Financial Liberalization and the Internal Structure of Capital Markets in Asia and Latin America

Edited by Miguel Urrutia

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INTRODUCTION: EXPERIENCE WITH REGULATED FINANCIAL SYSTEMS IN ASIA AND LATIN AMERICA

Miguel Urrutia

During the time that I lived in Tokyo, while I was Vice-Rector of the United Nations University, I had occasion to follow closely the public debates concerning financial reform in Japan, and also to study and discuss with local economists the innovations being introduced in the financial markets of other Asian countries. I was surprised to find little reference to the financial liberalization disasters in Latin America. It occurred to me that some of the economists studying financial liberalization in Asia might profit from looking at what had happened in Latin America when the recommendations of the new financial orthodoxy of North American academic economists were applied. The results of financial liberalization in the Southern Cone countries suggested that the new theories made assumptions about the functioning of financial markets in developing countries which were unwarranted.

On the other hand, it appeared that the very gradual liberalization of foreign exchange transactions and financial markets in Japan was a process worth studying for Latin American economists. Furthermore, it seemed that the North American economic literature on financial liberalization in the Republic of Korea, an experience which was used by foreign advisers working in Latin America as an example of how the elimination of financial repression could promote economic growth, simply did not reflect accurately Korean economic history. It was useful, therefore, for Latin American economists to find out, without intermediaries, what had been happening in some of Asia's most successful economies.

When I explored with the authorities of the United Nations Economic Commission for Latin America and the Caribbean (ECLAC) whether they would be interested in discussing the issue of financial liberalization with Asian scholars, I found an enthusiastic response, for two reasons:

1. It appeared that the economists of ECLAC had never before had the occasion to participate in a conference or workshop that analysed Asian economic experiences, and;
2. ECLAC was in the process of evaluating the benefits and costs of the recent financial liberalization episodes in the region.

Given this positive response, and with the support of Rector Soedjatmoko of the United Nations University, I presented the idea of holding a Latin American–Asian workshop on financial liberalization to Professor Kazushi Ohkawa, of the International Development Center of Japan (IDCJ). He gave support to the initiative, and we contacted a group of Asian scholars who were known to be working on issues of financial development.

The present volume presents some of the papers discussed at the workshop. The workshop participants were very stimulated by the intercontinental comparisons, and unanimously agreed that it would be useful if these papers were published, so that a wider audience might be made aware of economic experiences only very imperfectly known in each others' regions.

In what follows, I will attempt to reflect some of the issues that came up in the discussions.

The Methodology of Comparative Studies

The paper by Professor Kazushi Ohkawa addresses the methodological problems of economic comparative studies. On the basis of his wide experience in the international comparison of the growth experience of different nations, he sets out the usefulness of carrying out comparative studies within the perspective of the different development phases which most nations that developed after 1870 have passed through. He discusses the apparent differences between Asian and Latin American development by suggesting that one particular phase of development crucial in East Asia, that of primary export substitution, seems to have been skipped or postponed in Latin America, and that this may explain many of the differences in development between the two regions.

He also explores some of the causes for differential industrial performance in Asia and Latin America. His empirical finding that the residual, which might be a proxy for technological-organizational progress, is much lower in Latin America than in Asia opens up a whole new area for further research.

The description of the different development phases in East Asia also suggests that financial liberalization was not carried out successfully before the phase of secondary import and export substitution. Since few countries of Latin America have fully entered into that phase, the failures connected with the financial liberalizations of the 1970s are not inconsistent with the Asian experience.

Professor Ohkawa's paper points out the importance of having a common framework in comparative studies in order to maximize their usefulness for the building of economic theory and for policy analysis. For this seminar a looser framework than that proposed by Professor Ohkawa was used, and the contributors were only asked to present the experience of financial liberalization in their country. From reading these papers it becomes clear that further comparative analysis on the role of the financial sector in different phases of development would be very interesting, and that probably different phases of development call for different degrees and types of financial regulation.

The Latin American Experience

The paper by Andrés Bianchi describes the crisis of the 1980s in Latin America, and serves as background for the discussion of the Latin America experiments with financial liberalization. Such background is crucial for non-Latin Americans to understand the multi-faceted nature of this crisis. Although financial liberalization may have helped to create the crisis in some countries, there are other important causes of economic stagnation and even of the financial crises experienced in 1981–1984.

The paper by Hirohisa Kohama also serves as background on Latin America for Asian readers. It compares the larger Latin American economies with the Republic of Korea, utilizing the "economic phases" categories discussed by Professor Ohkawa.

The paper by Joseph Ramos is a thorough, illustrative survey of the financial liberalization experiments in Argentina, Brazil, and Uruguay in the 1970s. His final assessment is that the experiments did not live up to the expectations of their authors. He states that "the profound changes which financial liberalization and opening up brought about did not translate themselves, despite intentions, into systematically higher savings or into clearly improved resource allocation. Indeed, the three experiences came to a close with their financial systems in a shambles."

His analysis suggests that part of the failure of the financial liberalization attempts was due to the economic setting in which the reforms were carried out. He concludes that "it was thus a grave policy error to have liberalized financial markets so rapidly, and to such an extent, precisely at a time when, because of the stabilization policy, important disequilibria still remained to be resolved in other critical sectors of the economy."

In addition to the problems of trying to liberalize financial markets at a time when major disequilibria persist in other sectors of the economy, Ramos also thinks that the architects of the reforms did not take into account the inevitable increases in consumption that liberalization would inevitably bring about. He explains this point in section 7 of his conclusions. "Also overlooked by most policy-makers was the fact that 'financial repression' not only kept interest rates artificially low but, by rationing credit, necessarily repressed the demand for certain types of credit (generally that for consumption). It was thus a serious oversimplification for neo-conservative theorists to focus exclusively on the favourable effects financial liberalization might have on effective savings and investment (via higher interest rates) and to neglect the unfavourable effect it could have on these by releasing the pent-up demand for consumption."

Eduardo Sarmiento makes the same point in his paper, but goes further in the critique of those who argued for liberalization as a way of increasing savings and improving resource allocation. The very title of his paper suggests that there are substantial imperfections in the capital markets of developing countries which would argue against liberalization. The experience in Latin America in the 1970s gives strong empirical backing to this thesis.

In summary, the description of the financial liberalization experiments in Latin America in the 1970s suggests that the results that the policy-makers expected in terms of savings, interest rates, and efficient allocation of credit did not become a reality. Clearly some of their assumptions concerning the functioning of the financial system had not been realistic.

The paper by David Ibarra is somewhat different, and its value is due not so much to the analytical contribution it makes to an understanding of the Mexican case as to the fact that it is a description of events from the point of view of one of the major actors in a crucial period of Mexican economic history. David Ibarra was the Mexican Minister of Finance (1977–1982) during the period in which oil began to dominate the Mexican economy and in which the Mexican debt started to grow rapidly. The paper gives some hints about the political determinants of policies that in hindsight seem to have led Mexico to the debt and inflation crisis of 1982–1986. The discussion of this paper at the seminar was particularly interesting, in so far as it illustrated the role of the different social sectors in decision-making in Mexico. One impression one got was that the extensive negotiations with various social groups leading to the important tax reform which introduced the value added tax took up a good part of the time of the policy-makers, while major unexpected shifts were taking place in the Mexican economy owing to oil-price changes and public sector investment decisions that seemed outside the control of the economic authorities.

The paper by David Ibarra suggested to the participants the importance of studying the process of political decision-making in different societies in order to understand the process of financial development.

The Asian Experience

The Asian papers were a surprise for the Latin American participants. Many of the foreign advisers on capital market development who had come to Latin America had argued that some of the economic success of East Asian economies was due to the adoption of policies of financial liberalization.

The paper on the Republic of Korea, and discussions with Kim Joong-Woong, suggested that in fact the financial markets in that country were highly regulated. Although a liberal economist who favours some further liberalization of financial markets in the Republic of Korea's present stage of development, Kim maintains in his paper that, "in the earlier stages of development, the use of direct and selective instruments of financial policy ensured an efficient allocation of financial resources." He then describes financial practices not unlike those which receive so much criticism from foreign experts who advise Latin American governments: "The Korean financial sector has been effective in channelling financial resources to the preferred or strategic sectors designated in the economic development plans. This was achieved mainly through preferential loans extended at low interest rates." He then explains that "the major commercial banks were all largely public enterprises . . . with the result that there was direct government control of virtually every aspect of banking operations. Second, as a means of allocating investment funds according to national priorities, the government resorted to strict control of interest rates and provided extensive preferential credit at subsidized rates." Clearly, the high Korean growth rates are not explained by the existence of liberalized financial markets.

The country where liberalization has gone further has been Malaysia, but even there freedom in financial markets does not determine higher savings rates. Andrew Sheng points out that a significant portion of the high savings rates (30 per cent of GNP) was captive (forced savings) in the form of provident fund contributions. Furthermore, interest rates were freed only in 1978, and lending guidelines to priority sectors were maintained.

In Japan, state intervention in financial markets has also been extensive. Akio Hosono describes the institutions created by the state to meet the credit needs of different sectors of the economy that would not normally have access to funds in the free capital market.

Professor Juro Teranishi introduces his paper *Economic Growth and Regulation of Financial Markets* with a rather provocative statement: "What was particularly interesting for researchers in money and banking was that this rapid growth [9.2 per cent GNP growth rate between 1953 and 1972] had taken place within a highly regulated financial framework."

An interesting point underlined in the Teranishi paper is that the strict regulation of international capital transactions seems to have provided the necessary conditions for sustaining the regulated financial system. The Latin American experience described by Ramos, Ibarra, and Sarmiento would suggest the same hypothesis. In Mexico, where international capital transactions cannot be easily regulated, not too much regulation in the financial system is possible. In Colombia, foreign exchange regulations that control with some degree of effectiveness international transactions have sustained a regulated financial market during different phases of development.

Finally, the paper by Mario B. Lamberte on the Philippine financial market points out again the surprising similarity in policy framework existing in Latin America and the Philippines.

Conclusions

In summary, the participants came away from the cross-continental exchange with the feeling that much of the recent theory pointing out the advantages of financial liberalization may overstate such advantages and ignore some of the realities which may make rapid liberalization a costly endeavour for a developing country. In particular, it would seem that the combination of trade and financial market liberalization may be quite explosive, and lead to a rapid increase in consumption of durable consumer goods, and this might have very dangerous effects on savings and the balance of trade.

On the other hand, even the most outspoken critics of the advocates of financial liberalization were careful to point out that maintaining interest rates at unrealistically low levels served no useful development purpose. Intervention in financial markets must be limited and realistic to be effective.

In general, the analysis of the financial liberalization case studies made all of the participants very aware of the need to proceed very gradually down this road. When the conference was organized there was little expectation that Asian and Latin American scholars would find themselves so easily in agreement in this policy area.

ON THE METHODOLOGY OF COMPARATIVE STUDIES

Kazushi Ohkawa

Introduction: The CA Project*

The major result of the CA project, "Japan's Historical Development Experience and the Contemporary Developing Countries: Issues for Comparative Analysis" has recently been published.[1] I should like to quote the following passage from its Introduction:

It is our conviction that, in the pursuit of a better understanding of what development is all about, the *comparative historical laboratory* has been seriously underutilized, especially relative to multi-country cross-sectional efforts, on the one hand, and strictly contemporary or forward-looking country-intensive efforts, on the other. The entire CA project has been based on the premise that analysis of past development experience, particularly of a generally "successful" case such as Japan, has something to teach us not so much in terms of the precise transferability of a total societal experience, as something about the transferability and, at times, non-transferability of a number of special sectoral or function dimensions considered important to an explanation of the Japanese experience [my italics].

*CA is an acronym for a comparative analysis project entitled "Japan's Historical Development Experience and the Contemporary Developing Countries; Issues for Comparative Analysis," which was carried out by the International Development Center of Japan (IDCJ) from 1975 to 1981, in collaboration with the Economic Growth Center of Yale University. The purpose of the project was to gain a clearer understanding of Japan's historical development pattern in relation to major critical issues in contemporary LDCs' growth performance.

In fact, the project has not been in a position to compare the Japanese historical experience in every dimension. In the selection of research topics and the ensuing results presented in the published volume, the areas focused on include an examination of the relevance of initial conditions and an overview of the historical experience (part I), the particular importance of technology choice and change in agriculture (part II) and in industry (part III), the flow of resources between the agricultural and non-agricultural sectors, the role of institutions and policies in finance (part IV), and the relation between trade and development (part V). The project was also not in a position to compare the Japanese experience with representatives of every other typology of contemporary developing countries, where typologies are defined by different clusters of characteristics such as initial conditions, resource endowment, country size, etc. The countries chosen for comparison are Thailand (initial condition), Republic of Korea, and Taiwan (historical perspective) in part I; Republic of Korea, Taiwan, and the Philippines, Indonesia and Colombia in part II; India (cotton) and Brazil (steel) in part III; Taiwan (terms of trade), India (resource flow), and the Philippines (finance) in part IV; Thailand (textile industry), East and South-East Asia (automobile parts production) and Republic of Korea, Thailand (trading companies) in part V. To our regret, the CA project did not include the study area which is directly relevant to the theme of this symposium, "comparative analysis of the experience of financial liberalization in Asia and Latin America."

Thus the project fell short in its capacity (financial and human) to undertake comparative analysis in a comprehensive way both across major typologies (particularly the Latin American and African cases, which are more "distant" from the Japanese model), and across countries within "neighbouring" typologies, for example, the South-East Asian and South Asian cases. In retrospect, ours should be called a selective, partial, comparative studies methodology.

Typologies and Phases

In the light of the limited experience of the CA project research, what I would like to discuss is the relation between typologies and development phases, as I believe this is a basic problem for comparative historical analysis.

In presenting an overview of the historical experience of Japan's development, we demarcated several development phases largely in conformity with the shorter post-war experience of Taiwan and the Republic of Korea: P1, 1870–1900, traditional export expansion, coupled with primary import substitution; P2, 1900–1920, primary export substitution; P3, after 1920, secondary import and export substitution. P1 is 1950–1962 (Taiwan) and 1953–1964 (Korea); P2 is 1962–1970 (Taiwan) and 1964–1972 (Korea); P3 is after 1970 (Taiwan) and 1972 (Korea).[2]

I should like to quote the paragraph relevant to our methodology for deriving such phases.

Analysis of comparative growth suggests sets of countries can be grouped around basic family affinities, a certain uniqueness not necessarily shared by other types of developing countries. However, even within a familyof less developed countries (LDCs), there may exist important, and instructive, differences. Recognition of such differences as well as similarities in behaviour among developing economies permits the generation of a more flexible evolutionary view of development, based on the notion that each phase in the transition (in Kuznets' sense) is characterized by a distinct structural form (morphology) and distinct mode of operation (physiology). Such phases may be identified through a combination of inductive evidence and deductive reasoning.

Can the phasing of historical experience of East Asia be applicable to Latin America? The answer seems to be "no" for a number of authors. The major difference might be the "skipping" of P2, the phase of primary export substitution (substitution of exports of agricultural products by those of manufactured goods), and a more prolonged P1 in most of the Latin American countries.[3] The phenomenon has been noted also to a certain extent in some of South-East Asia, for example Thailand and the Philippines. Although our research in the CA project did not cover this area, as has been pointed out earlier, we believe such differences can no doubt be identified.

The problem is "how to interpret it." It seems to me that the phase performance of East Asia has often been taken as the standard type, against which other types of phase performance, such as "skipping of phase 2," are to be evaluated. The assertion is made, when analysing the development strategy, that prolonged import substitution policies, including various kinds of protection measures, might be responsible for bringing about a behaviour which is "distorted" if compared with the "assumed" standard performance of phase sequence identified for the historical experience of Japan and other East Asian cases. I do recognize the difference of policy option and share a view that this has been influential in forming the different phase behaviour. However, it is my view that as a methodology of comparative analysis, we had better pay much more attention to the typological difference itself before going on to the policy debates, and this is the route we have taken in carrying out the CA project.

The typological difference, as seen broadly between East Asia and Latin America, is primarily rich *v.* poor natural resource endowment, among other things, although the implications are different when the country is rich in agricultural land or in mineral resources. Such a typological difference is also evident to a certain extent within Asia, say between East Asian and South-East Asian countries. Even within East Asia, Taiwan is relatively rich in agricultural resources. We should also discuss the difference between Latin American countries in this regard. Nevertheless, it can be assumed that we will be able to classify all the countries into groups of similar typology based on their affinity. In the present context, we are concerned with the East Asian, South-East Asian, and Latin American groups in particular. It would be quite natural to think about the possible variances in industrialization performance due to the typological difference, which economically is in terms of comparative advantage of primary sectors. The reason for describing such a seemingly obvious fact stems from our view that there may be an alternative approach which avoids the concept of standard type of phase performance. This alternative approach would interpret all the three variants as "neutral" without setting any standard type as an evaluation criterion.

My factual knowledge is limited, but it can be conjectured that each group of affinity can be characterized respectively by: (a) the pronounced and distinct performance of primary export substitution activities (East Asia); (b) the long-lasting import substitution activities (Latin America), without making a distinction between so-called non-durable consumer goods and durable goods for producers and consumers; and (c) a behaviour of intermediate type (South-East Asia). Much has been said about the East Asian and Latin American models, but the intermediate type would need a brief illustration. For example, in the Indonesian development plan and economic policies, it is hard to draw a sharp distinction between the primary and the secondary import substitution approaches at present, although certainly the primary one did start earlier and, as a matter of fact, primary export substitution is of great importance. Such a mixed type of behaviour is also witnessed, though to a lesser extent, in Thailand. The point here is that primary export substitution and secondary import substitution cannot be considered as a distinct alternative option either at the policy level or in the actual process of industrialization.[4]

Productivity and Employment

If we observe the process of industrialization of LDCs using a broader common indicator, say, the historical changes in the manufacturing output's share of GDP, irrespective of its composition in non-durables and durables, a fairly regular performance would be identified through the three groups of different typologies presented above. For example, in Japan's case, its percentage share is 10–17 in P1, 17–23 in P2 and over 23 in P3. As is widely known, the fast pace of increase in this share is characteristic of the development process and it becomes distinctly slower in the industrialized state. Therefore, comparative studies of two countries belonging to different typology groups cannot be carried out effectively without taking this aspect into account. The Republic of Korea and Brazil can be compared as representative of East Asia and Latin America respectively, but Indonesia and Mexico should not be compared. In the former case, the share of manufacturing output is more or less the same, but in the latter case the share of Indonesia is definitely smaller than that of Mexico.

The discussion leads us to a broader aspect of comparative analysis, which concerns the changes in the industrial structure in terms of domestic production. The phase demarcation in terms of import and export developed for Japan and other East Asian countries, as has been pointed out in the introduction to our paper in the CA volume, referring to C. Clark and S. Kuznets, is nothing but a deeper observation of changes in terms of comparative advantage in open economies, reflecting changes in final demand and productive capacity during the development process. With respect to the alternative approach suggested previously, I want to draw your particular attention to this aspect, before getting into the policy aspect of the problem.

In evaluating this broad process of industrialization, we believe two criteria are basic, and they are the pace of productivity and employment increase, in particular in the industrial sector. (From a social point of view, one should consider whether the latter improves income distribution or not, but I will not discuss this aspect here.) Unfortunately, our empirical knowledge about the historical performance of productivity and employment and their relationship has not been arranged so as to be able to evaluate the varied behaviour of the three groups demarcated by typological characteristics in this respect. Of course we are given a number of partial data. For example, one author points out that the incremental/capital output ratio, an indicator of capital productivity, appears to be higher in Latin American countries than in Asian countries. Another says that the employment-absorbing power of the industrial sector in the former is much smaller than the latter. These may or may not be valid statements, depending on the time.[5] At any rate, the challenge for us is, first, a problem – "how do we make our factual knowledge more systematic?" and, second, "how can we link these features, if any, to the typological characteristics or phase differences?"

I am not qualified enough to answer the challenge even in part. Nevertheless, I will try to suggest, by illustration, some of the examples of analysis towards which we have to proceed.

The incremental capital/output ratio, in its reciprocal ($\Delta Y/I$, Y: output, I: investment), can be broken down into two terms: contribution of the conventional input, capital, K, and labour, L, in their incremental, ΔK and ΔL, and the residual, R, contribution of the non-conventional factors, also in its incremental term, ΔR. If we assume the contribution of conventional factors can be evaluated by their opportunity costs (wage rates, w, and rates of capital return, r) in the base year for the hypothetical case of no technological-organizational changes in the year to be compared, we can have a simple formula as follows.

$$\Delta Y/I = \Delta R/I + w\Delta L/I + r, \tag{1}$$

where for simplicity's sake I is used in place of ΔK, ignoring replacement investment. This is an incremental version of the usual growth accounting

Table 1. Decomposition of incremental capital-output ratio: industrial sector, Japan

Phases	I/ΔY	ΔY/I	wΔL/I	ΔR/I	I/Y	ΔR/Y	ΔY/Y
P1	3.32	30.1	4.8	13.3	16.5	2.19	5.29
P2	3.16	31.6	5.9	12.7	21.3	2.92	7.32
P3[a]	3.18	31.5	4.5	13.0	18.4	2.76	5.08
P3[b]	2.95	33.9	8.5	12.3	35.4	4.70	14.60

a. Pre-war
b. Post-war. r is flatly assumed to be 12 per cent.
Sources: K. Ohkawa and N. Takamatsu, "Capital Formation, Productivity and Employment: Japan's Historical Experience and Its Possible Relevance to LDCs," IDCJ Working Paper Series, no. 26 (Tokyo, 1983); K. Ohkawa, "Capital Output Ratios and the 'Residual': Issues of Development Planning," *IDCJ Working Paper* Series, no. 28 (Tokyo, 1984).

formula, and is convenient for observing the behaviour of productivity and labour employment in their relationship in the evolutional path of development.

Table 1 summarizes the result of its tentative application to the industrial sector of Japan.

I do not intend to discuss in detail the procedures and results of this hypothetical calculation. What deserves noting here is as follows:

1. The capital-output ratio tends to decrease in the long run.
2. The incremental term of Lw/K does not show a trend of decrease – instead, in the post-war P3, the phase of secondary export substitution, it increased.
3. The incremental increase of the residual per investment has been kept almost unchanged. Because of a trend of increase in the investment proportion, its value per output had increased in particular in P3b. Thus the proportion of the residual increase to the rate of output increase amounted to 30–50 per cent throughout the entire period.[6]

The residual is, as a matter of fact, a measure of "unknown" parts of output growth. Nevertheless, it does include as a major component the result of technological-organizational progress. While realizing such a sustained behaviour of productivity increase, the employment effect of investment shows a notable performance. I would draw your particular attention to the large value of P3b. It is my view that this was brought forth by a rapid growth of the machinery industry in a favourable international environment and that, speaking in general, the secondary export (and possibly import) substitution process does not necessarily have to be unfavourable in terms of solving the employment problem. Actually, in Japan's case the capital labour ratio, K/L, tends to be almost equal between the textile and machinery industries (except transportation machinery), and much lower than that of the so-called heavy chemical industries. What differs between textile and machinery is the high wage-rates of the latter, indicating a higher quality level of labour.

From a methodological point of view, it is desirable to make a comparative analysis by applying this formula to the representative countries, at least, of the