprise that in a bid to improve foreign exchange earnings, the government strove to provide financial incentives to the non-traditional segment of Tusania's export sector. Reliance was placed on quantitative restrictions (QRs) and custom duties to curb imports. With the onset of the crisis in Y_5, government response to deteriorating trade and the current account balance was largely in the form of short-run crisis management steps such as QRs and licensing on imports, increases in import duties, and cutbacks in excise duties on manufactured goods destined for exports. These efforts, however, did not succeed in assisting the fast deteriorating current account balance. With an overvalued Siwat, appreciating real exchange rate, and a system of selective QRs, the foreign trade regime became even more distorted. Pressures on the domestic price level and nominal exchange rate intensified. The trade deficit began to rise swiftly in the mid-years, and eventually became non-sustainable, choking off the short-term inflows that had been the main source of financing the trade deficit.

4.16 The impact of the trade deficit was softened by increased inflows on services accounts of remittances of Tusanians based overseas. These remittances were fairly large, reaching at an all time high of $865 million in Y_2, dipping to $708 million in Y_5, and thereafter increasing to $762 million in Y_7. These remittances of Tusanians overseas were fairly stable, as these inflows were mainly to support families and business. Whenever the differential between the official and curb market exchange rate increased, part of the remittances were shifted over to unofficial sources of transfer. Nonetheless, the remittances, which provided a much-needed cushion for the trade deficits throughout the period, were regarded as a fairly reliable source of foreign exchange earnings and were a major factor in attracting fCDs, as discussed above.

4.17 What aggravated the current account deficit during the review period was that interest payments began to rise swiftly from a net of $211 million to $398 million in Y_4, and to $542 million in Y_7. This increase in interest charges was partly offset by remittances, but given the size of the trade deficit each year, the current account deficit swiftly increased from $396 million in Y_1 to $917 million in Y_4, and then to $1.0 billion in Y_7. No amount of stopgap efforts to improve trade performance could offset deficits of this magnitude. Foreign exchange earnings did increase significantly during Y_1-Y_7, but they were more than offset by an increase in imports and net interest payments on the services accounts.

Corrective Measures

4.18 With a steadily deteriorating economic situation and no improvement in sight, the government gingerly embarked upon long-needed reforms in Y_5 consisting of devaluation of the Siwat, the introduction of a market-based auction system for foreign exchange, abolition of some QRs, and reduction in effective protection — all pointing towards a realignment of the foreign trade regime. In tandem, in mid-Y_5 the government imposed some control on public sector outlays, small but much needed increases in utilities' tariffs, and intensified revenue-raising measures as part of its annual economic program. These efforts, however, did not lead to a manageable balance of payments position. In spite of roll-overs, the size of short-term obligations created an overhang of liabilities both on trade and external debt accounts. At the same time, the revaluation of external liabilities by creditors due to devaluations of the US dollar and adverse cross-rate movements led to mounting arrears, externally. On the domestic front, the counterpart Siwat obligations of the private sector rose faster owing to devaluation, thus contributing to a severe financial squeeze on the private sector, already overburdened by rising interest rates, the tightening of domestic credit, and other adverse domestic financial trends. The Tusanian economy was forced to endure severe belt-tightening due to the financial squeeze as service payments wiped out foreign exchange availability for critical economic needs. Import compression and

rising import costs forced several businesses to close down, and the general public faced severe hardship in the absence of any meaningful safety net. The government was forced to take a number of steps to control the growing foreign trade imbalance, starting with exchange rate policy and tariff structure aimed at revamping its trade regime.

Exchange Rate Policy

4.19 The CBT operated a fixed exchange rate system pegged to the US dollar up to Y_4. Under this fixed system, the CBT did periodically adjust the exchange rate and devalue the Siwat against the dollar, but the Siwat remained overvalued and the real effective exchange rate appreciated throughout the review period. The nominal exchange rate set by the CB was 80 Siwats to the US dollar at the end of Y_1, and with the devaluation during Y_2 and Y_3, the official rate by the end of Y_4 increased to 94 Siwats to the US dollar (*see Annex IV, Table 4-1 for details*). Thus, during the Y_1-Y_4 period, the Siwat was devalued by nearly 17.5 per cent — a substantial devaluation. But Tusanian inflation was running high, and the domestic price level had risen by 57 percent as measured by the cost of living index, much higher than the 15 percent inflation in trading partner countries over the same period. The real exchange thus appreciated by 12 percent during the Y_1-Y_4 period. In Y_5, the Siwat was devalued again to 102 to the dollar, followed by yet another devaluation in Y_6 to 110 Siwats to the dollar. By then, however, Tusanian inflation had gained substantial momentum, and the Tusanian price level rose by nearly 22 per cent per year. Despite yearly efforts to maintain the value of the Siwat, CBT authorities were unable to stabilize the exchange rate. Periodic devaluations became almost routine and much awaited each November at the time of the announcement of the Annual Programs. In mid-Y_5, the government finally gave up on the fixed exchange rate regime, as discussed in Chapter IX, and adopted a crawling peg system. This was backed by sizable foreign exchange reserves provided by the CBT as part of the stabilization package and with the financial support of the AMLs. The nominal exchange rate at

Box 4.3 Foreign Exchange Auction System

In the third quarter of Y_5, the CBT introduced a foreign exchange auction system to provide for a smooth adjustment in the official exchange rate denominated in US dollars, and based on a basket of major currencies. It was a variant of a managed floating system that allowed the CBT to undertake periodic devaluation in measured steps, instead of the large discrete devaluations of the past. Tusanian banks licensed for foreign exchange trading were asked to submit their bids twice weekly for an amount of foreign exchange predetermined by the CBT for each bank, depending on the size of its operations, ownership, and concentration of activities. The auction started off with the prevailing exchange rate of 96 Siwats to the US dollar, which was already over-valued. The CBT let it be known to the banks that it would not accept wild swings, that is, it predetermined the range of acceptable bids. The banks were tempted to tender higher bids based on the spread between parallel market and official rates and other considerations, but they did not want to lose their eligibility for auctioned amounts. As a result, the bids stayed within 1.0-1.5 percent of the prevailing official exchange rate. This was the crawling peg part of the float. Whether it was a managed float or a dirty float depends on how it was perceived by the participating banks. In effect, the auction system transferred the foreign exchange eligibility and distribution authority to the banks, away from the previous system of access to foreign exchange by import license holders, and the Ministry of Commerce that used to grant these licenses.

the end of Y_7 was 126 Siwats to the US dollar, still well below the parallel market rate of 149 Siwats to the US dollar.

4.20 The exchange rate in the parallel market exerted tremendous pressure on the official exchange rate, foreign capital inflows and movement of funds, banking credit and, indirectly, on the interest rate structure. In Tusania, the Siwat is easily convertible, but at unofficial rates, and flows of funds are not necessarily constrained by the size of cross-border illegal trade, which is rather large. The massive size of the parallel market can be gauged by cross-border illegal trade in consumer goods, electronics, foodstuffs, textiles, light machinery, and vehicle spare parts. No one knows the true size of the parallel market, but it is not an adjunct curb-side activity. Its

presence is palpable and has a strong impact on the economy which cannot be ignored. As a result, throughout the review years the parallel market rate remained higher than the official rate. In Y_1, it was 92 Siwat to the dollar, as compared to the official rate of 80 Siwats; in Y_4, the parallel rate was 115 Siwats to the dollar against the official rate of 94 Siwats. After that, it began to rise faster and was 138 Siwats to the dollar in Y_6, against the official rate of 110 Siwats. In Y_7, the gap narrowed somewhat, as the parallel market rate stood at 149 Siwats against the official rate of 126 Siwats.

4.21 The sliding Siwat provided the opportunity for "round tripping" in the parallel market and was financed, in part, by the banking system as interest rates remained affordable and banking credit expanded sharply. Each time the Siwat took a slide, speculators gained on currency trade and came back through the financial system for the next round. The mechanism employed was fairly simple. Since Tusanian banks readily advanced credit against foreign currency accounts as collateral, the speculators tendered their balances in foreign banks to obtain Siwat credit, purchased foreign currency in the parallel market with these credits, and then remitted it overseas. When the Siwat depreciated, the speculators converted their foreign balance to pay off banks and obtain fresh credits, thus starting the cycle all over again. As the pressure on the Siwat in the parallel market continued unabated, the differential between the official and the parallel rate widened significantly, forcing authorities to devalue, thus reinforcing speculative behavior in a recursive fashion. This cycle was interrupted in late Y_6, when the government took draconian liquidity control measures by prohibiting foreign account guarantees for credit and freezing the accounts of all SEs with the banking system. These steps, together with a rising interest rate, choked off the (formal) banking finance feeding the parallel market activities and stabilized the Siwat, but only after a good deal of instability in the markets and at a cost to the Tusanian economy and banking system.

4.22 A major re-alignment of the exchange rate and an overhaul of the system of operation was needed in the foreign exchange market of Tusania, and was eventually implemented in Y_5. But while the exchange rate policy was aimed at realigning

relative prices and improving the foreign trade position and balance of payments, it also profoundly affected the banking system. The reforms, taken together, rendered the weaknesses of the banking system more acute. The relative price shift adversely hit overextended borrowers and aggravated their financial distress. The immediate impact of these policies was negative for the over-extended borrower, to whom the banking system was sufficiently exposed. The revamped price structure — the subsidy and incentive regime — adversely affected the financial position of many of these borrowers. This adverse impact was transmitted to the financial institutions. Further, the exchange rate policy and its auction system, to the extent that it had a built-in economic rent, led to a perverse allocation of foreign exchange by the banking system at the enterprise level. Already reeling under economic and financial pressures, the private sector now found access to foreign exchange very difficult and simply could not compete with the traders, and others, in service sectors because they could not afford the economic rent. Worse yet, to the extent that access to foreign exchange was tied to banking credit, those who could pay the premium for foreign exchange obtained easier credit. This contributed to a perverse lending phenomenon by the banking system in which the private sector was crowded out with severe consequences for economic revival and growth. As will be seen later, the financial system was at the center of this process.

Export Promotion

4.23 The government had for a long period provided incentives and financing to promote non-traditional exports, mostly benefiting light manufacturing, and agro-processing industries. These industries were established under a protective structure, *á là* infant-industry promotion. Once established, the government offered export rebates to manufacturers and exports on classified items declared eligible under an export rebate scheme. In parallel, the government classified exporting activities as a priority sector requiring the banking system to provide credit for exports under the directed credit system, discussed in detail in Chapter VII. Both of these promotional policies

had financial implications. The export-rebate scheme was funded from the federal budget, and apart from the merits of the scheme, it added to federal expenditures, hence federal deficits which were covered by borrowings. In effect, the government provided subsidies at a financial cost to the funding arrangement.[1] The priority credit scheme through the banking system did not involve explicit subsidies on direct financial costs to the banks, in so far as these credits were market-based and didn't replace other eligible borrowers.

4.24 The export rebate scheme has been in operation for nearly a decade inclusive of the review period. It is intended to offset the excise taxes paid by manufacturers, and import duties and charges on the import content of exports — a sort of duty drawback arrangement, but not as sophisticated and effective as a stand-alone scheme of this type in other countries. The rebate is expressed as a percentage of the f.o.b. export price or the c.i.f. price where goods are carried by Tusanian transport. The eligibility of exports for rebates is periodically revised by the Ministry of Commerce and is classified under several lists, with rebates ranging between 10 to 40 percent of the f.o.b. price for exporters with an annual turnover of $1.0 million or more and up to 30 percent for exporters with smaller turnovers. Nearly one-third of merchandise exports were thus eligible for rebates and the average rate of the rebate was around 20 percent during the first five years of the operation of the scheme. At the aggregate level, it is difficult to establish whether the rebate scheme contributed to exporting performance. For textiles and leather goods manufacturers, however, the rebates had a significant impact and assisted considerably in exporting. Though it could be argued that the rebates are generous, their implementation and coverage need improvement. In particular, the scheme should weed out opportunities for its misuse and cut back on the cost to the government.

[1] The rebate amount paid by the government was in the range of Siwats 3.5-4.5 billion per year, a fairly small amount relative to total government expenditures during Y_1-Y_7.

4.25 Export financing by the banking system was fairly adequate as exporters had priority access to banking credit (*see Chapter VII for details*). Exporters needed two types of financing: for export trading and for export manufacturing. Export trading finance never posed any serious problems for the banks, whether for traditional agricultural commodities or light manufacturing items consisting mainly of textiles and leather goods. Occasionally, exporters ran into import quota restrictions, especially on textiles, but this did not pose any insurmountable financing difficulties either for the bankers or exporters. Credit for manufacturing, especially medium- and long-term credit by the banks, did create issues of viability for the proposed credit. Banks circumvented this, however, by granting short-term loans and then roll overs, thereby mitigating both the credit risk and interest rate risk. The targeted share for exporting was specified under manufacturing, to which the banks were required to lend 30 percent of their total credit. The target shares in the directed credit system were easily met, since the cash flow of exporters was superior to those of other manufacturers limited to the domestic market. Domestic financing of export manufacturing was not a serious constraint on export performance.

4.26 A meaningful reform of the foreign trade regime had to come to grips with the import policy and the structure of protection. As mentioned earlier, to curb imports for balance of trade concerns and to promote indigenous industries, the government relied on an extensive system of import duties and quantitative restrictions which needed a major overhaul. This could not be achieved, however, within the short-term horizon of successive Annual Programs and did not result in demonstrable improvements in trade performance. The government's policy response in this area was to resort to adjustments in the tariffs, more as a revenue measure than as a trade policy move. This task began in Y_8, beyond the review period, as part of a broader program of structural changes initiated in late Y_7.

External Debt

4.27 The short-term financing of the balance of payments deficit, arising out of the foreign trade deficit, interest payments, and liabilities on medium- and long-term debt and arrears, had a drastically negative impact on Tusania's external debt position. The downward slide began in Y_4 and had snowballed by Y_7. Tusania had a comfortable external debt position in the early years of the review period which had been fairly manageable because the external debt consisted largely of the public and publicly-guaranteed medium- and long-term (M&LT) debt. The short-term debt, basically trade financing obligations of less than one year, was relatively small and manageable. In Y_1, the short-term debt was $806 million, of which $601 million was in fCDs and $187 million was in trade financing instruments of suppliers' credits and bankers' acceptances. The M&LT debt in Y_1 was $2,549 million, amounting to about 76 percent of total external debt outstanding and disbursed (DOD). Thus the total external debt (DOD) was $3,355 million in Y_1 (*see Table 4-2 below*). By Y_4, the DOD had risen to $4,368 million, of which $3,018 million was in M&LT debt and $1,350 million was in short-term debt, with more than half ($735 million) in fCD accounts. By Y_7, the overall picture had changed considerably, as short-term debt rose to $2,256 million, or about 38 percent of a total outstanding debt of $5,885 million, while the M&LT debt was $3,629 million or about 62 percent of total debt. In other words, not only did the amount of external debt increase substantially, but there was also a major shift in the structure of external debt outstanding.

4.28 The source of the shift in the structure of the external debt was the emergence of arrears on short-term liabilities, discussed earlier — mainly the fCDs. As the figures show in *Table 4-1*, new fCDs held on to their historic levels of around $530 million up until Y_3, but by Y_4 there was a sharp decline. New fCD inflows began to dry up, while at the same time fCD arrears began to rise from 74 million in Y_1, to $468 million in Y_4, $849 million in Y_6 and $1,028 million in Y_7, amounting to about 46 percent of the total short-term liabilities of Y_7. At the same time, arrears rolled over in new short-term liabilities emerged in Y_3 totaling $228 million in Y_4,

Table 4.2 External Debt Outstanding and Disbursed (DOD)

	Annual Indicators					
	Y_1	Y_4	Y_5	Y_6	Y_7	Y_8
	(US$ millions, end of period)					
Total External Debt (DOD)	**3355**	**4368**	**4707**	**5403**	**5885**	**6750**
Medium & Long-Term (M&LT)	**2549**	**3018**	**3228**	**3435**	**3629**	**6065**
Multilateral	871	1012	1066	1092	1130	1466
Bilateral (governments)	1526	1774	1898	2061	2183	2840
Private Banks (multinationals)	108	145	174	191	219	1657
Others	44	87	90	91	97	102
Short-Term Debt	**806**	**1350**	**1479**	**1968**	**2256**	**685**
Foreign Currency Deposits (fCDs)	601	735	746	870	1036	0
fCDs (new)	*527*	*267*	*112*	*21*	*8*	*0*
fCDs in Arrears	*74*	*468*	*634*	*849*	*1028*	*0*
Arrears Rolled -Over	0	228	312	357	382	0
Other Arrears	18	40	23	164	208	0
Negotiated Credits	0	163	251	458	462	470
Suppliers Credits and Acceptances	187	184	147	119	168	215
Amortizations on M&LT Debt	171	234	267	289	310	258
Interest on M&LT Debt	102	137	148	162	174	369
Average Interest on M&LT Debt (%)	4.0	4.5	4.6	4.7	4.8	6.1
Debt Service on M&LT Debt	***273***	***371***	***415***	***451***	***484***	***627***
Interest on Short-Term Debt	92	180	198	268	312	82
Average Interest on Short-term Debt (%)	11.4	13.3	13.4	13.6	13.8	12.0
Penalties and Charges on Arrears	4	18	24	35	43	0
Average cost of Short-Term Debt (%)	11.9	14.7	15.0	15.4	15.7	12.0
Service Charge on Short-Term Debt	*96*	*198*	*222*	*303*	*355*	*82*
Total Debt Service	**369**	**569**	**637**	**754**	**839**	**709**
Debt Service Ratios (%)						
Debt Service/Exports	***31.7***	***36.5***	***36.6***	***41.8***	***45.7***	***34.5***
Debt Service/Exports & Remittances	***18.4***	***24.9***	***25.8***	***29.7***	***32.7***	***25.2***

For details see **Annex IV**, Table 4-2

increasing to $357 million in Y_6, and $382 million in Y_7. To finance the balance of payments, as mentioned earlier, the Tusanian government borrowed short-term gap-fill

amounts in negotiated credits. These credits increased from $163 million in Y_4 to 458 million in Y_6 and to $462 million in Y_7.

4.29 As regards the M&LT portion of the external debt, the main sources of these borrowings were, 1) long-term loans obtained from multilateral agencies and, 2) bilateral loans, mainly for financing investments of both the public and private sectors. The multilateral loans outstanding were $871 million in Y_1, increasing steadily to $1,130 million in Y_7, predicated as they were on considerations other than balance of payments financing. The larger part of the M&LT debt, however, was in bilateral obligations of the Tusanian government. These amounted to $1,526 million in Y_1, or about 45.5 percent of the total M&LT debt. This proportion increased to about 58 percent in Y_4 when the bilateral debt was $1,898 million. Although M&LT debt increased to $3,629 million in Y_7, the bilateral debt increased faster to $2,183 million in Y_7, — about 60 percent of total M&LT. As a result, the major source of M&LT debt was bilateral borrowings of the Tusanian government from other governments, followed by multilateral loans, while borrowings from private foreign banks and other sources were a negligible proportion.

4.30 The substantial increase, as well as the shift, in the structure of the external debt liabilities had a drastic impact on the debt servicing burden. In Y_1 the debt servicing burden was about 31.7 percent of exports, defined as the ratio of interest payment ($198 million) and amortization ($171 million) on M&LT debt divided by exports ($1,163 million) in Y_1. Creditors, however, looked at foreign earnings from exports ($1,163 million) and remittances ($805 million) as roughly the foreign cash inflow available for debt servicing, and by this reckoning the debt service ratio was 18.4 percent in Y_1. As a result, their incentive to continue lending through fCDs and other short-term incentives went unabated, given the very attractive lending terms they obtained. The average interest charge on short-term obligations in Y_1 was 11.4 percent, consisting of interest rates of 8.5 to 10.0 percent and the remainder consisted of front-end fees. With the penalties and charges on arrears, however, the average interest cost of short-term debt was 11.9 percent. In comparison, the average interest

on M&LT debt in Y_1, was much lower – nearly 4.1 percent. This cost structure of foreign borrowings prevailed throughout the review years. In Y_4, total debt service was an estimated $569 million, of which $335 million was interest and $234 amortization of M&LT debt. The debt service ratio in Y_4, therefore, increased to 36.5 percent on export earnings and to 24.9 percent on export plus remittances. By Y_7, the average interest on short-term debt had risen to 13.8 percent, inclusive of fees. When penalties and charges are added on arrears outstanding, the average cost of short-term debt rose to 15.7 percent, in comparison with the average cost of M&LT borrowings of about 4.8 percent in interest charges. That is, short-term liabilities were nearly three times more expensive than M&LT liabilities. As a result, the debt service ratio in Y_7 became an unbearable 45.7 percent of export earnings and 32.7 percent of exports and remittances.

4.31 No matter how it is looked at, the debt service burden became nonsustainable. Tusania could not afford these debt service obligations, hence the emergence of arrears during Y_5-Y_7, as discussed earlier. Moreover, these service obligations included penalties and charges associated with default, thus raising the effective cost of defaulted obligations more than three times the average cost of the M&LT borrowings. Reliance on the short-term borrowings to finance the current account deficit not only caused a debt overhang but was also very costly as all the due amounts eventually became sovereign obligations through debt reschedulings in late Y_7. Further, since the CBT and other authorities insisted on dealing with creditors individually, and until a resolution was found, they regarded the outstanding liabilities in dispute. Therefore, the full size of these obligations, in the aggregate, was never recognized up front. But when defaults began to appear, together with stiff penalties and charges, Tusania had no choice but to declare a moratorium on its debt obligations, short-term or otherwise. This created a panic among its creditors and precipitated a crisis at home and abroad.

Rescheduling of External Debt

4.32 With mounting repayment obligations in Y_6, Tusania declared a moratorium, thus bringing external financing to a grinding halt. As a result, efforts began to deal with the debt burden. In the beginning, creditors were left to their own devices, but soon it was obvious that a major joint effort was needed by the creditors to sort out these obligations. Therefore, in mid-Y_7 (as discussed in Chapter IX), under the auspices of the Paris Club, the multilaterals, together with the short-term creditors consisting of a consortium of bankers, the export credit agencies and others; began a series of negotiations to reach an agreement on terms of rescheduling for Tusania. The lynch-pin of the agreement was to be a stabilization package, with implementation by Tusania as a pre-condition for any debt relief, and rescheduling, along with $670 million in fresh credits to finance the balance of payments deficit. This balance of payments assistance was woefully inadequate to keep Tusania current on its liabilities. The stabilization package failed to bring about a significant turn-around, both domestically and in the external debt position, mainly because no comprehensive agreement could be reached on arrears outstanding.

4.33 In early Y_7, it was clear that the only way out of the impasse was to put together a far-reaching debt rescheduling agreement containing debt relief as well as a moratorium on amortizations that covered the short-term liabilities and arrears estimated at about $1,900 million. The negotiations, culminating in the third quarter of Y_7, converted $1,236 million of short-term arrears into M&LT liabilities guaranteed by the government. It also converted part of the bilateral liabilities of about 620 million into new M&LT debt, under an umbrella arrangement to reschedule the Tusanian external debt of $1,856 million. As part of the rescheduling agreement, Tusania was provided a grace period of three years on its repayment obligations in order to provide some headroom for essential imports and economic recovery. This was also largely because Tusania simply could no longer attract foreign financing from international markets, and even if it did, it could not afford the high cost of financing. The arrangement was that during the three-year grace period, the total debt

service of Tusania would not exceed 35 percent of foreign exchange earning from exports, or 25 percent of earnings from exports plus remittances. The agreement further stipulated that the interest rate on the rescheduled short-term debt was to be variable, pegged at LIBOR plus 0.75 percent on the $1,236 million of arrear liabilities. The interest on the rescheduled bilateral debt was agreed to at 5.0 percent, with some maturity structure as mentioned above. This agreement provided measurable debt relief and improved the grant element of bilateral debt outstanding. The AMLs did not reschedule their obligations, but they agreed to provide additional loans for balance of payments support, provided Tusania initiated a far-reaching program of economic reforms and structural adjustment through its annual programs. The first program to incorporate elements of structural adjustment was the Y_8 program, discussed in detail in Chapter IX. Eventually, this short-term overhang of external debt was converted through rescheduling into M&LT debt. Tusania's short-term creditors ended up being long-term creditors, first involuntarily, and later willingly, realizing that not only would they recover their amounts outstanding but at a reasonable return – though perhaps not as high as before.

4.34 It was no wonder, then, that the crisis of Y_5-Y_7 was perceived in Tusania essentially as a balance of payments crisis, originating as it did from the overhang of external debt and culminating in an unprecedented squeeze on foreign exchange balances, while drying up external liquidity. Foreign creditors were seen using leverage to wrench economic and financial concessions from Tusania that would not have been possible otherwise. But the underlying factors responsible for landing Tusania in this situation were obscure to many except for a handful of officials at the MoF and the CBT. It was not popularly realized that the crisis was rooted in the domestic processes of generating and allocating financial resources in a policy regime that needed major changes, thereby making the task of policy makers doubly difficult in dealing with the aftermath of the crisis. This is discussed in the section below and the next two chapters.

ANNEX IV - Exhibit 1

BALANCE OF PAYMENTS and EXTERNAL FINANCING

1. Exports
2. Imports
3. Trade Balance
4. Interest (Net)
5. Others Services (overseas remittances, profits)
6. Services Balance
7. Current Account Balance (3 + 6)
8. Capital Account Balance
   - i. Borrowings by Government
     from: Multilaterals, Bilaterals, Private Banks
     less: Amortizations
   - ii. Borrowings by State Enterprises/banks (Guarantees)
     from: Foreign Sources (banks, companies)
     less: Amortizations
   - iii. Direct Foreign Investment (Equity Capital)
     less: Repayments
   - iv. Capital n.i.e. (not included elsewhere)
9. OVERALL BALANCE (7 + 8) (if negative, then)
   Financed By: (Short-term Net Inflows *as Below*)
   - i. Foreign Deposits with Banking System (net)
   - ii. Foreign Supplier's Credits (net)
     to: Enterprises, Companies, Traders
   - iii. Central Bank Borrowings
     (from Central Banks, BIS, Overseas Private Banks and Foreign Money Markets)
   - iv. Banking System Foreign (Bankers' Acceptances, Others)
   - v. Borrowings from IMF
   - vi. Foreign Exchange Reserves (Draws)
   - vii. Errors and Omissions

ANNEX IV *Table 4-1 Balance of Payments (1 of 2)*

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(US$ millions, end of year)						
Balance of Payments Deficit	**-237**	**-465**	**-504**	**-686**	**-715**	**-876**	**-815**
Financed by:							
Short-Term Inflows (net)	*714*	*812*	*919*	*679*	*571*	*497*	*558*
fCDs	527	558	531	267	112	21	8
Suppliers Credit	115	167	178	117	92	77	110
Banker's Acceptances	72	87	96	67	55	42	58
Arrears Rolled-Over	0	0	114	228	312	357	382
Negotiated Foreign $ Credits	0	0	0	163	251	458	462
Syndicated Loans	**0**	**0**	**0**	**163**	**137**	**118**	**134**
AML & Others (net)	0	0	0	0	114	340	328
Reserves	-266	-194	-231	-42	-12	39	-38
Net errors/omissions	-211	-153	-184	-114	-95	-118	-167
Total Foreign Finance	**237**	**465**	**504**	**686**	**715**	**876**	**815**

Memo Items

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
Balance of Payments		*(US$ millions, end of year)*					
Exports	1163	1313	1403	1561	1741	1805	1834
Imports	2188	2388	2537	2793	3000	3196	3118
Trade Balance	*-1025*	*-1075*	*-1134*	*-1232*	*-1259*	*-1391*	*-1284*
Invisibles (Services,net)	629	567	403	315	282	254	220
Remittances	840	865	764	713	708	741	762
Interest (net)	-211	-298	-361	-398	-426	-487	-542
Current Account Balance	**-396**	**-508**	**-731**	**-917**	**-977**	**-1137**	**-1064**
Capital Movements (Autonomous inflows of Medium and Long-Term Finance)							
Public M&LT (net)	121	148	178	180	210	207	194
Amortization	171	192	211	234	267	289	310
Public M&LT (gross)	292	340	389	414	477	496	504
Direct Private Investment	38	43	49	51	52	54	55
Net M&LT Inflows	*159*	*191*	*227*	*231*	*262*	*261*	*249*
Balance of Payments Deficit	**-237**	**-317**	**-504**	**-686**	**-715**	**-876**	**-815**
Arrears Outstanding	92	169	268	508	657	1013	1236
BOP Deficit --adjusted	***-329***	***-486***	***-772***	***-1194***	***-1372***	***-1889***	***-2051***
Total Arrears	**92**	**169**	**382**	**736**	**969**	**1370**	**1618**
of this: fCDs	74	127	215	468	634	849	1028
Trade and Others	18	42	167	268	335	521	590
Arrears Rolled -Over	0	0	114	228	312	357	382
Arrears Outstanding	92	169	268	508	657	1013	1236

ANNEX IV *Table 4-1* *Balance of Payments* *(2 of 2)*

Memo Items

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
Exchange Rate (nominal) US$1.00 = Sumat							
Official Exchange Rate	80	83	87	94	102	110	126
Parallel Market Rate	92	97	102	115	127	138	149
Sumat Values							
(ST billions, end of period)							
Foreign Trade and GDP							
Exports, current values	93	109	122	147	178	199	231
Imports, current values	175	198	221	263	306	352	393
Export Growth Rate	10.6	17.1	12.0	20.2	21.0	11.8	16.4
Import Growth Rate	9	13	11	19	17	15	12
Exports, constant (real) values	93	102	106	114	118	111	112
Imports, constant (real) values	175	185	191	204	204	196	190
Export Growth Rate	8.7	9.5	3.7	7.7	4.1	-6.6	0.9
Import Growth Rate	5.3	5.8	3.1	6.6	0.3	-4.1	-3.1
GDP constant (real) values	1280	1321	1362	1400	1434	1451	1454
Exports/GDP ratio	7.3	7.7	7.8	8.1	8.3	7.6	7.7
Imports/GDP ratio	13.7	14.0	14.0	14.5	14.2	13.5	13.1
GDP deflator index	100.0	107.0	115.6	129.0	149.9	179.5	207.0
Foreign Financing							
Public M&LT (net)	9.7	12.3	15.5	16.9	21.4	22.8	24.4
Direct Private Investment	3.0	3.6	4.3	4.8	5.3	5.9	6.9
Net M&LT Inflow	12.7	15.9	19.7	21.7	26.7	28.7	31.4
Short-Term Inflows (net)	57.12	67.4	80.0	63.8	58.2	54.7	70.3
fCDs	42.16	46.3	46.2	25.1	11.4	2.3	1.0
Suppliers Credit	9.2	13.9	15.5	11.0	9.4	8.5	13.9
Banker's Acceptances	5.8	7.2	8.4	6.3	5.6	4.6	7.3
Arrears Rolled-Over	0.0	0.0	9.9	21.4	31.8	39.3	48.1
Negotiated Foreign $ Credits	0.0	0.0	0.0	15.3	25.6	50.4	58.2
Syndicated Loans	0.0	0.0	0.0	15.3	14.0	13.0	16.9
AML & Others (net)	0.0	0.0	0.0	0.0	11.6	37.4	41.3
Total Foreign Finance	19.0	38.6	43.8	64.5	72.9	96.4	102.7

Average Annual Growth Rates

	Y_1-Y_7	Y_1-Y_4	Y_4-Y_7	Y_5-Y_7			
Exports, current values	7.9%	10.3%	5.5%	2.6%			
Imports, current values	6.1%	8.5%	3.7%	1.9%			
Exports, constant (real) values	3.1%	6.9%	-0.6%	-2.9%			
Imports, constant (real) values	1.4%	5.2%	-2.3%	-3.6%			

ANNEX IV *Table 4-2* *External Debt Outstanding and Disbursed (DOD)*

	Y_1	Y_4	Y_5	Y_6	Y_7	Y_8
		(US$ millions, end of year)				
Total External Debt (DOD)	**3355**	**4368**	**4707**	**5403**	**5885**	**6750**
Medium & Long-Term (M&LT)	**2549**	**3018**	**3228**	**3435**	**3629**	**6065**
Multilateral	871	1012	1066	1092	1130	1466
Bilateral (governments)	1526	1774	1898	2061	2183	2840
Private Banks (multinationals)	108	145	174	191	219	1657
Others	44	87	90	91	97	102
Short-Term Debt	**806**	**1350**	**1479**	**1968**	**2256**	**685**
Foreign Currency Deposits (fCDs)	601	735	746	870	1036	0
fCDs (new)	*527*	*267*	*112*	*21*	*8*	*0*
fCDs in Arrears	*74*	*468*	*634*	*849*	*1028*	*0*
Arrears Rolled -Over	0	228	312	357	382	0
Other Arrears	18	40	23	164	208	0
Negotiated Credits	0	163	251	458	462	470
Suppliers Credits and Acceptances	187	184	147	119	168	215
Memo Items						
Amortizations on M&LT Debt	171	234	267	289	310	258
Interest on M&LT Debt	102	137	148	162	174	369
Average Interest on M&LT Debt(%)	4.0	4.5	4.6	4.7	4.8	6.1
Debt Service on M&LT Debt	***273***	***371***	***415***	***451***	***484***	***627***
Interest on Short-Term Debt	92	180	198	268	312	82
Average Interest on Short-term Debt (%)	11.4	13.3	13.4	13.6	13.8	12.0
Penalties and Charges on Arrears	4	18	24	35	43	0
Average cost of Short-Term Debt(%)	11.9	14.7	15.0	15.4	15.7	12.0
Service Charge on Short-Term Debt	96	198	222	303	355	82
Total Debt Service	***369***	***569***	***637***	***754***	***839***	***709***
Debt Service Ratios (%)						
Debt Service/Exports	***31.7***	***36.5***	***36.6***	***41.8***	***45.7***	***34.5***
Debt Service/Exports & Remittances	***18.4***	***25.0***	***26.0***	***29.6***	***32.3***	***25.2***
		(US$ millions, end of year)				
Exports	1163	1561	1741	1805	1834	2054
Remittances	840	713	708	741	762	760
Exports and Remitttances	2003	2274	2449	2546	2596	2814
Interest and Charges	198	335	370	465	529	451

CHAPTER V

FINANCIAL OPERATIONS OF THE PUBLIC SECTOR: GOVERNMENT AND THE SEs

5.1 The financial operations of the Tusanian public sector have consistently generated deficits throughout recent history, but the trend worsened during the mid-years of the review period and reached crisis proportions in later years. The consolidated public sector deficit was ST185 billion in Y_1, increased to ST269 billion in Y_4, and by Y_7 had grown to ST552 billion. The rate of growth of the public sector deficit during Y_1-Y_7 was very high at 20 percent per year. This average rate of growth during Y_1-Y_7, however, belies the nature of the financial burden the public sector faced during Y_5-Y_7, when the deficit's rate of growth was 29.7 percent per year as compared to 13.3 percent during Y_1-Y_4. This led to a more than three-fold increase in the *level* of public sector deficit over the Y_1-Y_7 period. Further, the budget deficit as reported by the federal government, the *federal deficit*, does not capture the demand for financial resources by the entire public sector unless the *quasi-deficit* is also accounted for. This consists of the deficits of public sector enterprises, SEs, local governments on their financial operations, other public organizations, and quasi-government institutions. In the presentation scheme followed here, the deficits of the local government are not shown separately, rather they are included in the federal deficit, while the quasi-deficit is defined primarily as

the deficits of SEs and other public organizations. Thus, the financial operations of government, whether federal, provincial or local, are consolidated in federal government accounts; while the financial operations of SEs, the parastatals, and other public sector organizations are treated as quasi-government accounts. This classification is not a strict fiscal reporting convention but is followed here to keep matters simple and straightforward. The term 'quasi-deficit" is used here synonymously with 'SE's deficit' for purposes of this case study.

5.2 In addition to the above, for fiscal accounts the need is to capture the arrears and revaluation loss on external liabilities of the government and quasi-government borrowings, which later became sovereign liabilities as a result of the guarantees extended by the government. During the crisis years, as discussed in Chapter IV, a part of the increase in these external liabilities occurred on the foreign borrowings of quasi-government organizations and also on the external financial operations of the banking system. The counterpart Siwat liabilities of these arrears are not separately identified in these fiscal accounts. Instead these are included partly in the investment program, and partly in the operations, to the extent that the original external liabilities were incurred to finance these items. With these adjustments in the fiscal accounts of the federal government and quasi-government, the public sector deficit increases to the levels reported here.

5.5 To recapitulate, the total public sector deficit as shown here includes two items. First, it includes the federal deficits estimated from the routine budget operations strictly on the basis of federal revenues, expenditures, and transfers together with the financial operations of the state and local governments. This recognizes that the deficits of state and local governments in large measure became the responsibility of the federal government. The financial operation of states, local governments, and quasi-government institutions are not fully known, hence a clear picture of their financial operations is not possible. However, given that there are few revenue sources of state and local governments, besides their revenue share in the

budget and extra-budgetary allocations from the federal government, their net fiscal operations are added to federal accounts and appear as federal deficits. Second, the public sector deficit includes the quasi-deficit, largely based on the financial operations of the SEs and other public sector organizations.

The Deficits

5.4 On this basis, the *federal deficit* was ST112 billion in Y_1 or 60.5 percent of the total public sector deficit, while the SEs deficit was ST73 billion or 39.5 percent of the total. These proportions changed, however, because the federal deficit increased by 10.5 percent per year during Y_1-Y_4, while the quasi-deficit increased faster at the rate of 17.4 percent over the same period. As a result, the proportion of federal deficit in the total public sector deficit declined to 56.1 percent in Y_4. These proportional shares of both the federal and SE deficits in total public sector deficit were sustained through later years.

5.5 This is somewhat misleading, however, because the government provides support of various kinds to the SEs, which is formally not a part of the SE's financial operations and does not appear as a line item of federal support on the SE's financial statements. The support may consist of subsidized inputs such as petroleum, electric power and transport, the cost of auxiliary infrastructure to enable SEs to carry out their operations, and indirect subsidies on SE's products and services. These items are not part of a direct financial transaction between the government and SEs. They are transfer items, and their costs need to be traced as they are spread out in various departmental budgets. The aggregate of these transfer costs is shown in *Table 5-1* as 'transfer to SEs,' separate from federal expenditures. The size of these transfers, which has been fairly significant throughout the years, was an estimated ST42 billion in Y_1. These transfers increased to ST74 billion in Y_7, amounting to nearly 26.8 percent of the government's total revenues. That is, for each Siwat of revenue collected by the government, 0.27 Siwat ended up being used for SE support from the

Table 5.1 ***Financing Public Sector Deficits- Government, State Enterprises***

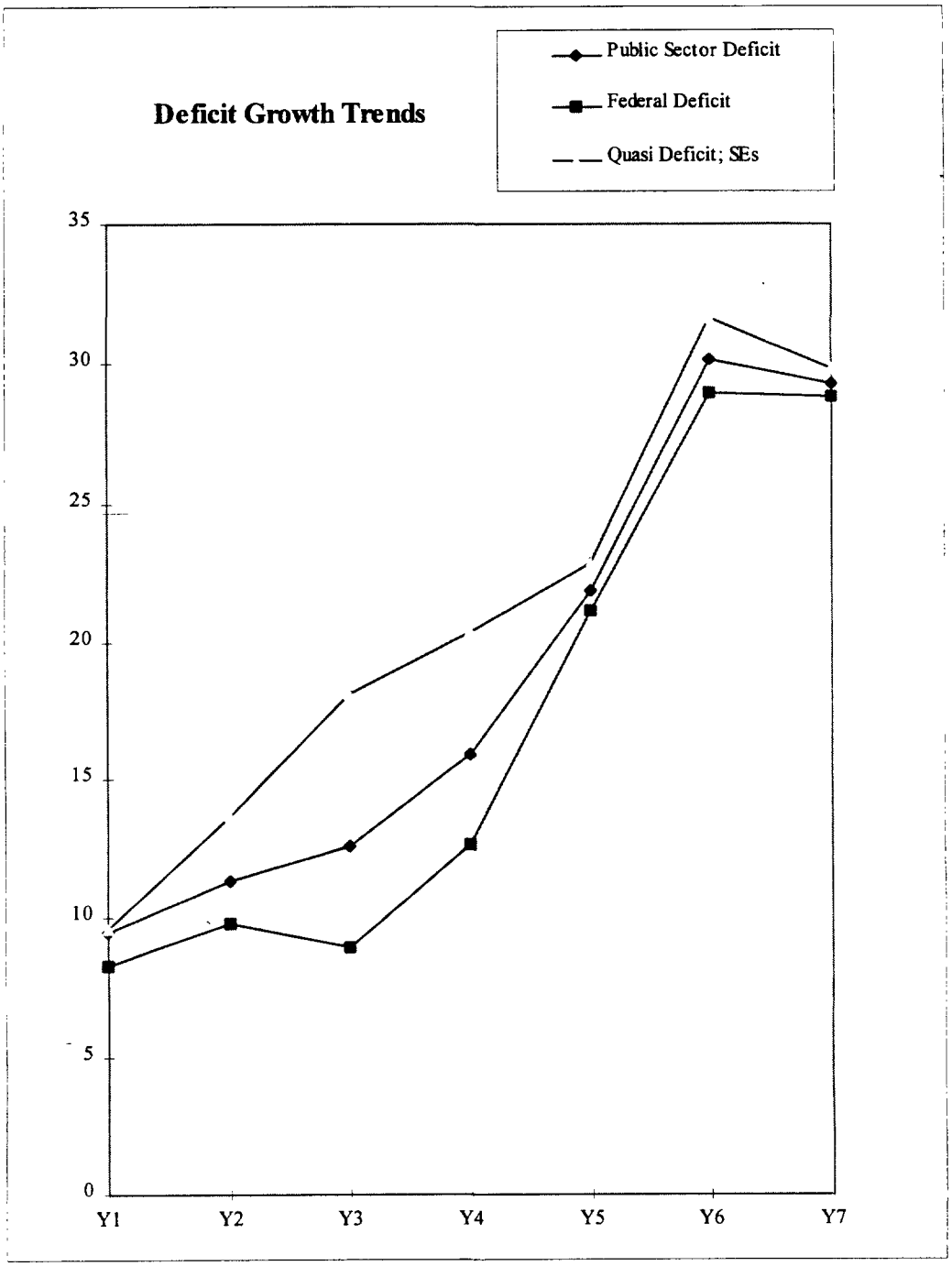
	Annual Indicators				Average Annual Growth Rates		
	Y_1	Y_4	Y_6	Y_7	Y_1 - Y_7	Y_1 - Y_4	Y_5 - Y_7
	(ST billions)				*(per cent)*		
Public Sector Deficit	**185**	**269**	**427**	**552**	20.0	13.3	29.7
Federal Deficit	***112***	***151***	***236***	***304***	18.1	10.5	28.9
Revenues	212	235	260	276	4.5	3.5	5.9
Expenditures	255	295	390	453	10.1	5.0	16.8
Transfers to DFIs (net)	27	37	44	53	11.9	11.1	15.1
Transfers to SEs, Other (net)	42	54	62	74	9.9	8.7	13.9
Quasi Deficit; SEs	***73***	***118***	***191***	***248***	22.6	17.4	30.8
Investment	42	58	80	102	15.9	11.4	25.3
Operational Losses, SEs	31	60	111	146	29.5	24.6	35.1
Financed by:							
Domestic borrowings:	*168*	*239*	*283*	*486*	19.4	12.5	31.5
Foreign Borrowings	*5*	*7*	*11*	*15*	*20.1*	*11.9*	*22.5*
Arrears and Others	*12*	*23*	*33*	*51*	27.3	24.2	17.6
Annual Growth Rates (%)							
Public Sector Deficit	*9.5*	*15.9*	*30.2*	*29.3*			
Federal Deficit	*8.3*	*12.7*	*29.0*	*28.8*			
Revenues	3.0	4.0	5.7	6.2			
Expenditures	3.2	7.3	17.5	16.2			
Transfers to DFIs (net)	12.6	15.4	30.8	22.1			
Transfers to SEs, Other (net)	7.3	9.4	10.6	11.0			
Quasi Deficit; SEs	*9.6*	*20.4*	*31.7*	*29.8*			
Investment	10.4	11.5	23.1	27.5			
Operational Losses	12.1	30.4	38.8	31.5			
Ratios of GDP							
Public Sector Deficit / GDP	14.5	14.9	16.4	18.3			
Federal Deficit	8.8	8.4	9.1	10.1			
Quasi Deficit; SEs	5.7	6.5	7.3	8.2			

For details see **Annex V**, Table 5-1

federal budget as transfers, over and above support provided through the CBT and DFI credits to SEs at preferential interest rates. When these federal transfers are added to the net operational losses of SEs, and simultaneously, deducted from the federal finances, the proportion of SE deficits becomes larger than the government deficit at the aggregate level. On this basis, the *SE's deficits*, re-defined as consisting of transfers plus operational losses and investments, become ST115 billion in Y_1, rising to ST241 billion in Y_5, and to ST352 billion in Y_7 – more than half of the total public sector deficit throughout these years.

5.6 No matter how one looks at the public sector deficit, its growth was phenomenal and could not be sustained. As mentioned in the opening paragraph of this chapter, the average rate of growth of the deficit during the review period Y_1-Y_7 was 20 percent per year. This increase simply could not be absorbed by the fiscal or financial system, or by the Tusanian economy. The ratio of the total public sector to the GDP was fairly high to begin with at 14.5 percent in Y_1. Then, after marginally increasing to 14.9 percent in Y_4, it jumped to 18.3 percent in Y_7. Of this, the ratio of federal deficit to GDP was 8.8 percent in Y_1, declining slightly during Y_2-Y_5. Thereafter, it rose to 9.1 percent in Y_6 and then to 10.1 percent in Y_7. The ratio of quasi-deficit to GDP was 5.7 percent in Y_1, rose to 6.5 percent in Y_4, and to 8.2 percent in Y_7 (*see Table 5.1*). That is, the *SE's deficits* significantly contributed to the fiscal burden, with serious implications for the overall financial resource requirements of the public sector as a whole. The government, while attempting to reduce the fiscal imbalance through reducing expenditures, had not pursued policies of fiscal adjustment on the revenue side. During the crisis years, rapid inflation and the erosion of real salaries and wages severely constrained the revenue mobilization effort. In addition, the fiscal operations of the states and quasi-government agencies, together with direct subventions and net lending to the SEs, substantially added to the financial needs of the public sector. In the face of growing deficits, the federal government borrowed substantially to finance transfers, subventions, and direct budgetary support to public sector organizations and SEs.

Chart 5-1



5.7 Essentially, the same was true for SEs because their own revenue generation efforts were stymied by a pricing and tariff structure which did not enable them to cover their operating costs. As a group, the SEs had running losses throughout,

though these losses had been manageable in the past. However, owing to their rigid price structure, and the inability or unwillingness to adjust their operations, SE losses began to increase in Y_3. By Y_7, the losses were more than twice their Y_4 level, way beyond the capacity of federal finances to absorb them. In Y_1, the SEs operational losses were ST31 billion on a revenue base of ST67 billion. In Y_4, those losses doubled to ST60 billion on a revenue base of ST78 million. This happened because expenditures rose from ST98 billion in Y_1 to ST138 billion in Y_4. By Y_7, the SE's expenditures had increased to ST240 billion, while revenues were ST94 billion. As a result, the SEs losses in Y_7 were ST146 billion (*see ANNEX V, Table 5-1*). The growth rates provide a better understanding of these magnitudes. During Y_1-Y_7, expenditures increased at an average rate of 16.1 percent – nearly three times faster than the 5.8 percent average rate of growth revenues. As a result, the SE's losses increased at an average rate of 29.5 percent over the entire review period. The growth of SE's losses was slower in early years but still fairly high at 24.6 percent per year during Y_1-Y_4, accelerating to 35.1 percent during the Y_5-Y_7 period.

5.8 In addition, the development strategy of Tusania called for growing levels of investment by SEs. The investment program of SEs was regarded as almost sacrosanct — and every effort was made to maintain it in the belief that any reduction in SE investment levels would be tantamount to deliberately reducing economic growth. The pressures to keep these investments high increased in the face of deteriorating economic conditions, precisely during those years when public sector finances could not sustain it. As a result, the financial needs of the SEs increased more than three times and the quasi-deficit went out of control, growing from ST73 billion in Y_1, to ST118 billion in Y_4, and then to ST248 billion in Y_7.

Financing the Deficit -- Borrowing Operations

5.9 How was this consolidated public sector deficit financed? It was financed mainly from domestic borrowings through the financial system, the CBT, the DFIs and commercial banks — in that order, and in small part from foreign borrowings. The domestic borrowings from the financial system provided nearly all of the finance to cover the public deficit throughout the review period. Foreign borrowings were fairly small in this picture at the aggregate level, though for some public sector organizations at the unit level – especially the SEs in communication and transport – foreign borrowings were critical for their operations and investment needs. The point is that foreign borrowings were not used to finance the gap between public sector revenues and expenditures. The shortfall in public sector savings was met domestically by transferring financial savings of the general public and the private sector to the public sector. This transfer was affected through operations of the financial system and through domestic borrowing operations, as discussed below.

5.10 The consolidated borrowing operations of the public sector, both the federal government and SEs, provide a measure of the pressure put on the financial system to allocate financial savings at the macro-level. The consolidated domestic borrowings of the public sector were ST168 billion in Y_1. Of this, CBT provided ST102 billion, the DFIs ST28 billion, and commercial banks ST26 billion while the remaining ST12 billion was borrowed from other sources like non-bank financial institutions and the public. In Y_4, these consolidated borrowings were ST239 billion, of which CBT provided ST121 billion, DFIs ST53 billion, and commercial banks ST44 billion. By Y_7, consolidated borrowings of the public sector were ST486 billion, nearly three times the borrowings in Y_1. The bulk was borrowed from CBT, which provided ST296 billion, while DFIs provided ST94 billion, mostly to SEs, and commercial banks ST68 billion.[1] It is true that commercial banks provided less than before

[1] For CBT credit to the government and to SEs, see *ANNEX V, Table 5-1*. The total of these two lines is reported above.

proportionately, but clearly the banking credit system yielded to the public sector at the private sector's expense and thus provided the mechanism for the resource transfer. These borrowings by the government were done through money market instruments such as treasury bills, securities, and development stocks. These were subscribed to mainly by the CBT, and to a lesser extent by the banking system. The quasi-government institutions also borrowed both domestically and abroad, mainly with guarantees of the government. Non-bank borrowings of the public sector were minimal.

5.11 These consolidated borrowing operations of the public sector are given in *Table 5.2* below. As shown there, federal government borrowing was ST108 billion in Y_1, of which CBT credit to the government was ST90 billion, while commercial bank credit, mainly the holdings of T-bills, was ST18 billion. These proportions held, roughly, throughout the review period. In Y_7, federal government borrowings were ST242 billion, of which CBT credits were ST224 billion, and commercial bank credits were again ST18 billion. That is, CBT was the main creditor to the federal government throughout. The SEs had a more diverse borrowing base, in that the CBT and DFIs together provided the bulk of the credit, but based on an entirely different set of lending arrangements and costs. The SEs also borrowed from the commercial banks, other financial institutions, and commercial credits from those willing to extend short-term financing. For example, in Y_1, total SE borrowings were ST60 billion. CBT credit, mostly in priority credits for medium to long-term was ST12 billion; the DFIs credit was ST28 billion to finance SE's investments; commercial bank credits, mostly short-term overdrafts, were ST8 billion; and other commercial credits were ST 12 billion. This pattern of SE borrowings prevailed throughout the period. That is, the investment program of the SEs was financed mainly from medium- to long-term priority-based credits of the CBT and DFIs, both provided at below-market interest rates. The commercial credits, mainly to support the routine operations of the SEs, were extended at market cost in short-term loans.

Table 5.2 ***Domestic Borrowing Operations, Domestic Public Debt : Government, State Enterprises***

	Annual Indicators				Average Annual Growth Rates		
	Y_1	Y_4	Y_6	Y_7	Y_1-Y_7	Y_1-Y_4	Y_5-Y_7
		(ST billions)			*(per cent)*		
Total Deficit	**185**	**269**	**427**	**552**	20.0	13.3	29.7
Federal Deficit	***112***	***151***	***236***	***304***	*18.1*	*10.5*	*28.9*
Quasi Deficit; SEs	*73*	***118***	***191***	***248***	*22.6*	*17.4*	*30.8*
Financed by:							
Domestic Borrowings	*168*	*239*	*383*	*486*	*19.4*	*12.5*	*31.5*
Foreign Borrowings	*5*	*7*	*11*	*15*	*20.1*	*11.9*	*22.5*
Arrears and Others	*12*	*23*	*33*	*51*			
Domestic Borrowings	**168**	**239**	**383**	**486**			
Government borrowings	*108*	*120*	*203*	*242*	*14.4*	*3.6*	*31.9*
SEs and Others' borrowings	*60*	*119*	*180*	*244*	*26.3*	*25.6*	*31.1*
Borrowing Instruments	**168**	**239**	**383**	**486**	19.4	12.5	31.5
Government Papers, <6 mos	73	102	174	198	18.1	11.8	22.9
Preferred Credits,CBT,1-2 yrs	41	40	77	126	20.6	-0.8	77.5
Priority Credits, DFIs,1-5 yrs	28	53	72	94	22.4	23.7	25.2
Commercial Credits, <6 mos	26	44	60	68	17.4	19.2	16.6
Borrowings Costs (amounts)	**9.3**	**15.7**	**26.3**	**33.1**	23.6	19.2	31.0
for Government	*4.9*	*6.9*	*12.7*	*15.6*	*21.3*	*12.1*	*34.7*
for SEs, and Others	*4.4*	*8.8*	*13.6*	*17.5*	*26.0*	*26.3*	*28.0*
Government Papers, <6 mos	4.4	6.6	12.2	14.9	22.6	14.8	32.1
Preferred Credits,CBT,1-2 yrs	0.6	0.6	1.3	2.3	25.7	3.7	88.2
Priority Credits, DFIs, 1-5 yrs	2.1	4.2	6.5	8.5	26.1	26.4	28.8
Commercial Credits, <6 mos	2.2	4.2	6.3	7.5	22.5	23.7	22.3
Average cost (Rate, %)	**5.5**	**6.6**	**6.9**	**6.8**			
for Government	4.5	5.8	6.3	6.4			
for SEs, and Others	7.3	7.4	7.5	7.2			
Government Papers, <6 mos	6.0	6.5	7.0	7.5			
Preferred Credits,CBT,1-2 yrs	1.4	1.6	1.7	1.8			
Priority Credits, DFIs, 1-5 yrs	7.5	8.0	9.0	9.0			
Commercial Credits, <6 mos	8.5	9.5	10.5	11.0			
Instruments; Share (%)	**100**	**100**	**100**	**100**			
Government Papers, <6 mos	43.5	42.7	45.4	40.7			
Preferred Credits,CBT,1-2 yrs	24.4	16.7	20.1	25.9			
Priority Credits, DFIs,1-5 yrs	16.7	22.2	18.8	19.3			
Commercial Credits, <6 mos	15.5	18.4	15.7	14.0			

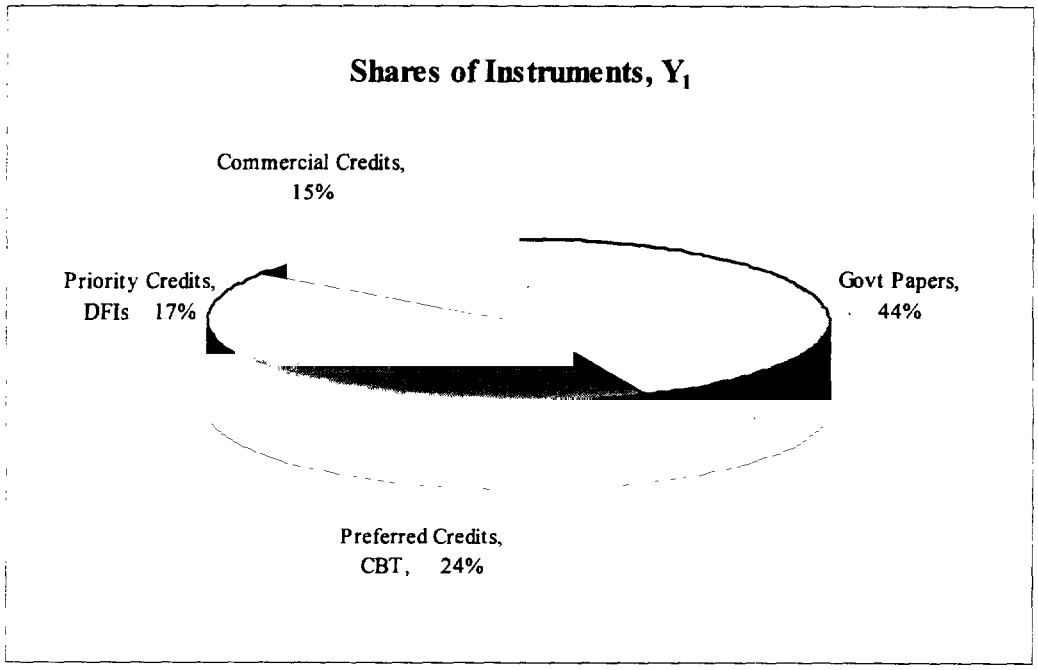
For details see **Annex V**, Table 5-2

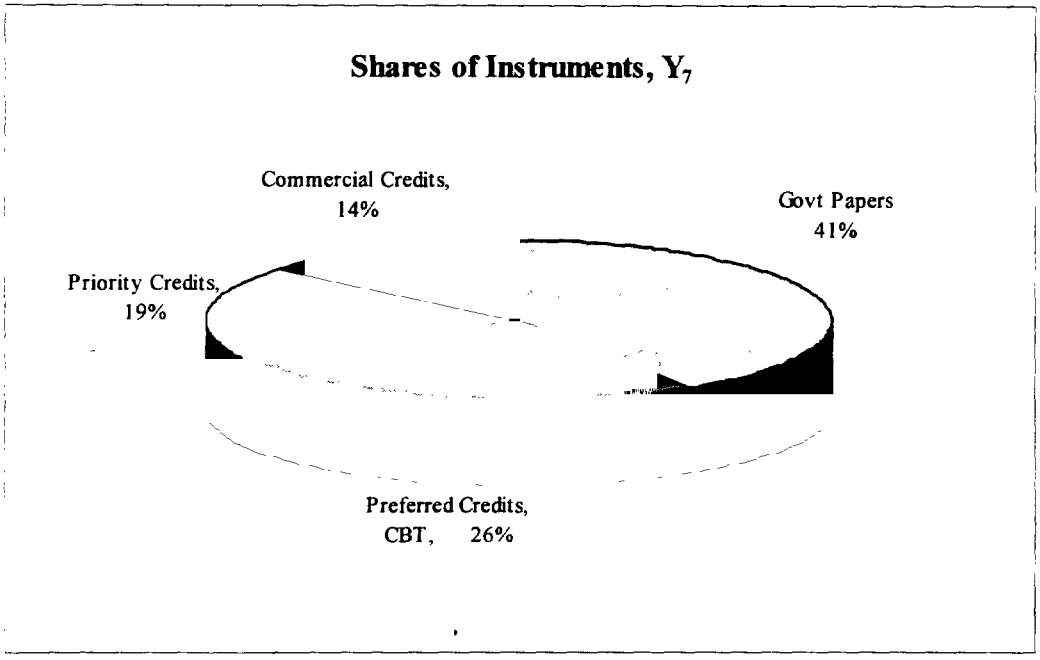
5.12 Overall, the general pattern of financing the public sector deficit from domestic borrowing is common to many countries and is not typical of Tusania. This rise in deficit-financing did not cause alarm in official circles, partly because full information was only available to a select few, and partly because it was not seen as anything out of the ordinary. There was little debate on the underlying issues, or even on the size of the public sector deficit, let alone the level of borrowing and the size of the domestic debt. Since most of the government borrowings were rolled over in new issues at the time they were due for repayment, the borrowing did not carry any amortization burden on government finances in a given year. The rollover simply added to the stock of the government debt. Even the interest cost in some cases was rolled over into new debt obligations, therefore, the government did not face any serious financial burden of its domestic debt. That is, there was no 'retirement' or net reduction in the stock of government debt. Rollovers of earlier liabilities and new borrowings simply ended up as part of the total domestic debt. This practice represented an inter-temporal transfer, a time preference but not a financial burden, commensurate to the annual level of borrowings.

Instruments of Borrowing and Costs

5.13 The most commonly used instrument of borrowing for the public sector was government papers, mostly T-bills. These are short-term obligations of the federal government of less than six months. In the early years of Y_1-Y_4, government papers were 43.5 percent of total borrowings, and then decreasing to around 41 percent in Y_7. In Y_1, the federal government borrowed ST73 billion through these papers out of total borrowings of ST168 billion. In Y_4 government papers totaled ST102 billion, and in Y_7, these were ST198 billion out of the total borrowings of ST486 billion. The bulk of these government papers were held by the CBT at any given time, that is, the CBT was the creditor. Only part of the government papers was held by commercial banks in T-bills, largely because, as discussed in Chapter VII, the T-bills could be tendered by commercial banks as 40 percent of their reserve requirements, and not

Chart 5-2


Shares of Instruments, Y_1
Commercial Credits, 15%
Priority Credits, DFIs 17%
Govt Papers, 44%
Preferred Credits, CBT, 24%


Shares of Instruments, Y_7
Commercial Credits, 14%
Govt Papers 41%
Priority Credits, 19%
Preferred Credits, CBT, 26%

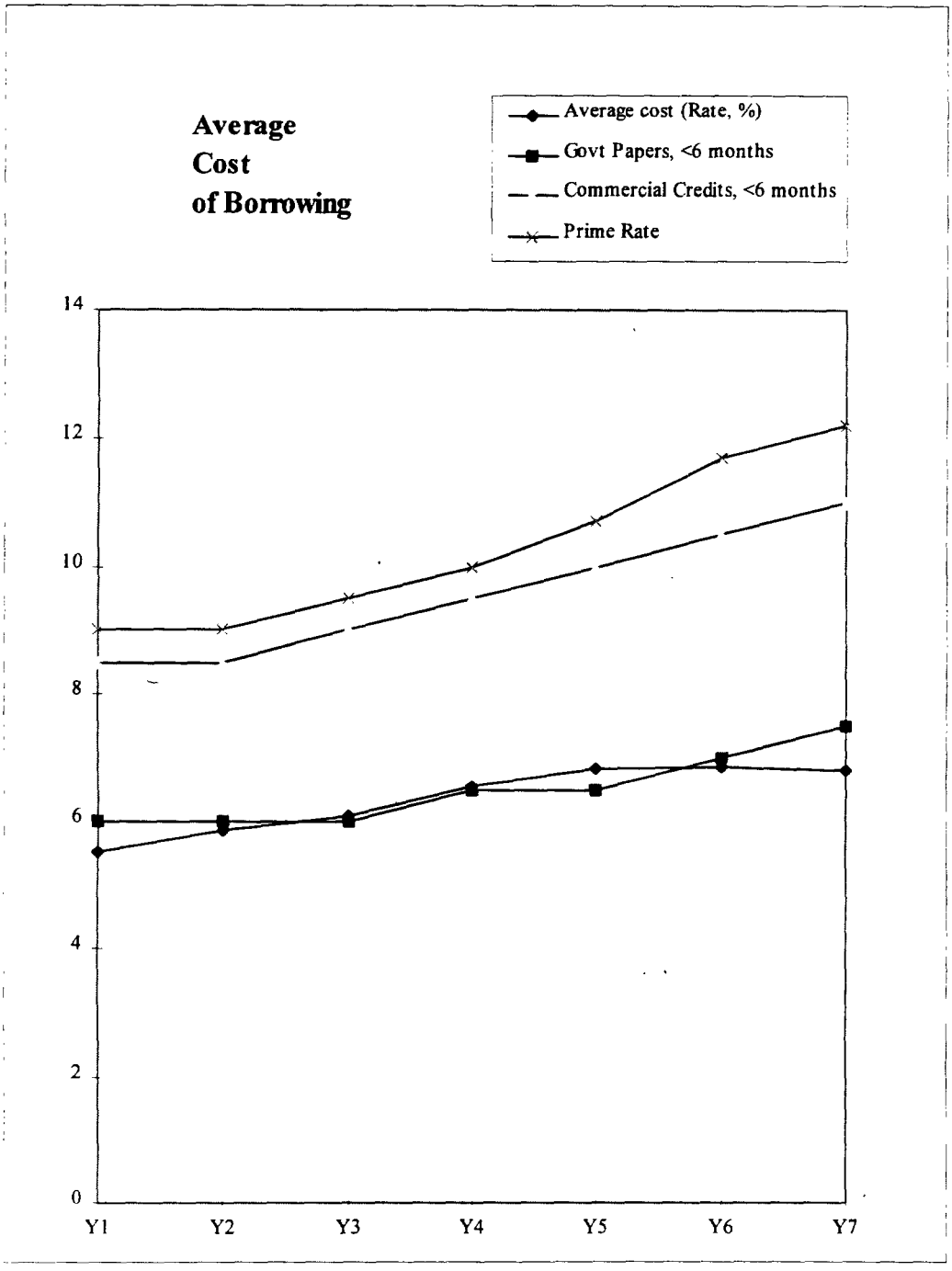
because these papers offered a reasonable return. The average cost of these short-term maturity government papers was 6.0 percent during Y_1-Y_3, 6.5 percent during Y_4-Y_5, and 7.5 percent in Y_7, reflecting largely the re-discount rate of T-bills during these years.

5.14 Next in the line of borrowing instruments were preferred credits of the CBT. These were mostly advanced to the federal government in maturities of one-to-two years at a nominal charge of around 1.5 percent during the early years, and of 1.7 percent in the later years of the review period. The amounts borrowed annually were fairly sizable. In Y_1 preferred credits were ST41 billion, and held around that level until Y_5. In Y_6, the preferred credits were ST77 billion and ST126 billion in Y_7. That is, much of the increase in this type of borrowing occurred during the crisis years, and it represented a sort of mandatory lending by the CBT to the government.

5.15 Both these instruments of borrowing did not entail a real amortization burden to the government because a good part of these obligations were rolled over into new obligations as they fell due. Hence, the financial cost for the government was mainly the interest charge, which was nominal for preferred credits at around half of the market interest rate for T-bills. Therefore, the financial cost of borrowing through T-bills and preferred credits was ST 5.1 billion in Y_1, ST7.2 billion in Y_4, and ST17.2 billion in Y_7. This easy and almost cost-free access to credit was a major factor in the uncontrolled growth of credit, money supply, and hence, aggregate money demand. This led to financial pressures and inflation in later years as discussed in the next chapter.

5.16 Among the public sector's borrowing instruments, commercial credits represented the highest-cost source of borrowing to the public sector for short-term maturities. These credits were essentially similar to the loans extended by commercial banks to their prime borrowers at interest rates slightly below the market

Chart 5-3


Average Cost of Borrowing
Average cost (Rate, %)
Govt Papers, <6 months
Commercial Credits, <6 months
Prime Rate
14
12
10
8
6
4
2
0
Y1
Y2
Y3
Y4
Y5
Y6
Y7

rates. The cost of lending for these loans is lower than for other types of loans, and above all, the credit risk is minimal. Therefore, the interest rate on commercial credits to the public sector, although the highest cost it paid, was still slightly lower than the prime rate year after year. These rates ranged between 8.5-9.5 percent during Y_1-Y_4, and then rose to 10-11.5 percent range during Y_5-Y_7.

Borrowings by SEs

5.17 Most of these commercial credits to the public sector were in fact borrowings of the SEs, rather than the government. The instruments of borrowings for the SEs varied depending upon the creditor. The borrowings from the CBT were provided as a line of credit to the borrowing SE, with the authorization of the Ministry concerned as well as the MoF. But the CBT did not require the SE to submit supportive financial statements, nor was the CBT concerned with the repayment capacity of the SEs concerned. That is , the CBT did not carry out borrower evaluation in the strict sense of the term. The loan agreement, a fairly standardized document, only stipulated the repayment stream, and in the event of a default, the amount of default was simply added to the loan outstanding in the account of the SE concerned. Most of the CBT loans to SEs were priority credits running parallel to the directed credit system for the private sector discussed in Chapter VII. The typical maturity of CBT loans to SEs was 3 to 5 years – in some cases up to 7 years – at priority credit interest rates, well below market rates, thus harboring interest rate subsidies to the SEs. The financial cost of these subsidies was significant to the CBT.

5.18 SEs borrowing from the DFIs was more commercial in nature, in that interest rates were slightly higher than those of the CBT, yet DFI loans to SEs did not entail a strict repayment evaluation or an assessment of the financial status of the SE. It was not collateralized lending, nor did the credit mechanism involve any financial penalties or losses to the SE in case of non-performance. Since most of the borrowings from the DFIs was to finance SEs investment, the bulk of the DFI credit

to SEs was of 5 to 6 years maturity, though SEs also borrowed short-term for their operations. The SEs turned to commercial loans on market terms only after they had exhausted their credit line with the CBT and the DFIs, because the banking system charged not only market rates, but required realizable collateral and stringent reporting, thus imposing some financial discipline. For a few financially viable SEs, commercial loans were a source of extra liquidity to manage their cash positions on a temporary basis. Some SEs also obtained suppliers' credit with bank guarantees extended generally by the DFI concerned. Overseas borrowing of SEs, which were small and always involved a guarantee of the Tusanian government both for the credit risk and foreign exchange risk, were practically sovereign borrowings. Given the absence of penalties and of a meaningful collateral system underlying SE borrowings, there was no recovery management in case of default. Although there were defaults, these were not reported because the CBT or the DFI simply rolled over the credit. That is, financial failure for the SE did not imply bankruptcy or foreclosure for the enterprise concerned. Only the commercial credit entailed penalties, and their financial obligations were met through transfers if not through their own cash flows.

5.19 The borrowings of the SEs as priority credits from the DFIs were ST2.1 billion in Y_1, rising to ST4.2 billion in Y_4, and doubling again to ST8.5 billion in Y_7. The average interest on DFI credit was 7.5 percent during Y_1-Y_3, rising to 8/0-9.5 percent during Y_4-Y_5, and finally to 9.0 percent during Y_6-Y_7. For government guaranteed borrowings, these rates represented reasonable costs to the SEs, and were free of any risk premium to be paid to the lending institutions.

5.20 On this basis, the average cost of the annual borrowings to the public sector were 5.5 percent in Y_1, rising to 6.6 percent in Y_4, to around 6.9 percent during Y_5 and Y_6, and to 6.8 percent during Y_7. These were the average costs on the ***annual*** borrowing operations of the government, and should not be confused with the average costs of the public domestic debt outstanding discussed below. Further, the cost of borrowings of the public sector were similar to the pattern observed in other

countries. These were well below market costs because the borrowings are sovereign liabilities with no credit risk or repayment risk. In economic terms, the real cost of borrowings were substantially negative as discussed in the next chapter, and thus represented a net transfer of resources to the public sector from the rest of the economy. We will return to this issue later on.

Domestic Debt and Debt Servicing Costs

5.21 The domestic debt outstanding in Y_1 was ST553 billion, increasing to ST878 billion by Y_4, and finally to ST1398 billion in Y_7. This phenomenal increase in the domestic debt outstanding occurred because of the new borrowings needed to finance the deficit together with rollovers of existing obligations, mainly in preferred credits advanced by the CBT to the government. The preferred credits outstanding were ST368 billion in Y_1, nearly two-thirds of the total debt outstanding; while government papers were ST73 billion, or 13.7 percent of the total debt in the same year. In other words, the CBT was the main holder of the public sector debt, amounting to about 80 percent of the domestic debt. This pattern prevailed throughout this period.

5.22 The average cost structure of the debt outstanding was, however, similar to those discussed earlier, that is, preferred credits of the CBT were the least-cost borrowing instrument of the government. Because of the dominance of preferred credits, the average interest cost of the debt outstanding for government borrowings was 2.2 percent in Y_1, which marginally increased to 2.8 percent by Y_7. In comparison, the average interest cost of the debt outstanding for the SEs, mainly DFI credits and commercial loans, was much higher, around 7.7 percent in Y_1, rising to 9.6 percent by Y_7. Since the government was able to obtain such low cost credit, it could afford a substantial increase in the domestic debt burden over these years.

Table 5.3 Domestic Debt Public Sector: Government, State Enterprises

	Annual Indicators						
	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Domestic Debt Outstanding	**533**	**624**	**754**	**878**	**1044**	**1203**	**1398**
Government Papers, <6 months	73	82	89	102	131	174	198
Preferred Credits,CBT,1-2 yrs	368	432	528	610	721	814	938
Priority Credits, DFIs,1-5 yrs	72	89	107	125	144	161	184
Commercial Credits, <6 mos	20	21	30	41	48	54	78
Domestic Debt Servicing costs	**16.6**	**19.9**	**24.0**	**30.3**	**37.1**	**46.2**	**56.9**
Government Papers, <6 months	4.4	4.9	5.3	6.6	8.5	12.2	14.9
Preferred Credits,CBT,1-2 yrs	5.2	6.5	7.9	9.8	11.5	13.8	16.9
Priority Credits, DFIs,1-5 yrs	5.4	6.7	8.0	10.0	12.2	14.5	16.6
Commercial Credits, <6 mos	1.7	1.8	2.7	3.9	4.8	5.7	8.6
Domestic Debt Servicing costs							
as per cent of revenue	7.8	9.1	10.6	12.9	15.1	17.8	20.6
as per cent of expenditures	6.5	7.5	8.7	10.3	11.2	11.8	12.6
Foreign Debt Service M&LT,	**21.8**	**25.1**	**29.4**	**34.9**	**42.3**	**49.6**	**61.0**
***of this*: 68% federal**	**14.9**	**17.0**	**20.0**	**23.7**	**28.8**	**33.7**	**41.5**
Total Debt Servicing costs	**31.5**	**36.9**	**44.0**	**54.0**	**65.9**	**79.9**	**98.4**
Domestic Debt Servicing costs	16.6	19.9	24.0	30.3	37.1	46.2	56.9
Foreign Debt Servicing costs	14.9	17.0	20.0	23.7	28.8	33.7	41.5
as per cent of revenue	14.9	16.8	19.5	23.0	26.8	30.7	35.7
as per cent of expenditures	12.4	14.0	16.0	18.3	19.8	20.5	21.7
Average cost (Rate, %)	3.1	3.2	3.2	3.4	3.6	3.8	4.1
for Government	2.2	2.2	2.1	2.3	2.4	2.6	2.8
for SEs, and Others	7.7	7.7	7.8	8.4	8.9	9.4	9.6
Government Papers, <6 months	6.0	6.0	6.0	6.5	6.5	7.0	7.5
Preferred Credits,CBT,1-2 yrs	1.4	1.5	1.5	1.6	1.6	1.7	1.8
Priority Credits, DFIs,1-5 yrs	7.5	7.5	7.5	8.0	8.5	9.0	9.0
Commercial Credits, <6 mos	8.5	8.5	9.0	9.5	10.0	10.5	11.0
Domestic Debt; Shares (%)	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Government Papers, <6 mos	13.7	13.1	11.8	11.6	12.5	14.5	14.2
Preferred Credits,CBT,1-2 yrs	69.0	69.2	70.0	69.5	69.1	67.7	67.1
Priority Credits, DFIs,1-5 yrs	13.5	14.3	14.2	14.2	13.8	13.4	13.2
Commercial Credits, <6 mos	3.8	3.4	4.0	4.7	4.6	4.5	5.6

For details see **Annex V**, Table 5-3

5.23 The total interest charge on the *domestic* public debt was ST16.6 billion in Y_1 and increased to ST30.3 billion in Y_4. Such a steep rise in the interest cost of the domestic debt was still manageable, considering that these interest charges amounted to a small proportion, only 6.5 percent of total federal expenditures in Y_1, 10.3 percent in Y_4, and 12.6 percent in Y_7. This is the main reason why the government was not too concerned about incurring deficits, borrowings, and debt servicing costs. The interest cost as a proportion of federal revenue, however, was higher. It was 7.8 percent in Y_1, increased to 12.9 percent in Y_4, and to 20.6 percent in Y_7. That is, for each Siwat of revenue, the government paid about 21 percent in interest obligations of domestic debt in Y_7, though much lower than it had in preceding years.

5.24 This picture changes considerably when the Siwat counterpart of external debt servicing obligations are added. Since the government was the main borrower of the foreign M&LT loans, about 68 percent of the amortization and interest charge is appropriated to the government's fiscal accounts, while the remaining 32 percent is ascribed to SEs, since a good part of these external M&LT loans financed the SEs investment program. On that basis, the cost of servicing foreign M&LT obligations to the federal government was an estimated ST14.9 billion, rose to 23.7 billion in Y_4, and then increased to ST41.5 billion in Y_7. Thus, there was a nearly threefold increase in the foreign debt servicing cost. While this increase occurred in part because of an increase in the external M&LT debt, the major cause of the increase was the devaluation of the Siwat and a consequent increase in the counterpart liabilities.

5.25 When these debt servicing costs on the external debt are combined with the costs of the domestic debt, the *total debt servicing cost* to the federal government increases significantly. In Y_1, these total costs were ST31.5 billion amounting to 14.9 percent of federal revenues. In Y_4, these costs increased to 54.0 billion, amounting to 23.0 percent of revenues. By Y_7, total debt service charges rose to ST98.4 billion, 35 percent of total revenues. Therefore, on the revenue side, there was a significant

impact, as the amount of total debt service increased by more than three times, and the *proportion* of these costs in total revenues more than doubled over the review period. On the expenditure side, however, the total cost of debt servicing was still not a deterrent in financial terms. These costs were 12.4 percent of total expenditures in Y_1; thereafter increased to 18.3 percent in Y_4, and finally to about 21.7 percent of total expenditures in Y_7. On the revenue side, the burden was not negligible, since for each Siwat of revenue the government had to pay about one-fourth to one-third in service charges during the Y_5-Y_7 years. If the arrears are also included, together with a slowdown in the roll-over of domestic liabilities, the implicit burden of debt servicing could have amounted to about 45 percent of revenues. But as matters stood, the debt servicing burdens of both the domestic and foreign liabilities were not an insurmountable constraint for the federal government in local currency, as long as the CBT was willing to charge these debts, especially the preferred credits, as an 'extra-ordinary' item on its balance sheet. Therein lies another reason why the government and the CBT perceived the Y_6-Y_7 crisis as mainly a financial phenomenon, originating from external illiquidity, rather than a structural macro-financial imbalance. Yet these imbalances existed.

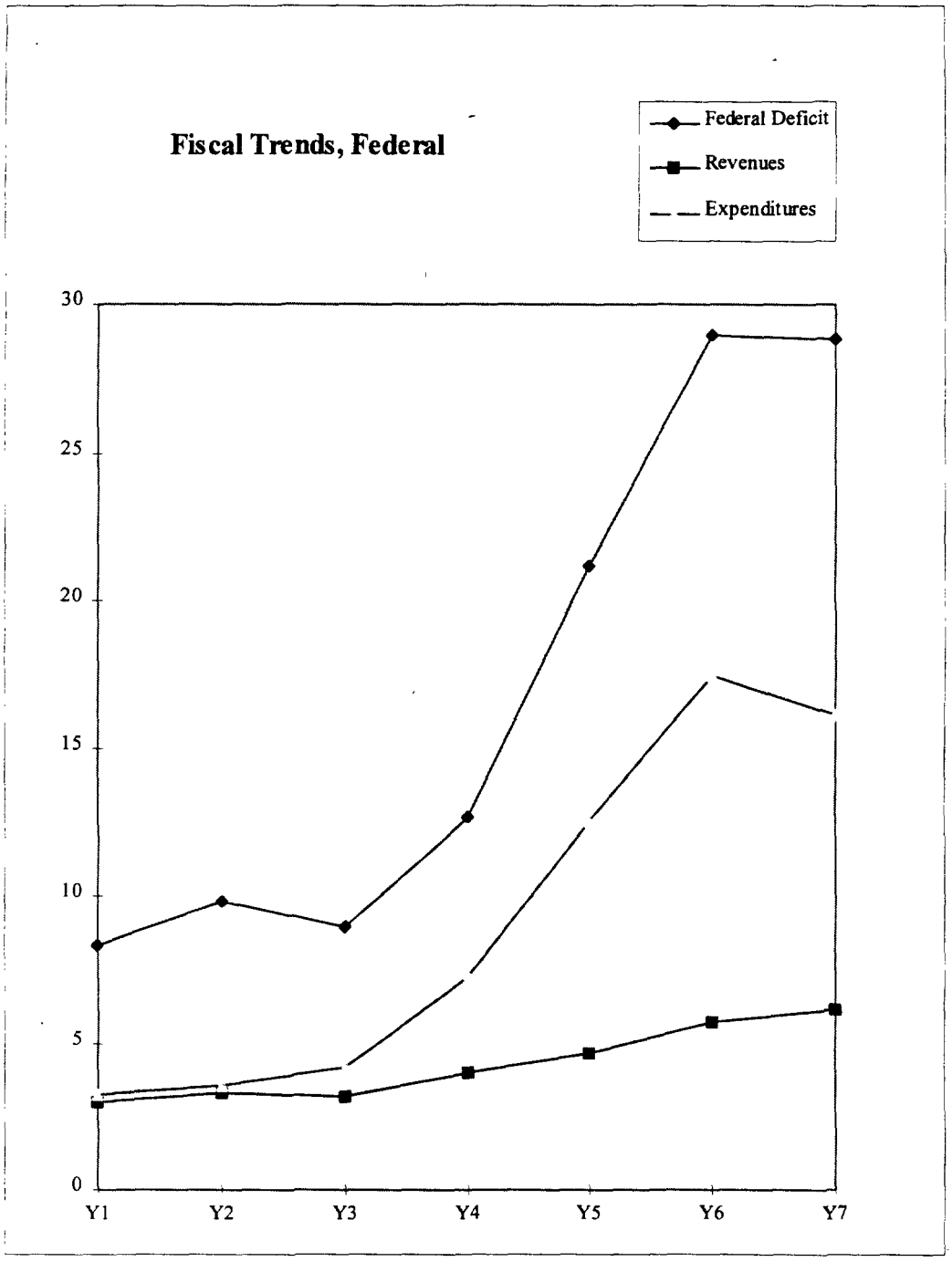
5.26 The demand for domestic financial resources by the public sector during the Y_5-Y_7 years, arose at a time when the private sector needed as much financial resources as it could get to tide over increased operating costs, loss of sales, and operating revenues owing to severe austerity measures and restructuring needs caused by a revamped incentive regime and major shifts in relative prices. Since the mid-years of the review period, this pattern has been very much in evidence. For a full measure of this shift of both the financial and real resources from the private sector to public sector, the analysis of financial system credit flows at the aggregate level, and detailed discussion of the mechanism and the policy regime governing the operations of the financial systems which facilitated this transfer, see Chapter VI.

Fiscal Operations of the Government

5.27 To evaluate the fiscal operations of the federal government we need to look at three items in some detail: revenues, expenditures and transfers to DFIs and SEs. Apart from the transfers, the destabilizing trend came from the expenditure side, while revenue levels held fairly steady throughout the period. During Y_1-Y_7, revenues increased at an average annual rate of 4.5 percent, but the growth in expenditures was twice as fast at 10.1 percent per year. In the early part of the review period, Y_1-Y_4, growth in revenues was 3.5 percent per year while expenditure growth was 5 percent per year. In contrast, during Y_5-Y_7, while growth in revenues was 5.9 percent, expenditures grew nearly three times faster at 16.8 percent per year (*see Table 5.1, and Annex V, Table 5-1*). Alarmed by this, the government began to apply the brakes in Y_7 and partially succeeded in restraining the expenditure growth, yet expenditures still grew by 16.2 percent in Y_7. Likewise, transfers to DFIs increased fairly rapidly from 11.1 percent per year during Y_1-Y_4, and by 15.1 percent in Y_5-Y_7. The reason that the transfer to DFIs increased so rapidly was the pressure on the government to maintain the operations investment program of the SEs in spite of rapidly deteriorating federal finances. These transfers to the SEs were ST42 billion in Y_1, increased to ST58 billion in Y_4, finally rising to ST74 billion in Y_7. Taken together, transfers to DFIs and the SEs were one-third of total revenues of the federal government in Y_1, rising to 38.7 percent in Y_4, and then steeply rising to 46.0 percent in Y_7.

5.28 A detailed review of the underlying causes of these fiscal trends, which is not attempted here, would require an in-depth analysis of the revenue base and major expenditure categories: entitlements and defense. This would divert the focus of this case study from macro-financial aspects to fiscal aspects. Therefore, for the purposes of this exercise, the fiscal outcome is taken as given. It is linked to the credit operations of the CBT and the banking system to finance the resulting deficit and its implications for the private sector and the Tusanian economy. But to provide a flavor

Chart 5-4


Fiscal Trends, Federal
Federal Deficit
Revenues
Expenditures
30
25
20
15
10
5
0
Y1
Y2
Y3
Y4
Y5
Y6
Y7

of understanding, let us have a closer look at the Y_7 federal budget and the underlying trends, followed by a summary of how the Tusanian government could possibly improve its fiscal operations.

5.29 The Tusanian government proposed a record budget for Y_7. Revenues were projected to grow by 7.5 percent from ST260 billion in Y_6 to ST280 billion as compared to average increases of 5.2 percent in the previous two years. This was to be accomplished essentially without change in tax rates or introduction of new taxes. The only change of the tax base was for the property tax following a new assessment in Y_6. Apart from the effects of real GNP growth and inflation, continuing improvements in tax administration were expected to account for the remaining increase in revenues. On the expenditure side, alarmed by a 17.5 increase in Y_6, the government proposed a 12.0 increase in Y_7. This increase was still faster than the target rate of revenues but zero, if not negative, in real terms. The government nearly succeeded in its efforts, but by mid-Y_7, the parliament got into action and increased the federal budget, added extra expenditures and stipulated a higher level of transfers to DFIs and SEs. This forced the government to borrow more from the CBT and to approve the DFI and SE operations, as though there were no financial crisis. Eventually the growth of expenditures declined slightly to 16.2 percent, still higher than the targeted budget rate of 12.0 percent.

5.30 The Tusanian annual programming exercise has a built-in lag of one year. That is, fiscal projections for Y_7 were done in mid-Y_6, using Y_5 as a base year. As a result, total expenditures and transfers programmed for Y_7 appeared fairly reasonable to those engaged in program formulation. That Y_6 would turn out to be worse than Y_5 could be anticipated, but not officially, as no government would admit in advance to a worsening financial situation. In a way, therefore, Y_7 projections of expenditures were ceiling figures, a cap on growth of the government's outlays and investment program. Apart from the deliberate scaling down of expenditure plans, a reduction in

the investment program, and the hardest one politically, could not materialize. Rapid inflation in Y_6 and Y_7 did not help matters either.

5.31 The real failure in fiscal performance was on the revenue side, because for successful demand management a good deal of improvement on the fiscal side had to be anchored in raising revenues. In the economic situation of Y_5-Y_7, this was a challenge given the low tax base, the hardships already being experienced by the general public, and poor tax administration —the reasons put forth as hampering revenue-raising efforts. Yet, the argument can be made that Tusania's tax effort had been reasonable, since economic and fiscal studies have shown that Tusania had performed above the levels expected for a country of its size and economic structure. Revenues averaged around 16 percent of the GDP in the early years, though falling to 11.4 percent in Y_5. However, in view of both the immediate needs for more public saving and Tusania's ambitious long-term investment plans, an increase in this ratio was needed. But the current level of fiscal deficit was the result of a tax system whose elasticity with respect to income was still relatively low. Even with recent improvements in tax administration, important tax revenue potential has not been touched or fully exploited. Tax collection rose in Y_5 and Y_6, though not so rapidly. This happened for several reasons: 1) a growing economy and price increases, 2) some of the monopoly revenues and taxes on imported goods deferred earlier were collected; and 3) an effort was made to improve tax collections involving: the expansion of offices and staff, provision of mobile tax collecting units, simplification of appeal procedures and tightening of collection procedures. This increase in tax revenue did not come from new levies or changes in the tax structure and no new tax charges were envisaged in the annual programs of Y_6 and Y_7.

5.32 Given that major gains in raising tax revenue were achieved through piecemeal efforts, tax specialists advocated that improvement in tax revenues would require the government to:

i. enlarge the coverage of the agricultural income tax and bring more of the larger units into the tax system. The target for Y_6 was to cover 3 percent of larger units covering 20 percent of the cultivated areas, and the proposal for Y_7 was to extend this to at least 7 percent of the units.

ii. enlarge the coverage of the personal income tax (other than for agricultural income).

iii. tighten up on exemptions to businesses for corporate taxes, have a quick one-shot increase, and to tighten up on reporting requirements for tax on income from corporate bonds.

iv. increase the rates on property taxes and make independent checks of a sample of self-assessments.

v. broaden the base of the production tax by applying it to more commodities, pending the introduction of indirect tax reform, possibly including the introduction of a value-added tax.

vi. reduce exemptions on tariffs on imported capital goods, and consider increased tariffs on imported consumer goods and components for them.

vii. to improve municipal government incomes and to pass a new law substantially increasing rates to cover inflation

5.33 These tax proposals could not be implemented in their entirety, though the government did take some actions concerning the property tax, deferrals, and exemptions. These efforts were inadequate, however, and resulted in federal deficits of the magnitude discussed earlier.

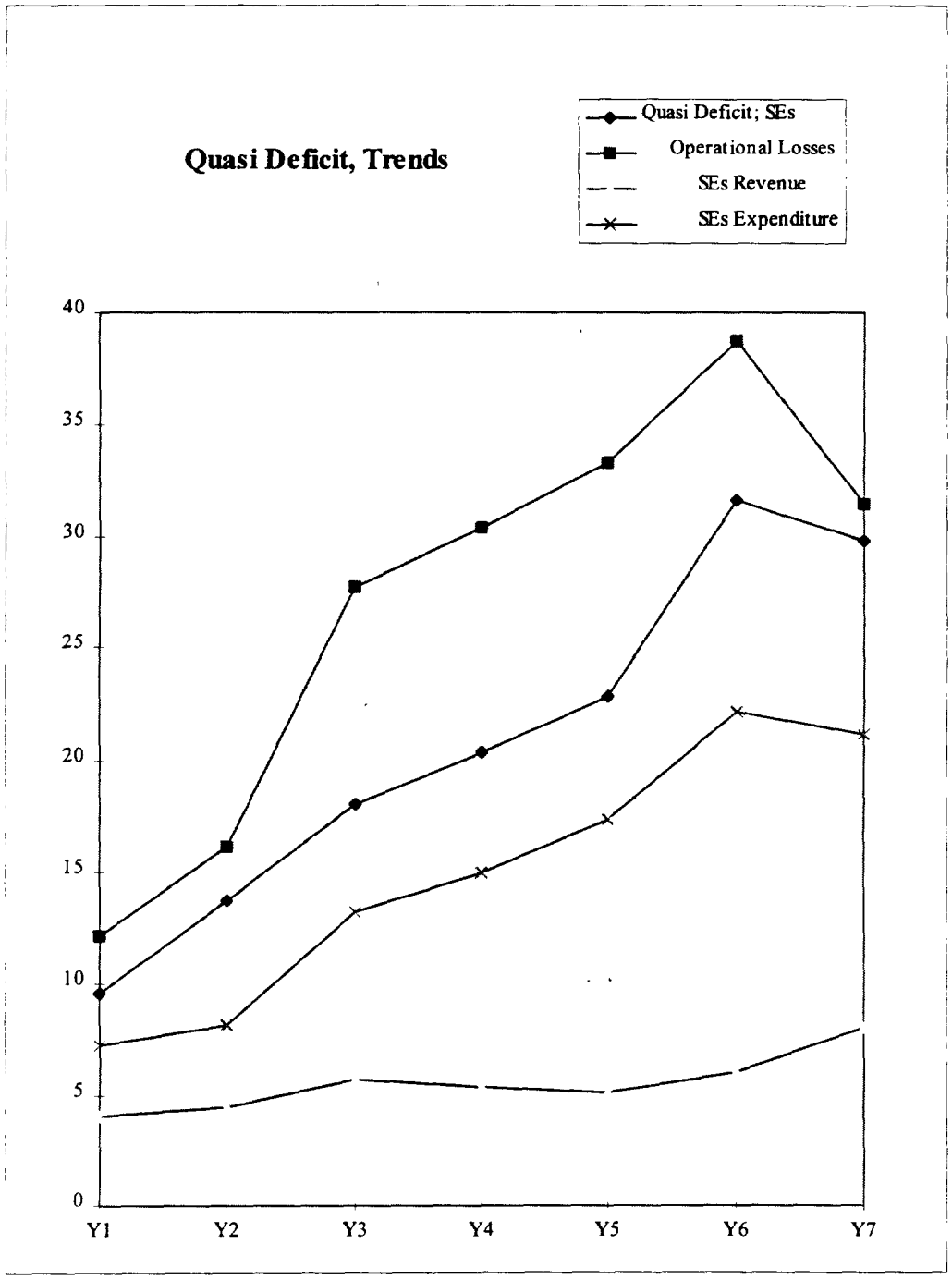
Financial Operations of State Enterprises (SEs)

5.34 Preparing a consolidated financial position of SEs is a daunting challenge because even the federal government does not prepare these consolidated accounts. The SE finances are subsumed under Ministerial or Departmental budgets, depending on their sector of operations, and thus are captured in federal fiscal accounts through

these Ministerial budgets. Besides, SEs do not follow uniform standards of accounting and reporting, therefore, simply adding up line items of the SE's financial statements may lead to meaningless aggregation. For example, the transfers that the SEs receive from the federal budget are not a direct transfer, rather an 'extra-budget' item and may be routed through a Special Fund at the Ministry or the sectoral DFI. There are several of these funds. Worse yet, the transfer may be subsumed under "Residual Funding," a line item in the Ministerial budget; or it may even be lumped under a "lending fund" maintained at the CBT or the DFIs. Likewise, since the SEs investment program is part of the Ministry or the Department's investment program, it may appear under sectoral investment as capital budget expenditures, participation, operating finance, or depreciation items. An evaluation of the SE's accounting procedures is not intended here. Rather, the point is that it will be very difficult to prepare a meaningful consolidated position of SEs finances, especially as a guide to pricing policies and macro-financial programming, until the MoF itself prepares a consolidated SE account by requiring the SEs to submit their financial statements directly to the MoF.

5.35 Given these imponderables, the SEs consolidated financial position is reported here on the basis of the aggregation of Ministerial or Departmental accounts. The overall size of the SE's deficit has already been discussed, inclusive of operational losses and investment, as a first approximation, and then including the federal transfers. That the SEs operational losses had been running high was widely known, but the size of it had always been in dispute. For example, total revenue of SEs in Y_6 is estimated at ST87 billion, but the only breakdown available lists four of

Chart 5-5


Quasi Deficit, Trends
Quasi Deficit; SEs
Operational Losses
SEs Revenue
SEs Expenditure
40
35
30
25
20
15
10
5
0
Y1
Y2
Y3
Y4
Y5
Y6
Y7

the largest SEs covering railways, coal, electricity, and the Agricultural Production Office, which is not an SE, but a conglomeration of SEs engaged in the agricultural sector. Likewise, no direct estimate of SEs costs of operation is available, since a good part of the cost is covered by contribution in kind via allocation of materials and services, which may have been paid for by a different agency of the government. The expenditure estimates have been cobbled together on the basis of various financial reports of the SEs and ministries. These estimates show that the expansion of SEs expenditures started in Y_3 and peaked in Y_6 at 22.2 percent, followed by another 21.2 percent increase in Y_7 after the government put restraints on these expenditures. The main reason for the increase in expenditures, besides the routine increase owing to the growth of operations, was inflation. As inflation gathered momentum, SEs lost control on the cost side, as wages and salaries and prices of raw materials and inputs kept rising, though not as fast as inflation. While the wages and salaries structure of the SEs and the public sector is not contractually indexed to inflation, the labor unions were able to command substantial increases in wages, together with employee benefits, to prevent erosion of their real income.

5.36 Given the major increases in operational losses, in Y_6 the government announced a package of SE price increases ranging between 7.0 percent to 18.0 percent for Y_7. At the time of preparation of the Y_7 Annual Program, the MoF was not in a position to quantify the sum total of the impact on revenues. It was expected that the growth of revenues would nearly double to about 12.0 percent, as compared to about 5 or 6 percent per year in the previous couple years. As it turned out, revenue growth in Y_7 was 8.0 percent, higher than 6.1 percent the previous year. Clearly, if the government is to impose financial discipline on the SEs, the implementation machinery has to be strengthened, otherwise price increases by themselves are no guarantee to reduce operational losses, as was the case in Y_7.

5.37 The most difficult category of expenditures to assess concerns investment by SEs. The enterprises need investment finance to cover increases in stocks and in

working capital and participations, as well as for fixed investment. Sources of financing include the surplus on government operations, transfers from the general budget, DFI's regular loans, special funds, foreign project credits and other loans, e.g. suppliers' credits, and credit from the banking system. Since total permitted credit from the banking system is fixed by the macro-financial program to maintain real growth and price increases are set as part of the MoF fiscal program, SE's fixed investment is the residual item which must adjust to the available financing. While this is the case on the financing side, the government sets targets for investment, based on an assessment of production capacity sector-by-sector in quantitative terms. These are later used by the Ministry of Industry in granting approvals and license both to the SEs and the private sector for establishing manufacturing units. Clearly, there was significant growth in SEs investment as estimated here from ST42 billion in Y_1 to ST102 billion in Y_7, increasing around 16 percent per year during Y_1-Y_7. This provided for real increases despite inflation, at least in the early period. But the largest increase in investment appears to have occurred during Y_5-Y_7 when the SEs investment increased by 25.3 percent in spite of financial difficulties all around.

5.38 If the government were to keep SEs finances within reasonable limits, then SE's investment needs had to be brought in line as part of the macro-financial program, and SEs access to credit needed to be curtailed and closely monitored. The SEs extensively borrowed domestically from the banking system as well as overseas with the federal government's guarantee. These eventually became the government's liability, both on external and domestic accounts, as the SEs were unable to service these obligations from their own sources,. The SEs had also accumulated substantial arrears, both on their routine operations and on loans, as only a small portion of the amount due was paid during the years Y_6 and Y_7. Part of the arrears were rolled over by the banking system, but these liabilities added to the burden of the public sector finances and pre-empted private sector access to the financial system, with disastrous consequences for productive sectors, as discussed in Chapter VII.

ANNEX V - Exhibit 1

The analysis of government finances requires the aggregation of data on financial operations as shown in Exhibit 1. But this refers to the fiscal operations of the federal government only, which is the largest part of the total public sector finances. Using a similar approach, fiscal operations of the provincial and local governments can also be prepared and merged together under the category of government fiscal accounts to arrive at the Federal Deficit. Next step is to determine the net financed balances of the SEs and other agencies who depend on government finances, federal and local, to arrive at the quasi-fiscal deficit. The sum of government's fiscal deficit and the quasi-fiscal deficit, mainly on SEs accounts, provides the total public sector deficit. The analysis of the size and composition of the public sector deficit is critical to the formulation of macro-financial program.

FINANCIAL OPERATIONS OF THE GOVERNMENT

REVENUE	EXPENDITURES
Tax Revenues	Current Expenditures
Direct Taxes	Defense
Income tax	Administrative
Wealth/Capital gain tax	Social Services and Entitlements
Other direct taxes	Interest Expenses on Borrowed
Funds	
Indirect Taxes	Capital Expenditure
Sales tax, VAT	Investments by Sector
Custom duties	
Other indirect taxes	
Non-Tax Revenues	

DEFICIT/SURPLUS.....(-/+)

FINANCING (of deficit through)

- Foreign Borrowing (net, drawing less repayments)
  - From Official Sources (bilateral, multilateral)
  - From Private Sources (foreign banks...)
- Domestic borrowing (net)
  - Central Bank (Currency issues, Credits, Cash Balances)
  - Banking System (bills, certificates, credits)
  - Non-Bank Public (bills, certificates)
  - Other Funds

RATIOS

- Revenue/GDP Ratio
- Deficit/GDP Ratio
- Expenditure/GDP Ratio

ANNEX V *Table 5-1 Financing Public Sector Deficits: (1 of 2)*
Government, State Enterprises (SEs)

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Public Sector Deficit	**185**	**206**	**232**	**269**	**328**	**427**	**552**
Federal Deficit	**112**	**123**	**134**	**151**	**183**	**236**	**304**
Revenues	212	219	226	235	246	260	276
Expenditures	255	264	275	295	332	390	453
Transfers to DFIs (net)	27	31	34	37	40	44	53
Transfers to SEs, Other (net)	42	47	51	54	57	62	74
Quasi Deficit; SEs	**73**	**83**	**98**	**118**	**145**	**191**	**248**
Investment	42	47	52	58	65	80	102
Operational Losses,SEs	31	36	46	60	80	111	146
SEs Revenue	67	70	74	78	82	87	94
SEs Expenditure	98	106	120	138	162	198	240
Financed by:							
Domestic Borrowings	*168*	*185*	*209*	*239*	*281*	*383*	*486*
Foreign Borrowings	*5*	*6*	*6*	*7*	*10*	*11*	*15*
Arrears and Others	*12*	*15*	*17*	*23*	*37*	*33*	*51*
Total Financing	185	206	232	269	328	427	552
Total Financing	**185**	**206**	**232**	**269**	**328**	**427**	**552**
Memo Items							
Domestic Borrowings	**168**	**185**	**209**	**239**	**281**	**383**	**486**
Government borrowings: from	***108***	***110***	***113***	***120***	***139***	***203***	***242***
Central Bank	90	91	90	96	112	182	224
ComBanks	18	19	23	24	27	21	18
Qausi-govt borrowings: from	***60***	***75***	***96***	***119***	***142***	***180***	***244***
ComBanks	8	12	16	20	23	39	50
Central Bank	12	17	22	25	34	54	72
DFIs	28	37	44	53	60	72	94
Others	12	9	14	21	25	15	28
Annual Growth Rates (%)							
Public Sector Deficit	*9.5*	*11.4*	*12.6*	*15.9*	*21.9*	*30.2*	*29.3*
Federal Deficit	*8.3*	*9.8*	*8.9*	*12.7*	*21.2*	*29.0*	*28.8*
Revenues	3.0	3.3	3.2	4.0	4.7	5.7	6.2
Expenditures	3.2	3.5	4.2	7.3	12.5	17.5	16.2
Quasi Deficit; SEs	*9.6*	*13.7*	*18.1*	*20.4*	*22.9*	*31.7*	*29.8*
Investment	10.4	11.9	10.6	11.5	12.1	23.1	27.5
Operational Losses	12.1	16.1	27.8	30.4	33.3	38.8	31.5
SEs Revenue	4.1	4.5	5.7	5.4	5.1	6.1	8.0
SEs Expenditure	7.2	8.2	13.2	15.0	17.4	22.2	21.2
Shares, Ratios (%)							
Federal Deficit/Total Deficit	60.5	59.7	57.8	56.1	55.8	55.3	55.1
Quasi Deficit/Total Deficit	39.5	40.3	42.2	43.9	44.2	44.7	44.9
Transfers/Revenues	32.5	35.6	37.6	38.7	39.4	40.8	46.0
Transfers/Total Deficit	37.3	37.9	36.6	33.8	29.6	24.8	23.0

ANNEX V *Table 5-1 Financing Public Sector Deficits: (2 of 2) Government, State Enterprises (SEs)*

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Ratios of GDP							
Public Sector Deficit / GDP	14.5	14.6	14.7	14.9	15.3	16.4	18.3
Federal Deficit	8.8	8.7	8.5	8.4	8.5	9.1	10.1
Revenues	16.6	15.5	14.3	13.0	11.4	10.0	9.2
Expenditures	19.9	18.7	17.5	16.3	15.4	15.0	15.0
Quasi Deficit; SEs	5.7	5.9	6.2	6.5	6.7	7.3	8.2
Investment	3.3	3.3	3.3	3.2	3.0	3.1	3.4
Operational Losses	2.4	2.5	2.9	3.3	3.7	4.3	4.9
SEs Revenue	5.2	5.0	4.7	4.3	3.8	3.3	3.1
SEs Expenditure	7.7	7.5	7.6	7.6	7.5	7.6	8.0
GDP (current)	1280	1413	1575	1806	2149	2604	3010

Average Annual Growth Rates

	Y_1-Y_7	Y_1-Y_4	Y_4-Y_7	Y_5-Y_7			
Public Sector Deficit	20.0%	13.3%	27.1%	29.7%			
Federal Deficit	18.1%	10.5%	26.3%	28.9%			
Revenues	4.5%	3.5%	5.5%	5.9%			
Expenditures	10.1%	5.0%	15.4%	16.8%			
Transfers to DFIs (net)	11.9%	11.1%	12.7%	15.1%			
Transfers to SEs, Other (net)	9.9%	8.7%	11.1%	13.9%			
Quasi Deficit, SEs	22.6%	17.4%	28.1%	30.8%			
Investment	15.9%	11.4%	20.7%	25.3%			
Operational Losses	29.5%	24.6%	34.5%	35.1%			
SEs Revenue	5.8%	5.2%	6.4%	7.1%			
SEs Expenditure	16.1%	12.1%	20.3%	21.7%			
Financed by:							
Domestic Borrowings	19.4%	12.5%	26.7%	31.5%			
Foreign Borrowings	20.1%	11.9%	28.9%	22.5%			
Arrears and Others	27.3%	24.2%	30.4%	17.4%			
Total Financing	20.0%	13.3%	27.1%	29.7%			
Government borrowings: from	14.4%	3.6%	26.3%	31.9%			
Central Bank	16.4%	2.2%	32.6%	41.4%			
ComBanks	0.0%	10.1%	-9.1%	-18.4%			
Quasi-govt borrowings: from	26.3%	25.6%	27.0%	31.1%			
ComBanks	35.7%	35.7%	35.7%	47.4%			
Central Bank	34.8%	27.7%	42.3%	45.5%			
DFIs	22.4%	23.7%	21.0%	25.2%			
Others	15.2%	20.5%	10.1%	5.8%			

ANNEX V *Table 5-2 Domestic Borrowing Operations: (1 of 2)*
Government, State Enterprises (SEs)

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Total Deficit	**185**	**206**	**232**	**269**	**328**	**427**	**552**
Federal Deficit	***112***	***123***	***134***	***151***	***183***	***236***	***304***
Quasi Deficit; SEs	***73***	***83***	***98***	***118***	***145***	***191***	***248***
Financed by:							
Domestic Borrowings	*168*	*185*	*209*	*239*	*281*	*383*	*486*
Foreign Borrowings	*5*	*6*	*6*	*7*	*10*	*11*	*15*
Arrears and Others	*12*	*15*	*17*	*23*	*37*	*33*	*51*
Domestic Borrowings	**168**	**185**	**209**	**239**	**281**	**383**	**486**
Government borrowings	*108*	*110*	*113*	*120*	*139*	*203*	*242*
SEs and Others' borrowings	***60***	***75***	***96***	***119***	***142***	***180***	***244***
Lending to Public Sector	**168**	**185**	**209**	**239**	**281**	**383**	**486**
by: Central Bank	102	108	112	121	146	236	296
by: Commercial Banks	26	31	39	44	50	60	68
by: DFIs	28	37	44	53	60	72	94
by: Others	12	9	14	21	25	15	28
Borrowing Instruments	**168**	**185**	**209**	**239**	**281**	**383**	**486**
Govt Papers, <6 months	73	82	89	102	131	174	198
Preferred Credits, CBT, 1-2 years	41	35	37	40	40	77	126
Priority Credits, DFIs,1-5 years	28	37	44	53	60	72	94
Commercial Credits, <6 months	26	31	39	44	50	60	68
Borrowing Costs (amounts)	**9.3**	**10.9**	**12.7**	**15.7**	**19.3**	**26.3**	**33.1**
for Government	*4.9*	*5.3*	*5.7*	*6.9*	*8.6*	*12.7*	*15.6*
for SEs, and Others	*4.4*	*5.6*	*7*	*8.8*	*10.7*	*13.6*	*17.5*
Govt Papers, <6 months	4.4	4.9	5.3	6.6	8.5	12.2	14.9
Preferred Credits, CBT, 1-2 years	0.6	0.5	0.6	0.6	0.6	1.3	2.3
Priority Credits, DFIs,1-5 years	2.1	2.8	3.3	4.2	5.1	6.5	8.5
Commercial Credits, <6 months	2.2	2.6	3.5	4.2	5	6.3	7.5
Average cost (Rate, %)	**5.5**	**5.9**	**6.1**	**6.6**	**6.9**	**6.9**	**6.8**
for Government	*4.5*	*4.8*	*5*	*5.8*	*6.2*	*6.3*	*6.4*
for SEs, and Others	*7.3*	*7.4*	*7.3*	*7.4*	*7.5*	*7.5*	*7.2*
Govt Papers, <6 months	6	6	6	6.5	6.5	7	7.5
Preferred Credits, CBT, 1-2 years	1.4	1.5	1.5	1.6	1.6	1.7	1.8
Priority Credits, DFIs,1-5 years	7.5	7.5	7.5	8	8.5	9	9
Commercial Credits, <6 months	8.5	8.5	9	9.5	10	10.5	11
Prime Rate	9.0	9.0	9.5	10.0	10.7	11.7	12.2

ANNEX V *Table 5-2 Domestic Borrowing Operations: (2 of 2) Government, State Enterprises (SEs)*

Memo Items

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Instruments; Share (%)	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Government Papers, <6 months	43.45	44.32	42.58	42.68	46.62	45.43	40.74
Preferred Credits, CBT, 1-2 years	24.4	18.92	17.7	16.74	14.23	20.1	25.93
Priority Credits, DFIs,1-5 years	16.67	20	21.05	22.18	21.35	18.8	19.34
Commercial Credits, <6 months	15.48	16.76	18.66	18.41	17.79	15.67	13.99

Average Annual Growth Rates

	Y_1-Y_7	Y_1-Y_4	Y_4-Y_7	Y_5-Y_7			
Total Public Deficit	20.0%	13.3%	27.1%	29.7%			
Federal Deficit	18.1%	10.5%	26.3%	28.9%			
Quasi Deficit; SEs	22.6%	17.4%	28.1%	30.8%			
Financed by:							
Domestic Borrowings	19.4%	12.5%	26.7%	31.5%			
Foreign Borrowings	20.1%	11.9%	28.9%	22.5%			
Domestic Borrowings							
Government borrowings	14.4%	3.6%	26.3%	31.9%			
SEs borrowings	26.3%	25.6%	27.0%	31.1%			
Borrowing Instruments	19.4%	12.5%	26.7%	31.5%			
Government Papers	18.1%	11.8%	24.7%	22.9%			
Preferred Credits, CBT	20.6%	-0.8%	46.6%	77.5%			
Priority Credits, DFIs	22.4%	23.7%	21.0%	25.2%			
Commercial Credits	17.4%	19.2%	15.6%	16.6%			
Costs of Borrowings	23.6%	19.2%	28.2%	31.0%			
Government Papers	22.6%	14.8%	30.8%	32.1%			
Preferred Credits, CBT	25.7%	3.7%	52.5%	88.2%			
Priority Credits, DFIs	26.1%	26.4%	25.9%	28.8%			
Commercial Credits	22.5%	23.7%	21.4%	22.3%			
for Government	21.3%	12.1%	31.2%	34.7%			
for SEs, and Others	26.0%	26.3%	25.7%	28.0%			

ANNEX V *Table 5-3 Domestic Debt Public Sector: Government, State Enterprises (SEs)*

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Domestic Debt Outstanding	**533**	**624**	**754**	**878**	**1044**	**1203**	**1398**
Government Papers, <6 months	73	82	89	102	131	174	198
Preferred Credits, CBT, 1-2 years	368	432	528	610	721	814	938
Priority Credits, DFIs,1-5 years	72	89	107	125	144	161	184
Commercial Credits, <6 months	20	21	30	41	48	54	78
Domestic Debt Servicing costs	**16.63**	**19.86**	**23.99**	**30.29**	**37.09**	**46.18**	**56.87**
Government Papers, <6 months	4.4	4.9	5.3	6.6	8.5	12.2	14.9
Preferred Credits, CBT, 1-2 years	5.2	6.5	7.9	9.8	11.5	13.8	16.9
Priority Credits, DFIs,1-5 years	5.4	6.7	8.0	10.0	12.2	14.5	16.6
Commercial Credits, <6 months	1.7	1.8	2.7	3.9	4.8	5.7	8.6
Domestic Debt Servicing costs							
as per cent of revenue	7.8	9.1	10.6	12.9	15.1	17.8	20.6
as per cent of expenditures	6.5	7.5	8.7	10.3	11.2	11.8	12.6
Revenues, ST billions	212	219	226	235	246	260	276
Expenditures, ST billions	255	264	275	295	332	390	453
External debt serivce M&LT,$	273	302	338	371	415	451	484
Official Exchange Rate	80	83	87	94	102	110	126
External debt serivce M&LT,ST	**21.8**	**25.1**	**29.4**	**34.9**	**42.3**	**49.6**	**61.0**
of this: 68% federal	14.9	17.0	20.0	23.7	28.8	33.7	41.5
Total Debt Servicing costs	**31.5**	**36.9**	**44**	**54**	**65.9**	**79.9**	**98.4**
Domestic Debt Servicing costs	16.6	19.9	24	30.3	37.1	46.2	56.9
Foreign Debt Servicing costs	14.9	17	20	23.7	28.8	33.7	41.5
as per cent of revenue	14.9	16.8	19.5	23.0	26.8	30.7	35.7
as per cent of expenditures	12.4	14.0	16.0	18.3	19.8	20.5	21.7
Average cost (Rate, %)	3.1	3.2	3.2	3.4	3.6	3.8	4.1
for Government	2.2	2.2	2.1	2.3	2.4	2.6	2.8
for SEs, and Others	7.7	7.7	7.8	8.4	8.9	9.4	9.6
Government Papers, <6 months	6.0	6.0	6.0	6.5	6.5	7.0	7.5
Preferred Credits, CBT, 1-2 years	1.4	1.5	1.5	1.6	1.6	1.7	1.8
Priority Credits, DFIs,1-5 years	7.5	7.5	7.5	8.0	8.5	9.0	9.0
Commercial Credits, <6 months	8.5	8.5	9.0	9.5	10.0	10.5	11.0
Domestic Debt; Shares (%)	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Government Papers, <6 months	13.7	13.14	11.8	11.62	12.55	14.46	14.16
Preferred Credits, CBT, 1-2 years	69.0	69.2	70.0	69.5	69.1	67.7	67.1
Priority Credits, DFIs,1-5 years	13.5	14.3	14.2	14.2	13.8	13.4	13.2
Commercial Credits, <6 months	3.8	3.4	4.0	4.7	4.6	4.5	5.6

CHAPTER VI

MACRO- FINANCIAL MANAGEMENT

6.1 In the absence of a well functioning money market, the government and the CBT normally have relied on direct instruments of monetary control to contain aggregate demand, which remains the cardinal feature of the Tusanian demand management to this today. There were some belated attempts to use indirect instruments of monetary control, but these attempts were not effective. Further, whatever indirect controls were operative, they simply could not cope with the recurring monetary instability, the dimensions of financial imbalances, and the pressures on the exchange rate and price levels. Given the size of public sector deficits and domestic borrowings, the government preempted the market mechanism to ensure that financial resources be available to the public sector both in the required magnitudes and at costs well below market level. Additionally, the system of direct controls discussed in Chapter VII, together with a system of interventions led to significant financial repression and segmentation over the years, and the financial system was heavily taxed. The CBT, in most cases, for macro-financial management purposes, had no choice except to resort to direct controls on monetary magnitudes during the crisis years. These mechanisms of control worked chiefly through the financial operations of the banking system, stipulated by the CBT, and mainly affected the commercial banks. The DFIs played an increasing role, but mainly on the lending side and credit supply to the SEs and priority sectors, and not so much on the containment of monetary expansion.

6.2 Historically, the routine controls on monetary growth have not been particularly effective for Tusania. In formulating short-run monetary policy as a demand management policy tool, the Tusanian monetary authorities regard money supply, broad money and domestic credit as the most relevant intermediate target variables in order to achieve a set of predetermined macroeconomic objectives. At the beginning of each year, monetary authorities determine target rates of growth of these aggregates on the basis of expected developments of the economy in the coming year. They choose a rate of expansion of the money supply consistent with a desirable rate of inflation and a rate of GDP growth set by the government in its annual program. Once the target rate of the expansion of money supply is set, then authorities determine the rate of growth of bank credit to ensure an optimum increase in the money supply on the basis of expected changes in foreign reserve holdings and government borrowing from the financial system.

6.3 This approach, however, does not allow for any casual linkage between money and real output on the one hand, and for money and the balance payments on the other. Money may be neutral in the long-run, but it certainly affects real income, the balance of payments, and the price level through a variety of channels in the short run. Disregarding these casual linkages in formulating monetary policy leads to unrealistic estimates of the target rates of expansion of the monetary variables and produces destabilizing effects. Above all, the degrees of freedom available to the CBT in the conduct of monetary policy are limited because the government's fiscal policy, especially expenditure policy, overrides monetary policy except during the crisis years when the adherence to an economic program became imperative. Then, fiscal controls simply could not provide the leverage to contain the aggregate demand.

6.4 Since domestic credit expansion is pivotal to monetary growth, the CBT sets credit ceilings to control the rate of domestic credit growth for the banking system, both at the aggregate and institution level. This ceiling is expressed in terms of a

percentage increase in bank credit over the preceding year's level. The CBT enforces the credit expansion by requiring the banks to submit a monthly report on their loan activities and by imposing penalties when they fail to observe the ceiling (*for details, see Chapter VII*). Enforcement of these ceilings has been difficult, and even when the CBT succeeds in enforcing them, direct credit control does not necessarily enable CBT to meet the target rates of growth of the money and the broad money supply. For example, unexpected changes in the balance of payments or the government's budgetary operations could easily frustrate the CBT's efforts to control the money supply. While this happened in the crisis years of Y_5-Y_7, such changes may not affect the credit ceiling management. If the money supply is the relevant intermediate variable as a gauge of the direction of monetary policy, the direct credit control has not been as effective an instrument of control as it has appeared.

6.5 In view of these limitations, the CBT is left with the alternative of controlling the money supply by regulating liquidity levels, the reserve base, and other direct measures. Since the liquidity and cash reserve ratios are less effective as policy instruments, the CBT cannot easily control either the money multiplier or the reserve base. The reserve base in Tusania has been generated by the monetization of government debt and foreign exchange holdings during the fixed exchange rate regime and even after partial deregulation in late years. Until then, monetary authorities had no way of preventing the monetary consequences of balance of payments deficits unless they resorted to direct controls over the foreign trade regime, which is what happened in the early review period. Subsequently, during the late review period, with the devaluation of the Siwat, the managed foreign exchange auction system, and a liberalized foreign trade regime, the CBT still found it difficult to control monetary magnitudes as it had no control over the government's fiscal operations and was obliged to accommodate fiscal deficits. Under these circumstances, the CBT could not easily control the growth of monetary magnitudes.

6.6 There is sufficient evidence that *financial deepening* in Tusania is close to the average levels observed in most developing countries with a per capita GNP of $870, and it has remained stable. The indicator of financial depth – the ratio of M_1 and M_2 to GNP – was around 19 percent of GDP throughout the review period. In an economy such as Tusania's, financial deepening hinges more upon the speed and level of monetization of economic activities. An improved financial system can foster greater mobilization of resources and monetary authorities can help the process by 1) removing segmentation of financial markets and, by 2) promoting diversification of financial instruments, thus enhancing financial deepening. But this would only occur provided that positive real interest rates and monetary stability are maintained for sufficiently long periods. This did not happen in Tusania. When real interest rates did turn positive, it happened in an environment of monetary instability and speculative behavior as witnessed during the Y_5-Y_7 period.

6.7 In Tusania, owing to the low and rather rigid interest rate structure, which per force leads to credit rationing, the cost of borrowing remained an inoperative monetary policy tool. Instead, direct measures at banking credit and liquidity control were the most frequently used instruments of monetary management, as discussed later in this Chapter. Banking institutions in Tusania seldom advance consumer loans. They basically finance trade, working capital, and, to some extent, fixed investments. This pattern of lending implies that liquidity constraints of the banking system have little impact on consumer spending. For that matter, monetary policy instruments cannot regulate consumer outlays. But monetary instruments do affect trade financing, working capital and fixed investment outlays, and liquidity controls affect private investment and borrowing from the banking system. They thus have a greater impact on production and employment. The government, however, as a major investor in Tusania, unlike the private sector, is not subject to the liquidity constraint as it has access to borrowings from CBT. It readily exercises this privilege, while the SEs have monopoly access to DFIs and also to the CBT. This pattern of access to credit, combined with the government's command over real resources owing to its

monopoly power to create money – *seigniorage* – almost guarantees the passivity of monetary controls to government's fiscal operations. Further, since the money market is rudimentary and is dominated by short-term government papers with below market rates and yields, interest rates are not much of a constraint to government borrowings from the financial system, either. The indirect instruments of monetary control, therefore, are neutral with respect to a large part of aggregate money demand, and the burden of adjustment is disproportionately borne by market-based components affecting the private sector.

Interest Rate and Price Trends

6.8 Interest rates in Tusania have been regulated throughout, but attempts were made at partial deregulation during Y_5-Y_7. At the same time, there was a segmentation in the rate structure as applicable to the private and public sectors. For a long period, interest rates were kept fairly low both on the deposits and loans of the banking system. In particular, lending rates were subsidized for the public sector and on SE borrowings from the DFIs and CBT. The rate structure was intended more as a mechanism for allocating banking credit between private and public sector borrowers and among various uses of credit within each category of borrower. In general, both the deposit and lending rates for the financial operations of the public sector were generally lower than prevailing market rates effective for the private sector. Lending rates to the priority sector borrowers were clearly subsidized, regardless of whether the loans originated from the CBT, the DFIs, or the commercial banks. This overlapping system of segmentation in the interest rate structure contributed to financial repression, and the resulting distortions reinforced distortions of the incentive regime in the real sectors. Even after deregulation, the government tried, though unsuccessfully, to control interest rates. It stipulated that the spread between the deposit rate and the prime rate would not be more than 5.0 percent, and that the difference between the prime rate and the maximum lending rate would not be more than 2.5 percent. In practice, these guidelines could not be adhered to.

Table 6.1 Price and Interest Rates

	Annual Indicators				Average Annual Growth Rates		
	Y_1	Y_4	Y_6	Y_7	Y_1-Y_7	Y_1-Y_4	Y_5-Y_7
		(per cent)			*(per cent)*		
Prices, Annual Increase							
Cost of Living	9.1	15.6	24.5	22.4	17.7	12.9	23.4
Food Prices	6.0	11.7	18.1	16.1	13.0	9.5	17.1
Wholesale Prices	7.3	12.9	19.3	18.2	14.4	10.6	18.7
GDP deflator	6.0	11.6	19.7	15.3	12.9	8.9	17.5
Interest Rates		*(per cent)*					
CBT Lending Rates							
T-Bills Rediscount	6.0	6.5	7.0	7.5			
Medium-Term Credits	8.0	8.5	9.5	9.5			
Priority Credits	7.5	8.0	9.0	9.0			
Banking System Lending Rates							
General Rate - Overdrafts	9.5	10.5	12.5	13.0			
Short-term credits	11.0	12.5	14.5	15.0			
Medium-term Credits	12.0	13.0	16.0	16.5			
Inter-bank call money	14.0	16.5	18.5	19.0			
Prime Rate	9.0	10.0	11.7	12.2			
Banking System Deposit Rates							
Savings Accounts							
0 - 3 months	2.5	3.0	3.5	3.5			
3 - 6 months	3.0	3.5	4.5	4.5			
6-12 months	4.0	4.5	5.5	5.5			

For details see **Annex VI**, Table 6-1

The banking system found ways to circumvent restrictions through an elaborate system of fees and charges, which effectively raised the cost of borrowing to the private sector beyond the posted rates. The public sector was insulated from these practices and hence enjoyed not only preferential access to credit but also a lower cost of borrowing due to this segmentation in the rate structure.

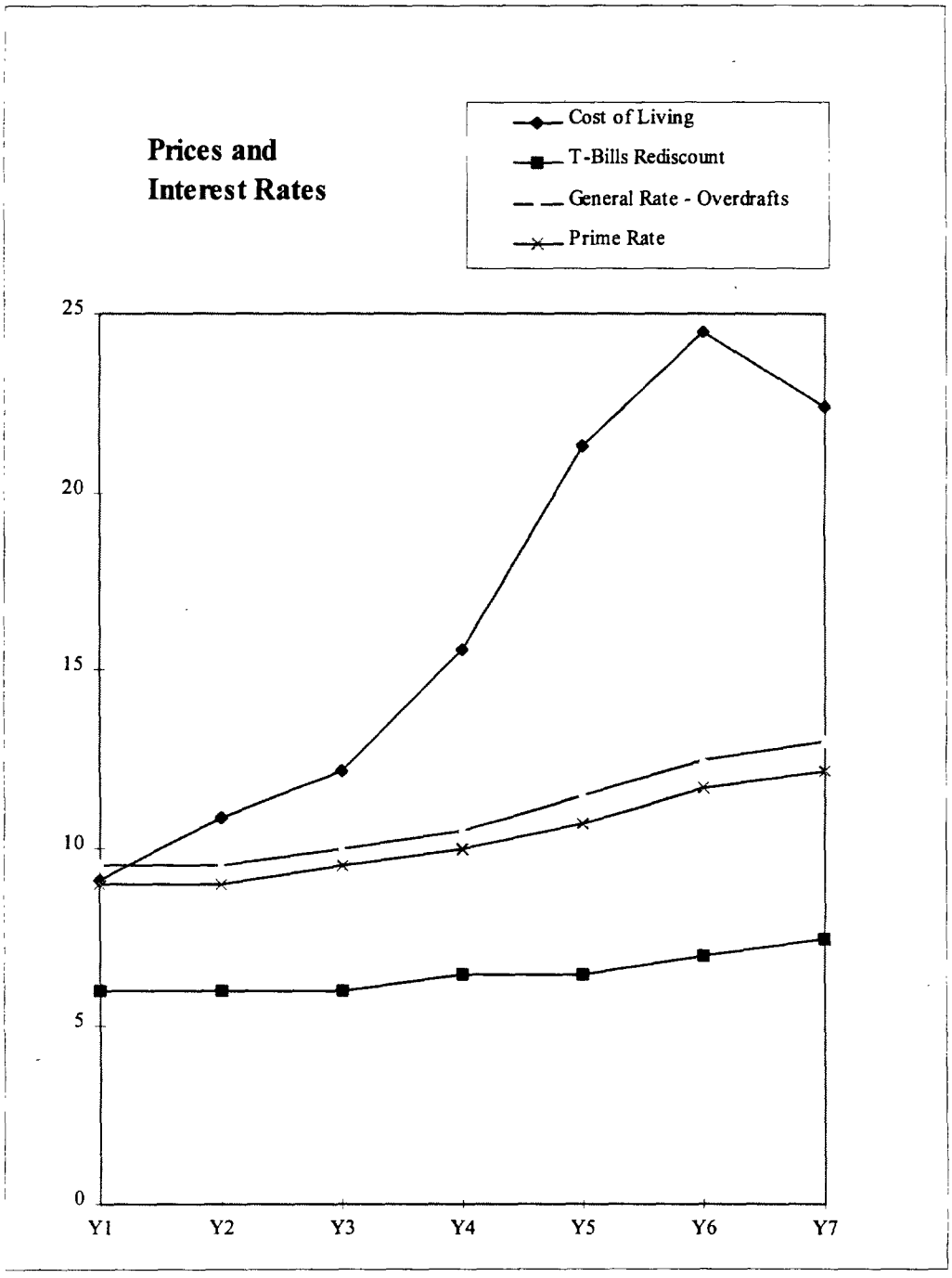
6.9 Interest rates remained fairly stable in the early part of the review period. Toward the end of Y_4 it was clear that the CBT would have to allow the peg rate – the rate of rediscount on treasury bills – to increase, given the monetary expansion and intensifying inflation. The CBT rediscount rate ranged between 6-6.5 percent during Y_1-Y_5, was raised to 7 percent in Y_6, and to 7.5 percent in Y_7. Thus, there was a substantial increase in the rediscount rate during Y_6-Y_7 and, as a result, the entire rate structure both on the lending and deposit side shifted upwards. The CBT raised its lending rates on priority credits from 7.5 percent during Y_1-Y_3 to 8 percent in Y_4, to 8.5 percent in Y_5 and to 9 percent during Y_6-Y_7. These rates were applicable on the bulk of CBT credit to public-sector borrowers. Likewise, the CBT raised the interest rates on medium term credits, keeping the same differential between the rediscount rate and its lending rates to the public sector. The lending rates of the banking system increased even faster, from the range of 9.5-12.5 percent prevailing during Y_1-Y_4, and to 12.5-16.5 percent during Y_6-Y_7. Since the bulk of the banking system's lending is in overdrafts of 3 months, the interest rate on overdrafts is regarded as a peg rate for commercial loans. It increased from 9.5 percent during Y_1-Y_2 to 10.5 percent in Y_4, gradually increasing to 13 percent in Y_7. In contrast, the inter-bank call money rate increased from 14 percent during Y_1-Y_2, to 16.5 percent in Y_4, jumped to 18.5 percent by Y_6, and to 19 percent by Y_7. This is because inter-bank borrowing in Tusania is used mostly to shore up liquidity and to avoid CBT penalties. It is the most expensive type of borrowing and is normally done as a last resort. The prime rate of the banking system is the lowest-cost borrowing since it is applicable to well-established corporate borrowers and ranged from 9.0 percent during Y_1-Y_3 to about 12.0 percent during Y_6-Y_7.

6.10 This shift in the rate structure on the lending side was not matched by a similar shift in the rate structure on the deposit side. Short-term deposit rates increased from around 2.5-3.0 percent during Y_1 -Y_4, to 3.5-4.5 percent during Y_5-Y_7, with a noticeable increase in the rate on money market CDs. The bulk of the deposits of the banking system, however, were not affected by the shift in the interest

rates. Demand deposits rarely carry any interest and short-term savings deposits have the lowest interest rate in the entire banking system. The savings deposits of the banking system are a small proportion of total deposits and deposits of a maturity longer than a year or fixed maturity deposits are even smaller. Therefore, the general shift in the interest rate structure that occurred during Y_5-Y_7, especially on the lending side, did not have much impact on the deposit side. The maximum range of deposit rates was 3.5-5.5 percent during Y_6-Y_7, at a time when lending rates were significantly higher, and it was well below the rate of rediscount on T-bills. The general increase in interest rates on the lending side was not accompanied by a strong inducement to savers. In fact, when these interest rate trends were juxtaposed with price trends, as shown in *Chart 6-1*, the resulting negative real rates on deposits may have intensified preferences for current expenditures over savings. This further added to aggregate demand pressures and compounded the difficulties in the task of monetary control.

6.11 The price level came under pressure during Y_4-Y_5 – the mid years. Until then, inflation as measured by cost of living increase, the consumer price index (CPI), was tolerable. The CPI increased at the average annual rate of 12.9 percent during Y_1-Y_4, but this average rate does not adequately convey the pressures on the price level. These pressures began to emerge in Y_4 when inflation was 15.6 percent. During the first half of Y_2, inflation gathered momentum. By Y5, the CPI had jumped to 21.3 percent, nearly double the rate prevailing in early years. In Y_6 the CPI rose by 24.5 percent, and in Y_7 when some brakes were applied, the CPI still managed to rise by 22.4 percent. Food prices also increased substantially during Y_5-Y_7, but through an elaborate system of controls and subsidies on strategic consumer items and food staples, the rate of food price increases was kept to around 17 percent per annum during Y_5-Y_7, still double the rate of early years. These price increases were accompanied by substantial upward pressures on wages and salaries but despite labor union actions and widespread unrest, the fixed income groups – mainly the salary and wage earners and pensioners – saw a significant erosion of their real

Chart 6-1


Prices and
Interest Rates
Cost of Living
T-Bills Rediscount
General Rate - Overdrafts
Prime Rate
25
20
15
10
5
0
Y1
Y2
Y3
Y4
Y5
Y6
Y7

incomes and purchasing power. The lower wage earning groups were hit specially hard, and in the absence of a social safety net, except for subsidies on food items, their relative position worsened. This caused widespread unrest and opposition to the belt-tightening measures being advocated by the government in Y_7.

6.12 The swift rise in the general price level during Y_4-Y_7 cannot be explained in terms of growth of money supply and banking credit alone. The root cause of inflation was continued public sector spending without a parallel increase in revenues, either through taxes or the SE's pricing structure. The growth of monetary magnitudes, especially credit to public sector on the financing side, was the major source of this excess demand. Likewise, depreciation of the Siwat, both in the parallel and official markets, was widely perceived as a destabilizing factor "causing" price increases as each devaluation was immediately translated into a rise in the price of imported items. This was invariably followed by a rise in the general price level. To begin with, however, devaluation occurred because Tusanian inflation was much higher than that of its major trading partners. The partial devaluations generated a self-sustaining speculative cycle that fed on the slide of the Siwat, first in the parallel market, and then in the formal market. This led to a massive turnover of funds both in the official and parallel markets, thus siphoning off banking credit to finance speculation and starving the real sectors of liquidity and credit. It was only in the late part of the crisis years that these inter-links became more vivid as speculative activities intensified.

6.13 Given these price trends, if one compares the interest rates of the banking system on the lending side and the general price level, real lending rates were positive, though barely, during the early years. As inflation gathered momentum, the rigidities of the system did not allow for adjustments and real interest rates turned negative. In general, adjustments in interest rates during inflationary periods lag behind unless the authorities take firm actions to bring the peg rate – the rediscount rate of the Central bank – at par, or in exceptional circumstances, ahead of the rate of

inflation. But when price increases are substantial, as they were in Tusania during the crisis years, it is almost impossible for authorities to bring about a big jump in interest rates within a short period. Therefore, real interest rates almost invariably turn negative. Besides, in times of rapid inflation like this, it is far from clear why the authorities must always attempt to maintain positive interest rates. As a long-term policy, positive real interest rates are desired, but it is not possible to have the entire interest rate structure shift or move in tandem with inflation, albeit with a lag. In this sense, Tusania's situation was no exception. Worse yet, the lending rates of the CBT were raised but not by enough of a margin, and therefore the real cost of borrowing to its customers in the public sector declined with inflation. This encouraged a perverse behavior in the public sector, i.e. to increase outlays at a time when the exigencies of demand management and control of inflation required just the opposite – a reduction in public sector outlays. The CBT's lending rates for priority sectors were 7.5 percent during Y_1-Y_3, reasonably close to the rate of inflation. As inflation accelerated to above 20 percent during Y_5-Y_7, these CBT lending rates were raised to 8.5-9.0 percent, far below the rates of inflation. Thus, CBT lending rates in real terms became negative by a wide margin.

6.14 In contrast, the lending rates of the banking system were higher than, or on a par with, the rate of inflation during Y_1-Y_3, especially for commercial banks, both for short- and medium-term credits. During the mid-review years, however, these lending rates also began to fall behind the rate of inflation. During Y_5-Y_7, the rates were lower by about 8 percent, leading to negative real rates during the crisis year, and thus compounding the difficulties of monetary controls on credit expansion. For example, the interest rate on overdrafts was below the rate of inflation during Y_1-Y_3, but reasonably close. Later on, it increased to 11.5-13 percent during Y_5-Y_7, but the inflation rate outstripped this gradual increase by a wide margin. The lending rates of commercial banks for short- and medium-term credit were slightly higher than the overdraft rates, but followed the same pattern. The lending rate to prime borrowers of the banks was 9.3 percent during Y_1-Y_3, increased to 10.3 percent during Y_4-Y_5,

and then to 11.5 percent to 12.0 percent in Y_6-Y_7, well below the rate of inflation throughout the period. This is not to suggest that negativity of the real rate of interest must always immediately be compensated for, and in full. Besides, this is an almost impossible task for monetary authorities and not necessarily a prudent course of action. If the negativity coincides with speculative behavior, however, and banking credit is diverted to finance speculative activities, especially in the foreign exchange market, the pressures on exchange rate and price level are intensified, as happened in Tusania. Further, routine business borrowings of a short-term nature have more to do with a comfortable cash-flow and good business outlook. If they coincide with lower or negative real costs, all the better from a purely business point of view, but this also induces spending and intensifies inflation.

6.15 More or less similar trends prevailed on the deposit side with substantially negative real rates during the Y_5-Y_7 period. Although the deposit rates rose to 3.5-4.5 percent on short-term deposits and 5.5 percent on longer term deposits during Y_5-Y_7, deposit rates in real terms remained substantially negative throughout these years, adversely affecting deposit growth. It is true that several factors besides the real interest rate affect financial savings such as real income, attitudes towards thrift, and expectations. In an economy like Tusania, rapid inflation did exert a downward pressure on the private propensity to save through creating a relative price effect, making current consumption favorable over future consumption. Further, as happened in Tusania, having reached a plateau, consumption may not decline commensurably to the loss of real income, in spite of efforts to control spending through a whole range of direct controls. When these factors are combined with the inadequacy of policy measures, price and interest rate trends do adversely affect financial savings.

6.16 Clearly then, the interest rate policy of the government failed as a major anti-inflationary tool during the crisis years. The authorities felt that since there had been a substantial rise in interest rates and that the interest rate structure both on deposits

and lending had shifted upwards, that there was no room for a further increase in interest rates without choking-off economic activity thereby causing a deeper recession. No government could afford this in the midst of what was perceived essentially as a foreign liquidity crisis, rather than a deeper financial and economic malaise with roots extending well beyond the crisis years. The only recourse left to the Tusanian authorities was to impose strict price controls to stem rising inflation and to resist price increases of the SEs. Price controls were imposed on strategic food items, pharmaceuticals, oil and petroleum products, and essential consumer items. This led to a thriving curb-market for these items. State-owned stores were soon emptied, long lines formed, and protests erupted, while the media displayed the hardships suffered by veterans and the elderly. This public display of the government's failure, made it even more difficult to adhere to fiscal discipline, impose financial accountability on the SEs, and control monetary growth in face of rising inflation.

Monetary growth

6.17 Monetary growth during the early part of the review period Y_1-Y_4 was high but stable. Growth, however, quickly gathered momentum during Y_5 and became volatile during Y_6-Y_7. The CBT had little success in controlling the rate of expansion of monetary aggregates. Reserve money, the source of money supply and liquidity expansion, increased by 10.6 percent per year during Y_1-Y_4. During Y_5-Y_7 the average annual growth was 21.6 percent, nearly double the rate of growth during the first half of the review period. This pattern was common to all monetary aggregates. The money supply growth rates were similar to those of reserve money, though there were some differences in the pattern of growth of the components. During Y_1-Y_4, the growth of currency was 10.1 percent per year, but during Y_5-Y_7, the rate of currency expansion was 21.1 percent per year. Consequently, the rate of growth of M_1 during Y_5-Y_7 was nearly double the rate of the early part of the review period. There was a

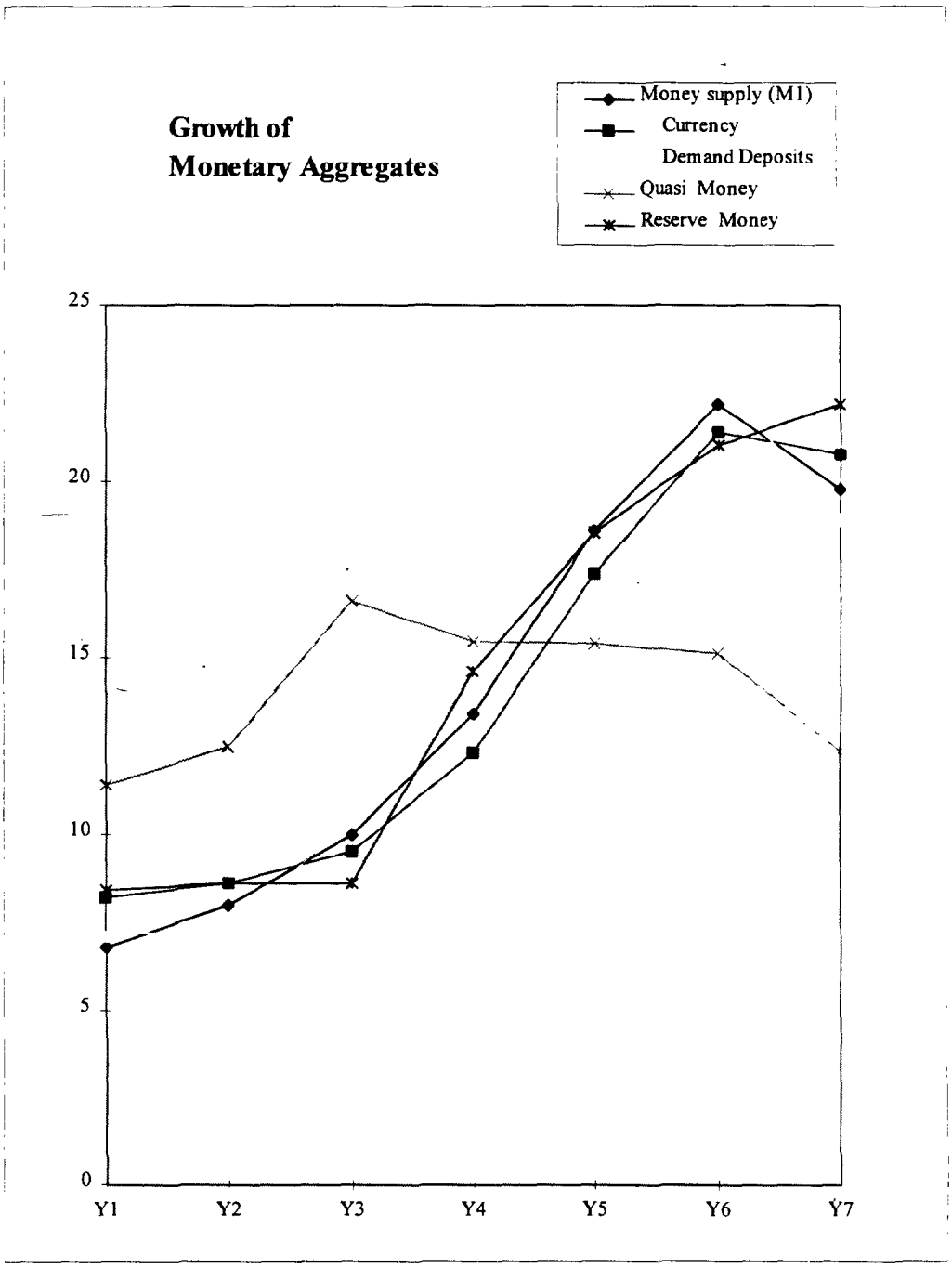
Table 6.2 Monetary Survey

	Annual Indicators				Average Annual Growth Rates		
	Y_1	Y_4	Y_6	Y_7	Y_1-Y_7	Y_1-Y_4	Y_5-Y_7
	(ST billions)				*(per cent)*		
Money supply (M_1)	**251**	**338**	**490**	**587**	15.2	10.4	21.0
Currency	116	155	221	267	14.9	10.1	21.1
Demand deposits	135	183	269	320	15.5	10.7	20.9
Quasi Money	64	97	129	145	14.6	14.9	13.8
M_2 = M_1+Quasi Money	**315**	**435**	**619**	**732**	15.1	11.4	19.5
Total Deposits: FinSystem	199	280	398	465	15.2	12.1	18.5
Total BankSys Deposits	*191*	*269*	*384*	*439*	14.9	12.1	17.3
ComBanks Deposits	*184*	*255*	*365*	*417*	14.6	11.5	16.9
Annual Growth Rates (%)							
M_1	6.8	13.4	22.2	19.8			
Money Supply (M_2)	8.9	13.9	20.7	18.3			
Currency	8.2	12.3	21.4	20.8			
Demand Deposits	7.1	14.4	22.8	19.0			
Quasi Money	11.4	15.5	15.2	12.4			
Reserve Money	8.4	14.6	21.1	22.2	15.5	10.6	21.6
BanSys Deposits	4	20.0	20.0	14.8	16.3	12.9	17.4
Deposits of FinSystem	8.7	14.8	20.2	16.8			
BankSys Deposits	9.3	14.5	20.4	14.3			
ComBanks Deposits	9.1	13.8	19.7	14.2			
Shares, Ratios (%)							
M_1 / GDP	19.6	18.7	18.8	19.5			
M_2 / GDP	24.6	24.1	23.8	24.3			
Currency / GDP	9.1	8.6	8.5	8.9			

For details see **Annex VI**, Table 6-2

substantial expansion in quasi-money, but its growth during Y_1-Y_4 was 14.9 percent per year, much higher than that of M_1, and during Y_5-Y_7 the growth was 13.8 percent per year, lower than that of M_1 growth. This is attributed to a shift in deposit patterns from interest-bearing deposit instruments to more liquid deposits, owing to accelerating inflation and the higher liquidity requirements of both businesses and

Chart 6-2


Growth of
Monetary Aggregates
Money supply (M1)
Currency
Demand Deposits
Quasi Money
Reserve Money
25
20
15
10
5
0
Y1
Y2
Y3
Y4
Y5
Y6
Y7

households. As a result, the rate of growth of M_2 increased from 11.4 percent in Y_1-Y_4 to 19.5 percent during Y_5-Y_7.

6.18 There were several reasons for large monetary growth during Y_5-Y_7 The main factors included substantial growth in public sector deficits financed by the borrowing from CBT and the banking system, short-term inflows of CDs, and other foreign funds treated as net additions to foreign assets in so far as these represented foreign currency deposits of the CBT with overseas banks. In fact, these were short-term foreign external debt liabilities of Tusania lodged with the CBT. To analyze both of these items, we need to have a closer look at the CBT's financial operations. The major item on the asset side of the balance sheet is the net domestic credit extended by the CBT. It had substantial growth during Y_5-Y_7 at 34.6 percent per year as compared to 9.1 percent growth per year during Y_1-Y_4. This was the major factor in monetary expansion. The net foreign assets as reported by the CBT showed a major increase from ST9 billion in Y_1 to ST23 billion in Y_4 and then to ST54 billion in Y_7. This is already discussed in Chapter IV concerning the pattern of inflows of foreign currency deposits (fCDs) which continued to increase in the early years, and subsequently reversed the trend. CBT accounts do not fully capture these trends because they exclude foreign arrears that began to build up, first slowly, and then substantially during the crisis years. The uncovered counterpart of these short-term foreign liabilities began to appear in Y_4 estimated at ST13 billion, increased to ST43 billion in Y_5, then further increased to ST99 billion in Y_6 and to ST110 billion in Y_7. The sheer size of these liabilities, as reported by foreign creditors, have a serious implication for the CBT's balance sheet. If fully accounted for, the CBT's net foreign assets as reported should be substantially negative. These liabilities have to be covered in some fashion through flows of financial resources to the CBT, either domestically from the rest of the financial system, or from abroad. That the CBT engaged in these transfers is clear, representing the reverse of sterilization of foreign fund inflows, since these uncovered foreign arrears were not

Table 6.3 Summary Accounts, CBT

	Annual Indicators				Average Annual Growth Rates		
	Y_1	Y_4	Y_6	Y_7	Y_1-Y_7	Y_1-Y_4	Y_5-Y_7
	(ST billions)				*(per cent)*		
Total Assets	**159**	**220**	**349**	**432**	18.1	11.4	29.1
Foreign Assets (Net)	9	23	43	54	34.8	36.7	29.9
CBT Domestic Credit (Net)	***114***	***148***	***255***	***319***	18.7	9.1	34.6
Public Sector	*102*	*121*	*236*	*296*	19.4	5.9	42.4
Government	*90*	*96*	*182*	*224*	16.4	2.2	41.4
SEs and Others	*12*	*25*	*54*	*72*	34.8	27.7	45.5
Others	*12*	*27*	*19*	*23*	11.5	31.0	-12.4
Total Liabilities	**159**	**220**	**349**	**432**	18.1	11.4	29.1
Currency	116	155	221	267	14.9	10.1	21.1
Reserves of ComBanks	25	36	54	62	16.3	12.9	17.4
Other Reserves	7	11	17	19			
Other Liabilities	11	18	57	84	40.3	17.8	110.3
Reserve Money	**139**	**188**	**270**	**330**			
BanSys Deposits	25	36	54	62			
Currency, non-bank public	107	141	199	249			
Reserves of other FinIns	7	11	17	19			
Arrears and Reschedulings	0.0	18.8	154.8	177.6			
Arrears Due (-)	0.0	13.0	99.0	110.0			
Balance (new liabilities)	0.0	5.8	55.8	67.6			
Annual Growth Rates (%)							
Total Assets	9.2	14.6	34.7	23.8			
Domestic Credit	6.1	10.4	44.9	25.1			
To: Public Sector	3.6	8.0	61.6	25.4			
Government	1	6.7	62.5	23.1			
SEs and Others	28.3	13.6	58.8	33.3			
Total Liabilities	9.2	14.6	34.7	23.8			
Currency	8.5	12.3	21.4	20.8			
Reserves of ComBanks	6	20.0	20.0	14.8			

For details see **Annex VI**, Table 6-3 and **Annex VII**, Table 7-3

included in the government's accounts either. These arrears were mainly for balance of payments financing, though a small part of the short-term foreign borrowings

ended up financing public sector deficit, thereby contributing to domestic monetary expansion.

6.19 These foreign arrears, the foreign liabilities of CBT, have two parts. One is the counterpart of the fCDs mentioned above. The other consists of trade and external debt arrears, both in the public and private sectors. The Siwat value of fCD liabilities was around 44 billion in Y_3. In Y_4 nearly half of it was rolled over, but an additional ST21.9 billion was re-deposited in CBT accounts overseas. By mid-Y_5, it was quite clear to the creditors that these fCDs could not be repatriated and ended up as the bulk of arrears of ST43 billion. In Y_6 as the foreign exchange shortage turned into a liquidity crisis, trade financing credits and other external debt obligations also ended up as part of the arrears, even though they originated partly in the private sector. Eventually, Tusania had to request massive rescheduling to cover these arrears, and all these obligations ended up being sovereign obligations of the government. But the CBT did not report these obligations as liabilities on its accounts because a good portion were not CBT obligations, in the strict sense, and in any case had serious consequences for the CBT's own financial operations.

6.20 In purely economic terms, the flow of financial resources through the CBT to the public sector, whether of domestic or foreign origin, were provided at below-market cost and their costs are not fully captured. For example, on the liability side of the CBT, currency in circulation is nearly a zero-cost item. It increased from ST116 billion in Y_1 to ST267 billion in Y_7 at the average rate of 14.9 percent per year, much of it occurring during Y_5-Y_7. The reserves and deposits of the banking system with CBT likewise increased from ST25 billion in Y_1 to ST62 billion in Y_7, and again much of the deposits carry zero-interest cost to the CBT. Banks are allowed to keep 40 percent of their reserves in treasury bills. Because the treasury bill rate had been substantially below the market interest rate, the government was able to obtain financing at a rate well below market cost from the banking system. Later on, the government issued stabilization securities, and the CBT made it

mandatory for commercial banks to hold these securities as part of the liquidity requirement, over and above the reserve requirements. Since these stabilization securities carried a rate closer to T-bills, again, the amount held in the represented securities forced lending by the banking system to the government through the CBT. Since these short-term instruments are the liability of the government, and not of the CBT, the reserves and other deposits of the banking system with CBT, offered below market-cost resources to the public sector, and led to a substantial monetary expansion.

Monetary Control Mechanism

6.21 In the normal course of events, the CBT, like any other monetary authority, does have an array of policy instruments at its disposal. These are: open market operations, interest rates, liquidity and cash reserve ratios, stabilization directives, and a roster of direct controls over banking system credit. Among these instruments, the CBT almost exclusively relies on direct credit and liquidity controls to influence the rate of growth of money and other monetary variables instead of indirect instruments operating through money and capital market mechanisms. Direct measures to control liquidity expansion in times of swift inflation are, however, an exception rather than the rule. They are inadequate to provide the brakes needed on monetary expansion, and worse yet, lead to an adverse impact on those segments of the economy unable to pay the premia to secure sufficient credit for their operations.

Open Market Operations (OMO)

6.22 In Tusania, open market operations (OMO) are not important and have not been important in controlling monetary aggregates for several reasons – principally the absence of a well-functioning money market. The CBT, however, buys and sells government securities to raise funds for the government and to service government debt. But given the limited size of the market, and since the government controls the

return on government securities of various types, the investors – households or institutions – are reluctant to hold them. In many cases, potential investors do not have access to some of these markets. The buying and selling of all government papers is done by the CBT through designated banks only, for amounts as stipulated by the government, and at discount rates determined by the government and the CBT. Thus, the CBT finds itself in the unenviable position of stipulating quantity, price, timing, and buying and selling terms of government securities. A large part of the government securities, such as treasury bills and certificates, is held by the financial institutions for liquidity reasons, maintaining the required reserve ratio, or because holding of the securities is declared mandatory by the CBT on behalf of the government, amounting to forced lending. As far as the financial institutions are concerned, such an operation is equivalent to an increase in liquidity, cash, or reserve ratios because the banking institutions have no choice but to hold these securities. Since these securities are fully backed by the government and are practically risk-free assets, financial institutions hold them partly for portfolio reasons even though the return is below market levels. This asset preference, however, is diluted in times of tight liquidity. For those financial institutions who would like to sell their holding of these securities, their only recourse is the rediscount window of CBT. Therefore, the CBT in effect acts as the last-resort buyer and has to accommodate secondary transactions originating from the financial institutions. The CBT, rather than the market, has the initiative in the purchase or sale of securities through sales contracts or repurchase agreements, since there is hardly any active secondary market.

6.23 The CBT does change, though rather infrequently, the rediscount rate. Since the interest rate structure was kept at unrealistically low levels, a change in the treasury bill rate alone had no noticeable effect on the supply of money and bank credit, except as indicating the intention of authorities in their future monetary policy operations. In view of these factors, open market operations in government securities in Tusania are neither open nor market-based. To label the sale and purchase of the securities by the CBT as OMOs is a misnomer. The size of the market for T-bills and

other government papers has remained fairly small and secondary markets could not be developed. Therefore, OMOs are unlikely to be an important factor. Likewise, the legal and institutional settings embedded in the structure of the Tusanian financial system do not facilitate open market operations.

Reserve Requirements

6.24 In Tusania, reserve requirements are mainly applicable to commercial banks, though the banking law stipulates that all the financial institutions, including DFIs, engaged in the lending business, should be subjected to compliance. The DFIs, since they are not deposit-money banks and mainly serve the public sector, are exempt from this obligation, as are non-bank financial institutions. The reason for this segmentation is that the CBT regards reserve requirements mainly as a monetary policy tool rather than as a part of a safety-net mechanism to ensure the solvency of financial institutions. The CBT operates a fractional reserve requirement computed for a 30-day accounting period on liquid and near-liquid liabilities of the commercial banks – mostly demand deposits, time deposits, and savings deposits lodged with the banking system. This amounts to about 85 percent of the total deposit liabilities of the commercial bank, and is called the reserve requirements (RR) base. The required reserves are classified into primary reserves, consisting of deposits with the central bank, and secondary reserves, consisting of eligible assets such as T-bills – up to 40 percent of the required reserves. The banks, however, maintain excess reserves to ensure that their inter-bank and inter-branch accounts are covered for clearance and settlement purposes, and to avoid penalties. The banks do not normally keep free reserves, nor do they maintain borrowed reserves. Thus, most of the reserves are held in compliance with reserve requirements, along with some excess reserves in sufficient amounts for settlement and clearance through the Tusanian payment system for inter-bank accounts.

6.25 The impact of the reserve requirements on Tusanian commercial banks is to increase their financial intermediation costs, since reserve deposits with CBT do not earn any interest. Commercial banks would prefer to hold reserves in interest-bearing instruments. The banks also argue that these requirements should be imposed on the DFIs as well as on those financial institutions who compete with the banks in lending business, since the lack of these requirements confers upon these institutions an edge in the credit market. In periods of rising interest rates, the costs of the reserves becomes more binding. That is, the main reason for the CBT to use them is as an instrument to limit monetary expansion.

6.26 For a considerable time, throughout the early years of the review period, the CBT maintained a reserve requirement of 20 percent for the deposit-money banks, mainly the commercial banks, and some DFIs, such as the Savings Bank and the Tusanian National Bank. The commercial banks as a group, however, maintained about 4 percent more as excess reserves, thus the actual reserve ratio during Y_1-Y_3 was around 24 percent. In Y_4 the reserve requirements were raised to 22 percent, and in Y_5 to 23 percent, a level that prevailed through Y_6. In Y_7 , the required reserve ratio was again raised to 24 percent. Each time the ratio was raised, the actual reserve ratio increased by about another 4 percent to account for the excess reserves. Thus during Y_5-Y_7, the actual reserve ratio was around 27 percent of the liquid and near-liquid liabilities of the commercial banks, amounting to about 85 percent of all the deposit liabilities in a given year.

6.27 On this basis, the total reserves maintained by the banking system were ST37 billion in Y_1, rose to ST55 billion in Y_4, further increased to ST82 billion in Y_6, and to ST96 billion in Y_7. Since 40 percent of the required reserve amount could be kept in T-bills, the actual reserves deposited with CBT in non-interest bearing accounts were ST25 billion in Y_1, rising to ST36 billion in Y_4, with a sharp increase to ST54 billion in Y_6 and ST62 billion in Y_7. Since the increase in the reserve requirements coincided with an increase in the T-bill rediscount rate, followed by an upward shift

Table 6.4 Reserve Requirements

	Annual Indicators						
	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
			(per cent)				
Required Reserve Ratio (RR)	***20.0***	***20.0***	***20.0***	***22.0***	***23.0***	***23.0***	***24.0***
Actual Reserve Ratio of ComBanks	***23.7***	***23.7***	***23.9***	***25.8***	***26.9***	***26.9***	***27.3***
			(ST billions)				
Deposit Liabilities of ComBanks	**184**	**202**	**224**	**255**	**305**	**365**	**417**
RR Base ~85%	**156**	**169**	**188**	**213**	**253**	**305**	**348**
Required Reserves (amounts)	***31***	***34***	***38***	***47***	***58***	***70***	***84***
of which 40% T-Bills	12	14	15	19	23	28	33
R-Deposit with CBT	19	20	23	28	35	42	50
Excess Reserve Deposit with CBT	*6*	*6*	*7*	*8*	*10*	*12*	*12*
Actual Reserves of Commercial Banks	**37**	**40**	**45**	**55**	**68**	**82**	**96**
of which:							
Deposited with CBT	25	26	30	36	45	54	62
Reserve of Other Banks	**7**	**9**	**10**	**11**	**13**	**17**	**19**
Total Reserves of BankSys	**44**	**49**	**55**	**66**	**81**	**99**	**115**

For details see **Annex VI**, Table 6-4

in the structure of lending rates, the banking system cost of loanable funds increased by the amount of the interest differential on the reserves deposited with CBT. These cost increases coincided with the tightening liquidity position of the commercial banks during late Y_6, and by Y_7 there was a noticeable impact on the growth of commercial bank credit to the private sector.

Liquidity Control

6.28 Direct controls of liquidity levels are an important feature of the monetary control system in Tusania. Traditionally the liquidity ratio in Tusania is more of a prudential instrument than an instrument for monetary control because it is not a statutory requirement and does not carry a penalty for non-compliance as does the reserve requirement. The liquidity ratio is defined as the ratio of short-term liquid and near-liquid assets to total deposit liabilities. This differs from the more standard type of liquidity ratio stipulated to compare assets and liabilities of roughly the same maturities. Besides, banks have to maintain sufficient levels of liquidity, anyway, to support their lending operations. Otherwise, the financial costs of being non-liquid are severe, starting with the very high costs of inter-bank borrowings – the call money rates discussed earlier. Therefore, Tusanian banks have typically maintained fairly high liquidity ratios, defined as the ratio of liquid and near liquid assets to total deposit liabilities. These assets consist of vault cash, T-bills held both in lieu of reserve requirements and as portfolio balances, the net inter-bank call money position, reserve deposits with CBT, and other short-term near liquid assets like Treasury Certificates and commercial bills of exchange of less than 30 days. In this sense, the liquidity ratio in Tusania is a composite of the cash ratio, the reserve ratio, and some additional liquidity to safeguard against unexpected increases in cash obligations emerging from the payments system or unforeseen losses to the banks. The ratio of cash to demand deposits for Tusanian banks remained fairly comfortable through the review period, ranging between 7-8 percent, depending on the size of the bank, with higher ratios for larger banks. This range of cash ratio is close to the cash ratios observed in the banking systems of countries similar to Tusania. However, since this ratio is based on the vault cash of commercial banks and demand deposits, rather than total liquid and near-liquid liabilities of the banks, it does not fully capture system-wide needs of hard liquidity. Nonetheless, even with these exclusions, changes in the cash ratio affect credit creation in broadly the same manner as changes in a standard reserve requirement, even though it is not part of the required reserves.

Table 6.5 Liquidity of Commercial Banks

	Annual Indicators						
	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
			(ST billions)				
Total Assets of ComBanks	**237**	**272**	**311**	**347**	**403**	**461**	**527**
Total Liquid Assets	**66**	**73**	**84**	**101**	**120**	**146**	**143**
Cash in Vault	9	10	12	14	17	22	18
Total T-bills	18	21	22	28	31	37	37
Balances with CBT	25	26	30	36	45	54	62
Others	14	16	20	23	27	33	26
ComBank Deposit Liabilities	**184**	**202**	**224**	**255**	**305**	**365**	**417**
			(per cent)				
Liquidity and other Ratios							
Liquidity Ratio (LR)	35.9	36.1	37.5	39.6	39.3	40.0	34.3
Cash R on all Deposits	4.9	5.0	5.4	5.5	5.6	6.0	4.3
Cash R on DDs only	7.3	7.5	8.2	8.5	8.5	8.8	6.3
Liquidity net of RR	15.8	16.3	17.4	18.0	17.0	17.5	11.3
Liquid Assets/Total Assets	27.8	26.8	27.0	29.1	29.8	31.7	27.1
Annual Growth Rates							
Cash in Vault		11.1	20.0	16.7	21.4	29.4	-18.2
Total T-bills		16.7	4.8	27.3	10.7	19.4	0.0
Balances with CBT		4.0	15.4	20.0	25.0	20.0	14.8

For details see **Annex VI**, Table 6-5

6.29 The liquidity ratio is estimated by Tusanian banks in two different ways. As a composite ratio of all liquid and near-liquid assets – including cash and reserves with the CBT – to total deposit liabilities. This liquidity ratio ranged from 36 percent in Y_1 to a high of 39.6 percent in Y_4, rising to 40 percent in Y_6, and then decreasing to 34.3 percent in Y_7. But in effect, the banks separate the reserve component, and calculate their liquidity net of reserve deposits with CBT and T-bills on the asset side. On the liability side, 85 percent of all the deposit liabilities are taken as the required liquidity base. This liquidity ratio, net of reserve requirements, provides the bank

with a better gauge of their liquidity position. This "net" liquidity ratio ranged between 16-17 percent through Y_1-Y_6, and then dropped 11.3 percent in Y_7.

6.30 Given this system, the impact of changes in the liquidity ratio by itself was not significant. Banks have always maintained higher liquidity levels than needed, on top of cash and required reserves. Therefore, raising the composite liquidity ratio indirectly through reserve requirements did not serve the purpose of controlling inflation or reducing the pressure on exchange rates during the crisis years. The CBT, therefore, resorted to direct liquidity controls. In the first round, in late Y_6, the CBT ordered the banking system to recall all loans secured through foreign currency collateral in overseas accounts. These loans were the major source of round-tripping in the parallel market by speculators who made large profits as the Siwat depreciated in the parallel market. However, this did not stop speculation and round-tripping. Therefore, in early Y_7, the government froze **all** deposits of the public sector with the banking system, which traditionally were about 23 percent of the total deposits of the banking system. Such a large and sudden freeze created a liquidity squeeze and the inter-bank rate shot-up to 19 percent in Y_7. This decision was aimed to stop the banks from using public-sector deposits to finance the speculative private sector borrowings, trade financing, and foreign exchange transactions. This was to induce the banks to reduce overdrafts and increase their efforts to mobilize deposits, or to cut back on their overall credit levels.

6.31 In view of the experience of the early years and given the premia on being liquid on a routine basis in a financial system like Tusania, the banking system had built up substantial liquidity levels by Y_5. In Y_6 the CBT ordered banks to hold stabilization securities and proceeded forthwith to debit the accounts of banks holding large liquid funds. The rate offered on the stabilization securities was tied to Treasury Bills rate at around 7 percent. The CBT declared that the holdings of stabilization securities was mandatory. They were non-negotiable and non-transferable for a 90-day maturity period. In effect, it amounted to a forced transfer

of financial resources from the banking system to the public sector at below-market cost. The objectives of the policy were plausible, however, the implementation was not undertaken in an orderly manner; rather, in an abrupt fashion. The result was that a good number of banks, including some major ones, were caught in a liquidity crisis in late Y_6 through early Y_7. The CBT had no choice but to extend the required liquidity to those banks severely affected by these controls to prevent their collapse. During mid-Y_7, the CBT extended credit facilities to these banks in difficult liquidity positions totaling ST40 billion, as lender of the last resort. Of these banks, two state commercial banks were not only illiquid but were also technically insolvent.

6.32 These direct liquidity control measures did have a noticeable impact during the early part of Y_7. Commercial banks began to apply brakes on banking credit and intensified their loan recall on overdraft accounts. At the same time, commercial banks began pulling away from medium-term investment types of loans and started selling T-bills and other government papers in excess of their reserve requirements. As a result, bank's holdings of T-bills decreased from ST47 billion in Y_6 to ST40 billion at the end of Y_7.

6.33 These measures succeeded in dampening speculation, inflationary and exchange rate pressures. However, this was achieved at the great cost of starving the productive sector – the economically efficient borrowers – of banking credit. It allowed the less efficient borrowers, traders, speculators and the public sector, to ride out the crisis. With one hand, the government pulled out banking liquidity and credit from the system, and with the other hand, the government was forced to re-inject liquidity into the banking system. In the process, it further distorted credit allocation to the real sectors. The interest-rate increase prevented the productive sectors from sustaining their operations, as they could no longer afford new banking credit. Only the high turn-over businesses could afford access to banking credits. These trends did not help to revive an already sagging economy, and the entire burden of adjustment fell upon direct controls on credit, discussed in the next chapter.

ANNEX VI - Exhibit 1

MONETARY AGGREGATES

MONEY SUPPLY (M_1)
- Currency in Circulation
- Demand Deposits

QUASI MONEY (Time Deposits)

MONEY SUPPLY (M_2)=(M_1 + QUASI MONEY)
- M3=M2 + Other Liabilities of Deposit Banks

RESERVE MONEY
- Currency in Circulation
- Reserve of Deposit Money Banks

CREDIT TO DOMESTIC ECONOMY (Net)
- Private Sector
- Public Sector

NET FOREIGN ASSETS
- Foreign Liabilities
- Foreign Assets

RATIOS
- M_1/GDP
- M_2/GDP
- M_3/GDP (financial deepening)
- Currency/GDP
- Private Sector/Total Credit
- Public Sector/Total Credit

TARGET RATES
- Money Supply (M_1)
- Credit To Domestic Economy (Net)
- Private Sector
- Public Sector

ANNEX VI - Exhibit 2

ASSETS AND LIABILITIES OF THE CENTRAL BANK

TOTAL ASSETS

1. Foreign Assets
   - Gold
   - Foreign exchange
   - Holdings of SDR
   - Contribution to IMF:
     - Gold
     - Foreign exchange
     - SDR
2. Local Currency Contribution to IMF
3. Claims on Central Government
   - Balance at provincial treasuries
   - Treasury bills
   - Government bonds
   - Loans and rediscounts for OFCIs
   - Coins in issue department
4. Claims on Private Financial Institutions
   - Rediscounts
   - Government bonds
5. Other assets

TOTAL LIABILITIES

1. Notes in circulation
2. Deposits
   - Central government
   - Counterpart funds
   - Private sector
   - Commercial banks
   - Government savings bank
   - Others
3. Allocations of SDRs (IMF)
4. Liabilities to IMF
5. Bilateral swap arrangement (CB guarantees)
6. Capital accounts
7. Other liabilities

ANNEX V - Exhibit 3

LIQUIDITY OF COMMERCIAL BANKS

TOTAL LIQUID ASSETS

- Vault cash
- Balances with Central Bank
- Inter-bank balances and call money (net)
- Treasury bills
- Treasury certificates
- Other liquid assets

TOTAL DEPOSIT LIABILITIES

LIQUID ASSETS (as percent of total deposit liabilities)

- Vault cash
- Balances with Central Bank
- Inter-bank balances and call money (net)
- Treasury bills
- Treasury certificates
- Other liquid assets

ANNEX VI *Table 6-1 Prices and Interest Rates*

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
				(per cent)			
Prices, Annual Increase (%)							
Cost of Living	9.1	10.9	12.2	15.6	21.3	24.5	22.4
Food Prices	6.0	7.5	9.2	11.7	15.8	18.1	16.1
Wholesale Prices	7.3	8.7	10.1	12.9	17.6	19.3	18.2
GDP deflator	6.0	7.0	8.0	11.6	16.2	19.7	15.3
Indices Yo = 100							
CPI	109.1	121.0	135.8	156.9	190.4	237.0	290.1
Food	106.0	114.0	124.4	139.0	161.0	190.1	220.7
Wholesale	107.3	116.6	128.4	145.0	170.5	203.4	240.4
GDP Deflator	100.0	107.0	115.6	129.0	149.9	179.5	207.0
Interest Rates							
CBT Lending Rates (%)							
T-Bills Rediscount	6.0	6.0	6.0	6.5	6.5	7.0	7.5
Medium-Term Credits	8.0	8.0	8.0	8.5	9.0	9.5	9.5
Priority Credits	7.5	7.5	7.5	8.0	8.5	9.0	9.0
Banking System Lending Rates (%)							
General Rate - Overdrafts	9.5	9.5	10.0	10.5	11.5	12.5	13.0
Short-term credits	11.0	11.0	11.5	12.5	13.0	14.5	15.0
Medium-term Credits	12.0	12.0	12.0	13.0	14.5	16.0	16.5
Inter-bank call money	14.0	14.0	15.0	16.5	17.4	18.5	19.0
Prime Rate	9.0	9.0	9.5	10.0	10.7	11.7	12.2
Banking System Deposit Rates (%)							
Savings Accounts							
0 - 3 months	2.5	2.5	2.5	3.0	3.0	3.5	3.5
3 - 6 months	3.0	3.0	3.0	3.5	3.5	4.5	4.5
6-12 months	4.0	4.0	4.0	4.5	4.5	5.5	5.5
2 - 3 years	5.5	5.5	5.5	6.5	6.5	7.0	7.5
Money Markets, CDs							
0 - 3 months	2.7	2.7	2.7	3.5	3.5	4.0	4.5
3 - 6 months	3.4	3.4	3.4	3.8	3.8	5.0	5.2
	Average Annual Growth Rates						
	Y_1-Y_7	Y_1-Y_4	Y_4-Y_7	Y_5-Y_7			
Rates of Inflation							
Cost of Living	17.7%	12.9%	22.7%	23.4%			
Food	13.0%	9.5%	16.7%	17.1%			
Wholesale	14.4%	10.6%	18.4%	18.7%			
GDP Deflator	12.9%	8.9%	17.1%	17.5%			

ANNEX VI *Table 6-2 Monetary Survey (1 of 2)*

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
			(ST billions, end of period)				
Money supply (M_1)	**251**	**271**	**298**	**338**	**401**	**490**	**587**
Currency	116	126	138	155	182	221	267
Demand deposits	135	145	160	183	219	269	320
Quasi Money	64	72	84	97	112	129	145
M_2 = M_1+Quasi Money	**315**	**343**	**382**	**435**	**513**	**619**	**732**
Reserve Money	**139**	**151**	**164**	**188**	**223**	**270**	**330**
BankSys Reserves	25	26	30	36	45	54	62
Currency	107	116	124	141	165	199	249
Reserves of other FinIns	7	9	10	11	13	17	19
Annual Growth Rates (%)							
Money supply (M_1)	6.8	8.0	10.0	13.4	18.6	22.2	19.8
Currency	8.2	8.6	9.5	12.3	17.4	21.4	20.8
Demand Deposits	7.1	7.4	10.3	14.4	19.7	22.8	19.0
Quasi Money	11.4	12.5	16.7	15.5	15.5	15.2	12.4
M_2 = M_1+Quasi Money	8.9	8.9	11.4	13.9	17.9	20.7	18.3
Reserve Money	8.4	8.6	8.6	14.6	18.6	21.1	22.2
BankSys Reserves	4.0	4.0	15.4	20.0	25.0	20.0	14.8
Reserves of other FinIns	11.2	28.6	11.1	10.0	18.2	30.8	11.8
Shares, Ratios (%)							
M_1 / GDP	19.6	19.2	18.9	18.7	18.7	18.8	19.5
M_2 / GDP	24.6	24.3	24.3	24.1	23.9	23.8	24.3
Currency / GDP	9.1	8.9	8.8	8.6	8.5	8.5	8.9
Effective RR	23.8	23.6	23.7	25.8	27.0	26.9	27.4
			(ST billions, end of period)				
Total FinSys Credit	**321**	**361**	**410**	**467**	**538**	**665**	**798**
to: Private Sector	**153**	**176**	**201**	**228**	**257**	**282**	**312**
to: Public Sector	**168**	**185**	**209**	**239**	**281**	**383**	**486**
by Central Bank	114	123	134	148	176	255	319
by ComBanks	26	31	39	44	50	60	68
by Other Banks (DFI'	28	31	36	47	55	68	99
Annual Growth Rates (%)							
Total Credit	10.6	12.5	13.6	13.9	15.2	23.6	16.2
to: Private Sector	13.8	15.0	14.2	13.4	12.7	9.7	10.6
to: Public Sector	10.0	10.1	13.0	14.4	17.6	36.3	26.9
Central Bank	5.9	7.9	8.9	10.4	18.9	44.9	21.2
ComBanks	13.6	14.0	15.0	11.2	10.9	12.5	9.1

ANNEX VI *Table 6-2 Monetary Survey (2 of 2)*

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Total Deposits of FinSystem	**199**	**217**	**244**	**280**	**331**	**398**	**465**
Demand Deposits	135	145	160	183	219	269	320
Time and Savings Deposits	64	72	84	97	112	129	145
Total BankSys Deposits	191	211	235	269	319	384	439
ComBanks Deposits	184	202	224	255	305	365	417
Annual Growth Rates (%)							
Deposits of FinSystem	8.7	9.0	12.4	14.8	18.2	20.2	16.8
BankSys Deposits	9.3	10.5	11.4	14.5	18.6	20.4	14.3
ComBanks Deposits	9.1	9.8	10.9	13.8	19.6	19.7	14.2
	(ST billions, end of period)						
GDP (current)	1280	1413	1575	1806	2149	2604	3010

Average Annual Growth Rates

	Y_1-Y_7	Y_1-Y_4	Y_4-Y_7	Y_5-Y_7
Money supply (M_1)	15.2%	10.4%	20.2%	21.0%
Currency	14.9%	10.1%	19.9%	21.1%
Demand deposits	15.5%	10.7%	20.5%	20.9%
Quasi Money	14.6%	14.9%	14.3%	13.8%
M_2 = M_1+Quasi Money	15.1%	11.4%	18.9%	19.5%
Reserve Money	15.5%	10.6%	20.6%	21.6%
BankSys Reserves	16.3%	12.9%	19.9%	17.4%
Reserves of other FinIns	18.1%	16.3%	20.0%	20.9%
Total FinSys Credit	16.4%	13.3%	19.6%	21.8%
to: Private Sector	12.6%	14.2%	11.0%	10.2%
to: Public Sector	19.4%	12.5%	26.7%	31.5%
by Central Bank	18.7%	9.1%	29.2%	34.6%
by ComBanks	17.4%	19.2%	15.6%	16.6%
by Other Banks (DFI's)	23.4%	18.8%	28.2%	34.2%
Total Deposits of FinSystem	15.2%	12.1%	18.4%	18.5%
Demand Deposits	15.5%	10.7%	20.5%	20.9%
Time and Savings Deposits	14.6%	14.9%	14.3%	13.8%
Total BankSys Deposits	14.9%	12.1%	17.7%	17.3%
ComBanks Deposits	14.6%	11.5%	17.8%	16.9%

ANNEX VI *Table 6-3 Summary Accounts, CBT (1 of 2)*

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Total Assets	**159**	**174**	**192**	**220**	**259**	**349**	**432**
Foreign Assets (Net)	9	12	16	23	32	43	54
Other assets	36	39	42	49	51	51	59
CBT Domestic Credit (Net)	***114***	***123***	***134***	***148***	***176***	***255***	***319***
Public Sector	102	108	112	121	146	236	296
Government	90	91	90	96	112	182	224
SEs and Others	12	17	22	25	34	54	72
Others	12	15	22	27	30	19	23
Total Liabilities	**159**	**174**	**192**	**220**	**259**	**349**	**432**
Currency	116	126	138	155	182	221	267
Reserves of ComBanks	25	26	30	36	45	54	62
Other Reserves	7	9	10	11	13	17	19
Other Liabilities	11	13	14	18	19	57	84
	Memo Items						
Reserve Money	**139**	**151**	**164**	**188**	**223**	**270**	**330**
BanSys Deposits	25	26	30	36	45	54	62
Currency, non-bank public	107	116	124	141	165	199	249
Reserves of other FinIns	7	9	10	11	13	17	19
Arrears and Reschedulings	0.0	0.0	0.0	18.8	77.3	154.8	177.6
Arrears Due (-)	0.0	0.0	0.0	13.0	43.0	99.0	110.0
Balance (new liabilities)	0.0	0.0	0.0	5.8	34.3	55.8	67.6
Annual Growth Rates (%)							
Total Assets	9.2	9.4	10.3	14.6	17.7	34.7	23.8
Domestic Credit	6.1	7.9	8.9	10.4	18.9	44.9	25.1
To: Public Sector	3.6	5.9	3.7	8.0	20.7	61.6	25.4
Government	1.0	1.1	-1.1	6.7	16.7	62.5	23.1
SEs and Others	28.3	41.7	29.4	13.6	36.0	58.8	33.3
Total Liabilities	9.2	9.4	10.3	14.6	17.7	34.7	23.8
Currency	8.5	8.6	9.5	12.3	17.4	21.4	20.8
Reserves of ComBanks	6.0	4.0	15.4	20.0	25.0	20.0	14.8

ANNEX VI *Table 6-3 Summary Accounts, CBT (2 of 2)*

Average Annual Growth Rates

	Y_1-Y_7	Y_1-Y_4	Y_4-Y_7	Y_5-Y_7			
Total Assets	18.1%	11.4%	25.2%	29.1%			
Foreign Assets (Net)	34.8%	36.7%	32.9%	29.9%			
Other Assets	8.6%	10.8%	6.4%	7.6%			
CBT Domestic Credit (Net)	18.7%	9.1%	29.2%	34.6%			
Public Sector	19.4%	5.9%	34.7%	42.4%			
Government	16.4%	2.2%	32.6%	41.4%			
SEs and Others	34.8%	27.7%	42.3%	45.5%			
Others	11.5%	31.0%	-5.2%	-12.4%			
Total Liabilities	18.1%	11.4%	25.2%	29.1%			
Currency	14.9%	10.1%	19.9%	21.1%			
Reserves of ComBanks	16.3%	12.9%	19.9%	17.4%			
Other Liabilities	40.3%	17.8%	67.1%	110.3%			
	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(US$ millions, end of period)						
Foreign Finance							
Short-Term Inflows (net)	714	812	805	432	163	80	51
Suppliers Credit	115	167	178	98	57	35	31
Banker's Acceptances	72	87	96	67	38	24	12
fCDs ($$,net)	527	558	531	267	68	21	8
Negotiated Foreign $$ Credit	0	0	0	133	178	267	345
Rolled over Debt	0	0	129	257	177	102	81
Arrears and Reschedulings	0	0	0	230	910	1682	1741
Arrears Due bop	0	0	0	159	506	1076	1078
Balance (new $$ liabilities)	0	0	0	71	404	606	663
Official Exchange Rate	*80*	*80*	*82*	*82*	*85*	*92*	*102*
	(ST billions, end of period)						
Foreign Finance							
Foreign Assets (Net)	9	12	16	23	32	43	54
Short-Term Inflows (net)	57.1	65	66	35.4	13.9	7.4	5.2
Suppliers Credit	9.2	13.4	14.6	8	4.8	3.2	3.2
Banker's Acceptances	5.8	7	7.9	5.5	3.2	2.2	1.2
fCDs (net)	42.2	44.6	43.5	21.9	5.8	1.9	0.8
Negotiated Foreign Credit	0	0	0	10.9	15.1	24.6	35.2
Rolled over Debt	0	0	10.6	21.1	15	9.4	8.3
Arrears and Reschedulings	0	0	0	18.8	77.3	154.8	177.6
Arrears Due (-)	0	0	0	13	43	99	110
Balance (new liabilities)	0	0	0	5.8	34.3	55.8	67.6

ANNEX VI *Table 6-4 Reserve Requirements*

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
		(Per Cent)					
Required Reserve Ratio, (%)	***20***	***20***	***20***	***22***	***23***	***23***	***24***
Reserve Ratio, ComBanks	***23.7***	***23.7***	***23.9***	***25.8***	***26.9***	***26.9***	***27.3***
	(ST billions, end of period)						
ComBank Deposit Liabilities	**184**	**202**	**224**	**255**	**305**	**365**	**417**
RR Base ~85%	**156**	**169**	**188**	**213**	**253**	**305**	**348**
Required Reserves (amounts)	***31***	***34***	***38***	***47***	***58***	***70***	***84***
of which 40% T-Bills	12	14	15	19	23	28	33
R-Deposit with CBT	19	20	23	28	35	42	50
Excess Reserve Deposit with CB	6	6	7	8	10	12	12
Actual Reserves of ComBanks	**37**	**40**	**45**	**55**	**68**	**82**	**96**
of which:							
Deposited with CBT	25	26	30	36	45	54	62
Reserve of Other Banks	7	**9**	**10**	**11**	**13**	**17**	**19**
Total Reserves of BankSys	**44**	**49**	**55**	**66**	**81**	**99**	**115**

ANNEX VI *Table 6-5 Liquidity of Commercial Banks*

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Total Assets of ComBanks	**237**	**272**	**311**	**347**	**403**	**461**	**527**
Total Liquid Assets	**66**	**73**	**84**	**101**	**120**	**146**	**143**
Cash in Vault	9	10	12	14	17	22	18
Total T-bills	18	21	22	28	31	37	37
T-Bills for Reserves	12	14	15	19	23	28	33
T-Bills for Liquidty	6	7	7	9	8	9	4
InterBank Call money (net)	4	4	5	5	6	7	5
Balances with CBT	25	26	30	36	45	54	62
Others (TCs, ComBills)	10	12	15	18	21	26	21
ComBank Deposit Liabilities	**184**	**202**	**224**	**255**	**305**	**365**	**417**
Demand Deposits	124	134	146	165	201	249	288
Time and Savings Deposits	60	68	78	90	104	116	129
Liquidty Net of RR	29	33	39	46	52	64	47
RR liquidity	37	40	45	55	68	82	96
Total Liquid Assets	***66***	***73***	***84***	***101***	***120***	***146***	***143***
Liquidity and other Ratios (%)							
Liquidity Ratio (LR)	35.9	36.1	37.5	39.6	39.3	40	34.3
Cash R on all Deposits	4.9	5	5.4	5.5	5.6	6	4.3
Cash R on DDs only	7.3	7.5	8.2	8.5	8.5	8.8	6.3
Liquidty net of RR	15.8	16.3	17.4	18	17	17.5	11.3
Liquid Assets/Total Assets	27.8	26.8	27	29.1	29.8	31.7	27.1
Annual Growth Rates (%)							
Total Liquid Assets		10.6	15.1	20.2	18.8	21.7	-2.1
Cash in Vault		11.1	20	16.7	21.4	29.4	-18.2
Total T-bills		16.7	4.8	27.3	10.7	19.4	0
Balances with CBT		4	15.4	20	25	20	14.8
Others (TCs, ComBills)		20	25	20	16.7	23.8	-19.2

Memo Items

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
		(ST billions, end of period)					
LR calculations on 85% of Deposit Liabilities							
LR Base ~85%	**156**	**169**	**188**	**213**	**253**	**305**	**348**
Liquidity Ratio (%)	**42.3**	**43.2**	**44.7**	**47.4**	**47.4**	**47.9**	**41.1**
Liquidty net of RR	18.6	19.5	20.7	21.6	20.6	21	13.5

CHAPTER VII

THE CREDIT SYSTEM, GROWTH AND ALLOCATION

7.1 The government has intervened extensively in the allocation of financial resources in Tusania through an elaborate system of directed credit operated by the banking system. Under this system, both the allocation and pricing of credit are controlled to influence the composition of investment. Most governments of both developed and developing economies intervene in the allocation of financial resources, directly or indirectly, and Tusania is no exception. These interventions are often justified on the grounds that financial markets are imperfect and do not allocate resources to the sectors with the highest rates of return, and even if they do, the allocation is not consistent with development, equity, or social objectives. In Tusania the degree of intervention has lessened over the years, but three issues remain: first, how justified are the interventions in the process of allocation; second, how rational are the criteria of allocation, that is, are they intrinsically consistent and not at cross purposes; and third, whether the allocation system and control mechanisms have achieved the objectives set forth – the litmus test of directed credit arrangements.

7.2 The above mentioned issues are central to the financial system.. They also have significant implications for productive sectors – agriculture, industry, exports and others – to which financial resources are being directed through the credit allocation mechanism. Typically, the growth policies dictating priorities of development would occasionally designate some of these sectors as priority sectors,

based on a host of considerations such as self-sufficiency, employment generation, regional development, and the promotion of indigenous industries. Often the problems of financing investments in priority sectors originate outside the financial system and policies. These concern an incentive regime that motivates production and investment in the economy. But when distortions arise from the incentive regime, financial policies are used to compensate and redirect financial flows to productive sectors. In some cases, however, such compensatory packages strengthen the distortions at the source and weaken the financial system. The appropriateness of the incentive regime prevailing in the productive sectors affects both real and financial resource flows. They are also affected by growth and distribution policies. These linkages are sometimes only vaguely understood, and they are often compromised in the process of policy formulation to accommodate conflicting interests.

7.3 Overlapping these considerations are the exigencies of macro-financial management, which become the over-riding objectives as happened during the crisis years in Tusania. The authorities, and especially the Central bank, then have the even more difficult task of accommodating the objectives of monetary control, price stability, and liquidity management, with growth and distribution objectives. In the case of Tusania, monetary control concerns dominated during the crisis years, but the attempt to maintain certain desired levels of credit to priority sectors introduced yet another layer of distortion into the credit system. This compounded the difficulties of monetary control as well as the revival of economic activity, as happened during Y_5-Y_7 of the review period.

The Intervention Mechanism

7.4 The intervention mechanism involves differential interest rates, sectoral and regional credit targets, direct allocations, and use of specialized financial institutions, such as the DFIs. Interest rate controls encourage investment at low rates of return,

reliance on imports, capital-intensive technology and discourage financial savings. Faced with rationed credit, banks lend to prime borrowers and pre-empt others, which is commonly interpreted as market imperfection. Both of these phenomena are the outcome of the directed credit system. Further, as discussed in Chapter VIII, the financial markets in Tusania are at a preliminary stage of development, display many elements of market imperfection, and are not able to allocate resources to the sectors with potentially higher financial returns, much less to those sectors whose development is considered socially and economically desirable. Therefore, the issue is not whether the government should or should not interfere in the market mechanism. It is, rather, the mode and the extent to which the government should intervene. Almost all of the directed credit-system intervention techniques common to other countries are used in Tusania with varying degrees. Among the developing economies, Tusania has historically used a more rigid credit allocation mechanism. Only now are attempts being made to soften the impact of the credit regime.

7.5 In late Y_5, as part of the economic program, the Tusanian government adopted a more market-oriented approach for the financial sector. The number of priority sectors for mandatory credit allocations was reduced, interest rate controls were selectively lowered, and banks were allowed to charge final borrowers closer to what the market will bear. The general level of interest rate is, however, still influenced by CBT's moral suasion, guidelines, buying and selling of T-bills, and other government securities, at well below the current deposit rates, as discussed in Chapter VI. The CBT credit ceilings for individual banks limit incentives for banks to mobilize additional deposits. The banks are constrained by their lending ceilings, and there is no reason to go all-out to raise deposits beyond the lending levels set forth by the CBT. During the past decade, the financial system has slowly been liberalized. The control mechanisms of the pre-reform period have been retained, although not as elaborately as before.

The Layered System of Credit

7.6 There are overlapping sets of rules and requirements intended to regulate the banking credit system in Tusania - both at the aggregate level as well as at the sectoral level - and at the enterprise level by ownership. This layered system of credit allocation has been simplified over the past years but a good deal of the old system still survives (*see box*). There are several ***layers*** of control; some are contained in the banking law, others are specified in the annual monetary program, and a good number are specified in the directives periodically issued by the CBT.

Box 7.1 Layered System of Credit Allocation

At the Macro-Financial Level (First Layer)

i. **Economy: the Aggregate Level**

ii. **Broad Categories of *USERS*;**
- the public sector
- the private sector

iii. **Broad Categories of *SUPPLIERS;***
- the Central bank
- the commercial banks
- the DFI's

At the Sectoral Level (Second Layer)

i. **Priority sectors:**
- priority sector
- non-priority sector

ii. **Broad sectoral targets:**
- agriculture
- exporting
- manufacturing and others

At the Micro-Level (Third Layer) Enterprises and Borrowers
- groups of borrowers, indigenous
- types of enterprises, SMEs

7.7 In **summary**, the system of regulating growth and allocation of banking credit is as follows:

First, at the aggregate level, the annual monetary program, released together with the budget, specifies growth targets for credit to the economy, both by the banking system and the CBT, in addition to its distribution among public and private sectors. In order to control the rate of growth of domestic credit, at the beginning of each year the CBT sets a ceiling on the amount of bank credit for all banks. The ceiling is expressed in terms of a percentage increase in bank credit over the preceding year's level. The CBT enforces the credit expansion by requiring the banks to submit a monthly report on their loan activities and by imposing penalties when they violate the ceiling.

Second, the CBT stipulates ceilings on credit expansion by commercial banks and DFIs, both as a group and individually.

Third, at the sector level, the CBT specifies bank-by-bank credit ceilings for priority sectors, whose composition has been changing over time.

Fourth, the CBT requires that each bank maintain a minimum credit allocation of 70 percent to indigenous borrowers, 20, percent of which should be reserved for small and medium-scale enterprises (SMEs) owned by Tusanians. The distribution of the 20 percent among such SMEs is based on their annual business turnover, and is classified in an ascending order of distribution starting from 20 percent of the turnover.

Fifth, credit guidelines require that a minimum of 50 percent of loans and advances of specialized banks, the DFIs, should be of medium to long-term with a maturity of one to five years and a maximum of 20 percent with short-term maturity.

Sixth, commercial banks must maintain a minimum cash deposit with the CBT as default penalty on credit targets, which ranges from 2 to 3 percent of total deposit liabilities in addition to the required reserves.

Seventh, commercial banks must lend to rural borrowers a minimum of 45 percent of the total deposits mobilized by their rural branches within the regions, in addition to an 8 percent regional credit target stipulated at the aggregate level.

7.8 In addition to the regular credit guidelines contained in the annual monetary circular which banks must adhere to during the year, the CBT issues directives during the course of the year affecting liquidity, such as public sector deposit transfer and

mandatory purchase of short-term money market instruments. These directives affect both resource mobilization and allocation patterns, but in general their foremost impact is on credit flow and its allocation, thus affecting trade, investment, and general economic activity.

Effectiveness of the Credit Guidelines

7.9 Taken together, these guidelines represent stringent controls on the banking system in the allocation of credit. The penalties for noncompliance are severe. By and large the banking system does comply because banks do not want to lose their access to CBT or incur penalties, except in cases where the penalties for non-compliance would be larger than the loss incurred in carrying out the instructions. Non-compliance may lead the CBT to debit the account of the financial institutions, which may require inter-bank call money borrowings, loss of liquidity, or worse, barring the bank from access to the foreign exchange auction system of the CBT. These penalties impose an implicit tax on profits, and the banking system treats it that way. For example, if the lending to small farmers, SMEs, or to rural borrowers - all designated priority status - is perceived to cause loan losses without recourse to a meaningful recovery, the banks may prefer not to lend and thus incur penalties rather than take the credit risk and face loan losses. They would prefer the lesser of two evils. Or, as frequently happens, banks may classify loans which may nominally belong to the desired sector, but for all intents and purposes may be used elsewhere, since there is no way to control the use of funds. The reporting and classification by banks of loans at the retail level has acquired an art form of its own. For CBT officials it is very difficult, almost impossible, to trace the ultimate use of the credit, because banks may be indulging in "creative accounting."

7.10 A review of the banking credit flows at the system level suggests that the layered credit system has not been an effective mechanism for providing a "desirable" allocation of resources to the priority sectors, and the system is very

costly to operate. This had nothing to do with the direction of the policy regime or its appropriateness, rather with the delivery mechanism embedded in the functioning of the banking credit system. The policy objectives of achieving food self-sufficiency or exportable surpluses through modernization of agriculture, or promoting employment through the support of SMEs, or relocating agro-industrial or manufacturing units in the underdeveloped regions, these were all laudable objectives with reasonable popular support. The management of banks as a group is not against it, nor is it the case that they do not subscribe to these objectives. But there are conflicts of interest of major proportions. If the banks are to pursue viable and credit-worthy borrowers, these borrowers are often not to be found in the "priority" sectors, but rather in distributive trading services or in off-balance-sheet activities such as guarantees, leasing, and the non-banking business, in general. If the banks intend to fulfill their obligations under the directed credit system, they have to devote a large number of their trained officers to do lending, credit adjustments and the required paper work. For these reasons, banks circumvent the credit guidelines to the extent they can. This situation remains unchanged, and the credit system remains burdened by the requirements thus imposed.

7.11 For its own part, the CBT has no effective way of enforcing the guidelines, nor does it have the manpower to supervise the system in a meaningful way. Further, the objective of providing financial resources to the priority sectors, whether through the banking system or through the DFIs, has not succeeded in promoting their growth in the face of a seriously distorted relative price structure and a distorted incentive regime. It has adversely affected healthy growth of the financial system and has contributed to financial repression, an increase in implicit taxation of the banking system, and the concentration of lending activities in businesses with quick and guaranteed turnover. Currently, the banking system, especially the DFI, is saddled with a shaky loan portfolio and cannot absorb the full financial cost of a major revamping of relative prices. It will be quite some time before the system fully absorbs these financial losses.

7.12 Therefore, the evaluation of the intervention mechanism has to contend with the criteria that monetary authorities use for credit expansion and allocation and with whether these criteria are internally consistent and rational. The criteria are influenced not only by economic efficiency but also by social and political objectives, the development strategy the government pursues, and short-term objectives of monetary control and stability. Since the government attempts to achieve a multiplicity of conflicting objectives, it is almost impossible to judge the rationale or the optimality of these criteria. There is simply no reliable yardstick to go by. Since data on private capital formation on a sectoral basis is unavailable, it is extremely difficult to design a set of criteria for the sectoral allocation of credit, let alone to justify it. Therefore, the only thing to do is to examine the performance of the system over the past years to see whether the objectives of the government have been achieved, and to identify the problems that have emerged due to these interventions.

Credit Expansion and Monetary Control

7.13 Super-imposed on these considerations are issues of monetary management through credit control mechanisms which over-ride considerations of sectoral needs and growth targets. The enactment of credit expansion in a given year, first and foremost, is based on an assessment of public sector financing needs, needs of the SEs. The next step is to control the expansion of credit to the economy and its allocation to sectors, which is managed through a system of credit ceilings. Experience has shown that enforcement of these ceilings has been difficult, and even when successful, direct credit control does not necessarily enable CBT to meet the target rates of monetary growth . For example, unexpected changes in the balance of payments or the government's budgetary operations could easily frustrate CBT's effort to control the money supply, as happened in Y_5, Y_6, and Y_7, though they may not affect the credit ceiling management. Therefore, while the money supply is the relevant variable used to gauge the direction and stance of monetary policy, direct credit control is more widely used, though it is not a fully reliable instrument. Yet

credit control is the only effective instrument available to Tusanian monetary authorities and was extensively used throughout the review years.

7.14 At the macro-financial level, there was a substantial increase in total domestic credit to the economy during the Y_1-Y_7, growing at an average rate of 16.4 percent per year. There was significant variation, however, during this seven-year period. In the early years, Y_1-Y_4, the rate of average annual increase in total domestic credit was 13.3 percent, and it jumped to 21.8 percent during the Y_5-Y_7 period. Each year, this growth exceeded the annual targets set forth in the government's annual economic program. During Y_1 and Y_2, the target growth for total domestic credit was 10-10.5 percent, and the actual growth was 10.6-12.5 percent. The target rate was raised to 12.0 percent in Y_3, and prevailed through Y_5, while the actual growth was again higher. At the beginning of Y_5, the actual growth of domestic credit began to outstrip the target rate, and in Y_6 actual growth was 23.6 percent measured against a target growth of 18.5 percent. There were some moderating influences in Y_7, yet the overall credit growth of 20 percent in Y_7 was higher than the target growth of 17.5 percent *(for detail, see ANNEX VII, Table 7-1).*

7.15 A closer look at the composition of the credit supply, however, shows interesting differences. The growth rate of credit provided by commercial banks as a group was 12.6 percent per year during Y_1-Y_7, as compared to 12.4 percent during Y_5-Y_7. This was due to the fact that commercial banks' credit expanded faster during the early years at an average rate of 13.4 percent, and then dropped slightly to an average rate of 12.4 percent in later years as the government began to apply the brakes on monetary expansion. This growth was pretty close to the target rates set forth for the commercial banks, never exceeding the target by more than one percentage point largely due to stiff financial penalties. For example, the target rate of increase in the commercial banks' credit was between 11.0-11.5 percent annually during Y_4-Y_7, and the actual rate of increase was between 11.0-12.4 percent per year

Table 7.1 Sources of Credit

	Annual Indicators				Average Annual Growth Rates		
	Y_1	Y_4	Y_6	Y_7	Y_1-Y_7	Y_1-Y_4	Y_5-Y_7
	(ST billions)				*(per cent)*		
Total Domestic Credit	**321**	**467**	**665**	**798**	**16.4**	**13.3**	**21.8**
Central Bank	114	148	255	319	18.7	9.1	34.6
Banking System	195	294	373	432	14.2	14.7	14.9
Commercial Banks	164	239	298	335	12.6	13.4	12.4
Other Banks (DFIs)	31	55	75	97	20.9	21.1	25.1
Non-Bank Institutions	12	25	37	47	25.6	27.7	15.9
Annual Growth Rates	*(per cent)*						
Total Domestic Credit	**10.6**	**13.9**	**23.6**	**20.0**			
Central Bank	5.9	10.4	44.9	25.1			
Banking System	14.6	12.2	14.1	15.8			
Commercial Banks	13.6	11.2	12.5	12.4			
Other Banks (DFIs)	21.0	17.0	21.0	29.3			
Shares							
Total Domestic Credit	**100**	**100**	**100**	**100**			
Central Bank	35.5	31.7	38.3	40.0			
Commercial Banks	51.1	51.2	44.8	42.0			
Other Banks (DFIs)	9.7	11.8	11.3	12.2			
Non-Bank Institutions	3.7	5.4	5.6	5.9			
Credit Targets, Growth Rates							
Total Domestic Credit	10.0	12.0	18.5	17.5			
Central Bank	6.0	10.0	20.0	17.5			
Banking System	12.0	12.0	12.0	12.5			
Commercial Banks	12.5	11.0	11.5	11.5			
Other Banks (DFIs)	16.0	16.0	18.0	20.0			

For details see **Annex VII**, Table 7-1

during the same period. In fact, the actual increase in commercial banks' credit was 10.9 in Y_5 and the target was 11 percent. In an attempt to control total domestic credit expansion, the authorities lowered the target increase in commercial banks' credit during Y_4-Y_7 in comparison with the Y_1-Y_3 years and commercial banks complied with lowered ceilings, keeping credit expansion at the desired levels.

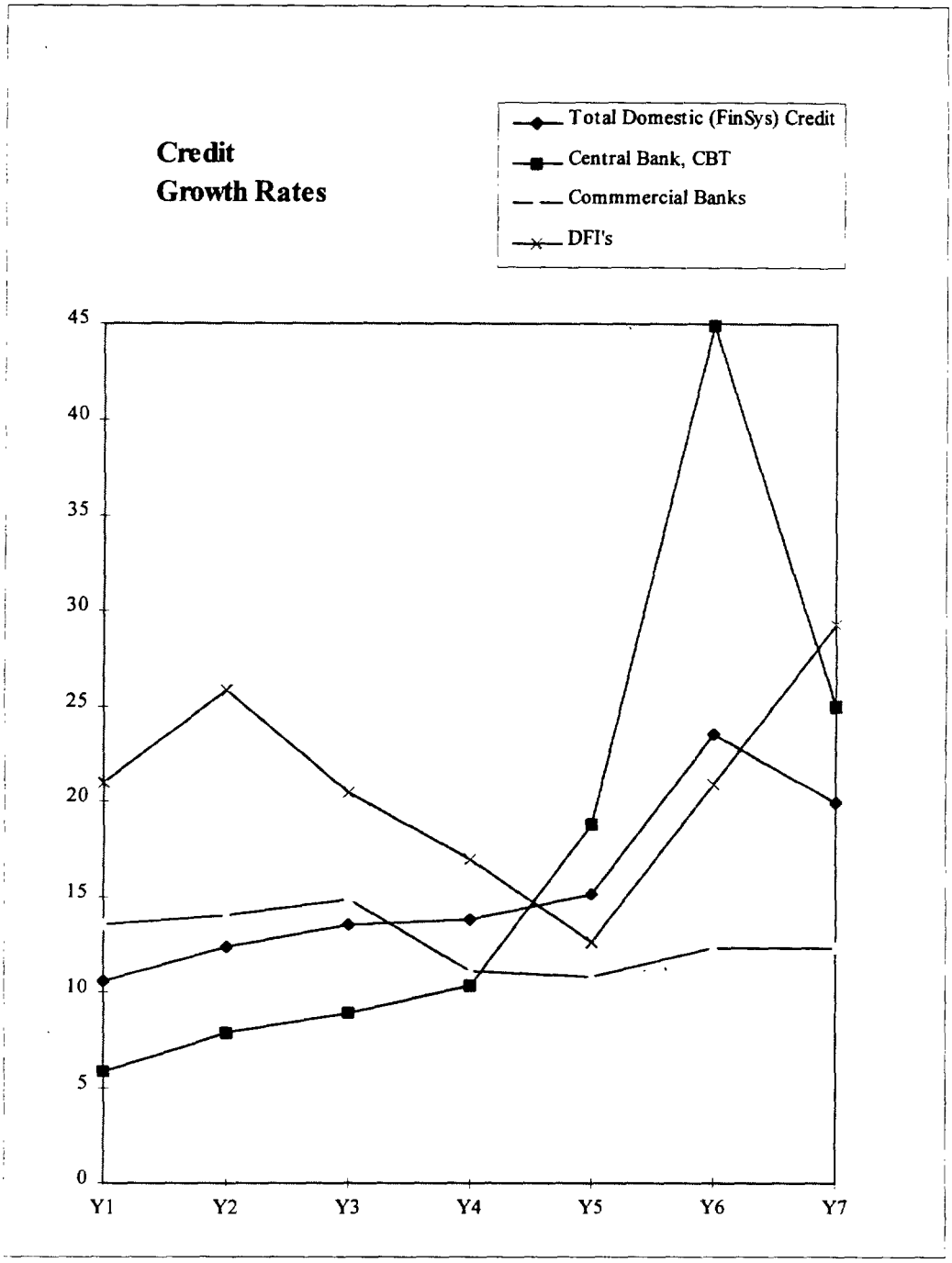
Therefore, the commercial banks - the largest part of the Tusanian banking system - did behave responsibly throughout. They were in line with the credit policies set forth by authorities, whether intended for monetary control and stability, relative expansion of the components of financial system, or sectoral growth.

Credit Operations of the CBT and the DFIs

7.16 Then, what went wrong? In contrast, CBT credit expanded much faster at an average rate of 18.7 percent per year during Y_1-Y_7. The expansion in CBT credit in the early years of Y_1-Y_4 was under control, more or less, at an annual average of 9.1 percent, though higher than intended levels. The targets set forth for these years ranged between 6 percent in Y_1 and 10 percent in Y_4. But starting in Y_5, CBT credit expansion accelerated to 18.9 percent, double the average rate during the previous four years. It then jumped to an uncontrollable level of almost 45 percent during Y_6. In Y_7, when brakes were applied, CBT credit still increased by 25.1 percent - much higher than the target level of 17.5 percent. Thus, the system of targeting credit expansion for monetary control and aggregate demand management failed at the CBT, not in the banking system. The target rate of CBT credit growth is, in any event, to be interpreted as a desired level of credit expansion for the economy, and is non-binding because there are no financial penalties for the CBT to exceed its targets. Since the CBT credit expansion is entirely devoted to financing public sector deficits, as discussed in Chapter IV, the CBT credit operation is more a reflection of the government's command at appropriating financial resources for the public sector in times of financial crunch, rather than a monetary control device.

7.17 Likewise, there was a three-fold increase in credit extended by government-owned financial institutions and the DFI's from ST37 billion in Y_1, to ST97 billion in Y_7. The growth rate of credit of the DFIs as a group was 20.9 percent per year during Y_1-Y_7. In the early years of Y_1-Y_4, the average annual increase was 21.1 percent, and

Chart 7-1


Credit
Growth Rates
Total Domestic (FinSys) Credit
Central Bank, CBT
Commmercial Banks
DFI's
45
40
35
30
25
20
15
10
5
0
Y1
Y2
Y3
Y4
Y5
Y6
Y7

then increased to 25.1 percent per year during Y_5-Y_7. Much of this credit increase by the DFIs was to finance the needs of the SEs, both investment and routine operations, as discussed in Chapter IV. Since the DFIs are not deposit-taking institutions, they are not subject to the routine credit controls by the CBT through reserve and liquidity requirements, as is the case with commercial banks. The DFIs are not chartered as commercial banks under the Banking Act of Tusania, rather, each was founded through a separate provision/decree of the government under a special charter. DFIs report to the Ministry of Finance (MoF) on their financial operations, and deal directly with the operating departments or ministries such as agriculture and industry. The important difference is that they are outside the routine reporting requirement and supervision of the CBT. The DFI's are also stipulated a target rate of credit expansion as part of the CBT's monetary program, but these targets are not mandatory, nor do they carry any financial penalty in case of non-compliance. Therefore, stipulation of credit targets for the DFIs is interpreted by their management more as a guideline than as a compliance requirement.

7.18 As a result, the only binding constraint on the lending operations of the DFIs is their capital base and availability of loanable funds, both of which are provided by the government or the CBT. Government transfers from its budget to the DFIs have been substantial. These transfers are used to increase the capital base of the DFIs, and a large part of it is intended as loanable funds to the SEs. These are almost cost-free funds, because the government charges a nominal rate of 2 to 3 percent on the portion of funds used for lending operations. The DFIs treat these transfers as borrowing from the government, but for all practical purposes these are financial transfers, given the nominal cost and absence of a real liability for repayment. The DFIs, however, borrow funds from the CBT at 2.5 percentage points below the interest rate charged by the CBT for priority credits. Thus, the effective cost of borrowing for the DFIs from the CBT was 5 percent during Y_1-Y_5 and increased to 6.5 percent during Y_6-Y_7. Still, this was substantially below their lending rates to their borrowers, the SEs, pegged to the CBT's medium-term credit rate which was 8

percent during Y_1-Y_3 and rose to 9.5 percent during Y_6-Y_7. Given this rate structure, the DFIs borrow a small amount from the CBT, ranging between 15-20 percent of the funds needed for their lending operations. The DFIs occasionally borrow funds from multilateral institutions and seldom access international financial markets. However, since the foreign borrowings of DFIs are covered by the government's explicit guarantees of both the credit and exchange rate risk, the DFIs do not face the same type of risks as other banks in incurring these liabilities. These DFI borrowings are, in effect, sovereign debt. Therefore DFIs do not face market-based constraints in their lending operations as other banks do.

7.19 The two government-owned banks, the National Bank of Tusania (NBT) and the Savings Bank (SBT), are chartered as commercial banks and are therefore subject to routine credit controls and reserve requirements. Their financial operations, however, are geared to provide for public sector needs, and the size of their operations is relatively small in the overall banking system. Unlike other DFIs, these banks are deposit-taking institutions and offer interest-based accounts, though their lending business is with government activities, SEs, and public organizations. The NBT handles the government's payroll and provides short-term revolving trade financing credits to the SEs, but more importantly, acts as a corespondent bank for other DFIs, handling foreign exchange transactions on their behalf. The SBT is more like a savings society of government employees and has a good deposit base, but it is not involved in retail lending. Instead, the bulk of its funds are lent to the DFIs, or deposited with the CBT.

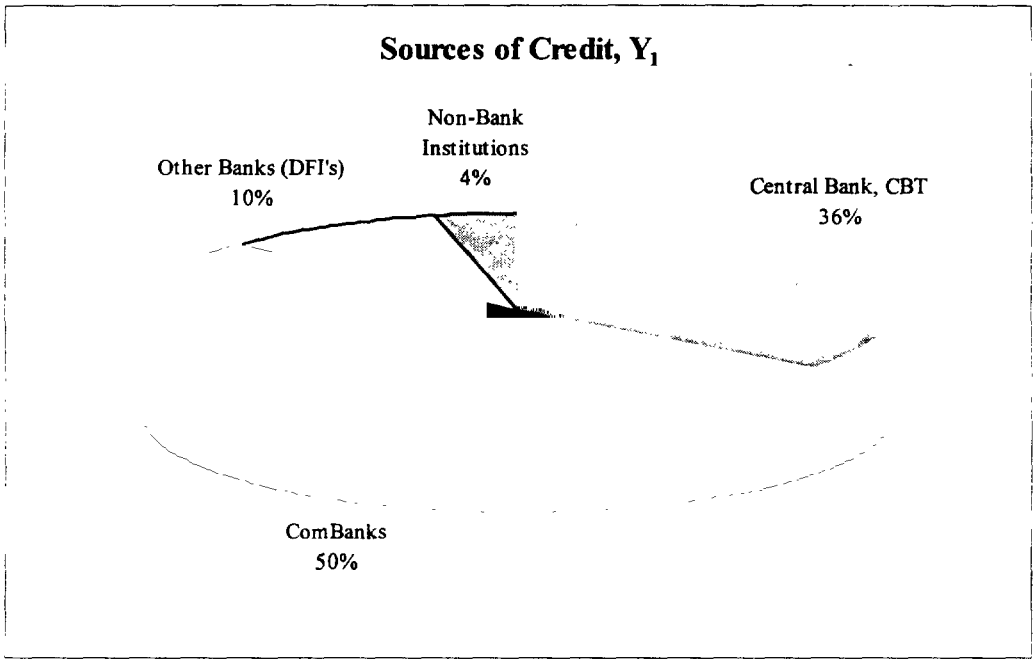
7.20 As a group, the DFI's client base is very different from those of commercial banks. These are basically the SEs, with varying degrees of financial strength, as compared to the financially strong commercial borrowers of the rest of the banking system. Likewise the instruments of lending and the maturity of their outstanding loan portfolio is quite different from those of commercial banks. The bulk of DFI's lending is for 2 to 3 years or even longer, unlike the short-term overdraft lending of

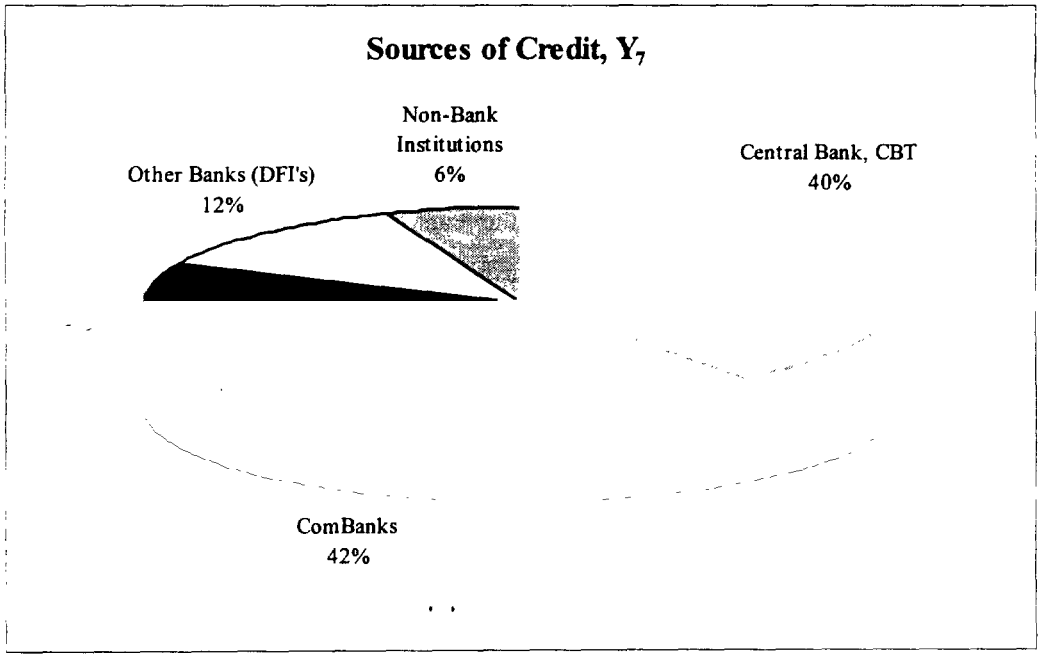
commercial banks. The collateral base of DFI borrowers is also quite different from those of commercial banks. Their financial viability is of varying quality and is rarely recalled in case of loan default. Given these differences in the lending operations of the DFIs as compared with the rest of the banking system, the large credit expansion of the DFIs as a group during Y_1-Y_7 was easily obtained, since it did not have the financial constraints faced by the rest of the banking system.

7.21 These institutional factors concerning the mode of operations of the CBT and the DFIs had a noticeable impact on their relative shares in total domestic credit supply. The relative share of the CBT increased from 35.5 percent in Y_1 to 40 percent in Y_7, and the DFI's share increased from 9.7 percent to 12.2 percent over the same period. This occurred at the expense of the commercial banks' share of credit which decreased from 51.1 percent in Y_1 to 42 percent in Y_7. This pattern of credit growth and changes in relative shares reflects more the prevailing economic conditions rather than prescribed ceilings of the annual monetary program. They are principally affected by the credit to the government on which the CBT has limited control. During the early years, Y_1-Y_4 for instance, the banking system's net claims on the government sector remained fairly stable. This was primarily due to manageable levels of government finances resulting from increases in government revenue coupled with a draw-down of project-based foreign loans. This enabled the government to keep its borrowing from the banking system at moderate levels. However, public sector credit expansion during the late years was driven largely by the needs of SEs to meet the quasi-public sector deficit. In spite of worsening trends during Y_6 and Y_7, the target growth of public sector credit was set at unrealistically low levels - around 18 percent - which simply could not be adhered to given pressures to keep up public sector expenditures.

7.22 These changes in relative shares over such a short period may be regarded as 'stylized events' mainly for illustrative purposes of this case study. Changes like this do occur, although over a longer span, and are regarded as structural changes.

Chart 7-2


Sources of Credit, Y_1
Non-Bank Institutions 4%
Other Banks (DFI's) 10%
Central Bank, CBT 36%
ComBanks 50%


Sources of Credit, Y_7
Non-Bank Institutions 6%
Other Banks (DFI's) 12%
Central Bank, CBT 40%
ComBanks 42%

Further, a reversal of these trends, that is, a reduction in the relative share of the public sector in total credit, is the central element of the transition to a market-based credit system where the banking system begins to respond to indirect controls on credit expansion through changes in the effective costs of credit in a liberalized rate structure – both on lending and the mobilization of loanable funds.

Credit Operations of the Commercial Banks

7.23 In spite of increases in the CBT and DFI's relative shares of the supply of domestic credit, the commercial banks still retained a dominant position in Tusania's financial system. At the end of Y_7, commercial banks held on to a 42 percent share in total credit, most of which was advanced to the private sector. The accounts of commercial banks are given in detail in **Annex VII**, *Table 7-3* and a summary is presented below. As discussed earlier, the average annual growth rate of commercial bank credit in the early years of Y_1-Y_4, was 13.4 percent per year and was higher than the 12.4 percent per year growth during Y_5-Y_7. These figures reflect controls applied to credit expansion during the later years, mainly affecting the private sector, and having a negative impact on the overall economic situation of Tusania. In Y_1, 84.1 percent of commercial bank credit was for the private sector, gradually decreasing to 79.7 percent by Y_7, while the share of public sector credit advanced by commercial banks increased commensurably from 15.9 percent in Y_1 to 20.3 percent in Y_7. The interesting aspect of this pattern is the significant increase in commercial bank credit to the SEs whose share increased nearly three times from 4.9 percent in Y_1 to 14.9 percent in Y_7. This replaced much of the government borrowing from commercial banks, whose share decreased from 11 percent in Y_1 to 5.4 percent in Y_7. The underlying lending mechanism of commercial banks to the SEs and the government is quite different than to the private sector. Commercial banks' loans to SEs are not normally collateralized in the same strict manner as they are for private borrowers. This would pose a severe handicap to commercial banks were they to lend strictly by the book, demanding financially secure collateral, whereas lending to the government

Table 7.2 Summary Accounts of Commercial Banks

	Annual Indicators				Average Annual Growth Rates		
	Y_1	Y_4	Y_6	Y_7	Y_1-Y_7	Y_1-Y_4	Y_5-Y_7
	(ST billions)				*(per cent)*		
Commercial Banks							
Total Assets	**237**	**347**	**461**	**527**	14.2	13.6	14.4
Total Credit	**164**	**239**	**298**	**335**	12.6	13.4	12.4
Private Sector	138	195	238	267	11.6	12.2	11.4
Public Sector	26	44	60	68	17.4	19.2	16.6
Deposit Liabilities	**184**	**202**	**365**	**417**	14.6	11.5	16.9
Demand Deposits	124	134	249	288	15.1	10.0	19.7
Shares		*(per cent)*					
Total Credit	**100.0**	**100.0**	**100.0**	**100.0**			
Private Sector	84.1	81.6	79.9	79.7			
Public Sector	15.9	18.4	20.1	20.3			
Government	11.0	10.0	7.0	5.4			
SEs	4.9	8.4	13.1	14.9			
Ratios							
Deposit/Total Liabilities	77.6	74.3	79.2	79.1			
Credit/Deposit	89.1	92.6	81.6	80.3			
Credits/Assets	69.2	68.8	64.6	63.6			
Capital/Credits	23.8	23.5	21.8	20.9			
Capital/Assets	16.5	16.2	14.1	13.3			

For details see **Annex VII**, Table 7-2

by the commercial banks essentially involves purchasing T-bills or treasury certificates, which can readily be discounted at the CBT. These instruments carry much lower rates of interest than loans to SEs, which carry market rates of interest, nearly twice that of the T-bills. Further, the maturity structure is also much shorter for lending to the government, typically 90-day T-bills, whereas loans to SEs have a longer maturity of one to three years. Therefore, not only did the relative share of credit to the government increase, but the profile on the loans outstanding - the primary assets of commercial banks - changed. The impact of this change on

commercial banks' income statements was positive in accrual terms, owing to higher lending rates, and also on cash inflows, provided that commercial banks could collect repayments from the SEs on their outstanding loan balances. To the extent that a good number of these loans turned out to be non-performing, the net impact on incomes and profits varied from bank to bank.

7.24 As shown by the summary accounts, commercial bank credits constitute the largest proportion of their total assets. This proportion decreased from 69.2 percent in Y_1 to 63.6 percent in Y_7, reflecting both the inability and the unwillingness of commercial banks to conduct lending business at routine levels during the crisis years. The reasons were two-fold. First, as part of the monetary control, the CBT lowered the target rate of credit growth to 11.5 percent during Y_6-Y_7, as compared to 12.5 percent during Y_1-Y_2. At the same time the government froze public sector deposits with commercial banks and it increased reserve requirements from 20 percent in the early years to 23 percent in Y_6 and to 24 percent in Y_7. The result was a severe liquidity crunch on the commercial banks in Y_7, whose liquidity net of reserve requirements dramatically decreased from 17.5 percent in Y_6 to 11.3 percent in Y_7. This was the main reason for slower growth in commercial bank credit. The second reason was, given the premia on being liquid, commercial banks found off-balance sheet activities, especially speculation on foreign exchange markets, much more lucrative than routine lending. They diverted their liquid funds away from credit operations. Yet, they had to maintain a balance in this shift and by the end of Y_7, total credit by the commercial banks managed to increase by 12.4 percent, fairly close to credit expansion in previous years.

7.25 On the commercial banks' consolidated balance sheet, while loans outstanding dominate on the asset side, the other two major items are shareholders funds and reserve deposits with the CBT. The shareholders funds include the commercial banks' subscribed capital and internal reserves built-up over the years of their operations. The overall ratio of shareholders' funds to total assets remained

fairly decent throughout the review years, though there was a decline from a comfortable level of 19.4 percent in Y_1 to a manageable level of 15.7 percent in Y_7. The capital to asset ratio likewise decreased from 16.5 percent in Y_1 to 13.3 percent in Y_7, and from 23.8 percent in Y_1 to 20.9 percent in Y_7. Among these, the ratio of shareholders' funds to total assets has implications for solvency, including other considerations. The capital to credit ratio infringes on lending operations since it is linked with 'headroom' available to the commercial banks. A dip in both these ratios in later years, nevertheless, underscored the need for increasing the capital base of Tusanian commercial banks if they were to sustain their lending levels of early years. Besides, a gearing ratio of one-to-four – the capital to credit ratio – is typically considered acceptable, while a gearing ratio of one-to-five typically denotes a riskier level of lending operations, as was the case in Y_7 in Tusania.

7.26 Commercial banks' total reserve deposits consisting of the required reserves and excess reserves, as discussed in the preceding chapter, increased owing to the higher reserve requirements. As a result, the ratio of these deposits to total assets increased from 10.5 percent in Y_1 to 11.8 percent in Y_7. These are basically blocked funds of the commercial banks, and represent an income penalty from the point of the commercial banks' income statement. From the vantage point of monetary control, however, these deposits are part of the reserve money or high-powered money and, as such, contribute to overall monetary growth. How much net impact these two opposing factors have on credit expansion can be gauged by changes in the rate of credit growth of the commercial banks. In Tusania's case, the net impact was negative as desired by the CBT in its efforts to control overall monetary growth during the crisis years.

7.27 On the funding side, commercial banks' deposits provide the base for lending operations in Tusania, as in any other country. Other sources of funding like borrowings from the financial markets, are much smaller and are rarely used for lending operations because of the relative cost of funds. There was a major increase

in commercial banks' deposits as the rate of growth of deposits nearly doubled from 9.4 percent in Y_1 to 19.7 percent during Y_5 and Y_6. It then decreased to 14.2 percent in Y_7, still significantly above the rate of increase in early years. A good part of the deposits were blocked as reserve funds. The banks had to supplement their lending base, partly from the shareholders' funds and in small part from borrowings, both domestically and from overseas such as bankers' acceptances in early years. Later on, when Tusania was declared off-cover by international financial markets, bankers' acceptances and foreign borrowings of Tusanian commercial banks nose-dived to negligible levels. Domestically, given the state of Tusania's financial markets, commercial banks' borrowings are fairly small for various reasons, as discussed in Chapter VIII. They are limited to negotiable commercial papers of 50 to 60 days, but these are supplemental to trade financing activities of businesses more than they are a source of funds to commercial banks for their overall lending operations.

Credit Allocation and Sectoral Finance

7.28 At the macro-financial level, we have already discussed credit allocation and usage in other contexts. To recapitulate briefly, first we need to look at credit allocation between public and private sectors. From an allocation point of view, the rate of increase of the public sector credit was 19.4 percent per year during Y_1-Y_5, as compared to 12.6 percent for the private sector over the same period. Moreover, the growth of private sector credit from all sources was 14.2 percent during the early years of Y_1-Y_4, and decreased to 10.2 percent during the crisis years of Y_6-Y_7, closely reflecting the trends of commercial bank credit previously discussed. Just the opposite happened with regard to the growth of credit to the public sector from all sources. During the early years of Y_1-Y_4, this average growth rate was 12.5 percent per year and then jumped to a 31.5 percent per year during Y_6-Y_7. As a result of these disparate trends, the share of private sector credit in total domestic credit extended by the financial system decreased from 47.7 percent in Y_1 to 39.1 percent in Y_7. In a mirror-image fashion, the share of credit to the public sector increased from

Table 7.3 Uses of Credit

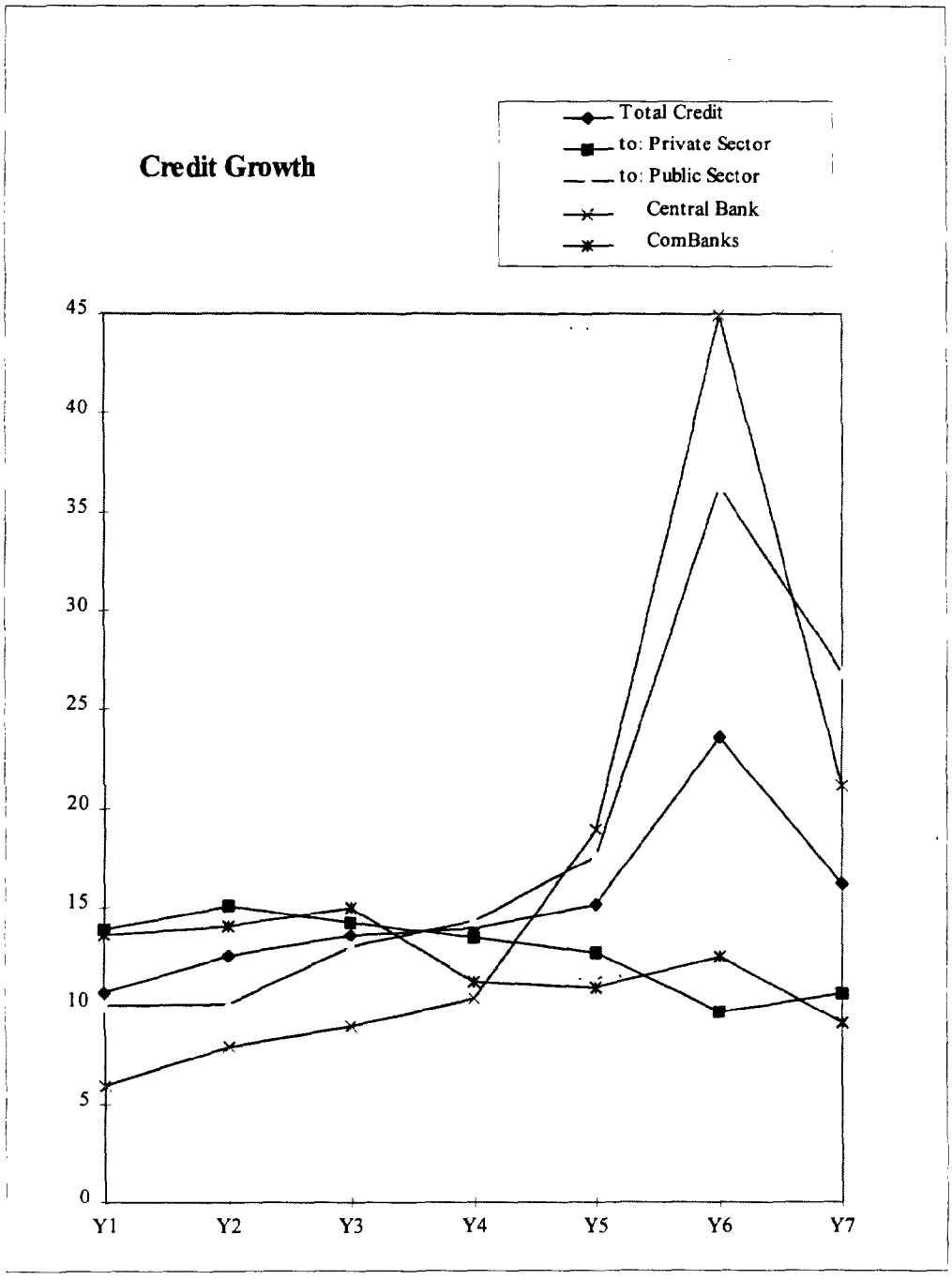
	Annual Indicators				Average Annual Growth Rates		
	Y_1	Y_4	Y_6	Y_7	Y_1-Y_7	Y_1-Y_4	Y_5-Y_7
	(ST billions)				*(per cent)*		
Total FinSys Credit	**321**	**467**	**665**	**798**	16.4	13.3	21.8
To Private Sector	**153**	**228**	**282**	**312**	12.6	14.2	10.2
by: Commercial Banks	138	195	238	267	11.6	12.2	11.4
by: Others (DFIs)	15	33	44	45	20.1	30.1	3.5
To Public Sector	**168**	**239**	**383**	**486**	19.4	12.5	31.5
by: Central Bank	90	96	182	224	19.4	5.9	42.4
Government	108	120	203	242	14.4	3.6	31.9
SEs (borrowings)	60	119	180	244			
Shares (%)	*(per cent)*						
Total FinSys Credit	**100**	**100**	**100**	**100**			
To Private Sector	***47.7***	***48.8***	***42.4***	***39.1***			
by: Commercial Banks	43.0	41.8	35.8	33.5			
To Public Sector	***52.3***	***51.2***	***57.6***	***60.9***			
by: Central BanK	31.7	26.0	35.1	37.1			
Government	33.6	25.7	30.5	30.3			
Total SEs (borrowings)	18.7	25.5	27.1	30.6			

For details see **Annex VII**, Table 7-3

52.3 percent in Y_1 to 60.9 percent in Y_7, resulting in a major shift in the allocation of financial resources.

7.29 In Y_1, of the 52.3 percent share of total domestic credit held by the public sector, 33.6 percent was borrowed by the government, mostly the CBT, and a small amount from commercial banks. The remaining 18.7 percent was borrowed by the SEs for their operational needs and investment purposes. *(The detailed distribution of credit is given in the ANNEX VII, Table 7.3).* Later, this pattern of credit use shifted and in Y_7, of the 60.9 percent share of credit to the public sector, government

Chart 7-3


Credit Growth
Total Credit
to: Private Sector
to: Public Sector
Central Bank
ComBanks
45
40
35
30
25
20
15
10
5
0
Y1
Y2
Y3
Y4
Y5
Y6
Y7

and SEs borrowings from the financial system were nearly equal – around 30 percent each – showing a net gain in the SEs' access to domestic credit. Once again, the CBT and the DFI's were the main sources of credit to the public sector, and both increased their lending over Y_1 levels.

7.30 As regards credit to the private sector, though its rate of growth was slower than that of the public sector, the volume of credit nearly doubled from ST153 billion in Y_1 to ST312 billion in Y_7, mainly extended by the commercial banks and a small part by the DFIs and other financial institutions.

The Directed Credit System

7.31 In parallel to these considerations operating on the side of market-based credit, the government's development concerns led it to augment the amount of credit available to the productive sectors from private sources. The overriding concern was to make available a fairly large amount of credit, and in this pursuit the government succeeded. In addition to private sector credit, the credit made available through the DFIs and the CBT provided additional amounts to the sectors. The difference was that while the private sector lent mostly to privately-owned companies in a given sector, the government made available credit to the SEs operating in the same sector. This segmentation on the user-side in a given sector added to distortions in incentive regime operations for a given sector with serious implications for pricing policies and distributive concerns. Nevertheless, as shown in *Table 7-4* below (*details in Annex VII, Table 7-4*), the total credit made available to the productive sectors was ST202 billion in Y_1. Of this amount, ST153 billion was provided by the private sector and ST49 billion was supplied by the CBT and the DFIs. The annual growth rate of credit to productive sectors was fairly high in the early years, averaging 16.2 percent during Y_1-Y_4. Later on, this rate of expansion slowed but was still fairly high at 13.9 percent per year during Y_5-Y_7. As a result, there was more than a two-fold

Table 7.4 ***Banking System Credit to Sectors: Sectoral Distribution, Targets, Actual Growth***

	Annual Indicators				Average Annual Growth Rates		
	Y_1	Y_4	Y_6	Y_7	Y_1-Y_7	Y_1-Y_4	Y_5-Y_7
			(ST billions)		*(per cent)*		
Total Domestic Credit	**321**	**361**	**665**	**798**	**16.9**	**13.3**	**21.8**
Total Sectoral Credit:	**202**	**234**	**436**	**498**	16.2	17.8	13.9
to:							
Public Sector (SEs loans)	49	58	154	186	24.9	27.7	21.0
Private Sector: from	153	176	282	312	12.6	14.2	10.2
Total Sectoral Credit:							
for:							
Production	96	115	211	242	16.7	18.1	16.9
Manufacturing	50	61	119	137	18.3	20.7	18.2
Agriculture	46	54	92	105	14.7	15.0	15.3
General Commerce	57	68	160	188	22.0	23.7	19.8
Services	49	51	64	68	5.6	2.7	9.2
Actual Shares			*(per cent)*				
Total Sectoral Credit:	**100**	**100**	**100**	**100**			
for:							
Production	47.5	49.1	48.5	48.6			
Manufacturing	24.8	26.1	27.4	27.5			
Agriculture	22.8	23.1	21.1	21.1			
General Commerce	28.2	29.1	36.8	37.8			
Services	24.3	21.8	14.7	13.7			
Target Sub-sectoral Shares			*(per cent)*				
Total Sectoral Credit:	**100**	**100**	**100**	**100**			
for:							
Production	52.0	55.0	55.0	55.0			
Manufacturing	28.0	30.0	30.0	30.0			
Agriculture	24.0	25.0	25.0	25.0			
General Commerce	30.0	33.0	33.0	33.0			
Services and Others	18.0	12.0	12.0	12.0			

For details see **Annex VII**, Table 7-4

increase in volume of credit directed to the productive sectors, and in Y_7 the amount rose to ST498 billion compared to ST202 billion in Y_1.

7.32 On the surface, the directed credit system, at least at the macro-financial level, succeeded in its overall objective of providing financial resources to the productive sectors. Moreover, the actual rate of increase exceeded the target rate of growth by a wide margin, but it failed to achieve the second layer of target shares. If evaluated against the criteria of whether the credit availability achieved its overall objectives of sectoral growth, diversification and sustainable development, however, various issues emerge. Among these:

i. At the sectoral level, the stipulated target shares were never met; the banking system could not extend the required amounts in spite of efforts to supplement market-based credit of commercial banks with CBT and DFI credits to the SE's.

ii. The present term structure of credit reflects the preponderance of the overdraft system and lack of term-financing needed by the productive sectors.

iii. Except for limited activities of the DFIs and some merchant bank lending, there is little project-based lending in the system at the enterprise level.

iv. The interest rate structure has been generally non-binding on the supply of credit to the medium and large-scale prime borrowers, but binding upon the supply of credit to borrowers across the productive sectors, especially to small borrowers. The government has used interest rate policy to influence pricing, allocation, and supply of credit between sectors and classes of borrowers.

v. Efforts at directed lending have been limited for industry, but significant for agriculture. Subsidies have been costly and have not achieved their objectives.

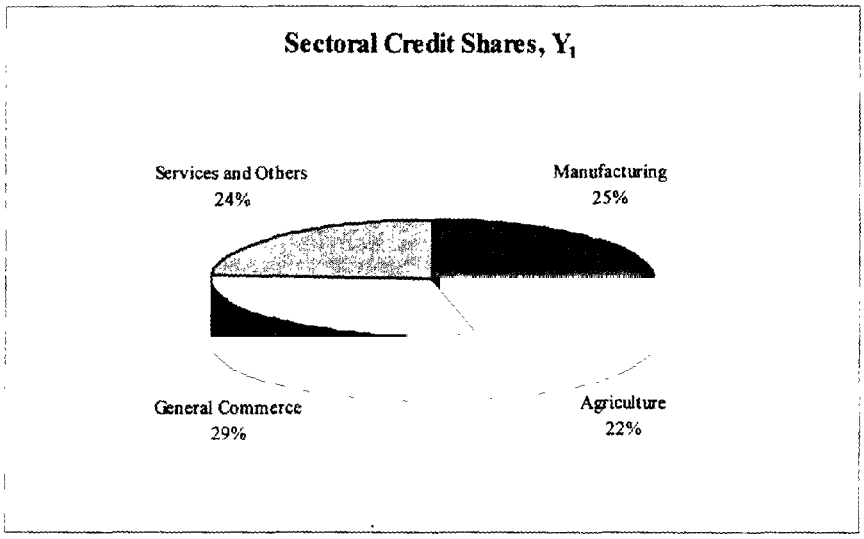
vi. Access to credit by small borrowers across all sectors has been limited. Directed lending arrangements have been inadequate and costly to the government, and have not succeeded in alleviating these

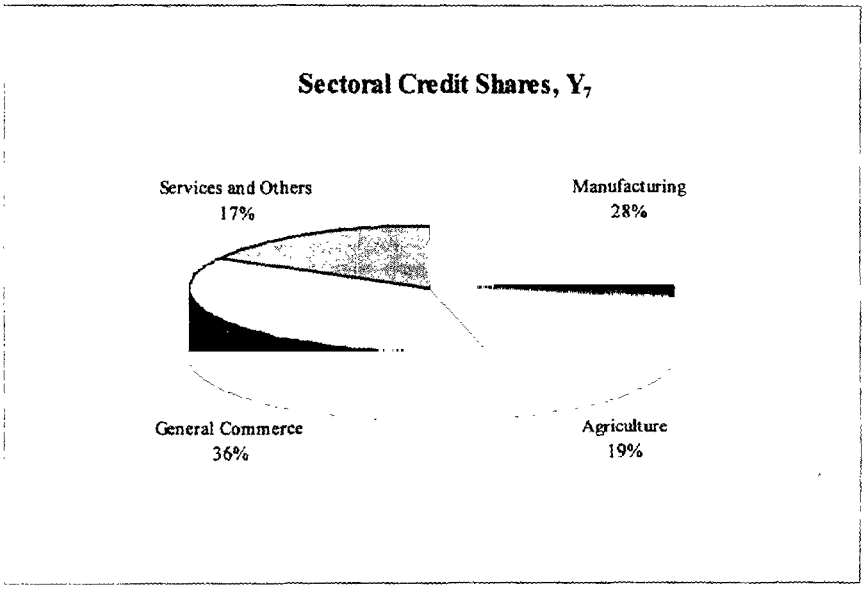
problems. Further, collateral requirements are severely binding upon small borrowers.

7.33 At the sectoral level, commercial banks are required to comply with a sectoral credit allocation scheme specified in percentage shares for priority sectors. The percentage shares are outlined in the monetary program every year at the time the budget is released. These sectoral shares are mandatory and are the basis of compliance. Penalties are invoked if any bank is unable to meet these targets. Adherence to these sectoral shares is monitored at the institutional level, bank by bank, and is in line with the overall credit growth stipulated at the macro-financial level as a policy target of the annual monetary program. The same rate of credit growth is applied to a single bank and is treated as a control variable at the aggregate level. This is the layered system of credit control and its allocation. Up to Y_3, the priority sectors included agriculture, export, manufacturing, mining, construction, transport, and communications, in that order. These priority sectors together were allocated 65 percent, nearly two thirds of the banking credit extended by commercial banks with some minor variations year to year. The non-priority sectors included real estate and domestic and retail trade. In Y_4, this system was rearranged and simplified. The number of priority sectors was reduced to agriculture and manufacturing, which together were allocated 55 percent of total banking credit. Agriculture was allocated 25 percent and manufacturing 30 percent, that is, the commercial banks were required to lend more than half of their total loans and advances to these two sectors. Throughout these years, the government remained particularly concerned about adequate credit supply to agriculture and manufacturing, especially for those units classified as small and medium enterprises – the SMEs – in the growth of the outlying regions.

7.34 As the data shows in *Table 7-4* above and *Chart 7-4* below, the sectoral credit target shares were never adhered to. In some years the actual credit expansion was close to the specified targets. Year after year, the actual credit to agriculture and manufacturing fell short of stipulated share in total credit. Besides, given the loose

Chart 7-4


Sectoral Credit Shares, Y_1
Services and Others
24%
Manufacturing
25%
General Commerce
29%
Agriculture
22%


Sectoral Credit Shares, Y_7
Services and Others
17%
Manufacturing
28%
General Commerce
36%
Agriculture
19%

definition of sectors and sub-sectors, there was considerable room for ingenuous reporting by resourceful banks. What was actually classified as agricultural credit could very well have been foreign trade finance in commodities, a sub-sector hardly in need of priority attention. Up to Y_3 and prior to reforms and changes in the system in Y_4, the sectoral targets for production were stipulated at 52.0 percent, whereas actual lending was around 48 percent. For manufacturing, the target share was at 28 percent, while the actual share was close enough. In the case of the agricultural sector, the target share was 24 percent, while the actual share was around 21 percent. In contrast, the credit shares for general commerce and services sectors were pretty close to the targets, up to Y_3, and in cases of services and other sectors, the shares exceeded the stipulated levels.

7.35 In Y_6, the government streamlined this system, simplified the rules, and cut back on the listing of priority sectors, as discussed above in paragraph 7.33. But owing to a number of factors, there was a substantial shortfall in credit to agriculture, whose relative share began to decline from 20.4 percent in Y_4 to 18.9 percent in Y_7, in comparison to the target of 28 percent. The share of credit to manufacturing got stuck around 27.5 percent, as compared to the target of 30 percent. This rather harmonious under-performance of the banking system, within a 3 percent differential, owes to the graduated penalty system, which specifies that a full penalty for non-compliance is applicable after a 4 percent differential between stipulated target and actual shares.

7.36 Clearly then, this non-compliance with credit guidelines at the sectoral level shows that the government's attempt to replace the financial markets as an allocation mechanism was not successful over these years. The underlying reason was distortions at the root of the productive sectors of the economy. The overbearing nature of intervention makes the task even more difficult. For example, banks are required to submit monthly reports to the CBT on their credit operations. If non-compliance is found, as is often the case since business credits do not adhere to

official schedules, they are penalized. But compliance on a monthly basis is operationally impossible and, if strictly enforced, the allocation system would result in a sectoral imbalance and idle funds. Given a ceiling on aggregate credit expansion and assuming they meet the sectoral guideline requirements at the end of the preceding period, banks can increase the amount of credit extended to each of the sectors by the same percentage. The banks will first classify loan applications by sector and in each sector by Tusanian and other borrowers, then by small-scale Tusanian borrowers and others. Most of the banks appear simply to ignore the guidelines, however, and in many cases put up numbers to show compliance. If a large bank with almost a hundred branch offices and numerous loan customers attempts to comply with the guidelines to the letter, it must devote a large number of people to doing nothing but the paper work required by the CBT.

7.37 More importantly, different sectors have different funding requirements. Some sectors need mostly long-term financing whereas others seek short-term loans. Seasons also affects the demand for loans and the sectoral credit demand changes continuously. As a result, banks may have to turn down profitable and economically viable lending opportunities and accept dubious ones to meet monthly quota requirements. This situation creates strong incentives for evading the quota or falsifying monthly returns. This also lengthens the lag time involved in loan processing. Banks may like to commit funds, but actual disbursements may be delayed depending on the quota situation. The rigidity of the system, which gives the banks little discretion in credit allocation, discourages them from extending long-term loans as these loans reduce their operational flexibility.

7.38 The demand for credit by the private sector at the micro-financial level – businesses and companies – is governed by the financial cost of borrowing, namely, the structure of lending rates, fees, maturity and collateral requirements, and profitability, that is, output prices and cost of production. This in turn depends on the incentive regime and the extent to which prices reflect market conditions. This is

where the financial link between the banking system and productive sectors is forged. Mandatory ceilings and targets on private sector credit, which are stipulated without regard to these two criteria, are analogous to quantitative restrictions (QRs). If imposed in a distorted incentive regime, they are unlikely to be adhered to. As the financial cost of borrowing and profitability are gradually brought in to line with underlying economic forces in the real sector of the economy at the enterprise level, the need for credit allocation becomes irrelevant and credit ceilings become non-operative.

7.39 If viewed from this perspective, the growth in private sector credit and its distribution during the review period can be logically explained. Linked with the performance of real sectors, the growth in credit primarily occurred in general commerce and trade financing, whose share increased from 29.2 percent in Y_1 to 36.5 percent in Y_7. Credit to production – mainly agriculture and manufacturing – remained around 46 percent over this period. Share of credit to service sectors and others decreased from 24.8 percent in Y_1 to 17.1 percent in Y_7, providing a cushion for increased lending to general commerce. There were two other major forces at work causing a sharp increase in credit to trade and general commerce. First, anticipated inflation encouraged the private sector to keep ahead of the predicted rise in business costs and to maximize its profitability on inventory build-up, both of imported and domestically produced goods. As inflation gathered momentum, this trend was reinforced. Private business sector expenditures for these purposes were in large part financed from borrowings from the banking system. Second, this trend was intensified by the depreciation of the Siwat, both in the official and parallel markets, as discussed in Chapter V. While depreciation of the official exchange rate was a factor in anticipatory behavior, the precipitous depreciation of the Siwat in the parallel market was the major inducement to spending with borrowed money in a bid to catch up before the next round of price increases came through, especially in imported items. This is because prices of imported items are indexed to the parallel market rather than the official exchange rate. From mid-Y_5 onwards private

borrowing, especially business borrowing, turned speculative. This was not only because significant profits were to be made on routine business turnover, but much more was to be made in currency trading in parallel market, financed largely by borrowing from the banking system. The cycle became self-sustaining, the rapidity of the turnover increased, and the private sector credit increased in spite of a sluggish economic situation.

7.40 One contributing factor was the depressed interest rate structure, both on the deposit and lending side, which encouraged capital flight in the face of a depreciating Siwat. Banking system credit was diverted from productive sectors to commerce through a host of credit-advancing mechanisms, fueling the speculative behavior of trading sectors. A major portion of parallel-market transactions and a good part of official market transfers were of this nature. Since lending rates were deliberately kept low, the speculative currency transactions yielded profits at a level that made the interest rates an inconsequential cost of borrowing. Realizing this, the CBT imposed drastic liquidity controls, which did not deter borrowings of this kind. It merely resulted in preempting the productive sectors from the private sector side (see Chapter V). This deficiency was made through expansion of public sector credit to SEs engaged in production. A good number of banks were caught in the mismatch of the maturity structure on the credit and deposit sides, while the overall effect was an unprecedented squeeze on banking credit to productive sectors.

Term Financing

7.41 Data on the term structure of banking systems' loans and advances by sectors is not available, but at the institutional level there is clearly a preponderance of short term loans. Nearly half of the commercial banks' advances are on call, or have a maturity of l to 6 months, and 30 percent of loans have a maturity of one year or less. Thus, nearly 80% of commercial bank loans are short-term credits, while only about 20 percent have a maturity of 1 to 3 years and very few have a maturity of 5 years or

more. The major reason is that the banking system has been unable to generate long-term finance. It has relied on short-term funding sources, and has been operating under a repressed interest rate structure and high intermediation spreads. It has had to contend with the relatively weak financial strength of borrowers needing long-term financing and ad hoc government interventions in the credit system. Further, there are powerful constraints on term lending owing to the higher credit risks involved. Generally, there are two kinds of additional risks inherent in term lending. First, short-term deposits may be withdrawn in such quantities as to exhaust the liquid reserves of the banks. Second, interest rates may rise rapidly within a short period of time. Both these risks materialized in Y_7; therefore, the banking system seems to have slowed down transformation – at least temporarily – but this remains to be seen.

7.42 In the public sector, SEs were able to obtain adequate long-term finance from the government through its equity participation and direct lending. The shortage of term financing, therefore, affects mostly private sector borrowers. Private firms cannot expect to raise much long-term funding through capital markets either. They secure practically all of their short-term financing through financial institutions. In a typical medium- to larger scale industrial firm in Tusania, short-term loans and over-drafts range from 70 to 80 percent of total credit liabilities as financial institutions have not been able to provide medium- or long-term credit.

7.43 The fact that commercial banks allocate less than 20 percent of their loans and advances to term-financing, does not mean that only a small fraction of investment resources are channeled to long-term investment projects. The government controls the bulk of investment resources, and compared to these, the amount of bank credit the banking system could generate for investment financing is insignificant. The government could and does lend through DFIs to whichever borrowers it prefers – SEs, farmers, private business – on whatever terms it chooses. Thus, a good deal of long-term finance is available, but is accessible mainly to public sector borrowers, and the private sector is nearly shut out of the system. By reducing

the size of public sector investment, the government could easily expand the availability of term finance to the private sector, but whether such a reallocation is possible and desirable is another issue. The banks could allocate a larger proportion of their resources to the financing of long gestation investments. They have not been able to do so, primarily because of the short-term nature of their liability structure, which effectively sets the limit on their capacity of long-term finance. One of the major reasons for the lack of term financing, therefore, is savers' preference for short-term deposits. Through continuous roll-overs and renewals the banks, in effect, supply more long-term finance to many of their creditworthy customers than their loan portfolios actually show. The banks seem to prefer this type of long-term finance to avoid asset illiquidity, a mismatch of maturity structure, and to increase their operational flexibility. Some of the banks who did commit long-term loans were caught in the liquidity squeeze in Y_7. Precisely for this reason, whatever contractual term finance was trickling through has also been shut-off. The public sector deposit withdrawal action in Y_7, therefore, has increased rather than reduced premia on liquidity and short-term lending. Term-financing is unlikely to emerge in the near future unless special arrangements are devised. Further, as far as the banks are concerned, the rate of interest, adjusted for risks involved in long-term loans in an unstable environment, is inadequate and does not compensate for these risks. Rigid credit guidelines further constrain the banks' ability to generate additional long-term finance. Finally, heavy government borrowing from financial markets also reduces the availability of finance to the private sector, as it crowds out private borrowings. The private borrowing operations are hampered to begin with, owing to the inadequacy of financial instruments and mechanisms available to the financial market participants.

Financing of Priority Sectors--Mechanisms and Instruments

7.44 The foregoing analysis of the credit system and trends has shown that the allocation system is not effective in reaching the intended target groups of borrowers.

The designation of priority sectors and an allocation system based on credit shares cannot overcome the weaknesses of the credit mechanism given the fungibility of credit, both on the lenders' and borrowers' level. Effective delivery of preferential credit to target groups, consisting of farmers, exporters, the SMEs, and the priority sectors, would require 1) revamping the incentive regime operative on the real sectors, governing the financial operations of the banking system as first priority of policy formulation, and 2)) establishing a viable credit system, mechanism, and instruments, as discussed below.

7.45 The banking system is biased against the indigenous weak segments of the borrowers in the priority sectors, but this problem is not unique to Tusania. Most developing countries operate one system or another of directed credit to rectify this bias. The extensive Tusanian credit allocation system is designed in part to eliminate sectoral imbalances in credit allocation. The authorities have been trying to deliver development finance or concessionary credit to the weaker segments of the economy through the DFIs and through the networks of the commercial banks, even though their role has all along been marginal in the total credit structure. The commercial banks have the resources, network, manpower, and experience, but they are not enthusiastic to be the delivery mechanism of directed loans to the target groups. In this respect, the debate is not yet over regarding the role of the DFIs in Tusania, even though a great deal of evidence is available regarding the inadequacy or the inefficiency of financing priority sectors through DFIs. The issue at the operational level is the design of a delivery mechanism to provide development finance to priority sectors that would be self-sustaining.

7.46 In Tusania, as discussed earlier, the proportion of credit provided by all the DFIs taken together has been fairly small. DFIs have not been a significant source of credit, nor has their coverage been adequate. Further, as a financial institution, DFIs have had neither successful financial performance nor portfolio quality. The recession and currency devaluation in later years of the review period eroded the

ability of many firms to service their debt to financial intermediaries. The current problems of DFIs relate in part to their basic approach to finance, the limitations on their management, and frequently their inability to follow sound business practices in terms of independent assessment of risks and the viability of their borrowers. They are heavily dependent on government resources, operate in highly regulated financial markets, and their spreads often do not reflect the costs and risks involved in long-term lending to higher risk projects of the SEs, where the DFI's operations have been concentrated. Most DFIs in developing countries, including Tusania, are in the risky business of long-term financing of investments. It is now recognized that DFIs could improve profitability through diversification in activities that complement their existing term finance business. For example, DFIs could begin providing working capital and trade finance to their clients, in addition to arranging complete financial packages for client firms. That is, let the DFIs evolve into merchant banks, or even emulate commercial banks, though whether they would be able to compete in a level playing field and become market-oriented remains to be ascertained.

Lines of Credit

7.47 In recent years, a number of multiple institution loans and lines of credit have been set up to channel funds through commercial banks and DFIs in order to extend the coverage and the efficiency of the credit delivery mechanism. In many countries, the priority sector system of finance for agriculture and industry through DFIs has been important, as shown by the past experiences of Mexico, Argentina, Brazil, Kenya, Turkey, Pakistan, and the Philippines. So long as flexibility is maintained in designing the lines of credit with due regard to institutional arrangements to channel funds, there is a role for specialized financial institutions, provided that 1) the credit mechanism is designed in the context of the broader objectives of financial sector development, 2) the focus is on the financial viability and managerial autonomy of the intermediaries, and 3) reliance is on market interest rates and market-based mechanisms. A good number of line-of-credit arrangements attempt to cope with

Box 7.2 Lines of Credit

LINES OF CREDIT

i. Purposes

- both domestic and foreign currency loans
- medium-long term investment finance
- working capital

ii. Sources

- foreign currency loans of multilaterals, the AMLs
- local currency loans of the banking system

iii. System

- layered financing, layered controls and management; wholesale, and retail lending levels

iv. Mechanisms

a. Participation Agreement - the Protocol

- Apex institution, the Central Bank
- Participating banks, system of pre-qualification based on performance, size, network, clientele
- Foreign Exchange Risk covering system
- Credit Risk coverage
- Reporting requirements, documentation, information flow

b. Approval

- Loan documentation and preparation, technical, financial, managerial
- Project-based lending; financial and economic evaluation of proposed projects for financing
- Layered approval based financial feasibility, technical viability, FRR, ERR, IRR calculations
- System of lending limits, the AMLs, central bank and participating banks
- Managerial aspects; management of project and management of loan capabilities

c. Lending

- Layered lending limits and ceilings for foreign currency and local currency
- Lending liabilities in local currency both to borrower and participating bank

d. Disbursements

- Procedures for foreign currency based on lending limits, system of control
- Procedures for local currency
- Documentation requirements and control system

e. Repayments and Revolving Funds

- Management of revolving funds, conditions, requirements
- Management of maturity structures
- Re-lending system, approval process
- System of repayments, requirements

v. Management

- System of controls and monitoring of the CBT, at participating banks
- Supervision of line of credit, reporting
- Management of defaults

these aspects. Efforts are underway in Tusania to set up these arrangements. The lines of credit provide a mechanism of direct linkages with macro-financial policy and program objectives, as well as the credit allocation and delivery at the sectoral and enterprise level within an institutional arrangement whose viability is easily monitored.

7.48 Briefly, lines of credits are typically funded by multilateral agencies, the AMLs, and provide to the enterprises a blend of foreign currency and local financing *(see Box 7.2, Lines of Credit).* The sources of finance are primarily foreign long-term loans extended by the AMLs with the sovereign guarantee to the Central bank, and are augmented by local funds from the banking system. The purpose of lines of credit is to provide project-based investment finance for medium- to long-term, mostly in foreign currency, together with working capital for short- and medium-term to qualified enterprises, whether publicly- or privately-owned. There is a layered system of financing, involving the CBT at the apex of the system and a group of participating banks pre-qualified on the basis of their performances, strength, and clientele network. This is the wholesale level of funds. The participating banks, in turn, provide credit at the retail level to borrowers mostly on project-based investment proposals. The mechanism of lines involves three layers of inter-connected items. These are: 1) credit approval mechanisms, 2) lending mechanisms and 3) disbursement mechanisms. These arrangements are spelled out in the protocol of a participating agreement, which specifies the institutional base, financial liabilities, and the mechanism. The line of credit management is bestowed upon the CBT as the apex institution and is specified in the participation agreement. At the macro-level, the lending risk is borne by the participating banks. The foreign exchange risk is borne by the CBT through a costing arrangement between the CBT and participating banks. The documentation requirements are fairly extensive. They stipulate an extensive information flow at all levels of the line of credit, with the borrower at the one end and the CBT and AMLs at the other.

7.49 Since the lines of credit are market-based and are not sector-specific, the issue of financing priority sectors is subordinated under the mechanisms of lending through the DFIs and commercial banks. Typically this involves augmenting the access of priority borrowers to the credit system, but stopping short of providing credit guarantees or credit insurance. The participating banks may be given incentives to cover extra costs of lending to the priority borrowers, or they may be allowed interest differentials to compensate for higher risks involved with the marginal but priority borrowers.

Agriculture and Rural Finance

7.50 Agricultural credit policies in Tusania were motivated by the same set of concerns as those of many developing countries, that is, self sufficiency in food production and exportable surpluses. While export sales of cotton and a few other agricultural commodities were important to the producers, their exports were even more important for foreign trade and balance of payments concerns. The policies to promote agriculture for a number of years, however, were pursued in a distorted price structure which militated against the financial viability of a good number of agricultural borrowers. Traditionally, the government has followed a two-pronged approach, with provision of credit to agriculture through the banking system under credit guidelines, already discussed above, and through the Agriculture Development Bank of Tusania (ADBT). The objectives of the government policy were an increased supply of institutional credit at concessional interest rates, easier terms of borrowing, and wider coverage to reach a larger number of farmers and agricultural enterprises.

7.51 The problems of agricultural finance in Tusania are similar to those of small- and medium-scale enterprises. While large-scale agricultural or agro-industrial businesses do not suffer much from the shortage of credit, small holders have

practically no *access* to institutional credit. Despite the existence of a guarantee scheme, banks seem to prefer not to lend to small holders in agriculture given the high costs of administering numerous small loans and low recovery rates. For these reasons, the ADBT and the government launched an agricultural credit guarantee scheme to reduce the risks involved in lending to agriculture by providing adequate collateral for loans through guarantees and group loans.

7.52 The ADBT was established mainly to cover the gaps left in the agricultural credit supply by the banking system, which focused mainly on large-scale and commercial farmers. But ADBT operations were not able to cope with this segmentation in an effective manner or provide any significant increase in the credit flow to agriculture. ADBT's loans and advances steadily increased, but its credit supply is a small proportion of total loans and advances extended by commercial banks to the agriculture sector. Further, the composition of ADBT's outstanding loan portfolio shows that more than half the loans were advanced to companies, corporations, even state governments, while loans to farmers and cooperatives were around 35 percent of ADBT's total loans and advances. Thus, a small number of large borrowers had the bulk of ADBT's loans and advances, while medium and small borrowers had about one-third of ADBT's credits, contrary to the objectives of the agricultural credit policies of the government.

7.53 As regards the agriculture guarantee scheme, the aim was to encourage participation of commercial banks in agricultural credit through CBT guarantees on agricultural loans. The guarantee scheme has been in operation for a number of years, but the CBT has not received frequent requests for repayments. In order to qualify for repayment for defaulted loans from CBT under the scheme, banks must observe a set of strict conditions. These restrictions are so stringent that few banks believe that they will be able to meet them and, as a result, that the CBT will ever have to honor its commitments. For example, banks must secure adequate collateral for every agricultural loan they extend. Very few farmers are able to post real estate

or securities collateral because of the existing land tenure structure. If the banks fail to secure collateral, they are not qualified for repayment of a delinquent loan under the scheme. These strict conditions were designed to prevent abuse of the system, but experience suggests that they work against the scheme's objective. Given the flawed design of the guarantee scheme and stringent requirements of CBT, it will be difficult to make the scheme a viable means of augmenting agricultural credit. Above all, given the default in sectoral targets, commercial banks, as a rule, do not approach the CBT to access the guarantee scheme.

7.54 The Tusanian rural sector has shared modest development and diversification of its economic base since the early years. It remains predominantly agricultural, composed mostly of small traditional land owners. There has been some improved utilization of land through the introduction of fertilizers and mechanization. Some agro-allied and semi-processing industries also have been established along with small and medium industries. The improved road network and communication facilities have increased access to rural areas. The contribution of the agricultural sector to GDP has also grown, and the income of farm households from farm and non-farm sources has increased. Some rural branches have become profitable since their establishment; however, financial flows to rural areas have not increased as anticipated due to the fact that lending practices and the interest rate structure were set up so that most rural borrowers could not access the banking system.

7.55 To provide rural finance, the government instituted a rural banking scheme in the early years which required commercial banks to expand their banking services to rural areas. The objectives were to extend the banking system's coverage and improve credit flow and savings mobilization in rural areas. The scheme had three phases. Commercial banks were required to open rural branches in these phases according to a time-table. In the first phase, 16 commercial banks were required to open 200 rural branches; in the second phase, 20 commercial banks were required to open 266 branches, and in the third phase, 28 commercial banks required to open 300

rural branches. The choice of location for these branches was usually based on CBT recommendations, using such criteria as the population, level of economic activity, and accessibility to transport. In a few cases, however, these rural branches were approved by CBT purely on political rather than financially viable concerns. This arrangement ended up imposing a heavy financial burden on the banks. The government has encouraged the establishment of co-operative credit banks and community banks to supplement rural finance, but the establishment of these quasi-financial institutions adds to segmentation of the system. Since they are outside CBT's review, reporting process and oversight functions, it is unlikely that they will mature into self-sustaining financial institutions.

Industrial Finance

7.56 As discussed earlier, the major source of industrial finance, both short- and medium-term funds, has been commercial banks. On average, commercial banks provided about 25 percent of their loans and advances to manufacturing during Y_1-Y_7, while the DFIs provided a larger share of their loans and advances to manufacturing SEs, and for longer maturities. Other sources of finance to manufacturing, such as non-bank financial institutions, have not been significant for industrial finance as a whole. For a variety of reasons, capital markets have also not been a viable option for many industrial enterprises, mainly because of their structure of operations as discussed in Chapter VIII. In addition, the investment incentive regime, and the regulatory framework and investment climate in general, precluded capital markets from furnishing long-term finance for industrial growth.

7.57 There has been more segmentation in industrial finance than in other areas, primarily because of the longer maturity needed by industrial borrowers. The industrial SMEs in particular had limited access to banking credit, given the lending practices of banks concerning collateral requirement, past banking records, group linkages, and financial viability. The size distribution of banking credit shows that

typically a small number of borrowers, less than 5 percent, receive more than half of the banking credit. While the number of small borrowers may be large, the amount of credit received is fairly small. The problem of industrial SME borrowers needs a more exhaustive treatment than is possible here. Suffice it to say that the banking system generally cannot meet the needs of industrial SMEs in a significant manner, which is why the government designated SMEs as a priority sector.

7.58 The government established the small-scale industries credit guarantee scheme in the early years to help cover the credit risk. Under the scheme, the federal government was required to make available to each provincial or local government an amount equal to the matching grant put into the credit scheme by these local governments. Later on, the government moved away from the matching grant approach to a system that was managed by the National Investment Bank of Tusania (NIBT). The scheme was later discontinued, and the government established the Industrial Development Bank of Tusania (IDBT) to provide medium- and long-term industrial finance for medium- and large-scale industries as well as for industrial SMEs. Currently, IDBT's minimum lending is ST50,000, with ST5 million for the SMEs as the maximum exposure. It prefers to secure its loans on the basis of the first legal mortgage on the fixed assets of the borrower. The pattern of IDBT lending reflects the industrial structure, with a predominance of light and consumer goods industries. The NIBT was established in parallel to IDBT with the aim of providing investment banking services to manufacturing enterprises and soft loans to small-and medium-scale industries. By the end of Y_6, NIBT had financed 760 projects and its loans outstanding were ST900 million. Most of its loans support food and beverage industries followed by loans to services and other sectors. During Y_6, NIBT's operations consisted of 74 project approvals for ST182 million. Pending a more thorough evaluation of NIBT's portfolio, it is known that a large part of its loans are non-performing and it is sustaining significant losses. The government is gradually moving away from its focus on DFIs as the main source of credit to the priority sector. It has expanded efforts to include the banking system to provide project-

based term finance to priority sector borrowers, be they SMEs or large borrowers. These efforts are still in the initial stage and small relative to the size of the requirements.

7.58 Given this state of the credit system, the challenge to authorities in formulating a macro-financial program is how to reconcile its policy objectives of macro-financial stability with development, growth of leading sectors, and social and distributive considerations. As demonstrated above, this will require a nifty balancing act. It presumes that those responsible for charting the macro-financial programs are also adept in the use of control levers and are able to trace their impact through the operations of institutions and enterprises at the unit-level. This may be too much to expect from the policy-makers' environment and too much to assume on the part of those responsible for it.

ANNEX VII - Exhibit 1

CONSOLIDATED BALANCE SHEETS OF THE COMMERCIAL BANKS (a)

TOTAL ASSETS

1. CASH AND DUE FROM BANKS
   - Cash on hand
   - Check and other cash items
   - Due from Central Bank
   - Due from other banks

2. LOAN PORTFOLIO (NET)
   - Interbank loans receivable
   - Loans and discounts
   - Bills purchased
   - Customer's liability on drafts
   - Trading account securities - loans

3. INVESTMENTS
   - Trading account securities - investments
   - Investment in bonds and other debt instruments
   - Equity investment in allied/non-allied

OTHER ASSETS
- Bank premises/fixtures and equipment
- Real and other properties owned or acquired
- Customers liability on acceptances outstanding
- Other assets

ANNEX VII - Exhibit 1 (cont'd)

CONSOLIDATED BALANCE SHEETS OF THE COMMERCIAL BANKS (b)

TOTAL LIABILITIES AND CAPITAL ACCOUNTS

1. DEPOSITS
   - Demand Deposits
   - Savings Deposits
   - Time and Others

2. BILLS PAYABLE
   - Deposit Substitutes
   - Central Bank
   - Interbank
   - Local banks
   - Non-banks
   - Private firms
   - Foreign, Others

3. OTHER LIABILITIES
   - Time Certificate - special financing
   - Special foreign currency deposits
   - Due to Central Bank
   - Due to the Treasurer
   - Due to local banks
   - Due to foreign banks
   - Treasurer's/manager's gift checks
   - Outstanding acceptances executed by/for
   - Marginal deposits
   - Special time deposits
   - Accrued taxes and other expenses
   - Unearned income and other deferred credits
   - Payment orders payable
   - Cash letters of credits
   - Other Liabilities

TOTAL CAPITAL ACCOUNTS
- Capital Stock
- Surplus and surplus reserves
- Undivided profits
- Due to and from head office
- Assigned capital
- Revaluation profits/(losses)
- Trust accounts

ANNEX VII - Exhibit 2

INCOME & EXPENDITURE OF COMMERCIAL BANKS'

GROSS OPERATING INCOME

1. Interest Income
   - Interbank loans receivable
   - Loans and discounts
   - Investments
   - Deposits in banks
   - Due from Central Bank
   - Trading account securities

2. Other Income
   - Bank commissions
   - Fees/commissions/Service charges
   - Trading gain/(loss)
   - Foreign exchange profit/(loss)
   - Gold trading gain/(loss)
   - Trust department income
   - Other income

GROSS OPERATING EXPENSES

1. Interest expenses
   - Deposits
   - Borrowed funds
2. Finance Charges
3. Compensation/fringe benefits
4. Management and other professional fees
5. Supervision and examination fees
6. Fines, penalties and other charges
7. Taxes and licenses
8. Insurance
9. Depreciation/amortization
10. Litigation/assets acquired expenses
11. Bad debts expenses
12. Other expenses
13. Provisions for bad loans

Net Operating Income: (Loss) *Equals*
(Gross Operating Income *less* Gross Operating Expenses)

ANNEX VII - Exhibit 2 (cont'd)

INCOME & EXPENDITURE OF COMMERCIAL BANKS (cont'd)

EXTRAORDINARY CREDITS/(CHARGES)
LOSSES AND RECOVERIES

1. Recovery on charged-off assets
2. Income from assets acquired
3. Profits/(losses) from assets sold/exchanged
4. Dividends-equity investments
5. Revaluation profits/(losses)
6. Profits/(losses) on foreign exchange swaps
7. Other Credit/Charges

Net Operating Income/(Loss)
Less Losses And Recoveries
Equals PROFITS BEFORE TAXES

Less Provision For Taxes
Equals NET PROFIT/(LOSS) AFTER TAXES

ANNEX VII - Exhibit 3

FINANCIAL PERFORMANCE OF COMMERCIAL BANKS

RATIOS OF FINANCIAL STRUCTURE

1. Total debt/equity
2. Total liabilities equity

RATIOS OF FINANCIAL PERFORMANCE

(As % of average total assets)

1. Total gross income
2. Financial expenses
3. Gross interest spread
4. Administrative expenses
5. Provisions
6. Income tax
7. Net profit after tax
8. Net Profit as % of Average Equity

FINANCIAL PERFORMANCE

1. Return on risk assets
2. Return on assets
3. Return on equity

LIQUIDITY (%)

1. Liquid Assets/Total Deposit Liabilities
2. Normal risk assets/core deposits
3. All risk assets/core deposits

CAPITAL ADEQUACY (%)

1. Equity/normal risk assets
2. Equity/all risk assets
3. Equity/total assets
4. Equity/core deposits
5. Equity/funding liabilities

ANNEX VII - Exhibit 3 (cont'd)

GROWTH INDICATORS (%)

1. Change in normal risk assets
2. Change in all risk assets
3. Change in total assets
4. Change in equity participation's
5. Change in core deposits
6. Change in trust funds
7. Change in equity

PRODUCTIVITY

1. Staff expenses/core deposits
2. Staff expenses/all risk assets
3. Staff expenses/net income

ANNEX VII *Table 7-1* *Sources of Credit*

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Total Domestic Credit	**321**	**361**	**410**	**467**	**538**	**665**	**798**
Central Bank, CBT	114	123	134	148	176	255	319
Banking System	195	226	262	294	327	373	432
ComBanks	164	187	215	239	265	298	335
Other Banks (DFI's)	31	39	47	55	62	75	97
Non-Bank Institutions	12	12	14	25	35	37	47
Annual Growth Rates (%)							
Total Domestic Credit	**10.6**	**12.5**	**13.6**	**13.9**	**15.2**	**23.6**	**20.0**
Central Bank, CBT	5.9	7.9	8.9	10.4	18.9	44.9	25.1
Banking System	14.6	15.9	15.9	12.2	11.2	14.1	15.8
ComBanks	13.6	14.0	15.0	11.2	10.9	12.5	12.4
Other Banks (DFI's)	21.0	25.8	20.5	17.0	12.7	21.0	29.3
Shares (%)							
Total Domestic Credit	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Central Bank, CBT	35.5	34.1	32.7	31.7	32.7	38.3	40.0
ComBanks	51.1	51.8	52.4	51.2	49.3	44.8	42.0
Other Banks (DFI's)	9.7	10.8	11.5	11.8	11.5	11.3	12.2
Non-Bank Institutions	3.7	3.3	3.4	5.4	6.5	5.6	5.9
Average Annual Growth Rates							
	Y_1-Y_7	Y_1-Y_4	Y_4-Y_7	Y_5-Y_7			
Total DomesticCredit	**16.4%**	**13.3%**	**19.6%**	**21.8%**			
Central Bank, CBT	18.7%	9.1%	29.2%	34.6%			
Banking System	14.2%	14.7%	13.7%	14.9%			
ComBanks	12.6%	13.4%	11.9%	12.4%			
Other Banks (DFI's)	20.9%	21.1%	20.8%	25.1%			
Non-Bank Institutions	25.6%	27.7%	23.4%	15.9%			
Memo Items							
Credit Targets, Rates of Growth (%)							
Total DomesticCredit	10.0	10.5	12.0	12.0	12.0	18.5	17.5
Central Bank, CBT	6.0	7.0	9.0	10.0	16.0	20.0	17.5
Banking System	12.0	14.5	14.0	12.0	11.0	12.0	12.5
ComBanks	12.5	12.5	14.0	11.0	11.0	11.5	11.5
Other Banks (DFI's)	16.0	18.0	16.0	16.0	16.0	18.0	20.0

ANNEX VII *Table 7-2 Commercial Bank (1 of 3)*
Summary Accounts

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Total Assets	**237**	**272**	**311**	**347**	**403**	**461**	**527**
Net Foreign Assets	5	7	10	12	17	20	22
Shareholder's Funds	46	52	60	64	71	79	83
Capital	39	44	51	53	58	65	70
Reserves	7	8	9	11	13	14	13
Deposits with CBT (Reserves	25	26	30	36	45	54	62
Other assets	8	12	12	18	36	50	73
Total Credit	**164**	**187**	**215**	**239**	**265**	**298**	**335**
Private Sector	138	156	176	195	215	238	267
Public Sector	26	31	39	44	50	60	68
Government	18	19	23	24	27	21	18
SEs	8	12	16	20	23	39	50
Annual Growth Rates (%)							
Total Assets	14.2	14.8	14.3	11.6	16.1	14.4	14.3
Total Credit	13.6	14	15	11.2	10.9	12.5	12.4
Private Sector	12.7	13	12.8	10.8	10.3	10.7	12.2
Public Sector	16.3	19.2	25.8	12.8	13.6	20	13.3
Government	8.7	5.6	21.1	4.3	12.5	-22.2	-14.3
SEs	22.6	50	33.3	25	15	69.6	28.2
Total Liabilities	**237**	**272**	**311**	**347**	**403**	**461**	**527**
Total Deposit Liabilities	***184***	***202***	***224***	***255***	***305***	***365***	***417***
Demand Deposits	124	134	146	165	201	249	288
Time Deposits	38	43	49	57	67	76	85
Savings Deposits	22	25	29	33	37	40	44
Borrrowings	***12***	***14***	***17***	***18***	***19***	***15***	***14***
Other Liabilities	***41***	***56***	***70***	***74***	***79***	***81***	***96***
Annual Growth Rates (%)							
Total Deposit Liabilities	9.4	9.8	10.9	13.8	19.6	19.7	14.2
Demand Deposits	8	8.1	9	13	21.8	23.9	15.7
Time Deposits	12.1	13.2	14	16.3	17.5	13.4	11.8
Savings Deposits	12.6	13.6	16	13.8	12.1	8.1	10
Shares (%)							
Total Credit	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Private Sector	84.1	83.4	81.9	81.6	81.1	79.9	79.7
Public Sector	15.9	16.6	18.1	18.4	18.9	20.1	20.3
Government	11	10.2	10.7	10	10.2	7	5.4
SEs	4.9	6.4	7.4	8.4	8.7	13.1	14.9

ANNEX VII *Table 7-2 Commercial Bank (2 of 3)*
Summary Accounts

Memo Items

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Total Deposit of FinSys	**199**	**217**	**244**	**280**	**331**	**398**	**465**
Demand Deposits	135	145	160	183	219	269	320
Time and Savings Deposits	64	72	84	97	112	129	145
Total FinSys Credit	**321**	**361**	**410**	**467**	**538**	**665**	**798**
Total ComBank Credit	**164**	**187**	**215**	**239**	**265**	**298**	**335**
CenBank Credit	**114**	**123**	**134**	**148**	**176**	**255**	**319**
Public Sector	102	108	112	121	146	236	296
Government	90	91	90	96	112	182	224
SEs and Others	12	17	22	25	34	54	72
Private Sector	12	15	22	27	30	19	23
Others	**43**	**51**	**61**	**80**	**97**	**112**	**144**
Other Banks (DFI's)	31	39	47	55	62	75	97
Non-Bank Institutions	12	12	14	25	35	37	47
Ratios (%)							
ComBanks Dep/FinSysDeposit	92.5	93.1	91.8	91.1	92.1	91.7	89.7
Deposit/Total Liabilities	77.6	74.3	72	73.5	75.7	79.2	79.1
Borrowings/Total Liabilities	6.5	6.9	7.6	7.1	6.2	4.1	3.4
D-Deposits/Total Deposits	67.4	66.3	65.2	64.7	65.9	68.2	69.1
Credit/Deposit	89.1	92.6	96	93.7	86.9	81.6	80.3
Credit/Total Assets	69.2	68.8	69.1	68.9	65.8	64.6	63.6
Shareholder's Funds/Assets	19.4	19.1	19.3	18.4	17.6	17.1	15.7
Capital/Total Assets	16.5	16.2	16.4	15.3	14.4	14.1	13.3
R-Deposits,CBT/Assets	10.5	9.6	9.6	10.4	11.2	11.7	11.8
Capital/Credits	23.8	23.5	23.7	22.2	21.9	21.8	20.9

Average Annual Growth Rates

	Y_1-Y_7	Y_1-Y_4	Y_4-Y_7	Y_5-Y_7
Total Assets of ComBanks	14.2%	13.6%	14.9%	14.4%
ComBanks Total Credit	12.6%	13.4%	11.9%	12.4%
Private Sector	11.6%	12.2%	11.0%	11.4%
Public Sector	17.4%	19.2%	15.6%	16.6%
Government	0.0%	10.1%	-9.1%	-18.4%
SEs	35.7%	35.7%	35.7%	47.4%
Total Liabilities	14.2%	13.6%	14.9%	14.4%
Other Liabilities	15.2%	21.8%	9.1%	10.2%
Deposit Liabilities	14.6%	11.5%	17.8%	16.9%
Demand Deposits	15.1%	10.0%	20.4%	19.7%
Time Deposits	14.4%	14.5%	14.2%	12.6%
Savings Deposits	12.2%	14.5%	10.1%	9.0%

ANNEX VII *Table 7-2 Commercial Bank Summary Accounts (3 of 3)*

	Average Annual Growth Rates						
	Y_1-Y_7	Y_1-Y_4	Y_4-Y_7	Y_5-Y_7			
Total FinSys Credit	16.4%	13.3%	19.6%	21.8%			
Total ComBank Credit	12.6%	13.4%	11.9%	12.4%			
CenBank Credit	18.7%	9.1%	29.2%	34.6%			
Public Sector	19.4%	5.9%	34.7%	42.4%			
Government	16.4%	2.2%	32.6%	41.4%			
SEs and Others	34.8%	27.7%	42.3%	45.5%			
Others	22.3%	23.0%	21.6%	21.8%			
	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
Reserve Estimates		*(ST billions, end of period)*					
RR Base of ComBanks~85%	***156***	***169***	***188***	***213***	***253***	***305***	***348***
Reserve Ratio (RR)	20	20	20	22	23	23	24
Reserve Amounts	31	34	38	47	58	70	84
of which 40% Tbs	12	14	15	19	23	28	33
R-Deposit with CBT	19	20	23	28	35	42	50
Excess R-Deposit with CBT	6	6	7	8	10	12	12
Total R-Deposit with CBT	25	26	30	36	45	54	62
Eff RR of ComBanks (%)	23.7	23.7	23.9	25.8	26.9	26.9	27.3
Reserves of ComBanks	37	40	45	55	68	82	95
T Bills of RR	12	14	15	19	23	28	33
Deposits Reserve with CBT	25	26	30	36	45	54	62
Reserve of Other Banks	*7*	*9*	*10*	*11*	*13*	*17*	*19*
Total Reserves of BankSys	***44***	***49***	***55***	***66***	***81***	***99***	***114***
R-Dep. of BankSys w/CBT	*32*	*35*	*40*	*47*	*58*	*71*	*81*
Reserve of ComBanks	25	26	30	36	45	54	62
Reserve of Other Banks	7	9	10	11	13	17	19

ANNEX VII *Table 7-3 Uses of Credit (1 of 2)*

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Total FinSys Credit	**321**	**361**	**410**	**467**	**538**	**665**	**798**
To Private Sector	**153**	**176**	**201**	**228**	**257**	**282**	**312**
by: ComBanks	138	156	176	195	215	238	267
by: Others (DFIs)	15	20	25	33	42	44	45
To Public Sector	**168**	**185**	**209**	**239**	**281**	**383**	**486**
for Govt., CenBank	90	91	90	96	112	182	224
for Govt., ComBanks	18	19	23	24	27	21	18
Total Govt. (borrowings)	***108***	***110***	***113***	***120***	***139***	***203***	***242***
for SEs by ComBanks	8	12	16	20	23	39	50
for SEs by Cen Bank	12	17	22	25	34	54	72
for SEs by DFIs	28	37	44	53	60	72	94
for SEs by Others	12	9	14	21	25	15	28
Total SEs (borrowings)	***60***	***75***	***96***	***119***	***142***	***180***	***244***
Annual Growth Rates (%)							
Total FinSys Credit	10.6	12.5	13.6	13.9	15.2	23.6	20
To Private Sector	**13.2**	**15**	**14.2**	**13.4**	**12.7**	**9.7**	**10.6**
by: ComBanks	12.8	13	12.8	10.8	10.3	10.7	12.2
by: Others (DFIs)	28.4	33.3	25	32	27.3	4.8	2.3
To Public Sector	**9.2**	**10.1**	**13**	**14.4**	**17.6**	**36.3**	**26.9**
for Govt, CenBank		1.1	-1.1	6.7	16.7	62.5	23.1
for Govt, ComBanks		5.6	21.1	4.3	12.5	-22.2	-14.3
Total Govt (borrowings)	***2.0***	***1.9***	***2.7***	***6.2***	***15.8***	***46***	***19.2***
for SEs by ComBanks		50	33.3	25	15	69.6	28.2
for SEs by Cen Bank		41.7	29.4	13.6	36	58.8	33.3
for SEs by DFIs		32.1	18.9	20.5	13.2	20	30.6
Total SEs (borrowings)	***18.0***	***25***	***28***	***24***	***19.3***	***26.8***	***35.6***
Shares (%)							
Total FinSys Credit	**100**	**100**	**100**	**100**	**100**	**100**	**100**
To Private Sector	**47.7**	**48.8**	**49**	**48.8**	**47.8**	**42.4**	**39.1**
by: ComBanks	43.0	43.2	42.9	41.8	40	35.8	33.5
by: Others (DFIs)	4.7	5.5	6.1	7.1	7.8	6.6	5.6
To Public Sector	**52.3**	**51.2**	**51**	**51.2**	**52.2**	**57.6**	**60.9**
for Govt, CenBank	28.0	25.2	22	20.6	20.8	27.4	28.1
for Govt, ComBanks	5.6	5.3	5.6	5.1	5	3.2	2.3
Total Govt (borrowings)	***33.6***	***30.5***	***27.6***	***25.7***	***25.8***	***30.5***	***30.3***
for SEs by ComBanks	2.5	3.3	3.9	4.3	4.3	5.9	6.3
for SEs by Cen Bank	3.7	4.7	5.4	5.4	6.3	8.1	9
for SEs by DFIs	8.7	10.2	10.7	11.3	11.2	10.8	11.8
for SEs by Others	7.8	5.1	7	9.2	9.7	5.3	9
Total SEs (borrowings)	***18.7***	***20.8***	***23.4***	***25.5***	***26.4***	***27.1***	***30.6***

ANNEX VII *Table 7-3 Uses of Credit (2 of 2)*

	Average Annual Growth Rates						
	Y_1-Y_7	Y_1-Y_4	Y_4-Y_7	Y_5-Y_7			
Total FinSys credit	16.4%	13.3%	19.6%	21.8%			
To Private Sector	12.6%	14.2%	11.0%	10.2%			
by: ComBanks	11.6%	12.2%	11.0%	11.4%			
by: Others (DFIs)	20.1%	30.1%	10.9%	3.5%			
To Public Sector	19.4%	12.5%	26.7%	31.5%			
for Government, CenBank	16.4%	2.2%	32.6%	41.4%			
for Government, ComBanks	0.0%	10.1%	-9.1%	-18.4%			
Total Government (borrowings)	14.4%	3.6%	26.3%	31.9%			
for SEs by ComBanks	35.7%	35.7%	35.7%	47.4%			
for SEs by Cen Bank	34.8%	27.7%	42.3%	45.5%			
for SEs by DFIs	22.4%	23.7%	21.0%	25.2%			
Total SEs (borrowings)	26.3%	25.6%	27.0%	31.1%			
Total ComBank credit	12.6%	13.4%	11.9%	12.4%			
to Private Sector	11.6%	12.2%	11.0%	11.4%			
to Public Sector	17.4%	19.2%	15.6%	16.6%			
to Government	0.0%	10.1%	-9.1%	-18.4%			
to SEs	35.7%	35.7%	35.7%	47.4%			
CenBank Credit	18.7%	9.1%	29.2%	34.6%			
Public Sectors	19.4%	5.9%	34.7%	42.4%			
Government	16.4%	2.2%	32.6%	41.4%			
SEs and others	34.8%	27.7%	42.3%	45.5%			
Non-Bank Private Sector	11.5%	31.0%	-5.2%	-12.4%			
	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Total FinSys Credit	**321**	**361**	**410**	**467**	**538**	**665**	**798**
Total ComBank Credit	**164**	**187**	**215**	**239**	**265**	**298**	**335**
to Private Sector	138	156	176	195	215	238	267
to Public Sector	26	31	39	44	50	60	68
to Government	18	19	23	24	27	21	18
to SEs	8	12	16	20	23	39	50
CenBank Credit	**114**	**123**	**134**	**148**	**176**	**255**	**319**
Public Sector	102	108	112	121	146	236	296
Government,federal	90	91	90	96	112	182	224
SEs	12	17	22	25	34	54	72
Other Government	12	15	22	27	30	19	23
Others	**43**	**51**	**61**	**80**	**97**	**112**	**144**
Other Banks (DFI's)	*31*	*39*	*47*	*55*	*62*	*75*	*97*
Non-Bank Institutions	*12*	*12*	*14*	*25*	*35*	*37*	*47*
to Private Sctor	15	20	25	33	42	36	45
to Public Sector	28	31	36	47	55	76	99
Annual Growth rates (%)							
Total FinSys credit		12.5	13.6	13.9	15.2	23.6	20.0
Total ComBank Credit		14.0	15.0	11.2	10.9	12.5	12.4
to Private Sector		13.0	12.8	10.8	10.3	10.7	12.2
to Public Sector		19.2	25.8	12.8	13.6	20.0	13.3
to Government		5.6	21.1	4.3	12.5	-22.2	-14.3
to SEs		50.0	33.3	25.0	15.0	69.6	28.2

ANNEX VII *Table 7-4 Banking System Credit to Sectors (1 of 2)*
Sectoral Distribution, Targets, Actual Growth

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Total Domestic Credit	**321**	**361**	**410**	**467**	**538**	**665**	**798**
Total Private	153	176	201	226	250	274	312
Total Public	168	185	209	241	288	391	486
Total Sectoral Credit: to	**202**	**234**	**279**	**330**	**384**	**436**	**498**
Public Sector (SEs loans)	*49*	*58*	*78*	*102*	*127*	*154*	*186*
Private Sector: from	*153*	*176*	*201*	*228*	*257*	*282*	*312*
ComBanks	138	156	176	195	215	238	267
Other Financial Systems	15	20	25	33	42	44	45
Sectorial Shares (Amounts)							
Total Sectoral Credit: for	**202**	**230**	**279**	**319**	**365**	**435**	**498**
Production	94	111	135	153	175	205	231
Manufacturing	50	61	78	88	101	121	137
Agriculture	44	50	57	65	74	84	94
General Commerce	59	68	83	99	118	150	182
Services and Others	49	51	61	67	72	80	85
Sectoral Shares (%)							
Total Sectoral Credit: for	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Production	46.5	48.3	48.4	48	47.9	47.1	46.4
Manufacturing	24.8	26.5	28	27.6	27.7	27.8	27.5
Agriculture	21.8	21.7	20.4	20.4	20.3	19.3	18.9
General Commerce	29.2	29.6	29.7	31	32.3	34.5	36.5
Services and Others	24.3	22.2	21.9	21	19.7	18.4	17.1
Annual Growth Rates (%)							
Total Sectoral Credit: for	**15.6**	**13.9**	**21.3**	**14.3**	**14.4**	**19.2**	**14.5**
Production	17.6	18.1	21.6	13.3	14.4	17.1	12.7
Manufacturing	19.2	22	27.9	12.8	14.8	19.8	13.2
Agriculture	12.9	13.6	14	14	13.8	13.5	11.9
General Commerce	14.7	15.3	22.1	19.3	19.2	27.1	21.3
Services and Others	4.5	4.1	19.6	9.8	7.5	11.1	6.3
Target Shares (%)							
Total Sectoral Credit: for	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Production	52.0	52.0	52.0	55.0	55.0	55.0	55.0
Manufacturing	28.0	28.0	28.0	30.0	30.0	30.0	30.0
Agriculture	24.0	24.0	24.0	25.0	25.0	25.0	25.0
General Commerce	30.0	30.0	30.0	33.0	33.0	33.0	33.0
Services and Others	18.0	18.0	18.0	12.0	12.0	12.0	12.0

ANNEX VII *Table 7-4 Banking System Credit to Sectors (2 of 2)*
Sectoral Distribution, Targets, Actual Growth

Average Annual Growth Rates

	Y_1-Y_7	Y_1-Y_4	Y_4-Y_7	Y_5-Y_7			
Total Sectoral Credit: for	16.2%	17.8%	14.7%	13.9%			
Public Sector (DFIs,etc)	24.9%	27.7%	22.2%	21.0%			
Private Sector: from	12.6%	14.2%	11.0%	10.2%			
ComBanks	11.6%	12.2%	11.0%	11.4%			
Other Banks (DFI's)	20.1%	30.1%	10.9%	3.5%			
Total Sectoral Credit: for	**16.2%**	**16.5%**	**16.0%**	**16.8%**			
Production	16.2%	17.6%	14.7%	14.9%			
Manufacturing	18.3%	20.7%	15.9%	16.5%			
Agriculture	13.5%	13.9%	13.1%	12.7%			
General Commerce	20.7%	18.8%	22.5%	24.2%			
Services	9.6%	11.0%	8.3%	8.7%			

CHAPTER VIII

FINANCIAL MARKETS

The Money Market

8.1 The Tusanian money market is primarily a vehicle for the mobilization of funds for the government. During Y_1-Y7, growth was fairly rapid at a rate of 18.5 percent per year. In the early years, of Y_1-Y_4, the growth of money markets was slow at an average rate of 13.6 percent, but in the Y_5-Y_7 period, this growth accelerated to 22.6 percent per year due to a large increase in government papers. The value of government papers increased from ST73 billion in Y_1 to ST107 billion in Y_4, and in Y_7 the value of these government papers was ST198 billion. Most of these money market instruments are government papers such as 90-day treasury bills, treasury certificates of one- to two-year maturity, development stocks, and stabilization securities of 90-day maturity. These government papers amounted to about 77 percent of all the money market instruments throughout the review years, and the remainder are private commercial papers. The growth of commercial papers was close to those of government papers at 19.8 percent during Y_1-Y_7. Overall, the expansion of the money market has been substantial, largely because of government borrowings from the market.

Table 8.1 Money Market

	Annual Indicators				Average Annual Growth Rates		
	Y_1	Y_4	Y_6	Y_7	Y_1-Y_7	Y_1-Y_4	Y_5-Y_7
	(ST billions)				*(per cent)*		
Money Market	**94**	**141**	**226**	**260**	**18.5**	**14.5**	**22.6**
Government Papers	**73**	**107**	**174**	**198**	18.1	13.6	22.9
T-bills	60	104	157	196	21.8	20.1	24.2
Commercial Banks	18	28	37	37	12.8	15.9	9.2
Central Bank, CBT	21	31	65	79	24.7	13.9	38.8
Others	5	8	12	14			
T-Certificates	21	28	41	45	13.5	10.1	13.4
Development Stocks	8	12	19	23			
Commercial Papers	**21**	**34**	**52**	**62**	**19.8**	**17.4**	**21.5**
CD's	6	11	19	24	26.0	22.4	30.9
Commercial Bills	12	18	24	27	14.5	14.5	13.4
Unit-Funds	3	5	9	11	24.2	18.6	25.4
	(per cent)						
Shares of Money Market	100	100	100	100			
Government Papers	77.7	75.9	77.0	76.2			
of which:							
T-bills	51.7	52.3	52.0	54.0			
T-Certificates	46.8	47.5	50.4	50.0			
Development Stocks	8.5	8.5	8.4	8.8			
Commercial Papers	22.3	24.1	23.0	23.8			
Growth Rates							
Money Market	11.6	17.5	30.6	15.0			
Government Papers	12.0	16.3	32.8	13.8			
T-bills	12.6	17.5	39.0	14.0			
T-Certificates	8.5	12.0	17.1	9.8			
Commercial Papers	13.2	21.4	23.8	19.2			

For details see **Annex VIII**, Table 8-1

8.2 Treasury bills dominated the money market as their proportion was about 48 percent of all money market instruments during the entire period of Y_1-Y_7. In effect, the money market in Tusania is basically a treasury bill discount and trading system.

The rediscount rate of T-bills at the CBT was about 5 percent in early years, was raised to 7.5 percent in Y_6 and to 8 percent in Y_7 – a substantial increase over the two years. In comparison, the lending rates of the banking system were much higher though this rate differential in Tusania was similar to the rate differential observed in other countries. The issue therefore is why T-bills remain such a preferred short-term instrument. To begin with, the CBT has, all along, been a major holder of T-bills and a major lender to the government. In Y_1, CBT's share of holdings in total T-bills outstanding was about 46.8 percent, and it increased to about half in Y_7. As far as the rediscounting of T-bills is concerned, it is part of the CBT's routine function. It has little control over the amounts involved on a daily basis and represents short-term borrowings by the government on which CBT has little control either. Further, the T-bills rediscount rate is regarded as the anchor to short-term rates and the financial system does oblige by keeping its short-term interest rate structure close to the T-bills rate. Effective yields on T-bills however, have been rather poor and this, in part, has been responsible for large holdings of T-bills by the CBT.

8.3 Commercial banks reduced their holdings of T-bills from nearly 30 percent in the early years to about 27 percent in later years. Banks treat T-bills as a liquidity source, though at a cost. Their holdings of T-bills in excess of reserve requirements are not so much for portfolio considerations as to have assured liquidity at hand for contingency purposes. Their standing arrangement with the CBT is automatic discounting of T-bills whenever their account with the CBT is overdrawn. This is to avoid various penalties, the most important one being the denial of access to foreign exchange. Other financial institutions hold T-bills more or less for the same reasons. Further, the CBT occasionally instructs the banks to buy additional T-bills and other government papers – essentially T-bills with another name – in amounts exceeding their reserve requirements or liquidity levels. The holding of these securities is mandatory; these are non-transferable and non-negotiable during their 90-day maturity. In effect, it is forced borrowing by the government at below- market costs

and an implicit taxation on the banking system profits. The private non-bank sector also holds governments papers in small amounts.

8.4 There is hardly any trading in these papers over the counter or rediscounting by the banking system. The main reason for the lack of re-discounting of T-bills by the banks at large is that such rediscounting is regarded as an extension of credit by banks rather than as a money market transaction, which bumps against credit ceilings of individual banks. That leaves only the CBT to rediscount the T-bills or government securities. In the past, the authorities maintained that the lack of activity in the money market was primarily because there were not enough banks to undertake the trades. But in a situation where the quantity, price, and the terms are all specified by a seller, there can hardly be a market, regardless of the number of participants.

8.5 In Y_5, the government introduced a system of auctions in T-bills as part of its effort to encourage development of a secondary money market. It held a number of auctions. The over-riding concern during Y_5-Y_7, however, was to halt increases in domestic credit and liquidity control and interest rates were allowed to rise, but the general level of interest rates remained fairly low, in comparison to the price level. The T-bill rate increased, yet the spread between the T-bill rate and the market rates was now larger than it had ever been. Further, since only authorized banks can trade T-bills and access the rediscount at CBT, and since over-the-counter trade is not allowed, a secondary market could not emerge.

8.6 More or less the same is true with treasury certificates (TCs). These TCs also have a short-term maturity, bearing an average interest rate close to T-bills. In Y_1, the amount of TCs outstanding was ST21 billion and rose to ST45 billion in Y_7. More than half of TCs have been held by the CBT through a perpetual roll-over throughout the years. There is hardly any market activity associated with TCs except trading between the banks, and the CBT is the instrument. Development stocks are primarily capital market instruments floated in the capital market, but they are

eligible for discount at the CBT when their maturity is within 3 years. The proportion of development stocks eligible for rediscounting is fairly small relative to the total amount of development stocks outstanding. At the end of Y_7, the amount of development stocks eligible for rediscounting were rather small – about ST8 billion. These are not money market instruments. However, since they can be rediscounted at the CBT, if eligible, they are being perpetually rolled over and are an instrument of short-term monetary management. The CBT regards them as money market instruments, odd though it may be. Further, this eligibility covers development stocks issued by the federal government and not the bonds issued by the state governments, though they are similar.

8.7 As regards private commercial papers, commercial bills of exchange are the dominant part of the market. Their value more than doubled from ST21 billion in Y_1 to ST62 billion in Y_7. However, an encouraging development is the substantial increase in the certificate of deposits (CDs) from ST6 billion in Y_1 to ST24 billion in Y_7. But most of the increase in CDs occurred during Y_5-Y_7 coinciding with a partial deregulation of the interest rate. In mid-Y_7, there was again a push for CDs at substantially higher interest rates and the impression is that CDs are gaining a larger acceptance among the public.

8.8 For these reasons, the money market has not deepened in Tusania. Unless the government moves towards indirect instruments of monetary control, uses open market operations, unhinges the rate structure currently anchored to T-bill rates, removes the credit ceiling, and actively promotes second-party rediscounting and over-the-counter trade, there will not be much of a money market, primary or secondary, in Tusania. For the same reasons, money markets will remain an insignificant factor in market-based resource mobilization and allocation.

The Capital Market

8.9 In Tusania, the capital market is rudimentary. It has not been an important source of long-term funds, either to the private or public sectors. Like the money market, the capital market is also dominated by securities of government-owned companies, government bonds, and publicly-guaranteed papers. The share of government stocks has typically been nearly one-fourth of total stocks traded at the Tusanian Stock Exchange (TSE) over a number of years, except in recent years when this proportion declined slightly. There was a steady growth in market capitalization throughout the review years at an annual average rate of 7.1 percent. In the early years of Y_1-Y_4, the growth was fairly rapid at 7.9 percent per year, but later during Y_5-Y_7, it slowed to 4.9 percent. Likewise there was healthy growth in the activities of the TSE. The volume of shares traded increased at an annual average rate of 8.7 percent during Y_1-Y_7, but there were significant variations during these years. The volume of shares traded increased at 10.4 percent per year during Y_1-Y_4, and then declined to 8.1 percent in Y_6. In Y_7, especially in the second half of the year, stock markets picked up momentum and both trading and values increased faster than in the previous years

8.10 The capital market turnaround in Y_7 was due to two reasons. First, the high interest rates made it attractive for firms to look for equity rather than loan finance. Second, the government brought forth for sale nearly 94.5 million shares for privatization of public enterprises. New offers for subscription increased in Y_7, and the amount of new issues was ST4 billion. The companies, however, consider the cost of issuing at the TSE too high, and a good amount of trading is done off the TSE. In Y_7, the volume of shares traded on the TSE was 281 million as compared to 432 million shares traded in Y_6. The value of shares traded was ST32 billion, as compared to ST55.2 billion in Y_6. The stock price index at the TSE had its ups and downs. Starting at 102.7 in Y_1, it increased to 119.0 in Y_7 – up by nearly 4

Table 8.2 Tusanian Stock Exchange

	Annual Indicators				
	Y_1	Y_4	Y_5	Y_6	Y_7
	(US$ millions, end of period)				
Market Capitalization	**51**	**64**	**70**	**74**	**77**
Volume Shares (million)	281	378	411	432	463
Value Share, (billion)	32.0	49.6	53.2	55.2	61.5
Volume Shares (daily, 237)	1.19	1.59	1.73	1.82	1.95
Value Shares (daily, million)	135.0	209.3	224.5	232.9	259.5
Stock Price Index	102.7	118.2	115.8	114.6	119.0
Number of Listed Securities	163	179	183	186	188
Government Stocks	**54**	**60**	**64**	**67**	**69**
Corporate bonds	14	29	33	34	35
Equities	95	90	86	85	84
Number of Dealer Members	17	25	29	31	32
Number of Listed Companies	95	90	86	85	84
Annual Growth Rates					
Market Capitalization	7.8	6.7	9.4	5.7	4.1
Volume Shares (million)	10.2	11.5	8.7	5.1	7.2
Value Share	12.6	17.8	7.3	3.8	11.4
Stock Price Index	2.7	5.3	-2.0	-1.0	3.8

For details see **Annex IV**, Table 4-1

percentage points over Y_6 – in contrast with nearly 1 percentage point decline in Y_6, and on the heels of another decline of about 2 percent in Y_5. This turnaround in Y_7 in the stock market, in contrast with a decline in the previous two consecutive years, provided a much-needed build-up of investor confidence in the Tusanian economy. A good deal of this turnaround was concentrated in the second half of year Y_7.

8.11 In the bond market, federal government development stocks dominate. These papers are floated with the objective of borrowing a pool of funds by the federal government for onlending to the state governments on the basis of an agreed formula, instead of each state going to the market and borrowing on its own. The development

stocks are issued by the CBT on behalf of the federal government, and these are quoted on the stock exchange. CBT purchases most of the stocks, and the issues are gradually sold to the savings-type institutions. The number of these stocks outstanding has remained the same over a number of years, at about ST8.6 billion, though it increased slightly to ST9.2 billion by Y_7. At any time, the CBT has held about 40 percent of these stocks, while the deposit money banks have held about 20 percent. The remainder is distributed over a number of financial institutions and the public.

8.12 A second-tier securities exchange was established in Y_3 to encourage smaller domestic companies to list on the TSE, but such efforts have culminated in only 10 new issues as of Y_7. In the mainstream, however, of those companies that did issue public shares, the majority were foreign-controlled. There is also a notable absence of municipal and local authority issues, real estate investment trusts, and other security vehicles. The relatively small number of industrial securities listed on the TSE is attributed to relatively cheaper sources of funds available through banks until the increase in interest rates in Y_7. As a result, the impression is that the ratios of debt to equity have been relatively high, although no data is available to confirm this.

8.13 A few commercial banks, engaged in investment-type banking, play an important role in the capital market. Lately, they have become more active on behalf of their clients in raising equity finance. Insurance companies and pension funds are entering the stage of mobilizing longer-term resources. To encourage equity finance for the expansion of small and medium size businesses, the government has allowed commercial and merchant banks to take limited equity positions in corporate enterprises. Limits provide that each bank's total equity position in all small- and medium-scale enterprises it invests in does not exceed one-third of the shareholders' fund or 10 percent of the company's equity.

8.14 The Securities and Exchange Commission (SEC) is the regulatory authority of the capital markets. Its responsibilities are to:

i. register securities proposed to be offered;
ii. maintain surveillance over the securities market;
iii. register stock exchanges and securities' dealers and agents;
iv. approve share allotments;
v. price new shares; and
vi. ensure that small investors are given the maximum allotment of shares.

Its role in determining prices of new shares rather than reviewing prices proposed by underwriters is most controversial. This role is not a statutory defined, but has grown in practice over time. The rationale for the SEC pricing policies lies in the concern that investors, relatively unsophisticated, need to be protected and that low share prices would increase the demand. As a result, many companies have stayed away from issuing public shares. It has been suggested that the SEC should discontinue the pricing function and let syndicates of stock brokers set the price of the securities when they are floated.

8.15 Although it is designated as the regulatory body for the capital markets, the SEC has little power over the members of the Exchange. Instead, the CBT and the TSE wield most of the power. Currently, SEC activities are oriented strongly toward "investor protection", rather than toward market development, which has a cost. Emphasis is needed on the development of the market. For this purpose, the SEC law and the enabling legislation of the capital markets need to be reviewed to offer increased potential for market development. Most importantly, the equity share price-setting function, performed de facto by the SEC, discourages would-be issuers of shares since prices set by the SEC may be below their estimate of an optimal price. This has been cited as a conflict of interest of major proportions – the SEC cannot be an independent regulatory authority at the same time as a price-setting and share-evaluation authority.

8.16 A number of other factors have impeded the development of the capital market. Under the Trustee Investment Acts, trustees of pension funds can invest only in those securities listed on the stock exchange and those whose issuing company has a paid-up share capital of ST10 million. Moreover, trustees are required to invest at least 67 percent of their funds in government securities. These requirements result in pension funds being under-invested in stocks and restrict the flow of trust funds into the capital market. There is evidence of discrimination against institutional investors versus individual investors in equity shares. When shares are issued, preference is usually given to small investors that apply for 100 to 1,000 shares before remaining shares are allocated to institutional investors. Insurance companies are therefore unable to purchase all the equity securities they are required to hold on the stock market because of the stock exchange policy. Constraints also exist for individual investors. Under current law, an individual Tusanian investor can purchase shares in any one company up to a maximum of only 5 percent or ST50,000, unless the investor is the owner or manager.

8.17 Certain tax laws create disincentives for the growth of an equity market. For example, the law requires that all entities must pay withholding tax on the income from invested funds, regardless of their tax-exempt status. While in recent years pension funds were exempt from such a tax, they are now no longer. Also, the tax rate of small companies has been reduced but the definition of small-scale companies limits the number of firms that can benefit from the reduction. Redefinition of small businesses would reduce the tax burden on companies and increase capital formation. Finally, the capital market laws do not allow foreigners to participate.

8.18 In Tusania, owners of companies are generally reluctant to dilute their ownership and control. Non-resident owners are also reluctant to offer their shares for sale and do not want to further dilute their ownership. Occasionally, investors buy shares with loans or use shares as collateral for other loans and thus cannot participate in share trading. Further, Tusanians view share-holdings as long-term

assets, and a sale is taken as a sign of financial weakness. The regulations controlling transactions in stocks are rigid. For instance, two brokers bidding for one parcel of shares are required to divide the parcel, so they cannot bid the price up until one concedes. The prices, therefore, are depressed. As long as the company pays regular dividends, Tusanian shareholders see no reason to offer their shares for sale, certainly not at depressed prices. Moreover, the law does not allow transfers of shares to people other than to relations with similar names.

8.19 Public awareness regarding participation in stock-trading activities is weak. Few people are aware of how the TSE or the SEC operate and what services may be available. Above all, it is very difficult for small investors to size up the market value of shares, as hardly any information is available to the public on the companies offering shares for sale. Even when one participates, a lot of time is wasted between subscription, allotment, and receipt of the certificate of stock ownership.

8.20 In addition, there are a number of problems concerning the logistics and operations of the TSE which hamper the functioning of the capital market. There are three trading floors for the stock exchange, communications are very poor, and it is almost impossible to get feedback at the close of each business day. The TSE badly needs to computerize its operations and has sought assistance several times without much success. These issuing costs are too high for indigenous companies, who may opt for the public issue of their shares on the exchange. Legal charges, printing, and distribution costs are very high compared to many other countries. Company registration services are expensive. The total issuing cost could be about 5 per cent of the issue amount, with the one per cent agency/brokerage commission inclusive. There is also a serious shortage of skilled stock traders, agents, brokers, and financial appraisers. There is no distinction between jobbers and brokers on the exchange, and there are no underwriters *per se* in the market. The quality of services provided by stockbrokers, issuing houses, and registrars has been improving, but are still poor.

8.21 The unlisted securities market is large, owing to listing requirements, the high cost of being quoted on the exchange, and the reluctance of indigenous companies to seek public quotations. There are no reliable statistics on the size of the market, but given that in Y_7 995 million shares were raised off the TSE, the market in the organized private sector is large enough. In the unorganized sector, a lot of companies chose to sell their shares outside the exchange through private arrangements, thus excluding institutional investors. Although issuing houses do get involved in arranging some private placements for their clients on a commission basis, most of the deals seem to be among a restricted circle of business associates without any financial or other assistance from institutions. There is, thus, an institutional gap, by choice, in providing equity finance and the management services to the indigenous companies in Tusania.

8.22 Lately, trading activities at the TSE have picked up, and the stock market has begun to play its role in savings mobilization. Most of the shares offered in Y_7 were oversubscribed. With this deluge of shares from both the public and private enterprises, the main issue is the capacity of the market to cope with the demand for equity finance.

ANNEX VIII *Table 8-1* *Money Market*

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Money Market	**94**	**106**	**120**	**141**	**173**	**226**	**260**
Government Papers	**73**	**82**	**92**	**107**	**131**	**174**	**198**
T-bills	44	50	57	67	82	114	130
ComBanks	18	21	22	28	31	37	37
Central Bank, CBT	21	24	28	31	41	65	79
Others	5	5	7	8	10	12	14
T-Certificates	21	23	25	28	35	41	45
Development Stocks	8	9	10	12	14	19	23
Commercial Papers	**21**	**24**	**28**	**34**	**42**	**52**	**62**
CD's	6	7	8	11	14	19	24
Com-Bills	12	14	16	18	21	24	27
Unit-Funds	3	3	4	5	7	9	11
Shares (%) of Money Market	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Government Papers	77.7	77.4	76.7	75.9	75.7	77.0	76.2
T-bills	46.8	47.2	47.5	47.5	47.4	50.4	50.0
T-Certificates	22.3	21.7	20.8	19.9	20.2	18.1	17.3
Development Stocks	8.5	8.5	8.3	8.5	8.1	8.4	8.8
Commercial Papers	22.3	22.6	23.3	24.1	24.3	23.0	23.8
Growth Rates (%)							
Money Market	11.6	12.8	13.2	17.5	22.7	30.6	15.0
Government Papers	12.0	12.3	12.2	16.3	22.4	32.8	13.8
T-bills	12.6	13.6	14.0	17.5	22.4	39.0	14.0
T-Certificates	8.5	9.5	8.7	12.0	25.0	17.1	9.8
Development Stocks	11.7	12.5	11.1	20.0	16.7	35.7	21.1
Commercial Papers	13.2	14.3	16.7	21.4	23.5	23.8	19.2

Average Annual Growth Rates

	Y_1-Y_7	Y_1-Y_4	Y_4-Y_7	Y_5-Y_7			
Money Market	18.5%	14.5%	22.6%	22.6%			
Government Papers	18.1%	13.6%	22.8%	22.9%			
T-bills	19.8%	15.0%	24.7%	25.9%			
ComBanks	12.8%	15.9%	9.7%	9.2%			
Central Bank, CBT	24.7%	13.9%	36.6%	38.8%			
T-Certificates	13.5%	10.1%	17.1%	13.4%			
Commercial Papers	19.8%	17.4%	22.2%	21.5%			
CD's	26.0%	22.4%	29.7%	30.9%			
Com-Bills	14.5%	14.5%	14.5%	13.4%			
Unit-Funds	24.2%	18.6%	30.1%	25.4%			

ANNEX VIII *Table 8-2 Size: Turanian Stock Exchange*

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7
	(ST billions, end of period)						
Market Capitalization,*(billions)*	**51**	**54**	**60**	**64**	**70**	**74**	**77**
Volume Shares (millions)	281	312	339	378	411	432	463
Value Share, (billions)	32.0	36.4	42.1	49.6	53.2	55.2	61.5
Volume Shares (daily)	1.19	1.32	1.43	1.59	1.73	1.82	1.95
Value Shares (daily, millions)	135.0	153.6	177.6	209.3	224.5	232.9	259.5
Stock Price Index	102.7	105.4	112.2	118.2	115.8	114.6	119.0
Number of Listed Securities	163	168	178	179	183	186	188
Government Stocks	54	56	57	60	64	67	69
Corporate bonds	14	18	25	29	33	34	35
Equities	95	94	96	90	86	85	84
Number of Dealer Members	17	20	22	25	29	31	32
Number of Listed Companies	95	94	96	90	86	85	84
Annual Growth Rates (%)							
Market Capitalization	7.8	5.9	11.1	6.7	9.4	5.7	4.1
Volume Shares (millions)	10.2	11.0	8.7	11.5	8.7	5.1	7.2
Value Share	12.6	13.8	15.7	17.8	7.3	3.8	11.4
Stock Price Index	2.7	2.6	6.5	5.3	-2.0	-1.0	3.8

Average Annual Growth Rates

	Y_1-Y_7	Y_1-Y_4	Y_4-Y_7	Y_5-Y_7			
Market Capitalization	7.1%	7.9%	6.4%	4.9%			
Volume of Shares	8.7%	10.4%	7.0%	6.1%			
Value of Shares	11.5%	15.7%	7.4%	7.5%			

CHAPTER IX

THE ANNUAL PROGRAM FOR Y_8

9.1 This chapter provides in outline the Annual Program for Y_8 that the Tusanian government formulated and adopted in response to the crisis prevailing over the past couple of years. This, in itself, was not unusual because every year the government enacts an Annual Program outlining the direction of the Tusanian economy; a set of broad-based objectives, and target levels of economic and financial developments, based on a package of policies and programs. The package is seen as a continuation of previous annual programs, but for Y_8 the "business as usual" approach was clearly out of the question. The government realized that the Annual Program of Y_8 had to be far-reaching to come to grips with the crisis situation. It also had to be credible enough to begin to restore confidence, both domestically and abroad, and to break the ongoing cycle of high inflation, declining growth, and the severe financial crisis, coupled with speculation which could not be sustained and that was diverting resources to activities which further destabilized the Tusanian economy.

Overall Objectives

9.2 The foremost objective of the Annual Program for Y_8, therefore, was to restore stability, and having achieved that, to provide for recovery and modest growth. Restoring stability primarily meant controlling inflation, followed by

restoring confidence among the leading segments of the Tusanian economy – especially the financial system. This was to ensure that the flow of financial resources was not disrupted or diverted away from those with the potential of contributing the most to production, trade, and the balance of payments. The Annual Program of Y_8 had to allow enough financial resource, credit, and liquidity to the productive sectors through the banking system to prevent a wide-spread shut-down and closures of industrial capacity. No government could survive declining production and income over a prolonged period. Already during Y_5-Y_7, there had been a decline in the rate of growth of GDP to 0.7 percent per year, with only 0.2 percent growth in real output and income during Y_7. For three years in a row, economic performance had been unacceptably poor, and this situation could not be sustained any longer. The Y_8 Program was also meant to restore the confidence of foreign creditors and financiers to resolve the overhang of external liabilities and arrears. This would ensure a net inflow of external finance to allow a critical minimum of imports of industrial raw materials, machinery, spare parts, and oil and petroleum products, to sustain domestic production and employment. These were the dimensions of the tasks concerning restoration of stability, followed by recovery and modest growth.

The Process—Approach and Constraints

9.3 The program formulation process is as follows. Routinely, the Tusanian government begins the annual program formulation six months ahead, charting out bench-marks for the upcoming year. The government issues these bench-marks and guidelines by mid-May to the group responsible for policy and program formulation, mainly the Ministry of Finance (MoF) and the CBT. The next step is for this group to develop a draft short-term economic and macro-financial program for Tusania. The starting point is to sketch the feasible boundaries of the resource requirements based on feasible bench-marks, both for internal and external balances, and a realistic assessment of the government's capacity to implement the program and sustain its

impact without major reversals. The goal is to ensure that the feasibility of the program squares off with the general acceptability of a short-term prospect both for the government and the public. The draft program is submitted to the government by July, incorporating the assessment and feasibility. A process of internal review follows, keeping an eye on the type of stabilization package being advocated by the AMLs, who eventually are requested to provide the essential backing and external finance to support the program's implementation. The government finalizes the program by mid-September for presentation to the legislature in early October. After a month of deliberation, the program is approved by the legislature and by mid-November the program is released. This is a routine process, however, the formulation of the Y_8 Program was anything but routine. By the time the government started the formulation of the Y_8 Program in mid-Y_7, the Tusanian crisis had worsened, making the task far more complicated.

9.4 The approach adopted was as follows. The centerpiece of the program package concerned aggregate-demand management. It involved macro-financial, fiscal, and foreign trade policy measures over the short-term, defined as Y_8 and Y_9, while Y_8 was to be the focus of the Annual Program year. The main short-term impact was anticipated from the control of domestic money demand through control of domestic liquidity to curtail both private and public sector expenditures. For the public sector this would require reducing the budget deficit through fiscal measures, control of credit availability, a slowdown in investment expenditure, and control of the SEs' financial performance to reduce the quasi-fiscal deficit, thus reducing the overall borrowing requirements of the public sector. To achieve a reduction in private sector demand, reliance had to be placed on the price mechanism. This would start with the removal of price controls, the economic pricing of goods and services provided by the SEs and the public sector, a realistic alignment of the interest rates with availability of credit, reduction of preferential or directed credit, and increases in revenues through taxes where feasible. This general belt-tightening was to be accompanied by both exchange rate adjustments, as needed, and appropriate trade

policies affecting short-term capital inflows. It was obvious that small adjustments in the exchange rate of the type pursued over the previous two years, and most recently in early Y_7, would be ineffective by themselves. The devaluation would have to be significant to correct the erosion in Tusania's foreign trade and capital inflows over the past few years. Because no government has survived declaring in advance that it is contemplating devaluing its currency, any devaluation had to be implicit in the benchmarks and targets embedded in the program. In other words, the economic and macro-financial program, though short-term in its time horizon, had to address the underlying causes of the economic and financial crisis. While it would not have been possible over the period of a couple of years to eliminate or even substantially remove the underlying structural imbalances caused by price and non-price distortions and interventionist policy regimes, the program had to begin to restore the balance between resource supply and resource use. These short-term actions would not only be painful, but would also require a determined effort on the part of the government as they would have to be implemented as a package, not piecemeal. An attempt was made, to the extent possible, to ascertain both the direction and the degree in which these measures had to be applied. Provided these measures were implemented in substance, the perception was that Tusania should be able to move out of the current crisis, achieve stability, and resume economic recovery.

9.5 This agenda would be a daunting challenge for any government, and especially Tusania, since for the past couple of years, the Annual Programs for Y_5 and Y_6 had been similar in content and direction and had proclaimed that stability and recovery were just around the corner. For the policy makers, the challenge was to restore their credibility. For the parliamentarians and opinion-makers the challenge was to confront a skeptical electorate that would greet the call for further belt-tightening with a déjà-vu sentiment. Restoration of confidence was not just a matter of the technocratic aspects of the Annual Program for Y_8, but also of the political dimensions of the perception of the Program. Over the past couple of years, the government had had to resign en-bloc twice, and the third government in mid-Y_7 was

already nervous about being ousted if the economic situation did not stabilize. The government was aware that it might be obliged to bow out in the aftermath of its efforts to implement a stringent program. In essence, any program enacted in response to the type of economic and financial crisis discussed above was bound to impose severe hardships on the public without any gain or immediate improvement in sight, thereby causing an uproar and opposition no matter what the system of governance. The sight of long bread-lines, store shelves bare of necessities, the breakdown of strategic utilities and services, protest marchers with empty baskets – all conjured up the recipe for a breakdown that politicians and governments could not contemplate. The technocrats in charge of the formulation of the economic and macro-financial program could not afford to be oblivious to these consequences, heaped upon an already prevailing crisis situation. The euphemism that the program will cause further belt-tightening, though improvements were around the corner, was not enough solace to those affected. If the political process will allow it, the opposition is likely to succeed in de-stabilizing the government. Those were the risks involved, debilitating to any government intending to launch a major stabilization program in the midst of a crisis situation.

9.6 In such an environment, the severity of the crisis imposed a binding set of constraints for the policy makers, reducing their degree of freedom for action on a wider front. The first set of constraints was the availability of both domestic and external finance to sustain the program, the so-called "elbow-room." The second set of constraints was concerns of how freewheeling the government could be in adopting any program, the acceptability of the program to the public in general, and the ability of the government to resist dilution and compromises by powerful groups and influential constituents. The third set of constraints was the capacity of the government to implement and carry through central elements of the program without serious erosion of the effectiveness in its chain of command, down the line, in reaching the target groups.

Dimensions of the Y_8 Annual Program—*Benchmarks and Targets*

9.7 In specific terms, the Y_8 Program set forth the following broad-based economic targets:

i. Price level (CPI-based) to be contained at 15 percent as compared to about 23 percent per year during the past three years. This did not represent a "target" in the strict sense of the term, rather an outcome anticipated by authorities.

ii Money Supply (M_2) to increase by 16 percent as against 19 percent per year during Y_5-Y_7.

iii. Domestic credit to increase by 15 percent as against 20 percent per year during Y_5-Y_7.

iv. Total public sector deficit not to exceed 14 percent of nominal GDP, one of the most stringent requirements of all.

v. Increase of 12 percent in exports, and 8 percent in imports, thus keeping the current account deficit at $1 billion in Y_8.

vi. Foreign borrowings and debt servicing to adhere to the multi-party international agreement, so as to keep the debt servicing burden at 25 percent of foreign exchange earnings from exports and remittances.

vii. Based on the above, the Program stipulated a target rate of growth of real GDP at 1.4 percent during Y_8.

Table 9.1 Bench-Marks – Annual Program for Y_8

	Actual		Projected	Annual Increase (%)		
	Y_6	Y_7	Y_8	Y_6	Y_7	Y_8
Prices, Level (CPI Index)	237.0	290.1	333.6	24.5	22.4	15.0
GDP (constant value)	1451	1454	1474	1.2	0.2	1.4
Money Supply (M_2)	619	732	842	20.7	18.3	15.0
Domestic Credit	665	798	878	23.6	20.0	10.0
Public Sector Deficits	427	552	487	30.2	29.3	-12.7
Exports (US$)	1805	1834	1925	3.7	1.6	5.0
Imports (US$)	3196	3118	3242	6.5	-2.5	4.0
Debt Service Ratio (%)	29.7	32.7	25.2			

9.8 These targets and bench marks need to be evaluated with reference to recent developments that have already been reviewed. These have been summarized in *Table 9.1* above and are discussed in the following paragraphs.

The Macro-Financial Program

9.9 The centerpiece of the macro-financial program for Y_8 was to control the growth of domestic liquidity, mainly through controls on money supply and domestic credit to the economy. A layered system of growth targets was specified in the Annual Program for Y_8, both for the CBT and the banking system on their lending operations, since the size of the domestic credit was critical to control the aggregate demand. The credit control mechanism already in place provided a relatively better grip on the growth of credit, both to the public and private sectors, than the growth of money supply (M_2). Only currency growth could be directly controlled by the CBT, not the deposit growth, and currency constituted about one third of M_2. Therefore, controlling growth of domestic liquidity boiled down to credit controls and currency growth during Y_8. The primary control instruments were quantitative targets and interest rate hikes, while reserve requirements remained unchanged for reasons given below.

Domestic Credit

9.10 The bench-mark target for the growth of total domestic credit was stipulated at 10 percent in the Y_8 Program on the heels of 19.6 percent growth per year over the preceding three years. Already, during the first half of Y_7, total domestic credit had increased by nearly 14 percent, as shown by the quarterly financial statements released by the CBT.[1] Among the components, credit to the public sector had

[1] Analysis of macro-financial developments during the year is limited by the lack of up-to-date information. The data received regularly are the quarterly CBT balance sheets, but the data is not disaggregated to enable tracing of CBT credit to the public and commercial bank credit to the private sectors. Routine reporting of monetary variable has a six-month lag, and

increased even faster, and was growing unabated during Y_7, while credit to the private sector was showing sluggish growth. As a result of this overall rapid credit expansion, various price increases, such as doubling the prices of the SE's farm products, moderate increases in agricultural support price, the government's ambitious expenditure plans, and devaluation of the Siwat, – all these factors, put considerable pressure on the general price level. By mid-Y_7, the expectation was that inflation, as measured by the CPI index, would again be in excess of 20 percent for Y_7. The target, however, was set to increase in the general price level at 15 percent for Y_8. Further, the cap of a 10 percent increase in total domestic credit implied that there would be a substantial reduction in the borrowings of the public sector from the CBT and the banking system over the Y_7 level. This in turn depended upon how the public sector would be able to contain its deficit, and what its credit needs would be. In parallel, if indeed there was to be some economic recovery and growth of real GDP, at even a modest 1.4 percent as included in the Program bench-marks, credit to the private sector would have to be maintained not only at previous levels, but increased proportionately. This increase in private credit would have to come at the expense of the public sector. On this basis:

i. the target rate of a 10 percent increase in the total domestic credit to the economy implied that the financial system could credit from ST798 billion in Y_7 to ST878 billion in Y_8;

ii. in order that public sector credit needs be contained, the credit to the public sector in Y_8 could increase by only about 5 percent to ST510 billion over the Y_7 level estimated at ST486 billion;

iii. to revive economic activity, credit availability to the private sector could be increased by 18 percent in Y_8 to ST 368 billion, as compared to an estimated ST312 billion in Y_7. Of this ST318 billion, the bulk of it was to be provided by commercial banks, and the remainder ST50 billion by other banking institutions.

---

the component data is even further behind. Fiscal data is available, again with a six-month lag, though budget totals on taxes, revenues, expenditures and deficits, are available on a quarterly basis.

iv. these aggregate credit levels, from the supply side, could be realized only if the public sector credit supplied by the CBT increased by no more than 6 percent in Y_8 to ST338 billion over the Y_7 level of ST319 billion. Of this total CBT credit, ST258 billion was to be borrowed by the government to finance the federal deficit, ST66 billion by the SEs, and the remaining ST14 billion for other government organizations;

v. again, on the supply side, these aggregate targets implied that the commercial bank credit could increase by 15.8 percent to ST388 billion in Y_8. Of this, ST318 billion was credit to the private sector by the commercial banks, and ST70 billion to the public sector, mostly to the commercially viable SEs;

vi. The target for the DFI's credit expansion was stipulated at 13.5 percent for Y_8, and the credit amount was ST110 billion, compared to ST97 billion estimated for Y_7. The bulk of the DFI's credit was intended for the SEs and a small amount for the private sector.

Table 9.2 Banking Credit – Annual Program for Y_8

	Actual		Projected	Annual Increase (%)		
	Y_6	Y_7	Y_8	Y_6	Y_7	Y_8
	(Siwat billions)					
Total Domestic Credit	665	798	878	23.6	20.0	10.0
Public Sector	383	486	510	36.6	26.9	5.0
Private Sector	282	312	368	9.7	10.6	18
CBT Credit	255	319	338	45.0	25.0	6.0
Commercial Bank	**298**	335	388	12.5	12.4	15.8
DFIs	75	97	110	21.0	29.3	13.5

9.12 This is how far the Annual Program went in stipulating quantitative targets for credit growth, by major sources, and intended use in the public and private sector. Beyond that, the implementation mechanism of the CBT took over to monitor institutional level performance through its directives, but only for private sector operation. These directives provided for bank-by-bank credit ceilings, given their

past record, performance, liquidity levels, and equity base. These institutional targets, however, were not elaborated in the Annual Program. For the public sector, separate sub-ceilings for CBT credit to the government and to SEs were stipulated, but further breakdown was not provided because these are variables derived from decisions about revenues and expenditures.

9.13 In Tusania, there is basically only one financial pot for both the government and SEs, since transfers of funds between the two are both possible and frequent in practice. There is a question mark, however, concerning the willingness and ability of the government to engineer such a slowdown. Tusania's commitment to the SEs is well known. In addition, the government is committed to maintaining public investment in infrastructure and manufacturing even if it means exceeding the expenditure ceiling of the fiscal program. Further, given the historical pattern, the private sector was frozen out of the CBT credit, since the private sector could meet its credit requirements mainly from commercial banks and partly from the DFIs and other financial institutions.

9.14 The expectation, however, was that the targeted slowdown in credit expansion would still leave enough room for the attainment of economic recovery, though constrained by the balance of payments. By contrast, for many countries the experience with stabilization programs has been that of stagnation and unemployment instead of economic growth. It was obvious that Tusania would need to take steps to ensure that investment, both public and private taken together, remained adequate to ensure, first, utilization of existing capacity, and second, completion of manufacturing units under construction – especially those fairly close to starting production. Therefore, a modest investment growth was contemplated and was the driving consideration behind a substantial increase in credit to the private sector.

9.15 Based on these considerations, the targeted levels of credit growth for the public and private sectors in the Y_8 Program did not seem unreasonable. To prevent a

breach of the ceiling on public sector credit by the CBT, direct recourse to the CBT by public agencies was suspended, and access was to be routed through the MoF to ensure proper allocation of credit among public sector agencies. While credit to the private sector was loosened, the authorities considered interest rate increases, together with higher reserve requirements, to keep private sector demand within acceptable limits. Among these, the reserve requirements were already fairly high at 24 percent in Y_7 and 23 percent in the preceding two years. Besides, given the need to remain liquid, banks routinely maintained excess reserves and the actual reserve ratio for commercial banks was 27.3 percent. Raising the reserve requirements, therefore, was ruled out as part of the Y_8 package.

9.16 The only option left to the authorities was to raise interest rates, in particular, the re-discount rate of the CBT on treasury bills (T-bills), which served as the anchor for the entire interest rate structure in Tusania, as discussed in Chapter V. During Y_5-Y_7, the CBT had undertaken a modest increase in the re-discount rate from 6.5 percent in Y_5 to 7.5 percent in Y_7 without much impact on the demand for credit. The Y_8 Program envisaged increasing this rate to 8.7 percent, even though it would mean a nearly 16 percent increase on the cost of borrowing to the government through T-bills. This increase in the re-discount rate was expected to increase the structure of lending rates by about 2 percent, and across-the-board, from 15.5 to 18.0 percent, a substantial increase and fairly close to the anticipated increase in price level. But the interest increase was also expected to substantially cool down the economy and perhaps snuff out any expectations of economic recovery.

Money Supply Growth

9.17 The bench-marks of the Y_8 Program called for 16 percent growth in the money supply (M_2) based on several considerations, discussed in detail in Chapter VI. To summarize, the formulation of target growth of the money supply in the Tusanian annual programs is based on the targeted growth rate of real GDP, the

anticipated level of inflation, the historic demand for real money balances, and a margin of flexibility of 2 to 3 percent. This allows for a differential in Tusanian productivity growth and that of its major trading partners, so that the higher inflation rate in Tusania will not hurt Tusania's competitiveness. This total price increase must also absorb the impact of the devaluation of the Siwat on the domestic price level, which was not expected to be substantial. On this basis, the target growth rates of money supply should have been about 18.5 percent for Y_8, as compared to 22.4 percent in Y_7. A money supply growth rate of 18.5 would have been closer to the observed ratio of money supply to the GDP and would have been in line with the historic demand for real money balances in relation to GNP, corrected for inflation and liquidity levels needed by the banking system. That the bench-marks of Y_8 called for a lower rate of increase of 16 percent in money supply, indicated that the authorities gave up the productivity differential adjustment and were confident that inflation could be contained at 15 percent in Y_8. Above all, the authorities did not allow anticipation of a major devaluation in the Siwat in an official manner, though it was abundantly clear that a major devaluation of the Siwat was pivotal to the stabilization package being negotiated with multilateral agencies – the AMLs. Without this package in place, there would be no resolution of the overhang of external debt, arrears, and defaults. Curiously enough, devaluation did not figure in the stipulation of money supply growth targets in the Annual Program for Y_8.

9.18 That being so, among the components of the M2 under control of the CBT, only currency growth could be directly controlled, whereas the deposits of the banking system were outside the control mechanism. Currency growth had averaged around 2.1 percent over the previous three years, and the target growth of currency expansion was set at 16 percent for Y_8, the same as over-all money supply growth. The foreign reserve base of Tusanian currency, the Siwat, had been slowly eroding away over the previous years, thus contributing to its weakness in the currency market. A slower growth appeared to be more manageable given this depletion of foreign reserves.

9.19 Likewise, the CBT did not expect growth in reserve money in Y_8 anywhere near the 21 percent growth rate over the previous three years, Y_5-Y_7. This was, in part, because no further increase in reserve requirement was contemplated in Y_8. More importantly, the CBT anticipated the liabilities of deposit-money banks to grow no faster than the anticipated increase in other money aggregates, and that it might be held around at 18 percent during Y_8. Although reserve money growth was not part of the Y_8 Program in a formal sense, it was a pivotal variable affecting the growth of domestic liquidity. In this regard, the 18 percent growth in reserve money was not out of line with the expected increase in other macro-financial aggregates, given the across-the-board 2 percent increase in the interest rate structure, both on the lending and deposit sides.

9.20 This was the macro-financial program for Y_8. The program called for a noticeable departure from some rather unstable financial inter-relationships of the past couple of years. Restoration of the long-term relation between money supply, GDP, and reserve money growth relative to domestic liquidity is maintained. Net foreign assets return to positive levels, and the distribution of credit between private and public sectors is such that it has maximum impact on demand management without impinging on GDP growth. The credit ceilings, summarized above, already allowed for maximum permissible deficits on the financial operations of the public sector, given the real growth and price assumptions. Given lags in the operation of control mechanisms and their impact on real variables, considerable efforts were made to maintain consistency with the overall stabilization package contained in the Annual Program for Y_8.

9.21 Given the growth rates of domestic liquidity, as mentioned above, growth in the domestic assets of the banking system can be specified, but they are not needed for growth in the Y_8 Program formulation. The growth in the domestic assets of the banking system needs would essentially depend on increases in credit to the public

and private sectors, and in turn, this would depend on the expected growth rates of investment for the two sectors, as well as the size of public sector deficit for Y_8, for which we now turn to the fiscal program.

The Fiscal Program

9.22 Against this backdrop of the macro-financial Program, and given the target growth of real GDP at 1.4 percent – the target for the price level – and the requirement that the public sector deficit be reduced from 21 percent of nominal GDP to 15 percent in Y_8, meant that the level of the public sector deficit had to be cut back from ST552 billion in Y_7 to ST482 billion in Y_8. This would be a reduction of 12.7 percent in one year against the 30 percent increase in the previous two years. Whether this was realistic or not, the federal deficit could not exceed ST286 billion in Y_8 as compared to ST304 billion in Y_7. The quasi-deficit would have to be substantially reduced to ST196 billion in Y_8, as compared to a deficit of ST248 billion in Y_7. How this could be achieved is discussed in the following section. A reduction in the public sector deficit to the ST482 billion level meant that domestic borrowing requirements would have to be consistent with the contemplated 10 increase in the total domestic credit, as discussed in paragraph 9.10 above.

9.23 The formulation of the fiscal program for Y_8 represented a major challenge to the government. Its complexities were far more difficult to surmount because the thrust of the fiscal program was a major reduction in government and quasi-government expenditures, both for controlling inflation and maintaining the feasibility of the stabilization package. These reductions could not be achieved without participation of all parties concerned in the effort to roll back the all too pervasive public sector commitments. Therefore, the Y_8 Annual Program provided only the bench-marks, whereas the Y_8 Budget provided the decomposition of the bench-marks and targets set forth at the aggregate level, as far as possible. The bench-marks set forth a major reduction in the ratio of public sector deficit to GDP,

from nearly 20 percent in the previous year to 14 percent in Y_8. This could not be achieved through reduction in public sector expenditures only. Simultaneously, major efforts were needed to improve the revenue side of the government through a tax effort and SE price increases.

9.24 This posed a policy dilemma of major proportions for Tusania. Given the severity of the crisis, the public was already suffering hardships, squeezed dry with hardly any room for further belt-tightening, yet a way had to be found to reduce the obligations of the public sector. This required a substantial increase in the SE's prices, hikes in the utility rates and prices for public sector services, transport, and communications, at a time of declining real incomes. This amounted to a breach of the social contract between the government and the Tusanian public. Further, since much of any year's budget represents commitments for ongoing projects and programs, expenditures could not be rolled back within a short span of a few months. Besides, considerable investment expenditures were already undertaken for several projects and they were firmly committed through Y_7 and possibly Y_8 and beyond. Cutting back on these commitments would mean zero return on the sunk cost. By the time the stabilization package was to be adopted, a good part of the government, and particularly the SEs, was committed and entailed substantial costs in the suspension of contractual obligations. The discretionary part of the government's budget was fairly small, and a good deal of current expenditures had a momentum of their own, such as defense, civil services, pensions, and statutory benefits. Therefore, for the policy and program formulators in the Y_8 Program as a first cut, public expenditures were to be treated as more or less a given, with little real reduction possible.

9.25 Given these structural constraints on its fiscal operations and little room to maneuver, the government proposed a modest budget for Y_8 as part of the Y_8 Program. Federal revenues were projected to grow from ST276 billion in Y_7 to ST300 billion in Y_8, or by 8.5 percent in Y_8, a dubious proposition given that the

Table 9.3 Fiscal Operations of the Government and the SEs
Annual Program for Y_8

	Actual		Projected	Annual Growth Rates (%)		
	Y_6	Y_7	Y_8	Y_6	Y_7	Y_8
Public Sector Deficit	427	552	487	30.2	29.3	-12.3
Federal Deficit	236	304	286	29.0	28.8	-0.6
Revenues	260	276	300	5.7	6.2	8.5
Expenditures	390	453	506	17.5	16.2	11.7
Transfers (SEs, DFIs)	106	127	80	9.2	19.8	-37.0
Quasi Deficit, SEs	191	248	201	31.7	21.9	-19.0
Investment	80	102	95	23.1	27.5	-6.8
Operational Losses	111	146	106	39.0	31.5	-27.3

average rate of growth in revenues in the previous three years was 6.1 percent per year. Federal expenditures, both current expenditures and investment programs, excluding transfers to DFIs and SEs, were projected to grow from ST453 billion in Y_7, to ST506 billion in Y_8, or by 11.7 percent in comparison with 16.7 percent average annual growth during Y_5-Y_7. The federal budget also stipulated that major reductions take place in the transfers to the DFIs and SEs from ST127 billion in Y_7 to ST80 billion in Y_8. On this basis, the federal deficit was expected to be reduced from ST304 billion in Y_7 to ST 286 billion in Y_8.

9.26 The fiscal program, thus, called for a major revenue raising effort together with a lower rate of increase in federal expenditures. This was essential to realize the macro-financial targets discussed earlier, especially public sector credit growth. Since the typical response to fiscal stringency is to allow accounts payable and taxes to go unpaid, the government simultaneously had to enact measures to prevent the private sector from becoming the unwilling financier of public spending through the banking system and credit mechanism. Overall, Tusania faced a major domestic resource mobilization effort, especially on the fiscal side. Whether this could be

accomplished in times of general austerity and economic decline remained doubtful at the time of formulation of the Y_8 Program.

9.27 On the revenue side, Tusania's tax effort required a major boost, since past performance was not much comfort to formulators of the Y_8 Program contemplating how to finance the deficit in the absence of additional revenues. They knew that major gains could not be anticipated from better tax administration, tax collection system, strengthening tax offices, and staff training, as these efforts had already been in operation for the past couple of years. Therefore, to raise revenues, the government announced it would:

i. enlarge the coverage of personal income tax, agricultural income tax, excise tax, and all those taxes required and approved by the legislature;

ii. increase rates on property tax and inheritance tax; and

iii. tighten-up exemptions to the business tax, tariffs on imports, and increased vigilance on corporate taxes.

Each of these actions required approval by the legislature and would certainly invoke the opposition of those affected. For these reasons, the budget targets of the Y_8 Program were overly optimistic.

9.28 These revenue and expenditure items in the federal budget subsumed the government's financial commitments with regard to support prices and subsidies. Clearly, given the crunch, the government could not afford to continue supporting prices for the agricultural sector, nor could it offer the same level of subsidies and rebates. But there was tremendous pressure to maintain support prices, as they had been effective in stabilizing food prices and were regarded as the bulwark of the already-strained safety-net. Increases in food prices over and above general inflation would not have been tolerable to the urban population and removal of support prices would risk losing support of the farming population. Faced with these options, the Y_8

Budget called for keeping the system of support prices intact, but narrowing it to 50 to 80 percent of the parity on the Y_7 base, terminating the "cost-plus" support pricing, and reducing the number of items, where possible. These efforts did help keep expenditure levels within the stipulated fiscal program.

9.29 The biggest challenge that the government faced was how to control the quasi-deficit's run-away growth of about 31 percent per year, in particular, how to reduce the SEs losses and their investment program. A host of powerful considerations militated against these objectives, given the constituencies involved, and the employment, income, and financial constraints. Among these, a cut-back in the investment program was easiest. The Y_8 target called for ST95 billion in investment as compared to ST102 billion in Y_7, implying about a 7 percent reduction. SE losses, however, were another matter. The Program called for a reduction in losses to ST106 billion from ST145 billion per year through a combination of price hikes and rolling back SE expenditures, implying a 27.3 percent reduction in SE losses in Y_8. This was the weakest part of the Program, because it was not substantiated by financial programs at the institutional level. From the start, it was clear that these targets would not be met during Y_8 and, as a result, that the public sector deficit would be higher than envisaged.

9.30 These fiscal operations of the government were estimated to result in a federal deficit of ST286 billion, lower than in Y_7. This was to be financed by CBT credit of ST258 billion and a banking system credit of ST30 billion. The important feature of the financing program was that the government would not borrow overseas to finance its deficit. Even it wanted to, it could not, given the precarious external financing situation, discussed below, with regard to the balance of payments. As it was, foreign borrowings were woefully inadequate to cover routine external debt obligations in addition to the obligations emerging from multi-institution re-scheduling agreements of foreign liabilities. There was little left over to be used for financing budget deficits.

The Balance of Payments and External Debt

9.31 The over-riding concern of the authorities regarding the balance of payments was how Tusania would be able to cope with the dire situation prevailing at the time the Y_8 Program was being formulated. In particular, since no recourse was able to obtain external finance, restoring foreign exchange cover was the paramount objective given the overhang of the external debt, the arrears, and liabilities. This would provide a reasonable level of imports needed for stabilization and economic recovery embedded in the Y_8 Annual Program. As discussed in Chapter IV, at the time of the Y_8 Program's formulation in the middle of Y_7, Tusania was engaged in a series of negotiations with creditors to reach an umbrella agreement on its external liabilities – especially the arrears on fCDs, trade financing, and other obligations. Their main objective was to obtain some debt relief together with a moratorium on external dues in order to have some room to maneuver for at least two years – Y_8 and Y_9. The indications were that an agreement would be reached offering Tusania a broad-based rescheduling agreement, keeping in view the debt servicing capacity of about 25 percent of its export earnings and remittances as the outer limit to allow for a reasonable level of imports to support the stabilization program. The multilaterals were expected to provide fresh long-term loans to support the package for economic reforms and structural adjustments and to finance the balance of payments gap in parallel to the umbrella agreement to shore up the financing package.

9.32 Given these considerations, the Y_8 Program called for an exports target level of $2,054 million in Y_8. This was based on the historic rates of growth in exports, available stocks of its major agricultural exports, and a re-adjustment in relative pricing through devaluation, though devaluation of the Siwat was not explicitly stated for reasons previously discussed. The imports were targeted at $3,372 million, remittances at $751 million, and net interest at $451 million, given the key elements of rescheduling agreements. On this basis, the current account

Table 9.4 Foreign Financing and Balance of Payments

	Actual		Projected
	Y_6	Y_7	Y_8
Balance of Payments Deficit	-876	-816	-575
Financed by:			
Short-term Inflows	497	558	215
Negotiated Foreign $ Credits	458	462	411
Others (net)	-79	-205	-51
Exports	1805	1834	2054
Imports	3196	3118	3372
Invisibles (net)	254	220	300
Current Account Balance	-1137	-1064	-1018
Capital Movements			
Public M&LT (net)	207	194	363
Direct Private Investment	54	55	80
Balance of Payments Deficit	-875	-815	-575
Total External Debt	5403	5885	6750
Medium and Long-Term	3435	3629	6065
Short-Term	1968	2256	685
Debt Service Ratio (x)	41.8	45.7	34.5
Debt Service Ratios (x=r)	29.6	32.3	25.2

deficit was estimated at $1,018 million for Y_8 – slightly below the levels of the past three years. The underlying consideration was that Tusania could not afford a debt servicing burden of previous years, nor could it afford to have a current account deficit in excess of $1 billion during Y_8. The level of exports stipulated in Y_8, in a way, was exogenous to these considerations. The amount of imports was, in part, based on foreign liquidity considerations together with the requirements of stabilization and recovery during Y_8. Given the projected current account deficit of $1,018 million in the Y_8 Program, a net M&LT inflow of $363 million was anticipated. Based on various agreements, and a resumption direct investment of $80 million, the balance of payments deficit was estimated at $575 million in Y_8. This overall balance of payments deficit was to be financed by $215 million in short-term

inflows, mainly suppliers' credits and banker's acceptances; $411 million was to be provided in negotiated credits mainly by the AMLs, provided access to foreign borrowings was restored for Tusania by foreign creditors.

9.33 The rescheduling agreement was eventually reached in late Y_7, after the Annual Program for Y_8 was officially adopted by the government, incorporating the salient elements of the stabilization package, as discussed above. In support of this program, the AMLs and creditors agreed to provide fresh foreign credits, restored foreign exchange cover for Tusania, and provided debt relief as part of the rescheduling agreement. The task of restoring Tusania's creditworthiness thus began with a comprehensive external financing package incorporating the above elements. As discussed in Chapter IV, the rescheduling agreement called for a grace period of 3 years on a rescheduled debt of about $1,856 million, including $1,236 in short-term arrears, and the remaining $620 in other liabilities. The agreement further stipulated that the interest rate would float at LIBOR plus 0.75 percent, well below the short-term rates and penalties that creditors accrued on the unpaid liabilities. The AMLs concurrently offered a supportive financial package of about $550 million in medium to long-term loans, with a sizable grant element for balance of payments financing, subject to continuous review of progress on the stabilization package, economic reforms, and adjustment. In the past, on several occasions, AMLs had suspended disbursements from loans of this type for unsatisfactory performances, and keeping that in mind, the $400 million component was treated as short-term inflows on the financing side of the balance of payments accounts – below the line items. With the debt overhang substantially behind, Tusania now faced the challenges of stabilization, adjustment, and recovery, of which the Y_8 Program was to be one of several to come in future years.

ANNEX IX *Table 9-1 Balance of Payments (1 of 2)*

	Y_1	Y_4	Y_5	Y_6	Y_7	Y_8
	(US$ millions, end of year)					
Balance of Payments Deficit	-237	-465	-504	-686	-715	-876
Financed by:						
Short-Term Inflows (net)	714	812	919	679	571	497
fCDs	527	558	531	267	112	21
Suppliers Credit	115	167	178	117	92	77
Banker's Acceptances	72	87	96	67	55	42
Arrears Rolled-Over	0	0	114	228	312	357
Negotiated Foreign $ Credits	0	0	0	163	251	458
Syndicated Loans	0	0	0	163	137	118
AML & Others (net)	0	0	0	0	114	340
Reserves	-266	-194	-231	-42	-12	39
Net errors/omissions	-211	-153	-184	-114	-95	-118
Total Foreign Finance	237	465	504	686	715	876

Memo Items

Balance of Payments	Y_1	Y_4	Y_5	Y_6	Y_7	Y_8
	(US$ millions, end of year)					
Exports	1163	1313	1403	1561	1741	1805
Imports	2188	2388	2537	2793	3000	3196
Trade Balance	*-1025*	*-1075*	*-1134*	*-1232*	*-1259*	*-1391*
Invisibles (Services,net)	629	567	403	315	282	254
Remittances	840	865	764	713	708	741
Interest (net)	-211	-298	-361	-398	-426	-487
Current Account Balance	**-396**	**-508**	**-731**	**-917**	**-977**	**-1137**
Capital Movements (Autonomous inflows of Medium and Long-Term Finance)						
Public M&LT (net)	121	148	178	180	210	207
Amortization	171	192	211	234	267	289
Public M&LT (gross)	292	340	389	414	477	496
Direct Private Investment	38	43	49	51	52	54
Net M&LT Inflows	*159*	*191*	*227*	*231*	*262*	*261*
Balance of Payments Deficit	**-237**	**-317**	**-504**	**-686**	**-715**	**-876**
Arrears Outstanding	92	169	268	508	657	1013
BOP Deficit --adjusted	*-329*	*-486*	*-772*	*-1194*	*-1372*	*-1889*
Total Arrears	**92**	**169**	**382**	**736**	**969**	**1370**
of this: fCDs	74	127	215	468	634	849
Trade and Others	18	42	167	268	335	521
Arrears Rolled -Over	0	0	114	228	312	357
Arrears Outstanding	92	169	268	508	657	1013

ANNEX IX *Table 9-1 Balance of Payments (2 of 2)*

	Y_1	Y_4	Y_5	Y_6	Y_7	Y_8
Exchange Rate (nominal) US$1.00 = Siwat						
Official Exchange Rate	80	83	87	94	102	110
Parallel Market Rate	92	97	102	115	127	138
Siwat Values						
(ST billions, end of period)						
Foreign Trade and GDP						
Exports, current values	93	109	122	147	178	199
Imports, current values	175	198	221	263	306	352
Export Growth Rate	10.6	17.1	12.0	20.2	21.0	11.8
Import Growth Rate	9	13.2	11.4	18.9	16.6	14.9
Exports, constant (real) values	93	102	106	114	118	111
Imports, constant (real) values	175	185	191	204	204	196
Export Growth Rate	8.7	9.5	3.7	7.7	4.1	-6.6
Import Growth Rate	5.3	5.8	3.1	6.6	0.3	-4.1
GDP constant (real) values	1280	1321	1362	1400	1434	1451
Exports/GDP ratio	7.3	7.7	7.8	8.1	8.3	7.6
Imports/GDP ratio	13.7	14.0	14.0	14.5	14.2	13.5
GDP deflator index	100.0	107.0	115.6	129.0	149.9	179.5
Foreign Financing						
Public M&LT (net)	9.7	12.3	15.5	16.9	21.4	22.8
Direct Private Investment	3.0	3.6	4.3	4.8	5.3	5.9
Net M&LT Inflow	12.7	15.9	19.7	21.7	26.7	28.7
Short-Term Inflows (net)	57.1	67.4	80.0	63.8	58.2	54.7
fCDs	42.2	46.3	46.2	25.1	11.4	2.3
Suppliers Credit	9.2	13.9	15.5	11.0	9.4	8.5
Banker's Acceptances	5.8	7.2	8.4	6.3	5.6	4.6
Arrears Rolled-Over	0.0	0.0	9.9	21.4	31.8	39.3
Negotiated Foreign $ Credits	0.0	0.0	0.0	15.3	25.6	50.4
Syndicated Loans	0.0	0.0	0.0	15.3	14.0	13.0
AML & Others (net)	0.0	0.0	0.0	0.0	11.6	37.4
Total Foreign Finance	19.0	38.6	43.8	64.5	72.9	96.4

Average Annual Growth Rates

	Y_1-Y_7	Y_1-Y_4	Y_4-Y_7	Y_5-Y_7		
Exports, current values	7.9%	10.3%	5.5%	2.6%		
Imports, current values	6.1%	8.5%	3.7%	1.9%		
Exports, constant (real) values	3.1%	6.9%	-0.6%	-2.9%		
Imports, constant (real) values	1.4%	5.2%	-2.3%	-3.6%		