

**FINANCIAL LIBERALIZATION STRATEGIES
- SOME IMPORTANT CONSIDERATIONS**

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Introduction

In recent times a number of regional economies have found themselves grappling with the issue of financial liberalization. Regional economies entering into structural adjustment programmes with the assistance of the International Monetary Fund (IMF) have committed themselves to reforming their financial systems. It was argued and the evidence seems to suggest that the heavily regulated financial systems of most developing countries retard the process of financial deepening and hampered the development process in these countries. But financial reform programmes undertaken with a blind adherence to the principles of free market, without a clear appreciation of the market failures in finance, can only lead to financial crisis. These market failures are arguably greater in developing countries.

This is evident from the experience of a number of developing countries which have undertaken financial reform programmes over the last two decades, aimed at allowing market forces to play a greater role in the financial system. The process of financial reform in many of these developing countries has not produced a successful transition to more efficient and market-oriented financial systems. The experiences of these countries have shown that there are some important considerations. In some developing countries banking systems liberalized without little attention to their initial condition encountered subsequent financial distress. The experiences of these countries can be contrasted with those of countries which sought first to

stabilize their economies and were relatively successful with their financial liberalization. These experiences provide us with a set of strategies for successful liberalization of the financial system (Delano Villanueva and Abbas Mirakhor, 1990).

Regional economies, like all developing countries, are concerned with the acceleration of growth for which it is accepted that finance is critical, so that the issue of financial liberalization is an important one. Policy-makers and advisors need to be fully cognizant of what is involved if they are to avoid a potentially damaging financial crisis. One must appreciate the limitations of the free market principle in the area of finance and understand the important role that macroeconomic instability and banking supervision and regulation play in the success of financial liberalization. This paper seeks to inform on the current thinking on these issues. The first section reviews the literature on financial liberalization that draws on the experiences of a number of developing countries to highlight what the important considerations are and make suggestions for strategies for financial liberalization. The lessons these experiences provide would be helpful in the design of financial liberalization programmes in the region.

Financial Liberalization Strategies

McKinnon and Shaw popularized the phrase financial repression to describe policies that distort domestic capital markets - for example, ceilings on interest rates, high reserve

requirements, and selective credit ceilings. In the financially repressed economy real deposit and lending rates are often negative, with adverse consequences for the development of the financial system and for savings and investment generally. The standard thinking is to establish positive real rates of interest on deposits and loans by among other measures, eliminating interest rate ceilings and direct credit allocations and pursuing price stabilizing through appropriate macroeconomic and structural policies. It was expected that the once this was done the true scarcity price of capital could then be seen by savers and investors, leading to a reduced dispersion in profit-rates among different economic sectors, improved allocative efficiency and higher output growth. The experience of some countries with such policies has been less than successful which has prompted some economists to question the traditional approach to interest rate policy and financial liberalization.

The accepted view of the time was and it still is today that free markets function better to allocate scarce resources. While it is evident (for most cases) in the commodity market that the price mechanism results in a more efficient allocation of resources, problems arise when this free market notion is applied to the market for bank credit. While the market clearing solution might be optimal and efficient in the commodity market in the market for bank credit it is neither optimal nor efficient. This is because the market for bank credit differs fundamentally from the market for commodities. In the commodity market the rate of return is exactly equal to the price of the commodity¹. In the market for bank credit the interest

¹Assuming that transaction costs are minimal. Where there are costs related to the exchange of goods and services and these costs are significant firms are created which supersede the market and internalize transactions at a lower cost (see Coase(1937) and Williamson(1975, 1985 and 1986)).

rate charged on the loans differs from the expected return to the bank, which is the product of the interest rate and the repayment probability of borrowers. This probability is always less than 100 percent because of asymmetric information between banks and borrowers, defined as a situation where borrowers have more information about their default risk than do banks.

The probability of repayment itself is negatively related to the interest rate charged; that is, as the interest rate on the loan increases, the probability of repayment will decline. Beyond a certain interest rate level, the repayment probability would fall by more than the increase in the interest rate, and the expected return to the bank actually decline with further increases in the interest rates. This feature of bank credit shows the limits to which interest rates can be raised. This means that when faced with excess demand for loans properly regulated banks even in competitive markets do limit lending to borrowers and charge an interest rate below the level that clears the market. In this situation the market clearing is neither optimal or efficient for the bank, because at this rate the bank's expected profit is less than at the credit rationing level, since borrowers with higher repayment probabilities tend to drop out and are replaced by those with high default risks. Efficiency prevails at the credit rationing rate. Credit rationing is characteristic of any market where imperfect or asymmetric information is inherently present².

²The research of Stiglitz and Weiss (1981) showed that bank profits fall beyond a certain rate of interest because firstly, the more credit-worthy borrowers would be discouraged (adverse selection effect) and secondly, other borrowers would be induced to choose projects with a higher probability of default, because riskier projects are associated with higher expected profits (the adverse incentive effect).

This outcome is beneficial to all concerned but it is heavily dependent on strong bank supervision and regulation systems. If the system of prudential regulation is weak either in design or enforcement or both, such that levels of bank capital (in relation to risk assets) and provisions for loan losses are grossly inadequate and there is free deposit insurance either implicit or explicit - where the regulatory authorities stand ready to prevent a collapse of the banking system at little or no cost to the banks themselves- the result is that unsound banking practices go unabated (penalties might exist but they are not enforced). Consequently, banks have an incentive to provide high-interest rate, and high risk loans. Why? Because the bank can keep extraordinary profits in good times without having to pay the full cost of large losses in bad times.

Another important consideration in the credit market is macroeconomic stability (defined as a situation where large changes in the price of goods and factors of production lead to increase variance and positive covariances in return on investment projects, that is many or all investment projects would be affected adversely (favourable) by poor (good) macroeconomic performance). Any potential moral hazard that may be induced by economic instability is effectively contained by strict official supervision and prudential regulation requiring sufficient reserves against loan losses. The higher reserves against defaults required by the regulatory authorities in response to macroeconomic instability would lower the expected profit function of the bank at given levels of the loan interest rate. The response of the bank is to lower interest rates on loans further and to ration credit more severely. This is why low and stable bank lending rates can be observed in countries where bank supervision and

prudential regulation are strong and effective.

From the above it is evident that macroeconomic stability and strong bank supervision and prudential regulation are important in the market for bank credit. In the absence of these a collapse of the financial system is highly likely. It was the failure of a number of developing countries to consider the importance of these factors in the financial market, as they sought to liberalize their heavily regulated financial systems - which many felt was responsible for retarding the process of financial deepening and hampering the development process in these countries - that led to the financial crisis which they experienced. While it was accepted that these financial systems needed liberalizing, there was no agreement on the best strategy for achieving these goals.

Two decades of experience of developing countries with such policies has highlighted the importance of strong banking supervision and prudential regulation and economic stability in the process and provides a set of strategies for successful liberalization of the financial system.

Experiences with Financial Reform in developing countries

Delano Villanueva and Abbas Mirakhor(1991) examined the experiences of a number of developing countries with different liberalization strategies. The writers noted that while

there is no set mechanism for attaining positive real interest rates, the experiences of many developing countries point to the importance of the initial state of the economy, in particular the financial position of the private sector and the quality of prudential regulations over the financial system.

The experiences of Chile, Argentina and Uruguay were well documented by Corbo and de Melo (1985). In these three countries there was severe macroeconomic imbalances existent when interest rate liberalization and financial reform policies were implemented. The environment was one of low rates of growth of output, savings and investment. Inflation rates were high and the external balance was low in relation to national output. The policy approach was an abrupt removal of interest rate ceilings and credit controls, coupled with a relaxation of government supervision over a monopolistic banking structure and virtually free deposit insurance-either explicitly or implicitly.

The outcome was an immediate run-up in real interest rates in the banking system and increasing uncertainty about the cost of borrowing with the volatility in interest rates as the interaction between unstable macroeconomic environment(UM) and inadequate banking supervision(IS) intensified moral hazard in the banking systems. Banks raised lending rates to higher and riskier levels in the expectations that deposit insurance would cover any unusual losses (and it did). The higher interest rates forced many low risk firms out of the market, causing the quality of bank loans to suffer. The combination of deposit insurance,

inadequate supervision and an unstable macroeconomic environment allowed banks to take excessive risks by providing credits to firms with high default probabilities. Non-performing loans rapidly developed and many firms were forced into bankruptcy.

In Chile the number of bankruptcies rose from two corporate enterprises in 1978 to 75 in 1982 and from 75 general establishments in 1974 to 810 by 1982. Loan defaulters represented nearly 19% of loan portfolios by 1983, compared with only 2% in 1981. (See Behrens (1985) and Ludris (1985)).

In Argentina bad and doubtful debt as a ratio of total bank loans rose from less than 2% in 1975 to over 9% in 1980. The trend was similar in Uruguay (Cho and Khatkhate (1989)).

In all three countries, business firms increased their leverage during the financial liberalization period. Increasing indebtedness at first did not pose any problem; many firms generated sufficient operating earnings to cover real interest rates of up to 25% and still showed positive profits. When real interest rates soared to the 40% range, however, rising indebtedness reflected distress borrowing just to pay interest and many firms eventually went under (See Corbo and de Melo (1985)).

Cho and Khatkhate (1989) and Atiyas (1989) documented the experience with financial reform in the Philippines and Turkey and found much the same pattern of events that was observed in the Latin-American countries - macroeconomic instability interacting with severe

moral hazard. According to these studies in both countries interest rate liberalization was carried out in a period when the business sector's financial position was fragile. The writers argued that the deterioration in the quality of bank portfolios in these countries could be traced to the high levels of real lending interest rates in relation to the marginal productivity of capital, combined with relatively high gearing ratios of the corporate sector.

There was a further decline in profitability following financial liberalization. In the case of Turkey, Atiyas (1989, p. 30) concluded that an inadequate regulatory framework allowed insolvent banks to avoid bankruptcy by offering high rates to depositors, using mobilized funds to refinance non-performing loans. At the same time, firms that made losses increased their leverage, even though the cost of borrowing had gone up.

The Malaysia's story was entirely different. Long periods of economic stability and a strong tradition of banking supervision enabled the government in the late 1981 to liberalize interest rates fully. The process took less than three years without the adverse consequences of an immediate increase in interest rates. Positive real levels were achieved consistent with enhanced credit flows to the borrowing sector at stable interest rates and the banking system's generally sound portfolio.

Cho and Khatkhate (1989) also studied the experience of Korea, Sri Lanka and Indonesia in detail. These countries suffered macroeconomic imbalances in varying degrees on the eve of financial liberalization. They undertook financial reform in the context of overall liberaliza-

tion and generally strong adjustment programmes. In addition, the system of banking examination and supervision either remained intact or was considerably strengthened.

As a result positive real interest rates were achieved and maintained through credible macroeconomic policies that successfully reduced inflation to low levels. While stabilizing the economy and boosting effective banking supervision, these countries also made incremental adjustment in regulating nominal interest rates to maintain positive real level. Positive real interest rates stimulated bank deposits, thereby increasing the amount of credit available to productive firms.

Cho and Khatkhate (1989) describe the Korean approach to the deregulation of interest rates as pragmatic, noting that lending interest rates were quickly adjusted downward when the financial position of the corporate sector turned out to be affected adversely. Such concern for the financial vulnerability of the corporate sector may be interpreted as a policy of not undermining implicit contracts between banks and corporate borrowers. At the same time, a strengthened system of examination and supervision ensured that banks did not take excessive risks and that bankruptcy would be costly. Only later, when macroeconomic stability was firmly established and a permanently effective system of prudential regulations was in place and enforced, did the government fully liberalize interest rate in financial markets. By this time, the interest rate liberalization introduced no shock, as evidenced by lower inflation rates, stable interest rates and firmly established implicit contracts.

Drawing from the experiences of these countries Villanueva and Mirakhor identified the following financial reform policy strategies depending on whether the initial macroeconomic environment is stable (SM) or unstable (UM), and whether bank supervision is adequate (AS) or inadequate (IS). In a situation where macroeconomic instability interacts with weak banking supervision (UM/IS), or in which the potential interaction between economic instability and moral hazard (the decision of banks to undertake risky lending in the presence of deposit insurance) is largely offset by effective banking supervision (UM/AS) or in which the economy is stable but moral hazard in banks presents a potential problem because of inadequate supervision (SM/IS) then macroeconomic stabilization and stringent bank supervision must occur before complete interest rate liberalization. In a situation where the economy is stable and the banking system adequately supervised (SM/AS), interest rates can be liberalized simultaneously while maintaining economic stability and supervision. Interest rate liberalization can only be successful when pursued in this manner and this is supported by the evidence.

Consideration was also given to the level of inflation present in the country. In low inflation rate countries with strong banking supervision, economic stability, long periods of price stability, achieved largely through sound and credible macroeconomic policies, the recommendation was for full liberalization of interest rates. In the case of low inflation rate countries that have already liberalized their interest rates, it was suggested that they maintain interest rate stability and continually improve banking supervision.

In high inflation countries a strong credible stabilization program and equally strong set of prudential regulations are usually the best initial policy measures, with the removal of interest rate regulations being postponed until the monetary situation has been stabilized and banking supervision strengthened. Successful countries combine price stability with flexible, even if regulated interest rates. When interest rates are raised, the increases must be pre-announced so that the existing loan contracts can be renegotiated.

A high inflation country that has already deregulated interest rates can strengthen the system of prudential controls over the banking sector and implement a strong and credible stabilization program. If interest rates appear out of control it may be necessary to go back to regulating nominal interest rates and maintain them at positive real levels. Policies aimed at price stability are crucial.

Villanueva and Mirakhor also made a number of recommendations for strengthening the banking system. Besides the standard provision for capital adequacy and reserves against loan losses, they suggested reforming deposit insurance by imposing a bankruptcy penalty on bank activity or an actuarial fair insurance premium on bank liabilities, in direct proportion to the riskiness of the portfolio.

Conclusion

This analysis provides guidelines on the best possible strategy for liberalizing financial

systems in any environment. The experience tells us that macroeconomic stability and adequate prudential regulation are critical to achieving successful financial liberalization. In recent times a number of countries in the region have undertaken to reform their financial systems. It is strongly recommended that they carefully assess their initial macroeconomic environment and the adequacy of their prudential regulation before they undertake to fully liberalize their financial systems, if they are to avoid a damaging financial crisis.

Recent events with B.C.C.I., which had branches in some of the countries of the region, has brought home to the region just how important it is that they make provisions for deposit insurance and ensure that the supervisory and regulatory framework is adequate. In recent times both Barbados and Jamaica have been actively working on improving their supervisory and regulatory framework and are now considering making provisions for deposit insurance (a number of other regional countries are doing the same)³. This represents a step in the right direction. It should also be borne in mind that as our financial systems evolve so to must the supervisory and regulatory under which financial system operates.

Another important issue regarding financial liberalization which the region must consider is the implications for monetary policy of financial liberalization. Tseng and Corker(1991) noted that financial liberalization significantly changes the environment in which monetary

³In 1992 a study of the bank supervisory practice was undertaken by the International Monetary Fund, at the request of the Governors of the Central Banks of the Caribbean in order to determine how convergence of bank supervisory practices could best be achieved. These efforts are currently ongoing and represents a step in the direction towards better bank supervisory practices in the region.

policy operates. Financial liberalization can create new complexities in the design of monetary policy.

The channels through which monetary policy operate depend on the financial structure of an economy- the maturity and depth of financial markets, the flexibility of interest rates and exchange rates, and the external capital mobility. In most developing countries financial systems are underdeveloped, typically characterized by interest rate regulations, domestic credit controls, the segmentation of financial markets, an absence of capital and money markets, and restrictions on international capital flows. In this environment, monetary policy work mainly by directly affecting the availability of credit. Monetary policy in this environment takes the form of credit rationing, changes in reserves and liquidity requirements, or reduced bank's access to rediscount facilities. Financial liberalization and reforms create problems for the conduct of monetary policy. Developments in the financial market alter the channels of monetary policy, affecting the relationship between money demand and incomes and interest rates. Financial liberalization might cause onetime shifts in money velocity or changes in the responsiveness of money demand to changes in incomes and interest rates. In addition, new influences may have become important determinants of money demand after liberalization and the precision with which monetary developments can be predicted may have been altered (Wanda Tseng and Robert Corker, 1991).

In addition, as small developing countries operating under balance of payment constraints, with underdeveloped financial systems regional economies must weight the benefits of full

liberalization, successfully achieved against the loss of these instruments of monetary policy. Regional economies are susceptible to BOP crisis which usually arise as a result of external shocks and may need to defend their BOP. At such times it becomes necessary to harness all the available instruments of fiscal and monetary policy (in an underdeveloped financial system these instruments are limited)- credit controls, interest rate ceilings and reserve requirements- to bring about a reduction in aggregate demand, thereby reducing the pressure on the BOP. This also suggests the need to further develop our financial systems prior to financial liberalization.

These are just a few of the issues which countries in the region must consider in liberalizing their financial systems. These issues need to be properly researched and should involve detailed studies of the financial systems in the region, with a view to assess the likely implications of liberalizing these systems and to make recommendations on appropriate strategies for the various countries.

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