FINANCIAL LIBERALIZATION:
THE EXPERIENCE OF DEVELOPING COUNTRIES

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INTRODUCTION

Theoretical models predict that financial liberalization can promote economic development, by increasing saving, investment, and the productivity of capital. However, much of the evidence from financial liberalization episodes from both developing and developed economies points to significant destabilizing consequences, including incidents of severe financial crises. In this paper we attempt to explain and bridge the gap between the theory and the evidence, focusing our attention on the factors that contributed to this divergence. We argue that the financial liberalization hypothesis crucially depends on the assumptions of perfect information and perfect competition. In a world with market and information imperfections it implicitly assumes that the institutional framework of an economy is sufficiently strong to address their distortions. Furthermore, the liberalization thesis pays scant attention to stock markets, which have been an important source of instability, especially in emerging market economies. In view of these unrealistic assumptions and omissions, the implementation of financial liberalization programs, especially in developing countries with weak institutions, has created many more problems than it has solved. We, therefore, argue that a much more cautious stance should be adopted in the future.

We begin with an outline of the main tenets of the financial liberalization thesis, followed by a brief discussion of how recent advances in new growth theory can shed further light on the theoretical benefits of financial liberalization. We then discuss the key implicit assumptions and omissions of the financial liberalization thesis and the adverse evidence from the experience of the 1970s, 1980s and the more recent South East Asian crises in the 1990s. We also examine the role of capital flows, in the light of recent financial crises. This excursion leads conveniently to an outline and examination of the revisions that were made to the liberalization thesis as a result of these experiences. We discuss recommendations for the future in the concluding section.

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FINANCIAL LIBERALIZATION: THEORY AND POLICY IMPLICATIONS

The McKinnon/Shaw Approach

Government intervention in the financial system, including the setting of interest rates, the imposition of high reserve requirements and quantitative restrictions on credit allocation, was a fairly common practice in the 1960s and 1970s, especially in developing countries. That practice was challenged initially by Goldsmith [1969] and later by McKinnon [1973] and Shaw [1973], who saw it as being responsible for low savings, credit rationing and low investment. They dubbed it "financial repression." As an antidote, the authors proposed the financial liberalization thesis, which essentially involved freeing financial markets from government intervention and setting the market determines the price and allocation of credit.

Goldsmith [1969] argued that the main transmission channel of financial repression was through the marginal productivity of capital. In that case, when the interest rate is lower than the equilibrium rate of interest, high quality projects do not undertakes. McKinnon [1973] and Shaw [1973] stressed two other channels: first, financial repression affects how efficiently savings are allocated to investment; and second, through its effect on the return to savings, it also affects the equilibrium level of savings and investment. In this framework, therefore, investment suffers not only in quantity but also in quality terms, since bankers do not ration the available funds according to the marginal productivity of investment projects but according to their own discretion. Under these conditions the financial sector is likely to stagnate. The low return on bank deposits encourages savers to hold their savings in the form of unproductive assets such as land, rather than the potentially productive bank deposits. Similarly, high reserve requirements restrict the supply of bank lending even further while directed credit programs distort the allocation of credit since political priorities are, in general, not determined by the marginal productivity of different types of capital.

The policy implications of this analysis are quite straightforward: remove interest rate ceilings, reduce reserve requirements and abolish directed credit programs. In short, liberalize financial markets and let the free market determine the allocation of credit. With the real rate of interest adjusting to its equilibrium level, low-yielding investment projects would be eliminated, so that the overall efficiency of investment would be enhanced. Also, as the real rate of interest increases, saving and the total real supply of credit increase, inducing a higher volume of investment. Economic development would, therefore, be stimulated not only through the increased investment but also due to an increase in the average productivity of capital. Moreover, the effects of lower reserve requirements reinforce the effects of higher saving on the supply of bank lending, while the abolition of directed credit programs would lead to an even more efficient allocation of credit thereby further stimulating the average productivity of capital.

Endogenous Growth

The McKinnon-Shaw type models predict developments that led to endogenous growth theories. As a result, while financial liberalization arguments may explain how financial development affects saving, investment, and the level of income, they are silent on its effects on the steady-state rate of growth, which is determined by exogenous technical progress. New growth theory suggests that there can be self-sustaining growth without exogenous technical progress. While individual firms may be faced with declining returns to sales their efficiency may depend on the aggregate capital stock. Capital accumulation may trigger a learning process and could, therefore, be considered as a public good that raises overall efficiency in the economy.

Still, results broadly similar to financial liberalization are also evident in the literature on endogenous growth. In such models financial development can affect growth not only by raising the saving rate but also by raising the amount of saving funneled to investment and/or raising the social marginal productivity of capital (Aghion, 1990). The first two channels are quite obvious: if deepening leads to a higher rate of investment, the equilibrium growth rate rises, a proposition which emanates from one of the most important properties of endogenous growth models, that the rate of investment influences positively the growth rate of output. The third channel could be the result of the financial system's ability to (1) evaluate alternative investment projects, or (2) to induce individuals to invest in riskier but more productive technologies by providing risk sharing opportunities. Banks accept high liquidity deposits and invest them in illiquid and productive projects. Stock markets, by allowing portfolio diversification, reduce rate-of-return risk. These two considerations enhance agents' willingness to save, which in turn facilitates investment in illiquid and more productive technologies (Benvenega and Smith, 1991; Greenwood and Jovanovic, 1990).

With few exceptions (Easterly, 1993), the endogenous growth literature views government intervention in the financial system as distorting and predicts that it has a negative effect on the equilibrium growth rate. Increasing taxes on financial intermediaries is seen as equivalent to taxes on innovation activity, which lowers the equilibrium growth rate (King and Levine, 1993). Imposing credit ceilings reduces individual incentives to invest in innovation activity, which retards the growth of the economy. However, the endogenous growth theory has not yet produced models that directly address the impact of financial liberalization policies. It is, therefore, premature to draw any conclusions regarding the effects of such policies in a framework in which the existence of intermediaries themselves is based on imperfect information and missing markets (but see, however, the relevant collection of papers in Hermene and Lensink [1996]).

KEY ASSUMPTIONS AND OMISSIONS

The financial liberalization thesis contains three implicit assumptions that are unlikely to be met in reality. They are as follows: perfect information, profit-maximizing competitive behavior by commercial banks, and institution-free analysis. It also
pays little attention to the role for stock markets. These assumptions and omission have a number of implications that we discuss below.

**Perfect Information**

Imperfect information is endemic in financial markets. This is because information is usually distributed unequally, or asymmetrically, between the two parties of any financial transaction. For example, borrowers are normally better informed about their own actions or intentions than the lenders they approach for funds. Asymmetric information leads to two types of problem: adverse selection and moral hazard (Stiglitz and Weiss, 1981).

Adverse selection occurs before a financial transaction takes place and refers to the situation where the individuals that are attracted to the transaction are those who are more likely to produce an adverse outcome for the other party. Specifically, in the market for loans the problem refers to borrowers who use the loan to engage in excessively risky investments, without the lender's knowledge. Adverse selection is particularly acute when interest rates are high or rising. In such cases, many "scrupulous" borrowers, who are not prepared to take excessive risks, no longer seek to obtain credit. This leaves a greater proportion of "high" risk borrowers in the borrowing pool. Thus, the probability of default that a lender faces inevitably increases substantially.

Moral hazard describes a situation where the borrower acts "immorally," that is, in a way that is not in the best interest of the lender. An example would be a borrower engaging in a project different from the one approved by the lender. Moral hazard may contribute to increasing the cost of borrowing, as even prudent borrowers may be encouraged to take on excessive risks in order to be able to pay higher interest rates.

Adverse selection and moral hazard are also faced by depositors, since they too can be considered to be lenders with the banks as borrowers. In markets without adequate banking supervision, banks themselves may take on excessive risks. However, while depositors may to some extent be protected by deposit insurance, implicit or explicit, the problem does not go away. The burden of excessive risk taken by banks is just shifted to the taxpayer, who will be called to foot the bill in case of bank failures. Under such circumstances the banks are, in essence, beneficiaries of an unfair bet against the government: if the projects they have financed do well they make a lot of profit; if they do badly they rely on the government to rescue them. This type of moral hazard is not easy to address because removing the implicit (or explicit) government guarantee of banks is likely to produce other adverse consequences. While it has been argued that depositors would become more cautious if deposit insurance were removed or reduced, they are unlikely to be sufficiently well informed about the risks taken by banks to be able to accurately assess risks. Thus, removing deposit insurance is likely to result in financial disintermediation, which will inevitably have adverse real effects.

The early analysis of financial liberalization, which adopts the assumption of perfect information, is clearly based on unrealistic theoretical premises. As a result, the informational consequences of higher interest rates, which usually follow financial liberalization, are ignored. While McKinnon (1973) and Shaw (1973) put forward the liberalization thesis before the information economics revolution, we can no longer legitimately push aside these problems. There is no doubt that the higher interest rates associated with financial liberalization exacerbate information-related problems, which threaten the stability of the banking system. Ignoring these problems, or wishing them away, can only lead to frequent financial crises.

**Perfect Competition**

McKinnon-Shaw type models are also based on the assumption of perfect competition, which is particularly unrealistic in the case of developing economies. Given that banking sectors in many of these countries are oligopolistic, financial liberalization may well lead to increased spreads between lending and deposit rates, without increased financial deepening (Demetriades and Luinental, 1998). Furthermore, financial liberalization without increased competition may lead to increased inefficiencies in the banking system, placing a further burden on the rest of the economy.

Interestingly, asymmetric information itself could be the source of oligopolistic behavior in the credit market, even if the number of banks is large. With a large number of banks, the market for deposits tends to be characterized by the law of one price because depositors are relatively free to seek the highest return for their savings. However, in the market for loans there would be borrowers who form long-term relationships with a very small number of well-known lenders, in order to obtain loans. It is a stylized fact in the UK economy, for example, that equivalent loan products carry different interest rates across lenders. Borrowers who chose to pay higher interest rates than the lowest available in the market, do so not only because they value their long-term relationship with their lender, but also because they may be rationed by cheaper lenders due to incomplete information.

**Institution-free Analysis**

There is the argument that given the very special economic role of money and the intrinsic uncertainty associated with it, financial laissez-faire, if ever implemented, would at best give way to its own form of central banking. Uncertainty is an unquantifiable risk and in order for the economic process to proceed in spite of uncertainty, society adopts conventions and other institutions, supported crucially by the state, to create elements of stability to aid decision-making. The legal system enables the establishment of contracts and the enforcement of contracts, property rights, bankruptcy procedures and the like, while the provision of outside money and bank regulation supports the evolution of a banking system that produces money as an asset to hold in times of particular uncertainty. Money is integral to the economic process, just as the state is integral to the evolution of private sector institutions and conventions. In this role, the state provides an important support, which is to inspire confidence in money's capacity to retain value. It is this confidence that underpins the roles of money as means of payment and store of value, as well as unit of account and thus as a denominator of contracts. The institutional framework surrounding the
financial liberalization thesis does lead to excessive policy mistakes.

An important example of institutional aspects ignored by the earlier literature on financial liberalization is the role of banking supervision and central banks. As a result of the mistakes of the earlier liberalization episodes, particularly in Latin America, it is now widely accepted that financial liberalization needs to be preceded by improved quality of regulation (World Bank, 1980). More recently, the experience with the East Asian crises have demonstrated weaknesses in the legal framework, including the non-existence or deficiency of bankruptcy laws and procedures, as well as deficiencies in banking regulation. The problem, however, is much deeper in developing countries because of the rudimentary market development that greatly denotes the ability of markets to act as a medium of risk and information assessment. This problem is systemic and is concerned with the institutional mechanisms necessary to link the real and financial sectors. The institutional imperatives must, therefore, go beyond the legal framework, central banks, and regulatory bodies to deal with the myriad of problems that emanate from the non-existence, or very poor functioning, of financial markets.

**No Role for Stock Markets**

Another omission of the financial liberalization thesis pertains to the role of stock markets. There has been an enormous growth of stock markets over the last ten to fifteen years (Areces and Demetriades, 1997; Singh, 1997). Despite these developments, financial liberalization supporters have paid very little attention to stock market development. Essentially, the reason for this neglect is the belief that the flow of funds from the household to the business sector through the stock market is very small. Consequently, stock market development is viewed as either unimportant or at best a slow evolutionary process, and can thus be ignored completely (Fry, 1997).

Stock markets acquire an enhanced role following financial liberalization for at least three reasons. First, the higher interest rates, which are usually associated with the liberalization of the banking system, encourage firms to issue equity. Second, stock markets provide an important channel by which international investors gain access to emerging market economies. Third, they are often imposed, explicitly or implicitly, conditionally as part of financial liberalization packages. Increased stock market capitalization, as a result of domestic or foreign inflows, increases the resources available for investment. Furthermore, deep and liquid stock markets enhance an economy's ability to diversify risk and improve the allocation of capital. Thus, stock markets are potentially important mechanisms for promoting economic growth. However, the extent to which stock markets in emerging economies are able to do this depends on how efficient they are at pricing risk. This, in turn, depends on a whole range of institutional factors, including the legal framework within which they operate, enforcement of contracts, bankruptcy laws, transparency and so on. It is now well known that stock markets in many developing economies are not able to price risk accurately and suffer from excessive volatility, lack of transparency, and insider trading (Singh, 1997). Thus, it is not clear whether an enhanced role of stock markets, which financial liberalization entails, is necessarily good for growth.
nancial crises in the second half of 1997. During the 1990s these countries undertook extensive financial liberalization. They removed or loosened controls on companies’ foreign borrowing, abandoned coordination of borrowing and investments, and failed to strengthen bank supervision. Firms were able to borrow from abroad, directly or indirectly through domestic banks, without government control. This was partly because they could borrow abroad twice as cheaply as they could domestically. As a result, large amounts of capital flowed into these countries, which permitted the acceleration of bank lending; a credit boom ensued. The credit boom was also facilitated by western investors who transferred vast amounts of capital to South East Asia countries. The better returns in these countries when markets elsewhere offered less profitable opportunities, especially in the industrialized countries owing to their slow economic growth, was a significant contributory factor. Low interest rates in the industrialized world led investors to search for higher returns, and these South East Asian countries offered fertile ground. The high growth rates and high interest rates of these countries, and the economic problems in Latin America, produced large interest rate differentials, which international investors exploited. The 10-year experience of currency pegs, which implied fluctuations relative to the dollar of less than 10 per cent, was another significant contributory factor. Net private capital inflows rose significantly, escalating foreign debt, most of which was private and short-term (maturing in twelve months or less).

Prior to 1996 these developments did not appear to have caused any obvious problems, simply because the smaller inflows were utilized essentially for investment purposes. In 1996 and 1997, however, partly as a result of diminishing returns — there were no longer sufficiently profitable real investment opportunities — much of the inflow, which was of the order of $109 billion (11 percent of before-crisis aggregate GDP) was directed at activities that could be considered highly risky. The credit explosion was also associated with the deregulation of the financial systems of developed countries, or at least the lack of regulation over new financial devices. The ability of banks in the South East Asian countries to take advantage of the unregulated international financial markets was extremely important. What is of some interest, though, in this context is the different experience of these countries. In South Korea, a maturity mismatch between the sources and uses of funds prevailed. Production was financed by new “merchant bank” loans borrowed on the international financial markets, a recipe for disaster.1 In other countries in the region, Thailand and Malaysia for example, credit was directed more towards real estate and equities, thus becoming susceptible to their downward price fluctuations.

In all South East Asian countries when the bubble burst the share of non-performing bank loans rose dramatically. Vulnerability was heightened as many banks and their corporate customers, in an effort to lower borrowing costs, undertook most of their foreign borrowing at short maturities and in foreign currency. A serious unfolding contagion of financial disturbance across countries ensued. The contagion was facilitated by the fact that the region’s currencies were on the whole pegged to the U.S. dollar (an important mechanism in their attempts to develop their economies in a globalized world), which prevented the currencies from moving in response to deteriorating fundamentals.2 A currency crisis in Thailand in the summer of 1997 (when the baht was devalued) spread almost overnight to Malaysia, Indonesia, and the Philippines. In November 1997 South Korea’s currency came under heavy pressure, as a result of foreign investors’ reluctance to renew short-term loans. The ensuing collapse of the won meant that the IMF would need to be called in to help finance its short-term debt. Several major firms were declared insolvent and by mid-December smaller firms were failing at the rate of 50 per day. Short-term interest rates soared to over 30 percent in an attempt to stabilize the exchange rate. More recently, Russia and Brazil went through similar experiences (1998 and early 1999) although differences are inevitable.3

THE ROLE OF CAPITAL FLOWS

An important aspect of the financial and banking crises discussed in the previous section concerns capital flows and their liberalization. Liberalization makes capital flows, especially portfolio flows, very volatile, which can have destabilizing effects. Still worse, these effects are not confined to the domestic economy, but may spread to other economies through contagion, as the recent South East Asian crisis has vividly demonstrated.4 Concentrating on the five most affected South East Asian countries, Table 1 cites portfolio and direct investment flows from 1994 to 1999. It is clear from the data that the behavior of portfolio flows is much more volatile than that of direct investment flows, which are essentially of a long-term nature. Given these differences, we should sharply distinguish between short-run and long-run capital flows. We discuss this issue below.

Short-run Capital Flows

The liberalization of short-run capital flows provides opportunities for speculation to flourish. It enables international investors to shift money around in pursuit of quick profits. It is no wonder that, following financial liberalization over the last twenty years or so, speculative activity has increased substantially (IMF, 1996; World Bank, 1997). This has been facilitated by the deregulation of “emerging” stock markets, which was an important part of external financial liberalization in many lesser developed countries. These deregulated stock markets inevitably became attractors of “hot-money,” in the form of short-term portfolio flows. Estimates produced by the McKinsey Global Institute show that the total stock of all financial assets traded in global markets rose from $5,000 billion in 1980 to $35,000 billion in 1992 and they are expected to reach $83,000 billion (about three times the OECD GDP) by the year 2000 (Arestis and Demetriades, 1998).

Increased short-term capital inflows have a number of destabilizing consequences. First, they are a direct source of macroeconomic instability by putting upward pressure on the exchange rate of the receiving country. If the exchange rate is allowed to appreciate, experts would become less competitive, with subsequent increases in the current account deficit. If instead the monetary authorities attempt to keep the level
event in the case of developing countries that are endowed with low human capital in relation to developed countries. They are thus constrained from undertaking research and development, which would generate new knowledge with its attendant spill-over effects. This gap can be bridged through direct investment, which transfers to developing countries knowledge created in developed countries. International spill-over effects are thus significant. Local labor and management and links between the foreign and local firms are the vehicles of the spill-over effects. Local firms can also learn by watching. Moreover, local firms may be compelled by the mere presence of foreign firms with their superior endowment of technology to invest in research and development to keep up with the competition. This in turn may force the foreign firm to bring in superior quality technology and know-how. Consequently, imported technology and skills enhance the marginal productivity of capital and thus growth in the host country.

The success of foreign direct investment, though, depends heavily on the ability of the host country to absorb and effectively utilize the imported know-how and technology. This, in turn, requires a healthy economic climate. In its absence, foreign direct investment may be counterproductive and can lead to crowding-out of domestic investment. Moreover, under adverse circumstances, there is the danger of direct disinvestment, an outflow of foreign capital. Because of their long-term, illiquid, nature, though, long-term capital outflows can never be as serious as highly liquid short-term capital outflows. They certainly could not be the cause of the type of boom-bust cycles that short-term capital flows are capable of producing.4

**THE REVISED LIBERALIZATION THESIS**

*Revisions Following the 1970s and 1980s Experience*

As a result of the unsuccessful attempts at liberalization in the 1970s and 1980s, a revision of the main tenets of the liberalization thesis took place. A number of factors were blamed for these events, including differential speeds of adjustment, competition of instruments, macroeconomic instability, and inadequate bank supervision. In this section, we outline these factors and explain the way in which they were incorporated into the new version of the liberalization thesis.

More recent work by McKinnon (1993) has attempted to account for institutional capabilities and weaknesses, under "the optimum order of economic liberalization." It is thus argued that "how fiscal, monetary, and foreign exchange policies are sequenced is of critical importance. Government cannot, and perhaps should not, undertake all liberalizing measures simultaneously. Instead, there is an 'optimal' order of economic liberalization, which may vary for different liberalizing scenarios depending on their initial conditions" (McKinnon, ibid., 4). McKinnon (ibid.) elaborates by suggesting that the speed of adjustment is sluggish in the goods markets, and faster in the financial markets. Thus, financial markets could not be reformed in the same manner and in the same instance as other markets, without creating awkward difficulties. Recognition of these problems has led to the proposition of sequencing in financial reforms. Successful reform of the real sector is now seen as a prerequisite to financial reform.
Thus, financial repression would have to be maintained during the first stage of economic liberalization. Furthermore, different aspects of reform programs may work at cross-purposes, disrupting the real sector in the process. This is precisely what Sachs [1988] labelled as "competition of instruments." Such conflict can occur when abrupt increases in interest rates cause the exchange rate to appreciate rapidly thus damaging the real sector. Sequencing becomes important again. It is thus suggested that liberalization of the foreign markets should take place after liberalization of domestic financial markets. In this context, proponents suggest caution in sequencing in the sense of gradual financial liberalization emphasizing the achievement of macroeconomic stability and adequate bank supervision as preconditions for successful financial reform. It is also argued by the proponents that the authorities should more aggressively pursue on financial reform in good times and more slowly when borrower net worth is reduced by negative shocks, such as recessions and losses due to changes in the terms of trade [World Bank, 1989].

Caprio et al. [1994] have reviewed financial reforms in a number of primarily developing countries and studied the experience of six countries at some depth and length. They conclude that managing the reform process rather than adopting a laissez-faire stance is important, and that sequencing along with the initial conditions in finance and macroeconomic stability are critical elements in implementing successfully financial reforms. It is thus recommended now that gradual financial liberalization — if not very little — is to be preferred. In this gradual process a sequencing of financial liberalization [Edwards, 1989; McKinnon, 1988] is recommended, emphasizing the achievement of stability in the broader macroeconomic environment and adequate bank supervision within which financial reforms were to be undertaken [Cho and Ghatak, 1989; McKinnon, 1988; Sachs, 1988; Villanueva and Mirakhor, 1990]. Employing credibility arguments, Gallo [1988] and Drechsler [1987] suggest a narrow focus of reforms with financial liberalization left as last. These post hoc theoretical revisions were thought to be sufficient to defend the original thesis of a disappoiting empirical record.

Even more recently and in view of the East Asian crisis, moral hazard arguments leading to the so-called overborrowing syndromes have been employed [McKinnon and Pill, 1997]. These arguments are associated with private monetary intermediaries, both national and international, because their deposits are insured by governments, and international institutions in their turn would resort to helping governments in financial difficulties if necessary.

Further Requirements Following the South East Asian Crisis

The modern version of the liberalization thesis represents an attempt to account for the implications of imperfect information and, to some extent, institutions. Assuming that sequencing is capable of producing a stable macroeconomic environment and that banking supervision is sufficiently strengthened to address the moral hazard and adverse selection problems in bank lending, it is in principle possible to design a program of reforms that does not result in financial crises. The experience so far with financial liberalization, however, may suggest otherwise. Even where argu-

ably correct sequencing took place (i.e., Chile), where trade liberalization had taken place before financial liberalization, not much success can be reported [Laib, 1987]. The opposite is also true, namely that in those cases like Uruguay, where the reverse sequencing took place, financial liberalization before trade liberalization, the experience was very much the same as in Chile (Grabel, 1995). The experience with financial liberalization, in both developed and developing countries, in the 1980s and 1990s, suggests a marked increase in the frequency and severity of financial crises [Lindgren, Garcia and Saal, 1996; Demirguc-Kunt and Detragiache, 1998]. Indeed another study [Demirguc-Kunt and Detragiache, 1999] based on 53 countries covering the period 1980-1995 demonstrates that banking and financial crises are more likely to occur in liberalized financial systems with weak institutions. The stronger the institutional environment is, the lower the probability that financial liberalization would affect the banking sector adversely. Relevant institutional characteristics include respect for the rule of law, a low level of corruption, good contract enforcement and effective prudent regulation and supervision. These results support the view that financial liberalization should be approached cautiously, especially where institutions are not fully developed.

The most recent crises in South East Asian countries, in which the initial macroeconomic conditions were very favorable, have shown that even in the best of circumstances, financial liberalization remains a treacherous policy exercise. While some analyses of the Asian crisis have revealed weaknesses in banking supervision and have blamed the moral hazard in implicit deposit insurance as the main culprit, the question of why liberalization went ahead in the first place if those weaknesses were known remains unanswered. Western financial institutions, including the IMF, now claim that they did not know about these weaknesses ex ante. In fact, not so long ago the dominant view of Korea, Thailand and Malaysia was that these countries benefited from strong institutions, including the civil service and government [World Bank, 1993]. But if the Bretton Woods institutions, with their abundance of resources and regular monitoring, are unable to be accurately informed about institutional weaknesses in Asia, and as a result are now identifying "transparency" as another key requirement for financial reforms, it is not at all obvious that simply insisting for greater transparency would be sufficient to overcome this problem elsewhere. Even worse, next time around it could be something else!

The experience of banking and financial crises we have discussed in this paper point to three striking findings [IMF, 1996; World Bank, 1997]. The first is that recent banking crises have been both frequent and severe. The second is that the costs of these crises to the local economies have been substantial and have caused or exacerbated downturns in economic activity. The third finding is that these crises cannot be construed as simply a return to the incidence of crises of earlier periods. The IMF [1996] report offers comparisons across time periods and can find no historical precedent for the dismal track record of banking difficulties just referred to.

This analysis suggests that advocating adequate banking supervision, macroeconomic stability and appropriate sequencing of reforms, albeit useful and necessary, is clearly not sufficient to prevent financial crises. Even if we add transparency to this list, it would, in our view, be incomplete. Recent experience suggests that the list
should be much longer, and even then there is little confidence it would be exhaustive. Strong and uncorrupt institutions, including the civil service and the central bank, a well-functioning legal system that effectively enforces contracts and property rights, effective bankruptcy laws and procedures are among the items that should be added to the list. We conclude that, insofar as many emerging markets are concerned, there is little point in making utopian assumptions about institutional strengths, ignoring weaknesses in central banks and so on, and pushing ahead with financial liberalization. The best that can be done in these circumstances to avoid crises in the future is to ensure these weaknesses are addressed before any "liberalizing" or reforms can take place.

RECOMMENDATIONS FOR THE FUTURE

In this paper we have argued that the early financial liberalization thesis is based on weak theoretical foundations. Specifically, it neglects information-related problems, such as moral hazard and adverse selection, assumes competitive market institutions that ignores institutional considerations. The modern version of the financial liberalization thesis, synthesized by the World Bank (1988), partly addresses these concerns by emphasizing the role of prerequisites, such as effective banking supervision and macroeconomic stability. However, the recent financial episodes in South East Asia have shown that even where these conditions appear to be satisfied, financial liberalization could still become the main source of financial crises. The various analyses of the South East Asian crises have identified many institutional factors that contributed to the crises, such as weaknesses in the legal framework governing the operation of financial markets, including bankruptcy laws and the lack of transparency. One irony is that, before the recent crises, the East Asian economies were widely regarded as possessing a strong institutional framework conducive to promoting economic growth (World Bank, 1993). The recent crises have also revealed the potentially destabilizing role that could be played by external financial liberalization, particularly the liberalization of short-term capital flows. Ex post one can once again blame it all on ineffective banking supervision, arguing that central banks should probably have been able to safeguard the banking system from known institutional weaknesses. However, this is clearly a tall order for any bank supervisor and is unlikely ever to be met in practice. Thus, to blame the banks is tantamount to maintaining a belief in a utopia, which would continue to result in expensive mistakes in the future.

A better approach, we believe, is to drop utopian assumptions altogether and work within real-world constraints, rather than insist that the world should change to fit theoretical models, biases and preconceptions. In theoretical terms, this means working models that take into account institutional weaknesses, information related problems and such. Meanwhile, in practical terms, a cautious approach should be pursued with respect to financial liberalization. Caution is particularly called for where institutions are weak, even if macroeconomic stabilization has been achieved.

Thus, another prerequisite for financial liberalization must now be to strengthen the institutional framework, such as the legal system and government institutions, including the central bank.

FINANCIAL LIBERALIZATION

Finally our analysis suggests that a more cautious attitude needs to be adopted towards external financial liberalization. There is currently an ongoing debate on the re-introduction of some form of capital restrictions. We believe that the intellectual case for freely flowing short-term capital has not been made. Only the wider notion that capital should move freely around the world for efficiency reasons supports this argument. While this argument is clearly valid in the case of physical capital and would justify the freedom of long-run capital flows, "hot-money" could hardly be thought of as capital in a productive sense. In the light of the overwhelming evidence of their destabilizing consequence, we expect that in this debate caution will prevail.

NOTES

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1. In a sense, it should not be surprising that financial liberalization has caused problems in the developing world as a good number of developed economies also suffered. Recent evidence cited by Demirguc-Kunt and Detragiache (1998, 1999) corroborates this observation. Using data from 53 countries from 1960 to 1995, these authors find that financial liberalization significantly increases the probability of a banking crisis, by a factor of around three to five. This factor falls as the strength of the institutional of the country concerned rises. These results also explain the reverse causality between financial development and growth frequently observed by time-series studies (Demirguc-Kunt and Huising, 1999).

2. See, for example, Stein (1990) for the experiences of African countries.

3. Alper and Swanepoel (1999), Levine (1996), and Levine and Zervos (2000) provide empirical evidence of a strong, positive relationship between stock markets development and economic growth. They argue that stock markets may affect growth through liquidity, which makes investment less risky. Companies enjoy permanent access to capital through liquid equity issues. This argument, leads to the conclusion that "stock market development explains future economic growth" (Levine, 1996, 8). Arnot, Barnett, and Lothian (1994) offer an alternative view, which emphasizes the negative affects of the volatility of expectations.

4. "Merchant Bank" in South Korea is a term used to refer to a category of non-bank deposit-taking long-dating financial institutions. They were introduced in 1979 and by the end of 1997 they had captured the bulk of deposits and loan markets. In addition, they had 82% in foreign debt, 64 percent of which was short-term debt, and most of their assets were short-term (Bank of Korea, 1998).

5. "Merchant Bank" in South Korea is, therefore, different from its usual meaning of a bank providing trade credit to merchants (as in the UK, for example). In the USA recently the term "merchant bank" is used to refer to investment banks which take heavy speculative positions. We are grateful to the editor of this journal, Kenneth Kehoe, for bringing this distinction to our attention.

6. We should readily concede that the contagion referred to in the text was not precipitated on pegged exchange rates—it only facilitated the process. Fluctuating exchange rates in the horrid of the 1980s would still have produced the contagion. Our argument, therefore, does not rely on the pegging of exchange rates during the period. Rather, it is based on a systematic explanation, the root of which is essentially located within the financial liberalization debate.

6. More recently, Russett and Boulden used similar experiences (1968) and early 1999 respectively.

6. See, for example, Palma (1998) for more details on differences between the South East Asian crisis and Brazil. On the Brazilian experience, see Rosefolds (1999).

7. Recent work by Demirguc-Kunt and Patimon (1999) on the Korean crisis suggests that the liberalization of capital flows made the economy vulnerable to bank-run type problems, exposing and exacerbating the poor quality of assets in the banking system.

8. Foreign direct investment is, of course, a topical issue, albeit with a huge, complex array of unresolved difficulties. We have merely touched upon a relevant few in the text, and we recognize that there are many more. See Stein (1996) for a recent attempt to analyze foreign direct investment in Africa, taking issues, however, that are extremely specific and relevant to many other parts of the world (especially South East Asia and the periphery of the European Union).
REFERENCES


