2. FINANCIAL DEVELOPMENT POLICY

2.1 FINANCIAL LIBERALISATION VS. FINANCIAL REPRESSION

Since the mid-1970s, the literature on financial development has been dominated by arguments for financial liberalisation (see McKinnon, 1973; Shaw, 1973). This body of thought has attempted to relate capital market developments to long-term economic growth in developing countries (where capital markets are generally underdeveloped). They claim that 'financial deepening' through growing financial intermediation and monetarisation of the economy aids economic development, and assert that 'financial repression' is detrimental to long-term economic growth. It is argued that fostering free competition and liberalising of the financial sector from interest rate ceilings and other restrictions facilitates economic development and growth.

The theoretical and empirical foundations of the financial liberalisation hypothesis have, however, received many criticisms. Theoretically, it is challenged by Keynesian economists who question the hypothesis because the underlying model assumes that savings determine investments. The hypothesis asserts that higher real rates of return on domestic financial assets, particularly bank deposits, encourage both savings and investments. Higher real deposit rates increase the propensity to save, and encourage savings to be shifted to banks, thereby increasing the availability of investment finance. Nevertheless, it is questionable that investments will increase even if savings are raised by higher real interest rates since from the Keynesian point of view, higher real interest rates tend to impede investment.

Moreover, it has been pointed out that whether or not higher interest rates in the formal sector will increase aggregate savings following liberalisation will depend not only on
how it affects current spending decisions, but also on how it alters the distribution of income between debtors and creditors (Akyuz, 1991: 2; Akyuz and Kotte, 1991: 7). Higher interest rates tend to reduce the aggregate volume of private savings by redistributing income from debtors to creditors, particularly when debtors have a higher propensity to save than creditors. On the whole, the household sector is typically a net creditor and the corporate sector, a net debtor. If the corporate sector saves a greater proportion of its income than the household sector, a rise in interest rates on corporate debt can lower total private savings unless it induces a sufficient increase in the propensity to save by households. Besides, higher interest rates not only lower aggregate private savings, but also reduce corporate investment because in many developing countries, undistributed corporate profits are an important part of private savings and the most important source of business investment.

Similarly, given its primary budget balance, a redistribution of income from the government to the household sector brought about by a higher rate of interest on government debt will reduce domestic savings; increased interest payments by the government will partly go into private consumption, and as a result, the public debt will rise sharply unless government revenues are increased and current expenditures are reduced.

In such cases, financial deepening (growth of the financial sector relative to gross domestic product) can occur alongside a decline in aggregate domestic savings and investment, and an increase in household savings, as well as corporate and public debt (Akyuz, 1991: 2). Financial deepening can occur in spite of deterioration in the finances of the corporate and public sectors, due to the accumulation of debt in order to finance the increased interest bill rather than for new investment.

Empirical evidence from many countries which have liberalised their credit markets and increased real interest rates does not show a systematic rise in aggregate savings. As an
analysis of the financial liberalisation experiences of Turkey, New Zealand, Philippines, Yugoslavia and Korea concludes: 'Evidence from the country studies confirm that there is no simple relationship between financial liberalisation and interest rates, on the one hand, and the volume of savings, on the other' (Akyuz and Kotte, 1991: 7). Cho and Khatchate (1989) also draw the same conclusion from their analysis of the financial liberalisation experiences of Korea, Malaysia, Sri Lanka, the Philippines and Indonesia. This also seems to hold for Africa, specifically Ghana, Kenya, Malawi, Tanzania and Zambia and Latin America.⁵

From a different perspective, Wade (1988) maintains that a repressed financial system facilitates rapid economic growth. In discussing Wade's argument, it would be useful to start with the distinction between three distinct types of financial systems (Zysman, 1983: 285). The three systems are: first, a capital market-based system with resources allocated by competitively established prices; second, a credit-based system with administered prices; and third, a credit-based bank-dominated system. What differentiates the financial systems is the relative importance of two types of financial markets; i.e. capital or stock markets and loan or credit markets (Zysman, 1983: 60).⁶

Wade (1988: 133-34) claims the following advantages of a state-dominated credit-based system. First, a credit-based system permits faster investment in developing country conditions than would be possible if investment depended on the growth of firms' own profits or on the inevitably slow development of securities market. More importantly, productive investment is less affected by speculative stock market booms.

Second, a credit-based system encourages more rapid sectoral mobility, and permits the government to guide such mobility. Where the government is trying to promote rapid growth by selectively fostering key sectors, a credit-based financial system provides the
government with a powerful mechanism for inducing firms to enter sectors they would otherwise not enter.

Third, a credit-based system helps to avoid the bias towards short-term profitability inherent in a stock market system. Since lenders of long-term finance are interested in the ability of borrowers to repay loans over the long term, performance over the long-term becomes the dominant consideration.

Fourth, a state-dominated credit-based system can provide a government with key instruments to carry out industrial policy.

Amsden (1989) argues that financial repression has been an essential feature of ‘late industrialisation’. In her model of late industrialisation (of which Taiwan and Korea are two classic examples), the government deliberately uses selective credit allocation to speed up the process of industrialisation. Although financial repression can foster a subsidy mentality and may induce wasteful rent-seeking behaviour, it is argued that the government can overcome such problems by imposing strict performance standards to minimise the abuse of preferential credit allocation.

Lee (1992) also argues in favour of financial repression. Lee’s argument—which can be characterised as the ‘internal capital market hypothesis’—draws upon recent developments in transaction cost economics. He proposes that the government and large private enterprises be viewed as together constituting a quasi-internal organisation. As such, what is commonly regarded as a repressed financial system can be seen as an internal capital market, where the government selectively allocates credit among large enterprises to develop certain priority product lines. Through the direct and close relationships established, the state and large private enterprises can share information which would otherwise have to be conveyed indirectly through prices. Besides, the quasi-internal organisation can reduce uncertainty by
coordinating the decisions of interdependent enterprises to adapt to unforeseen contingencies. With better information and reduced uncertainty, the quasi-internal organisation reduces transaction costs. Therefore, such a financial system can be more efficient than a free financial market system which inevitably suffers from various market imperfections, e.g. due to uncertainty.

Although the above arguments are appealing, we must be cautious. As Chowdhury and Islam (1993: 142-3) point out:

First, one should be careful not to confuse a credit-based system with a state-controlled credit-based system. Financial repression is a necessary feature of the latter, not the former. More importantly, the major advantages of a credit-based system as identified by Wade do not require the existence of state-control (and hence, financial repression). The only way in which financial repression can contribute to economic growth in this framework is to presuppose that a strong-willed government has the capacity to overcome the inadequacies of private capital markets without the corresponding risk of government failure. . . . The hypothesis of the superiority of a state-controlled financial system is questionable when one takes account of the interactions between formal and informal credit markets. . . . When formal financial institutions are regulated, the informal credit market expand. Such markets provide funds to those who cannot obtain credit from formal sources. In addition, privileged borrowers in regulated markets have an incentive to re-lend to users in unregulated markets (and hence profit from arbitrage). The net outcome is that informal credit markets act as a channel for diverting official (regulated) credit to more profitable investment opportunities, thus invalidating the notion that the state can effectively monitor the behaviour of borrowers.

2.2 'IMPERFECT INFORMATION' PARADIGM

The McKinnon-Shaw thesis focuses on the repression of imperfect credit markets in developing countries. Nevertheless, recent theoretical work in the 'imperfect information' paradigm contends that even if credit markets were perfect, market-determined interest rates would not be allocatively efficient due to asymmetric information between lenders (banks) and users of finance (corporations). The primary concern of this body of thought is to explain the
presence of credit rationing in competitive capital markets (see Stiglitz and Weiss, 1981, 1983). Because of asymmetric and incomplete information, each economic agent is tempted to use his informational advantage to pursue his own interest, which may differ from objectives of those (principals) who are influenced by his action.\(^7\) Banks making loans are concerned about the interest they receive on the loans and the riskiness of the loans. The interest rate a bank charges may itself affect the riskiness of the loans by either sorting potential borrowers or affecting the actions of borrowers. The interest rate a borrower is willing to pay may act as a screening device to identify ‘good borrowers’; those willing to pay higher interest rates may, on average, be worse risks because they perceive the probability of repaying their loans to be lower. Different borrowers have different probabilities of repaying their loans. The ‘adverse selection’ problem arises when the bank does not have the crucial information about the riskiness of its borrowers; the bank can end up with a pool of high risk borrowers who have higher probability of default and are willing to accept high interest rates. Another main information problem facing banks is that they do not know how the loans they give are being invested. Expected return to the bank obviously depends on the probability of repayment. As the interest rate rises, the return on projects which succeed decreases; an ‘incentive effect’ arises because borrowers tend to favour projects with a higher probability of default when the interest rate is raised.

Since the bank is not able to directly control all the actions of the borrowers, it will formulate the terms of the loan contract in such a way as to induce the borrower to take actions which are in the interest of the bank, as well as to attract low-risk borrowers. For both these reasons, the return to the bank may increase at a diminishing rate as the interest rate increases, and beyond a point, \(r^*\) (which Stiglitz and Weiss refer to as the bank optimal rate), it may actually decrease, as illustrated in Figure 1.
It is conceivable that at \( r^* \), the demand for funds exceeds the supply of funds. While both the demand for loans and the supply of funds are functions of the interest rate, the latter is determined by the expected return at \( r^* \). That is why even when there is excess demand for loans at a certain interest rate \( r^* \), it is more profitable for the bank to ration credit rather than raise interest rates. Thus, Stiglitz and Weiss showed that increasing the interest rate could increase the average riskiness of the projects a bank is financing, either by discouraging safer investors (adverse selection effect), or by inducing borrowers to invest in riskier projects (incentive effect).

To reduce or overcome such inefficiencies, Cho (1986: 197-8) proposed that credit markets need to be complemented by a well-functioning equity market as part of a comprehensive liberalisation strategy: 'Equity finance is free from adverse selection and moral hazard effects while debt finance is subject to them in the presence of asymmetric information. . .Equity capital can finance those risky, productive borrowers for whom asymmetric information is acute, while banks concentrate their finance on the well-established, safe borrowers.'
However, Cho’s analysis is far from satisfactory. In his comment on Cho’s article, Kumar (1994: 341-43) expressed his skepticism about the supposedly well-functioning equity markets claimed by Cho. Kumar summarises the following reasons why equity markets are not free from allocative distortions. First, asymmetric information may give rise to principal-agent problems. With asymmetric information, managers may prefer to rely on internal financing and may prefer debt to equity if new capital is needed. Managers may be reluctant to issue new shares, even at the cost of passing up good investment opportunities. Thus, real capital investment is misallocated. The distortions in investments in developing countries may be even worse since ownership and management of many small and medium-sized firms are usually in the hands of families.

Second, information imperfections limit the ability of a firm to raise equity capital due to ‘incentive problems’ and ‘signalling effects’ (Greenwald, Stiglitz and Weiss, 1984: 195). Incentive problems may worsen when a firm is equity-financed. With debt financing, managers have less flexibility in diverting profits for their private use as lenders have the power to discipline managers by withdrawing their funds. This acts as a sanction that may be more effective than shareholder control via share voting in which majority rule applies, or via takeovers, which are not likely to be an effective control mechanism (the reasons for this will be discussed in the next section). Thus, with equity financing, incentive problems may be more acute when managers in a firm are less restricted in diverting profits for their private use.

In addition, signalling effects may arise because attempts to sell equity may convey a strong negative signal about a firm’s quality. It is believed that ‘good’ firms tend to be more willing to rely on debt capital as both the absolute level of bankruptcy risk as well as any incremental increase in risk due to added debt will be smaller for ‘good’ than for ‘inferior’ firms. That is to say, equity will predominantly be sold by ‘inferior’ firms rather than by
‘good’ firms. The effective marginal cost of capital comprises the monetary cost of interest plus the marginal increase in expected bankruptcy cost associated with additional debt. Thus, adverse signals associated with issuing equity may restrict a firm’s access to equity markets as the cost of equity is prohibitive for many firms. It may reduce a firm’s value, as indicated by some empirical studies.⁸

Third, the limited liability of the modern corporation restricts the aggregate claims of various claimants on the corporation to the market value of the firm. Thus, a corporation’s limited liability induces corporate insiders to make investment decisions that are sub-optimal from the perspective of the welfare of all stakeholders. This, in turn, results in a conflict of interest between equity stockholders and other stakeholders (suppliers, customers and workers).
2.3 FINANCIAL RESTRAINT

Based on a stylized analysis of policies pursued by a number of high performing East Asian economies, Hellmann, Murdock and Stiglitz (1994, 1995) propose a set of financial policies constituting 'financial restraint', aimed at the creation of rents in the financial and productive sectors in order to induce agents in the financial sector to engage in beneficial activities; financial restrain is argued to be more efficient than either financial repression on the one hand or laissez-faire policies on the other.

Unlike financial repression, where the government extracts rents from the private sector, financial restraint involves the government creating rent opportunities for the private sector. With financial restraint, the government can create rent opportunities, but allows profit maximising firms to pursue and capture these rents, thus enabling private information to be utilised in making allocation decisions. As Hellmann, Murdock and Stiglitz (19945: 1) put it:

Rents in the financial and production sectors can play a positive role in reducing information-related problems that hamper competitive markets. In particular, these rents induce private sector agents to increase the supply of goods and services that might be underprovided in a purely competitive market, such as monitoring of investment or the provision of deposit collection.

Thus, this is a fundamentally different approach to conventional interventionist thinking, where the government undertakes the believed socially beneficial actions itself. By leaving the efficiency of execution to private agents, the numerous inefficiencies that can be expected from direct government action can be avoided. In addition, this approach differs significantly from a view of a government distributing rents through subsidies and other support programmes, which typically are not performance-based and may create greater dependency rather than self-sufficiency among subsidized firms.
In their analysis, Hellmann, Murdock and Stiglitz agree with McKinnon in warning against the government depriving the private sector of a positive real return on financial assets, and with Shaw’s view that improving the quality of financial intermediation is critical to increasing the efficiency of investment. Their analysis differs, however, from McKinnon’s and Shaw’s in arguing that selective intervention—financial restraint—may help rather than hinder financial deepening. They identify several ways in which financial restraint can foster financial deepening.

Using a simple demand-supply model of the market for loans, Hellmann, Murdock and Stiglitz illustrate the effect of interest rate controls as a mechanism for the creation of rents within the financial sector. Figure 2a shows market equilibrium at an interest rate \( r_0 \) at the intersection of a household funds’ supply curve and a corporate funds’ demand curve.\(^{10}\) If the government intervenes by regulating the deposit rate of interest, rents are potentially captured by financial intermediaries. Given the equilibrium lending rate \( r_L \), the difference between the equilibrium lending rate and the deposit rate \( (r_L - r_d) \) defines the economic rents accruing to banks, as shown in Figure 2b. In this case, the lending rate is greater than it would be in the absence of intervention, allowing banks to capture rents both from households \( (r_0 - r_d) \) and from firms \( (r_L - r_0) \).
In their analysis, there are two broad categories of rent effects. First, it is argued that the rent effect on savings is large. Beyond interest rates, they claim that households are likely to be more responsive to deposit security and intermediation efficiency. This is because households are typically risk-averse, placing greater emphasis on the security of deposits. Besides, household savings depend crucially on the available efficient facilities and infrastructure for deposit collection, in particular on the extent of the bank branching network and the efficiency of services provided to local communities (Hellmann, Murdock and Stiglitz, 1995: 5). Under financial restraint, the creation of rents in the financial sector can increase savings by inducing greater security and improving deposit infrastructure; this rent effect also dominates the interest rate effect. How rents can increase savings by affecting these two non-price factors will be discussed in the next few paragraphs.

A simple graphical way of illustrating this rent effect is a rightward shift in the supply curve from \( S_1 \) to \( S_2 \), as shown in Figure 2b. Given the controlled deposit rate, \( r_d \), the excess for loans gives an equilibrium lending rate of \( r_{L1} \) and banks capture rents of \( r_{L1} - r_d \). Despite the rent captured by banks, firms are better off with the rent effect. They obtain a greater volume of loans at a lower interest rate than they would under ‘free market’ equilibrium.
(Q_0 > Q_b and r_{L1} < r_b). This is possible if the rent effect is large relative to the interest elasticity of savings, as they assert.

Regarding the question of how rents can affect financial intermediation, Hellmann, Murdock and Stiglitz (1995: 7-8) elaborate:

We emphasize two important roles of the creation of economic rents for financial intermediaries under a regime of financial restraint. First, by creating an ongoing flow of profits from the continuing operation of the bank, these rents create incentives for banks to operate as a long run agent (by creating a 'franchise value' for the bank) so that they will work to monitor effectively firms and manage the risk of their portfolio of loans. ..Second, by increasing the returns to intermediation, banks have strong incentives to increase their own deposit base. Bank will thus make investments to attract incremental deposits, for example, by opening new branches in previously unserved rural areas or by making other investments to bring new depositors to the formal financial system.

Second, rents do not so much involve the transfer of wealth as much as opportunities to create wealth (Hellmann, Murdock and Stiglitz, 1995: 2). Unlike rent transfers, which alter the distribution of income without directly changing incentives for, the parties competing for these transfers, rent opportunities are contingent on the agent's actions. With financial restraint, a bank may only capture rents through its own efforts—by attracting new deposits to loan to rent-generating sectors and by rigorous monitoring of its portfolio of loans to ensure maximum return on its investments. As pointed out by Hellmann, Murdock and Stiglitz (1995: 6), 'in the case of financial intermediaries, rent opportunities would include incentives to promote deposit mobilisation—both in the wealth and intensity of financial services—and to encourage efficient portfolio allocation and loan monitoring on the parts of banks.'

There are some further policies that are necessary to support financial rent creation. It is important to note their assumption, crucial to their argument, that the rents generated by the financial sector can even persist in the long run. Thus, the government needs to place
restrictions on competition in the banking sector\textsuperscript{12} as such competition could eliminate the rents. The government needs to control entry into the industry so that 'new entry does not erode the rents that are necessary to induce banks to value their franchise. Also, too much entry would prevent most competitions from achieving the efficient scale, thus lowering their ability and desire to invest in better information and monitoring capabilities, and worsening the overall quality of intermediation' (Hellmann, Murdock and Stiglitz, 1995: 17).

While there is no price competition under financial restraint, there can be non-price competition such as in the locality and quality of services. There is a possibility that rent will be competed away or at least reduced through non-price competition. In addition, there are other socially wasteful forms of competition. An example of this is 'a bank which opens a branch next to a competitor's branch does not mobilize any new funds; the new branch only competes for existing depositors' (Hellmann, Murdock and Stiglitz, 1995: 17). Thus, restriction on such competition is necessary to prevent socially wasteful duplication of activity.

Another set of policies is concerned with restricting households' ability to substitute out of financial sector deposits. An undesirable side effect of financial restraint is that deposit rate controls may lead to asset substitution, where depositors seek out alternative savings vehicles (Hellmann, Murdock and Stiglitz, 1994). Restrictions on competing asset markets are, therefore, necessary to limit inefficient reallocation of savings in response to deposit rate control.

There are four important asset alternatives they consider. First, in developed countries, bond and stock markets have become an attractive alternative for households to invest their savings. However, it is argued that the development of security markets may not be desirable as:
... security markets would compete with the banking sectors for household funds. Security markets can only be used by the largest and most reputed firms in the economy. If they were to go to the security markets, banks would lose some of their most profitable business and there is a loss of franchise value. It follows that security markets provide an alternative savings vehicle that undermines the rents in the banking sector, and may threaten the stability of financial system. (Hellmann, Murdock and Stiglitz, 1995: 19)

Their argument suggests that security markets should not be emphasized during a stage of development when an effective banking system is being developed.

Foreign deposits are another alternative to deposit savings with domestic financial intermediaries. Serious attempts should be taken to control international capital movements. Alternative investment options can be provided to investors to make capital flight unattractive to them.¹³

A third threat to the formal banking sector is the informal sector, which invariably pays much higher rates to attract deposits. They argue that the decision to deposit funds in the informal sector is not so much a function of the rate differential, but mainly a function of the efficiency and safety offered by the informal sector. If their argument is correct, then financial restraint may actually encourage and facilitate the flow of funds from the informal sector to the formal sector.

The fourth asset alternative is real assets such as gold. These assets are inflationary hedges as their values are not adversely affected by inflation. Real asset substitution poses a serious threat to financial sector deposits whenever real interest rates are negative. Consequently, the economy needs to have a stable macroeconomic environment, where inflation rates are low and predictable so that real interest rates will be positive. This is one of the preconditions that must be met in order for financial restraint to operate effectively.