

THE EFFICACY OF FINANCIAL LIBERALISATION IN DEVELOPING COUNTRIES: A REVISIONIST VIEW

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Abstract

This paper takes stock of some of the challenges facing the efficacy of financial liberalisation in developing countries from a theoretical perspective. The study has been motivated by the current debate on the efficacy of financial liberalisation, on the one hand, and the painful experiences some of the countries have had with the liberalisation of their financial sector, on the other hand. In particular, the current global financial crisis has made it worthwhile to revisit the financial deregulation theory. The study begins with a review of the evils of financial liberalisation; it then proceeds to the case for and against financial liberalisation. The paper finds that while there is a sufficient body of literature in support of the financial liberalisation policy, the theoretical constructs against this policy are steadily growing in number and substance. Whether financial liberalisation indeed contributes to economic growth, therefore, remains an empirical issue. The paper recommends that some friendly government interventions - in the form of financial restraints - should be implemented alongside financial liberalisation in developing countries, in order to protect the financial market against any mispricing or misalignments due to information asymmetry, moral hazards or speculative activities.

Keywords: financial liberalization, developing countries, financial markets

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1. Introduction

Since the introduction of the financial liberalisation hypothesis, the majority of developing countries have hurriedly implemented far-reaching reforms. Unfortunately, the experience of many developing countries (LDCs) with financial liberalisation has been predominantly disappointing. In the wake of financial liberalisation, many countries suffered sharp increases in interest rates, widespread bankruptcies of financial institutions, worsening inflation, a widening external deficit and unstable exchange rates. The fact of the matter is that, while financial liberalisation may contribute positively to economic growth, it may sometimes lead to financial instability, especially when the preconditions necessary for its success are not taken into account. In extreme cases, it may be just as damaging as financial repression. Moreover, the fact that financial repression was not successful does not necessarily mean that modest government intervention would not be healthy. Recent studies have shown that even if a free market system is the ultimate objective of an economy, some friendly government interventions need to be maintained in the financial sector in order to correct any mispricing in the financial market. A case in point is the recent global financial crisis. It is now clear that the current global financial crisis could have been averted if the

right financial restraints had been put in place. A crisis that started in the mortgage market, and which was caused by sub-prime mortgage lending that spread into the banking sector and the stock market, resulted in a global financial crisis. This paper attempts to review some of the controversies around the efficacy of financial liberalisation from a theoretical viewpoint. The paper is organised as follows. Section 2 highlights the disadvantages of financial repression, as presented in the literature. Section 3 presents the theory of financial liberalisation and its benefits from the theoretical and empirical fronts. Section 4 presents some of the controversies of financial liberalisation; while section 5 concludes the study.

2. The Disadvantages of Financial Repression

Financial repression refers to the indiscriminate distortion of financial prices, including interest rates and foreign exchange rates (see Odhiambo, 2004; 2007). Specifically, financial repression involves one or more of the following: legal interest rate ceilings (i.e. interest rates which are artificially kept below the market clearing rates); discriminatory credit control (i.e. overall and selective quantitative ceilings); fixed

exchange rates (quantitative foreign exchange controls); and high cash reserve ratios/requirements.

Under financial repression, it is the government that influences who receives and provides credit, and at what price. A government can exercise or reinforce such controls by regulating which financial institutions will be permitted to do business and how they will be permitted to operate; by owning banks and other financial intermediaries; and by exercising control over international capital movements (Williamson and Mahar, 1998). The devastating effects of financial repression have been popularised by Fry (1982) in a diagram, in which an upward sloping saving function intersects with a downward sloping investment function, in order to determine an equilibrium rate of interest, which balances savings and investment. The savings function in this case is assumed to depend largely on the growth of the economy and the real interest rate. As is argued in this analysis, holding the rate of interest below that which would be determined by the intersection of the curves would reduce the desired supply of savings, but increase the demand for investment. Lending rates are conventionally kept low in order to attempt to encourage investment. However, if lending rates are kept low, then the deposit rates also have to be low, unless the government is able to subsidise the financial intermediary.

One of the consequences of low interest rates in countries with high inflation is that real interest rates can often become negative. On average, the real interest rates in developing countries have been strongly negative since the 1960s (Gibson and Tsakalotos, 1994; World Bank, 1989). Aside from interest rate controls, the other form of financial distortion resulting from financial repression is compulsory credit allocations, whereby it is sought to ensure that credit is granted to key sectors of the economy.

In many developing countries, the key sectors included, among others, the industrial sectors, which were prioritised by the governments, the export industries sector, which can generate foreign exchange earnings, and government parastatals. This to a large extent hinders the commercial banks' ability to intermediate profitably, as they cannot decide freely on where to lend and how much to lend. Under financial repression, governments usually tax financial intermediaries - either directly through the collection of taxes on banks' income and/or capital gains - or indirectly, through forcing banks to hold a certain percentage of their deposits in government bonds and non-interest bearing reserves (cash reserves). Although excess reserves bear some interest, the tax on the banking system is, in most cases, equal to the difference between the interest rate that the bank receives on its reserves at the central bank, and the 'market' rate. The ultimate goal in this case is to provide the government with adequate funds to finance its high and increasing budget deficit. Fry

(1980) conducted a study to estimate the cost of financial repression in a number of LDC countries. His study was based on the assumption that a decline in the real deposit rate of interest reduces real money demand (broadly defined). The author concluded that the cost of financial repression has in the range of 0.48 - 0.66 points in economic growth foregone for every percentage point by which the real deposit rate is set below its market equilibrium level (see also Mavrotas and Kelly, 1999).

3. Financial Liberalisation Hypothesis

Financial liberalisation may be defined as the process of freeing the financial sector. It is the process of allowing markets to determine who obtains and grants credit and at what price. Financial liberalisation involves eight main dimensions: i) The elimination of credit controls; ii) The deregulation of interest rates; iii) Free entry into the banking sector; iv) Bank autonomy; v) Private ownership of banks; vi) The opening up of the domestic financial market to international capital flows; vii) The removal of exchange controls; and viii) The elimination of any barriers to the entry of foreign banks.

The theory of financial liberalisation was first popularised by Ronald McKinnon and Edward Shaw in 1973. Indeed, Ronald McKinnon and Edward Shaw were the first to seriously challenge the conventional wisdom of financial repression in 1973. In their separate writings, they argued that the pursuance policies such as low and administered interest rates, selective credit control, and concessional credit practices, among others things, lead to widespread financial repression in developing countries.

According to the authors, a repressed financial market discourages savings, retards the efficient allocation of resources, increases the segmentation of financial markets, and creates financial disintermediation in the banking system (see also Khan and Hassan, 1998). The essential message of the McKinnon-Shaw thesis is that a low or negative real rate of interest discourages savings, and hence reduces the availability of loanable funds. This constrains investments and, in turn, lowers the rate of economic growth (see Khan and Hassan, 1998; Odhiambo, 2004). Conversely, an increase in interest rates may induce savers to save more, which will allow more investment to take place. McKinnon and Shaw's thesis on financial repression and their proposal for financial liberalisation became the new orthodoxy in the 1970s and 1980s.

The main objective of financial liberalisation is to build a more efficient, robust and deeper financial system, which can support the growth of the private sector. Overall, financial liberalisation is expected to foster development and increase long-run growth (Levine, 1997; Demirguc-Kunt and Detragiache,

1998). Through financial liberalisation, developing countries can stimulate domestic savings and growth, and reduce excessive dependence on foreign capital flows (Demirguc-Kunt and Detragiache, 1998).

According to the proponents of financial liberalisation, the liberalisation of financial markets allows a more varied and specialised intermediation between savers and borrowers – by using a multitude of institutions, instruments and products. It also facilitates a freer flow of money to where it can be best invested, i.e. in investments with higher risk-adjusted rates of return (Kaul, 1999). As in other markets, the "invisible hand" of the financial market is, under financial liberalisation, expected to know how to match supply and demand efficiently (Kaul, 1999: 3). In addition, the "invisible hand" is able to identify who wants to save and/or lend, for what purposes, and who wants to borrow and on what terms (see Kaul, 1999).

Financial liberalisation, therefore, increases savings, improves the efficiency with which resources are allocated among alternative investment projects and, therefore, raises the rate of economic growth (Cobbina, 1999). According to Cobbina (1999), financial liberalization puts funds and resources to optimal use and ensures that the most beneficial projects gain access to scarce funds. It affords banks and other financial intermediaries more freedom to act; and it increases their ability to take risks.

Although McKinnon and Shaw agree on the general impact of financial repression and the need to liberalise financial markets, they take a rather different approach to the transmission mechanism by which real interest rates affect savings, investment and growth (see Fry 1978, 1988; Gibson and Tsakalotos 1994). Shaw, for instance, takes a debt-intermediation view. According to Shaw, financial liberalisation leads to an increased role for financial intermediaries. Shaw's approach to financial liberalisation is, consequently, in favour of the debt-intermediation view, which he himself pioneered in the 1950s (see Gurley and Shaw, 1960). Besides, Shaw's view is based on the inside-money assumption, in which money is backed, at least partially, by productive investment loans (see Fry, 1982; Arrieta, 1988).

Unlike Shaw (1973), McKinnon's explanation on how interest rates influence savings, investment and growth is based on three solid assumptions. The first is that all economic agents are confined to self-finance to undertake investment. The second assumption is that capital is discrete and heterogeneous. Hence, investment expenditure is indivisible when compared with consumption expenditure. Third, it is assumed that the formal financial sector concentrates on giving credit to urban, modern, and export industries. Based on the first two assumptions, McKinnon was able to develop his complementary hypothesis, which states that: since economic agents have to accumulate money balances

(or save), before investment can take place, money and physical capital are, consequently, complementary.

According to McKinnon's complementarity hypothesis, potential investors must accumulate money balances prior to their investment, and the more attractive the process of accumulating money, the greater is the incentive to invest. In this case, the relative lumpiness of investment expenditures implies that aggregate demand for money will be greater, the larger the proportion of investment in total expenditures (McKinnon, 1973; Fry, 1978, 1982; Arrieta, 1988; Mohlo, 1986; and Clarke, 1996). The essential message in McKinnon's hypothesis is that, at low real interest rates, people would not want to hold much money or other financial assets. As a result, the financial system would not adequately be able to fulfil one of its primary functions of integrating capital and capital markets and equalizing returns to investment (see also Thornton, 1990).

According to McKinnon, the demand for household firms changes as they shift from consumption to investment, because investment is lumpier and requires a longer period of accumulation from a given income stream before disbursement. Therefore, his proposition is that a rise in the rate of interest increases the volume of financial savings through financial intermediaries, and thereby raises investment funds. This phenomenon he called the "Conduit Effect". In this case, the realised investment actually increases because of the greater availability of funds. McKinnon further rationalised this complementarily relationship between investment, real assets and real money balances, by stating that an increase in real money balances would mean greater efficiency, and would, therefore, raise output sufficiently to offset the declining share of output allocated to investment (McKinnon, 1973: 46; Khatkhate, 1988). Hence, higher positive real interest rates are warranted to build up real money balances, increase financial intermediation and the unification of financial markets, thereby ensuring an efficient utilisation of resources, particularly the scarce capital. The complementarity between money and capital accumulation would therefore continue to exist as long as the real positive interest rate does not exceed the real rate of return on investment.

4. Controversies over the efficacy of financial liberalisation

Since the origin of the financial liberalisation policy, a number of schools of thought have criticised the role of financial liberalisation for various reasons. To date, there are at least six criticisms of the role of financial liberalisation (see Odhiambo, 2004; 2008).

The most influential of these is based on the argument that savings may not necessarily depend on the rate of interest (see Odhiambo, 2009). In other words, there is no profound relationship between the

deposit rate and savings. A number of arguments have been advanced in the literature to explain why higher interest rates may reduce - rather than increase - the volume of savings. The first and the most appealing reason is that the negative income effect of increased interest rates might offset the positive substitution effect between consumption and savings. A change in interest rates, just like other prices, has two effects: substitution and income effects (Odhiambo, 2009: 545-46). The substitution effect encourages saving by making current consumption more expensive, but the income effect deters savings, because at a higher interest rate the same income can be obtained with less savings. An increase in interest rates therefore has an ambiguous effect on savings and current consumption. The income effect leads to more current consumption (hence reduced savings); while the substitution effect leads to less current consumption (hence increased savings). It is, however, likely that the negative income effect of the increased interest rate will offset the positive substitution effect between consumption and savings (see Bandiera et al., 1999; Warman and Thirlwall, 1994; Cho and Khatkhate, 1990; Arrieta, 1988; Giovannini, 1983; Odhiambo, 2008).

The second argument, which has been advanced on the interest elasticity of savings, is anchored in the fact that an increase in the real interest rate will only reallocate the existing volume of savings in favour of financial savings, and leave the total volume of savings unchanged. In other words, when the real interest rate is high, financial savings are made more attractive, and economic agents find it more rewarding to transfer their savings from other forms of savings to financial savings. But such a reallocation may have no impact on the volume of total savings (Gupta, 1984; Mahambare and Balasubraman, 2000).

The third argument in this respect is that, at very low levels of income, interest rates are unlikely to stimulate savings. This is so because the totality of incomes will be devoted to consumption rather than to savings. Therefore, when income is low, even if a high deposit rate is sustained, savings will not increase unless the income level rises beyond the consumption level. Statistical evidence for this argument suggests that a one per cent increase in the real interest rate increases savings rate by only about one-tenth of one percentage point in relatively poor countries, whereas in relatively rich countries it increases the savings coefficient by about two-thirds of one percentage point (Ogaki et al, 1996). Even at relatively high levels of income, financial reforms, which ease borrowing constraints, may stimulate consumption rather than savings (also Japelli and Pagano, 1989, 1994; and Hall, 1978). In general, empirical studies on the elasticity of savings with respect to real interest rates have produced a mixed bag of results. Fry (1980) found a positive relationship between savings and the rate of interest for fourteen countries. Similar results were obtained

by Yusuf and Peters (1984) for South Korea, Leite and Makonnen (1986) for six African countries, and Ostry and Reinhart (1992) for 13 developing countries. Studies with distinctly negative or insignificant relationships include those of Giovannini (1983, 1985), Mwege et al. (1990), Oshikoya (1992) and Reichel (1991). Finally, mixed results were obtained by Gupta (1987), Lahiri (1989) and Villagomez (1997). The weight of evidence, however, supports a weak and relatively low positive elasticity of saving with respect to the interest rate.

The second criticism of financial liberalisation is based on the 'neo-structuralist' critique. The critical difference between the McKinnon-Shaw financial liberalisation hypothesis and the neo-structuralist view is the role accorded to the informal financial sector (see Odhiambo, 2004). The neo-structuralist school argues that because of the reserve requirements of banks, the diversion of funds away from the informal to the formal sector (due to increased interest rates) may lead to the total supply of loans to the private sector being reduced (see Buffie, 1984; Thirlwall, 2004). However, the validity of this argument depends largely on the relative size of the informal sector in the economy.

The third criticism is based on the Keynesian critique. According to the Keynesian school, a low interest rate bolsters investment and income, resulting in higher savings (see Khatkhate, 1988; 1972). Indeed, the main distinction between the Keynesian view and the McKinnon-Shaw hypothesis is the transmission mechanism between interest rates and economic growth. While the Keynesian school believes in a 'prior-investment' policy, the McKinnon-Shaw school believes in 'prior-savings'. Keynes (1936), for instance, succinctly argued that prior savings have no more tendency to release funds available for investment than does prior spending. Consequently, for the Keynesian school, a high interest rates policy discourages savings through its negative influence on investment and income; while, for the McKinnon-Shaw school, high interest rates promote savings, investment and income.

The fourth financial liberalisation criticism is based on the post-Keynesian critique. Just as in the Keynesian school, the post-Keynesians believe that it is investment that determines savings, and not the other way around, and that high interest rates may stifle investment and growth (see Warman and Thirlwall, 1994; Gibson and Tsakalotos, 1994). In general, the criticism of post-Keynesian apostles over the role of financial liberalisation is based on two premises.

Firstly, the Post-Keynesian school argues that the supply of bank credit is not exogenous, as treated by the McKinnon-Shaw school (see Davidson, 1986; Asimakopoulos, 1986). The post-Keynesians, therefore, argue that if banks can create credit without having to increase their deposits, then an increase in financial savings may make no difference to the total

credit given to the private sector (Warman and Thirlwall, 1994).

Secondly, the post-Keynesians argue that high interest rates may only result in stagflation - i.e. a combination of high inflation and unemployment. According to Dutt (1990), if there is excess capacity in the economy, higher interest rates will only worsen the distribution of income, increase inflation, and reduce the rate of economic growth. However, if the economy is at full employment, higher interest rates may improve income distribution and reduce the rate of inflation, but they will not necessarily increase growth²⁰.

The fifth criticism emanates from the Stiglitz and Weiss critique. Stiglitz (1994), for example, criticises financial liberalisation on the grounds that financial markets are prone to market failures. He suggests that there should be some form of government intervention that will not only make these markets function better, but would also improve the performance of the economy. Specifically, Stiglitz advocates government intervention to keep interest rates below their market equilibrium levels. In the same vein, Stiglitz and Weiss (1981) show that the limits to which interest rates can be raised is a direct consequence of imperfect information between lenders and borrowers. The basic intuition here is that, while a moderate increase in the lending rate would normally elicit a higher volume of lending, additional increases in rates beyond a certain level would prompt a lower level of lending activity by changing adversely the quality of borrowers in favour of those in the high risk category.

The sixth criticism of the McKinnon-Shaw theory of financial liberalisation is based on the argument that financial liberalisation ignores the important role of the stock market in economic development. It is believed that stock markets play a paramount role in external financial liberalisation in developing countries. Yet, the McKinnon-Shaw model fails to incorporate this contribution in their model. Levine and Zervos (1996), for example, argue that a well-developed stock market may be able to offer other forms of financial services than those available from the banking systems and may, therefore, provide a different kind of impetus to investment growth.

Aside from the criticisms of financial liberalisation outlined above, financial liberalisation has other challenges that have been advanced in the literature. Some of these challenges include the paradox of insolvency in the implementation of financial reforms, and the fiscal deficit explosions and high inflation associated with the liberalisation policy.

One of the fundamental challenges currently facing the implementation of financial liberalisation in developing countries is the level of insolvency in a

number of countries. The proponents of this argument believe that several interest rate liberalisation experiments have failed to produce the desired results because many developing countries are still operating in a paradox. On the one hand, they are anxious to mobilise domestic savings by offering attractive returns to savers, i.e. by implementing financial liberalisation. On the other hand, they want to finance their priority projects as cheaply as possible (i.e. the desire to pursue financial repression). When this paradox prevails, financial liberalisation is unlikely to achieve its desired outcomes (see Fry, 1995; Dixon, 1997; Stiglitz and Weiss, 1981)

The other challenge facing financial liberalisation is based on the relationship between financial liberalisation and high fiscal deficits, on the one hand, and the close association between financial liberalisation and inflation on the other. According to Fry (1997), many governments in developing countries rely on revenue from inflation tax, and the loss of such revenue during the financial liberalisation period may require higher revenue from alternative sources, or expenditure cuts of a similar magnitude. Therefore, for financial liberalisation to succeed, governments must be prepared to reduce their fiscal deficits through fiscal reforms (see also Diaz-Alejandro, 1985; Khatkhate, 1996).

Regarding the relationship between financial liberalisation and inflation, the debate has been whether financial liberalisation in its purest form fuels or dampens inflation. Although McKinnon (1973) and Shaw (1973) argue that high and flexible interest rates would dampen rather than fuel inflation, some studies have systematically shown that financial liberalisation can actually fuel inflation.

5. Conclusions

This paper has examined the relevance of the financial liberalisation policy from a theoretical viewpoint - within the context of developing countries. Specifically, the paper has taken stock of some of the controversies facing the efficacy of financial liberalisation. The paper has revealed that while there is a sufficient body of literature in support of financial liberalisation, the theoretical constructs against this policy are steadily growing in number and substance. Whether financial liberalisation indeed contributes to economic growth remains an empirical issue. While financial liberalisation may contribute positively to economic growth, it may also lead to financial instability, especially when information-asymmetry, moral hazards and macroeconomic instability are prevalent. Moreover, recent studies have shown that even if a free market system is the ultimate objective of an economy, some friendly government interventions in the form of financial restraints should be maintained - at least in the short run - in order to perfect the market. The paper, therefore, recommends that financial restraints be implemented alongside

²⁰ See also Serieux (1997).

financial liberalisation in developing countries, in order to protect the financial market against any mispricing or misalignments due to information asymmetry, moral hazards or speculative activities.

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