FINANCIAL RESTRAINTS IN DEVELOPING COUNTRIES: THE NEW ORTHODOXY OF MONETARY POLICY

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Abstract

Before the 1970s the thinking of both economists and policy makers was largely dominated by a policy popularly known as financial repression. However, since the 1970s, this agonising theory, which received massive support from the Keynesians, was replaced by the theory of financial liberalisation – which became the new orthodoxy of monetary theory and policy. Unfortunately, very little is known about the middle-ground policy known as financial restraint, which combines the various aspects of both financial repression and financial liberalisation in a stepwise fashion. In particular, the theoretical underpinnings of the financial restraint theory, as well as its dynamics have not been fully explored. The current study, therefore, fills this lacuna by examining the various forms of financial restraint namely interest rate restraint, restraint on the reserve and liquidity requirements, capital adequacy requirements restraint, capital inflows restraint and restraint on entry into the financial system. In addition, the study revisits the effects of financial repression and financial liberalisation vis-à-vis financial restraints in a stylised fashion. The study concludes that financial restraint may not only be desirable, but also necessary for the efficacy of financial sector reforms.

Keywords: Financial Restraints, Financial Repression, Financial Liberalisation, Monetary Policy

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1. Introduction

Financial restraint theory was first popularised by the so-called New-Keynesians, who recognised the problem of incomplete information inherent in the financial system and the essential role of government intervention (Hellman et al, 1997a,b; Lee, 2001). In a nutshell, financial restraint may be described as a middle-ground policy that carefully combines the various aspects of both financial repression and financial liberalisation in a benevolent and cautious fashion.

Financial repression refers to the indiscriminate distortion of financial prices, including interest rates and foreign exchange rates. 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; Odhiambo, 2004; Odhiambo, 2010).

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 so as to determine an equilibrium rate of interest, which balances savings and investment (see Odhiambo, 2010). The savings function in this case is assumed to depend largely on the growth of the economy and the real interest rate. As argued in this analysis, holding the rate of interest below that which would be determined by the intersection of the curves will 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 (Odhiambo, 2010).

As opposed to financial repression, financial liberalisation allows the markets to determine who obtains and grants credit and at what price. The theory of financial liberalisation was first popularised by McKinnon (1973) and Shaw (1973), and it involves eight main dimensions, namely: 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 (see Odhiambo, 2010).

The main aim of financial liberalisation, according to the proponents of the theory, is to build a more efficient, robust, and deeper financial system that can support the growth of private sector enterprise. The liberalisation of financial markets allows a more varied and specialised intermediation between savers and borrowers, using a multitude of institutions, instruments, and products. It also facilitates a freer flow of money to where it can be invested best, i.e. with a higher risk-adjusted rate of return. Just like other markets of the economy, the 'invisible hand' of the financial market under financial liberalisation is expected to know how to match supply and demand efficiently. 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 at what terms (Odhiambo, 2004; 2010).

Unfortunately, the experience of many developing countries with financial liberalisation has been largely 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 (Odhiambo, 2004). In fact, studies have shown that the conditions originally set out for the effective implementation of financial liberalisation are too ambitious and even unattainable. It is for this reason that some economists in recent years decided to advocate the policy of financial restraint instead of the *laissez-faire* financial liberalisation policy. Unfortunately, the theoretical underpinnings of the financial restraint policy have not been fully explored, and many policy makers still confuse financial restraint with financial repression. The current study, therefore, aims to examine the various forms of financial restraint from a theoretical perspective. The study also explores the link between financial repression, financial liberalisation and financial restraint in a stylised fashion. The rest of the paper is organised as follows. Section 2 highlights some of the advantages of financial restraint as presented in the literature. Section 3 presents an overview of some of the various forms of financial restraint, while section 4 concludes the study.

2. The Role of Financial Restraint: A Theoretical Construct

Financial restraint is fundamentally different from financial repression. While financial restraint policy enables the government to create rent opportunities in the private sector, financial repression enables the government to extract rents from the private sector to meet its deficits (see Hellmann et al., 1997a,b). It is argued that financial restraints in the form of mild government intervention in interest rates and entry of financial institutions can produce a rent that helps in stabilising the financial system (Stiglitz and Uy, 1996). Moreover, there is a strong belief that government-directed financial allocation could induce higher economic growth in developing countries (Stiglitz and Uy, 1996).

A fundamental strength of financial restraint is that the government does not directly interfere in the flow of funds from depositors to firms. The government only creates the rent opportunities, by placing a modestly binding deposit rate ceiling (Hellmann et al, 1997a,b). Depositors are therefore taxed according to the amount by which the rate ceiling is binding, with 100% of the revenue from this tax captured by the bank. This, according to Hellmann et al (1997a,b), provides fewer opportunities for government officials to divert funds to alternative uses. There is therefore less scope for corruption, as government officials are not controlling the resources themselves.

Moreover, studies have shown that the *laissez-faire* approach to financial liberalisation is unattainable, and may be undesirable. In fact, experience has shown that a *laissez-faire* approach may only work well in product markets and not in financial markets (Reese, 1996). As Fanelli et al (1998) put it, "there is no financial market structure free from intervention. There is always some degree of government intervention owing to the existence of market failures, emanating from market structures, externalities, uncertainty, and informational problems. Consequently, it is necessary to determine which regulations are market 'friendly' and therefore should be considered instead of financial repression" (Fanelli et al, 1998:5). All this implies that financial restraint may not only be desirable, but also necessary for the efficacy of financial sector reforms.

3. Various Forms of Financial Restraint

There are five broad types of financial restraint, which have been used in relatively recent times by governments in order to achieve prudential goals (Demetriades, Arestis, and Fattouh, 2000; Honohan and Stiglitz, 1999; Odhiambo, 2004; 2009). These are restraints on: i) interest rates; reserve and liquidity requirements; ii) capital adequacy requirements; iii) capital inflows, and iv) entry into the financial system.

3.1 Interest Rates Restraint

A number of authors have argued that, in the presence of information asymmetries, liberalisation of interest rates may not necessarily lead to efficient gains (Schiantarelli et al, 1994). In the presence of implicit deposit insurance, interest rate liberalisation may encourage banks to take excessive risks (McKinnon and Pill, 1997). This form of moral hazard may

manifest itself in loans that are too risky and even in speculative activities such as real estate acquisitions and stock purchases, which may divert the allocation of resources away from productive activities (Caprio, 1994). In such circumstances, interest rate liberalisation will not only reduce the average productivity of capital, but may also lead to an increase in bad debts (Demetriades, Arestis and Fattouh, 2000). Likewise, it is argued that financial liberalisation, if accompanied by increased competition, may erode the franchise value of banks (Caprio and Summers, 1993). This aggravates the problem of moral hazards in the banking system and encourages looting behaviour in banking, hence increasing the probability of financial crisis (Akerlof and Romer, 1993).

Due to these information asymmetries associated with interest rate liberalisation, economists have suggested that some types of financial restraint such as interest rate restraint can in fact reduce the problem of moral hazards and adverse selection (Stiglitz, 1994). In doing so, the restraint may enhance the soundness of the domestic banking system, which in turn may result in better allocation of resources (Arestis, and Demetriades, 1997; Demetriades, Arestis and Fattouh, 2000). In the same vein, Hellman et al (1994a,b; 1996a,b) argue that 'financial restraint' policies create rent opportunities in the financial sector, which enhance incentives for financial deepening. In Hellman et al (1996a, b) these ideas are applied to deposit mobilisation, which is crucial to many developing countries. The outcome of financial restraint under these conditions is, therefore, shown to be superior to those under a free market *laissez-faire* system[1].

In a more recent study on 'Financial Restraints in the South-Korean Miracle', Demetriades and Luintel (2001) found evidence which robustly shows that the direct effects of financial restraint on financial development in Korea were not only positive but also quite large, while the effect of changes in the real interest rate were insignificant. The authors conclude that "our empirical findings are consistent with our theoretical predictions but contrast sharply with the predictions of earlier literature that postulates that interest rate ceilings and other financial restraints constitute sources of financial repression" (Demetriades and Luintel, 2001:1).

Honohan and Stiglitz (1999) argue that ceilings on deposit interest rates are a robust policy which can give banks market power in the deposit market, at least to the extent that there are no perfect substitutes outside the scope of the ceilings. As such, they will provide a franchise value. They may also serve to limit the scale on which banking can be conducted, and this may mean a portfolio with lower average risk, depending on the range of loan opportunities available to banks.

[1] See also Demetriades, Arestis and Fattouh (2000).

3.2 Restraint on Reserve and Liquidity Requirements

Although the proponents of financial liberalisation policy argue that the abolition of reserve requirements increases the size of financial intermediation, and makes the allocation of financial resources more efficient, this argument may not hold if the revenue from reserve and liquidity requirements is used to finance productive public investment (see Demetriades, Arestis and Fattouh, 2000). Moreover, studies have shown that investment in public capital has a large positive effect on the productivity of private sector investment (see Aschauer, 1989; Lynde and Richmond, 1993; Nadiri and Mamuneas, 1994; Demetriades and Mamuneas, 1998). This, therefore, implies that reserve and liquidity requirements may well help to enhance the average productivity of capital (Demetriades, Arestis and Fattouh, 2000:7). According to the advocates of financial restraint, minimum reserve and liquidity requirements are particularly useful when money markets are not sufficiently deep or developed (Demetriades, Arestis and Fattouh, 2000).

3.3 Restraint on Capital Adequacy Requirements

The most common restraint on the composition of liabilities is minimum capital requirements, whether in terms of a percentage of assets, weighed or un-weighed for risk characteristics, or in terms of an absolute minimum amount (Demetriades, Arestis and Fattouh, 2000; Honohan and Stiglitz, 1999). There are three reasons why regulators impose capital adequacy requirements. First, capital adequacy requirements can help to reduce the scope for moral hazard behaviour by banks, thereby containing their tendency to take excessive risks. Second, capital adequacy requirements can reduce bank insolvency risk or default risk. Finally, with capital adequacy requirements, losses to depositors in the event of bank failure can be reduced (Wall and Peterson, 1996; Blum and Hellwing, 1995; Demetriades, Arestis and Fattouh, 2000; Honohan and Stiglitz, 1999).

On achieving the first and second objectives, the theoretical literature is not unanimous. Using a mean variance framework, Kim and Santomero (1988) suggest that capital regulation may in fact increase a bank's portfolio risk, and hence lead to an inefficient allocation of assets. Specifically, an involuntary reduction in leverage can be met by a change in the composition of a bank's portfolio towards more risky assets. In contrast, Keeley and Furlong (1990) argue that the mean variance approach used by Kim and Santomero (1988) is inadequate to address the impact of capital adequacy requirements. This is because the mean-variance framework fails to recognise that the bank does not have full liability and that the value of deposit insurance will increase as the bank's leverage

increases. When Kim and Santomero's (1988) model was adjusted to take this feature into account, Keeley and Furlong (1990) found that higher capital requirements would always result in lower risk-taking on behalf of the bank. However, Gennotte and Pyle (1991), while using a different approach that incorporates Keeley and Furlong's suggestion concerning the value of deposit insurance, and under the assumption that bank investments are subject to decreasing returns, found that capital requirements increase the risk of bank's portfolio.

Other studies which have been conducted on this subject include Hancork et al (1995), Honohan and Stiglitz (1999), and Burger et al (1995). Hancork et al (1995) show that the capital adequacy ratio may contribute to the crunch by reducing the amount of new loans to business. Burger et al (1995) argue that capital regulations may lead to allocative inefficiency by shifting the use of traditional bank loans to off-balance sheet assets. Honohan and Stiglitz (1999), however, argue that capital adequacy requirements directly insulate depositors (and the deposit protection agency) by providing a first line of reserves to absorb losses. Besides, they can provide a bonding effect on shareholders, thereby partly substituting for franchise value. In the same vein, Demetriades, Arestis, and Fattouh (2000), while conducting an empirical study on 14 countries using modern panel-time series methods, found that the effects of financial restraint (such as capital adequacy requirements and restrictions on capital flows) vary considerably across countries. The main predictions of financial liberalisation literature, however, are not borne out in this study, reflecting the prevalence of financial market imperfections. The authors conclude that "in contrast, our findings provide significant support to the thesis – currently gaining ground among international policy makers – that some form of financial restraint may indeed have positive effects on economic efficiency" (Demetriades, Arestis and Fattouh, 2000:21).

3.4 Restraint on Capital Inflows

It is widely recognised that short-term capital inflows may be associated with more costs than benefits (Demetriades, Arestis and Fattouh, 2000). It is therefore important for governments, and possibly the international system, to do more to restrain the movement of capital, especially of short-term 'hot money' (Stiglitz, 1998). While short-term capital inflows may, in principle, supplement domestic savings and lead to higher levels of investment and growth rates, this benefit is likely to be small in economies already possessing high savings and investment ratios (Demetriades, Arestis and Fattouh, 2000). The recent financial crisis in East Asia is a case in point. The crisis clearly demonstrated that when the short-term capital inflows are not productively invested, they can end up creating asset price bubbles. According to Stiglitz (1998), many countries seem to get private capital when they are strong and need it least, but have a relatively hard time accessing capital when they are experiencing difficult times, and when they need it most. As a result, capital flows do very little to smooth the business cycle, and may even amplify it (Sliglitz, 1998).

4. Conclusion

Before the 1970s the thinking of both economists and policy makers was largely dominated by a policy popularly known as financial repression, in which heavy-handed government intervention was the rule in the economy. This policy was partly supported by the Keynesian's prior-savings theory. Since the 1970s, the prevailing view in many developing countries has been in favour of financial liberalisation policy. This theory, which was first popularised by McKinnon (1973) and Shaw (1973), became so popular that it even received support from the IMF and World Bank. Unfortunately, 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 (Odhiambo, 2004). Indeed, the experiences of many countries with the liberalisation of the financial sectors have been largely disappointing. As a result, a number of economists have called for a middle ground policy between financial repression and financial liberalisation – popularly known as financial restraints policy. Financial restraints policy, in essence, is a policy that combines both the aspects of financial repression and financial liberalisation in a stylised fashion. Unfortunately, very few policy makers are familiar with the theoretical underpinnings of this policy. The aim of this study, therefore, is to evaluate the various forms of financial restraint from a theoretical front. Specifically, the study explores the link between financial restraints, financial liberalisation and financial repression in a stylized fashion. The study concludes that financial restraint may not only be desirable, but also necessary for the efficacy of the financial sector reforms.

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