

CHAPTER 8: FINANCIAL REPRESSION AND LIBERALIZATION

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2ND SEMESTER 2019-2020**

OUTLINE

1. Financial repression
2. Financial liberalization
3. Predicted benefits of financial liberalization
4. From theory to practice
5. liberalization and Growth
6. Policy implications

INTRODUCTION

- In general, financial sector development will lead to higher rates of economic growth (though the strength of this relationship differ from country to country)
- *Joseph Schumpeter*: well-developed financial sector mobilize savings and intermediate surplus capital and allocate capital to its most productive uses within the economy.
- Market failure!
- Government failure!

FINANCIAL REPRESSION

Financial repression: The replacement of market mechanisms by direct government intervention in the determining of the level of financial variables and the allocation of credit at prices determined by the state

- The term was introduced in 1973 by Stanford economists Edward S. Shaw and Ronald I. McKinnon

Systemic financial repression, developed in the second half of the twentieth century (it was as much the norm as are liberalized financial systems today)

- Direct response to circumstances → the great depression

FINANCIAL REPRESSSION: CIRCUMSTANCES IN THE SECOND HALF OF 20TH CENTURY

- Great depression → shook people's faith in the ability of free markets to produce optimal outcomes
- The war years demonstrated that '*command economies*' could function efficiently (stability and employment were achieved)

Command economy: A system where the government, rather than the free market, determines what goods should be produced, how much should be produced and the price at which the goods will be offered for sale. (faith in the power of the state)

- Economic and technological achievements of the Soviet Union
- Free markets were seen as unpredictable, suboptimal and potentially dangerous

FINANCIAL REPRESSION: CIRCUMSTANCES IN THE SECOND HALF OF 20TH CENTURY (CONT.)

- The immediate post-war period: establishment of a system of international fixed exchange rates pegged to USD (Bretton woods), international capital flows were restricted
- Caprio et al. (2001): popularity of financial repression due to the rise of nationalism and populism in the post-second World War era
- The rise of structuralist school of thought → restrictions on the entry of foreign financial institutions (dangers of developing countries being trapped in a situation of dependence vis-à-vis industrialized countries)
- The general view of the time: social objectives are more likely to be met if the financial system is not driven entirely by pursuit of profit (e.g. caps on interest rate: means of redistributing income)

KEY ELEMENTS OF FINANCIAL REPRESSION

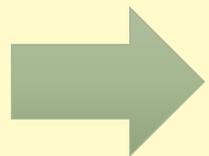
1. Interest rates controlled by government
2. Credit controls in place
3. Barriers to entry the financial sector in place
4. Government control of banking operations
5. Government ownership of banks
6. International capital flows restricted

FINANCIAL REPRESSION (CONT.)

- According to this definition: financial repression was almost universal among developing countries in the early 1970s
- Many of the features of repression are strongly interrelated: cap on interest rate → large incentives for capital flight → capital controls (in the absence of control financial resources go to places with higher interest) → barriers to entry of foreign-owned institutions
- Financial repression had become increasingly associated with economic cost
- By 1996 developed countries are almost entirely liberalized

THE ECONOMIC COSTS ASSOCIATED WITH REPRESSION

1. Deterioration of economic performance in terms of growth
2. Decline in the quality of lending → bank insolvencies
3. The goals of redistribution were not met
4. Negative real interest rates → significant capital flights and dependence on external sources of capital
5. Excessive use of capital-intensive production due to low real interest rates
6. Credit dedicated to support inefficient state enterprises → eliminate incentives to select viable projects, and to monitor the progress of investment



Deteriorating fiscal balances → higher tendency to borrow and/or to print money → increasing risk of crisis

- **MSH:** McKinnon and Shaw (1973): Most of the negative impacts of financial repression flows from the imposition of artificially low interest rates:
 - National savings rates being lower than would otherwise be the case (sometimes even negative!)
 - The funds available for intermediation through the banking system is lower than optimal
 - Low interest rates make low-yielding investment opportunities more viable → misallocation of resources

- ***Financial repression* created by an institutional environment is characterized by:**

- Poor system of property rights (unable to use collateral efficiently)
- Poor legal system (difficult for lenders to enforce restrictive covenants)
- Weak accounting standards (less access to good information)
- Government intervention through directed credit programs and state owned banks (less incentive to properly channel funds to its most productive use)

Countries with low level of economic growth and underdeveloped financial sector

FINANCIAL LIBERALIZATION

- Avoiding negative effects of repression → financial liberalization
- Today: Financial systems and markets increasingly operate without direct government intervention (at least in Anglo-Saxon economies)
- Liberalization started in 1980s **predicted**: efficient allocation of resources at the global level → positive impact on both global growth and growth rates of individual countries: if there is no restriction of inflows and outflows of capital, resources flow to countries with highest rate of return → global productivity and growth
local investors benefit from diversified international investment opportunities and lower risk

PREDICTIONS OF FINANCIAL LIBERALIZATION

1. Rise in real interest rates
2. Rise in savings rate
3. Increase in financial intermediation (financial deepening)
4. Reallocation of financial resources to its more productive use (flow of capital to countries with greater potential for growth)
5. Higher levels of investment and growth → reduction in levels of poverty within developing countries

FROM THEORY TO PRACTICE: LIBERALIZATION AND INTEREST RATE

Removing artificial ceilings on interest rate

- In many cases interest rates rose sharply to very high level instead of moving to modestly positive levels
- Negative real interest rates have many negative effects (described by McKinnon & Shaw) this does not mean that very high rates lead to positive outcomes!

FROM THEORY TO PRACTICE: LIBERALIZATION AND SAVINGS RATE

- Intuitively: higher interest rates \longrightarrow higher rates of savings (MSH)
- Assumption: all individuals have the same access to credit markets
- In reality: some individuals have no access to credit markets and have no ability to smooth their consumption, for low income savings rates will be relatively insensitive to changes in interest rates.

FROM THEORY TO PRACTICE: LIBERALIZATION AND SAVINGS RATE (CONT.)

- Literature that examines link between **interest rate** and **savings rate**:
 - Fry (1978): Asian countries: higher real interest rate → higher national savings (relationship is weak and not robust)
 - For different levels of interest rate: Reynoso (1989): savings increase rapidly as real interest move from extremely negative to slightly less than zero but the increase declines as rates become positive and turns negative as real interest rate rise further
 - Many studies: increase in the interest rate → fall in the savings rate at higher levels of development
 - Other studies: little or no link in developing countries, particularly the poorest

Why?

FROM THEORY TO PRACTICE: LIBERALIZATION AND SAVINGS RATE (CONT.)

In short, empirical evidence tell us:

1. Modestly positive real interest rates in middle income developing countries may be optimal for maximizing savings
2. Negative and very high real rates \rightarrow lower savings in middle income developing countries
3. Little or no relationship for the poorest countries
4. Higher real interest rates \rightarrow lower rates of saving in high income countries

Financial liberalization in developing countries \rightarrow sharp increase in real interest rates

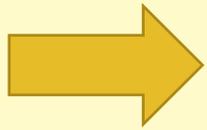
Very high interest rates \rightarrow negative relationship with rates of investment

FROM THEORY TO PRACTICE: LIBERALIZATION AND FINANCIAL DEPTH

- Different measures of financial depth
- One straightforward measure: money/GDP ratio
- Most studies confirm that financial depth has tended to increase following a liberalization
- Williamson & Mahar (1998): 34 countries: after liberalization, financial depth increased for developed countries, and most of the developing countries (except for France, Philippines, Turkey and Venezuela)

FROM THEORY TO PRACTICE: LIBERALIZATION AND EFFICIENT ALLOCATION OF *DOMESTIC* FINANCIAL RESOURCES

- Main argument: financial liberalization → more efficient allocation of resources (flows of funds towards more productive sectors) → increase growth rate



Financial sector development increase the quantity and quality of investment

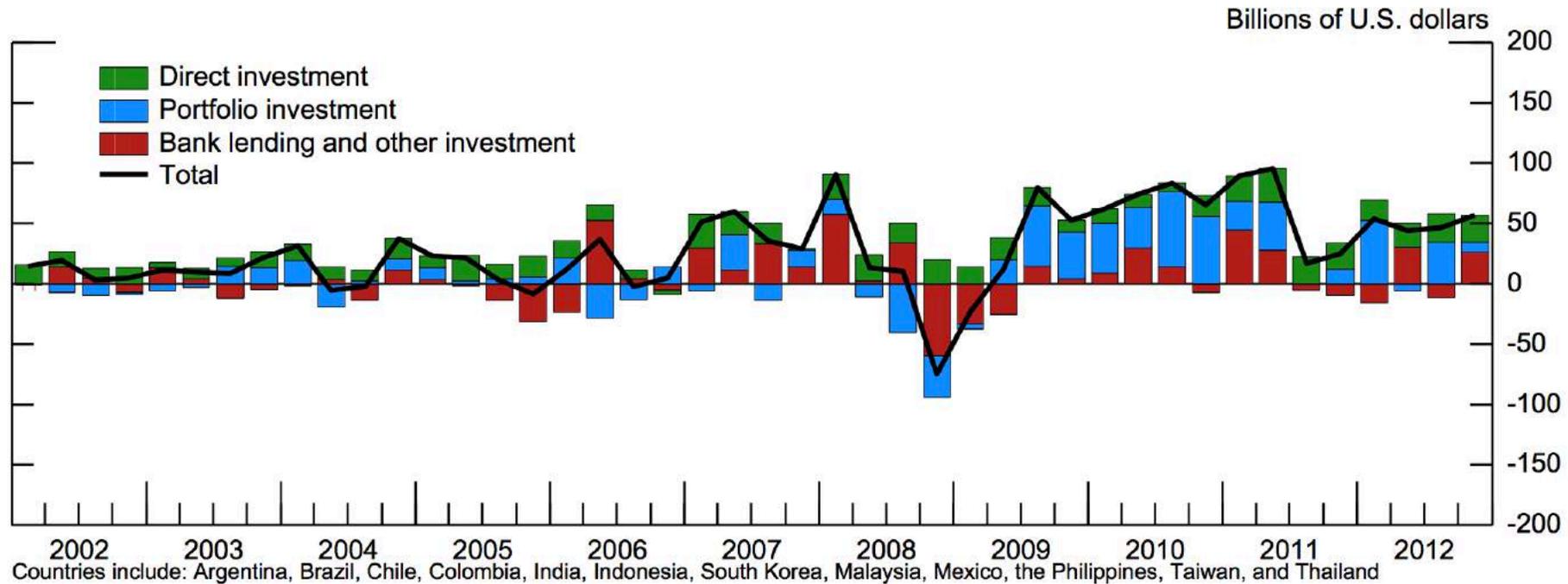
- Empirical evidence:
 - Gregorio & Guidotti (1992): 3/4 of the correlation between financial intermediation and growth can be explained by a more efficient pattern of credit allocation
 - Country level studies are supportive (Mexico, Argentina, Turkey, etc.)
 - Multi-country studies are also supportive

FROM THEORY TO PRACTICE: LIBERALIZATION AND THE EFFICIENT ALLOCATION OF *INTERNATIONAL* FINANCIAL RESOURCES

- Question: *Do we have the same efficient reallocation of global investment funds?*
- There should be a shift in the allocation of global capital from the developed countries towards developing and emerging world that have greater potential for growth

Figure 1: Net and gross private capital flows to EMEs

(a) Net flows



What we rather see are cyclical booms, where capital flows increase followed by 'busts'

FROM THEORY TO PRACTICE: LIBERALIZATION AND FINANCIAL CRISIS

- Carlos Diaz-Alejandro (1985): financial liberalization lead to an increased risk of financial crisis in developing countries
- Williamson & Mahar (1998): all countries in their sample (32) underwent a liberalization, all experienced some form of systemic financial crisis between 1980 and 1997
- Asian financial crisis of the late 1990s

The risk of a crisis increase after financial liberalization, but it is not inevitable.

The risk is strongly related to the strength of regulation and supervision of the financial system

FROM THEORY TO PRACTICE: CAPITAL ACCOUNT LIBERALIZATION AND GROWTH

- Recent advances both in theory and practice: there are many situations where the market mechanism is likely to fail to deliver optimal outcomes → justify government interventions
- No consensus regarding capital account liberalization
 - Advocates: it should be implemented in all circumstances
 - Opponents: it is a mistaken and damaging reform in all circumstances

A) CAPITAL ACCOUNT LIBERALIZATION: THEORETICAL BENEFITS

- One of the principals of economic theory is theoretical support for **free trade**: removing barriers to trade is a win-win policy (certainly there would be losers and gainers in different parts of the economy and in different sectors)
- If all benefit from the free movements of goods and services → the same is true for the free movements of capital
- Removing restrictions on capital allocation **domestically** should raise the productivity and growth (investment in businesses with highest return) → The same should hold internationally
- Eichengreen & Leblang (2003): this predictions are undermined in the presence of weakness in domestic and international financial systems (capital account liberalization amplifies these weaknesses) → increase in likelihood of financial crisis

BJ CAPITAL ACCOUNT LIBERALIZATION: THE EVIDENCE

Modern empirical work began in early 1990s, the results are not encouraging for advocates of reform :

- Alesina et al. (1994), Grilli & Milesi-Ferretti (1995), Rodrik (1998), Bordo & Eichengreen (1998): insignificant small effect or no relationship between capital account liberalization (CAL) and growth
- Quinn (1997): The first study to find positive relationship
- Edwards (2001): The results may have been compromised as growth itself may lead to CAL → after correcting for this: the effect is restricted to high-income countries
- Edison et al. (2002): link is stronger in emerging than developed countries

If there is a causal link between CAL and growth (must seriously doubted) , it is far from clear.

B) CAPITAL ACCOUNT LIBERALIZATION: THE EVIDENCE (CONT.)

- The link between CAL and incident of financial crisis is well-established (mostly in countries with restricted capital account)
- Eichengreen & Leblang (2001):
impact of CAL on growth via 2 Channels:
 - Positive → more efficient capital allocation
 - Negative → higher probability of financial crisis



Results are influenced by specific periods of time (periods of 1925-35 and 1993-1997), in periods of calm in the international financial system, capital controls is negatively associated with growth

Is Capital account liberalization good for growth? It depends on the interaction of numerous factors: external or country specific
In a world of ordered stable international finance the answer can be yes and in a world of volatile international finance the answer is almost certainly no!

FROM THEORY TO PRACTICE: LIBERALIZATION AND GROWTH

- The reason for financial liberalization: boost economic growth and reduce poverty rate.
- 1979-1990: Period of rapid liberalization
- Pioneer liberalizers in Latin America in the 1970s: Argentina, Chile
 - ✓ Removing controls over interest rate
 - ✓ Privatizing and injecting competition in the banking sector
 - ✓ The capital account was also liberalized at almost the same time
 - At a time of severe macroeconomic instability
 - In the early 80s both countries experienced crisis.

FROM THEORY TO PRACTICE: LIBERALIZATION AND GROWTH (CONT.)

Immediately a consensus developed for the *sequencing of reforms* as a key issue:

1. Stabilize the macroeconomic environment
2. Remove restrictions on international trade
3. Robust and effective framework of financial regulation and supervision
4. Remove controls over interest rates
5. Eliminate credit controls
6. Remove barriers to competition
7. Liberalize capital accounts

FROM THEORY TO PRACTICE: LIBERALIZATION AND GROWTH (CONT.)

- Williamson (1993): preconditions for CAL are:
 1. Trade liberalization at least two years previously
 2. A fiscal deficit below 5% of GDP for three previous years
 3. Domestic financial liberalization two years previously
 4. Opening of banking sector to domestic and foreign competition two years previously
 5. Government ownership of banking sector reduced to less than 40% two years previously
 6. A robust system of prudential regulation and supervision in place

FROM THEORY TO PRACTICE: LIBERALIZATION AND GROWTH (CONT.)

- Conditions 4 and 6 were less often met!
- The sequencing issues may seem now rather obvious in the light of the Asian financial crisis of the late 1990s.
- But in 1980s and early 1990s there were far less talk of the importance of such issues
- IMF encouraged widely the CAL
- The importance of the Western-trained neo-classical economists, and their influence on policy makers

Many mistakes were thus made in the process of liberalization

POLICY IMPLICATIONS AND CONCLUSION

- Both governments and markets can and do fail
- The financial repression of the post war era was largely a rational response to the market failure that had preceded it in the 1920s and 1930s
- The collapse of financial repression was itself inevitable in the context of widespread government failure to limit, target and manage the process properly
- Where repression worked it was time-limited, strictly focused and rationally planned with the incentives of key actors largely aligned. Where it did not, in contrast it became a self-reinforcing source of rent seeking and economic stagnation

POLICY IMPLICATIONS AND CONCLUSION (CONT.)

- Liberalization ‘shock-therapy’ has clearly failed (placing blind faith in market mechanism, regardless of historical and institutional context)
- We must seek a middle way that takes account of a country’s level of development and its institutional context (It is unlikely that full-scale liberalization would be appropriate in the poorest developing countries)

POLICY IMPLICATIONS AND CONCLUSION (CONT.)

- As countries develop and domestic market failures are addressed, increasing financial liberalization is justified
- Liberalized domestic financial sector is the most appropriate destination of middle-income countries
- For external sector the matters are less clear, capital account liberalization *can be* good for high-income developed countries

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- “Development Finance debates dogmas and new directions”- Stephen Spratt (2009)