

Schweickert, Rainer

Book Review — Digitized Version

[Book Review of] Financial opening: policy issues and experiences in developing countries, Helmut Reisen ... (eds.), Paris, OECD, 1993

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Nevertheless, there may be second-best situations when a government would need to know what industries will have a comparative advantage in the future. One chapter is used for a discussion of this issue. The chief method to assess potential comparative advantage presented by the authors is identification of a suitable “comparator” country, which then can be used for producing information on potential new products and/or markets for the country under scrutiny. Although there are certainly pitfalls in such a methodology it is, according to the authors, much preferable to administrative, non-economic decision criteria. It is not difficult to agree.

The final, fifth, part of Greenaway’s and Milner’s work concerns structural adjustment lending (SAL), where various conditions applied to trade policy play a central role. This is certainly no wonder, considering the apparent – albeit perhaps not fully understood – relation between outward-orientation and economic performance. The organization and monitoring of reform programmes on which SAL is conditional is an important area of application for the techniques described earlier in the book. All in all, the evidence as to the success of the programmes is rather mixed so far.

As a rule, Greenaway’s and Milner’s book is admirably clearly written. There are some exceptions though. Sometimes the exposition could be a little more thorough, even if the reader can go back to the original sources for more information and the examples usually lead the reader directly to original applications which are likely to clarify the issues. The curse of international economics, the acronyms, also haunts this text. A list at the end of the book would be helpful. Another, perhaps unintended lesson of the book is how much the theoretically correct measures usually have to be compromised in order to make measurement at all possible in the real world. Authors tend to play down the significance of that, and it is of course true that some measure is generally preferable to none. Still Greenaway’s and Milner’s book reminds the reader of dangers lurking even behind the most standardized framework.

Hans C. Blomqvist

Reisen, Helmut, Bernhard Fischer (Eds.), *Financial Opening. Policy Issues and Experiences in Developing Countries.* Paris 1993. OECD. 270 pp.

Financial opening is one of the last disputes to be won by the proponents of liberalization policies for developing countries. While the superiority of liberalizing trade and the domestic capital market is generally acknowledged, the resistance against liberalizing the capital account is still significant in developing countries. The papers included in the conference volume edited by Reisen and Fischer identify the relevant explanations:

- vested interests of different private groups and the government in favour of credit and capital controls (Haggard/Maxfield);
- demanding preconditions for financial opening (Williamson, Reisen, Fischer);
- consequences for macroeconomic control (Kenen).

Haggard and *Maxfield* show that opposition to financial opening is to be expected from domestic banks, sheltered from competition and burdened by government credit policies, and from governments wanting to reduce the cost of borrowing below market levels. They suggest that rapid reforms are more likely under crisis conditions and under new governments which may enjoy some autonomy from pressure of interest groups.

The papers by *Williamson* and *Reisen* identify institutional and policy measures which should precede financial opening. First, tax reform has to compensate for the loss of explicit and implicit taxes on financial intermediation, necessary if dismantling outflow controls is not to produce capital flight. Second, stabilization should precede financial opening in order to avoid misallocations from real overvaluation of the currency in the case of large capital inflows. Third, investor confidence in the permanence of a policy regime respecting their property rights has to be built up, in order to enable countries to borrow in difficult times and to smooth out cyclical shocks. Fourth, trade and the domestic capital market is to be liberalized before, in order to avoid biased price signals for international investors. Foreign direct investment and trade-related finance should be liberalized in an early stage.

Fischer further analyzes the liberalization of the domestic capital market as a precondition for a successful opening up of the capital account. He identifies segmented credit markets, oligopolistic structures in the financial industry, interlocking ownership among banks and firms, as well as bad loans in banks' balance sheets as critical impediments to achieve convergence of interest rates towards world levels and to improve allocational and operational efficiency. He suggests solutions for the enforcement of domestic competition, a strengthened prudential regulation and supervision, legal and accounting systems to cope with systemic risks, and the consolidation of the domestic banking system. Especially the bad loan problem has to be solved in order to provide a level playing field for an unfettered competition between domestic banks and new entrants.

Kenen offers two sets of conclusions with respect to macroeconomic control after the capital account has been liberalized. First, sterilized intervention is necessary to avoid an overvalued exchange rate due to capital inflows induced by the liberalization of capital flows. Second, the fact that financial opening makes capital flows more sensitive to domestic monetary policy strengthens the case for exchange rate flexibility while the fact that capital flows also become more sensitive to other events 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.

These conclusions are highly debatable and it would have been interesting to see a paper in the volume presenting a different view. It can be argued, e.g., that capital inflows are induced by stabilization policies and allowed for in the case of a liberalized capital account. In both types of stabilization policy – with fixed and with flexible exchange rates – the proper functioning of the policy depends on unsterilized capital flows which enforce adjustment and ensure the credibility of stabilization. Moreover, in the case of a large negative real shock it is at least open to question whether the effect on money supply, i.e. a monetary contraction, or the effect on the exchange rate, i.e. a nominal devaluation, is to be preferred. The answer depends on the relative advantages of the alternative strategies to bring about a real exchange rate devaluation.

In addition to the discussion of the general issues, the conference volume also contains country studies which present useful examples and which highlight some of the general issues. Unfortunately, the sample of countries does only include Asian countries. Some Latin American experience would have been useful to show why liberalization fails if the preconditions are not fulfilled. All in all, the conference volume is a good guide for economists and policy-makers looking for a non-technical introduction into the topic. Additionally, the volume has an important advantage over other conference volumes which makes it especially recommendable: it contains only relatively short papers.

Rainer Schweickert