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# Financial Opening in Developing Countries

*Many developing countries are currently considering liberalisation of external capital flows. While the ultimate objective of financial opening is to raise efficiency and growth, the reform process must be carefully designed to achieve these results. A recent conference has discussed the policy choices.<sup>1</sup>*

Monetary authorities in many developing countries are currently reflecting and implementing *de jure* liberalisation of external capital flows. At least three reasons can be identified for policy-makers' renewed interest in financial opening. First, there has been increasing *de facto* opening of the capital account: the effectiveness of controls has declined due to growing trade integration, financial innovation and financial opening elsewhere; and ten years after the debt crisis, credit rationing by commercial banks is fading away while flight capital is being repatriated. Second, some countries have become subject to pressure in bilateral trade talks to open up their financial systems and to let their currency float. Third, for those advanced developing countries considering future membership of the OECD, the OECD Codes of Liberalisation may constitute another reason to engage into financial opening; the Codes commit OECD member countries to eliminate any restrictions between one another on current invisible and capital movement operations.

While the ultimate objective of financial opening is to raise efficiency and growth, the reform process must be carefully designed to achieve these results. The Hamburg Institute for Economic Research (HWWA) and the OECD Development Centre have analysed impediments to liberalisation in developing countries and identified institutional and policy measures which should precede the abolition of various capital controls.<sup>2</sup> In order to assist countries for the reform process, central bankers, experts from international organisations and academics were brought together in July 1992 for a conference dealing with the various issues involved. Here are some important policy issues brought forward during the conference:

John Williamson (Institute for International Economics, Washington, D.C.) opened the conference with "A Cost-Benefit Analysis of Capital Account Liberalisation". After sketching the conditions that were identified in the "sequencing" literature as desirable before capital *inflows* should be freed (well-established non-traditional export industries, secure fiscal discipline, and liberalisation of both trade and domestic finance) Williamson proceeded to elaborate a separate set of preconditions for liberalisation of capital *outflows*. Policy-makers in developing countries often worry that liberalising capital outflows will reduce domestic investment. While it was often argued that capital controls are so porous that their removal would do little to increase the export of capital, controls could prevent the placement abroad of long-term institutional savings. Williamson noted that the liberalisation programme should not be guided by any attempt to fine tune the capital account. Rather, the appropriate criteria to liberalise capital flows are more fundamental:

- ☐ a policy regime that investors regard as permanent in respecting their property rights, in order to enable countries to borrow in difficult times and to smooth out cyclical shocks,
- ☐ adequate flexibility of policy instruments to cope with a high degree of capital mobility, meaning either a willingness to accept a flexible exchange rate or a degree of flexibility in fiscal policy,
- ☐ arrangements to limit erosion of the tax base implied by capital outflows, by allowing developing countries access

<sup>1</sup> Cf. Helmut Reisen and Bernhard Fischer (eds.): *Financial Opening: Policy Issues and Experiences in Developing Countries*, OECD Documents on Sale, Paris 1993.

<sup>2</sup> Bernhard Fischer and Helmut Reisen: *Zum Abbau von Kapitalverkehrskontrollen: Ein Liberalisierungsfahrplan*, Hamburg 1992.

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to tax information-sharing agreements negotiated at the OECD. Countries which face excessive capital inflows are advised to eliminate any subsidies to inward investment, such as free deposit insurance, to widen the band of permissible exchange rate fluctuations, and to engage in sterilised intervention.

In the first comment on Williamson's paper, William H. Branson (Princeton University) noted that the basic reason why countries control capital movements is because they lack fiscal control. Without fiscal control, the government has to violate the *Mundell assignment* and use monetary policy for internal balance. To use monetary policy for internal balance requires capital controls to insulate the country from international capital movements. Once the capital account is open, even imperfectly, monetary policy requires a comparative advantage in dealing with external balance, while fiscal policy is assigned to maintain internal balance. Branson warned against controlling capital inflows once fiscal control was established. Recontrolling inflows would invite the redirection of monetary policy toward internal balance; this was an unstable assignment and could result in the high real interest rates observed in developing countries as they tried to liberalise.

Mitsuhiro Fukao (OECD), the second discussant, pointed to the similarity between Williamson's recommended sequence of liberalisation and Japan's reform experience. Fukao distilled four lessons from the Japanese decontrol process:

- ☐ the futility of managing the exchange rate by partial liberalisation of capital controls,
- ☐ the difficulty of liberalising only inflows or outflows,
- ☐ the need for the timing of liberalisation to consider external policies, in particular US monetary policies and
- ☐ the possibility of raising the effectiveness of any remaining controls by more exchange rate flexibility.

Fukao argued that small countries could achieve full currency convertibility much earlier than Japan did by setting up currency-board type central banks. The cost of lost monetary independence would be small for a small country, provided strong supervision of financial institutions and fiscal control could be maintained.

## Measures Preceding Reform

In a paper addressed to those governments which opt for *de jure* liberalisation of capital movements, "Macroeconomic Policies Towards Capital Account Convertibility", Helmut Reisen (OECD Development Centre) identified institutional and policy measures which

should precede reform. First, to avoid macroeconomic complications with free capital flows, long-term budget control is required (often through supply-side tax reform). Tax reform also has to compensate for the loss of explicit and implicit taxes on financial intermediation, inevitable if dismantling outflow controls is not to produce capital flight. Second, stabilisation (and labour market reform) should precede financial opening. Using the exchange rate regime (by way of a nominal peg, an active crawl, or a clean float) would help speed up the disinflationary process with open capital markets, but the costs of the misallocations involved in real overvaluation of the currency turn such a policy into a high-risk strategy. Third, full financial opening would require the establishment and deepening of money and securities markets. Otherwise, while using indirect monetary tools for daily operations when times are quiet, the monetary authorities would encounter large liquidity shocks by resorting to direct credit-rationing and to mandated asset transactions to combat capital flight and recession. Reisen reminded the conference participants that policy-makers can sequence the process of capital account liberalisation itself. Foreign direct investment and trade-related finance are to be liberalised at the earliest stage: while absolutely necessary for development, they are unlikely to cause trouble for macroeconomic management and financial sector stability.

In his comment, Zainal Aznam Yusof (Bank Negara Malaysia) pointed out that Malaysia – often incorrectly represented as a country which removed capital controls very early – has adopted a sequencing of reform measures in line with economists' mainstream advice. Financial sector reform was implemented after real sector reform (trade liberalisation and price deregulation), and the opening of the capital account was achieved only after considerable liberalisation of the current account. An outstanding feature of Malaysia's reform experience has been a tradition of strong bank supervision which allowed for a controlled gradual liberalisation of the financial sector.

## Interest Groups

Economists have traditionally examined the aggregate costs and benefits of financial liberalisation, while ignoring distributional consequences and how these effects interact with financial market policy. In their paper "The Political Economy of Capital Account Liberalisation" Stephan Haggard (UC San Diego) and Sylvia Maxfield (Yale University) examined the political rationale of credit and capital controls by providing a stylized sketch of the vested interests of different private groups and the government. Forces which have opposed financial opening have often included domestic banks,

sheltered from competition and burdened by government credit policies, and governments concerned with lowering their borrowing costs below market levels. Conversely, political forces that are likely to push policy-makers towards greater financial openness are the political dynamics associated with economic crises, subsequent pressures arising from partial deregulation and liberalisation ("snowball effect") and external political pressures. Just how important these political factors have been in the past for enforcing liberalisation was explored for Italy, Chile and Korea. Haggard and Maxfield suggested that rapid reforms are more likely under crisis conditions and, in particular, under new governments which are likely to enjoy some autonomy from interest groups' pressure.

Silvio Borner (University of Basle) pledged for an institutional analysis of policy failure in the financial sector which should produce advice on institutional reforms. Because "credit" implied an intertemporal allocation, it was especially vulnerable to the lack of property rights, to the presence of government discretion and to weak enforcement of contract law. Borner stressed the need to remedy "institutional uncertainty" by making government institutions predictable (through less discretion) and regulations stable.

Charles Wyplosz (INSEAD) stressed that income distribution plays a heavy role in shaping credit policies but his concern was how this matches with electoral models. Evidence from Europe would suggest that distorting policies survive as long as a majority stands to benefit. Wyplosz also emphasized the links between domestic and international liberalisation. Repressing the domestic financial sector if borrowers and savers have access to foreign markets would be no viable option. Cutting the links with the rest of the world has redistributive, and hence political, effects which go beyond mere domestic credit allocation, covering, e.g., trade protection and exchange rates. Dismantling capital controls thus should be incorporated in decisions on sequencing various reform areas. Wyplosz felt that in severely distorted systems most initial measures would benefit a wide majority while all further steps would imply income redistribution.

Yung Chul Park (Korea Institute of Finance and Korea University) presented a paper on "Capital Movement, Real Asset Speculation, and Macroeconomic Adjustment in Korea", written jointly with Won-Am Park (Korea Development Institute). They find ambiguous evidence about the degree to which Korea's capital account has effectively opened over the past years. Using the Korea Development Institute Model, the effects on the Korean economy of an exogenous increase in capital inflows is

estimated. It is found that higher capital inflows would result in higher GDP growth, higher inflation and currency appreciation. While higher capital inflows translate into increased money supply, they also raise money demand so that interest rates would be slow to converge downwards to the international level. The authors emphasize the role of the real estate market in this respect: under current circumstances, foreign capital would largely flow into the real estate market and hence fuel domestic asset and other nontradable prices.

Ulrich Hiemenz (Kiel Institute of World Economics) discussed some of the arguments put forward in favour of controlling financial markets. He questioned the need for direct government intervention in credit allocation to prevent market failures, e.g. caused by information asymmetries. Hiemenz argued that the establishment of proper rules and regulations is sufficient to protect depositors and assure a smooth functioning of financial markets. He found little evidence that economies of scale further concentration in the banking industry and questioned whether concentration must lead to market failure if larger units are exposed to international competition.

## Prerequisites for Success

In his paper on "Impediments in the Domestic Banking Sector to Financial Opening" Bernhard Fischer (HWWA Institute, Hamburg) offered micro-economic explanations for why financial opening often did not arbitrage away domestic-foreign interest differentials. Segmented credit markets, oligopolistic structures in the financial industry, interlocked ownership among banks and firms as well as bad loans in banks' balance sheets had been shown to be critical structural impediments for financial opening to achieve interest rate convergence towards world levels. These factors also prevented improvements in allocational and operational efficiency. Fischer identified, from a micro-economic perspective, the prerequisites for successful financial opening. He suggested solutions for the enforcement of domestic competition, strengthened prudential regulation and supervision, legal and accounting systems to cope with systemic risk and the consolidation of the domestic banking system. Fischer pointed out that unfettered competition on level playing-fields between domestic banks and new entrants into the market critically depended on solving the bad loans problem. He recommended making participation by foreign banks in the consolidation of the domestic banking sector part of the entry conditions. This could take the form of direct mergers of foreign banks with ailing domestic banks or, alternatively, an auction procedure for a limited number of

new bank licences to be earmarked for the rehabilitation of the domestic banking system.

By referring to East Germany, Peter Bofinger (University of Würzburg) emphasized that domestic distortions can be reduced very rapidly. He saw the danger as witnessed by the Korean case that the sequencing literature provides a welcome argument for all constituencies likely to lose from more domestic and international competition. His suggestion was to substitute the sequencing literature by the general presumption that unrestricted markets provide the optimum outcome and that interventions should only be justified if one can convincingly argue that market failure cannot be corrected at its source.

Philip Turner (BIS) observed that there is a tendency to underestimate the size of the bad loan problem confronting countries in transition and in developing countries. Therefore, the need to impose hard budget constraints on enterprises would be a prerequisite for reform. Furthermore, he emphasized that prudence in managing the transition should take precedence over encouraging new entry into the banking sector. According to Turner, capital adequacy standards would need to be tougher in developing countries than in industrial countries to prevent a generalised bank failure, because it takes time for market agents to assess new risks in a freshly deregulated environment. Turner warned, however, that prudential schemes to weight risk should be kept simple, given the shortage of qualified supervisors in developing countries.

### Pacific Basin

In his paper "Financial Opening and Monetary Control in Pacific Basin Developing Market Economies", Maxwell J. Fry (University of Birmingham) examined the effects of financial opening on monetary policy in Indonesia, Korea, Malaysia, the Philippines, Taiwan and Thailand. Fry found that Asian countries retained considerable short-term monetary autonomy despite open capital markets. Asian offset coefficients were significantly smaller than in OECD countries (which are mostly financially open), and even lower than in other developing countries (where capital controls still prevail). Offset coefficients measure the degree to which changes in domestic credit leak through the country's balance of payments. A low offset coefficient can be due to exchange-rate flexibility, effective capital immobility, or imperfect asset substitutability (between different currencies). Fry also observed that Asian countries heavily (and since the 1970s even fully) sterilised net capital inflows, while monetary and fiscal policies in other developing countries were much more accommodative. Heavy sterilisation of capital inflows can

raise a country's risk premium (when the market has increasingly to absorb domestic bond issues), thereby reducing asset substitutability and the offset coefficient.

Emil-Maria Claassen (University of Paris-Dauphine) pointed out that Fry's analysis encompassed two regime shifts, the collapse of the Bretton-Woods system and Asia's move from a closed to an open capital account. He also questioned the relevance of offset coefficients since much of Asia had meanwhile moved from a dollar peg to managed floating. Claassen agreed with Fry that estimates on Asia's monetary independence cannot be derived from estimates of interest parity conditions. In practice, the arbitrage mechanism of interest rates still applies only to a limited menu of financial assets, while many Asian borrowers remain captives of the domestic banking system or curb market, with no access to the domestic and foreign bond markets.

A detailed account of "Monetary Policy Implementation Under Financial Liberalisation: The Case of Taiwan" was given by Deputy Governor Paul C. H. Chiu (The Central Bank of China, Taipei). Chiu's estimates based on the quantity theory of money and the money supply process show that changes in consumer prices in Taiwan are also governed by oil prices and by expectations regarding asset price inflation (in particular the stock market), rather than by money supply alone. While it has been quite an achievement of Taiwan's monetary authorities to sterilise the economy's excess savings (running up to 20 per cent of GDP a year) and to keep monetary aggregates, inflation and exchange rate appreciation in check, recent changes in Taiwan's redeposit scheme in the postal savings system are felt to threaten monetary control. In the past, sterilisation has relied on postal savings, part of which are redeposited with the central bank and part with the domestic banking system. To contract the net domestic assets component of base money, it sufficed to order a rise in the redeposit share held with the central bank.

Moon-Soo Kang (Korea Development Institute) followed to discuss "Monetary Policy Implementation Under Financial Liberalisation: The Case of Korea". Financial opening would force Korea's monetary authorities to move from reliance on credit controls to market-based monetary policy tools. Kang recommended reforming Korea's system of rediscount facilities and gradually deregulating interest rates. Since much central bank lending consists of the automatic rediscounting of subsidised loans made by the banking system, the discount window can only play a limited role in indirect monetary control. Interest rate deregulation threatens the soundness and safety of Korea's banking system as long as it is saddled with non-performing loans through

government credit allocation. Ongoing interest regulation, however, would inhibit the development of the domestic money market, bond markets and secondary securities markets – all important ingredients for open market operations.

Former Governor Andrés Bianchi (Central Bank of Chile) focused on Chile's exchange rate management in the early 1990s when the country experienced massive capital inflows. Judging these inflows to be of only a temporary nature, the monetary authorities decided to dampen upward pressure on the currency by foreign exchange market intervention which was subsequently sterilised. As this proved insufficient to dampen the appreciation, additional measures were taken which have so far succeeded:

- ☐ higher reserve requirements on short-term foreign credit,
- ☐ relaxation of outflow controls on the portfolio of pension funds,
- ☐ allowing higher profit remittances from investments financed under Chile's debt-equity swaps, and
- ☐ stricter limits on the share of dollar deposits that commercial banks can intermediate into peso loans.

In his comment, Donald Mathieson (IMF) pointed out that central banks have traditionally served two important macroeconomic functions that are likely to be affected by opening the capital account:

- ☐ providing an instrument of overall monetary control, and
- ☐ serving as a key component of the official safety net underpinning the stability of the financial sector.

Focusing on the second function, Mathieson asked whether the efficiency gains associated with financial opening have to be "purchased" at the expense of greater public sector funding obligations. Prudential supervision will be important in improving on any trade-off. Mathieson also warned that developing countries are unlikely to have the same techniques or options available to them for managing financial crises as the OECD countries; as a result, credit instruments would be likely to remain a standard part of the "tool kit" for managing crises in developing countries.

### Exchange Rate Regime

Peter Kenen (Princeton University) addressed two issues in his paper "Financial Opening and the Exchange Rate Regime": the exchange rate effects of moving to capital account convertibility, and the longer-run

implications of capital account convertibility for exchange rate policy. The abolition of capital controls often leads to the repatriation of domestic assets – a net capital inflow – because controls on capital outflows reduce the incentive to repatriate capital by "taxing" the option of re-exporting capital later. The net capital inflow produces an appreciation in real terms both under a floating exchange rate (by nominal appreciation) and under a pegged exchange rate (by raising domestic goods prices). Kenen concluded that the real appreciation resulting from financial opening resides in the failure of the monetary authorities to supply the appropriate mix of assets: the authorities do nothing in the floating-rate case; they issue money in exchange for foreign assets in the pegged-rate case; they should issue bonds instead by engaging in sterilised intervention.

Kenen went on to examine two major implications of capital mobility for exchange rate policy. The fact that financial opening makes capital flows more sensitive to domestic monetary policy would strengthen the case for exchange rate flexibility – unless monetary independence was abused. The fact that capital flows also become more sensitive to other events, domestic and foreign, expected and actual, would weaken the case for flexibility, as volatile capital movements can do greater damage to the real economy when they affect the exchange rate than when they affect the money supply. In view of the increasing evidence that OECD foreign exchange markets are at times detached from "fundamentals", a growing number of economists have recently advocated pegging the exchange rate as an anchor to promote price stability and to stabilize real exchange rates indirectly. Kenen warned that, "no sensible sailor throws out an anchor before the boat stops moving". More often than not, a pegged rate by itself has been unlikely to confer enough credibility on domestic policies to keep the real exchange rate from appreciating sharply.

Jacques J. Polak (Per Jacobsson Foundation) noted in his comment that with a high degree of capital mobility (which he perceived as a fact of life for almost all countries now), a credible policy of using the exchange rate as an anchor implied forswearing its role as a balance-of-payments and employment tool. While developing countries had only limited possibilities of benefiting from capital controls, this however would not imply that they should needlessly reduce the scope for monetary policy by abolishing *all* controls over capital movements. Countries with a good stability record could benefit from the disciplinary value of a fixed rate (either on a single currency or on a small number of strong currencies), but that required some reliance on foreign exchange reserves and/or payments controls.