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Financial Liberalization and Economic Development

The proliferation of financial assets and the deepening of financial markets are readily apparent characteristics of rapidly growing economies in Asia and South America. In general, the expansion of financial markets has been associated with increases in standards of living in developing countries.

This *Letter* examines some explanations and empirical evidence on financial liberalization and economic growth, focusing mainly on two issues. The first issue is a question of how the development of a formal financial sector, such as a commercial banking system, contributes to growth. Since it is achieved by absorbing financial savings out of the informal financial sector, such as "curb" markets, then financial liberalization must add to economic growth when the shift of financial resources from the informal to the formal sector yields a greater overall saving and/or a more efficient allocation of financial resources. The evidence presented here suggests that the most important way in which financial liberalization contributes to growth is through improvements in the efficiency of resource allocation rather than through increased overall saving.

The second issue involves how the role of government can impede economic development even as it promotes financial liberalization. In many developing countries, governments hold sway over their emerging banking sectors. Under those circumstances, a government could have an incentive to run deficits and finance them by requiring banks to buy its debt at favorable rates, which would result in reduced funds available to the private sector. Therefore, it appears that sound monetary and fiscal policy is a key prerequisite for financial liberalization to enhance growth.

Basic principles

Until the early 1970s, the key to economic growth was thought to be increases in physical assets, such as plants and equipment; financial assets, on the other hand, were viewed mainly as a way in which funds were diverted from physical capital. A logical extension of this view would make two policy prescriptions seem desirable ways to make physical assets more attractive than financial assets: (1) pursue an inflationary policy, since inflation lowers the real rate of return on financial assets, and (2) regulate or legislate "financial repression," that is, discourage the proliferation of financial assets and formalized financial markets.

Historical experience, however, seems to contradict this idea. For example, Ronald McKinnon and Edward Shaw pointed out in the early 1970s that the ratio of financial assets to total output is higher in both industrialized countries and rapidly growing economies than in less developed economies. Many subsequent studies have documented a positive link between the relative size of the financial sector in the total economy and superior growth performance. These findings suggest that physical and financial assets are better viewed as complements rather than substitutes. As such, it might make sense to encourage growth in the financial sector through financial liberalization. In addition to removing barriers to participation for a wide range of investors and establishing an organized banking system, financial liberalization also includes reducing government interventions in banks' financial intermediation.

Such policy measures could have a positive effect on growth through two mechanisms. First, financial liberalization could increase the overall size of savings. Second, establishing an organized financial sector could provide for a more efficient allocation of savings to alternative investments in physical capital.

Benefits of financial liberalization

Many developing economies have both formal and informal sectors. Typically, the formal sector consists mainly of banks. The informal sector includes a wide range of financial arrangements. One example is a small-scale credit circle organized at the household level; households pool financial savings, and participants take turns using the funds for a fixed period. On a larger scale, there are "curb markets"—that is, unregulated markets—in which private creditors directly lend to firms in need of capital. For example, such curb markets were an important source of financial capital for South Korea and Taiwan in the 1960s and 1970s. Stock markets, which could have offered alternative means of directly raising capital, were embryonic in those economies. Most informal financial arrangements are possible only when the lenders know the users of the funds or are familiar with the project that is being financed. Hence, the scope of informal credit arrangements is limited by how much information is available about the prospective borrower or the projects.

Financial liberalization typically means that the banking system becomes the primary financial intermediary. One important advantage of having banks is that they separate deposit-taking and credit extension, thus allowing specialization in each area. This, in turn, allows savers (depositors) to delegate to the bank the task of locating and assessing suitable projects. Banks specialize in gathering and assessing information of the profitability and riskiness of projects, and thus face fewer information problems.

In addition, a well-functioning banking system assures a continuous and predictable flow of funds in the economy. With a steady deposit base, an organized banking system is able to finance large-scale, long-term investments with long payback periods which can be an important factor in enhancing growth.

Another important benefit is that banks pool individual deposits to fund a variety of projects, enabling depositors to reap the benefits of diversifying risk. This usually is not possible in informal financial market financing, which typically is tied to a single project. Hence, the economy as a whole benefits from the superior risk-sharing afforded by banks (Bencivenga and Smith 1992). Thus, financial liberalization could promote both an efficient allocation of savings and an increase in the overall level of savings.

Some evidence

Gelb (1989) offered some empirical evidence on the issue of which channel—efficient allocation of savings or increasing the level of savings—is more important. His study used data from 34 developing countries over 21 years, and he approximated the degree of financial liberalization by the real interest rate. In countries that artificially depress nominal interest rates, real interest rates tend to be low. It is not uncommon to see negative real interest rates for several years in some developing countries.

The first channel, that financial liberalization contributes to growth by increasing the overall level of investment (achieved through higher savings), was measured by a ratio of investment to output. The second channel, that financial liberalization contributes to growth by increasing the efficiency of the use of capital, was measured by the ratio of investment to the annual change in the output, instead of its level. The second ratio captures how much additional output is produced per dollar of investment. A unit of investment can generate larger increases in output only when it is used more efficiently. Gelb found the efficiency effect to be much stronger than the level effect. Dornbusch and Reynoso (1989) also reached a similar conclusion.

Thus financial liberalization can enhance growth even if it does not increase total savings, but simply shifts savings from the informal to the formal sector. These findings also imply that an effort to lower the cost of capital by artificially holding down deposit and lending rates might be counterproductive. Suppose that the effort is directed to lowering the cost to all output-producing sectors. The resulting interest rate will be too low and consequently precipitate a flight of financial savings toward alternatives such as land holdings or foreign assets. Targeting a few specific sectors might not fare much better. Since financial capital is fungible, it will create a strong incentive for the credit receivers to divert funds to capital-starved sectors. This in turn, will compel the government to intervene more directly and widely in financial intermediation. Such developments will deprive banks of a chance to mature as independent and productive economic units that add to economic growth by allocating financial resources more efficiently.

Caveat: fiscal environment

Most economists agree that stable macroeconomic conditions, particularly a sound government budget, are crucial if financial liberalization is to enhance growth. For example, suppose a government is running a large budget deficit. In many developing economies, it is difficult to raise revenues to service the debt through direct tax levies on income or wealth because of a low tax base, a lack of reliable records, and enforcement problems. If the country does *not* have a formal financial sector, then the option of printing more money becomes an easy and perhaps unavoidable means of raising revenue. Since this effectively reduces the real value of money holdings, it amounts to a tax on money holders. This tax is called seignorage, and in some developing countries the size of seignorage is as large as 5 percent of total annual output.

Having a formal financial sector broadens a government's options, but still may lead to inflationary policies if the country lacks fiscal discipline. For example, in many emerging economies, the government has tight control of the banking sector; this could give rise to an incentive to finance its spending by forcing banks to hold government debt yielding below market interest rates. For a given deposit base, this will reduce the size of the funds that can be lent out. In the short run, this will be accompanied by measures that control bank liabilities (i.e., deposits) such as high reserve requirements on deposits, fixed deposit rates, and forced savings. When budgetary conditions worsen, financial savings may be mainly used to meet the government financing needs. Eventually, the economy's overall pool of loanable funds available to the private sector may actually shrink below what it was before the financial liberalization was implemented (Van Wijnbergen 1983). Moreover, the need to finance the debt with inflation will persist, so, in the long run, the government will turn to seignorage.

In fact, countries like Argentina and Chile experienced adverse consequences of financial liberalization accompanied by a fiscal imbalance in the late 1970s, even though part of the revenue raised was devoted to various development projects. Such experiences led McKinnon (1982) to emphasize the "right" order of financial liberalization. He argued that the stabilization of the fiscal conditions should precede the liberalization of domestic financial markets as well as the foreign exchange market.

Similar observations led Dornbusch and Reynoso (1989) to conclude that the combination of financial liberalization and the inflation associated with government deficits retarded economic growth by disrupting the price system, by shortening the economic planning horizon, and by inducing capital flight.

Conclusion

A couple of lessons can be drawn from this literature. First, stable overall macroeconomic conditions, particularly control of excessive government deficit financing, are crucial prerequisites for a well-functioning formal financial sector. Once concerns about an inflation tax become unimportant, organized financial markets can contribute to economic growth by enhancing more efficient use of financial resources.

Second, government policies that are overly intrusive in the normal functioning of a formal financial sector (interest rate ceilings, for example) might unintendedly encourage the informal financial sector to persist. This will reduce and delay the efficiency-improving contribution of an organized formal financial sector.

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