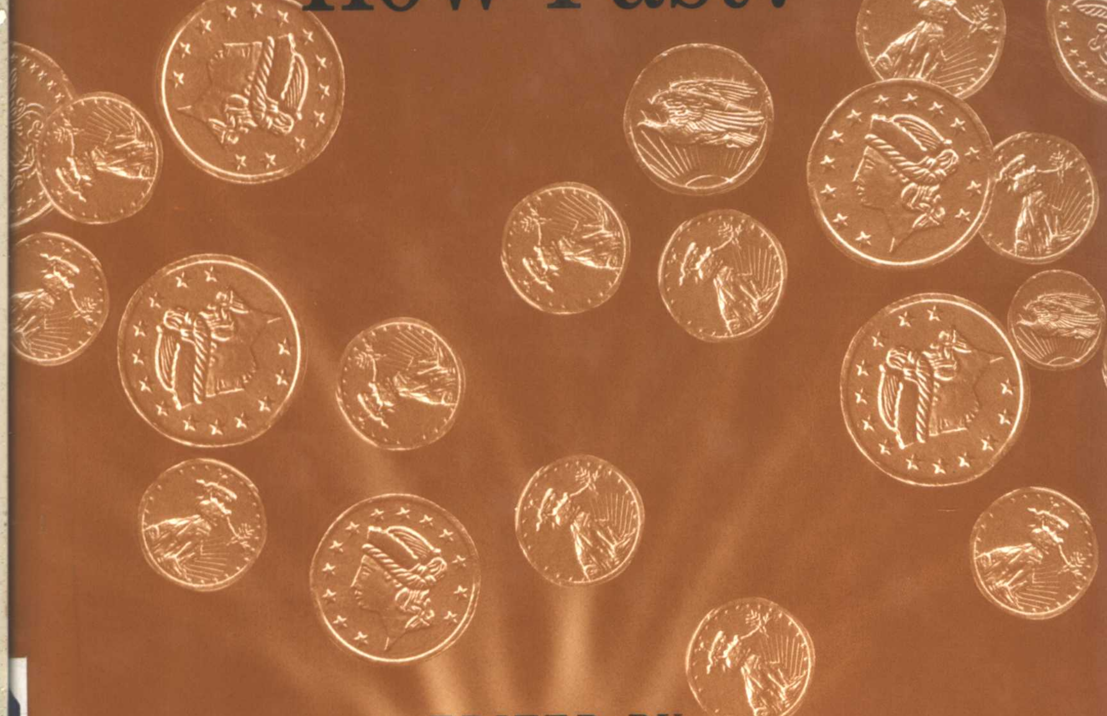
Financial Liberalization

How Far, How Fast?



EDITED BY
GERARD CAPRIO,
PATRICK HONOHAN,
AND JOSEPH E. STIGLITZ

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The Brookings Institution and Stanford University

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Contributors

Irfan Aleem
The World Bank

Gerard Caprio
The World Bank

Yoon Je Cho
Sogang University

Fabrizio Coricelli
University of Siena, Centre for Economic Policy Research,
and Central European University

Aslı Demirgüç-Kunt
The World Bank

Enrica Detragiache
International Monetary Fund

James A. Hanson
The World Bank

Patrick Honohan
The World Bank and Centre for Economic Policy Research

Louis Kasekende
Bank of Uganda

Luis Landa
The World Bank

Fernando Montes-Negret
The World Bank

Joseph E. Stiglitz
The Brookings Institution and Stanford University

Charles Wyplosz
Graduate Institute of International Studies, Geneva, and Centre for Economic Policy Research

Preface

The widespread financial crises of recent years have all too dramatically illustrated the shortcomings of financial policy under liberalization. The complexity of the issues mocks any idea that a standard liberalization template will be universally effective.

The goal of this volume is to bring a more broad-based empirical experience than has been customary to the theoretical debate on how financial systems should be managed. This is achieved, not only with cross-country econometrics, but also with an account of widely contrasting country cases. The evidence here described confirms that policy recommendations need to take careful account of country conditions.

The volume is the fruit of a research project sponsored by the World Bank's Development Economics Research Group.

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Financial Liberalization

How Far, How Fast?

The goal of this volume is to bring a more broad-based empirical experience than has been customary to the theoretical debate on how financial systems should be managed. This is achieved not only with cross-country economic studies, but also with an account of carefully chosen and widely contrasting country cases, drawn from Europe, Latin America, Africa, East and South Asia, and the former Soviet Union. The widespread financial crises of recent years have illustrated all too dramatically the shortcomings of financial policy under liberalization. The complexity of the issues mocks any idea that a standard liberalization template will be universally effective. The evidence here described confirms that policy recommendations need to take careful account of country conditions. The volume is the outcome of a research project sponsored by the World Bank's Development Research Group.

Gerard Caprio is Director of the Financial Policy and Strategy Department in the World Bank's Financial Sector Operations Vice Presidency and Manager of Financial Sector Research in the World Bank's Development Research Group. Before joining the World Bank in 1988, he was Vice President and Head of Global Economics at J.P. Morgan, held economist positions at the Federal Reserve Board and the International Monetary Fund, and taught at George Washington University. Dr. Caprio has researched and written extensively on financial sector policy, financial reform, and monetary policy implementation, including coediting *Reforming Financial Systems: Historical Implications for Policy* and *Financial Reform: Theory and Experience* (both Cambridge University Press). His current research is on the links between financial sector regulation and supervision and the performance of financial institutions, as well as on financial crises.

Patrick Honohan is Lead Economist in the Development Research Group of the World Bank. Based in Dublin, he is also a Research Fellow of the Centre for Economic Policy Research, London. Dr. Honohan has been Economic Advisor to the Taoiseach (Irish Prime Minister), and he has spent several years as Professor at the Economic and Social Research Institute, Dublin, and at the Central Bank of Ireland. He has acted as a consultant to the European Commission, the International Monetary Fund, and the Bank for International Settlements. Dr. Honohan has published widely on macroeconomics and monetary and financial sector issues, including financial liberalization and exchange rates, and he is past President of the Irish Economic Association.

Joseph E. Stiglitz is Senior Fellow at the Brookings Institution in Washington, D.C., and is on leave as Professor of Economics from Stanford University. Dr. Stiglitz served as Senior Vice President for Development Economics and Chief Economist at the World Bank (1997–99) and served as Chairman of the U.S. Council of Economic Advisors (1995–97). Prior to holding the Council chair, he was a member of the Council and an active member of President Clinton's economic team since 1993. Dr. Stiglitz was previously a professor of economics at Princeton, Yale, and All Souls College, Oxford. In 1979, the American Economic Association awarded him its biennial John Bates Clark Award, given to the economist under 40 who has made the most significant contributions to economics. Dr. Stiglitz's work has also been recognized through his election as a Fellow of the National Academy of Sciences, the American Academy of Arts and Sciences, and the Econometric Society.

Contents

ANALYTICS

1

Introduction and Overview: The Case for Liberalization and Some Drawbacks

Gerard Caprio, James A. Hanson, and Patrick Honohan

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.