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Financial Repression and Liberalization: A Survey of the Literature*

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Abstract

The literature on financial repression and financial liberalization in developing countries commenced with the seminal work of Mckinnon and Shaw in 1973 which focused on financial repression and the need for developing economies to allow real interests rates to be determined by market forces. With the adverse effects of financial repression on economic growth emerging, financial liberalization was advocated as a key to financial development and growth-enhancing economic policies. These arguments have been challenged by experiences of many developing countries which implemented liberalization policies and underwent devastating financial crisis.

Financial liberalization is intended to promote market efficiency and economic welfare. However, the experiences in many countries revealed that deregulation and liberalization without the requisite regulation resulted in excessive risk-taking and encouraged an over-accumulation of short-term external liabilities by both financial and corporate sector. Costly lessons learned from the experiences should not lead to a return to financial repression. Rather institutional framework, including regulatory reform and infrastructure reform, should be established for the enhancement of the economic benefits from the financial liberalization.

Keywords : deregulation, economic crisis, financial liberalization, supervisory reform

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Ⅰ. Introduction

For the past several decades, the regulation or deregulation has been very much popular topics in financial markets. The deregulation of financial markets in the US and the UK preceded worldwide financial liberalization during the 1980s and 1990s.

Financial liberalization starts with the deregulation of the regulated financial industry. The financial system is regulated to achieve a wide variety of purposes. The prime objective of financial regulation is to maintain the stability and confidence in the financial system by "safeguarding financial markets and institutions from shocks that might pose a systemic risk" (prevention of systemic risk).[1] Financial regulation also intends to protect the consumers such as investors, borrowers and other users of the financial system against undue risks of losses and other damage that may arise from failures, fraud, malpractice, manipulation and other misconduct on the part of providers of financial services (prevention of individual risk). It also aims to ensure a smooth, efficient, reliable and effective functioning of financial markets, including a proper working of competitive market forces (promotion of system efficiency) (Herring and Santomero, 2000).

The deregulation of financial markets began in the mid-1960s, accelerated in the 1970s, and exploded in the 1980s. The US Citicorp initiated deregulation by introducing the certificate of deposit in the 1960s for the purpose of the circumvention of Regulation Q. In the early 80s, globalization, liberalization and deregulation were advocated in tandem in the international financial arena as key drivers of economic growth. The deregulatory cycle accelerated during the 1980s in the US with the spirit of freer markets under the determined leadership of Ronald Reagan, and this trend became infectious worldwide with Margaret Thatcher of Britain 'declaring herself as the first disciple' (Khoury, 1990). Deregulation of the financial markets has been a key component of what is referred to as the 'Reagan Revolution' and the 'Big Bang' (Gowland, 1990).

There have been a plethora of studies on the topic since Mckinnon and Shaw published the seminal work in 1973, which focused on Financial Repression and the need for developing economies to allow real interests rates to be determined by market forces.

1) Systemic risk can be defined as the risk of a sudden, unexpected event that would damage the financial system to such an extent that economic activity in the wider economy would suffer (see Herring and Santomero, 2000).

This paper examines the economic theory behind financial repression and financial liberalization. The next section reviews financial repression and the third section introduces financial liberalization theory in the literature and examines the effects of financial liberalization, while the fourth section summarizes and concludes the paper.

II. Financial Repression

In the past decades, a growing number of developed and developing countries have moved towards liberalization of their financial systems. Financial liberalization includes lifting interest rate ceilings, lowering compulsory reserve requirements and entry barriers, reducing government interference in credit allocation decisions, and privatizing financial institutions. The trend toward financial liberalization is part of a broader trend toward reduced direct intervention of the state in the economy. In developing countries, in particular, financial liberalization has been a process to move away from restricted or 'repressed' financial system. This section defines financial repression and discusses economic theory of financial repression.

Financial systems in developing countries tend to be 'repressed' through high reserve requirements, interest rate ceilings, or foreign exchange controls, etc.

Before the 1970s, policies of financial restrictions were favored, particularly in capital-scarce countries, on several grounds. First, the government needed to impose anti-usury laws thereby intervening in the free determination of interest rates. Second, monetary authorities could better control money supply with strict control and regulation of the financial system. Third, it was thought that governments knew better than markets and financial institutions about the optimal allocation of savings and desirable investments. Fourth, financial repression was identified with interest rates below market rates, which reduced the costs of servicing government debts (Roubini and Sala-i-Martin, 1995). This claim was supported with evidence from East Asian high-growth economies, where governments supposedly manipulated financial systems in order to promote targeted industrial expansion.

The most typical restrictions in developing countries were government-established ceilings for interest rates on financial instrument such as deposits, loans and bond issues. These ceilings, which were applied in the organized financial markets, were below real market rates. This distortion has been a typical feature of the financial repression in developing countries (Giovannini and De Melo, 1993). The governments need to supply cheap credit to selective industrial sectors and encourage investment as a strategy for economic development with the limited resources (Sohn, 1995). The scarce resources produce excess demand for credit which leads to government intervention in the process of credit allocation of official financial intermediaries (Denizer, Desai and Gueorguiev, 1998). More broadly defined, financial repression encompasses a range of policies designed to limit competition in financial markets (Patrick, 1994).[2)] Roubini and Sala-i-Martin (1995) define financial repression as “the sets of policies, laws, regulations, taxes, distortions, qualitative and quantitative restrictions, and controls imposed by governments which do not allow financial intermediaries to operate at their full technological potential.”

The term "financial repression" was first introduced in the works of Ronald I. McKinnon and Edward S. Shaw in the early 1970s to describe a developing country environment. In their influential analyses, McKinnon (1973) and Shaw (1973) argue that financial repression ‐ indiscriminate distortion of financial prices including interest rates and foreign exchange rates ‐ reduces the real rate of growth and the real size of the financial system relative to non-financial magnitudes. This strategy has stopped or gravely retarded the development process.[3)] The main instruments of financial repression are high reserve requirements and interest rate ceilings. Fry (1997) diagnoses that interest rate ceilings distort the economy in four ways. First, low interest rates produce a bias in favor of current consumption and against future consumption. Therefore, they may reduce saving below the socially optimum level. Second, potential lenders may engage in relatively low-yielding direct investment instead of lending by way of depositing money in a bank. Third, bank borrowers able to obtain all the funds they want at low loan rates will choose relatively capital-intensive projects. Fourth, the pool of potential borrowers contains entrepreneurs with low-yielding projects who would not want to borrow at the higher market-clearing interest rate.

The essential common elements of the McKinnon-Shaw model are: (a) a saving function that responds positively to both the real rate of interest on deposits and the real rate of

2) These include entry restrictions, market segmentation, limitations on creation of financial instruments, and constraints on development of securities issues and secondary markets (see Patrick, 1994, p. 333).

3) See Shaw (1973, pp. 3-4).

growth in output; (b) an investment function that responds negatively to the effective real loan rate of interest and positively to the growth rate; (c) an administratively fixed nominal interest rate that holds the real rate below its equilibrium level; (d) inefficient non-price rationing of loanable funds. In the McKinnon-Shaw model, banks allocate credit not according to expected productivity of the investment projects but according to transaction costs and perceived risks of default. Quality of collateral, political pressure, name (or status of the company), loan size, and covert benefits to loan officers may also influence allocation.

Based on the situations in the developing countries, McKinnon (1973) and Shaw (1973) seek to understand the origins of financial repression on financial systems, and to suggest means to alleviate repression. The financial repression was a part of development strategy in many developing countries, in which "market forces" are mistrusted on the grounds that elasticity of response to relative prices are thought to be too high or too low for desired outcomes, that markets are vulnerable to exploitation or that "this country is different" (Shaw, 1973). However, financial repression had direct relationship with repressed political system as seen in Korea, where the government believed it could accomplish economic development by a repressed financial system.

King and Levine (1993b) also argue that financial repression reduces the services provided by the financial system to savers, entrepreneurs and producers; it thereby impedes innovative activity and slows economic growth. McKinnon (1991) summarizes the problems of the repressed financial system as follows:[4)]

The flow of loanable funds through the organized banking system is reduced, forcing potential borrowers to rely more on self-finance.

Interest rates on the truncated flow of bank lending vary arbitrarily from one class of favored or disfavored borrowers to another.

The process of self-finance within enterprises and households is itself impaired. If the real yield on deposits, as well as on coin and currency, is negative, firms cannot easily accumulate liquid assets in preparation for making discrete investments. Socially costly inflation hedges look more attractive as a means of internal finance.

Significant financial deepening outside the repressed banking system becomes impossible when firms are dangerously illiquid and/or inflation is high and unstable. Robust open

4) See McKinnon (1991, pp. 11-12).

markets in stocks and bonds and intermediation by trust and insurance companies require monetary stability.

Inflows of foreign financial capital may be unproductive when the domestic capital market is in disarray and foreign exchange rates are unpredictable.

Besides McKinnon and Shaw, there has been a large body of empirical evidence showing that financial repression policies have adverse effects on economic growth (e.g. Goldsmith, 1969; Fry, 1988; World_Bank, 1989; De Gregorio, 1992; Roubini and Sala-i-Martin, 1991; Roubini and Sala-i-Martin, 1992; and King and Levine, 1993a). Roubini and Sala-i-Martin (1995) study the relation between policies of financial repression and long-term growth, and argued that financial repression would reduce the efficiency of the financial sector, increase the costs of intermediation, reduce the amount of investment, and reduce the growth rate of the economy.

Pointing out the adverse effects of financial repression on economic growth, financial liberalization was advocated as a key to financial development and growth-enhancing economic policies. According to McKinnon (1991), financial liberalization includes liberalization of interest rates, elimination of onerous reserve requirements, mandate allocation of cheap credit and reduction of the rate of inflation. These arguments, however, have been challenged by experiences of many developing countries which initiated liberalization policies in the 1970s and 1980s, or more recently in the 1990s and 2000s.

III. Financial Liberalization

1.1 Financial Liberalization and its theory

In the 1970s and 1980s, a number of OECD countries took steps to deregulate or liberalize their financial markets and institutions by abolishing credit and interest rates ceilings, capital movement controls, and other regulations governing lending and borrowing activities. There are several economic rationales for financial liberalization. Financial liberalization would reduce the operating costs of financial intermediaries and hence the cost of their loans and other services. This would also improve the allocation efficiency of the financial system and would make the economy more resilient to short-run fluctuations of financial asset prices (Park, 1994).

Although the term "financial liberalization" takes various meanings in the literature, financial liberalization generally includes the deregulation of the capital market, the domestic financial market, and the stock market (Kaminsky and Schmukler, 2003). The liberalization of the capital market is to lessen or abolish the regulations on offshore borrowing by domestic institutions, on foreign exchange markets and on capital flow controls. In a fully liberalized capital account regime, banks and corporations are allowed to borrow abroad freely. In a fully liberalized domestic financial market, there are neither controls on interest rates nor credit controls and deposits in foreign currencies are permitted. A fully liberalized stock market allows foreign investors to hold domestic equity without restrictions and repatriate capital, dividends and interest freely. According to Kaminsky and Schmukler (2003), full financial liberalization occurs when at least two of the three sectors are fully liberalized and the third one is partially liberalized. A country is partially liberalized when at least two sectors are partially liberalized.

Financial liberalization theory has its origins in the work of McKinnon (1973) and Shaw (1973) although many scholars previously published the work on the relationship between financial development and economic growth (Schumpeter,1936; Gurley and Shaw, 1955; Gurley and Shaw, 1956; Patrick, 1966; Gurley and Shaw, 1967; and Goldsmith, 1969). The financial liberalization thesis, initiated by McKinnon (1973) and Shaw (1973), were further developed by King and Levine (1993a), King and Levine (1993b), Fry (1995), Fry (1997), and others (for example, Greenwood and Jovanovic (1990), Roubini and Sala-i-Martin (1992), Saint-Paul (1992), Levine and Zervos (1996), Levine and Zervos (1998), Rajan and Zingales (1998), etc).

Until the early 1970s, most economists believed that low interest rates would promote investment and economic growth in accordance with Keynesian and neoclassical theories. McKinnon (1973) and Shaw (1973) are the first to challenge seriously this conventional wisdom. They argue that financial repression, which consists of interest rate ceilings, high reserve requirements and direct credit policies, should reduce domestic investment and its productivity, and therefore, financial liberalization can foster economic growth. Their argument, which has recently been supported by a group of economists called the McKinnon-Shaw school, has provided a theoretical ground for the recent movements toward financial liberalization in a large number of developing countries.

McKinnon (1973) develops a framework in which a monetary reform – an exogenous increase in bank deposit and lending interest rates close to an equilibrium level – is shown to be conducive to a high rate of capital accumulation and economic growth through financial development, which is defined as accumulation of financial assets at a pace faster than accumulation of non-financial wealth.[5)]

Shaw (1973) is also convinced of the positive effects of financial liberalization. He maintains that financial liberalization by way of freeing interest rates from government control can raise the level of private domestic savings relative to income, open the way to superior allocation of resources by widening and diversifying the financial markets in which investment opportunities compete for savings, and even promote equalization for the distribution of income.

McKinnon-Shaw thesis, however, faced real-life test when Argentina, Chile and Uruguay implemented financial liberalization policies in the late 1970s. These Southern Cone nations suffered sky-rocketing interest rates, bankruptcy of many solvent firms, and eventually a financial crisis in 1982. The devastating consequence of the Southern Cone experiment led to a consensus that financial liberalization should be carried out in an environment suited for its success (see Lee, 2000).

McKinnon (1988) points out the importance of macroeconomic stability as a condition for the successful outcome of financial liberalization. Fry (1988, and 1995) also focus on the necessity of stable macroeconomic policy but added a sound regulatory framework as one of the preconditions for successful financial liberalization.

Later, McKinnon (1991) adds that a certain sequence of economic reform should be followed if financial liberalization is to be successful. The first step of the sequence is appropriate macroeconomic policy, which includes fiscal control, balancing the government budget, privatizing state-owned enterprises, and ensuring the adequate internal revenue service for the purpose of tax collection. The second step is the liberalization of domestic financing markets by allowing interest rates to be determined freely by the market, freeing up burdensome reserve requirements, and privatizing the banks.[6)] The third step in the sequence includes the liberalization of foreign exchanges, which includes the liberalization

5) It is also termed financial deepening by Shaw (1973). The level of financial deepening is an indicator of financial development – the ratio of total financial assets to GNP (Patrick, 1994, p. 325).

6) This step also includes the establishment of commercial law and the liberalization of domestic trade. McKinnon proposes that the privatization of banks may come near the end of this step because this can only occur after the proper re-capitalization of bad loans (see Lee (2000)).

of the exchange rate for current account transactions and the liberalization of tariffs, quotes, and other international restrictions. Capital account opening, according to the views on the sequence of liberalization (Edwards, 1989 and McKinnon, 1993), should be implemented in the final step following domestic financial market and current account liberalization.

Thus, while the goal of financial liberalization – the establishment of a market-based financial system – remained the same, the process necessary to achieve that goal was no longer regarded simply as that of doing away with government intervention in financial markets (Lee, 2000). It was regarded as a more complex process requiring proper sequencing and macroeconomic stability as a precondition for its success.

In the early 1990s, the new insight into the operation of financial markets led to a new debate on the financial liberalization with the focus from government to market failure (for example, Villanueva and Mirakhor, 1990; Akyuz, 1993; Demirguc-Kunt and Detragiache, 1998; and Drees and Pazarbasioglu, 1998). According to these views, developing countries do not have the institutions necessary for free-market policies. Demirguc-Kunt and Detragiache (1998) claim in a study of 53 countries during 1980-95 that financial liberalization increases the probability of a banking crisis but less so where the institutional environment is strong. In particular, they described, respect for the rule of law, a low level of corruption, and good contract enforcement are relevant institutional characteristics. Villanueva and Mirakhor (1990) point to the importance of institutional reform prior to financial liberalization by calling for the development of financial infrastructure such as adequate legal and accounting systems, credit appraisal and rating, and adequate channels for the flow of information. Gibson and Tsakalotos (1994) stress the role of institutions and their impact on economic performance. They claimed that a whole network of institutions including the state, firms, employers, federations, trade unions, banks etc. play a crucial role in gathering information and reducing uncertainty.

1.2 The Effect of Financial Liberalization

Recently there have been major economic crises in many of the developing countries that initiated such policies, such as Latin American countries in the 1980s and 1990s and East Asian countries in the 1990s. Much of the instability has been associated with financial liberalization.

Due to growing instability in liberalized financial markets, the basic liberalization theory has been heavily criticized by Post-Keynesian economists. Arestis and Demetriades (1999) argue that the liberalization process has negative impacts on output and promotes financial instability. Arestis, Nissanke and Stein (2003) maintain that financial liberalization policy is built on shaky theoretical premises. Economists called structuralists are strongly against the financial liberalization, pointing out that the financial liberalization always induces a vicious cycle of stagflation. They argue that the availability of loanable funds will decrease with the high interest rates after the liberalization program and thus economic growth will be retarded (Taylor, 1991). So-called New-Keynesians recognized the problem of asymmetric information inherent in the financial market and the essential role of the government regulation (Hellman, Murdock and Stiglitz, 1998). Stiglitz and Uy (1996) argue that the government-directed allocation of financial could induce higher economic growth in developing countries. Specifically, Stiglitz (1994) advocates government intervention to keep interest rates below their market-equilibrium levels. Moreover, the mild government repression called 'financial restraint' on interest rates and entry of financial institutions can produce rent to help stabilize the financial system (Stiglitz and Uy, 1996). However, this rent-seeking behavior has been linked to deep-seated corruption, bribery and concentration of economic power, prevalent in developing countries including Korea where individuals or companies (chaebol in particular) frequently lobby politicians and bureaucrats to obtain special favors such as loan subsidies, grants or tariff protection.

The effects of financial liberalization is difficult to evaluate because it is difficult, on the one hand, to determine exactly when liberalization efforts might have started and ended, on the other hand, it is difficult to come up with single empirical measures of financial liberalization and performance under financial liberalization that would help assess the link. With the wisdom of hindsight, financial liberalization appears to have been heavily associated with banking crises as seen in the Latin American experiences in the 1980s (Argentina, Chile, Uruguay). It also appears to promote growth, to the extent that it leads to financial deepening and economic development (Ucer, 1998).

During the past few decades, a great deal of attentions have been paid to the effect of financial liberalization. As described earlier, financial crises have been unusually frequent and severe especially in developing countries with fixed exchange rate regime and external debt, both relative to the experience of developed countries and to the experiences of the preceding period of time. Arestis (2005) reports that over two thirds of the IMF member countries experienced significant banking-sector problems during the period 1980-today. In Africa, in Asia, and in the transition economies of central and Eastern Europe, over 90 percent of the IMF country members suffered at least one serious bout of banking difficulties over the period. Industrial countries also had some banking crises of their own over the period (Spain, 1977-85; three Nordic countries in the late 1980s/early 1990s; the US saving and loan debacle, 1984-91; and the Japanese economic crisis, 1990s-2000s), although the frequency and scale of crises have lower than in the developing countries.

These crises are argued not to be unrelated to the financial liberalization policies pursued by countries, which adopted the principles of the thesis in the context of their existing institutional structure (Arestis, 2005). A broad literature has highlighted a number of critical issues of financial liberalization theory including sequencing, causality, etc. (for more details see Arestis, 2004).

Undesirable results of financial liberalization seem to be more due to inappropriate supervision on the financial system following financial liberalization measures than due to financial liberalization per se. Accordingly, Fry (1995) suggests that there are five prerequisites for successful financial liberalization, including adequate prudential regulation and supervision of the banking system; a reasonable degree of price stability; fiscal discipline taking the form of a sustainable government borrowing requirement that avoids inflationary expansion and prevents exchange rate appreciation; profit-maximizing and competitive behavior by the commercial banks; a tax system that does not impose discriminatory explicit or implicit taxes on financial intermediation. Now there seems to be a consensus that financial liberalization – if conjoined with appropriate government regulation – does well for the economy, whilst liberalization without monitoring & control is not a panacea for economic growth.[7)]

As discussed above, there has been a progressive widening the definition of financial liberalization. In the 1970s, following the basic McKinnon-Shaw thesis, financial liberalization focused on the removal of ceilings on interest rates to allow market-determination, and a reduction of controls to allow financial intermediaries greater management over the use of their resources. In the 1980s, the focus was extended to the

7) Many of economists have suggested that the capital account liberalization will not lead to higher economic efficiency and growth in financial market that are prone to herding, panics and boom-and-bust cycle. Appropriate macroeconomic policies and financial standards can reduce the risks if not eliminate them (Rodrik, 1998).

proper sequencing of the financial reform and macroeconomic stability as a precondition for successful financial liberalization. In the 1990s, the focus was shifted to market failures and the importance of institutional reform prior to financial liberalization. Most of developing countries, including Korea, which carried out financial liberalization and fell into financial crises, neglected the institutional reform for a safe and sound financial system. Especially, efficient supervisory framework should be in place before financial reform is implemented.

IV Summary and Conclusion

The work of McKinnon (1973) and Shaw (1973) set the basis for the debate by presenting the main arguments against the pre-reform system - called by them a "financially repressed" system - and proposing specific policy prescriptions towards a growth enhancing liberalized financial framework. A great number of such empirical studies across many different contexts, countries and time periods have been made. This paper gives a review of the literature on the financial repression and liberalization paradigm that appeared in finance theory.

Financial systems in developing countries tend to be repressed through high reserve requirements, interest rate ceilings, or foreign exchange controls, etc. Before the 1970s, policies of financial restrictions were favored, particularly in capital-scarce countries, for the purpose of the government's intervening in the determination of interest rates, control of money supply in the financial system, and the optimal allocation of savings for better investments. East Asian high-growth economies, where governments supposedly manipulated financial systems in order to promote targeted industrial expansion, supported the justification of the financial repression.

With the adverse effects of financial repression on economic growth emerging, financial liberalization was advocated as a key to financial development and growth-enhancing economic policies. Financial liberalization has been a process to move away from restricted or 'repressed' financial system. Financial liberalization includes liberalization of interest rates, elimination of heavy reserve requirements, mandate allocation of cheap credit, and reduction of the inflation rate. These arguments have been challenged by experiences of many developing countries which implemented liberalization policies and underwent devastating financial crisis. A wide literature has focused on the effect of financial liberalization.

Financial liberalization is intended to promote market efficiency and economic welfare. Financial liberalization means more freedom in the financial system. Deregulation is not a panacea for efficient financial markets. Rather, as Khoury (1990) points out, 'justifiable regulations' are essential. The experiences in many countries revealed that deregulation and liberalization without the requisite regulation resulted in excessive risk-taking and encouraged an over-accumulation of short-term external liabilities by both financial and corporate sector.[8] Before enjoying freedom, individual financial institutions also need to improve their internal control systems. Costly lessons learned from the experiences should not be a return to financial repression. Rather institutional framework, including regulatory reform and infrastructure reform, should be established for the enhancement of the economic benefits from the financial liberalization.

8) This was evidenced in the crisis-hit countries, such as Thailand and Korea, with currency and maturity mismatches, a heavy reliance on debt, and high levels of short-term foreign debt.

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금융억압과 금융자유화에 관한 선행연구고찰

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요 약

Mckinnon과 Shaw가 1973년에 개발도상국에서의 금융억압과 시장에 의한 이자율 결정 필요성에 대해 초점을 맞춘 획기적인 논문을 각각 발표하면서 개발도상국의 금융억압과 금융자유화에 대한 연구가 본격화되었다. 금융억압이 경제성장에 악영향을 준다는 연구가 대두되면서, 금융자유화가 금융발달 및 경제성장을 위한 정책의 열쇠로서 지지를 받아왔다. 이러한 주장은 금융자유화를 실시하면서 금융위기를 경험한 많은 개발도상국들의 예를 보면서 도전을 받고 있다.

금융자유화는 시장의 효율성을 향상하고 경제성장을 촉진하기 위한 도구로서 고안되었다. 그러나 많은 국가들의 예에서 보는 바와 같이 적절한 제어장치가 없는 규제완화나 자유화는 금융기관 및 기업들의 과도한 리스크 테이킹으로 이어지고 지나치게 단기위주의 자금조달을 촉진하는 계기가 된다. 그렇다고 해서 다시 금융억압의 상태로 되돌릴 수는 없으며 금융자유화로 인한 경제적 이익을 추구하기 위해서는 규제개혁 및 인프라 개선을 포함한 제도적 틀을 구축하여야 할 것이다.

핵심주제어 : 규제완화, 경제위기, 금융자유화, 규제개혁

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