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National Financial Policy in Developing Countries

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A fundamental question raised by recurrent financial crises in mature and emerging economies is how to ensure that the financial markets and institutions serve growth and development rather than being a constant source of instability and disruption in pursuit of self-interest. This is not only a question of how best to regulate the existing institutions and markets, but also how to restructure and organize them.

Starting in the 1980s, most developing and emerging economies (DEEs) have rapidly liberalized their domestic financial markets and institutions, dismantling control over interest rates and credit allocation, privatizing state-owned banks and allowing entry of foreign firms in financial services, both in banking and insurance. Many of them, including several African countries at a rudimentary state of industrialization and development, have also sought to establish and expand stock markets along the Anglo-American system of market-based finance even before establishing a modern banking system capable of supporting industrialization and development. The public sector has shifted almost everywhere from direct to indirect financing, but market discipline has failed to ensure greater fiscal discipline and restrain public deficits. Rather, many governments have seen a rapid accumulation of domestic debt.

There has also been widespread liberalization of the capital account, allowing freedom for most types of inflows from non-residents. Domestic equity and debt markets have been increasingly opened to foreigners in order to provide external financing for public and private sectors and to deepen these markets in the belief that this would make a major contribution to stability and growth. More recently, resident investment abroad has also been liberalized in several countries, in part in order to alleviate the pressure that the surge in capital inflows has exerted on currencies and balance of payments.

The record of DEEs under extensive state intervention in the financial system, described as "financial repression" by orthodox economists, with respect to stability and growth is mixed. While several economies had a poor record in terms of public sector deficits, inflation, savings, investment and growth, there were also notable exceptions, particularly among the late industrializers in East Asia. Similarly, Japan and many other mature economies which resorted to varying degrees of financial control in the decades following the second war enjoyed rapid and stable growth. For instance in the US where Regulation Q prohibited, until 1980, payment of interest on demand deposits and imposed a cap on interest rates on savings deposits, private savings were much higher than in the subsequent period of financial liberalization and financialization – that is, rapid growth of financial activities and incomes relative to the real economy. Today, several fast growing DEEs such as China and India still retain elements of extensive control over financial markets and institutions, and they have much better record with respect to savings and investment than many other DEEs with significantly liberalized financial systems.

Evidence suggests the absence of a strong link between the financial intensity of an economy and its growth rate. By contrast, excessive financial liberalization has clearly resulted in greater macroeconomic and financial instability in almost all countries, as well as compromising the ability of governments in DEEs to use financial policies for industrialization and development. The pendulum has swung too far with the benefits of free financial markets falling rapidly as liberalization surged ahead at full speed. Now, a rebalancing is necessary between state intervention and free markets in the sphere of finance in search for greater stability and sustained industrialization and growth. In this context at least five key issues need to be examined, drawing on the recent experience of both mature and emerging economies: the pros and cons of bank-based and market-based financial systems; the role of state owned banks; public intervention in private banking; the role and impact of foreign banks; and capital account liberalization.

Bank-based versus market-based financial systems

The first issue is whether DEEs should focus on developing and modernizing their banks along the lines of the German-Japanese bank-based system or promoting direct financing through securities markets following the Anglo-American market-based system of finance. The bank–based finance involves long-term lending by banks to enterprises and, hence, necessitate substantial own capital to safeguard solvency. By contrast, in the market-based finance, banks focus on short-term lending and hence need only adequate reserves and access to lender-of-last resort financing in order to avert liquidity crises, while corporate investment depends mainly on share issues. It is often argued that the bank-based system allows better monitoring of enterprises by banks and of banks by the state, gives access to finance to larger segments of the society and generates more evenly spread wealth. On the other hand, stock markets are said to provide wider options in the allocation of risks and monitoring by shareholders, but foster short-termism.

Historically the bank-based system is found to be more stable. However, there are also important instances of severe banking instability and crises. The Japanese banking crisis starting in the late 1990s is a well-known example. It was triggered by massive equity-based loans to private enterprises to support excessive and unviable investment and it cost the country at least a lost decade. Another example is Korea where extensive short-term foreign borrowing by banks to support global expansion of Chaebols was a major reason for the 1997 crisis. A similar situation emerged in 2008 but the crisis was much less deep thanks to the existence of large reserves.

With the outbreak of the sub-prime crisis, a view emerged that "the world has turned a page on the Anglo-Saxon model" (Sarkozy after the London summit of G20 in April 2009). But in reality with the repeal of the Glass Steagall Act in 1999, the US had moved to universal banking, lending long-term and securitizing and marketing their illiquid, non-traded claims. On the other hand, banks in Germany had invested heavily in the so-called toxic assets produced during the sub-prime bubble and consequently suffered large losses. More importantly, the bank-based system in Europe has been experiencing serious difficulties as a result of massive and rapid lending to support speculative private investment in property as well as to meet growing budget deficits in some of the peripheral countries. These developments no doubt hold valuable lessons for DEEs in organizing and regulating their financial systems.

Role of state-owned banks

Despite widespread privatization, state-owned banks continue to hold prominent positions in a number of DEEs, including major emerging economies such as Brazil, China and India. In some advanced economies too such as France, state ownership still continues to be important in the banking sector. Moreover, as a result of bailout operations necessitated by financial crises, governments in several countries have come to be major shareholders in previously privately owned banks. These include not only developing countries facing BOP-cum-financial crises in the 1990s and early 2000s (e.g., Malaysia and Turkey) but also some mature economies such as the UK where the government is the dominant shareholder in Northern Rock and Royal Bank of Scotland.

Privatization has always been advocated on grounds that state-owned banks are prone to inefficiency, waste and political capture. However, after recurrent crises involving private banks, it is now widely recognized that what is privately profitable is not necessarily socially efficient, and waste and political capture are not peculiar to state-owned banks. Indeed, private and public banks now appear to have reached a modus vivendi, and in some DEEs state-owned banks are now considered as more secure than private banks, with the public shifting deposits from the latter to the former during the recent crisis (see The Economist, May 13, 2010).

Public banks appear to have three main advantages compared to private banks. First, they can accelerate industrialization and development by directing credits at appropriate terms and conditions to sectors that have greater capacity to contribute to overall development. Second, they can embrace all segments of society in providing financial services, including poor and self-employed in rural and urban areas and SMEs. Efficient operation in these areas calls for reciprocity between support and performance and clear identification of the subsidy elements in lending and provision in the budget. Third, public banks have proved to be more effective in providing counter-cyclical financing during the recent economic downturn brought about by the sub-prime crisis.

However, it is also true that there are political cycles in lending by public banks in DEEs, with credit expanding rapidly before elections even when macroeconomic conditions do not warrant such an expansion. A main challenge thus is how to ensure that the public banks effectively render the function of developmental, inclusive and countercyclical lending while avoiding political cycles and rent seeking.

Public intervention in private banking

State ownership is not always necessary for many of the above functions to be rendered effectively. In Japan, without ownership the government exerted considerable control over the banking system through moral suasion and other means in the course of its industrial development. Again, late-industrializers in East Asia implemented policies of directed credit for industrialization through private banks, using administrative control, cross subsidies and incentives. However, in many cases intervention in the credit market was designed to provide cheap finance to the public sector by means of control over interest rates and compulsory holding of non-interest bearing government paper.

Such controls existed until the 1980s not only in DEEs but also in advanced economies. Restrictions on interest rate are estimated to have made a major contribution to the reduction of government war debt in the US and UK between 1945 and 1980. Recent interventions in several mature economies are also seen in this light. Increased purchases of government debt by central banks, negative real interest rates, higher liquidity requirements to be held in government securities and legislation forcing pension funds to hold government debt are all seen as signs of return of financial repression in mature economies (see IMF Finance and Development June 2011). Still, it remains true that these measures have been introduced not out of ideological conviction but to address the problem of increased public debt resulting from bailout operations and countercyclical policies necessitated by the financial crises triggered by speculative lending and investment by private banks.

The US experience with community banking also holds lessons for DEEs on how arrangements in a system dominated by private banks can help promote inclusive finance. Until 1980, the US legislation placed constraints on geographical diversification of activities of private banks. This forced them to focus on the neighbourhood in which they were operating, allocating much of their credits to communities in which they collected deposits. These restrictions were dismantled after the 1980s leading to a rapid concentration in the banking sector, a factor widely seen as having made a major contribution to the sub-prime crisis.

Another factor that favoured community banking in the US is the Community Reinvestment Act of 1977 designed to promote lending by commercial banks and savings associations to all segments of the society, notably in low- and medium-income areas. It has been argued that lending under this Act, as well as property lending by government sponsored agencies, Fannie Mae and Freddie Mac, was responsible for the subprime crisis, but studies by the Fed and BIS have found no evidence on the role of the CRA lending. Nevertheless, the policy of providing shelter to all segments of the society allowed the banks to engage in reckless lending without coming under close scrutiny. This experience thus holds lessons on how to prevent attempts to take financial services to all segments of the society becoming a source of instability.

Foreign banks

Entry of foreign banks to DEEs is often encouraged for two major reasons. First, by bringing know how, technology and competition foreign banks could increase efficiency in the banking system, improving financial services and reducing intermediation margins. Second, greater presence of foreign banks is seen to increase the access of DEEs to international financial markets and enhance their resilience to external financial shocks. These considerations have no doubt played an important role in several DEEs making commitments under GATS negotiations in the WTO in trade in financial services.

However, it is also recognized that the presence of foreign banks in DEEs enhance the scope for regulatory arbitrage. Such banks can easily shift large deposits and lending abroad in order to benefit from more favourable regulations. They tend to focus on more profitable operations such as trade credits, credit card lending to consumers and lending to large corporations, leaving less profitable activities and weaker borrowers, including SMEs, to domestic banks.

By contrast, significant presence of foreign banks in DEEs could increase their susceptibility to external financial shocks. In this respect the recent experience of Central and Eastern European countries holds many useful lessons. The banking system in several countries in that region is dominated by foreign banks (BIS Papers 54). These banks were heavily involved in carry-trade style lending before the outbreak of the global crisis, externally funding their domestic lending and benefiting from large arbitrage margins (see Akyüz paper on Capital Flows). When the subprime crisis broke out and banks in advanced economies came under liquidity squeeze, these subsidiaries acted as a conduit of capital outflows in support of their parent banks. The resolution of the consequent payments difficulties faced by several countries in the region necessitated international intervention involving the IMF and the European Commission, under the so-called Vienna Initiative, and entailing pro-cyclical policy conditionality.

The pros and cons of opening markets to foreign banks in terms of efficiency, its effect on vulnerability to external shocks and regulatory arbitrage need to be assessed, drawing on such lessons. This is also necessary for DEEs to develop a viable negotiating strategy for GATS in the WTO.

Capital account liberalization

Just as the case with domestic financial liberalization, there is no strong link between capital account openness and economic growth. But there is mounting evidence that capital account openness tends to lead to increased susceptibility to financial instability due to swings in capital flows and international contagion. However, despite recurrent crises triggered by reversal of capital flows in the 1990s and early 2000s, DEEs have continued to liberalize international capital flows in more recent years, including for both non-residents and residents.

Several emerging economies in Latin America and Europe have left their balance of payments and exchange rates to the whims of capital flows, but in Asia most countries have taken measures to reduce the likelihood of payments crises associated with boom-bust cycles in capital flows, by pursuing strong payments and reserve positions. The typical response of these countries to the surge in capital flows that developed alongside the global liquidity bubble after 2003 and sharp cuts in interest rates and rapid liquidity expansion in response to the consequent crisis of 2007-08 has been sterilized interventions in currency markets. In many cases interventions have also been accompanied by increased liberalization of resident investment abroad as a means of alleviating the pressures on the currency.

While preventing adverse impact of surges in capital flows on external trade and payments, these measures have not addressed a number of other problems associated with surges in inflows. Currency market interventions cannot prevent currency and maturity mismatches in private balance sheets, but only provide public insurance against private risks. It is costly to the government since rates on government debt used for sterilization exceed the return on reserves. It is also costly for the economy as a whole because return earned by foreigners on investment in DEEs exceeds the yield on reserves by a wide margin. More importantly, full sterilization is difficult and the consequent liquidity expansion often leads to bubbles in asset markets. In fact, asset markets in DEEs are now increasingly correlated with swings in net capital flows.

Similarly, liberalization of resident investment abroad could ease pressure on the currency and prevent liquidity expansion and the possible asset bubbles. But it does not prevent currency mismatches in private balance sheets. It also increases exposure to financial instability and crisis abroad, as seen in many European countries during the subprime turmoil where large sums were lost on investment in toxic assets. More importantly, it could mean one-way traffic – there is no guarantee that money will come back during bad times. In other words, unlike reserve accumulation, resident investment abroad does not provide self-insurance against reversal of capital inflows.

All these can make control over capital flows an indispensable tool in responding to destabilizing surges. Appropriately extended prudential measures can limit mismatches in banks' balance sheets and credit-related forex risks. But these may not be enough to contain destabilizing impulses since about 70 per cent of inflows to DEEs are not intermediated by the banking system. More direct measures may be needed. Indeed several DEEs have made attempts to introduce control over capital inflows in recent years. But these tax-based, market friendly ad hoc and partial measures have not been very effective in containing destabilizing impulses.

In view of heightened instability of capital flows due to self-seeking policies and increased financial difficulties in AEs, it is important to reconsider the policy response to surges in capital flows to DEEs. A key question in this respect is whether DEEs should establish a permanent regime of controls, to be used in appropriate doses as and when required, rather than introducing ad hoc market-friendly measures on a temporary basis, as now advocated by the mainstream, including the IMF.

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