

## **Financial Liberalisation and the Challenges for Policy-Makers in Developing Economies**

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### **Introduction**

The process of financial liberalisation has many implications and challenges for central banks operating in developing economies, particularly where financial markets are not very well developed. Towards the end of the 20<sup>th</sup> Century, financial liberalisation was redefined as three sets of inter-related measures: the opening-up of a country to the free flow of international finance; the removal of controls and restrictions on the functioning of domestic financial institutions so that they can become fully integrated into global financial markets; and the dissociation of the central bank's regulatory role with respect to the banking system from political influence, where this exists. Each dimension of financial liberalisation presents challenges to policy-makers, with respect to the appropriate institutional framework, the conduct of monetary policy and the maintenance of financial stability.

### **1. Institutional Framework**

The establishment of a sound institutional framework is one of the main ingredients for achieving sustainable economic growth. A very important aspect of this is the development of transparency in financial and business transactions, both within the public sector and between the public and private sector. Good examples are a clearly-defined relationship between the central bank and the executive branch of government, and

transparency in government's dealings with the private sector. In general, greater transparency allows economic agents to understand the "rules of the game" and, thereby, make more rational and efficient decisions. It also makes for an important first step to the attainment of credibility for policy-makers, since an understanding of the rationale behind policy statements engenders greater commitment by the public towards the accomplishment of the aims of such statements.

There is an increasing awareness among those in authority of the benefits of enhancing both the transparency and the credibility of public institutions. This has been reflected in the worldwide trend towards greater independence of central banks. Although it is difficult to find an exact definition of central bank independence in the literature (in fact most definitions are quite vague), one that is generally accepted is the freedom of the central bank to pursue its goals and to make decisions that are not easily reversed. Any reversal should require the approval of Parliament in the Westminster system of government, or Congress in the Federal system or the appropriate law-making entity of the country. During the 1990s, approximately twenty-five countries significantly increased the legal independence of their central banks. These included both developed and developing countries, such as France, Italy, Belgium, Spain, Venezuela, Mexico, Chile and Argentina, as well as many of the transition economies of the former Soviet Union and, more recently, Jamaica. Cukierman (1992) argues that this is even more remarkable considering that there had been very few changes in central banks' legislation in the preceding forty years.

Theoretical support for central bank independence is often attributed to the time inconsistency literature popularised by Kydland and Prescott (1977) and Barro and Gordon (1983). Simply put, time inconsistency occurs when the objective or plan currently announced by the policy-maker for some future period is no longer optimal at the time of implementation. Take for example, a policy-maker who announces a particular future inflation rate target (which is considered to be the best rate at the

time) prior to the determination of nominal wages contracts. This rate will be taken into consideration by unions and workers during the bargaining process and incorporated into wages contracts. However, once the contracts are finalised, it is optimal for a benevolent policy-maker to try to deliver a rate of inflation slightly higher than the announced rate, thereby driving down real wages and creating employment. While this is just an example of an employment motive for monetary expansion, the theory holds under any motive for monetary policy (revenue, seigniorage, financial stability or the balance of payments), unless there is a credible commitment on the part of the policy-maker.

Another reason, which appears quite intuitive and requires no deep understanding of economics, is that the effects of monetary policy on the real economy (output and prices) occur with a lag, but politicians are sometimes not very patient and can have shorter-term objectives. Therefore, while the technocrats may be less concerned with fine-tuning the economy and more focused on obtaining stable prices and output over a two or three-year period, the average politician and market players as well are more concerned with the day-to-day operations of the economy and may be inclined to reach for short-term gains at the expense of more significant future benefits. This is arguably the main reason why many governments are willing to enact laws to insulate their central banks from the political process.

From the central banker's point of view, credibility is perhaps the greatest rationale for independence. It has been argued by academics that the more credible the central bank, the lower the social costs of fighting inflation (see, for example, Bull, 1994; Taylor, 1983). However, there appears to be no empirical evidence to support this hypothesis of lower social cost. Nevertheless, Allan Blinder, former Vice Chairman of the United States Federal Reserve Board, commented that practical central bankers view credibility as a "precious asset not to be squandered" (Blinder, 2000). He defines credibility to mean that the central bank's pre-announcements are believed. Such

credibility is not normally achieved by incentive-compatible schemes or by rigid pre-commitment, but is assiduously built up by a history of matching actions to words. A central bank that consistently does what it says it will do, will acquire credibility almost regardless of the institutional structure (Blinder, 2000).

Numerous analyses have lent empirical support for the independence hypothesis by providing evidence of a negative correlation between measured indices of central bank independence and the level of inflation in developed countries. However, except for countries with high inflation, no such relationship appears to exist for developing countries. Nevertheless, Cukierman (1998) concluded that for developing economies there exists a positive association between growth and central bank independence. He further stated that there is a beneficial effect on growth directly resulting from greater independence. However, the indices of central bank independence employed in his and other studies may be positively correlated with generally stable economic policies, which were conducive to better economic performance rather than with central bank independence *per se*. In other words, correlation does not necessarily imply causation. Hence, the empirical evidence is not conclusive and, thus, the optimal degree and form of central bank independence in developing countries remain subjects of debate.

Significant controversy remains as to the optimal conduct of monetary policy; that is, the appropriate goals of, and ways to implement, monetary policy. As indicated earlier, the idea of central bank independence is meant to insulate the central bank from short-term biases of Government. At issue is the delegation of some aspects of the responsibility for monetary policy to an independent agent. In principle, the delegation of responsibilities and, hence, the degree of independence may refer to any aspect and level of policy. Central bankers may bear responsibility for choosing objectives of monetary policy, or they may agree on predetermined goals and be allowed to use the monetary instruments at their disposal to meet these targets. In

other words, central bank independence may come in very different forms and degrees.

However, it does not follow that institutional arrangements that maximise central bank independence should be expected unambiguously to enhance economic efficiency and welfare. For one thing, the quest for sound money (zero or near-zero inflation) cannot ignore the potential side-effects that may come with it. These primarily relate to the multi-dimensionality of central banking and the coordination between policy-makers when overall economic policy is separated into autonomous decision-making units. In addition, at least when the longer-term viability of a monetary structure in a democracy is at issue, due concern for democratic values is pertinent.

Keynes (1932), generally regarded as the architect of macroeconomic interventionism and discretionary demand management, nevertheless saw considerable scope for central bank independence (of a particular form and degree). He viewed central bank independence as an appropriate means to secure the "utmost decentralisation in the handling of expert controls", and generally regarded the independence and prestige of the Bank of England as assets. But Keynes envisaged a specific form and degree of central bank independence, one that was based upon checks and balances, which would constrain the technicians' scope for discretion, and establish ultimate – though indirect – democratic control over monetary policy.

Expressed in modern economic jargon, Keynes favoured instrument, but not goal independence based on indirect democratic control and accountability. Legislated rules that hindered the operational powers of the central bank were undesirable, in his view. Instead, the technicians' overall scope for discretion would be constrained by goal dependence, stringent transparency requirements, and accountability. However, the central bank technicians would be neither elected by, nor directly accountable to, the public. In this arrangement, the line of accountability for performance in the government's remit would run from the central bank to the government of the day, which in turn would be accountable to the people. Some

commentators argue that central bank independence implies that the central bank is obligated to explain its actions to the public. Blinder (2000) states that independence and accountability are symbiotic, not in conflict, with the latter legitimising the former. Thus, the preferred arrangement is for central bank independence to be always counterbalanced by an appropriate degree of transparency and accountability to the delegating executive.

Therefore, one challenge for policy-makers in the region is to ensure that there exists a balance between central bank independence, transparency and accountability. Blinder (2000) asserts that, at the minimum, this would require laws to be enacted to ensure that the central bank's actions are insulated from political influences so there is freedom to decide how best to pursue its legislated objectives. He contends that even when there is *de facto* operational independence, it is desirable that the legislation should make such autonomy explicit. Nevertheless, regardless of whether independence is explicitly stated or arises from custom, the central bank must be accountable to the executive branch of government for its actions, since these can have profound effects on the lives of ordinary people. A central bank should be required by law to explain what it is doing, why it is doing so and what it expects to accomplish by these actions. This can be done through periodic reporting of monetary policy decisions backed by thorough economic analysis, to the executive branch and to the public.

## **2. Monetary Policy, Capital Controls and Liberalisation**

The primary operational goal of monetary policy in the microstates of the Caribbean has been to maintain adequate foreign reserves and exchange rate stability. Four countries in the region, including Barbados, currently operate a fixed exchange rate system, with the domestic currency pegged to the United States (US) dollar. In the context of an increasingly liberalised financial environment, the issue of the ability or even

the desire of the central bank to maintain the fixed rate becomes more crucial. It has frequently been debated in the literature that no government can maintain a fixed exchange rate, free capital mobility, and an independent monetary policy; one of these three options must give. This is known as the "incompatible trinity". For instance, if the authorities want to maintain the nominal exchange rate as an anchor and conduct monetary policy, then this can only be achieved at the expense of capital controls. Those wishing to maintain the nominal anchor and capital and exchange controls, must be contented to allow interest rates to be market-driven and forfeit monetary policy. In other words, under a fixed exchange rate regime, the policy-maker can choose either to liberalise the capital account or maintain the ability to conduct monetary policy, but cannot do both simultaneously. Nevertheless, proponents of capital account liberalisation contend that openness to beneficial international capital flows, especially foreign direct investment, as opposed to short-term portfolios investments, can contribute to the development of small, open economies. This is useful in those economies that do not usually generate sufficient domestic savings to support potentially viable investment projects and infrastructure needs. Some analysts argue that a more open capital account can also assist domestic savers in diversifying their portfolios and, in cases of large shocks, there is likely to be a reduced impact on domestic residents holding some foreign assets. There is, however, the risk that capital outflows may be permanent. In foreign exchange-dependent economies, such losses can be catastrophic.

A review of the recent literature also reveals that the opening-up of the capital account has its pros and cons, even for large economies. Klein and Olivei (1999), for example, emphasised two advantages for capital account liberalisation. One, open capital markets enhance welfare and increase efficiency through better resource allocation and risk diversification opportunities. The other advantage is that foreign borrowing and lending can contribute to financial sector development. As the financial system develops, the problem of

asymmetric information is mitigated, transaction costs are reduced, and there is a more efficient allocation of resources. On the other hand, in a world with imperfect information and financial markets, free capital mobility is likely to amplify existing distortions, create moral hazard, encourage excessive risk-taking and generate crises. Eichengreen and Wyplosz (1996) and Frankel (1999) point out that most foreign exchange transactions have little to do with economic fundamentals and can actually reduce social welfare.

Empirically, the evidence does not support capital account liberalisation as a significant contributor to growth in developing economies. Klein and Olivei (1999) further showed that in the case of Latin American countries, capital account liberalisation had no significant effect in terms of financial deepening during 1986-1995. This contrasts with the case of the OECD countries, where capital account liberalisation positively affected financial deepening and economic growth during the same period. Similarly, Belford and Greenidge (2002) found no evidence of a link between capital account liberalisation and economic growth for Caribbean countries. Overall, therefore, the evidence suggests that financial liberalisation may be a complement rather than a precursor to economic growth.

Indeed, even as Barbados continues to liberalise its capital account as it seeks to comply with the requirements of Protocol II under the Caribbean Community Single Market and Economy initiative, the intellectual tide has turned, granting the whole issue of capital controls a new academic respectability. Nadal-De Simone and Sorsa (1999) have identified three reasons why capital controls remain useful. Firstly, capital controls can be used as a way to gain monetary independence, as they allow monetary policy to create a wedge between domestic and foreign interest rates. The efficacy of this is significantly reduced when markets are open and there exists a high degree of substitutability between domestic and foreign currency-denominated assets. Secondly, capital controls can be justified as a tool to improve social welfare. For example, asymmetric information often gives rise to distortions in the competitive



equilibrium by making private investors prone to noise trading, inducing herd behaviour, and amplifying a boom-and-bust cycle. Implicit government guarantees of banks' external liabilities under asymmetric information also generate welfare-reducing results. Thirdly, capital controls can help to sustain a good equilibrium or to move the economy to a relatively higher welfare equilibrium, from a sub-optimal equilibrium dominated by highly volatile capital flows.

A key challenge for regional central bankers is to capture the benefits that come from openness to financial flows, while avoiding many of the risks associated with increased volatility caused by sharp changes in the direction of those flows. Developing countries should limit short-term capital inflows if they believe that the risk of volatility outweighs the benefits, or that these flows are likely to place too great a strain on the balance sheets of private sector entities. Large short-term capital flows into countries with underdeveloped financial infrastructures can have detrimental results; Argentina is the latest example of this. A general conclusion that is adopted in the literature is that the benefits of an open capital account are determined by the initial level of development and sophistication of the domestic financial market; for countries in the early stages of development, such opening can have negative effects.

### **3. Financial Stability**

The financial system plays a vital role in the growth of developing countries. For one, it helps to convert financial savings into real savings by ensuring that the surplus funds of savers reach those with the most productive and profitable investment opportunities, which would in turn lead to economic growth. The more efficient the financial system, the better should be the process of re-allocation of resources in the economy. One school of thought argues that the one way to improve efficiency in the financial system is through the removal

of all restrictions, interest rates and otherwise, on the operations of banks and other financial institutions, and also to allow foreign banks to be able to compete in the domestic market.

The downside to this is that if financial institutions fail, the ripple effect on the whole system can be devastating, especially in a small, open economy. The failure of the financial system often leads to huge downturns in economic activity, as in the case of the Japanese slump in the 1990s and the recent financial crisis in the Asian economies. Empirical studies suggest that the financial system is particularly vulnerable to instability in periods following deregulation, principally because of increased competition for market share amongst financial institutions, which can often lead to excessive risk-taking. What is not usually highlighted in the literature is that the ability of the central bank to act as a lender of last resort is limited to debt denominated in a country's own currency. Therefore, when countries finance domestic projects with foreign denominated debt, they lose the stabilising potential of the central banks' lender of last resort power and confront a far more challenging and potentially unstable environment.

Again, one of the reasons for Argentina's inability to effectively solve many of its debt problems is that most of the huge private sector debt is denominated in foreign currencies and this limits the actions of its central bank. The Asian financial crisis is another example of financial distress that started in the banking system. Until the crisis, those countries attracted almost half the flows to developing countries. Much of this borrowing, by both financial and non-financial institutions, was largely unhedged and short-term, leaving them highly vulnerable to exchange rate and maturity mismatch risks. Although the inflows did permit faster economic growth, domestic banks were also allowed to expand credit rapidly, supporting imprudent investments and unrealistic increases in asset prices. This build-up of excessive external indebtedness began to erode international confidence in these countries and the ensuing reversal in capital flows exposed the inadequacies in the financial structures. The high level of unhedged foreign

borrowing by banks and corporations, weak domestic supervision and regulatory capacities, and political incentives that led to the misallocation of borrowed funds to unproductive investments, allowed the problems to grow and fester.

One of the very important lessons that came out of the Asian crisis is that the management of the macro consequences of large capital inflows can be particularly challenging for the authorities. Even though the Asian central banks sterilised a large part of the inflows (approximately one-fifth during 1994 to 1996) the resulting high domestic interest rates continued to be an incentive for external borrowing. Many commentators felt that the liberalisation of the capital account before adequate measures were in place to strengthen the domestic system was a major factor in the crisis.

Therefore, another significant challenge for central banks in small, open economies is to ensure that they strengthen their capacity for maintaining financial system stability, while pursuing the benefits of financial liberalisation. This would depend on the existence of a well-regulated and supervised environment and would require an appreciation of the issues by the financial institutions which, anticipate, manage and control risks, as part of the framework of prudential supervision. In such a system, both the local operations of foreign banks, as well as domestically-owned banks, are run prudently and critical issues such as the appropriateness of the existing legal framework and the power of regulators to effectively monitor financial institutions, as well as sanction inappropriate behaviour, are in place. The bank supervisor possesses the power to obtain information from individual financial institutions along with the capacity to act in times of crisis. Minimum credit standards for banks making loans are enforced, and there is some capacity to ensure that banks comply with these standards.

It is generally acknowledged that the issue of continuous upgrading in skills to meet the needs of a more complex financial system is also crucial.

## Conclusion

Credibility is very important in a liberalised environment, where financial flows have the potential to be extremely volatile, and economic agents are highly dependent on the central bank for accurate, timely and unbiased economic assessments and forecasts. Such credibility can be significantly enhanced by increasing the degree of independence vested in central banks. However, greater autonomy, must be balanced with accountability. It is argued that ideally, both the degree of independence and level of accountability should be codified in law.

With respect to capital account liberalisation policy-makers still wish to take advantage of the benefits that come from increased financial flows while limiting the potential disruptive effects of highly volatile capital flows. Indeed, in the initial stages of the opening-up of the capital account, there is a high probability of a surge in capital outflows by domestic residents and this can place a strain on the domestic resources.

Financial liberalisation also requires enhanced regulation of the financial system. Improvements include enhancing the legal framework under which central banks operate, and continued skills development with regard to supervision of the financial system.

The Caribbean stands to benefit from capital market integration, especially among the members of CARICOM. However, it is necessary that the region ensures that it is equipped to deal with the issues that can, and will arise, from financial liberalisation.

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