Financial Liberalization

How Far, How Fast?

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Introduction and Overview: The Case for Liberalization and Some Drawbacks

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INTRODUCTION

Few lament the demise of financial repression. Its fate was sealed in most countries by a growing awareness of its costly distortions, together with the increasing ease with which below-market interest ceilings and other repressive measures could be bypassed.

Unfortunately, years of repression often left financial systems poorly prepared for a liberalized regime. Spectacular failures, especially in East Asia, have caused some to question the extent and speed of financial liberalization and the opening of the capital account. Could the process have been managed better, and what is the best policy structure to aim for now?

This volume provides a basis for examining these issues. Six case studies illustrate how contrasting initial conditions in liberalizing countries as well as the design and phasing of the liberalization and the effectiveness of supportive policies – especially in regulation and supervision – matter for the success of liberalization. One chapter is devoted to considering whether some countries need to employ more robust measures of financial restraint than is now conventional if they are to avoid further solvency crises. Two cross-country econometric studies document the impact of liberalization on the behavior of interest rates and on the incidence of banking crises.

This introductory chapter begins (Section 1) by describing the emergence of financial repression and the costs and distortions which it entailed. Then (Section 2) we describe the effects of liberalization, including its impact on credit rationing and the associated rents, on short-term volatility and on the incentives for corporate governance and intermediary solvency. Section 3 presents a brief chapter-by-chapter overview of the case studies, while Section 4 concludes.

1 FINANCIAL REPRESSION AND THE CASE FOR LIBERALIZATION

Origins of Repression

Governments have long intervened in the financial sector to preserve financial stability and protect the public from unexpected losses, but also to limit concentrations of wealth and monopoly power, to generate fiscal resources, and to channel resources toward favored groups through the financial system rather than the more transparent instrument of public finances. Interest rate ceilings have existed – and been partially evaded – for centuries.[1] It is hard to find a country that has not had a state-owned financial institution or intervened in the sector.

Much of the twentieth century saw intensified financial repression. Governments attempted to fix interest rates well below market levels and to control the allocation of credit through directive or through ownership of the banks, especially in the years after World War II. More recently, however, a wave of financial liberalization has taken over. Most governments have relaxed or removed repressive financial controls, largely to avoid the costs discussed as follows.

The fad for financial repression was associated with the rise of populism, nationalism, and statism. Populist opinion thought of interest rate controls as a way of redistributing income. Private bank loans to large business houses or foreigners were standard populist or nationalist targets. A desire to avoid excessive concentrations of power in a few private hands, or to ensure that the domestic financial system was not controlled by foreigners who would be insensitive to long-term national goals, were familiar aspects of this type of politics. Social goals could, it was thought, be attained more easily if the activities of major financial institutions were not purely profit driven.[2] Populism also led to a slackening of debt collection, both from the state banks because of political pressures and from the legal framework as a whole.

[1] The discovery that interest prohibitions could be effectively bypassed through the use of forward foreign exchange contracts (bill of exchange) unleashed a great wave of financial innovation in the European Middle Ages and helps explain the historic tie between financial development and international trade (*cf.* de Roover, 1963).

[2] Lack of long-term credit was also an issue, in response to which many countries established public development finance institutions, often with multilateral assistance. With some exceptions, the experience with these institutions was poor. Generally financed either by directed credit, foreign borrowing, or – as in some oil exporting countries – the budget, many of these institutions went bankrupt, in some cases more than once. Factors in the bankruptcies were failure to collect debt service and dependence on unhedged offshore borrowing, which raised costs for either the institution or the borrowers when a devaluation occurred.

Statism may have been an even more significant factor in the increased financial repression. In midcentury, state intervention was widely regarded as a way to improve the allocation of resources and spur development. To fulfill an expanded role, the state needed more resources than could be mobilized by underdeveloped tax systems. The state also sought to expand its role in resource allocation outside the budget through interventions in the financial sector, as well as in the price system, investment decisions, and links to international markets.

Following these philosophies, the governments of many countries borrowed heavily, placed low interest ceilings on bank deposits and loans in order to reduce their borrowing costs, and directed bank credit to "priority sectors" such as agriculture, small-scale industry, and exports. The flow of resources to the budget was augmented by printing money and by imposing low-yielding reserve requirements (as much implicit taxation as tools of monetary control) on banks. Capital controls were instituted in order to curb movements of capital to countries with higher interest rates. Likewise, competition to the banking system was restricted in order to limit disintermediation.

The Costs of Repression

The economic performance of many countries deteriorated progressively under financial repression. Financial systems contracted or remained small and the efficiency of their lending (and collection) and of their operations was low, eventually leading to widespread bank insolvency. The declared distributional goals of the policies were not achieved, though the beneficiaries of the rents that were generated fostered a political constituency for their perpetuation. Growth and macroeconomic stability were impaired.

That overall development performance clearly suffered is confirmed by econometric analysis showing that countries with sharply negative real interest rates typically experienced much lower growth and allocative efficiency than those with low or positive real rates (*cf.* Caprio, Atiyas, and Hanson 1994; Levine 1998; Levine, Loayza, and Beck 1998).

Negative real interest rates predictably[3] resulted in severe disintermediation, capital flight, and a national dependence on foreign funding as domestic savers sought to preserve their capital abroad. While some repressing governments managed to keep the macroeconomy reasonably stable – albeit with shallow finance – others experienced a cyclical pattern of macroeconomic fluctuations associated with waves of intensified

[3] While economists initially provided little counterweight to the prevailing philosophies, by the 1970s McKinnon (1973) and Shaw (1973) had begun what became a widespread indictment of the costs of financial repression (*cf.* Fry 1995).

financial repression. Thus, emerging fiscal pressures led such governments to extract progressively more resources from the financial sector through an accelerating inflation tax and lower real interest rates, until the resulting exchange rate overvaluation and increased capital flight eventually triggered an external crisis. In extreme cases, hyperinflation reduced the ratio of financial assets (liquid liabilities) to Gross Domestic Product (GDP) to only about 4 percent in Bolivia and 7 percent in Argentina.[4]

Thus, despite being starved for loanable funds, repressed financial systems misallocated much of what they had, with credit often flowing to inefficient public enterprises and to favored (though often far-from-poor) private borrowers.

Indeed, use of below-market lending rates necessarily involves some nonmarket allocation mechanism for credit, which inevitably means that some of it goes to projects that otherwise would be unprofitable – and the low interest rate encourages the use of excessively capital-intensive techniques. At the same time, projects with higher returns are squeezed out, use self-finance, or forego efficient technology. Direction of credit, especially through state-owned banks, reduces the incentive for market-driven financial intermediaries to investigate projects and to select those most likely to have an adequate risk-adjusted return. It also reduces the motivation to recover delinquent loans and diverts official supervision from prudential considerations to verifying compliance with the credit allocation policy.[5]

The poor lending decisions and deterioration in repayment discipline came home to roost in the form of bank insolvency and large budgetary bailouts of depositors and foreign creditors.

Directed credit regimes often embodied a political dynamic that encouraged increased misallocation over time. The availability of large subsidies from eligibility for directed credit created incentives for wasteful rent-seeking behavior. The pressures for such directed credit grew as government deficits absorbed larger fractions of the available loanable funds, as "sticky" government-set rates deviated more from market interest rates and as the interest rates on remaining "free lending" inevitably increased. With credit from normal channels becoming scarcer and relatively more

[4] Brazil also experienced high inflation, but used indexation for much of the 1970s to maintain the real return on at least some financial assets.

[5] The operational efficiency of financial intermediaries and markets was also damaged. For example, a ceiling on deposit rates can trigger higher bank spreads which will suck excessive resources into the industry as banks employ costly nonprice means of attracting deposits. The potential profits also generate demand for bank licenses and a growth of potentially inefficient, unregulated near-bank finance. Furthermore, financial repression hinders the growth of long-term bond markets, especially when accompanied by macroeconomic instability.

expensive, would-be borrowers turned more and more to political channels thereby increasing the political pressures for nonmarket allocation of credit.

Distributional goals were rarely helped by the financial repression process. The wealthy and well-placed (including bank owners, management, and staff) often collected most of the rents that the ceilings created. The ceilings also generated a potential for abuses and corruption.

Arguments for Restraint

Unfettered market-based financial intermediation does not always achieve a socially efficient allocation of credit. Information asymmetries are pervasive inasmuch as users of funds inherently know more about their own operations and their intended use of funds than do intermediaries (and intermediaries know more than individual savers). Bankruptcy codes limit bank shareholders' liability. Hence, intermediaries face both moral hazard and adverse selection in allocating funds. As a result, they may ration credit at less-than-market clearing prices to reduce their risks, creating a potential case for policy action (Stiglitz 1994; Stiglitz and Weiss 1981).

Thus, while the traditional messages of demand and supply analysis with full information remain relevant as a useful first approximation, the full story of credit markets and their distortions cannot be assessed without reference to information and moral hazard issues. Subtle but important arguments suggest that well-designed government policies influencing credit allocation and risk taking may be helpful in some circumstances, a point to which we return.[6] Where problems of information and moral hazard are especially severe – such as when bank owners have little real capital at stake and no effective oversight – then the balance swings in favor of significant financial restraint.

Even on the information front, market-based allocation does retain some advantages. Although market forces do not elicit the fully optimum amount of information discovery,[7] market-based credit allocation does

[6] So far as directed credit is concerned, an effective scheme would be characterized by small size relative to total credit, small subsidies, broad base, leaving responsibility for selection and monitoring to banks, and inclusion of a sunset provision, involving the phasing out of the program, as it is difficult to create an argument for permanent subsidies of any activity or sector. For example, the Japanese policy based loans through the Japan Development Bank which satisfied most of these criteria, except the sunset provision, and the program actually grew in size relative to total credit in the 1970s, after its utility likely had passed (Vittas and Cho 1995).

[7] Individual intermediaries' and investors' benefits from information discovery will be less than the system's benefits. Since the information, once discovered, could be shared freely, from a systemic standpoint the amount of resources devoted to information gathering is likely to be suboptimum.

provide more incentives for the lender to discover information about users of funds than do government-directed credit operations. This is particularly important since information is not static; bank credit in particular is often based on a continuing relationship with the borrower that calls for constant updating of information.

In sum, as explored in Chapter 2, information and other distortions highlight valid and important reasons for financial restraint, but the implied policy interventions do require careful design. Neither the motivation nor the mode of operation of such interventions should be the same as in the period of financial repression. In particular, cruder violations of the simple logic of supply and demand must still be avoided.

Evasion and Other Problems of Practical Implementation

Although, as mentioned, a regime of financial repression can have a self-sustaining political dynamic, its effectiveness tends to be undermined by the behavioral reaction of economic agents. Any hope that regulatees will remain passive in the face of a change in the rules is contradicted by experience time and again. The history of finance is dominated by the drive of private participants to create ever cheaper and more convenient substitutes for money and for bank loans not least because of the regulatory costs of banking. The more costly it is to comply with a regulation, the more likely it is to be evaded.

To be sure, some forms of regulation can be partially self-policing: Attempts by bankers to circumvent a floor on deposit interest rates by imposing minimum balance requirements or charges are likely to trigger vocal objections from the depositors (as, for example, in Rwanda during the 1980s). But, while evasion of ceilings imposed on lending rates could conceivably have the same effect, it is less likely, as it would seem dependent on the borrowers being able to procure alternative sources of credit, which (given imperfect information) may not be the case. Under-the-table payments to, or off-balance sheet contracts with, depositors make deposit interest ceilings even easier to evade, with little incentive for depositors to whistle blow (Chapter 5).

Although financial repression was not the only source of capital flight, the scale of such flight is indicative of how porous control regimes could be. By the 1980s, annual capital flight offset a sizable fraction of the annual official borrowings of many countries (Cuddington 1986; Dooley et al. 1986). Increasingly, in many high inflation countries, and not just the famous cases such as Argentina, Bolivia, and Russia in the 1990s, the U.S. dollar bill became a widely used parallel currency.

The problem of evasion of controls became progressively more severe. Four decades ago it was wholesale funds that were involved when the eurodollar market arose as a way of bypassing the U.S. Federal Reserve's Regulation Q ceiling on deposit interest rates. Now the costs of computing and communicating have fallen so far that regulatory avoidance, once the domain of money center banks, large corporations and the rich, is a middle-class pastime conducted from anywhere on the planet over cellular phones or the internet. To be effective, the regulator of today must have a lighter touch than those of earlier times when evasion was more costly.

Thus, sooner or later, market pressures induce governments to abandon onerous repression in the form of binding interest rate controls because the controls become either ineffective (bypassed) or too costly in terms of side effects. So, the real issue is not so much whether to liberalize, but whether governments will be ready for the liberalization that is forced on them, and what regulatory regime they should use to reduce financial instability.

2 CONSEQUENCES OF LIBERALIZATION

Triggers and Form

The relaxation of controls on the financial sector during the past quarter century has not proceeded in a vacuum; it has been accompanied both by a more general liberalization of the domestic economy and by an opening-up toward the outside world (Williamson and Mahar 1998). Interest rate liberalization, like other liberalization (Rodrik 1996), is seldom accomplished without the stimulus or trigger of a crisis.[8] For example, from the case studies examined in this book, it was after the crisis of 1991–92 that India began gradually to liberalize interest rates, as part of its general program of liberalization, and it was after oil revenues dropped after 1981 that Indonesia liberalized interest rates and reformed taxes (Chapter 9). The transition economies liberalized interest rates after their constitutional crises (Chapter 8). In Latin America in the mid-1980s, countries such as Ecuador, Mexico, and Uruguay liberalized interest rates to mobilize domestic resources after the debt crisis led to inflation, exploding fiscal deficits, and a cutoff of external finance (Chapter 7). In other countries, the "crisis" was the dawning realization that government intervention had

[8] One counterexample is Colombia in the early 1970s, where a housing finance system using indexation was created to stimulate development, as part of the Plan of the Four Strategies (Sandilands 1980). The high nominal interest rates paid by the system created pressures to raise bank deposit rates. Similarly, in Japan in the 1970s the government was able to place small amounts of debt at interest rates somewhat below market levels. However, when deficits grew as a result of higher oil prices, the banks rebelled at the larger tax and, along with foreign forces, successfully pressed for deregulation, perhaps sowing the seeds for the subsequent bubble economy. Other reform episodes are reviewed in Johnston and Sundararajan (1999).

led to grossly misallocated credit and stagnant or negative per capita GDP growth (Chapter 10).[9]

The typically turbulent initial environment and complex mix of financial and nonfinancial policy reforms that characterize the liberalization episodes combine to make it exceedingly difficult to arrive at an empirical estimate of the net economic welfare gains from financial liberalization. The hoped-for indirect responses in the form of increased financial depth were experienced in most cases, as documented in our country studies that follow. And while there was no systematic increase in overall saving (Bandiera et al. 2000), econometric studies suggest that there was an improved allocation of credit (Caprio, Atiyas, and Hanson 1994). What is clear, though, is that the process of financial liberalization itself had important effects for more than a transitory period, changing as it did the underlying conditions in which the financial sector operated. The key elements here were:

- elimination of interest rate and other price controls together with less administrative direction of credit by government agencies.[10] This meant not only a reduction in the implicit taxation of financial intermediation, and in the associated rents, but also to higher short-term volatility – at least in nominal interest rates;
- privatization of state-owned intermediaries, admission of new entrants into the financial services industry, reductions in line-of-business restrictions on financial intermediaries, and removal of legal protection for cartelized financial markets. This drastically altered the incentives for risk management and risk taking and for governance of financial intermediaries.

[9] The World Bank has actively supported financial liberalization in developing and transition economies. For reviews of its adjustment lending operations in support of such liberalization, see Gelb and Honohan (1991) and Cull (2001).

[10] Many otherwise liberalized economies still retain, as a measure of consumer protection, a fairly high overall ceiling on lending rates, to eliminate what are seen as "usurious" rates (the term was once synonymous with any interest, but gradually narrowed its meaning to the pejorative sense) imposed by monopolistic moneylenders on unfortunate or impecunious borrowers. These usury ceilings can still be of practical importance especially – though not only – where high inflation has left the legal rates out of synch with market realities. Although the modern purpose of usury laws is consumer protection, that they can in practice preclude viable and socially advantageous money-lending activities, especially among the poor, is much debated. In one environment, Aleem (1990) found that wary moneylenders built the lending relationship very slowly and were charging almost 80 percent per annum to their clients; in another, studied by Udry (1994), the existence of a stock of social capital in a tightly-knit community greatly reduced risk and interest charged.

Higher Interest Rates, Erosion of Rents, and Credit Rationing

Liberalization not only exposed poor existing portfolios, it also confronted existing credit recipients with higher costs of credit and reduced rents and altered the distribution of credit (*cf.* Agénor and Montiel 1996). Those who had secured finance under the former regime suffered from the higher, market-based price they now had to pay. The higher interest rates and loss of rent pushed some heavily indebted borrowers toward insolvency. Since the aggregate size of implicit interest rate subsidies was quite substantial even in lower inflation countries in India, this could be a significant consideration.

Although long-term borrowers would have been partly or temporarily insulated if their interest contract was a fixed one, those who had agreed to interest rates that floated with the general short-term market rate will have been hit immediately and perhaps heavily. Intermediaries could suffer under either contingency and often responded to borrowers' problems by rolling over interest as well as principal, a mechanism likely to lead to problems later but possible where supervision was weak. Of course, such rollovers depended on the intermediary being able to mobilize the corresponding resources.

Where intermediaries had funded a long-term fixed interest contract with short-term borrowing they will have immediately been squeezed. This problem was faced by many housing finance institutions, notably in Eastern Europe and Latin America (where the situation was ultimately resolved through a variety of quasifiscal devices).[11] But even if their lending had been at a floating rate, the lenders may not have been fully insulated from the rise in interest rates: Only part of the rate risk will have really been hedged, the remainder merely transformed into credit risk, as was evident in Korea and other East Asian countries during 1997.

The losers thus did include intermediaries, partly because their borrowers could not sustain the higher interest rates, and partly through loss of whatever benefit they had previously received from effective deposit rate ceilings. The net effect of liberalization on intermediary profitability varied a lot over time and between countries. A frequent experience, especially in industrial countries, was of higher apparent bank profitability in the early postliberalization years, followed eventually by a reversal as existing banks felt their way to a more aggressive stance, and as new entrants made their presence felt. Also, apparent profitability had often proved to be illusory as hidden loan losses mounted. This is well documented in the Uganda

[11] The same problem was, of course, the beginning of the slide of the U.S. savings and loan industry (*cf.* Kane 1989).

story (Chapter 10), where full liberalization resulted in a ballooning of quoted interest rate spreads, not yet substantially reversed. The complex evolution of Mexican interest rate spreads is documented in Chapter 7; these too remain high. As also shown by the Uganda case, higher quoted spreads do not necessarily translate into profits, but also reflect a less favorable risk-mix of the borrowers willing to pay such high borrowing rates, especially to the new entrants.

For governments that had to refinance heavy domestic borrowings at the new interest rates (or even to replace the implicit subsidies to favored borrowers with budgetary funds, as in Uganda), liberalization had an adverse impact on the budget deficit, with knock-on effects on recourse to additional taxation or borrowing, at home or abroad. This tended to increase macroeconomic fragility and uncertainty.

Nevertheless, liberalization also had the potential to impose market discipline on governments: In Europe, removal of (external) capital controls was associated with an improvement in the budget, though this was not true of domestic credit controls. Indeed, the removal of domestic credit controls worsened the budget – though not the primary deficit (Chapter 5).

On a continuing basis, the removal of interest ceilings not only shifted surplus from borrowers (including government) to lenders, but also resulted in some relaxation of rationing, so that borrowers previously crowded out of the market altogether have had a better chance to secure funds. In India it appears to have been the middle-sized firms that have stood to gain from better access to credit (Chapter 9). In Korea the middle-sized *chaebols* (conglomerates) benefited, and indeed lenders underestimated the risk which this second tier represented (Chapter 6). Increased access for these groups may prove to be highly cyclical.[12] This is especially so because of their difficulty in escaping from the remaining rationing induced by lenders' fears of adverse selection.

These effects are but one part of the wider changes in capital values that occur when structural reforms, including adjustment of real exchange rates and internal relative prices, are introduced. But the high leverage of financial intermediaries makes them unusually susceptible to unhedged interest rate changes. The initial disruption to financial and real activities from a sharp rise in real interest rates following liberalization was a costly feature of some liberalizations which might have been eased by a phased convergence of controlled interest rates toward market-clearing levels.

Volatility

Interest rate liberalization affects both the level and the dynamics of interest rates. The strength of these effects depends in part on the evolution of compe-

[12] As shown for the United States by Gertler and Gilchrist (1993).

tition in the financial system; this in turn depends not only on other regulatory changes[13] but is strongly influenced in turn by interest rate developments.

The process of financial liberalization was expected to increase the volatility of interest rates and asset prices, to have distributional consequences in the form of reduced or relocated rents, and to have increased competition in the financial services industry. In Chapter 3, Patrick Honohan examines the available data on money market and bank interest rates for evidence on these propositions, and shows that, as more and more countries liberalized, the level and dynamic behavior of developing country interest rates converged to industrial country norms. Liberalization did mean an increased short-term volatility in both real and nominal money market interest rates. Treasury bill rates and bank spreads were evidently the most repressed, and they showed the greatest increase as liberalization progressed: This shifted substantial rents from the public sector and from favored borrowers. While quoted bank spreads in industrial countries contracted again somewhat during the late 1990s, spreads in developing countries remained much higher, presumably reflecting both market power and the higher risks of lending in the developing world.

The liberalization process per se often contributed to macroeconomic instability with an initial surge in aggregate credit as financial institutions sought to gain market share whereas policy in the era of financial repression had often induced a cyclical macroeconomic. Consequential overheating had to be dampened down by monetary policy and/or resulted in inflation and nominal depreciation which also fed back onto nominal interest rates. The run up to the 1994 Mexican crisis provides a dramatic example.

Another potential destabilizing impact of liberalization, already mentioned above, was through the public finances in those cases where governments failed to respond to the higher interest rates by curbing deficits. When this occurred, the deficits were either monetized leading to an inflationary surge, or refinanced at ever higher interest rates in an unsustainable spiral crowding out the private borrowers and thereby feeding back onto economic growth and stability.

Some of the volatility of interest rates in the liberalized environment may represent "useless volatility," in the sense applied by Flood and Rose (1995) to exchange rates.[14] In countries where the controls were light and

[13] Indeed, there have been episodes of "phony" decontrol of interest rates where these other changes have been lacking. Phony decontrol can take a variety of forms, including the de facto assumption by dominant state-owned banks of the controlling role previously entrusted to the central bank.

[14] Their proposition is that fixed exchange rate regimes have not been associated with higher volatility in other variables. As such, movements in exchange rates have not acted as buffer-absorbing disturbances which would otherwise appear elsewhere in the economy in line with Samuelson's application of the le Chatelier principle.

imposed not far from market-clearing rates, the controlled rates did provide a relevant signal for the cost of funds.[15] Being stable, these controlled rates arguably anchored rate expectations and market discount rates, thereby potentially removing a source of volatility in stock market, property, and other asset prices. If so, policy could generate considerable benefits in terms of economic growth and stability, by eliminating both this "useless volatility" and the fear of such volatility contributing to the risk premium.

An independent source of uncertainty came to the fore in those transition countries where liberalization was associated with a general loss of governmental control and a consequential increase in the difficulty of enforcing contracts. As shown in Chapter 8, the combination of high nominal interest rates and low costs of default have driven much of those economies into barter.

Entry and Franchise Value: Impact on Intermediary Governance

Admission of new entrants, including foreign entrants, into the financial services industry and antitrust measures against collusive price-setting has been an important element in the liberalization of financial markets in industrial countries, and begins to be more widespread in the developing world (Claessens and Jansen 2000). However, the new entrants enter the market without the handicaps that existing banks often carry, including an overhang of nonperforming debts and costly labor contracts.[16]

Increased competition can yield straightforward efficiency gains and innovation in terms of improved range of services. These benefits are not negligible and they increase over time. But, as mentioned earlier, the new freedoms often led to an initial scramble to retain or gain market share, with banks seeking new business in unfamiliar territory whose risks they often underestimated (Honohan 1999). Even the threat of new entry could have so eroded the prospects of inefficient incumbents as to lead them into greater risk taking. Indeed, the increased macrovolatility that often accompanied liberalization implied new risks even for well-established lines of business, such as lending secured on property.

In practice, incumbents often responded to the threat of new entry with an efficiency drive and restructuring that made the task of the entrants much tougher than had been anticipated. But even if the new equilibrium saw the old players retaining much of their market share, it was now a contestable and low-margin equilibrium, without rents generated by the

[15] Though in repressed systems quoted rates may not have been representative of the effective (shadow) cost of funds.

[16] Overstaffing and high wages often reflect a sharing of the available rents between shareholders, management, and employees.

directed credit system. With a reduced franchise value, banks in particular now had little room for error and many succumbed to the perils of excessive risk taking, a syndrome perhaps best illustrated by the case of Mexico (Chapter 7).

In other cases, entrants opted for a less aggressive but very profitable high margin–low volume strategy, allowing high-cost incumbents, and those burdened by a nonperforming portfolio, to stay in business often with higher gross margins than before liberalization – a phenomenon well illustrated by the cases of Pakistan and Uganda (Chapter 10).

As well as having new competitors, financial intermediaries began to be allowed new scope for their activities. This included an increasing trend toward universal banking, to be applied not only to the large commercial banks, but also to formerly specialized intermediaries such as mortgage banks and savings banks. Although new freedoms brought new profit opportunities and could thereby contribute to franchise value, the breaking-down of barriers to competition between different institutions and across-the-board liberalization of restrictions on line-of-business also increased the intensity of competition for existing lines and in dimensions such as branching, often resulting in lower margins than had been anticipated.

From Liberalization to Crisis: an Inevitable Sequence?

While one form of crisis led many countries to liberalize, it has often been observed that the liberalizing countries have often encountered a more virulent form of crisis subsequently. This cycle can be explained partly by the way in which the liberalized environment laid bare the previous inefficiencies and failures in credit allocation, and partly by the poor handling of liberalization, in particular the failure to correct the weaknesses of the initial conditions in the banking sector and to develop quickly strong legal, regulatory, and supervisory frameworks.

For instance, banks have found that their existing loan portfolio was less sound in the new environment because their borrowers were no longer able to service debts, whether because of poor quality loans, higher interest costs, other parallel measures of economic liberalization that changed relative prices, or because government subsidies were cut off, or simply because implicit guarantees from government on these debts were no longer effective. In such cases (including India and Indonesia), it is more that liberalization revealed the worthlessness of the portfolio, rather than causing the losses (Honohan 2000).

Confirming this with an econometric analysis of the experience of over fifty countries during 1980–95, Asli Demirgüç-Kunt and Enrica Detragiache show in Chapter 4 that banking crises are more likely to occur in liberalized financial systems, but not where the institutional environment is strong (in terms of respect for the rule of law, a low level of corruption, and good contract enforcement).

But if liberalization does not inevitably lead to crisis, liberalized financial markets have often clearly worked to reduce the franchise value of a bank license nevertheless. That this could adversely affect bank performance has long been evident. Long before the emergence of a literature on efficiency wages – wage rates that may be set above marginal productivity to discourage shirking or quits – the desirability of having some way of bonding bank insiders to make sure they took proper care of depositors' money was well recognized in banking. Indeed, in the mid-nineteenth century it was common practice for senior bank staff to post a substantial bond which would be forfeited if they mismanaged funds (*cf*. Gibbons 1859). In more recent times, the link between lowered franchise value and increased risk of failure has been noted.[17]

Capital requirements, now commonly imposed at the – somewhat arbitrary – level of 8 percent of risk-weighted assets, represent one way of insisting on a degree of franchise value. Most banking regulators now recognize the need for early intervention to restrain bank management when capital falls below this threshold, but the difficulty of measuring the true value of capital and the fact that the incentives of insiders and other shareholders may diverge reduces the effectiveness of capital requirements, especially in an environment of diminished bank profitability (Caprio and Honohan 1999).

If financial liberalization is associated with intensified competition, banks may bid deposit rates up to the point where prudent lending practices are no longer profitable. Deposit insurance, explicit or implicit, can drive a wedge between the portfolio risk accepted by bank insiders and that perceived by depositors. This is generally thought to be an important aspect of the sorry story of the privatized Mexican banks, for example, and may also play a part in the emergence and rapid growth of a group of risk-taking Ugandan banks. Excessive risk taking is much more likely when banks are already of dubious solvency, making deregulation dangerous under such circumstances. This was seen not only in the case of the U.S. savings and loan industry, but in the case of Mexico where, it is now

[17] *Cf*. Caprio and Summers (1996) and Keeley (1990). It must be acknowledged, however, that protection against entry and restrictions on interest rate competition are far from being the only sources of bank franchise value in an ever-changing market. Charles Calomiris has pointed to the trend growth in the stock market value of U.S. banks in the past two decades as an illustration of the potential here. Indeed the comfortable life of the protected bank, or one governed by directed credit, can cause the other sources (appraisal skills, market intelligence, administrative efficiency) to atrophy.

thought that the fact that many of the newly privatized banks had little real capital at risk, increased risk taking there.

Deliberate risk taking and prior portfolio weaknesses are not the only sources of banking weakness in a liberalized environment. Outright managerial failure is often a significant factor (Honohan 2000). Many bankers underestimated risks in the new environment, especially as they expanded into new lines of business. Some hit problems despite believing that their bank had been in no danger of failing. The moral hazard of their behavior was often unconscious.

Sometimes the pitfalls here have been exacerbated by other aspects of poor sequencing, especially poorly considered partial decontrol, as exemplified by the case of Korea (Chapter 6). There, the order in which markets were decontrolled encouraged a spiraling of short-term claims, especially in the poorly supervised corporate paper market, and financed by short-term foreign borrowing. The latter exposed the system to the run of foreign creditors which brought down the system.

The liberalized period also usually begins with another handicap, namely with regulation, supervision, and legal systems unsuited to a market-based environment. Under financially repressed regimes and government allocation of credit, regulation of risks typically is judged unimportant and supervision is directed to enforcing directives aimed at policy goals other than that of ensuring prudence in risk taking. Legal systems typically favor debtors. Even where laws are changed as part of the deregulation, judges and courts do not become instantly skilled in their interpretation. In short, deficits in banking skills, supervisory agencies, and the legal infrastructure needed for efficient market decisions mean that liberalizations have encountered many problems (Chapter 4). But as this argument suggests, much of the blame for postreform crises lies with the prereform environment and in the pace and sequencing of financial reform. Interest rate deregulation itself is a reform that is quick, easy, and cheap to implement, while building skills, infrastructure, and incentives are time consuming, difficult, and expensive. Two decades of financial crises should suffice to convince most analysts that more of the latter is sorely needed.

In Chapter 2, Patrick Honohan and Joseph E. Stiglitz ask whether more is needed. They observe that financial liberalization brought with it a vogue for relying on an indirect approach to prudential regulation through monitoring bank capital to ensure that it remains adequate in relation to the risk being assumed. But the difficulty for regulators in a liberalized financial system of observing the true value of bank capital and the true risk of bank portfolios, means that ensuring safe and sound banking may require the imposition of more robust measures of restraint. These would be characterized by easy verification, and a presumption that banks complying with the rules will be at lower risk of failure.

Theoretical models illustrate how banking tends to respond *discontinuously* to policy, and that standard recommendations for fine-tuned regulatory policies are very model-dependent and *fragile*. These characteristics are reinforced when the normal assumption of far-sighted shareholder-controlled banks is superseded by more realistic characterizations with agency problems involving self-serving or myopic management. This supports the view that simpler, stronger, and more direct measures are not only needed to ensure that policy is not ineffective or counterproductive but also that they can offer a *quantum leap* in the degree of risk reduction.

But which rules should be tightened, and under what circumstances? By assessing the relative performance in different environments of five different types of robust regulatory restraint, bearing in mind possible side effects and implementation difficulties, Honohan and Stiglitz identify the various failure-inducing conditions for which each is likely to be effective, as well as the circumstances under which side effects are likely to be most severe. They show how different country circumstances will call for different robust measures, and that these may not be required to bite at all times.

Some of the rules considered, such as minimum accounting capital, are long-standing features of the regulator's toolkit. Others, such as interest rate ceilings, have had a long, and somewhat discredited, history as a tool of macroeconomic or development policy but may under some circumstances have a more constructive role as a prudential measure, especially if they are pitched to apply only intermittently. The policy maker needs to be able to draw on such a portfolio of robust regulatory instruments.

3 LIBERALIZATION IN PRACTICE – OVERVIEW OF THE CASES

The six case studies presented in Part 3 are chosen to illustrate the variety of liberalization experiences and to illustrate the importance of starting conditions. We begin with two studies of relatively advanced economies, Europe in the past half century and Korea in the 1990s. Then we examine liberalizations carried out in highly volatile environments – Mexico as an illustration of the high and volatile inflation that has been characteristic until recently of Latin America, and the transition economies with a special focus on Russia. Finally we turn to India, Indonesia, and Uganda, countries where continued pressures from government involvement through bank ownership and extensive directed credit have molded the financial landscape.

Liberalization in Advanced Economies (Chapters 5 and 6)

Financial liberalization started in the industrial countries. It often appeared to be a relatively smooth process, especially since gradualism was the order of the day, as interest rate distortions had been relatively mild and as financial markets were already sufficiently deep, and at least moderately competitive. Nevertheless, almost every country did experience some increase in the incidence of intermediary failure, and severe problems systemic in scale arose in Japan, Spain, the United States, and the Scandinavian countries. Most of these economies had the administrative ability and resources to cope with the failures with only moderate economic disruption (although the degree to which bank fragility has contributed to the prolonged Japanese recession of the 1990s is arguably considerable). The early liberalizations also occurred at a time when the volume and reaction speed of international capital movements was a fraction of what it is today. Perhaps the greater pace and more punishing environment can help explain the scale of collapse in the Korean economy during 1997–98.

The account of European financial liberalization provided by Charles Wyplosz in Chapter 5 starts much earlier in the aftermath of World War II. He shows intriguing parallels between institutional developments in Belgium, France, and Italy. In each case the banking system was marshalled in support of government spending or government-favored priority borrowers. Interest rates and other controls ensured a cheap flow of finance to the budget or to favored industries, regions, or firms, while also preserving the profitability of the banks. Credit to others was rationed (with credit ceilings – not always very effective – the preferred instrument of monetary control in the 1960s and 1970s), encouraging capital inflows that were indeed needed to support a balance of payments chronically in deficit. Relatively tight exchange controls, including the use of dual exchange rates, where capital receipts and payments were diverted away from the official exchange market, were employed to limit capital outflows. Nevertheless, the inflation fuelled by monetary expansion within this regime led to repeated devaluations.

Some modification and relaxation in these regimes proved necessary in the face of some leakage to nonbanks and abroad, but the main features of the regime were qualitatively in place into the 1980s. The exchange rate crisis of 1983 led to a political reassessment of the compatibility of the existing approach with exchange stability in Europe and with France's membership of the European Union. The result was a complete change of approach in France, and by the end of the decade most domestic and international financial controls had been removed. The story is echoed with some differences of detail in Belgium and Italy.

Regression analysis shows that financial repression significantly lowered the real interest rate in the sample of nine European countries over forty years. The effect is highly significant, estimated at 150–200 basis points. Thus, as it was intended to do, the repression created a rent, much of which was captured by the state. The effect on interest volatility is less clear: The choice of exchange rate regime seems to matter more than whether financial restraint is in operation – though these two policies may be jointly determined. While domestic financial controls were designed to reduce budgetary pressures, they could have encouraged a higher primary government deficit: In practice, the regression results show that this offsetting effect was not significant, and that domestic controls did lower the deficit. Governments with large primary deficits did tend to operate behind exchange controls: The direction of causality is not evident.

What of the impact on banks? Here Wyplosz notes an interesting effect. Despite a sharp fall in staff numbers in most countries, staff costs have not declined by much. He conjectures that rents have not been eliminated (heavy switching costs and brand loyalty remain strong), but have shifted from bank shareholders to bank staff. The end of financial repression saw banks move from simple, trouble-free, low, value-added activities to producing more sophisticated, high, value-added products for which they need to rely more heavily on skilled and professional staff, whose ability to capture rent is thereby enhanced.

The European experience suggests that domestic financial repression is more damaging than external capital controls. Indeed, as Wyplosz notes, all domestic financial repression entails external capital controls, while the converse is not necessarily true. As such, domestic repression adds two sources of distortions. The logic of financial repression is to direct saving toward public sector objectives, while capital controls might be required only for the correction of currency market failures. Domestic repression prevents the emergence of a competitive financial sector with the implication that capital controls cannot safely be lifted until this sector is strengthened, which may take a substantial amount of time following domestic financial liberalization. The European evidence does not provide a strong case for rapid liberalization of external capital flows.

Despite a relatively rapid rate of recovery, especially during 1999, the collapse of the Korean economy in 1997 was a severe blow. Indeed, the Korean crisis had global implications, though at the time, these were contained to a smaller scale than had appeared likely at the outset. For some, Korea's experience provided evidence that the financial liberalization on which Korea had embarked only a few years before had been a mistake, and that a continuation of the previous practice of financial repression would have been a sounder policy. Others tell the story differently, asserting that Korea's financial system had remained substantially repressed, and that a sham liberalization had not been to blame.

In Chapter 6, Yoon Je Cho shows that the true story is more subtle, though clear and strong lessons can be drawn. Korea did liberalize its financial markets substantially, but it did so in the wrong order, encouraging the development of a highly fragile financial structure both in terms of the financial instruments employed (too much reliance on short-term bills), in terms of the financial intermediaries which were unwittingly encouraged (lightly regulated trust subsidiaries of the banks, and other newly established near-bank financial intermediaries), and in terms of market infrastructure development (failure to develop the institutions of the long-term capital market).

By liberalizing short-term (but not long-term) foreign borrowing, the Korean authorities made it virtually inevitable that the larger and better-known banks and chaebols would assume heavy indebtedness in short-term foreign currency debt. Meanwhile, the second tier of large chaebols greatly increased their short-term indebtedness in the domestic financial markets (funded indirectly through foreign borrowing of the banks). The funds borrowed were being invested in overexpansion of productive capacity.

The phasing of interest rate liberalization too was misconceived, with bank deposit interest rates held well below competitive levels, driving resources off-balance sheet and away from the regulated banking sector altogether. Here Cho points out that moral suasion meant that formal deregulation did not result in completely free market determination of many interest rates.

The reasons for this pattern of deregulation include a mechanical adherence to the importance of monetary aggregates (which induced the authorities to retain controls on these, while liberalizing near-substitutes), the preoccupation with maintaining an orderly long-term capital market (which distracted them from paying attention to the emergence of a new and much more disorderly short-term corporate paper market), and the persistence of directed policy lending (which meant that interest rate spreads needed to be wide enough to allow for crosssubsidization, but at the cost of losing market share for the banks).

The quality of loan appraisal, bank regulation, and private credit rating was always in doubt; overoptimism and complacency reigned.

In the end, it was not the bursting of a property bubble that ended the Korean expansion, but the refusal of foreign creditors to roll over their loans; a refusal prompted by their increasing unease at the loss of competitiveness and heavy indebtedness of Korean corporate borrowers. Even if the main sources of the Korean crisis lay elsewhere, Cho argues that the mistaken sequencing of financial liberalization contributed to the speed and severity of the crisis both by exposing the system to roll-over risk, and by encouraging excessive indebtedness of firms.

Extreme and Turbulent Conditions (Chapters 7 and 8)

The literature on optimal sequencing and the preconditions of financial liberalization has generally agreed that macroeconomic stability should be in place before the liberalization is put into effect. But this is easier said than done, and there are many cases where the opposite has happened. For example, turbulent macroeconomic conditions aggravated by a dysfunctional financial system can create a window of opportunity conducive to political acceptance of financial liberalization, as has happened in several Latin American countries. Impatient for the benefits of reform, and believing that achievement of macroeconomic stability would be difficult or impossible, reformers have sometimes seized such opportunities. In some of the transition economies of the Former Soviet Union, the big bang of initial liberalization was partly planned, partly a collapse of control.

Chapters 7 and 8 look at cases of liberalization undertaken against a turbulent background.

Mexico's liberalization beginning in the late 1980s is representative of the experience of several other Latin American countries from the 1970s to the present in the move from repression to liberalization under conditions of macroeconomic volatility. Fiscal pressures and price- and wage-setting behavior that resulted in successive surges of high inflation have long characterized this region: Average inflation in the region fell below 50 percent only in 1995, and remains high in several key countries.

Four major turning points punctuate Mexico's rollercoaster story: 1982 (exchange rate crisis, bank nationalization, and high inflation), 1988–89 (interest liberalization and the end of high inflation), 1991–92 (bank privatization), and 1994 (Tequila crisis). Following the exchange rate crisis of 1982, prices almost doubled every year for the next six years. Although inflation was down to 20 percent by 1989, a recent history of high inflation was the backdrop when interest rates began to be liberalized as part of a wider package of reforms that proved to be successful in restraining inflation until the "Tequila" collapse at the end of 1994.

As explained by Luis Landa and Fernando Montes-Negret in Chapter 7, the other major strand of the Mexican story has been the nationalization, privatization, and renationalization of the banks. Misread at first as an unproblematic return to the pre-1982 regime, the bank privatization of 1992 was disastrously underprepared. The new owners, in effect, financed the excessive prices they paid by borrowing from the newly privatized banks themselves. Inexperience and self-dealing further weakened their financial position so that they were in no condition to absorb the 1994 shock.

But the main focus of Chapter 7 is on interest rate spreads and how they evolved during this turbulent time. Despite the difficulty of distinguishing between the effects of structural and macroeconomic changes, the findings are intriguing. Before the crisis of 1988, wholesale deposit or bill rates were usually not sufficient to compensate for exchange rate