FINANCIAL LIBERALIZATION: HOW FAR? HOW FAST?

Introduction and Overview

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Abstract

Financial liberalization has had a dramatic effect on financial sector and general economic performance. There have been distributional consequences in the form of reduced or relocated rents; increased competition in the financial services industry and increased volatility of asset prices. All this has meant greatly altered incentives for risk-taking, risk management and corporate governance of financial intermediaries. In many cases, liberalization went too far too fast, with consequences that are all too evident. The solution is not to turn the clock back, but to strengthen the overall policy environment in which these effects have been occurring. Drawing on the variety of experience coming from countries which entered the liberalization process from widely different initial conditions, this volume aims to contribute to the formulation of an improved policy package designed to limit the adverse side-effects of liberalization.

1. Introduction

It was always on the cards that liberalization of financial markets, and specifically interest rate liberalization, had the potential to present surprises, and the speed and scale of some of the consequences, favorable and unfavorable, have often been breathtaking. But the broad main outlines of the major risks were foreseen. In advance, it was evident that the replacement of rationing of credit by quantity with rationing by price could impose substantial losses on those who had had privileged access to borrowed funds, including the government and its agencies. It also seemed likely that interest rates and asset prices, having been tightly controlled in repressive regimes, would become much more volatile, increasing risk. And there were also early warnings that, with monopoly profits severely eroded, banks could become prone to risk-taking and even looting by their managers, behavior that was tolerated by insouciant depositors, confident that they would be protected by government.

The severity of these problems in practice has depended on initial conditions, but it must now be acknowledged that the policy framework needed to limit the adverse side-effects of liberalization has generally been inadequate. Loss of rents from the financial system has seen fiscal authorities reacting in different ways, with perverse responses often resulting in protracted and painful adjustments. Liberalization in a volatile and uncertain policy or external environment has sometimes ended in hyperinflation or even a retreat into barter. Above all, the frequency of banking and other financial crashes in recent years, and the apparent correlation between these and prior financial liberalization, highlights the need for a reassessment of what is optimal policy in the new environment. The issue now is clearly not whether there should be policy intervention in the financial system but what the nature of the intervention should be. It is the purpose of this study to draw on the contrasting experience of different liberalization histories to throw light on this question.
This overview draws not only on the analytical findings of Part I, and the cross-country econometric evidence of Part II, but also the salient findings of the country studies presented in Part III and selected to represent the variety of initial conditions which has strongly influenced the contrasting experience of different countries with liberalization.

Here we begin (Section 2) by reviewing and categorizing the main elements of financial liberalization, focussing especially (Section 3) on interest rate liberalization and enhanced competition for funds. Section 4 describes the dimensions in which the chief consequences of liberalization can be expected: namely a shift in the distribution of financial-sector related rents, increased uncertainty, and a change in the incentive for good risk management and corporate governance among financial intermediaries. Section 5 outlines an approach to policy strategy. Section 6 offers concluding remarks.

2. The elements of financial liberalization

Governments have long acted to control financial intermediation with a view to limiting the concentrations of wealth and monopoly power, to protecting the general public from unexpected losses, and to preserving financial stability. Similar controls have often been exercised over non-financial enterprise, but less systematically, reflecting a perception that finance was particularly prone to these faults. The relaxation of controls on the financial sector during the past quarter century has not proceeded in a vacuum; it has been accompanied both by a more general liberalization of the domestic economy and by an opening-up towards the outside world. Indeed, the removal or easing of exchange controls and increasing *de facto* integration of world capital markets has been a key driving force of much of the specific measures of deregulation adopted for the financial sector.

Financial liberalization¹, as adopted across the world, has had many elements reflecting the variety of restrictions that had previously been enforced. Of these, the most important have been:

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¹ The World Bank has actively supported financial liberalization in developing and transition economies. For reviews of its adjustment lending operations in support of such liberalization, see Gelb and Honohan (1991), Cull (1997).
i) Elimination of interest rate and other price controls, amounting to a reduction in the implicit taxation of financial intermediation;

ii) Privatization of state-owned intermediaries and reduction of administrative direction of credit by government agencies;

iii) Admission of new entrants into the financial services industry, reductions in line-of-business restrictions on financial intermediaries and removal of legal protection for cartelized financial markets;

i) Interest rate liberalization

Although, as pointed out by Gerard Caprio and James Hanson in Chapter 1, the recent history of interest rate control is an aspect of the growth and decline of government interventionism in the mid-twentieth century, interest rate ceilings had been a constant feature of many legal systems for centuries. The substantial dismantling of such controls in the past quarter-century was at first driven, not so much by theory or ideology, but by the practical realities of increasingly unpalatable side effects. Improvements in communications and financial technology made the evasion or bypassing of the controls more and more easy. In addition, by the 1970s the increased incidence of high inflation on a sustained basis (accelerated by the abandonment of fixed exchange rates and first oil shock) made nominal interest ceilings bite much more severely than they had in the past.

Many countries still retain, as a measure of consumer protection, a fairly high overall ceiling on lending rates, to eliminate what are seen as "usurious" rates imposed by monopolistic moneylenders on unfortunate or impecunious borrowers. These usury ceilings can still be of practical importance especially - though not only - where high inflation has left the legal rates out of synch with market realities. Although the modern purpose of usury laws is consumer

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2 The discovery that interest prohibitions could be effectively bypassed through the use of forward foreign exchange contracts (bill of exchange) unleashed a great wave of financial innovation in the European middle ages and helps explain the historic tie between financial development and international trade. (de Roover, 1963).

3 The term was once synonymous with any interest, but gradually narrowed its meaning to the pejorative sense.
protection, that they can in practice preclude viable and socially advantageous money-lending activities, especially among the poor is much debated.\textsuperscript{4}

But in addition, by the 1960s and 1970s most countries had specific and tighter ceilings on bank lending rates (or on the spreads banks could charge above deposit rates). These were modulated by maturity, by branch of economic activity of the borrower, and occasionally by specific named borrowers. Of course a ceiling that is too low could cause lending in that category to dry up altogether, or to be greatly diminished and available only to the most secure of borrowers. To meet that problem, there was often a parallel requirement for licensed banks to allocate a given fraction of their resources for lending to certain sectors or for certain purposes at the regulated lending rates. This often included zero interest deposits at the central bank (often dubiously rationalized as a means of making monetary control more effective), special lending quotas to government, or to government agencies, or for long-term loans.

Arguing that the origins of liberalization were a response to the gross inefficiencies of financial repression, Caprio and Hanson show analytically why pervasive controls generate such inefficiencies and the impact of interest rate liberalization. The key point is that controlling interest rates also requires an allocation mechanism for the limited credit and the implicit subsidy which the control generates, and this mechanism has significant negative effects. This is true even taking into account the imperfection of information available to lenders. Market mechanisms – though imperfect – do help in the allocation process in that the incentives they provide can encourage the discovery and effective use of information, a factor that is lacking in government-based allocation. Moreover, the availability of implicit subsidies creates its own dynamic for political allocations of credit.

Such controls can be considered a form of tax.\textsuperscript{5} Interest rate ceilings and unremunerated compulsory reserves implicitly yielded substantial resources either directly to government or to

\textsuperscript{4} In one environment, Aleem (1991) found that wary moneylenders built the lending relationship very slowly and were charging almost 80 per cent per annum to their clients; in another, studied by Udry (1994), the existence of a stock of social capital in a tightly-knit community greatly reduced risk and interest charged.

\textsuperscript{5} Indeed, a sub-case here relates to specialized lending intermediaries such as housing finance banks benefiting from preferential tax treatment, but being required to lend for the designated purpose at a controlled interest rate.
the classes of borrowers it had designated as preferred. Although the financial intermediaries "paid" these quasi-taxes, and although they did influence the behavior of these intermediaries, the burden of the quasi-taxes did not necessarily fall on intermediary shareholders but would be passed on to customers – forward to borrowers or backward to depositors, depending on elasticities. Indeed, with the interest ceilings imposed often well below the cost of funds, a cross-subsidy from other lines of the intermediaries' business has typically been involved (as analyzed by Caprio and Hanson, and documented for the case of Mexico by Luis Landa and Fernando Montes-Negret in Chapter 7).

In addition, there were ceilings on deposit rates to be paid by banks and other intermediaries. The stated rationale for these ceilings was generally that they would help avoid ruinous competition between banks (a justification that can readily be supported by modern arguments, as we shall see below). At the same time it has to be acknowledged that deposit rate ceilings were often pitched so low as to hand a comfortable profit margin to banks as long as entry was limited and as long as deposit-substitutes could be effectively outlawed.6

ii) Privatization and elimination of directed credit
Government controls on the financial system have also been exercised through ownership of the major institutions. Of course the prime example here is the socialist banking system which, in its purest form under Soviet communism, performed no more than a bookkeeping function entirely driven by implementation of the national plan. But state-owned financial institutions have pervaded many non-socialist financial systems. With some notable exceptions, most countries have at least passed through a phase of nationalization or significant ownership of many of the larger banks and insurance companies. Indeed, it is hard to find a country that has not had a state-owned financial institution. These steps were often taken as a result of a political

6 For example, the value to the banks of outright prohibition on the payment of interest on checking deposits in France and the United States was well illustrated by the extent to which funds moved to the much higher yielding deposit substitutes that were permitted in those countries in the early and mid-1980s. To be sure, and as discussed by Charles Wyplosz for Europe in Chapter 5, such controls can be and were partly avoided by a variety of means. Side-payments in the form of in-kind gifts, and provision of below-cost banking services to those who placed deposits were commonly observed during the period of interest rate controls to a greater extent than today. Also, banks and others often established near-bank subsidiaries outside the scope of the controls and partly undermining their effect.
perception that broad social goals could more easily be attained if the major financial institutions were not purely profit seeking; this was the case for example in Uganda and France, cases discussed in this volume. A desire to avoid excessive concentrations of power in a few private hands, or to ensure that the domestic financial system was not controlled by foreigners who would be insensitive to long-term national goals, were often aspects of this politics.

Nowadays, only the central bank among financial intermediaries is generally considered a natural candidate for state ownership. Although there are examples of state-owned banks that performed in independent and profit-seeking manner, state-ownership is seen by advocates of financial liberalization to have entailed a confusion of goals, higher operating costs and often, under pressure of shareholder lending instructions, a deterioration of credit assessment and credit control functions. By separating public policy functions from the financial functions, and leaving the former in the hands of government departments and administrative agencies, privatization of state-owned financial institutions is part and parcel of financial liberalization. Only autonomous financial intermediaries can be expected to function well in the liberalized environment.

As pointed out by Caprio and Hanson, it was not surprising that credit allocation without an understanding of market forces would be done poorly. Their discussion of the difficulties in implementing controls is illustrated in Chapter 9 by Hanson with some practical examples from India and Indonesia. As liberalization got under way, the underlying incompatibility between directed credit programs and profit-seeking autonomous financial intermediaries operating in an otherwise liberalized market became quickly evident and resulted in the substantial dismantling of these programs, although sometimes (as shown in Chapter 10’s discussion of Uganda by Irfan Aleem and Louis Kasekende) the implicit subsidy involved has been made up by an explicit budgetary grant.

iii) Entry and anti-trust

In a famous quote that epitomises post-war banking in Europe up to the mid-1970s, Jeremy Morse, then chairman of Lloyd's Bank, a former Executive Director of the Bank of England,
remarked that banking was the easiest industry in which to make a profit. The British retail banking system of those years, cartelized among a handful of players, was indeed a comfortable place for the incumbents, but it was not unique in this. In Chapter 5, Charles Wyplosz describes the cozy reciprocation between banking and state in several other European countries in the 1950s and 1960s. Since then, however, admission of new entrants, including foreign entrants, into the financial services industry and anti-trust measures against collusive price-setting have played important roles in the liberalization of financial markets in industrial countries, and begin to be more widespread in the developing world.

Increased competition can yield straightforward efficiency gains and innovation in terms of improved range of services. These benefits are not negligible. But the new freedoms often led to a scramble to retain or gain market share, with banks seeking new business at narrower margins and in unfamiliar territory whose risks they often underestimated. Even the threat of new entry could have so eroded the prospects of inefficient incumbents as to lead them into greater risk-taking. Indeed, the increased macro volatility that often accompanied liberalization implied new risks even for well-established lines of business, such as lending secured on property.

In practice, incumbents often responded to the threat of new entry with an efficiency drive and restructuring that made the task of the entrants much tougher than had been anticipated. But even if the new equilibrium saw the old players retaining much of their market share, it was now a contestable and low-margin equilibrium. With a reduced franchise value, banks in particular now had little room for error and many succumbed to the perils of excessive risk-taking, a syndrome perhaps best illustrated by the case of Mexico (Chapter 7).

In other cases, entrants opted for a less aggressive but very profitable high margin–low volume strategy, allowing high-cost incumbents, and those burdened by a non-performing portfolio, to stay in business often with higher gross margins than before liberalization – a phenomenon well illustrated by the case of Uganda (Chapter 10).

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7 Nationalization has also come as a consequence of crisis, as in the case of Mexico in 1982.
As well as having new competitors, financial intermediaries began to be allowed new scope for their activities. This included an increasing trend toward universal banking, to be applied not only to the large commercial banks, but also to formerly specialized intermediaries such as mortgage banks and savings banks. Although new freedoms brought new profit opportunities and thereby, in some respects, contributed to franchise value, the breaking-down of barriers to competition between different institutions and across-the-board liberalization of restrictions on line-of-business also increased the intensity of competition for existing lines and in dimensions such as branching, often resulting in lower margins than had been anticipated by those entering new and unfamiliar territory.

3. Central role of interest rate changes

The net effect of all these changes has been to alter dramatically the environment facing financial market participants and intermediaries alike. Volatility, competitive pressures and the range of contractual possibilities have all increased, presenting new opportunities and risks. Perhaps it is in the levels and dynamics of interest rates that we find the most conspicuous and far-reaching changes, and these changes in turn encapsulate the major features of the new environment.

Other financial prices are also affected by liberalization, but interest rates retain a central importance for two reasons. First, borrowing contracts that specify a fixed repayment (and thus an explicit interest rate) are by far the dominant form of financial contract for the good reason that (in contrast to an equity or profit-sharing arrangement) they make it unnecessary for the lender to verify the borrower's eventual ability to repay; the fact of repayment triggers a transfer of control to the lender. It is probably for the same reason that the bulk of the other financial contracts that we observe can be interpreted as bundles of interest-bearing debt defined as payable under verifiable contingencies: they are derivatives of interest-bearing debt. To be sure, equity and its derivatives are also quantitatively important: but for these the return does depend on performance of the funded entity, and thus the equity contract places a heavier verification burden on the provider of funds.
Because of the dominance of interest rates as prices in financial contracts, a change in their level has considerable distributional effects, as well as altering access to funds.

When interest rates are liberalized, it is not just a question of sliding along the supply-of-funds curve to where the old demand curve intersects it. The regime change introduces new risks that have to be priced into supply and demand behavior. New demand and supply curves are applicable, and they are subject to new sources of volatility.

Furthermore, interest rates are determined in markets where the distribution of information, expectations and opportunities between participants is crucial. Behavior of participants in such markets differs in subtle ways from that of more conventional markets, and the consequences of market liberalization are less unambiguous. To mention just one well-understood phenomenon, the effect of higher interest rates on the demand for funds is not simply a one-dimensional effect lowering quantity: higher interest rates may also tend to discourage selectively those potential borrowers with lower risk. If lenders recognize this and have no adequate way of discriminating between high and low-risk borrowers, a market-clearing equilibrium may not exist, and instead there may be persistent credit rationing of small enterprises prepared to pay higher interest rates, but deprived of funds because of lenders' fear of adverse selection.\(^8\)

On the other hand, managers of financial intermediaries may also find themselves in a position where (at the expense of depositors, public insurers or even their own outside shareholders) they may find it to their advantage to bid-up deposit interest rates in order to finance risky, but potentially high yielding, projects (Chapter 2). This has been the source of some of the financial fragility observed in recent years.

4. **Consequences of interest rate liberalization**

Interest rate liberalization affects both the level and the dynamics of interest rates. The strength of these effects depends in part on the evolution of competition in the financial system; this in

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turn depends not only on other regulatory changes but is strongly influenced in its turn by interest rate developments.

The process of financial liberalization was expected to increase the volatility of interest rates and asset prices, to have distributional consequences in the form of reduced or relocated rents, and to have increased competition in the financial services industry. In Chapter 3, Patrick Honohan examines the available data on money market and bank interest rates for evidence on these propositions, and shows that, as more and more countries liberalized, the level and dynamic behavior of developing country interest rates converged to industrial country norms. Liberalization did mean an increased short-term volatility in both real and nominal money market interest rates. Treasury bill rates and bank spreads were evidently the most repressed, and they showed the greatest increase as liberalization progressed: this shifted substantial rents from the public sector and from favored borrowers. Whereas quoted bank spreads in industrial countries contracted again somewhat during the late 1990s, spreads in developing countries remained much higher, presumably reflecting both market power and the higher risks of lending in the developing world.

These interest rate changes have had far-reaching consequences running through the economy and operating in three widely differing dimensions:

i) on the distribution of quasi-rents and the degree of credit rationing;

ii) on uncertainty, associated both with the volatility of asset-prices and – in extreme cases – about the enforcement of contracts;

iii) on incentives for risk management and risk-taking and for governance of financial intermediaries.

i) Erosion of Rents and Credit Rationing

Indeed, there have been episodes of "phony" decontrol of interest rates where these other changes have been lacking. Phony decontrol can take any of a variety of forms, including the de facto assumption by dominant state-owned banks of the controlling role previously entrusted to the central bank.
To a degree, as spelled out by Caprio and Hanson in Chapter 1, controlling the price of credit well below market-clearing levels inevitably resulted in some potential purchasers being rationed while others benefit from the quasi-rent established by the control. To be sure, the market for credit is special in its sensitivity to information asymmetries. The free-market equilibrium can also exhibit credit rationing. Nevertheless, at a very first approximation, it is clear the removal of repressive interest rate controls allowed interest rates to rise, thereby reducing the degree of credit-rationing and the associated quasi-rents as well as altering the distribution of credit.\textsuperscript{10} Certainly, nominal interest rates have been higher - sometimes much higher - in the liberalized era. Those who would have secured finance under the former regime lose from the higher price they now have to pay.

The impact effect of the loss of quasi-rent for some heavily dependent borrowers may be to push them into insolvency. Hanson shows that the aggregate size of implicit interest rate subsidies was quite substantial in India, so this could have been a significant consideration. However, to some extent, as shown by Aleem and Kasekende for Uganda, explicit subsidies may have been substituted by government for the implicit subsidies previously received by borrowers.

Although a long-term borrower will be partly or temporarily insulated if their interest contract is a fixed one, those who have agreed to interest rates that float with the general short-term market rate will be hit immediately and perhaps heavily. Lenders may suffer under either contingency: if they have funded a long-term fixed interest contract with short-term borrowing they will immediately be squeezed. This has been the problem faced by many housing finance institutions, notably in Eastern Europe and Latin America, where the situation was resolved through a variety of quasi-fiscal devices.\textsuperscript{11} But even if their lending has been at floating rate, the lenders may not be fully insulated from the rise in interest rates: only part of the rate risk will have been hedged, the remainder merely transformed into credit risk, as was evident in Korea and other East Asian countries during 1997.

\textsuperscript{10} Cf. the modeling by Agénor and Montiel (1996) chapter 5.
\textsuperscript{11} The same problem was, of course, the beginning of the slide of the US savings and loan industry cf. Kane (1989).
The losers thus can and did include intermediaries, partly because their borrowers could not sustain the higher interest rates, and partly to the extent that the benefit they had previously received from effective deposit rate ceilings. The net effect of liberalization on intermediary profitability has varied a lot over time and between countries. A frequent experience, especially in industrial countries, is of higher apparent bank profitability in the early post-liberalization years, followed eventually by a reversal as existing banks feel their way to a more aggressive stance, and as new entrants make their presence felt. Also, apparent profitability has often proved to be illusory as loan-losses mount. This is well documented in the Uganda story (Chapter 10), where full liberalization resulted in a ballooning of quoted interest rate spreads, not yet substantially reversed. The complex evolution of Mexican interest rate spreads is documented in Chapter 7; these too remain high. As also shown by the Uganda case, higher quoted spreads do not necessarily translate into profits, but also reflect a less favorable risk-mix of the borrowers willing to pay such high borrowing rates, especially to the new entrants.

For governments that had to refinance heavy domestic borrowings at the new interest rates, liberalization has an adverse effect on the budget deficit, with knock-on effects on recourse to additional taxation or borrowing, at home or abroad. This increased macroeconomic fragility and uncertainty. While liberalization cut-off a source of quasi-tax revenue, it opened up a source of credit financing for government. As observed by David Cole and Betty Slade (Chapter 11), this alternative proved to be a strong temptation for some governments, with damaging consequences for macro stability.

Nevertheless, liberalization did impose market discipline on governments: in Europe, removal of (external) capital controls was associated with an improvement in the budget, though this was not true of domestic credit controls. Indeed, the removal of domestic credit controls worsened the budget – though not the primary deficit (Wyplosz, Chapter 5).

On a continuing basis, the removal of interest ceilings has not only shifted surplus from borrowers (including government) to lenders, but also resulted in some relaxation of rationing, so that some borrowers previously crowded-out of the market altogether have had a better chance to
secure funds. For India, Hanson (Chapter 9) argues that it is the middle-sized firms that have stood to gain from better access to credit. For Korea, Cho (Chapter 6) shows that middle-sized chaebols benefited, and that lenders underestimated the risk which this second-tier represented. Increased access for these groups may prove to be highly cyclical. This is especially so because of their difficulty in escaping from rationing induced by lenders' fears of adverse selection.

These impact effects are but one part of the wider changes in capital values that occur when structural reforms, including adjustment of real exchange rates and internal relative prices, are introduced. But the high leverage of financial intermediaries makes them unusually susceptible to unhedged interest rate changes. The initial disruption to financial and real activities from a sharp rise in real interest rates following liberalization was a costly feature of some liberalizations which might have been avoided if the transition could have been arranged at a time when the controlled interest rates were not too far away from market-clearing levels.

ii) Uncertainty
As well as higher levels, countries with liberalized interest rates have observed much higher real interest rate volatility (Chapter 3). To some extent, this volatility is simply the expression of a hitherto repressed volatility in market-clearing rates, but no doubt it partly also reflects an increase in the volatility of underlying interest rate determinants, and of the instability of expectations, especially linked with exchange rate regime developments.

The liberalization process per se often added to macroeconomic instability as aggregate credit expanded when financial institutions sought to gain market share. Consequential overheating had to be damped down by monetary policy and/or resulted in inflation and nominal depreciation which also fed back onto nominal interest rates. The run-up to the 1994 Mexican crisis provides a dramatic example.

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12 It is worth bearing in mind that, in the rationed market, one side of the market was normally unconstrained. Imposition of deposit interest ceilings did not prevent depositors from placing as much as they want in deposits (though it was not possible for banks to raise all they would wish at the controlled interest rates).

13 As shown for the US by Gertler and Gilchrist (1993).
Another destabilizing impact, already mentioned above, was through the public finances when government deficits, hit by the higher interest rates, were either monetized leading to an inflationary surge, or refinanced at ever higher interest rates in an unsustainable spiral crowding out the private borrowers and thereby feeding back onto economic growth and stability (Cole and Slade, Chapter 11 – though in Europe the disciplining effect of financial markets dominated, Wyplosz, Chapter 5).

Some of the volatility of interest rates in the liberalized environment may represent "useless volatility", in the sense applied by Flood and Rose (1995) to exchange rates.\textsuperscript{14} In countries where the controls were light, and imposed not far from market-clearing rates, the controlled rates did provide a relevant signal for the cost of funds.\textsuperscript{15} Being stable, these controlled rates arguably anchored rate expectations and market discount rates, thereby potentially removing a source of volatility in stock market, property and other asset prices. If so, policy could generate considerable benefits in terms of economic growth and stability, by eliminating both this "useless volatility" and the fear of such volatility contributing to the risk premium.

An independent source of uncertainty came to the fore in those Transition countries where liberalization was associated with a general loss of governmental control and a consequential increase in the difficulty of enforcing contracts. As shown by Fabrizio Coricelli (Chapter 8), the combination of high nominal interest rates and low costs of default have driven much of those economies into barter.

iii) Risk-taking and Intermediary Governance: the Role of Franchise Value

While it was one form of crisis that led many countries to liberalize, Caprio and Hanson (Chapter 1) observe that these same countries often soon encountered a more virulent form of crisis subsequently. They argue that this cycle can be partly explained by the way in which the liberalized environment laid bare the previous inefficiencies and failures in credit allocation, and

\textsuperscript{14} Their proposition is that fixed exchange rate regimes have not been associated with higher volatility in other variables. As such, movements in exchange rates have not acted as a buffer absorbing disturbances which would otherwise appear elsewhere in the economy in line with Samuelson's application of the le Chatelier principle.

\textsuperscript{15} Though in repressed systems quoted rates may not have been representative of the effective (shadow) cost of funds.
partly by the poor sequencing of liberalization, in particular the failure to take account of the weaknesses of the initial conditions in the banking sector and to develop quickly strong legal, regulatory and supervisory frameworks.

For instance banks have found that their existing loan portfolio was less sound in the new environment because their borrowers were no longer able to service debts, whether because other liberalizations changed relative prices, or because government subsidies were cut-off, or simply because implicit guarantees from government on these debts were no longer effective. In such cases, it is more that liberalization revealed the worthlessness of the portfolio rather than causing it (Honohan, 1997). Indeed, Hanson (Chapter 9) remarks that, for India or Indonesia, the relation between financial liberalization and financial distress seems fairly tenuous.

In the same vein, based on econometric analysis of the experience of over fifty countries during 1980–95, Asli Demirgüç-Kunt and Enrica Detragiache show in Chapter 4 that banking crises are more likely to occur in liberalized financial systems, but not where the institutional environment is strong (in terms of respect for the rule of law, a low level of corruption, and good contract enforcement).

But if liberalization does not inevitably lead to crisis, nevertheless, liberalized financial markets have often clearly worked to reduce the franchise value of a bank license. That this could adversely affect bank performance has long been evident. Long before the emergence of a literature on efficiency wages - wage rates that may be set above marginal productivity to discourage shirking or quits - the desirability of having some way of bonding bank insiders to make sure that they took proper care of depositors' money was well recognized in banking. Indeed, in the mid-19th Century it was common practice for senior bank staff to post a substantial bond which would be forfeit if they mismanaged funds. In more recent times, the link between lowered franchise value and increased risk of failure has been noted.  

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16 The practice, which appears to have been widespread, is described in detail in Gibbons (1859). An amusing example is the practice of the Bank of Ireland which (c. 1800) required its directors to post a £5 bond to warranty prompt attendance at board meetings: the penalty for late arrival was exactly 2s.8½d. (Hall, 1949).

17 Cf. Caprio and Summers (1996), Keeley (1990). It must be acknowledged, however, that protection against entry and restrictions on interest rate competition are far from being the only sources of bank franchise value in an ever
Capital requirements, now commonly imposed at the - somewhat arbitrary - level of 8 per cent of risk-weighted assets, represent one way of insisting on a degree of franchise value. Most banking regulators now recognize the need for early intervention to restrain bank management when capital falls below this threshold, but the difficulty of measuring the true value of capital and the fact that the incentives of insiders and other shareholders may diverge reduces the effectiveness of capital requirements, especially in an environment of diminished bank profitability (Caprio and Honohan, 1999).

If financial liberalization is associated with intensified competition, banks may bid-up rates to the point where prudent lending practices are no longer profitable. Deposit insurance, explicit or implicit, can drive a wedge between the portfolio risk accepted by bank insiders and that perceived by depositors. This is generally thought to be an important aspect of the sorry story of the privatized Mexican banks, for example, and may also play a part in the emergence and rapid growth of a group of risk-taking Ugandan banks. Excessive risk-taking is much more likely when banks are already of dubious solvency, making deregulation dangerous under such circumstances. This was seen not only in the case of the U.S. Savings and Loans, but in the case of Mexico where, it is now thought that the fact that many of the newly privatized banks had little real capital at risk increased risk-taking there.

Deliberate risk-taking and prior portfolio weaknesses are not the only sources of banking weakness in a liberalized environment. Outright managerial failure must also be borne in mind as a significant factor (Honohan, 1997). Even bankers that had no intention of bringing their banks sufficiently close to insolvency to give the deposit put option any significant value have hit problems because both the overall environment and the new lines of business they were expanding into proved to be riskier than they had anticipated.

changing market. Charles Calomiris has pointed to the trend growth in the stock market value of US banks in the past two decades as an illustration of the potential here. Indeed the comfortable life of the protected bank, or one governed by directed credit, can cause the other sources (appraisal skills, market intelligence, administrative efficiency) to atrophy.
Sometimes the pitfalls here have been exacerbated by other aspects of poor sequencing, especially poorly considered partial decontrol, as exemplified by the case of Korea (Chapter 6). There, the order in which markets were decontrolled encouraged a spiraling of short-term claims, especially in the poorly supervised corporate paper market, and financed by short-term foreign borrowing. This latter exposed the system to the run of foreign creditors which brought down the system.

5. **Policy issues**

To the extent that it has been driven by technology, a simple reversal of the process of financial liberalization is not feasible. Nor is it clear that, even if possible, it would be desirable given the distorting costs of the old regime. In particular, there is little to be said in favor of the use of the financial sector for the delivery of implicit subsidies. But it is less clear whether current policies and regulations are optimally adapted to the new regime.

Some territory is undisputed. Mechanisms for the effective enforcement of contracts, and a strengthening of institutions that can detect and limit fraud, managerial incompetence and abuses of political power in the financial sector are all clearly needed. Some problems could also have been avoided if full liberalization had been deferred until fiscal and macro stability had been attained, and until the controlled interest rates had converged towards market-clearing levels. The importance of sustainable and stable fiscal and monetary policies is also greatly heightened in a liberalized environment. But success on these fronts is not enough.

In Chapter 2, Patrick Honohan and Joseph E. Stiglitz look in some detail at this point. They observe that financial liberalization brought with it a vogue for relying on an indirect approach to prudential regulation through monitoring bank capital to ensure that it remains adequate in relation to the risk being assumed. But the difficulty for regulators in a liberalized financial system of observing the true value of bank capital and the true risk of bank portfolios, means that ensuring safe and sound banking may require the imposition of more robust measures of restraint. These would be characterized by easy verification, and a presumption that banks complying with the rules will be at lower risk of failure.
Theoretical models illustrate how banking tends to respond \textit{discontinuously} to policy, and that standard recommendations for fine-tuned regulatory policies are very model-dependent and \textit{fragile}. These characteristics are reinforced when the normal assumption of far-sighted shareholder-controlled banks is superseded by more realistic characterizations with agency problems involving self-serving or myopic management. This supports the view that simpler, stronger and more direct measures are not only needed to ensure that policy is not ineffective or counterproductive but also that they can offer a \textit{quantum leap} in the degree of risk-reduction.

But which rules should be tightened, and under what circumstances? By assessing the relative performance in different environments of five different types of robust regulatory restraint, bearing in mind possible side-effects and implementation difficulties, Honohan and Stiglitz identify the various failure-inducing conditions for which each is likely to be effective, as well as the circumstances under which side-effects are likely to be most severe. They show how different country circumstances will call for different robust measures, and that these may not be required to bite at all times.

Some of the rules considered, such as minimum accounting capital, are long-standing features of the regulator's toolkit. Others, such as interest rate ceilings, have had a long, and somewhat discredited, history as a tool of macroeconomic or development policy but may under some circumstances have a more constructive role as a prudential measure, especially if they are pitched so as to apply only intermittently. The policy maker needs to draw on such a portfolio of robust regulatory instruments.

6. Concluding remarks

As it worked out in practice, financial liberalization was far from a smooth transition to an equilibrium, competitive interest rate. Indeed, the static shifts in quasi-rents from previously subsidized borrowers may often have been the least important element of the regime change – and have in some cases been partially substituted by explicit budgetary subsidies. Instead,
especially where capital account was opened early, and especially where fiscal and other sources of macroeconomic instability were prominent, interest rate volatility contributed to banking fragility. In extreme cases of the FSU, liberalization unsupported by contract enforcement led to an implosion of the monetary economy itself. In most countries, interest rate spreads widened to levels that suggest a remaining lack of competition in practice, despite free entry. Indeed, banking authorities seemed often ill-equipped to apply necessary prudential restraints on entry, and to intervene to ensure exit of insolvent institutions or unsound management.

If we could turn the clock back, we would want to see a much more measured and nuanced approach to liberalization. Eliminating the most severe interest rate distortions did not necessitate complete and immediate removal of interest rate controls, especially in the presence of insolvent or fragile banks. Removal of controls on foreign capital (especially as affecting short-term flows) could have been phased-in late rather than early. Free entry should have been interpreted as qualified by adequate capitalization and personal and professional suitability of management. A longer lead-in would have allowed more thorough training and professional preparation of regulatory personnel, though their effectiveness might still have been limited by political interference.

There are still many countries who have not yet progressed very far down the road of financial liberalization. For them, these lessons of sequencing will be relevant.

For others, turning the clock back is not a practical option. They will have to push forward on the lengthy agenda of institutional strengthening now widely accepted as being the pre-requisite of a successful liberalized financial sector. Meanwhile, they can enhance the effectiveness of regulatory restraint by employing a portfolio of blunt instruments of intermittent effect.