

## WHAT ARE the ARGUMENTS AGAINST “COMPLETE FINANCIAL LIBERALIZATION” in the DEVELOPING WORLD in TERMS of FINANCIAL INSTABILITY and FINANCIAL CRISES?<sup>1</sup>

Ayca Sarialioglu HAYALI<sup>2</sup>

### ABSTRACT

The liberalisation process started in the 1980s and continued increasingly in the 1990s went through in financial markets as well as in the real sector to benefit the freeing of markets from government intervention and to rebuild pure market-oriented economies as in the golden era of “laissez-faire”, the 19<sup>th</sup> century. However, especially developing countries had severe experiences about complete financial liberalisation such as financial instability and financial crises. After such experiences complete financial liberalisation was started to be widely criticized. This paper aims to answer the question of “What are the arguments against complete financial liberalisation in developing world in terms of financial instability and financial crises?” To do this it tackles first the arguments in favour of complete financial liberalisation within the framework of the theory and brief literature review and then the topic is handled in two main parts as the criticisms against this dominant approach through first the theoretical and second the experimental arguments.

*Key Words: Complete Financial Liberalization, International Financial Crises and Financial Instability*

## FİNANSAL İSTİKRARSIZLIK ve FİNANSAL KRİZLER AÇISINDAN GELİŞMEKTE OLAN ÜLKELERDE TAM FİNANSAL LİBERALİZASYON ALEYHİNDEKİ ARGÜMANLAR NELERDİR

### ÖZET

1980’lerde başlayan ve 1990’larda artarak devam eden liberalizasyon süreci, hükümet müdahalesinden piyasaları kurtarmak ve “bırakınız yapsınlar” anlayışının altın çağı olan 19.yy’daki gibi tam piyasa yönelimli ekonomileri tekrar kurmak için finansal piyasaların yanında reel sektörde beraber yürümüştür. Ancak, özellikle gelişmekte olan ülkeler tam finansal liberalizasyonla ilgili finansal istikrarsızlık ve finansal krizler gibi acı tecrübeler yaşamıştır. Bu gibi tecrübelerden sonra tam finansal liberalizasyon geniş ölçüde eleştirilmeye başlanmıştır. Bu makale, “Finansal istikrarsızlık ve finansal krizler açısından gelişmekte olan ülkelerde tam finansal liberalizasyon aleyhindeki argümanlar nelerdir?” sorusuna cevap vermeyi amaçlamaktadır. Bunu yapmak için makale öncelikle teori ve kısa literatür taraması çerçevesinde tam finansal liberalizasyonun lehinde olan görüşleri ele almakta ve sonrasında konu, bu hâkim yaklaşıma karşı birincisi teorik ve ikincisi deneysel argümanlardan gelen eleştiriler şeklinde iki ana bölümde ele alınmaktadır.

*Anahtar Kelimeler: Tam Finansal Liberalizasyon, Uluslararası Finansal Krizler ve Finansal İstikrarsızlık*

### INTRODUCTION

In the 1980s, having been led by developed countries, the world economy underwent a restructuring era of capitalism called “neo-liberalism”, rooted in the 19<sup>th</sup> century, in order to avoid financial repression which had negative consequences in the 1960s and

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<sup>2</sup> Dr. (Ph.D.), The University of Sheffield, UK, the Department of Economics (The last affiliation and also the affiliation in which the work was conducted), e-mail address: aycasarialiogluhayali@gmail.com

1970s when negative real interest rates for depositors, caused by public controls over the banking system, made “financial repression” an obstacle to domestic savings and hence prevent their efficient allocation, and made financial intermediation inefficient.

The crises experienced in the early 1980s were thought to be stemmed from not implementing enough liberalisation pointing out the lack of transparency regarding the operation of the financial system and regulatory regime (International Monetary Fund (IMF), 1998: 61). IMF (1998) puts this issue as follows: “...These extensive restrictions [in the 1970s], by confining bank operations to approved or priority activities, often led to undiversified loan portfolios that soon contained a significant share of nonperforming or poorly serviced loans” (IMF, 1998: 61), which points out the banking crises that heavily indebted emerging markets experienced in the early 1980s. So, the liberalisation process which started in the 1980s and continued increasingly in the 1990s, the era which is called “globalisation”, by virtue of the significant developments in the Information and Communication Technologies (ICTs) and in the political arena through having entered a new bipolar world order after the collapse of the Soviet Union, went through in financial markets as well as in real sector to benefit the freeing of markets from government intervention and to rebuild pure market-oriented economies as in the golden era of “laissez-faire”, the 19<sup>th</sup> century. However, since the conditions were too far from the past, especially developing countries had bad experiences about complete financial liberalisation.

After such severe experiences, such as international financial crises, complete financial liberalisation in developing countries was started to be widely criticized. Stiglitz (1998) puts the main logic behind the criticisms as follows: “...Macroeconomic stability and long-term development require sound financial markets. But the agenda for creating sound financial markets should not confuse means with ends; redesigning the regulatory system, not financial liberalisation, should be the issue” (Stiglitz, 1998: 18).

Contributing to this logic, Furman and Stiglitz (1998) stress what should be the eventual aim of liberalisation as follows:

“...This is not to say that liberalisation is always bad; only to say that the case for it must rest on pragmatic grounds, it must be shown that it can be welfare enhancing even when private decisions can lead to inefficient ‘macroeconomic’ imbalances. The case for financial liberalisation cannot rest on a blanket faith in the efficiency of markets” (Furman and Stiglitz, 1998:30).

This paper handles the question “What are the arguments against complete financial liberalisation in developing world in terms of financial instability and financial crises”. To answer this question in an unbiased, unprejudiced and comprehensive manner the paper tackles first the arguments in favour of complete financial liberalisation within the framework of the theory and brief literature review about complete financial liberalisation as the dominant approach covering the era 1980-2008 in order to find out what it means exactly and what the pro arguments are. After this part the topic is handled in two main parts as the criticisms against this dominant approach. First one is about the arguments against complete financial liberalisation stemming from the theory, both in terms of

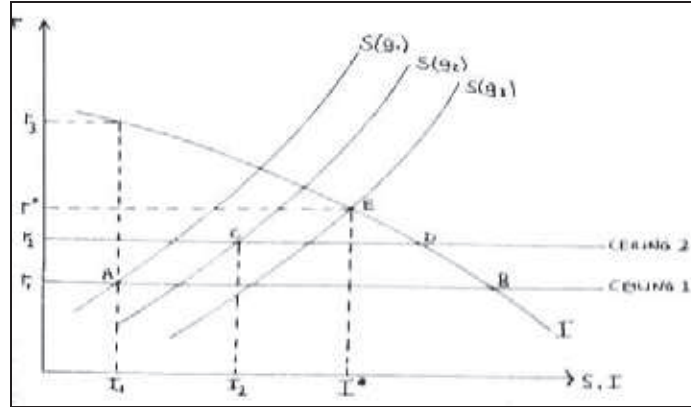
arguments against the domestic financial liberalisation and external financial liberalisation. And then the second one is about the arguments against complete financial liberalisation stemming from the experiences of developing countries that put what had happened in developing world after the complete and rapid financial liberalisation.

### **I. THE THEORY AND BRIEF LITERATURE REVIEW: THE ARGUMENTS IN FAVOUR OF COMPLETE FINANCIAL LIBERALISATION**

Financial liberalisation in developing countries within the framework of financial reform policies, supported by the IMF and WB, generally refers to “focusing on freeing interest rates, reducing or eliminating government control over credit allocation, easing restrictions on market entrance of new financial institutions and lifting controls on foreign exchange and capital inflows” (Vos, 1995: 181).

This kind of liberalisation process with the freeing of international capital movements, which highlight the lifting restrictions on foreign exchanges and capital controls in external financial markets, refers to “complete financial liberalisation” (Williamson and Mahar, 1998: 2) based on neoclassical economic literature stressing that “if the market for loanable funds is left free from intervention, then savings will always balance with investment” (Gibson and Tsakalotos, 1994: 603). The financial liberalisation is handled in two parts as “domestic financial liberalisation”, which has two legs as “domestic banking system and domestic capital markets”, consisting of “freeing interest rates, reducing or eliminating government control over credit allocation, easing restrictions on market entrance of new financial institutions” and “external financial liberalisation”, which focuses on “removal of all capital controls”, lifting controls on foreign exchange and capital inflows (Gibson and Tsakalotos, 1994: 592).

This “fully liberalisation” attitude constitutes a reflection of the view of “[liberalisation is] the only game in town” which goes to famous the McKinnon-Shaw Hypothesis on financial liberalisation, which they handle as a vehicle to promote financial development and hence growth. They particularly focus on financial repression, which is defined by McKinnon (1989) as “when governments tax and otherwise distort their domestic capital markets, the economy is said to be financially repressed”, within the framework of ceilings on deposit and loan interest rates. Having focused on the negative effects of them, their models argue that financial repression in the form of a ceiling on nominal interest rates will detriment financial deepening and hence economic growth since interest rate ceiling, which causes “low or negative real interest rates”, has two negative effects, as the first one is decreasing savings by promoting current consumption, diminishing the quantity of investment below its optimal level and reducing the quality of investment by attracting only low-return projects and hence decreasing the amount of loanable funds intermediated through “the formal financial system” and the second one is affecting the marginal productivity of capital by leading to low real interest rates (Andersen and Tarp, 2003: 191). The following figure 1 shows the model of McKinnon-Shaw told above.



**Figure 1: The McKinnon-Shaw Model**

Source: Gibson&Tsakalotos, 1994.

Investment ( $I$ ) is a negative function and savings ( $S$ ) are a positive function of the real rate of interest ( $r$ ) and also savings ( $S$ ) are influenced by growth of national income ( $g$ ). ( $I=I(r)$ ;  $I_r < 0$  and  $S=S(r, g)$ ;  $S_r > 0$ ;  $S_g > 0$ ) As seen in figure 1, interest rate ceilings on savings and investment are implemented by the government. If they were not, the equilibrium would be at  $E$ , with interest rate  $r^*$  and investment and saving  $I^*$ . However, assume that the government imposes a ceiling (CEILING 1) on both nominal deposit and loan interest rates and this ceiling causes an interest rate  $r_1$  below the equilibrium market-determined rate making a large proportion of investment ( $AB$ ) unsatisfied, which is called “credit rationing”. If the government undergoes a partial liberalisation by increasing the interest rate to  $r_2$ , via implementing CEILING 2, more savings of  $I_2$  would be realized through the savings function shifting to the right and thus the rate of economic growth increases from  $g_1$  to  $g_2$ . The efficiency of investment is increased by higher interest rates due to the fact that “entrepreneurs undertake projects with higher expected rate of return”, however, on the other hand, it is criticised as being more risky. Credit rationing still exists but narrower than before as the amount of  $CD$ . If the government goes for full liberalisation, namely, eliminates interest rate ceilings and more generally all other government regulations, which prevent the loan market from functioning competitively, then economic growth goes up to  $g_3$  and equilibrium savings and investment increases to  $E$  by the elimination of credit rationing (Gibson&Tsakalotos, 1994: 585-587).

Andersen and Tarp (2003) summarise the McKinnon–Shaw model as “[it] considers financial repression to be a disequilibrium phenomenon, which prevents markets from clearing and serving their allocative function in an optimal way. The policy implications are straight-forward: liberalize the financial system...” (Andersen and Tarp, 2003: 191).

Fry (1997) argues that the experiences of successful financial liberalisation programmes indicate some pre-conditions, notably adequate prudential regulation and supervision of commercial banks, price stability, fiscal discipline to prevent inflationary

expectations or currency appreciation, competitive and profit-maximization behaviour of banks and a non-discriminatory tax system to financial intermediaries should be maintained (Fry, 1997: 759). He underlines that economic growth is reduced by financial repression, but abandoning financial repression can be more costly for governments. So, he argues that "...to be successful financial liberalisation must be accompanied by fiscal reform aimed at ensuring that government debt will not explode in the aftermath of the liberalisation, as well as sound prudential supervision and regulation of the banking system" (Fry, 1997: 768).

## **II. THE THEORETICAL ARGUMENTS AGAINST THE "COMPLETE FINANCIAL LIBERALISATION"**

### **A. The Arguments against Domestic Financial Liberalisation**

The basic criticism in theory to this pure market-oriented approach comes from the Keynesian economics, maintaining that the conception of market economics as "self-equilibrating" is not valid necessarily, even in the full employment, as a contribution of new Keynesians, who argue that in the financial markets, as an example, even in a perfectly competitive loan markets, without government intervention, credit rationing, which affects a whole sector in an economy, can still exist. Because, in opposition to the literature of financial liberalisation assuming that freeing of interest rates will lead to elimination of credit rationing, they stress that market failures in general and asymmetric information in particular in loan markets may lead to credit rationing, since the quality of banks' loans will be negatively affected by higher interest rates that cause a fall of the rate of return on all projects and adverse selection problem (Gibson and Tsakalotos, 1994: 612-619). Moreover, Palma (1998) claims that under the circumstances of "an excess liquidity situation", as seen with the freeing of capital movements, if financial markets are "left to themselves" then they will be "not become deep, efficient, or robust" (Palma, 1998: 804).

It is also argued that a rise in savings does not mean a rise in investment, since savings and investments are not automatically equilibrated through movements in the interest rate, which is maintained in the money markets; moreover, investments are not only influenced by interest rate but also expectations of future demand and "animal spirits" (Gibson and Tsakalotos, 1994: 604). The second broad criticism to this classical approach comes in the context of institutions. It is argued that in the classical approach there is lack of the role of institutions, although in real economy, markets work through a whole network of institutions including the state, firms, employers federations, trade unions and banks *etc.*, which play a vital role in collecting information and reducing uncertainty, in order to have long-term, high-trust relations between market participants that lead a developing country to compete in international markets and hence for economic performance.

Stemming from this Keynesian view more comprehensive criticisms against complete financial liberalisation in developing countries have taken place in the literature, since it is argued that "simple liberalising programmes suggested by the financial

liberalisation literature are not appropriate for developing countries who should seek rather to promote a strategy which combines liberalisation with the development of appropriate institutions to enable the development of long-term, high-trust relations between economic agents” (Gibson and Tsakalotos, 1994: 605). In this regard, the arguments in theory against complete financial liberalisation in a developing country come from post-Keynesian and new structuralist schools that have the macroeconomic arguments against liberalisation and the stabilisation programmes, which accompany them, pointing out the negative effects of them on output, growth and inflation in the models that take the prices and wages as sticky. In addition, the recent criticisms against complete financial liberalisation in developing countries are about microeconomic arguments focusing on market failures, as moral hazard and adverse selection, which stem from the asymmetric information problems that can be commonly seen in financial markets, by leading to financial instability (Mishkin, 1999: 4). In this regard, Arestis and Demetriades (1999) criticise financial liberalization theory first in terms of its weak theoretical foundations including its assumptions, which are not consistent with reality, such as “perfect information” and “perfect competition” and its “institution-free analysis”. They argue that although the modern version of financial liberalization theory partly handles these criticisms by involving the prerequisites such as “banking supervision” and “macroeconomic stability”, financial liberalisation can still constitute the main basis of financial fragility resulting with financial crises in such prerequisites (Arestis and Demetriades, 1999: 443-445 and 454).

Within the Post-Keynesian view of financial liberalisation, it is argued that the effective demand, which is accepted as the main vehicle of economy, is affected by financial liberalisation negatively, contrary to the neoclassical approach of McKinnon and Shaw. Moreover, they argue that this may lead to financial instability and a fall in output growth (Gibson and Tsakalotos, 1994: 612-19).

Within the framework of neo-structuralist views of financial liberalisation, similar to the Post-Keynesians’ views, it is also argued that financial liberalisation may lead a reduction in aggregate demand through increasing saving, which causes a reduction in investment and consumption. They differ from Post-Keynesians in their detailed description of the supply of credit, focusing on the importance of the “curb (informal) market” for credit in developing countries and also their hypothesis on the potential negative impact of complete financial liberalisation in developing countries as “stagflation”. Moreover, they criticise the McKinnon- Shaw approach as the benefits of financial liberalisation is flawed since it was not able to model financial institutions in developing countries correctly, by not taking account the significant role of the unregulated curb markets, which also maintain direct funds to borrowers in developing countries (Hallwood and MacDonald, 2004: 433).

Within the framework of microeconomic arguments, it is argued that complete financial liberalisation may not produce the best framework for the promotion of the “dynamic efficiency and international competitiveness necessary for development”

(Gibson and Tsakalotos, 1994: 619). In this regard, it is pointed out that since the credit markets have asymmetric information problems where borrowers are likely to know more about their proposed projects than lenders, such as banks, the banks can face a situation of attracting bad borrowers who are willing to pay higher interest rates but less worried about the repayment (Gibson and Tsakalotos, 1994: 612-19 and Mishkin, 1999: 4). Moreover, it is argued that deposit insurance system, which is designed to prevent bankruptcies in developing countries, means bankers no longer need to worry about runs hence cause to riskier loans (The World Bank, 1989: 36).

Stiglitz and Weiss (1981) argue that increasing interest rates or collateral requirements could decrease the bank's profits by increasing the riskiness of the bank's loan composition via discouraging safer investors or leading to borrowers investing in riskier projects (Stiglitz and Weiss, 1981: 408). Moreover, contrary to the financial liberalisation approach Stiglitz (1994) maintains that capital allocation can be efficient thanks to "mild financial repression", with positive but not high interest rates, due to information imperfections in financial markets in developing countries. He lists the possible reasons as first lowering interest rates can develop the average quality of applicants to loans, second diminishing the cost of capital financial repression can enhance firm equity, third it can lead to export oriented growth and within this financial repression, sectors which support technological spillovers can be developed by directed credit programmes (Stiglitz, 1994: 39-42).

Demetriades and Luintel (1996) support the hypotheses of Courakis (1984), arguing that market structure has a significant impact on the way in which banking sector policies influence financial deepening, and the hypotheses of Stiglitz (1994), arguing that "asymmetric information may lead to monopolistic lending behaviour by individual banks". Because Demetriades and Luintel argue (1996) that contrary to financial liberalisation models, the banking sector, which is the main sector wanted to be liberalised to benefit market clearance, is indeed not competitive market in most of the developing countries, in opposition to the liberalisation models, rather an oligopolistic one due to dominated by a small number of banks and also, having asymmetric information, which gain bankers market power. So, contrary to the financial liberalisation arguments that object to any kind of controls, they maintain that "a lending rate ceiling can raise the volume of deposits under a monopoly banking" and also they argue that non-interest methods can be used to attract the volume of deposits by banks, giving supportive evidence from India (Demetriades and Luintel, 1996: 359, 361).

### **B. The Arguments against External Financial Liberalisation**

There is a growing list of arguments to complete and rapid financial liberalisation in developing countries due to its attitude making developing economies, which mostly do not have sound macroeconomic or financial conditions, appropriate legal framework or power to implement such a framework and have political corruption or market failures such as moral hazard problems or asymmetric information, vulnerable to financial crises more rapidly and destructively. It is criticised that although by virtue of liberalisation of capital in all over the world, enhancing the volume, speed and prevalence of capital is

aimed, without any barrier, this unrestricted movement of capital made the developing countries unstable, crisis prone and crisis spreader, fragile economies (Onis and Aysan, 2000: 132-133). In this regard, Arestis and Demetriades (1999) put the issue as follows: "...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" (Arestis and Demetriades, 1999: 449).

Sachs (1998) argues that the main reason of the many financial crises in the 1990s is the financial market liberalisation, particularly the elimination of controls on capital transactions, namely external financial liberalisation, pointing out a "boom-bust cycle, in which a sharp but temporary wave of capital inflow accompanied a pegged exchange rate" (Sachs, 1998: 254). It is argued that under the complete financial liberalisation of the external financial markets, high interest rates attract foreign capital, especially short term ones, the so called 'hot money', to "deregulated and liberalised domestic financial markets" causing real appreciation of the domestic currencies, which thus further worsen the trade balance and existing current account deficits of developing countries, by turning relative prices against exports (Kregel, 1998: 3). In this regard, without doing necessary structural regulations, such as fiscal discipline, rehabilitation of banking sector, risk management and independency of central bank, the interest rates get higher to fill the current account gap, leading to bubbles in asset prices, which attract more hot money, pointing out the self-reinforcing dynamics of the complete external financial liberalisation process, which is summarised in figure 2. Kaminsky (2005) puts it as follows: "Capital outflows worry policy makers, but so do capital inflows, as they may trigger bubbles in asset markets and lead to an appreciation of the domestic currency and a loss of competitiveness. Policy makers also worry that capital inflows are mostly of the "hot money" type, which is why capital controls have mostly targeted short-term capital inflows" (Kaminsky, 2005: 20). In this regard, in such a heated and fragile environment any economic, political or natural development, inside or outside the country, makes expectations adverse and thus causes capital to outflow rapidly.<sup>3</sup>

Schmukler and Zoido-Lobaton (2001) put the challenges of financial globalization as follows:

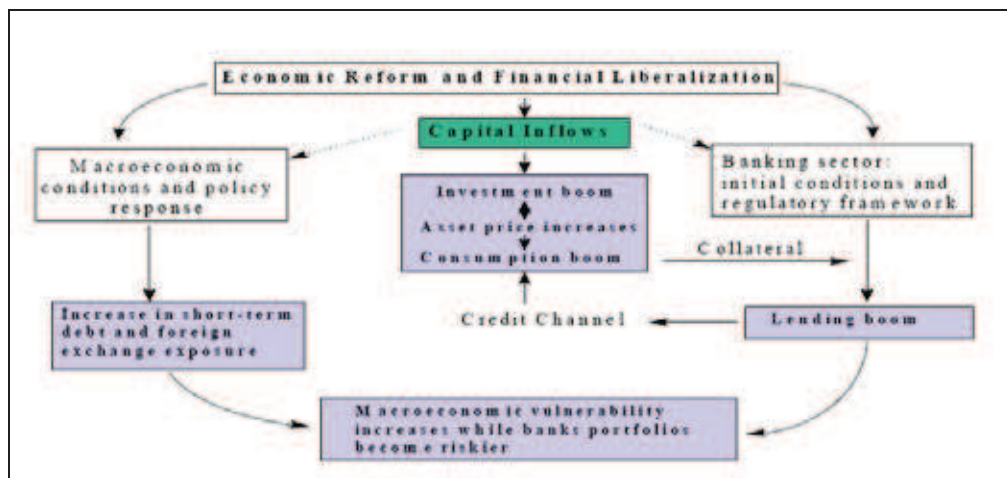
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<sup>3</sup>Although the crisis effect of the short term capital inflows, the so called hot money, as leading Current Account Deficit (CAD) by appreciating local currency and creating virtual welfare increase was widely examined in the literature, Foreign Direct Investment (FDI) compared to hot money were accepted more innocent and beneficial for the host country. However, FDI has been recently started to be criticized in terms of its possible crisis effect through the time inconsistencies of the transfers of its profits, which are from the host country to home country. In this regard, Singh (2005) argues that FDI surges also can cause undesirable results, such as exchange rate appreciation and so, decreasing developing country's competitiveness on international trade (Singh, 2005: 9). He argues that to avoid the financial fragility, stemming from the "unfettered FDI", which bases the economic structure prone to crises, the governments would need to monitor and regulate the amount and timing of FDI. Because, aggregate foreign exchange inflows and outflows, both in the short and long run, might be stemmed from the large FDI projects, which may generate a "time profile" of these outflows, in the form of dividend payments or profits transaction, and inflows that can be time inconsistent. In this regard, this time inconsistency can cause liquidity crises and even solvency crisis with worse consequences for economic development as seen in Asia (Singh, 2005: 9-10).



“Liberalization can lead to financial crises when it is not well managed. If the right financial infrastructure is not in place or is not put in place while integrating, liberalization followed by capital inflows can debilitate the health of the local financial system. If market fundamentals deteriorate, speculative attacks will occur with capital outflows from both domestic and foreign investors. For successful integration, economic fundamentals need to be and remain strong. Local markets need to be properly regulated and supervised. The need for strong fundamentals is key since, other things equal, financial globalization tends to intensify a country’s sensitivities to foreign shocks. Moreover, international market imperfections, such as herding, panics and boom-bust cycles, and the fluctuating nature of capital flows can lead to crises and contagion, even in countries with good economic fundamentals” (Schmukler and Zoido-Lobaton, 2001: 3).

In this respect, sudden movements of short term capital in a rapid and complete financial liberalisation of the developing economies in the 1990s are blamed for “violent fluctuations in foreign exchange rates that caused domestic financial turmoil that then led to further fluctuations in exchange rates and spread to other economies” (Tomita, 2000: 2), causing international financial crises, which then turn to economic crises with severe social consequences.



**Figure 2: Self-reinforcing Dynamics of the Complete External Financial Liberalisation Process**

Source: Alba *et al.*, 1998: 34.

In addition, Buira (1999) maintains that massive speculative flows, which are seen as difficult to ignore or underestimate in “the new global, electronically linked markets”, have not been taken sufficient care, pointing out the market distortions in the financial markets, particularly, in the banking sector (Buira, 1999: 8-9).

It is also argued that in this “new global, electronically linked markets” of the 1990s, the financial crises can emerge in the developing countries, which have even sound macroeconomic fundamentals, such as no fiscal deficits or Current Account Deficits (CAD), or have the right government policies, on the contrary to Fry’s (1997) arguments, underlined in the previous pages. All these point out the significance of the speculative attacks to the foreign exchanges and sudden capital outflows that create self-fulfilling crises, which are experienced under the free flowing foreign capital movements, which put the central banks on the spot exposure. This can be either in the case of fixed exchange rate system to maintain the fixed exchange rate or floating exchange rate system to stabilize the economy following a speculative attack or at the financial disruption. In this regard, IMF (2002) puts the differences between the “new type” currency crisis and the “old type” or “slow motion” currency crisis as the “new type” currency crisis occurs in fully liberalized domestic financial markets that are completely integrated with the world financial markets, by the sudden withdrawing of foreign creditors, who worry about the creditworthiness of the balance sheets of corporations, leading to “capital account crisis” due to the diminishing of foreign funding, contrary to the old type, which occurs when the overspending and real appreciation of local currency are followed by the huge current account deficits (IMF, 2002: 4).

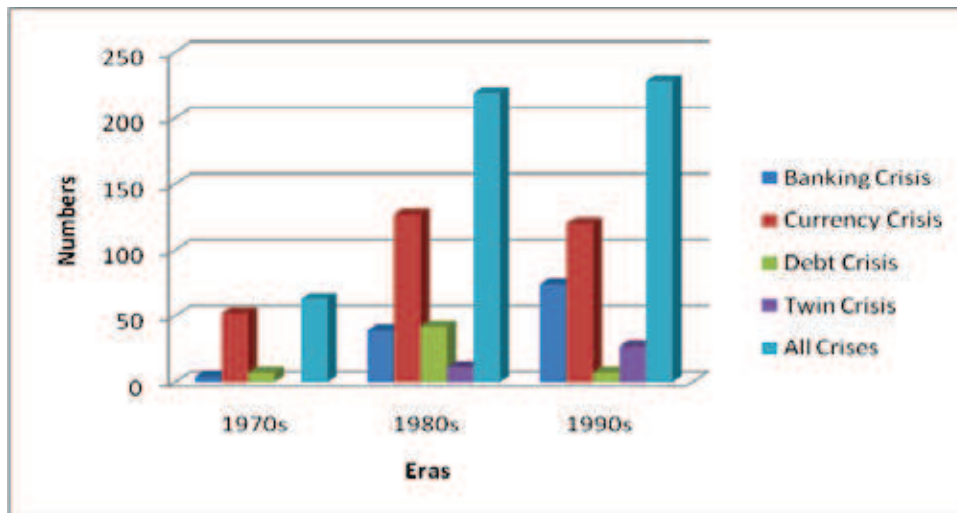
It is also stressed that the “irrational market behaviours” as herding behaviour, in which creditors act on the basis of the actions of the other creditors, not the basis of debtor countries’ economic fundamentals, with the asymmetric information problems, and thus, contagion issues, constitute the problems which developing countries suffer from, as seen in the South East Asian crisis, due to the complete financial liberalisation of the external markets, as well as the domestic ones. In addition, Buirra (1999) maintains that if there is a continuing well-based support of international community or IMF, it is not a rule that governments’ inconsistent monetary policies with exchange rates or weak macroeconomic fundamentals of the developing countries will always create crises by the support of international community or IMF that manipulate expectations of international investors (Buirra, 1999: 25).

It was advocated to apply some restrictions on portfolio investment, such as “speed bumps” requirements that investors hold onto financial instruments for a certain length of time. Or as Tobin (1996)’s highly discussed recommendation, the so-called “Tobin Tax”, a fixed rate of global tax on very short term capital flows as a mechanism like putting “sand in the wheel” (Tobin, 1996: 654-657) was also tackled. In this regard, it was recommended to use capital controls, taxes on inflows or outflows of the foreign capital movements, in developing countries to avoid financial crises or to prevent the deepening the crises. However, it is maintained that although a consensus constituted about taxes on short term capital inflows, as seen in Chilean case, it is seen dangerous to implement controls on capital outflows, pointing out the negative consequences of Malaysia’s experiment. On the other hand, it is argued that if irrational investors panic is the case whenever the government activities its stabilizers, then it can be relevant for countries to implement even such controls on capital outflows (Eichengreen, 1999: 55-56). Arguing that implementing capital controls depend on the economic and also political situation of

a country, Mosley and Duasa (2005) point out that “the smart controls” on capital movements can be the case if they are temporarily crisis measures, as seen in Malaysia, that encourage efficiency and productivity in the country by some devices, such as “performance contracts” implemented by government, the incentives that prevent rent seeking behaviours and promote local market competition (Mosley and Duasa, 2005: 24-25).

### III. THE EXPERIMENTAL ARGUMENTS AGAINST “COMPLETE FINANCIAL LIBERALISATION”

Since the 1980s the world has witnessed several financial crises as banking crises or currency crises or both of them, as called “twin crises”, which can be seen in figure 3. It is argued that all these financial crises were experienced mainly because of the nearly complete and rapid financial liberalisation, which was realized under the weak financial systems of most of the crisis countries.



**Figure 3: The Frequency of Financial Crises**

**Source: Laeven and Valencia, 2008: 56.**

In this regard, Radelet and Sachs (1998) put this issue as follows: “...Capital market liberalisation in Latin America, Eastern Europe and Asia has been followed by extreme macroeconomic crises... The rapid expansion in financial services was not matched by careful regulation and supervision. Regulatory reforms tended to be partial and incomplete...” (Radelet and Sachs, 1998: 13, 40). So, it is argued that sequencing of liberalisation process can be crucial to have the benefits of liberalisation and to avoid its possible detriments to developing economies. In this regard, it is argued that before liberalisation process, some protectionist policies should be implemented in order to strengthen the domestic firms and to make them ready for competition in development

process. After this stage, it is maintained that the liberalisation process, which should serve to welfare, as mentioned in the introduction part by the quotation from Furman and Stiglitz (1998), should be in sequencing as follows.

Domestic real sector liberalisation as “privatisation, setting up market-price system, removal of implicit or explicit taxes or subsidies on firms” and thus, increasing competitiveness of domestic markets should be the first and then domestic financial liberalisation in terms of “domestic banking system”, as freeing of interest rates and “domestic capital markets”, as strengthening and deepening capital markets, by diversification of financial tools and promoting the “listing of local firms”, should be implemented and lastly external financial liberalisation, as “removal of capital controls” should be done, after the external real sector liberalisation, as “removal of trade barriers”. All these “sequencing of economic reforms” point out “the order of liberalisation” that should be implemented in developing countries, including transition economies (Gibson and Tsakalotos, 1994: 591-592). In this regard, it is agreed that external financial liberalisation process should be implemented at the last stage of liberalisation process, in order to prevent the possibility of funds from inflowing to the unproductive sectors, by the intermediation of unsound banks that “gamble for resurrection” (Williamson and Mahar, 1998: 25).

In the first years of the 1980s, banking crises in the Southern Cone were experienced with several negative consequences to the overall economy as high inflation, rising unemployment, and the reimposition of financial repression (Hallwood and MacDonald, 2004: 436). Pointing out that “twin crises have something to do with deregulation of the financial sector” Andersen and Tarp (2003) note that the banking crises in Argentina and Chile are estimated to have caused losses in the order of 20–55 and 13–42 per cent of GDP, respectively, which is closer to the upper end of these ranges in both cases. Among the financial crises experienced in the 1990s, the ‘Tequila Crisis’ in Mexico in 1994 cost around 12 per cent of GDP for restructuring and the Southeast Asian crisis caused losses for Thailand, Indonesia and Korea in the order of 20–50 per cent of GDP (Andersen and Tarp, 2003: 190). It is argued that all these financial crises were experienced mainly because of the complete and rapid financial liberalisation which was realized under the weak financial system of most of the crisis countries of which banking sector is described as follows:

“...commercial banking skills are scarce and the legal framework for enforcing contracts is weak. Banking supervision is impeded by human resource constraints and there is a shortage of qualified professionals... Poor accounting standards further obstruct the task of supervision. Regulators need to be able to measure and value bank capital, but they may not be able to rely on bank accounts...To stay in business, banks have resorted to accounting fraud and backed deposits with credit enhancements from the government. Such insolvent banks are extremely damaging to the goal of allocating resources optimally. To improve chances of becoming solvent again, insolvent banks engage in paying too high deposit rates and accepting too low interest rates on high-risk loans and investments” (Andersen and Tarp, 2003: 198).

Beside their weak financial system, their macroeconomic indicators, generally CAD and in some cases, fiscal budget deficits could be problematic also. In this regard, capital inflows, which were attracted by high real interest rates, could be used by governments to finance their budget deficits, causing a sharp appreciation of real exchange rate and hence large current deficits after complete financial liberalisation. This also points out the “virtual welfare increase” promoting consumption in developing countries due to complete financial liberalisation (FL). Weller (2001) puts the issue as follows:

“...emerging economies become more vulnerable to both currency and banking crises after FL. In this view, greater internal and external deregulation result in more instabilities as greater liquidity is used increasingly for unsustainable, speculative expansions....This is not to say that institutional or macroeconomic weaknesses may not raise the likelihood of crises, but that they are unlikely to disappear due to deregulation. Already existing structural weaknesses are likely to become even more severe in a more deregulated environment” (Weller, 2001: 99-100)

Consequently, as the real exchange rates appreciated foreign debt mounted rapidly, having pointed out the dead end of the system through a financial crisis. By any relevant news, massive capital outflows realized, having caused a sharp devaluation of the exchange rate, the rapid increase of the net foreign debt and the triggering of governmental indebtedness faster than ever before (Hallwood and MacDonald, 2004: 436-437).

Gibson and Tsakalotos (1994) also note that evidence from developing countries shows that financial liberalisation does not necessarily create increased investment. Moreover, it often creates more credit for consumption in developing countries, albeit from developed countries, but not necessarily for industry. Hence it is criticised in terms of being not adequate for supporting restructuring and investment in new dynamic sectors, which are vital for development (Gibson and Tsakalotos, 1994: 613). In this regard, Arestis and Demetriades (1999) maintain that although financial liberalization is handled as a supporting factor for economic development by increasing saving, investment and the productivity of capital by theoretical models, the experiences about financial liberalization coming from both developing and developed countries do not support this prediction, pointing out important destabilizing results such as severe financial crises (Arestis and Demetriades, 1999: 441).

It is noted that when in the 1960s and the 1970s negative real interest rates for depositors, caused by public controls over the banking system, made “financial repression” an obstacle to domestic savings and hence prevent their efficient allocation, and made financial intermediation inefficient, the Southern Cone countries, “coming out of sundry populist experiences around the mid-1970s”, implemented financial reforms going beyond those of Brazil “in a laissez-faire direction”. In this regard, Post-1973 Chile is accepted as the clearest example of this type of financial liberalisation. However, Diaz-Alejandro (1985) points out that during 1981, Chile with a 14 per cent CAD of its GNP, had also “the concentration of potential economic power in the hands of a few

conglomerates or economic groups, which combined financial and nonfinancial cooperation” (Diaz-Alejandro, 1985: 9). Not only Chile but also Argentina, Uruguay, Thailand and South Korea have witnessed oligopolistic banking and “in-house lending practices”, which make firms overleveraged under the inadequate regulations and supervision, pointing out the detriments of financial liberalisation and financial opening policies when they were implemented at times when the economy is prone to crises, since the companies were highly indebted (Vos, 1995: 206-207).

The problem about the banking sector has been experienced in the transition countries also; among them the Russian case is famous. In this regard, it is pointed out that in Russia, similar to some crisis-hit developing countries, the government failed to overcome some oligopolistic groups, both from the old structure and the new oligarchs, and could not implement reforms soundly and completely. In the Transition Report 1998, it is underlined that “problematic corporate governance, slow restructuring and weak financial system” had several negative consequences in the transition economies, especially in Russia, which influenced the contagion of East Asia crises (European Bank, 1998: vii). In this regard, it is pointed out that the rapid pace of liberalisation and privatisation in the transition process of Russia, which were not accompanied by the development of institutions to back a well functioning market economy, caused market distortions as well as the huge gaps between sectors, such as banking sector and real sector and also inequalities in the society.

It is maintained that although most of the transition economies made significant developments on modern securities laws, few were successful in implementing them due to lack of supervisory institutions. So, fraud was commonly seen in those countries, *e.g.* in Romania or Albania (The World Bank, 1996: 107). In Russia also, the legal framework for finance and also implementing process were inadequate, so that the vulnerability of banking sector was high, due to their open foreign exchange positions and off-balance sheet activities. Moreover, banks especially financed government deficits not the real sector, causing the banking sector and government to be highly vulnerable to the volatilities of international capital markets (European Bank, 1998: 2-9).

Moreover, Gibson and Tsakalotos (1994) note that complete financial liberalisation is not the only case for successful development process, since the achievement in development of a number of Asian countries through allocating credits to some priority areas for development seems to prove the significant role of government in the development process. And also market failures, creating instability with high social costs in a number of Latin American countries, contribute to these arguments against complete financial liberalisation as maintaining supportive evidence. Hence, Gibson and Tsakalotos (1994) stress that it is not clear that traditional liberalisation programmes lead to growth in developing countries due to evidences from the experience and literature and

also the possibility of stagflation, as one of the worst cases for development (Gibson and Tsakalotos, 1994: 619).<sup>4</sup>

In the work of Vos (1995), it is argued that the experience on financial liberalisation is not uniform as its success depends on a number of factors related to “domestic economic structure and the organisation of the financial system, external conditions and the timing and nature of government interventions” (Vos, 1995: 182). In this regard, in several Latin American countries where complete financial liberalisation was implemented significant banking crises with its related economic recessions, which needed “subsequent government interventions at considerable economic cost”, were experienced. On the other hand, in a number of successful East Asian developing countries, such as the South Korea, which implemented a gradual and cautious approach towards financial liberalisation contrary to the complete and rapid financial liberalisation of Latin American cases, tightly government controls were used over the financial sector for several decades (Vos, 1995: 182).

However, this slow and cautious approach towards financial liberalisation, which is also described as “a rightly controlled financial system”, continued till the early 1990s. In this regard, it is noted that in South Korea, in the run-up to its crisis in 1997, complete and rapid financial sector liberalization started from the early 1990s by relaxing government controls on the financial sector and in 1993, the liberalization process was accelerated significantly by the Kim government, which declared a comprehensive five-year financial liberalisation plan in 1993 (Chang *et al.*, 1998: 736). Moreover, Andersen and Tarp (2003) give the successful economic development cases of China and Vietnam, which are not famous with their liberalized financial systems, in their own words “...while China and Vietnam are not exactly known for their liberalized financial systems, they are clearly front-runners in terms of economic growth” (Andersen and Tarp, 2003: 205). In this regard, in the development literature it is argued that to benefit the FDI for development, developing countries should have absorptive capacity such as human capital, physical infrastructure, qualified institutions etc. Even in that case, FDI should be the most efficient one with the motivation of seeking new strategic assets to achieve strong positive spillover benefits, not only seeking natural resources or seeking new markets or not to be mostly “brownfield investment”. Moreover, the host countries, which have even absorptive capacities for FDI, should implement “national development and technological plans” to benefit from the FDI, as in Asia (See Dunning, 1994; Freeman and Hagedoorn, 1989; Milberg, 1999). As Singh (2005) puts it, if developing countries want to attract the right kind of FDI, in the right amounts, and to be able to maximize the benefits from FDI for developing, there should be effective states that manage the process (Singh, 2005: 12). Otherwise, if the government is weak in both regulating and bargaining FDI, then it will cause “unequal distribution of benefits or abuse of market power” by MNCs (Lall, 2000: 8).

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<sup>4</sup>See Sarialioglu-Hayali (2009) for the criticisms towards traditional liberalisation programmes within the framework of FDI in terms of developmental perspective.

Vos (1995) underlines that in Turkey, Chile and the Philippines, the cases in which complete financial liberalisation was realized under unstable macroeconomic conditions, financial liberalisation caused a decrease in household savings whereas an increase in financial savings and also, in Brazil, Chile, Uruguay and the Philippines corporate profits and savings reduced drastically although interest rates were increased. It is pointed out that this non uniform experience shows that freeing of interest rates is not a sufficient condition for increasing savings, investment and growth. Rather, higher interest rates can even reduce private savings under unstable macroeconomic conditions and market imperfections, “some of which are inherent to financial markets in developing countries such as asymmetric information, and problems of moral hazard, some of which are rooted in the historical development of financial institutions, such as bank concentration and interlocking interest between bank and non-bank firms”. So, it is stressed that financial markets and institutions in developing countries are not usually perfect and not like “the text-book-type agents as optimally allocating resources” (Vos, 1995: 180-189), referring to the possible negative effects of domestic financial liberalisation in such cases.

### CONCLUSION

Significant arguments, which cannot be ignored, against complete financial liberalisation in developing countries come from both the literature and the experiences. All these generally argue that it is not a good idea to implement complete and rapid financial liberalisation in developing countries. At least, it is stressed that in emerging market countries before financial liberalisation, the weak financial system and macroeconomic background should be strengthened. In this regard, all this process should be done in a sequencing manner that takes account the order of domestic and external markets liberalisation.

Pointing out the potential negative consequences of complete financial liberalisation Andersen and Tarp (2003) put what should be done as follows:

“Liberalisation has to be managed carefully, and that it is imperative that the proper bank regulatory and supervisory structures are in place before liberalisation is attempted... An efficient regulatory structure is a *sine qua none* for financial liberalisation to work, financial liberalisation combined with an inappropriate regulatory structure may well carry with it highly problematic economic consequences” (Andersen and Tarp, 2003: 190).

More surprisingly, in the second golden era of liberalisation, started from the 1980s, after 19th century, the significance of government in a stable non-crisis development process of developing countries was started to be rediscovered. It is also underlined in the World Development Report that governments should play a key role even in market-oriented economies as prudential regulators, since experience has demonstrated that financial markets can be prone to instability and vulnerable to fraud (The World Bank, 1989: 26 and 36). So, it is maintained that governments had to regulate and supervise the financial system in developing countries (The World Bank, 1989: 26, 36), which can be accepted as the base of the arguments against the complete financial liberalisation advocating the eliminating of all kinds of government action.



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