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Economic and social effects of financial liberalization

Jayati Ghosh

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1. The nature of financial liberalization

Financial liberalization refers to measures directed at diluting or dismantling regulatory control over the institutional structures, instruments and activities of agents in different segments of the financial sector. These can relate to both internal and external liberalization measures. Typically, financial sector liberalization in developing countries has been associated with measures that are designed to make the central bank more independent, relieve "financial repression" by freeing interest rates and allowing financial innovation, reduce directed and subsidised credit, as well as allow greater freedom in terms of external flows of capital in various forms. The process usually includes some or all of the following measures, in varying degrees:

1.Reduction or removal of controls on the interest rates or rates of return charged by financial agents. Of course, the central bank continues to influence or administer that rate structure through adjustments of its discount rate and through its own open market operations. But deregulation typically removes interest rate ceilings and encourages competition between similarly placed financial firms aimed at attracting depositors on the one hand and enticing potential borrowers to take on debt on the other. As a result, price competition squeezes spreads and forces financial firms (including banks) to depend on volumes to ensure returns.

2. Dilution or removal of controls on the entry of new financial firms, subject to their meeting pre-specified norms with regard to capital investments. This does not necessarily increase competition, because it is usually associated with the freedom to acquire financial firms for domestic and foreign players and extends to permissions provided to foreign institutional investors, pension funds and hedge funds to invest in equity and debt markets, which often triggers a process of consolidation.

3. Reduction in controls over the investments that can be undertaken by financial agents, and specifically, breaking down the “Chinese wall” between banking and non-banking activities. Most regulated financial systems sought to keep separate the different segments of the financial sector such as banking, merchant banking, the mutual fund business and insurance. Agents in one segment were not permitted to in

foreign residents to hold domestic financial assets, those which allow domestic residents to hold foreign financial assets and those which allow foreign currency assets to be freely held and traded within the domestic economy (“dollarization” of accounts).

7. The withdrawal of the state from the activity of financial intermediation with the conversion of the “development banks” into regular banks and the privatization of the publicly owned banking system, on the grounds that their presence is not conducive to the dominance of market signals in the allocation of capital.

8. The easing of conditions for the participation of both firms and investors in the stock market by diluting or doing away with listing conditions, by providing freedom in pricing of new issues, by permitting greater freedoms to intermediaries such as brokers and by relaxing conditions with regard to borrowing against shares and investing borrowed funds in the market.

9. Shift to a regime of voluntary adherence to statutory guidelines with regard to capital adequacy, accounting norms and related practices, with the central bank’s role being limited to supervision and monitoring.

11. The theoretical arguments for financial liberalization

Underlying most of the arguments for financial liberalization measures are some basic monetarist postulates, namely : (i) real economic growth is determined by the available supply of factors of production such as capital and labour and the rate of productivity growth, and changes in money supply do not have any impact on real economic activity and the growth of output; (ii) money supply is exogenous rather than endogenous to the system and can be controlled by the monetary authorities who can successfully pursue well defined targets for monetary growth, and (iii) inflation is attributable to an excessive growth of money supply relative to an exogenously given “real rate of growth of output” and can be moderated by reducing the rate of growth of money supply. These postulates can then lead to arguments for an “independent” central bank whose essential job would be to control inflation by using money market levers to control money supply and therefore the price line.

The basic difficulty with these arguments is now rather well known. There is no clearly discernible relationship between the rates of growth of money supply and of inflation on the one hand, and real output growth on the other. The monetarist argument is based on the twin assumptions of full employment (or exogenously given aggregate supply conditions) and aggregate money supply determined exogenously by macro policy. Neither of these assumptions is valid; rather, there is a strong

repression tends to selectively ration out riskier projects, irrespective of their social relevance, because interest rate ceilings imply that adequate risk premia cannot be charged.

But there is of course a large theoretical literature pointing out that financial markets inherently cannot be as perfect as this, and are structurally more imperfect than the markets for goods. Since information as a commodity has strong public good characteristics (non-rivalry in consumption and non-excludability in provision), even a competitive market cannot ensure the adequate availability of the same. The public good characteristic of information typically results in the inadequate acquisition of information. Those who manage investments are, therefore, inadequately monitored, which encourages inappropriate risk-taking or even fraud that could lead to insolvency. There are many examples of market failure in financial markets resulting from asymmetric information, adverse selection, incentive-incompatibility and moral hazard, which then get aggravated because of further imperfections and the interlinkages between financial agents.

There are other problems which result because social returns differ from private returns. Projects with high social returns may not be the ones that deliver the highest profits to the bank or financial investor. Banks may be willing to increase their exposure to "sensitive sectors" like the stock and real estate markets, given the higher interest clients are willing to pay on the expectation of larger speculative profits. Besides exposing banks to the dangers of a stock or real estate market collapse, such options reduce lending to investors in manufacturing or the agricultural sector who cannot accept extremely high interest rates. This was one of the principal reasons why governments sought to create public sector banks and direct public and private credit to socially important sectors.

Likewise, there are reasons to question the arguments about financial repression. There are reasons to believe that financial deepening (measured by the ratio of financial to real wealth) and increased financial intermediation (measured by the share of financial assets of financial institutions in total financial assets) need not be in themselves stimuli to growth, despite myriad efforts to prove that this is true. The existence of usurious money lending in backward agriculture, that limits rather than promotes growth, is indicative of the fact that inequality of a kind inimical to growth influences the nature of a financial structure. And evidence

finance. These included the changing demographic structure in most of the advanced countries, with baby boomers reaching the age when they would emphasise personal savings for retirement. This was accentuated by changes in the institutional structures relating to pensions, whereby in most industrial countries, public and private employers tended to fund less of the planned income after retirement, requiring more savings input from employees themselves. All this meant growing demands for more variety in the form of savings as well as higher returns, leading to the greater significance of pensions funds, mutual funds and the like.

Financial liberalization in the developed countries was closely related to these developments. But it also contributed to the savings overhang. First, it increased the flexibility of banking and financial institutions when creating credit and making investments, as well as permitting the proliferation of institutions like the hedge funds which, unlike the banks, were not subject to regulation. It also provided the space for "financial innovation" or the creation of a range of new financial instruments or derivatives such as swaps, options and futures that were virtually autonomously created by the financial system. Finally, it increased competition and whetted the appetite of banks to earn higher returns, thus causing them to search out new recipients for loans in different economic regions.

Financial liberalization began with versions of the "big bang" in developed country markets. This was because, by the late 1960s, it became clear that old-style Keynesian policies were increasingly incapable of dealing with the secular deceleration that threatened most developed countries, especially the US. Further, with a weakening US economy leading to the breakdown of the Bretton Woods arrangement and the emergence of a world

The massive increase in international liquidity that followed found banks and non-bank financial institutions desperately searching for means to keep their capital moving. At first, there were booms in consumer credit and housing finance in the developed industrial nations. But when those opportunities petered out, a number of developing countries were discovered as the "emerging markets" of the global financial order. Capital in the form of debt and equity investments began to flow into these countries, especially those that were quick to liberalise rules relating to cross-border capital flows and regulations governing the conversion of domestic into foreign currency. The result of these developments was that there was a host of new financial assets in the emerging markets, which were characterised by higher interest rates ostensibly because of the greater risks of investment in these areas.

Financial liberalization in the developed countries increased the flexibility of banking and financial institutions when creating credit and making investments, and permitted the proliferation of institutions like hedge funds that, unlike the banks, were not subject to much regulation. It also encouraged "securitisation", or capital flows in the form of stocks and bonds, rather than loans, and "financial innovation", involving the creation of a range of new financial instruments or derivatives such as swaps, options and futures, virtually autonomously created by the financial system. These instruments allowed players to trade in the risks associated with an asset without trading the asset itself. Finally, it increased competition and whetted the appetite of banks to earn higher returns, thus causing them to search out new recipients for loans and investments in economic regions that were hitherto considered to be too risky.

The massive increase in international liquidity that followed, found banks and non-bank financial institutions desperately searching for means to keep their capital moving in order to deliver returns. At first, there were booms in consumer credit and housing finance in the developed nations. Later, a number of developing countries were discovered as "emerging markets". Capital- in the form of debt and equity investments- began to flow into these countries, especially those that were quick to liberalize rules relating to cross-border capital flows and foreign exchange convertibility. As a result of these developments, there was a host of new financial assets

in emerging markets characterized by higher interest rates, ostensibly because of greater investment risks in these areas. The greater 'perceived

financial scenario: it is difficult to judge the actual volume and riskiness of the exposure of individual financial institutions; and within the financial world there is a complex web of entanglement with all firms mutually exposed, but each individual firm exposed to differing degrees to any particular financial entities.

Entanglement takes other forms as well. With financial firms betting on interest rate differentials and exchange rate changes at virtually the same time, the various asset markets relating to debt, securities and currency are increasingly integrated. Crises, when they occur, do not remain confined to one of these markets but quickly spread to others, unless stalled by government intervention. Finally, the rise of finance in the manner described above feeds on itself in complex ways.

This means that there are two major consequences of the new financial scenario: it is difficult to judge the actual volume and risk of the exposure of individual financial institutions; and within the financial world, there is a complex web of entanglement, with all firms mutually exposed, but each individual firm exposed to differing degrees to particular financial entities. This also makes a mockery of prudential norms, such as “capital adequacy” ratios, which have supposedly become more strict over time, since it becomes difficult to actually define or measure the extent of capital once such pyramiding of assets is widely prevalent.

Further, the process of financial consolidation on this base has substantially increased the risks associated with the system. During the 1990s, the three-decade long process of proliferation and rise to dominance of finance in the global economy reached a new phase. The international financial system was being transformed in ways that were substantially increasing systemic risk, and rendering the system more crisis-prone. Central to this transformation was growing financial consolidation. This has concentrated financial activity and decision making in a few economic organisations and also integrated areas of financial activity earlier separated from another to ensure transparency and discourage unsound financial practices.

The proximate explanation for the wave of financial liberalization in the developing countries is that this pyramidal growth of finance, which increased the fragility of the system, was seen as an opportunity. Enhanced flows to developing countries, initially in the form of debt and subsequently in the form of debt and portfolio investments led to two consequences. First, the notion of external vulnerability which underlay the interventionist strategies of the 1950s and 1960s no longer seemed relevant – after all any current account deficit could be financed, it appeared, as long as such capital inflows were assured. Second, growth was now easier to ensure without having to confront domestic vested interests, since international liquidity could be used not merely to finance current and capital expenditures but also to ease any supply side constraints that would otherwise constrain such growth.

Until quite recently, the financial press, the international financial

This virtual financial explosion in developing country markets is largely explained by the factors encouraging financial capital to move out of the developed countries. First, emerging financial markets, though volatile, offer extremely high returns in a period when the debt overhang and slow growth in the developed countries has affected financial interests adversely. That makes risk-discounted returns in the developing countries much better than in the developed. Second, privatisation programmes have put up for sale resources of substantial value that can be acquired relatively cheap in a context of currency depreciation. Third, these are markets in which the pent up demand for credit is substantial and innovative financial instruments have not been experimented with in the past. And finally, real interest rates and therefore financial sector returns tend to be relatively high in developing countries undertaking adjustment programmes involving monetary stringency.

The combination of debt and portfolio capital had meant that for the last three decades, at least the more developed among the developing countries have found it much easier, excepting of course when crisis strikes, to access private foreign capital flows. This is taken to imply that the rise to dominance of finance and its globalising influence has rendered the current account deficit in many developing countries less of a binding constraint.

But the boom obviously could not be consistent in all emerging markets. First, it became clear that none of these borrowers were in a position to meet their debt service payments, without resorting to further borrowing. This together with the evidence of the colossal overexposure of the international banking system in many developing countries set afoot the deceleration in the flow of liquidity that came to be called the 'debt crisis'. The banks of course could not pull out completely, because that would have spelt closure for many of them, as much of developing country debt would have had to be written off rather than rescheduled. But the problem went deeper, since with the rise to dominance of finance capital relative to industrial capital in the developed nations, the financial system was awash with liquidity, but creditworthy borrowers were difficult to come by in an increasingly recessionary environment. In the event, debt was replaced with

other kinds of non-debt private capital flows. Here too, however, the evidence suggests that barring rare exceptions, periods of accelerated capital flow were followed by inevitable financial crises, when foreign investors turned wary and chose to withdraw their investments.

IV. The negative effects of financial liberalization

There are some significant negative economic and social effects of financial liberalization, which are often so large that they significantly outweigh any benefits in terms of access to more capital inflows. These relate both to financial markets and to the real economy. Essentially, financial liberalization creates exposure to the following kinds of risk: a propensity to financial crises, both external and internal; a deflationary impact on real economic activity and reduced access to funds for small-scale producers, both urban and rural. This in turn has major social effects in terms of loss of employment and more volatile material conditions for most citizens.

Financial fragility and the propensity to crisis

It is now widely accepted that financial liberalization has resulted in an increase in financial fragility in developing countries, making them prone to periodic financial and currency crises. These relate both to internal banking and related crises, and currency crises stemming from more open capital accounts. The origin of several crises can be traced to the shift to a more liberal and open financial regime, since this unleashes a dynamic that pushes the financial system towards a poorly regulated, oligopolistic structure, with a corresponding increase in fragility. Greater freedom to invest, including in sensitive sectors such as real estate and stock markets, ability to increase exposure to particular sectors and individual clients and increased regulatory forbearance all lead to increased instances of financial failure. In addition, as mentioned earlier, the emergence of universal banks or financial supermarkets increases the degree of entanglement of different agents within the financial system and increases the domino effects of individual financial failures.

Financial markets left to themselves are known to be prone to failure because of the public goods characteristics of information which agents must acquire and process. They are characterised by insufficient monitoring by market participants. Individual shareholders tend to refrain from investing money and time in acquiring information about managements, hoping that others would do so instead and knowing that all shareholders, including themselves, benefit from the information garnered. As a result there may be inadequate monitoring leading to risky decisions and malpractice. Financial firms wanting to reduce or avoid monitoring costs may just follow other, possibly larger, financial firms in making their investments, leading to what has been observed as the "herd instinct" characteristic of financial players. This not merely limits access to finance for some agents, but could lead to overlending to some entities, failure of which could have systemic effects. The prevalence of informational externalities can create other problems. Malpractice in a particular bank leading to failure may trigger fears among depositors in other banks, resulting in a run on deposits there.

Disruptions may also occur because expected private returns differ from social returns in many activities. This could result in a situation where the market undertakes unnecessary risks in search of high returns. Typical examples are lending for investments in stocks or real estate. Loans to these sectors can be at extremely high interest rates because the returns in these sectors are extremely volatile and can touch extremely high levels. Since banks accept real estate or securities as collateral, borrowing to finance speculative investments in stock or real estate can spiral. This type of activity thrives because of the belief that losses if any can be transferred to the lender through default, and lenders are confident of government support in case of a crisis. This could feed a speculative spiral that can in time lead to a collapse of the bubble and bank failures.

Meanwhile, all too often the expected microeconomic efficiency gains are not realised. Even in the US, bond markets play a limited role and equity markets virtually no role at all in financing corporate investment in these countries. The stock market is primarily a site to exchange risks rather than raise capital for investment. In developing countries too the new issues

market is small or non-existent expect in periods of a speculative boom, and bank lending post-liberalisation privileges risky high-return investment rather than investment in the commodity producing sectors like manufacturing and agriculture. The effects on those sectors of liberalisation is indirect, being realised through the

An appreciating real exchange rate encourages investment in non-tradable sectors, the most obvious being real estate, and in domestic asset markets generally. Given the differential in interest rates between domestic and international markets and the lack of any prudence on the part of international lenders and investors, local agents borrowed heavily abroad to directly or indirectly invest in the property and stock markets. Thus it was no accident that all the emerging market economies experiencing substantial financial capital inflows also at a similar time experienced property and real estate booms, as well as stock market booms. These booms in turn generated the incomes to keep domestic demand and growth growing at relatively high rates. This soon resulted in signs of macroeconomic imbalance, not in the form of rising fiscal deficits of the government, but a current account deficit reflecting the consequences of debt-financed private profligacy.

However, once there is growing exposure in the form of a substantial presence of internationally mobile finance capital, any factor that spells an economic setback, however small or transient, can trigger an outflow of capital as well. And the current acco

undesirable. If, for example, a country is suddenly chosen as a preferred site for foreign portfolio investment, it

bias towards deflationary macroeconomic policies and forces the state to adopt a deflationary stance to appease financial interests. To begin with, the need to attract internationally mobile capital means that there are limits to the possibilities of enhancing taxation, especially on capital. Typically, prior or simultaneous trade liberalization has already reduced the indirect tax revenues of states undertaking financial liberalization, and so tax-GDP ratios often deteriorate in the wake of such liberalization. This then imposes limits on government spending, since finance capital is generally opposed to large fiscal deficits. This not only affects the possibilities for countercyclical macroeconomic stances of the state but also reduces the developmental or growth-oriented activities of the government.

Financial interests are against deficit-financed spending by the state for a number of reasons. To start with, deficit financing is seen to increase the liquidity overhang in the system, and therefore as being potentially inflationary. Inflation is anathema to finance since it erodes the real value of financial assets. Second, since government spending is “autonomous” in character, the use of debt to finance such autonomous spending is seen as introducing into financial markets an arbitrary player not driven by the profit motive, whose activities can render interest rate differentials that determine financial profits more unpredictable. If deficit spending leads to a substantial build-up of the state's debt and interest burden, it is possible that the government may intervene in financial markets to lower interest rates with implications for financial returns. Financial interests wanting to guard against that possibility tend to oppose deficit spending. Finally, since financial interests privilege the role of markets, the presence of the state as regulator and the interventionist activity of the state can be seen as delegitimising the role of finance, which is another reason why the markets prefer reduced the control of government deficits.

These kinds of tendencies effect real investment in two ways. First, if speculative bubbles lead to financial crises, they squeeze liquidity, result in distress sales of assets and deflation that adversely impact on employment and living standards. Second, inasmuch as the maximum returns to productive investment in agriculture and manufacturing are limited, there is a limit to what borrowers would be willing to pay to finance such investment. Thus, despite the fact that social returns to agricultural and manufacturing

investment are higher than that for stocks and real estate, and despite the contribution that such investment can make to growth and poverty alleviation, credit at the required rate may not be available.

This is why it is increasingly recognised that liberalization can dismantle the very financial structures that are crucial for economic growth. While the relationship between financial structure, financial growth and overall economic development is complex, the basic issue of financing for development is really a question of mobilising or creating real resources. In the old development literature, finance in the sense of money or financial assets came in only when looking at the ability of the state to tax away a part of the surplus to finance its development expenditures, and the obstacles to deficit-financed spending, given the possible inflationary consequences if real constraints to growth were not overcome. By and large, the financial sector was seen as adjusting to the requirements of the real sector.

In the brave new world, however, when the financial sector is increasingly left unregulated or covered by a minimum of regulation, market signals determine the allocation of investible resources and therefore the demand for and the allocation of savings intermediated by financial enterprises. This results in the problems conventionally associated with a situation where private rather than overall social returns determine the allocation of savings and investment. It aggravates the inherent tendency in markets to direct credit to non-priority and import-intensive but more profitable sectors, to concentrate investible funds in the hands of a few large players and to direct savings to already well-developed centres of economic activity. The socially desirable role of financial intermediation therefore becomes muted. This certainly affects employment-intensive sectors such as agriculture and small-scale enterprises, where the transaction costs of lending tend to be high, risks are many and collateral not easy to ensure.

It also has a negative impact on any medium term strategy of ensuring growth in particular sectors through directed credit, which has been the basis for the industrialisation process through much of the 20th

reserves to the tune of \$245 billion in the same year! The curious workings of international financial markets have actually contributed to international concentration, whereby developing countries (particularly those in Asia) hold their reserves in US Treasury bills and other safe securities, and thereby contribute to the fact that the US economy currently absorbs more than two-thirds of the world's savings. This inverse and undesirable form of financial intermediation is in fact a direct result of the financial liberalization measures which have simultaneously created deflationary impulses and increased financial fragility across the developing world.