Seven Questions about the Consequences of Financial Liberalization

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A number of countries have liberalized their financial systems since the early 1980s. They ceased to control deposit and loan rates, stopped directing bank credits to specific firms, eased restrictions on opening of new branches and the entry of new banks, privatized state-owned banks, and allowed foreigners to trade securities and foreign banks to establish subsidiaries. How have these measures affected economic outcomes? The evidence on growth has been mixed. However, there have been bona fide gains for productive firms, which were able to access finance with ease, and for ordinary consumers, who were able to smooth consumption over time.

Question 1: Has financial liberalization brought economic growth?

This is a difficult question to answer because empirical evidence is inconclusive. On the one hand, some studies show that financial liberalization brought higher growth (Jayaratne and Strahan, 1996). On the other, some argue that financial liberalization led to crises in many countries (Stiglitz, 2000). These observations are not surprising, since both higher growth and higher volatility may have occurred simultaneously (Ranciere, Tornell, and Westermann, 2006). Even if one takes a closer look at specific financial variables, evidence is mixed: for example, savings do not increase after financial liberalization (Bandiera and others, 2000).

It is important to remember that financial liberalization is a different concept than financial deepening. The former is a government policy, something exogenous to economic agents, while the latter is usually measured by the size of financial assets (e.g., credit to GDP or M2 over GDP) and a result of people's choice given the policy. The impact of financial deepening on growth is often positive.

Question 2: Should one expect higher growth rates after financial liberalization?

Not necessarily. The mixed findings on the effects of financial liberalization are not inconsistent with economic theory. Indeed, theoretical predictions are mixed as well. So it seems unwise to evaluate the success of a financial liberalization program based on its effect on growth in savings, investment, and GDP.

For example, the removal of interest rate ceilings is supposed to lead to higher interest rates, in turn leading to higher savings (and higher investment if the capital account is not fully liberalized). A higher deposit rate may attract more deposits—this is called the substitution effect between today's and tomorrow's consumption. However, a higher deposit rate also increases tomorrow's income so that a smaller sum of deposits may be required to support the target level of tomorrow's consumption—this is called the income effect. Unfortunately, the relative impact of the income and substitution effects is theoretically unknown.

Question 3: Do crises happen only after financial liberalization?

No. Financial crises can also happen under heavily regulated financial systems, especially when countries employ an unsustainable mix of policies. For example, nominal deposit rate control with high inflation can translate into negative real deposit rates, which can then suppress savings, leading to large withdrawals of deposits, as was the case with Thailand in the early 1980s.

Moreover, crises can occur if the financial system is not liberalized in an orderly fashion. For example, to start allowing corporate bond issues, but only for AAA rated companies, while maintaining deposit and loan rate controls would deteriorate the quality of banks' asset portfolios. On the liability side, the size of deposits would be unchanged due to the controlled deposit rate as before. On the asset side, however, loans to AAA rated firms would have to be replaced by loans to new client firms that typically have lower credit scores. A bubble can emerge for sudden availability of cheap funding for firms with low credit scores. If this bubble bursts, it can create a wave of nonperforming loans. This example describes the experience of the Japanese financial system in the late 1980s to early 1990s (Hoshi and Kashyap, 2000).

Question 4: How does the financial system affect firms?

Although the effects of financial liberalization on growth are inconclusive, theories suggest unambiguous effects of a better functioning financial system on efficiency in allocating capital. Indeed, a number of studies argue that financial frictions make capital allocation inefficient: productive firms

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do not obtain enough capital, while unproductive ones may obtain too much.

Question 5: What are the effects of financial liberalization on firms?

Under efficient allocation, the expected marginal products of capital are equal to the prevailing interest rate and thus the same among firms. However, the marginal products of capital may vary among firms, especially when firms are faced with different interest rates under interest rate controls or when preferential treatment or discrimination in obtaining credit under a directed credit scheme. Financial liberalization results in capital being allocated in a transparent fashion. Therefore, it is expected to reduce the artificial dispersions of marginal products of capital. Abiad, Oomes, and Ueda (2008) investigate the movements in the dispersion of marginal products of capital. In their sample of five developing countries, the authors find that financial liberalization is especially beneficial for productive firms that have difficulties accessing finance.

Question 6: How does the financial system affect consumers?

Consumers prefer having a stable rather than a rocky consumption pattern over time. A stable consumption pattern can be maintained by adjusting savings and loans. When income is high, consumers save; when income is low, they dissave or borrow.

The idiosyncratic income risk (e.g., variation of each household's income) is known to be much higher than aggregate fluctuations (e.g., fluctuations in GDP growth). Therefore, ensuring the idiosyncratic income risk substantially improves consumers' welfare. With a better functioning financial system, the spread between the deposit and loan rates gets smaller, enabling consumers to more easily smooth consumption.

Question 7: What are the effects of financial liberalization on consumers?

Financial liberalization makes a financial system more efficient. Greater efficiency translates into lower fees, for example, so financial services become more accessible to consumers. The important question, then, is how large are the efficiency gains from financial liberalization.

Based on a canonical growth model with financial deepening and liberalization, Townsend and Ueda (forthcoming) find large benefits of financial liberalization for consumers. They first gauge the degree of de facto financial liberalization over time in a case study on Thailand. They then simulate counterfactual economies without financial liberalization and compare the implied consumption paths of consumers against those based on actual data. They measure the impact using a typical utility function asking how much extra annual consumption could compensate consumers who hypothetically live in an economy with no financial liberalization. This is a standard exercise of welfare gains/costs in macroeconomics. They find that financial liberalization produces large significant welfare gains—nearly 30 percent worth of average consumption annually.

The welfare gains may vary across countries and over time. The welfare gains may be high for a country like Thailand, a typical developing country where financial access is not yet fully established. However, the beneficial impact of financial liberalization for consumers should not be much smaller than Townsend and Ueda's estimates in advanced countries, where a larger fraction of population utilizes the financial services.

Insurance against future income risk may bring higher growth, as it enables entrepreneurs to seek higher-risk and higher-return projects. However, it may decrease the need for precautionary savings and result in lower rates of investment and GDP growth. The overall effect on growth is theoretically ambiguous. Townsend and Ueda (forthcoming) report that financial liberalization hardly increases GDP growth, in line with previous regression studies; yet they also find that welfare gains from financial liberalization are always sizable.

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