Finance on the loose

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The record of the past 25 years shows that there is more to financial liberalisation than freeing international flows of capital

UNDERSTANDABLY, given the role that cross-border flows of capital played in East Asia’s economic downfall, people have come to think of “financial liberalisation” as another way of saying “lifting capital controls”. This is wrong. Opening the capital account is only one aspect of a much broader process—and rarely the most important. Recognising this makes it easier to see why financial liberalisation is still desirable, provided it is done right.

John Williamson of the World Bank and Molly Mahar of the San Francisco Fed recently published a survey of research on this subject. They point out that it is 25 years since two classics in the literature—“Money and Capital in Economic Development” by Ronald McKinnon, and “Financial Deepening in Economic Development” by Edward Shaw—drew attention to the costs of “financial repression” in the third world. In the early 1970s, most developing-country governments intervened so heavily in finance that civil servants were deciding where credit came from, who received it and how much it cost. The result, among other things, was to keep financial sectors small—making the term “repression” especially apt.

Since those books were published, financial reform has happened much faster than seemed likely back then—often, indeed, a lot faster than the early advocates of liberalisation would have wished. (From the start, most liberalisers have stressed the importance of timing the various stages of reform very carefully.) Be that as it may, financial deregulation across a broad front has happened all over the world—in rich countries as well as poor—and this allows some preliminary conclusions to be drawn about its benefits and costs. The essay by Mr Williamson and Ms Mahar gives the clearest summary so far of the evidence.

The authors identify six dimensions of financial liberalisation:

• Abolishing credit controls;

• Deregulating interest rates;

• Allowing free entry into the banking industry or, more generally, into the financial-services industry;

• Making banks autonomous (that is, freeing them from ad hoc interference in day-to-day management);

• Putting banks in private ownership;

• Freeing international capital-flows.

Of these six, the case for “bank autonomy” deserves further comment. Liberalisers never argued that effective supervision and regulation were not required—quite the opposite. The moral hazard
in banking (caused by implicit or explicit government guarantees of deposits) makes proper oversight essential. But the liberalisers did object to routine official interference of a discretionary (as opposed to rules-based) kind. Interference of that sort was the norm in the early 1970s.

The new survey looks at 34 economies, rich and poor, asking how far liberalisation under each heading has gone. The change is dramatic. Summarising by means of a four-point scale ("repressed", "partly repressed", "largely liberal", and "liberal"), 24 economies were judged to be repressed, overall, in 1973. By 1996 that category was completely deserted. Meanwhile the number of largely liberal financial systems had increased from two to 18, and the number of liberal ones from four to ten.

The liberalisers had argued that reform would (a) lead to greater efficiency in the allocation of resources, and (b) promote saving. Both of these changes would, in turn, spur growth. Were they right?

On (a)—efficiency in the allocation of investment—they were. Numerous studies have found that financial liberalisation does promote efficient investment. Unsurprisingly, it seems that markets are better than politicians or bureaucrats at choosing worthwhile investment projects.

On whether liberalisation promotes growth through the extra-savings channel as well as through the efficient-investment channel, on the other hand, the evidence is less clear. Britain in the 1980s was a striking example of a country where financial liberalisation appeared to reduce saving. Argentina, Chile, Colombia and the Philippines experienced a similar effect, post-liberalisation—though in Chile at least this was later reversed.

What of the costs? Against the benefit of improved efficiency must be set the equally clear drawback of greater susceptibility to financial crisis. Here, cross-border capital flows are especially important. The survey shows that financial crises are often associated with a recently opened capital account. Again, there are exceptions. Argentina (in 1989), Venezuela (in 1994), South Africa (in 1985), Brazil (in 1994), South Korea (in the mid-1980s) and Sri Lanka (in the early 1990s) all suffered financial crises of varying severity despite being closed to short-term capital inflows.

Sometimes, that is, other aspects of liberalisation have been to blame for the increase in instability. In general, financial liberalisation represents a profound change in the economic rules of the game. The result, as one of the cited studies puts it, is to “increase the riskiness of traditional behaviour or introduce new and inexperienced players.” In these circumstances, accidents are likely to happen. This is as true for rich countries (witnes the United States and its saving-and-loans fiasco, or Britain and its credit-driven boom of the late 1980s) as for poor ones.

What muddies the water, however, is that liberalisation has very often been undertaken with too little regard for the warnings in the early pro-reform literature. The survey shows that many countries followed the standard advice in some respects—most freed trade and established better fiscal discipline before opening their capital account, for instance; but only a small minority set up a satisfactory system of prudential regulation and supervision before doing so. Careless liberalisation, rather than liberalisation in its own right, has often been the real culprit.