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ROZLYN COLEMAN, "CONFRONTING BUDGET DEFICITS" IMF ECONOMIC ISSUES No. 3, 2000

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The document is based on the fiscal operations of major industrial countries and presents a major concern that it is not the size of the budget as a ratio of the gross domestic product (GDP) that matters, but the persistence of budgetary shortfalls during long periods of peace, when governments traditionally offset their debts and save for the future. These countries included Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

Trend analysis showed that industrial countries had huge deficits in the mid-1970s arising from the oil crisis, which widened in the 1980s due to overspending by governments. Their total expenditure increased from 28 per cent in 1960 to 50 per cent in 1994. The resultant effects were relatively high public debt, weakening government finances and draining of resources from the economies.

Historically, persistent fiscal deficits in these countries predate the first and second world war, as governments drew down their treasuries and borrowed to survive. This situation was reversed to manageable level after the war but the worrisome trend began in the 1960s and worsened in the 1970s with the first oil shock. The persistent deficits in the 1980s and 1990s were attributed mainly to the commitment to social welfare programmes, demographic trends and fundamental macroeconomic shifts. Other factors were productivity slowdown, inflation and debt, and structural unemployment.

The stylized issues in the paper are presented below:

[i] The exigencies of the world wars demanded for safety nets for disengaged and unemployed members of these countries. Also, the great depression of the 1930s forced governments to social actions. Thus, the role of governments to their citizenry increased in the area of health care, pensions and other assistance to members of the armed forces. All these soured the fiscal operations of governments.

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[ii] Demographic status of the Organisation for Economic Cooperation Development (OECD) countries shows that by 2010 people aged 60 and above will constitute 23 per cent of the population, which in effect would exert much pressure on government finances. The declining birth rates in these countries since 1960, imply that fewer people will work relative to the retired population which would worsen the burden on government. In addition, the cost of health care by the aged population has been on the increase over years.

[iii] In the 1950s and 60s, unemployment and inflation were low, while growth was robust in these countries. However, in the late 1960s and early 70s, economic growth reversed to a secular decline because of fundamental macroeconomic shifts reflected in slower growth in productivity, volatile inflation, rising health care costs and increasing structural unemployment. Productivity declined considerably from the 1970s attributed to the end of a long-term economic cycle, the oil price shocks, as well as government policy undermining private sector investments in productivity gains. However, the improvements in the 1990s could not be translated to higher growth rates in these countries, as they maintained low but steady growth.

[iv] The fluctuations in corporate earnings often led to business cut back and layoffs which heightened the unemployment levels resulting in huge unemployment claims on governments, increased social welfare payments and food assistance. Also, short-term unemployment temporarily reduces income taxes as a source of revenue for government finances. These impacted negatively on government finances and increased the deficit positions.

In general, large and persistent fiscal deficits push up interest rates, exerts pressure on the exchange rate, reduce investment, and increase government's borrowing or indebtedness. Policy redress by these countries were mainly to increase economic growth through the cut in spending rather than increase in taxes, adoption of pension and health care reforms as well as legal provision for balanced-budget.

LESSONS FOR NIGERIA

The article is topical and very relevant to the fiscal cycle of an oil exporting developing country like Nigeria. Over the years Nigeria has operated persistent budget deficits (except for 1995 and 1996) averaged 5.2 per cent of GDP for the period 1988 through 2002. The features of Nigeria's fiscal operations are similar to the highlighted characteristics in the article under review and they include among others:-

- Volatility in oil revenue
- Low non-oil revenue due to high rate of tax evasion occasioned by large informal sector activities
- Huge unpaid military and public sector pensions, with no safety nets and social securities
- Uncontrolled government spending
- Low productivity and thus increased outflows due to drive for imports to meet domestic shortfalls
- Extra-budgetary expenditure
- Debt accumulation and delayed payments to contractors

The challenges for maintaining tolerable fiscal deficits are:-

- The need to actualize the move from an unfunded public pension system to funded, defined-contribution plan like that adopted in Chile in 1980
- Increased tax drive and tax reforms
- Integration of a large segment of informal activities into the formal sector for easy tax administration
- Public expenditure reforms
- Increased transparency in governance and
- Fight against increased corruption

Current effort in the ECOWAS sub-region towards the acceleration of economic growth and development through economic and monetary cooperation can not be sustained if governments overshoot their budgetary provisions. Under the second monetary zone – West African Monetary Zone (WAMZ) the Governments of member countries comprising The Gambia, Ghana, Guinea, Nigeria and Sierra Leone are required to maintain a fiscal deficit/GDP ratio of 5 per cent or less. The maintenance of track record of compliance

with this provision and other macroeconomic criteria is very critical for the success of the integration process and a necessary condition for the take-off of the single monetary zone in West Africa.

"BANK RISK AND DEPOSIT INSURANCE" BY LUC LAEVEN THE WORLD BANK ECONOMIC REVIEW, VOL. 16 NO 109-137,NOVEMBER 2002

G. K. Sanni*

1.0 INTRODUCTION

The paper attempts to establish relationship between bank risk and deposit insurance. This is because banks perform crucial roles in economic development of a country, during which they undertake many risks in the process of performing these roles, which if not well managed might lead to bank crises. Enquiries into bank crises have shown that, not only do banks often take excessive risks,but also, they often failed to carry out extensive risk analysis of their short-term portfolio investments. Therefore, some banks engage in more risks than their capital could bear.

The article estimated the cost of deposit insurance for a large sample of banks in fourteen different economies and assessed the relationship between the risk-taking behavior of banks and their corporate governance structure.

It noted that there is a positive correlation between bank risk and cost of deposit insurance. For instance, it argued that a relatively high cost of deposit insurance indicates that a bank takes excessive risks..

2.0 HIGHLIGHTS OF THE PAPER

The major highlights of the paper are as follows:

- the cost of deposit insurance is closely related to degree of risk taken by banks.
- implicit deposit insurance premiums are higher for banks in crisis countries and have some power in predicting bank distress.

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- the average cost of deposit insurance is higher during the crisis period 1997-98 in the sampled economies than during pre-crisis years.

- risk taking also differs across forms of ownership. In other words, concentrated ownership increase risk taking by banks while dispersed ownership is associated with lower risk.

- the cost of deposit insurance is lower in economies with low inflation rate, adequate security and enforcement of the rule of law. In other words, banking systems are expected to be less risky in economies with high GDP per capital and lower rate of inflation.

- banks with a high cost of deposit insurance have a higher chance of failing or being subject to intervention than banks with a low cost of deposit insurance.

- the cost of deposit insurance has some predictive power about the level of risks taken by banks and the possibility of being distressed.

- the cost of deposit insurance is highest for banks with concentrated private ownership especially those predominantly owned by a single person and to a lesser extent, the state or family owned banks. This indicate that these banks tend to take the greatest risks. In contrast, banks with dispersed ownership engage in a relatively low level of risk taking.

3.0 COMMENTS

The strength of this paper lies in the depth of its analysis. The article analyzed a large sample of banks in different economies and measured the degree of a bank's risk taking, the value of its deposit insurance services costs. The implicit deposit insurance cost was calculated by applying a well-known technique that models deposit insurance as a put option in the bank's assets. The put option approach to valuing deposit insurance assumes that stock markets are efficient. The sample was limited to economies that had relatively large and liquid stock markets. The sample was also limited by excluding countries with heavily regulated financial sectors. In order words, countries that had not liberalized

their financial sectors before 1990 were excluded from the study. However, the paper failed to examine other causes of bank risks which include non-compliance with the banking regulations, portfolio mismatch, failure to appreciate the environmental factors governing their operations, conflicts between profitability and security goals of the bank as well as poor operational strategies. These factors as well as conflict of interests between the management and shareholders often culminate in the failure of the banks rather than the payment of high deposit insurance. The payment of high deposit insurance therefore represents only a symptom but not a cause of bank failure. Also, the author did not address the impact of government fiscal and monetary operations on the activities of banks.

4.0 RELEVANCE TO POLICY

The findings of this paper are useful for policy considerations. First, the findings support the view of many policy makers that one of the keys to a sound financial system is a dispersed private ownership of banks. Second, the findings indicate that dispersed ownership is important for the stability of financial systems, especially, where corporate governance systems, and institutional environment in general are weak such as in many developing countries. Finally, as a proxy for bank risk, the cost of deposit insurance could be a useful additional tool for identifying troubled financial institutions and providing early warning of bank crises.

A major insight that could be gleaned from the paper is that widespread ownership of banks is more advantageous than concentrated ownership where a single individual owns the majority, which confers automatically sole control. This is because, the widespread ownership of banks provides the advantage of diverse opinions on the management of the business, and hence improve the quality of decisions. It is in this regards, that bank regulatory agencies should encourage greater dilution of ownership of banks through public quotation on the stock market. This would help to forestall financial distress and guarantee confidence in the banking industry.