Financial Liberalization and Economic Performance

Brazil at the crossroads

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Foreword

Jan Kregel[1]

Economists have long debated the impact of opening the economy to trade on growth and development. Paradoxically, the discussion of the impact of free international capital flows on developing countries is much more recent and much less thorough. The present book takes a big step towards remedying this deficiency.

One of the main reasons for the different treatment of capital and goods markets is the separation of the theories of trade and finance. This may be because of the usual argument of trade theorists that, in the end, imports must always be paid for by exports of real resources in the form of primary products or manufactured goods or services, no matter how trade is financed.

Traditional Ricardian theory suggests that countries can benefit from opening their economies to trade if they specialize in the products in which they have a comparative advantage. In effect this amounts to arguing that importing commodities of comparative disadvantage is equivalent to producing them with the foreign exporter's more efficient technology. Perfection of Ricardo's idea by Heckscher–Ohlin–Samuelson led to the conclusion that countries can benefit from trade if they export products that use their relatively abundant means of production more intensively. Developing countries should then concentrate on labor-intensive production for export and import the more capital-intensive exports of the developed countries. The limit to this argument is the equalization theorem that argues that it is not necessary for factors to be moved or traded across borders for their rates of return to converge, trade in goods is sufficient for that result. Gains from trade require neither labour nor capital mobility. Trade theory thus never considered the free movement of capital as necessary to obtain the gains from trade in support of development. Indeed, Ricardo argued that there were good reasons why capitalists would want to keep their capital at home, rather than sending it abroad!

The process of open trade specialization usually meant the export of primary commodities to pay for manufactured goods imports, and the experience of countries following this path soon disproved the predictions both Ricardian comparative advantage theory and of the Heckscher–Ohlin factor proportions theories. This failure was given theoretical form in the Prebisch–Singer–Myrdal theses concerning the trend decline in the terms of trade between primary commodities and manufactured goods. Indeed, virtually all of the "pioneers" of development economics rejected the gains from trade theories leading to specialization and recommended diversification through the creation of a manufacturing sector. Indeed, it was paradoxical that trade theory would contradict one of fundamental theorems of finance theory that risk-adjusted returns can be increased by diversification.

But in rejecting specialization in trade, this alternative approach did not argue that the manufacturing sector should be built up by opening capital markets and importing foreign finance. Instead it argued that development should be based on a more efficient employment of domestic resources, in particular by transferring labour from the agricultural sector where disguised unemployment hid zero or negative productivity, to the manufacturing sector where productivity and wages were higher. The famous model of Sir Arthur Lewis was emblematic of the approach in this period. It eventually led to the models of import substitution industrialization that were applied with success by many Latin American economies until the 1970s when a series of factors, including sharply increased external borrowing, led to the debt crisis of the 1980s.

Despite the contrary conclusions of Heckhser–Ohlin that is was unnecessary for capital to move from capital-abundant to capital-deficient countries, international finance theorists had argued that by allowing open markets capital would naturally flow from capital-rich countries where its rate of return was low to capital-poor countries where the rate of return was higher, thus raising global growth and efficiency. As noted above, Ricardo had argued that a return differential would be insufficient to produce this result:

> Experience, however, shows, that the fancied or real insecurity of capital, when not under the immediate control of its owner, together with the natural disinclination which every man has to quit the country of his birth and connexions, and entrust himself with all his habits fixed, to a strange government and new laws, check the emigration of capital. These feelings, which I should be sorry to see weakened, induce most men of property to be satisfied with a low rate of profits in their own country, rather than seek a more advantageous employment for their wealth in foreign nations.
>
> (D. Ricardo, *On the Principles of Political Economy and Taxation*, Chapter 7, p. 19)

Further, a number of early development theorists argued that the presumption that rates of return were higher in developing than in developed countries was incorrect, a position that has recently found support in real growth theory. The Cambridge controversies also challenged the marginal principle that there was an inverse relation between capital intensity and rates of return upon which the gains were supposed to rest. Finally, the historical record suggests that on average over the post-war period capital has moved from developing to developed countries, with the current inflows into the United States being the most recent example.

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Although it was never made clear if the gains that were to accrue from opening capital markets to foreign inflow was in addition to or in substitution for the gains from opening to trade in goods, capital-poor developing countries were encouraged open their capital markets to allow the free inflow of capital as part of their recovery from the crisis of the 1980s.

The famous Washington Consensus, formulated in the 1980s to provide a more open market-based development policy to substitute for import substitution, did not contain a direct recommendation in favour of opening capital markets as it did for goods markets. Nonetheless, all of the structural adjustment programs imposed on countries by the IMF added free movement of capital and of financial service enterprises to the requisites of the Washington Consensus. Indeed, not only was it argued that opening to foreign capital inflows would provide for a more efficient allocation of capital, it was argued that free entry for foreign financial service companies – global banks – were necessary to ensure that capital was efficiently allocated in developing countries.

However, aside from theoretically hypotheses, there was no evidence of the proposed benefits of opening capital markets and allowing free entry to global banks for developing countries. Indeed, the evidence of repeated financial crises in countries that had followed these prescriptions raised substantial doubts about the efficacy of these policies.

The merit of the present book is that it surveys the theoretical arguments for opening of both capital markets and foreign financial institutions and assesses the empirical evidence. In addition it provides an extensive analysis of one of the Latin American countries, Brazil, that has been an assiduous follower of the Washington Consensus in this regard. It opens a debate that should have taken place before these policies were recommended across the board to developing countries.

As the global economy responds to the most virulent financial market crisis since the Great Depression it serves as a useful warning and guide to the formulation of development policy in the aftermath of the current crisis. Brazil was particularly fortunate to have weathered this crisis with little loss of employment or wealth; although the initial response of the economy was deep, its recovery has been rapid. Brazilian economic policy thus faces a choice. This book provides an important indication of what that choice should be.

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1 Introduction

Since the beginning of the 1990s, Brazil has followed a pattern of economic development, which in broader terms was inspired by the Washington Consensus. This framework includes a set of liberalizing and market friendly policies such as privatization, trade liberalization, stimulus to foreign direct investment (FDI), financial liberalization, fiscal discipline, tax reform, labor and social security reforms, price stabilization, secure property rights, etc. Financial liberalization in Brazil and Latin America is part of a set of liberalizing reforms implemented during the 1990s, intended to reconnect the domestic financial markets to the international financial markets, after the stagnant "lost" decade of the 1980s.

According to economists who defend the benefits of financial integration it is seen as an inevitable step on the path of development and should therefore be embraced. The main reason for this is that the free movement of capital facilitates an efficient global allocation of savings and helps channel resources into their most productive uses, thus increasing economic growth and welfare. Furthermore, the presence of foreign banks in emerging countries could bring positive effects by increasing the efficiency of the domestic financial system, as they could:

1. have better access to foreign savings;
2. enhance the financial system, increasing its soundness in order to improve the country's resistance to shocks;
3. incorporate operational and macroeconomic efficiency of the banking sector.

Critics of financial liberalization, however, stress that the costs of this process can overcome the alleged benefits, due to the unstable effects of international financial integration on capital flows that constrains the autonomy of economic policies and can have negative effects on the real variables (output, employment, etc.).

At the end of the 1980s and beginning of the 1990s, Brazil and other Latin American countries, such as Argentina and Mexico, began continually to liberalize their balance of payments capital account. In 1991 the Brazilian government permitted the acquisition by institutional investors of equities of Brazilian firms. In 1992 the Central Bank of Brazil allowed a broad liberalization of the exchange rate market as it permitted that a special banking account called CC5 could be operated more freely by foreign financial institutions. This exception in practice created a privileged way to short-term capital flight that was used during periods of contagious currency crises, as any agent (resident and non-resident) with access to a foreign bank account could send dollars abroad. After the 1999 Brazilian currency crisis and the adoption of a floating exchange regime, economic authorities implemented a number of norms that resulted in greater flexibility in the exchange rate market, including the unification of the exchange rate markets and the simplification of the procedures related to capital remittance to other countries.

In Brazil, as in other major Latin American emerging countries, one of the key effects of the "Mexican crisis" contagion in 1994–5 was that it triggered the liberalization of the banking system. Indeed, before 1995 rules were more restrictive in the financial sector and foreign bank entry could only be undertaken with prior authorization of the Central Bank of Brazil or by Congressional decree. Although the 1988 Brazilian Constitution prohibited the installation of foreign banks, it allowed entry on a case-by-case basis through authorizations resulting from international agreements, from reciprocity or from the interest of the Brazilian government. The banking crisis in 1995 provided the Brazilian federal government with the opportunity to privatize state banks and to allow the entry of some foreign banks within the domestic banking sector.

Twenty years after financial liberalization began to be implemented in Brazil it is time to carry out a substantial analysis of this process. This book aims at assessing the determinants and impacts of financial liberalization in Brazil considering its two dimensions:

1 the opening up of the balance of payments capital account; and
2 foreign bank penetration in the domestic banking sector.

Concerning the *first dimension*, the book shows that financial liberalization has contributed to define a more unstable macroeconomic environment for economic growth in Brazil. Since the mid-1990s the Brazilian economy has presented a marked trend in terms of capital flows instability and, consequently, has suffered the impact of a succession of crises: Mexico in 1995, Asian countries in 1997, Russia in 1998, and its own crisis in early 1999 and in 2002–3. Therefore, financial liberalization in Brazil has not generated the benefits on macroeconomic variables that one would expect; instead, it has most probably contributed to a frequently unstable economic environment, with greater exchange rate volatility, very high domestic interest rates, a semi-stagnation trend for growth, etc. Indeed, economic growth has taken a stop-go pattern in Brazil: the average GDP growth in 1990–2008 was only 2.6 percent, very low compared to other big emerging countries, such as China and India. In particular, since 1999 economic policies in Brazil – the combination of a inflation targeting regime with a floating exchange rate regime under the conditions of full opening of the capital account – have been based on what has come to be known as the "New Consensus Macroeconomics." Even the leftist Lula da Silva's government embraced orthodox economic policies. However, there were some important policy initiatives to reduce external vulnerability – such as reduction of public external debt and the increase in the foreign exchange reserves – that allowed introducing some flexibility in the economic policy in Brazil in order to face the effects of the 2008 financial crisis.

Concerning the *second dimension*, entry of foreign banks, the evidence presented in the book shows that some of the expected benefits of foreign bank entry, such as the leadership in the credit supply and lower net interest margins due to the presence of more efficient institutions, did not materialize in Brazil, although foreign bank penetration in the domestic market has probably increased competition, enhancing banking efficiency. Interestingly, although foreign banks were expected to change banking sector behavior, with positive effects on credit supply, bank service fees and bank spreads, these changes have not occurred as expected. Evidence shows that, overall, the foreign banks have adopted an even more conservative stance than the domestic private banks. Furthermore, contrary to the recent experiences of other emerging countries, one distinguishing feature of the banking mergers and acquisitions (M&As) wave in Brazil is that some big domestic banks have actively taken part in this wave and have been at least as efficient as the foreign banks entering Brazil, if not more so.

The chapters of this book embrace some theoretical analysis with empirical and descriptive analysis. Some chapters make use of mathematical models and/or statistical techniques; however they are used only when they are necessary to the analysis.

In addition to this Introduction, the book is divided into three parts and ten chapters. Part I deals with capital account liberalization in Brazil and is divided into five chapters. Part II focuses on foreign bank entry in Brazil, and is divided in four chapters. Part III concludes.

At the beginning of Part I, Chapter 2 surveys the theoretical and empirical literature in order to analyze the costs and benefits of capital account liberalization for developing countries, focusing in particular on the conventional approach and the Keynesian approach. While conventional wisdom, based on theory of market efficiency, supports that free capital movements facilitate an efficient global allocation of savings and help channel resources into their most productive uses, thus increasing economic growth and welfare, critics of capital account liberalization suggest that the efficient-markets theory cannot be used to understand the capital flows movements, as financial markets tend to be intrinsically unstable, particularly in developing countries.

Chapter 3 shows the evolution of the Brazilian economy and the economic policy under the environment of economic openness and high capital mobility, beginning in 1990, the year that economic liberalization began to be implemented in Brazil, and finishing with the contagion of the international financial crisis in 2008–9. The chapter also discusses the shift in Brazil from the nationaldevelopmentist model to a new model of development for emerging economies, inspired by the Washington Consensus.

Chapter 4 examines the evolution of rules governing capital flows in Brazil, both as regards changes in rules governing the foreign exchange market and developments in deregulating the balance of payments capital account. For this purpose we have divided the analysis chronologically into two main periods: the financial liberalization in the 1990s, and the measures to consolidate and simplify foreign exchange rules in the 2000s.

Chapter 5 assesses the proposal of the full convertibility of the capital account – understood as the absence of any restrictions to change to transactions between reais and dollars – done for the former President of the Central Bank of Brazil, Persio Arida, first published in 2003, which met with lot of criticism from other Brazilian economists.

Closing Part I, Chapter 6 offers an empirical evaluation of the relationship between financial liberalization, economic performance and macroeconomic stability in Brazil. For this purpose, we apply VAR methodology to a set of macroeconomic variables with the use of two indexes: *de jure* index of financial liberalization (IFL) and de facto index of financial integration. The objective is to evaluate, in the first case, Arida's hypothesis that financial liberalization results in a reduction of country risk and thus in the domestic interest rate; and, in the second one, the hypothesis from the international literature, that financial liberalization has a positive impact on economic growth and macroeconomic stability, in addition to a disciplining effect on economic policy.

Part II begins by analyzing the determinants, evolution and characteristics of the internationalization of banks worldwide. For this purpose, Chapter 7 shows that the current banking internationalization trend is somehow related to the recent changes in the banking sector (financial liberalization, technological developments, etc.), and also analyzes the rationale of the strategy of banking internationalization, based on some theoretical studies and some empirical works.

Chapter 8 examines the main determinants of the foreign banks expansion in Latin America since the 1990s, that include a set of different factors, such as the process of restructuring the banking sector under the European Monetary Union (EMU); the dynamics of the internationalization of the Spanish banks; the process of market deregulation in the region since early 1990s; the better prospects of the region of increasing returns to financial institutions compared to developed countries, and the potential gains in efficiency. The chapter also analyzes the expansion strategies of the major European banks in Latin America: ABN AMRO, BBVA, HSBC, and Santander.

Chapter 9 analyzes the process of banking consolidation in Brazil after the Real Plan, focusing on the main "forces of changes" (price stabilization; privatization of state banks; banking distress of 1995 and the implementation of a program of banking restructuring; foreign banks entry and domestic banks reaction; Basel Accord) and some impacts of this process in terms of size and market share, banking concentration, and performance of banking sector.

Finalizing Part II, Chapter 10 assess the efficiency of the banks that actively took part in the M&As wave in the 1998–2008 period, ABN AMRO, Bradesco, HSBC, Itaú, Santander, and Unibanco, comparing in particular the segment of foreign banks vis-à-vis the segment of domestic private banks. In order to do this, the non-parametric DEA (Data Envelopment Analysis) method is used in two models: intermediation model and revenue model.

Chapter 11, in Part III, sums up the main arguments and findings of the book.

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