Two Discourses: Financial Liberalisation Happened

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Social policy abhors extremes. In response to unbending opposition to financial repression there is now a counter-position. It is argued that financial repression may be desirable, financial subsidies may be more effective than direct subsidies and various financial market failures may justify some intervention. All these arguments are certainly valid in particular periods and countries. The question people must ask themselves is whether they are likely to be so with the particular political regime and set of financial institutions and entrepreneurs with whom they actually find themselves endowed.

FREUD had come and gone as an Anglophone phenomenon before Lacan managed to present him in a form that was of interest to the Francophone world. Similarly, policy-makers had been committed to a financial liberalisation process for more than a decade by the time that the 1989 *World Development Report* and Maxwell Fry's book canonised financial liberalisation for theorists.[12]

Financial liberalisation implies a deregulation of financial institutions, permitting them to freely set their borrowing and lending rates and choose their customers - savers and borrowers. The banking industry is always regulated to some extent, especially in terms of its prudential soundness (levels of reserves and capitalisation, accounting procedures, and disclosure requirements) - the capital, assets, management, equity, and liabilities (CAMEL) of bank supervisors. These same supervisors generally control market entry and give access to such critical services as clearinghouses, and they frequently give the public an implicit or explicit guarantee when dealing with banks. Financial institutions are often regulated as well to secure for a country as a whole internal macro-economic stability and external balance. In essence, banks, if not other financial institutions, are accorded a protected market in return for conducting their business prudently and assisting with national economic management.

The policy-makers' commitment to financial liberalisation emerged from practical experience with failed credit programmes, especially programmes for agriculture credit.[14] The commitment to agricultural credit reform (e g, non-subsidisation) was already embedded in the operating directives for many multilateral and bilateral aid donors and lenders. These operating directives are chronicled by Robert Chambers and Oscar Sacay and Bikki Randhawa.[3.6] Although the failures of industrial, export, and small enterprise lending were not documented, few observers will deny that the actual experience with donor-financed orgovernment-dirceted cheap credit in less developed countries (LDC) was dismal in the vast majority of countries.[7]

This directed cheap credit had frequently been disbursed on a politicised, corrupt basis to non-sustainable or defaulting enterprises. In many cases, more than 70 percent of loan portfolios were in arrears, in most cases irremediably so. The severity of the non-repayment varied from country to country, but in most LDCs many of the lending institutions had become insolvent and in some cases illiquid. That is, they actually had no money in the till. Moreover, it is not clear in many cases that there was any additionality in investment stemming from the credit that had been extended. The funds disappeared, but the new enterprises that were funded cither never emerged or failed. India and other countries of south Asia have generally had a comparatively good experience with these credits, as compared with the disastrous international norm.

FINANCIAL LIBERALISATION REASSESSED

Now comes a counterattack. An unpublished set of memoranda produced in the Operations Evaluation Department (OED) of the World Bank defended the role of well-managed agricultural credit in promoting agricultural modernisation. The published results of this thinking can be found in a paper by Oscar Sacay and Bikki Randhawa.[8] The endorsement is tentative:

> The agricultural credit portfolio of the World Bank has declined sharply during the past five years. This decline coincides with the time period that the Task Force Report on Financial Sector Operations was circulated and subsequently followed by the issuance of Operational Directive 8.30 (OD 8.30). In its review of the Bank's agricultural credit portfolio, the Operations Evaluation Department (OED) traced the decline in lending to the adverse reaction to the operational directive. The OED report considered OD 8.30 to be too restrictive and the decline in lending unwarranted because agricultural credit projects had performed comparatively well [NotaBene]. In addition, the OED report slated that agricultural credit projects had a positive impact on agricultural production. Therefore, the OED report recommended that the OD be revised.
> Bank management, on the other hand, took the position that the decline in lending was justified in lieu of the poor performance of agricultural credit projects and that OD 8,30 in its present form was sound as well as adequately flexible. Management was of the view that rural finance projects can be properly designed if task managers were given guidelines on how to design projects based on best practices. It is the premise of this study that OD 8.30 in and by itself is not the source of the problem. Rather, the problem lies in the interpretation of the provisions of the OD in translating such provisions into effective project design.

That is, there was a disagreement about, empirically, how successful agricultural credit projects funded by the World Bank had been [OED - successful; management (i c, the Bank Board) - unsuccessful]. Sacay suggested a reconciliation based on a determination of just what characteristics differentiate *among* agricultural credit projects and cause some to be successful and some not, The characteristics of good projects were those that strengthened rural financial institutions. These characteristics helped transform "specialised agricultural credit institutions into competitive market-based, diversified, financially viable rural financial intermediaries which can mobilise resources and channel [them] into productive rura] enterprises." That is, some subsidisation was possible but only as a transitional element to get self-sustaining institutions going.

A more systematic review of the possibilities and limitations of agricultural credit with a clear focus on the rural poor was just produced by the International Food Research Institute.[9] This study concludes that public subsidy for the development of otherwise sustainable new financial institutions is valuable. Good institutions will not necessarily spring up just because the policy frame is right. But by implication, that actual ongoing subsidy of rural credit funds is not endorsed, as distinguished from subsidising the operating expenses of the institutions that manage them.

Moving from agricultural credit, Sticglitz and Uy in an article in the August 1996

World Bank Research Observer suggest that directed credit and financial repression (which transferred funds from households to corporations through the banking system at 'low' rates) almost certainly were among the secrets of rapid economic growth, at least in Japan and Korea.[10] Financial repression is the opposite of financial liberalisation, in which funds are diverted from where they might flow under entirely free market conditions. Savers typically receive less, and funds are diverted to social and economic priority enterprises at low rates. Stieglitzand Uy suggest that the use of 'performance'/ commercial criteria and the 'design' of Korean and Japanese institutions were key, as was insistence on sizeable equity contributions from borrowers. According to them, Japan eliminated potential Cents' from directed credits (presumably rents to banks) by interest rate controls and subjecting the banks to competition from non-bank financial intermediaries. They also contend, citing Campos, that the isolation of credit decisions from politics and the whole tenor of public and private relationships were important.[11] Vittas and Cho in the same issue of the *Research Observer* define a much more constrained set of programme characteristics for the effectiveness of programmes like those of Japan and Korea:

(1) Small, narrow, focused, lime-based programmes; (2) Low levels of subsidy; (3) Long-term funding; (4) Positive economic and social effects; (5) Promotion of industrialisation and exports; (6) Broad 'vision', including a strategy to develop a sound financial system; (7) Well-capitalised, competent institutions with managerial autonomy; (8) Clear programme criteria and detailed monitoring and assessment; (9) Good repayment record; and (10) Effective mechanisms for public private consultation.[12]

En passant, Korea appears to have met relatively few of these criteria, but perhaps only the ones that Stieglitz and Uy cite were critical and the rest were superfluous.

More generally Haggard et al suggest that certain east Asian countries have implemented a Quasi-Internal Organisation (QIO) Model that internalises typical credit market transactions. The terminology comes from Oscar Williamson and Coale, who analyse industrial structure on the basis of whether it is more economical in terms of transaction costs on the market to undertake market transactions or to group firms in common organisations so that they can internalise the transactions and save on the transaction costs that would be involved. The successful QIO countries subject their client firms to the test of export markets and insulate their financial decision-makers from political pressure. This practice avoids the patronage and corruption in 'subsidised' credit programmes experienced elsewhere. According to Haggard et al, Korea and Japan appear to have succeeded with this model; Indonesia and the Philippines appear to have failed. Thailand and Taiwan appear to have succeeded because their markets were able to function despite attempts to impose a QIO Model.[13,14] The question is whether other countries can successfully manage QIO Model.

Edward Friedman, on the contrary, in a review article in *Economic Development and Cultural Ctuinge,* argues that the success of the QIO Model in Japan and Korea was predicated not only on the political skill of the Japanese and the Koreans, but the favourable circumstances of the Bretton Woods period (1945-71) in the international economy.[15] He states that it is not possible to argue that the merits of the Japanese and Korean approaches still hold with the great capital mobility that has followed that period.

Others argue that many of the industry-specific interventions in Japan and Korea were ineffective. However, this argument contradicts my own observations and most of the evidence.[16]

WHY FINANCIAL LIBERALISATION HAPPINED

Arguments for financial repression and the directing of credit arc not surprising because directed and subsidised credit and tariff protection have been arrows in the quivers of those who want to transform less industrially, technologically, or economically advanced societies since the industrial revolution first began and even earlier, in the days of mercantilism. If we wish to substitute for lacking entrepreneurs, it is alleged, we must subsidise them. Lower taxes on higher incomes and capital gains are widely advocated as measures to promote enterprise. It is on this basis that recent relief in capital gains taxation was granted in the *US.*

Industrial banks were promoted under Napoleon III and in Russia, Austria-Hungary, and Germany in the 19th century (the Credit Mobilier and the Credit anstalt). Favours were extended by the state; guarantees and loans were given in Meiji Japan andC/arist Russia. All of these institutions and arrangements were intended to channel credit to certain industrial investments. As with Japan and Korea, it is difficult to know what would have occurred in the absence of these credit subsidies and interventions, but the Gerschenkron theory is that the banking system and the state made up the deficiencies of the market and entrepreneurs in such second round industrialised countries as Russia and Germany.[17]

With this background, it was thus natural that experts called on to 'develop' the LDCs after the second world war turned to promotional techniques such as subsidised credit and financial repression. Tariff protection, too, was usually increased by governments, although not typically advocated by the experts' own commitment to free trade. The industrial countries themselves (developed market economies) repressed their savers and provided extensive credit during the prosperous period of the 1950s and 1960s. Consequently, when the world turned itself to the challenge of the LDCs after post-second world war reconstruction, the instruments of choice were financial repression, channelling of credit, and industrial policy.

The instalments of financial repression had traditionally been used by backward economies to catch up with their advanced neighbours, and they were uniformly in place in the economies of the richer countries themselves. It was difficult to determine just what policy instruments were responsible for the prosperity of advanced countries, but there is a bias in favour of whatever they do.

In the years since LDCs first became of interest, say since 1960, responding to the acid critique of economists, the ingenuity of markets in circumventing repression, and a realisation of the limited impact of many credit market interventions, the advanced countries themselves have begun to liberalise their financial markets. Responding to a trend toward liberalisation, all markets, financial and otherwise, have been liberalised. This liberalisation occurred because it was demonstrated how much actual regulations often served the interests of specific, narrow pressure groups rather than the public. It should be noted in passing that deregulation of financial markets has so far resulted in again in income for the producers of financial services, at the cost of much greater instability in those markets. As in many market liberalisations the industry as a whole has grown, whatever happened to the distribution of its returns. Markets have become larger and more active in rich countries and in transferring capital to those poorer ones with good prospects. The explosive growth of so-called emerging markets has meant that the flows of private portfolio capital are frequently comparable to foreign direct investment (as in India) and have far surpassed concessional, government-supported funds transfer - although they are, of course, not substitutable for it. In developing countries, financial markets have extended their functions, providing consumer and housing finance, and credit funds for education and migration, as well as for new types of enterprise and trade.

However, it is generally agreed that there are limits to the full liberalisation of financial markets, just as there are to the full liberalisation of the markets in which some public utilities operate, because of certain characteristics of these markets. They deal in products with characteristics that are difficult to verify and sometimes hard to understand, are critically related to other activities, involve some monopoly aspects, and serve as a device for regulating the economy as a whole.

But the more powerful influences for financial liberalisation came from the collapse of some of the previously regulated financial institutions. The skyrocketing interest rates of the late 1960s, which broke inflation's back, almost ruined the American savings and loan associations while forcing them into the mainstream of US finance. Similar phenomena brought segments of many banking systems to the verge of collapse.

The growing internationalisation of financial markets undercut national efforts at regulation. Savers moved their funds from regulated bank and thrift institution savings accounts to unregulated money market funds until interest rates on bank savings were raised. Shifting currency exchange rates and low inflation combined to increase the risks in financial transactions. The financial innovations developed to deal with these new risks (swaps, strips, derivatives) increased the complexity of finance. US depositors have largely been protected from large-scale default, but that has not been the case in the UK,

Finally, the relative impact of channelling government directed funds to the favoured sectors of the economy declined because the volume of those funds declined relatively. The US agricultural sector itself declined in relative terms and the noncorporate small farmer more so. It was pointed out in country after country what a small proportion of industrial investment was assisted at what great cost. The situation with housing and construction is more complex, but at least in the US the government-supported financial role declined as well. One article argues that the recent increase in homelessness in the US is directly connected to the changes in housing finance.[18]

While the 'models' - the advanced industrial economies - were liberalising, the less advanced began to follow suit. The same intellectual critique of financial repression was made. In many LDCs, formal sector finance had never been available for a large portion of financial transactions, and this situation was finally accepted as inevitable. Furthermore, the same (high international interest rates and capital mobility) and additional factors (arrearage, corruption, limited public revenues) led to the collapse of financial institutions in LDCs as they had led to similar collapse in wealthier countries. In particular, the cumulative effect of high levels of arrearage, combined with severely limited public resources, brought many banks to the verge of bankruptcy. Finally, the donors, on whose beneficence public finance in many LDCs depends, became less generous in genera), but in particular about funding financial institutions that were not performing.

The spigot was turned off, and radical restructuring of financial institutions and their functioning was undertaken. It should be noted that disastrous collapses of production or even investment arc generally not reported - although the results from greater and lower priced credit availability have not yet been adequately studied.

In many countries, investment levels have remained low despite political stability and orthodox macro-economic management, and we must now again consider what might be done to increase investment or whether such an increase should be undertaken.

WHAT Is AT ISSUE?

Social policy abhors extremes. In response to unbending opposition to financial repression there is now a counter-position. It is argued that financial repression may be desirable, financial subsidies may be more effective than direct subsidies, and various financial market failures may justify some intervention.

Financial Repression May Be a Good Thing: Financial repression reduces returns to savers, but it is not clear how radically it will repress savings rates. Financial repression leads to Keynes' desired "euthanasia of the rentier." It increases the premium that borrowers receive, even though they may end up paying some of this premium as bribes to secure the allocation of funds. In fact, almost all financial intermediaries deliver funds on the basis of some rationing criteria, rather than on the basis of what borrowers are willing to pay - even in the best of cases financial institutions do some rationing. In any case, market criteria determine the allocation *of* funds even less in a repressed financial system than in a non-repressed market. The question is whether the judgment of the official allocators, whoever they are, is better than that of profit-motivated financial intermediaries. In most cases it would be hard to argue that the political authorities are better allocators, but in some cases they may be. The disadvantages of profit-oriented intermediaries are clearer if it is decided that low return, meritorious activities (such as industry and agriculture) need to be preferred to higher return activities (such as speculation and commerce).

Financial Subsidies May Be More Effective than Direct Subsidies: Financial subsidies may be more effective than direct subsidies because they are less transparent. It is easier to tax savers or unsubsidised borrowers through the financial system than directly through the tax system. These financial subsidies also respond to the demands for natural and symbolic equity. It appears more just to insist that entrepreneurs who will benefit from some capital subsidies be seen to contribute some equity, rather than simply be given grants. Important symbolic needs are served in some cases by these financial subsidies as well.[19,20]

Various Financial Market Failures May Justify Some Intervention: In the case of the US, federal government guarantees played some role and continue to underlie part of the housing mortgage system that has made many Americans home-owners at little cost to the treasury. (A similar role might be attributed to student loans, especially as contrasted with the alternative system of direct government scholarships, which most industrial countries use.) SBA guarantees and their predecessors may have increased bank confidence in small business loans even though they now play only a small role in providing such loans.[21] The rural electrification and telephone systems and the subsidised finance that they entail are undoubtedly far less costly than direct subsidisation would have been.

One special case here is microcredit. In exceptional cases microcredit institutions have been able to function on a commercially competitive basis, but generally even when microcredit is profitable and sustainable it does not offer terms comparable with the best available investments.[22] However, microcredit can be demonstrated to have had significant effects - social and economic - in assisting a large group of the poor.[23]

All of these arguments arc certainly valid in particular periods and countries. The question people must ask themselves is whether they are likely to be so with the particular political economic regime and set of financial institutions and entrepreneurs with whom they actually find themselves endowed.

Notes

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23 Timberg, T A, 'Comparative Experience with Micro-Enterprise Projects' in *Micro Enterprises in Developing Countries*, Intermediate Technology Publications, London, 1989. Not all of the poor are served, and not many get into the middle class. However, so few effective targeted techniques exist that most people should be willing to adopt them where they can be found.