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FINANCIAL LIBERALIZATION: A FOURTH GENERATION THOUGHT

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ABSTRACT

Empirical studies in the late 1980s and 1990s on financial liberalization lent support to the reforms carried out in line with the Mckinnon-Shaw hypothesis. Later evidence shows financial liberalization failed to achieve its desired results in many countries. Thus, the emphasis of current literature is to identify and explain the reasons for non-achievement of expected objectives to be realized through financial liberalization. An extensive literature survey done through this study reveals two main reasons for this failure. One is the incorrect policy procedure being followed in implementing financial liberalization referred to as a sequential problem. The other is to have policy inconsistencies during the reforming periods, referred to as a macroeconomic problem. This paper analyses the theoretical evolution of financial liberalization considering the empirical evidence presented by researchers through first, second and third generations of financial liberalization. The objective is to develop a more comprehensive analysis that can be identified as a fourth generation model of financial liberalization. Future researchers can make use of this model in their empirical analysis on measuring the success of financial reforms' in various countries.

JEL: G000, G010

KEYWORDS: Financial Liberalization, Mckinnon-Shaw Hypothesis, Sequential Problem, Macroeconomic Problem, Fourth Generation Model

INTRODUCTION

The relationship between finance and economic growth has been debated for quite a long time. The importance of finance for achieving a high economic growth from a modern point of view has been recognized initially during the beginning of the 20th century. Becker (2002) argued that Schumpeter (1911) was the first scholar to argue that financial resources were required for technological innovations and economic growth. Schumpeter further argued that one can only become an entrepreneur by becoming previously a debtor. Following these views Keynes (1936) also highlighted the importance of increasing financial savings for investment and thereby speeding up economic growth, although he did not talk about the specific modalities in this regard (as cited by Arestis, 2005).

Gurley and Shaw (1955) published their seminal paper of the role of finance on economic growth by drawing attention to the significance of financial intermediation and the role of credit supply for economic growth. Patrick (1966) highlighted three ways in which financial systems can influence the capital stock to acquire an economic growth. Goldsmith (1969) mentioned that having a "financial super structure" was necessary although it was not a sufficient condition for acquiring an economic growth. Patrick and Park (1994) pointed out the positive role that finance can play to achieve economic growth. According to Levine (1997) the financial market lubricates the economy by providing liquid funds and the expertise required for growth and investment (as cited by Arestis, 2005). In contrary to the above view points, there are many others who disagree partly or sometimes even fully with the viewpoints expressed in support of the relationship between finance and economic growth and development. Robinson (1952) argued that financial development primarily follows after economic growth and the financial system does not matter.

That is economic growth develops entrepreneurship and other variables of development in a country and these developments will ultimately bring the financial development (as cited in Arestis, 2005). Which shows that, entrepreneurship leads to develop a financial system and not the other way around. Andres *et al.* (1999) also through their empirical analysis based on Organization for Economic Co-operation and Development (OECD) countries did not find any positive link between growth and financial development (as cited by Paudel, 2007).

In 1973, a path breaking contribution was made by Mckinnon and Show (Mckinnon-Show hypothesis) through theoretical basis as well as empirical evidences, that adopting liberalized financial sector reforms in developing countries will precede to economic development. These findings lead to the opening up of the financial markets in many developing nations in order to get out of the financial repression and achieve economic growth as desired. More than three decades have passed liberalizing the financial system in many counties but the results were not good as anticipated. Mokhtar and Fatemah (2007), Aretis (2005) and Dooley (1997) and Edwards (1989) have attributed the failure of financial liberalization to achieve its expected outcomes to the incorrect sequence of policies being followed in implementation stage of financial liberalization (sequential problem). However it should be noted that these research findings have not been sufficiently tested and sustained empirically.

Extensive literature analysis on the sequential problem and macroeconomic problem has shown that there is a methodical process that needs to be followed when implementing the financial liberalization in a country in terms of policy implementation. However, no research has so far been done in order to identify the order of financial liberalization theoretically. Further it is crucial to identify how macroeconomic factors need to behave to influence the desired financial liberalization outcomes. Therefore the main objective of this study is to develop a model and identify the procedure to be taken when implementing financial liberalization in a country. When analyzing financial liberalization literature it shows that 'Southern Cone experience' has led to produce 'First and Second generation' models and the 'East Asian currency crisis' has led to create the 'Third generation model'. The conceptual frameworks been developed through this study draws attention to generate a 'Fourth generation model' which has been developed by analyzing the failure of the financial liberalization (Sequential problem and macroeconomic problem). This can be considered as the next development of financial liberalization hypothesis, and hence, this name is author coined. In order to develop the model constructively this paper is divided in to four parts. The first part will provide an introduction about research, the second part which is the literature review will provide an extensive analysis on the theoretical arguments and empirical evidences on financial liberalization, the third part will develop the sequential model for financial liberalization in a country and finally the fourth part will provide the conclusion of the study.

LITERATURE REVIEW

Theory of Financial Liberalization- Theoretical Evolution

Gemech and Struthers (2003) stated that Mckinnon-Shaw hypothesis in its various forms is thirty years old. During this period literally hundreds of empirical studies have been done examining the hypothesis in many different context. Initially it focused on financial repression and the need for developing economies to allow real interest rates (along with other financial indicators) to be determined by market forces. In later years the researches have extended the debate to consider other effects of financial repression on economic growth, financial crisis and poverty. According to this the literature on financial liberalization can be classified into a number of approaches since the original Mckinnon-Shaw hypothesis as follows:

First Generation approach (Krugman 1979)
Second Generation approach (Obstfeld, 1996)
Third Generation approach again represented by the work of Krugman (1998, 1999)

When looking at the original Mckinnon-Shaw hypothesis, Mckinnon (1973) suggested that financial liberalization would lead to higher rates of economic growth. Savings in the formal financial system is limited under conditions of financial repression. When interest rates are allowed to rise to market-clearing levels, there would be an increase in domestic savings and a portfolio shift out of inventories, precious metal and foreign exchange. In addition, borrowers would be able to shift from unorganized markets to the formal financial system. High real interest rates would actually increase investment because of the need to accumulate funds to undertake lumpy investments. This makes money and physical capital complementary rather than substitutive assets. This "complementary hypothesis" suggests that raising controlled interest rates would raise the demand for domestic savings and time deposits lower the cost of accumulating funds for the purchase of physical capital and thereby promote economic growth. Shaw (1973) argued that raising interest rates would also improve the quality of domestic investment. When interest rate is below equilibrium level total investment will be limited by the amount of savings available. Higher interest rates would attract more savings into the financial system and increase investment. In addition, previously unfunded projects with high returns (optimal projects) are likely to be funded. The efficiency of the banks in providing funds to projects with high returns will lead to enhance the economic growth of a country than the money circulation in the informal markets inefficiently.

The 'First Generation' model of currency crisis (Krugman,1979) is the next developments of financial liberalization after the Mckinnon-Shaw hypothesis. The first generation models focus on inconsistencies between domestic macroeconomic policies such as an exchange rate commitment and a persistent government budget deficit that eventually must be monetized. The deficit implies that the government must either deplete assets such as foreign reserves or borrow to finance the imbalance. However, it is infeasible for the government to deplete reserves or borrow indefinitely. Therefore, without fiscal reforms, the government must eventually finance the deficit by creating money. Since excess money creation leads to inflation, it is inconsistent with keeping the exchange rate fixed and first-generation models therefore predict that the regime inevitably must collapse. The 'Southern Cone experience' which is the financial crisis of Latin American economies such as Uruguay, Argentina and Chile in the late seventies has led to the development of the 'First Generation' of currency crises models.

The 'Second Generation' of models (Obstfeld, 1996) suggest that currency crises may also occur as a result of self-fulfilling expectations, speculative attacks and changes in market sentiments despite sound fundamentals. In this framework, a speculative attack is more likely to succeed if higher interest rates exacerbating existing weak domestic employment or banking sector conditions. Consequently, the timing of the attack and whether it will occur cannot be determined as it is no longer unique. The fundamental imbalances stressed by first-generation models make a country vulnerable to shifts in investor sentiment, but once a crisis does occur the second-generation models help to explain its self-reinforcing features.

The 'Third Generation' Models (Krugman, 1998, 1999) attempt to stylize the causal mechanics underpinning the 1997 'East Asian currency crisis', as the First and Second Generation models did not fully explain this phenomena. One version of the 'Third Generation' model attributes the crisis to implicit guarantees offered by domestic banks in developing countries leading to a massive influx of short-term capital which turns out to be unsustainable. This invariably results in an asset price bubble that is destined to burst and reverse the capital inflows. Another version of 'Third Generation' model identifies the existence of 'Fragile Financial Institutions'. These have existed as the cause of the buildup of un-hedged short-term borrowing denominate in foreign currency. A sudden change in market sentiment can cause panic and investor responses which bring about a reversal in these capital flows. This transforms an illiquid asset into insolvency and ultimately a currency peg collapse (as cited by Gemech and Struthers, 2003). When reviewing the above evidences it is possible to detect a clear lineage stemming from the original Mckinnon – Shaw (1973) contribution in the later developments as well (Gemech and Struthers, 2003).Thus, the financial repression has led to the proposition of original financial liberalization. The 'Southern Cone experience' in the nineteen seventies has led to 'First and the second generation' models

and the 'East Asian Currency Crisis' in the late nineteen nineties has led to the development of 'Third generation' model.

Empirical Evidence on Financial Liberalization

Having considered the background that demanded a financial liberalization and its theoretical underpinning, it is important to look at empirical research conducted in this regard. During the late 1970s and 1980s, a number of financial sector reforms such as deregulation of interest rates, revamping the direction of credits and the measures to promote competition in the financial service have become an integral part of the overall structural adjustment programmes in many developing countries. In this background, Gemech and Struthers (2003) have cited number of empirical studies conducted. For the purpose of this study, few selected major studies are summarized below (Table 1) in a chronological order. Thus, the results of the most empirical studies provide limited justification to the financial liberalization ideology leading to inconclusive conclusions.

Table 1: Empirical Studies on Financial Liberalization

	Name of the researcher	Year	Research
1.	Giovannini	1985	Taking 18 developing countries, empirically tested responses of consumption to real interest rates, findings were mostly negligible and negative.
2.	Ostry & Reinhart Ogaki et al.	1992 1996	Empirically tested the responses of consumption to real interest rates, also concluded that relationship was negligible or negative
3.	Jappelli and Pagano	1994	Analyzed the role of the capital market on aggregate savings and growth due to financial deregulation. The authors concentrated on OECD countries using panel date for the period of 1960 to 1987 and concluded that financial deregulation in the 1980s has caused a decline in the national savings and growth rates of these countries.
4.	Demirguc-Kunt & Detragiache	1998	Analyzed the financial liberalization and financial fragility covering 53 different counties. The study covered the period of 1980-1995 and used econometric techniques to draw their conclusions. The paper emphasizes institutional reforms for reducing crisis.
5.	Bandiera, et al.	2000	Constructed an index of financial liberalization on the basis of eight different components: interest rates, reserve requirements, directed credit, bank ownership, prudential regulation, securities markets deregulation and capital account liberalization. Their data spans from 1970 to 1994 for eight countries. Among the key findings of the estimate of their benchmark model is that there is no evidence of any positive effect of the real interest rate on saving.
6.	Reinhart and Tokatlidis	2001	In a study of 50 countries (14 developed and 36 developing) reported that financial liberalization appears to deliver: higher real interest rates (reflecting the allocation of capital toward more productive, higher return projects.), lower investment but not lower growth (possibly owing to a shift to more productive uses of financial resources), a higher level of foreign direct investment and high gross capital flows. Liberalization appears to deliver financial deepening as measured by the credit and monetary aggregates but low income countries do not appear to show clear signs of such a benefit.
7.	Kaminsky and Schmukler	2001	Studied 28 developed and emerging economies, using 3 measures of financial liberalization (capital account liberalization on interest rates, credit and reserves and stock market liberalizations) and concluded that; i) Liberalization is not a continuous process in emerging economies, ii) Liberalization leads to booms and busts in emerging economies especially in short run, iii) Quality of institutional governance is crucial to process.
8.	Baldicci et al.	2002	Empirically tested the impact of financial crises (large scale nominal currency depreciation) on poverty and income distribution and it found: i) Formal and informal sector effects, ii) Relative price changes after crises raise price of imported food, iii) Fiscal retrenchment affects public services, iv) "Better off" is affected by wealth consequences of real interest rates and real estate prices.

This table shows few selected empirical studies done on financial liberalization in a chronological order.

Financial Liberalization: Background for New Trends

A number of new researches have been carried out on financial reforms with the premise that financial liberalization has been a failure and they have also analyzed the causes for such a failure as well. This trend is further continued and according to Arestis (2005) no convincing empirical evidence has been provided in support of the success of financial liberalization hypothesis. Further, as cited by Arestis (2005), Lucas (1988) argued that economists 'badly over-stress' the role of the financial system and thereby it is difficult to agree on the link and its direction between finance and growth.

But proponents of financial liberalization thesis argue that failure is there because of the existence of inadequate banking supervision and macroeconomic instability. This shows that the failure of financial liberalization to live up to its potential had reignited the opponents of financial liberalization and at the same time giving proponents of the financial liberalization a new lease of life. In this regard Mckinnon (1973 and 1993) himself had played a prominent role. Among others Krueger (1986) and Edwards (1989) are also prominent personalities, who saw nothing wrong with financial liberalization but emphasized that the way in which financial liberalization was implemented and certain other factors eroded the effectiveness of financial liberalization. Furthermore, when drawing attention to studies such as Mokhtar and Fatemah (2007) they highlighted some other aspects of the problem. Accordingly, for the failure of financial liberalization they have identified such prominent reasons as i) not following a correct order in financial reforms and ii) having a macroeconomic instability. Further, confirming the same causes Arestis (2005) emphasized that the 'adequate banking supervision', 'macroeconomic stability' and the 'correct sequencing of financial reforms' among other requirements needed for the success in financial liberalization and shows that these root causes needed to be addressed appropriately. Edwards (1989) also agreed with Mokhtar and Fatemah (2007) and Arestis (2005) by identifying that the failure of financial liberalization is because of not having appropriate sequencing, speed of reforms, trade regime problems and accompanying macroeconomic structural reforms.

When analyzing the above findings of the scholars for the failure of financial liberalization to achieve its desired objectives, they have emphasized two main reasons, one is incorrect policy procedure being followed in implementing financial liberalization (sequential problem) and the other is having policy inconsistencies / imbalances / influence (macroeconomic problems) during the reform periods distorting the financial liberalization outcomes. These conclusions draws the attention to identify that a successful implementation of financial liberalization depends on the correct sequence been followed and balanced macroeconomic policies. Therefore, this study draws attention to generate a new model which identifies the correct sequence to be followed with the appropriate macroeconomics policies in order to liberalized the financial sector of a country successfully.

Findings: The Fourth Generation Model

The 'fourth generation model' emphasizes the importance of following a correct sequence for acquiring a successful financial liberalization. Arestis (1989) stated that sequencing contains two interrelated questions: (i) what is the optimal speed of reforms? (i.e. overnight / one shot vs. Gradual) and (ii) in what order should markets be deregulated and liberalized? Although the sequential analysis mainly deals with the second question, it is also important to look at the first question with the intention of further highlighting the significance of the second question. Krueger (1986) is quiet emphatic in advocating a rapid dismantling of distortions. In this it is clear that she argued with the premise of welfare as well as the credibility considerations. The argument is mainly rooted in claiming that once the protectionist regime is taken out there will be a drop in welfare considerations and once the masses feel that they are not better off it is likely to create credibility concern leading to derailing the financial liberalization process. Thus, an overnight liberalization is seen as a better option in preventing gradual resentment of financial liberalization (Kelegama, 1989). However, it should also be noted that an overnight policy is likely to have two kinds of

costs to the economy viz. adjustment cost of the balance of payments and the increase in distributional costs. In this premise, it is argued that a gradual, multistage implementation is superior to overnight completion. Edward and Van-Wijnbergen (1986) using a two-period inter-temporal model have also concluded that it is advisable to implement gradual reforms. Hebbel and Hernández (2001) also said that excessively rapid financial reforms lead to unsustainable credit and boom activities that ultimately cause a financial crisis. That is why prudential regulation and strong supervision of banks and financial institutions and other liberalized capital market reforms are essential. Similarly, Andersen and Tarp (2003) also focused on the sequential process of liberalization and concluded that a smoothly functioning of financial system has a vital role in economic growth. However, he has emphasized that it should be applied in a suitable sequential order with sufficient time and an appropriate middle way for financial sector reform rather than haphazardly applying liberalization (as cited by Paudel (2007).

In addressing the second question 'In what order should markets be deregulated and liberalized' available literature allows the identification of two schools of thought: one school which looks at the phases in financial liberalization whereas the other school looks at a more wider scope looking at real (stabilizing) reforms first and financial reforms second. Edwards (1989) provided a number of views which support the second school of thought. Accordingly, Mckinnon and Mathison (1981) highlighted that liberalization will have a better chance of succeeding if undertaken with a fiscal surplus. This was supported by Mckinnon (1984) identifying that the main problem with aborted liberalization is that they have been accompanied with massive capital inflow that results in real appreciation. Best way to avoid the need for foreign funds is to achieve fiscal surplus prior to the liberalization. Further it was identified that since inflation generates serious distortions, liberalization will take place under inappropriate signals.

Thus, inflation should be brought down first (Fischer, 1986, 1989). Sachs (1987, 1988) through historical evidences from successful Asian countries has shown that stabilization should be consolidated before attempting trade reforms (as sited by Aretis 2005). Finally Gibson and Tsakalotos (1994) stated that domestic financial liberalization is to be made after the industrial and real sector liberalization and before the external financial sector's liberalization; otherwise credit would flows from the banking sector to the protected industrial sector. If protection of the industrial sector is removed it would suffer in many ways and that the domestic financial sector is to be freed before the external financial sector to control the plight of capital from the national economy. Mokhtar and Fatemah (2007) also gave the trade reforms first and then financial reforms view point in a very concise manner stating that "the majority of the authors (Edwards 1986, 1990; McKinnon 1982, 1991; Krueger 1986) agreed on the existence of four great sequences in the process of liberalization. Accordingly it is identified that in liberalizing, domestic financial liberalization (sequence 2) must follow domestic real liberalization (sequence 1) and precede liberalization of foreign trade (sequence 3) and that of the capital movements (sequence 4)".

This sequence is shown in the table 2. However, it should also be noted that there exist substantial opposition for 'one optimal sequence' as identified above. Krueger (1986), is non-committal as for trade liberalization first or simultaneous implementation of both policies (real or reforms). Edwards (1989) and Mokhtar and Fatemah (2007) also noted that there is a great controversy around the order of stabilization policies and liberalization of the foreign trade, citing Funke (1993) who concluded that the direction of causality between the external and domestic financial liberalization is less clear. Perhaps such arguments against an optimal structure were fuelled by the fact that a number of researchers based on the 'southern cone' financial liberalization experience show that Uruguay and Argentina did not follow the commonly accepted sequence. However, Chile did follow the stipulated sequence but all three countries ended up with the same story of 'financial liberalization failure'. Nevertheless when weighting the thoughts for and against a better way of making financial liberalization, majority is definitely in favor of following a more rational financial liberalization (optimal) sequence as highlighted by the Table 2.

Table 2: Optimal Sequence of Liberalization

Sector	Domestic	External
Real	01. - fiscal discipline (stability) - elimination of implicit and explicit taxes and subsidies - privatization	03. - liberalization of current transactions - creation of foreign currency exchange market and currency convertibility
Financial	02. -restructuring/privatization of the domestic bank system -creation/reactivation of the money market	04. -control elimination on capital movement -total currency convertibility

This table shows the optimal sequence of liberalization according to Mokhtar and Fatemah (2007).Firstly, a country should liberalized its domestic real sector. Following that domestic financial sector could be liberalized. Afterwards, external real sector which is international trade could be liberalized and finally, external capital movements can be open up.

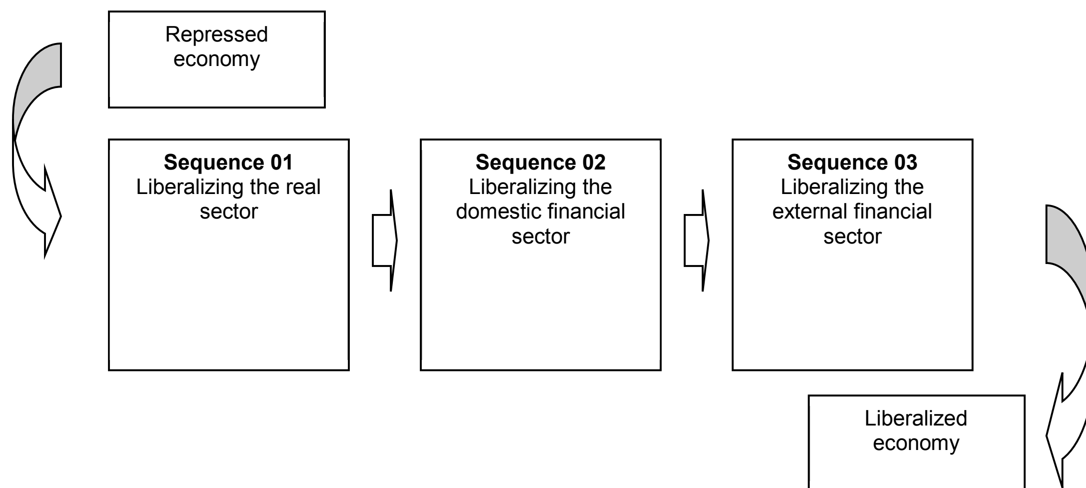
With regard to 'optimal sequence', the onus is now to look at some of the important justifications available regarding the sequences highlighted by Mokhtar and Fatemah (2007). Firstly, McKinnon (1993) stated that trade liberalization should only take place after the fiscal deficit is eliminated sighting the infamous 'southern cone' experience and emphasizing that government will face no necessity to borrow from abroad to finance (which leads to the over-borrowing syndrome) its expenditure. Thus, the need for capital inflows during the transition will be minimized. There after it needs to get the domestic financial markets liberalised in line with the McKinnon-Shaw hypothesis.

Further Edwards (1989) extracting the comments of Frankel (1982) stated that goods and asset markets clear at different speeds. While asset markets clear almost instantaneously, the attainment of equilibrium in the goods market usually takes some time. Thus, Frankel argued a synchronization of the structural reform process will call for the goods markets (i.e. the current account) to be liberalized before the capital account. In addition Mckinnon (1993) and Edwards (1989) also stated that financial liberalization will result in capital inflow and it will result in a real exchange rate appreciation which in turn de-protects the tradable sector. It is argued that in order to ensure success of the trade reforms it is crucial to avoid real exchange rate overvaluation. Hence, opening up external financial sector should be the last in an optimal sequence of liberalization.

The Model for Sequential Analysis

Based on the above extensive theoretical rationale a conceptual frame work for testing the sequential analysis is developed as shown below (Figure 1). Based on conceptual framework developed it is possible to investigate the sequential procedure of liberalization to determine whether a country has followed the optimal sequence of liberalization or not in determining its success. Thus, the model first looks at whether there is evidence to suggest that real sector liberalization has taken place in creating conducive environment for financial liberalization. Then, the model tries to find out evidence to decide whether the domestic financial sector has been liberalized. Next, evidences are collected to see whether the external sector has been liberalized. Finally, all three stages are monitored together in substantiating whether the Financial liberalization undertaken has followed the correct sequence of financial liberalization or not.

Figure 1: Model for Optimal Sequence of Liberalization



This figure shows the optimal sequence of liberalization that needs to be followed during the financial reforms. Firstly a repressed economy should liberalized the real sector. Afterwards they should take steps to liberalized the domestic financial sector. Finally a country needs to liberalized its external financial sector in order to become a fully liberalized economy.

CONCLUSION

The financial liberalization based on the Mckinnon-Shaw hypothesis calls for more liberal financial sector reforms to acquire a higher economic growth. The early hypothesis of McKinnon and Shaw (1973) assumed that financial liberalization, would be associated with higher real interest rates. As a result of lifting control policies and reducing inflation would stimulate saving assuming that saving is responsive to interest rates. Finally higher saving rates were assumed to finance a higher level of investment leading to higher economic growth. Subsequently, there were further developments to financial liberalization through the 'first generation' and 'second generation' models which mainly addressed the rapid reversals in international capital flows, self-fulfilling expectations, speculative attacks and changes in market sentiments that were evident with the financial crisis faced by the 'Southern Cone' countries in the 1970s. Then, the 'third generation' model attempted to stylize the causal mechanics underpinning the 1997 'East Asian currency crises' since the first and the second generation models did not fully explain this latter phenomenon. Despite all these developments and experiences, financial liberalization in many countries has not been successful and were unable to produce the expected outcomes from liberalization of the financial sector. With respect to this argument scholars have identified two key reasons for the non achievement of stated outcomes of financial liberalization.

That is the incorrect policies being followed in implementing financial liberalization (sequential problem) and policy inconsistencies (macroeconomic problem) in eroding the outcomes of financial liberalization. Taking these reasons for the failure into consideration fourth generation model of financial liberalization has been developed. This model clearly shows the correct path that needs to be followed when implementing financial liberalization in a country. Further it will also be useful to identify the reasons for the failures if the financial liberalization has not provided the desired outcomes in a nation. Therefore, this developed new model will bring a new evolution to the studies in the area of financial liberalization.

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