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The Prerequisites for Financial Repression and Financial Liberalization Policy

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Abstract
This paper examines theoretically the effect of financial policies on economic growth for four selected developing countries. At the end of 1970s and in the beginning of 1980s these countries embarked on financial reform for a stability and growth purpose.This theoretical study suggests that both financial repression and financial liberalization policies provide the expected growth but it is subject to certain requirements. As a prerequisite, financial liberalization needs macroeconomic stability, institutions, political stability and, better supervision and regulation of the sector. And then after exercising liberalization increases efficiency of the sector. While financial repression needs benevolent dictator government, which is free from corruption and bribery and ultimately servant of the population. The lower real interest rate environment because of financial repression is the big opportunity to increase investment and economic growth. Otherwise, adopting both policies without fulfilling requirements provides instability and lower growth.
Keywords: financial repression, financial liberalization, economic growth

1. Introduction

The effect of financial policies on macroeconomic stability and economic growth is one of the old orthodoxy which formally introduced by McKinnon and Shaw school during 1973. But a number of economists [5]are still in a debate both theoretically and empirically.

What does it mean by financial repression or liberalization policy? What indicates it?

Financial repression is a set of governmental legal restrictions which prevent financial intermediaries in the economy from functioning at their full capacity level (Hiro, 2005). For Okpara, (2010) financial repression is a deliberate and calculated distortion of financial prices via different instruments[6]. These, financial repression can have a consequence on the two economic actors (Jérôme, et al., 2015).

While financial liberalization is an elimination of directional credits and high reserve requirements, opening the financial market for new entrants and letting the interest rate to be determined by the market forces rather than by regulation in order to increase efficiency; a move strongly advocated by the influential work of McKinnon (1973) and Shaw (1973). In their separate work they argue that such financial repression policies discourages saving, increase the segmentation of the financial market and creates financial disintermediation of the banking system. Thus, their proposal for financial liberalization has become new orthodoxy since 1970s and 1980s.

Even though there is something of consensus over the effect of financial liberalization on economic growth still many development economists are in support of repression policy. Because by repression policy the government can funnel funds easily without legislative procedure and corrects market failure. Additionally repression policy reduces the costs of servicing government debt (Sala-i-Martin, 1992).

Against to Sala-i-Martin, (1992), Kozo, et al., (2007) suggests some of the important potential benefits that may be realized from liberalization financial policy.

- Financial liberalization has positive effects on the efficiency of the banking sector. This is because of domestic banks are forced to compete with more efficient foreign banks.
- Additionally the entry of foreign banks through financial liberalization may improve bank supervision through regulatory spillover
- And numerous studies have confirmed that state-owned banks are less efficient than private banks.

2. Reasons for repressed or liberalized financial policy

Different governments argue different reasons why they follow repressed or liberalization policy.

2.1. Macroeconomic stability argument: As a pre request to liberalization policy stability is a must. That is

[5] Economists disagree about the effect of the financial policies on economic growth. For example, for Robert Lucas (1988), Joan Robinson (1952), and Meier and Seers (1984) financial sector has no contribution for growth. While, for Merton Miller (1998), Schumpeter (1912), Goldsmith (1969) and McKinnon (1973) financial sector can have a significant effect on economic growth based on policies adopted, as cited in Levine, (2005).

[6] The instruments are interest rate ceilings, liquidity ratio requirements, high bank reserve requirements, capital control, directions of credit allocation and monopolizing the banking industry.

why government follow a tendency first stabilize and then liberalize. Because the budget deficit causes government debt higher, and this debt compels to have repression policy (Hossain & Chowdhury, 1996).

Yet, repression works best when combined with modestly elevated rate of inflation around 1% to 3%. Higher inflation makes interest rates negative in real terms, favoring debtors at the expense of creditors: while the nominal stock or face value of outstanding debt may be unchanged, and acts as a tax levied on holders of domestic debt (Stewart & Dosso, 2012).

2.2. Fear of financial crisis

Although deregulation is intended to improve efficiency in financial markets, it has made financial systems more vulnerable to financial crises (Soros, 2008).

For example, if real interest rate is fully and rapidly liberalized it is obvious that the market can experience higher market determined real interest rate. And this higher interest rate leads to face adverse selection [7]problem once the safe borrowers shy away and the risky borrowers remain.

The unsafe borrowers usually cheat the lender because of their business proposals and with that the lender again faces the second information asymmetry problem the so called moral hazard (Mishkin, 2004). Those two problems jointly or separately increase probability of default (see, Bardhan & Udry, (1999), which can again result a bank run and bank Punic. At last considering the WALRAS [8]law the entire financial market fails.

2.3. Institutions, political stability, Supervision and regulation

According to Chowdhury, (2010) economic regulation (controls over interest rates and credit allocation) and prudential regulation are essential to mitigate market failure and stability issues. While the original theory of financial repression argued for liberalization of economic regulation on the grounds of improving efficiency and financial deepening. But there was no coherent theory for dismantling prudential regulation.

Alesina et al., (1992), articulate that those countries with unstable political environment are experiencing lower economic growth. Logically, it is also the government responsible for such poor politics and its bad result. So, intervention to tackle is a rank one activity given to the government. Furthermore, for Gulenay, Dalgic, & İyidogan, (2015) and Cihak, et al., (2012) quality institutions, supervision and regulation are a must to have before financial liberalization policy undertaken and later on the policy yields economic growth. If not repression is optimal.

2.4. Imperfect information and monopolistic market structure

"Many of the greatest economic evils of our time are the fruits of risk, uncertainty, and ignorance'' (Keynes, 2016)

By default liberalization needs relaxation of barriers. What we call it by principle perfectly competitive market structure but in most developing countries we look such monopoly powers over different sectors. Similar case in the finance sectors, giant government owned financial institutions taking the lion share of the ratio of deposit and loan over the total finance sector.

As a result if we practice liberalization in such situation; the country will face such risks and uncertainty because of the information asymmetry and there by growth puts on comma. Finally, repression becomes optimal (Stiglitz, 1998).

3. Finance - Growth nexus: LDCs experience

After Washington consensus most of developing countries are adopting different policies following structural adjustment programs. After heyday of this reform package, the economy of these countries also experiences reduction on government debt, economic growth for few countries and financial crisis (williamson, 2006).

To have shaped understanding we explore the role of this reform via creating ideal arguments. By and large we try to see for selected nations of Latin America, Asia and Africa. From Latin America countries Argentina is the one which relaxes all repression policy instruments and adopt the reform package during 1977. The table below gives us interested information about Argentina experience before and after the reform.

[7] Adverse selection refers to a market process in which bad results occur due to information asymmetries between buyers and sellers: the "bad" products or customers are more likely to be selected.

[8] WALRAS law states the interdependence of markets. For example, we have an economy with L- markets and if the L-1 market clears/fails, the L^{th} market also clears/ fails.

Table 3.1: Argentina experience from financial liberalization policy

Country	Initial condition of the country	Policy undertaken	The resulting outcome
Argentina	Unstable macroeconomic environment - High budget deficit - Higher inflation	Liberalization: deregulation of all barriers of financial market	- Government debt decreases - Inflation decreases but at highest level. - Over 70 financial institutions are liquidated
	Inadequate and in effective supervision and regulation		

Source: (Hossain & Chowdhury, 1996)

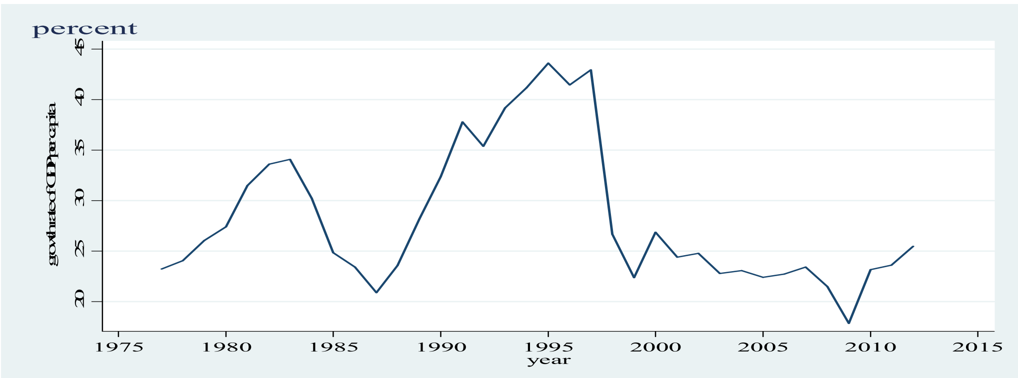
Therefore, for Argentina the reform package provides financial crises because of unfulfilling the prerequisite of liberalization policy.

From Asian countries, we try to investigate experience of Malaysia. She has a success story of financial liberalization with limited scoped reform which was begun during 1978. Looking pre reform history of Malaysia it was regulated and with mid time they relax their interest rates and adopt managed or dirty float exchange rate regime with prudential regulations and supervisions (E.charette, 2006). After few years, the country experiences financial distress which runs to other weak financial institutions. But the central bank intervenes to inject capital and with that it has maintained stability during the reform along with economic growth (Hossain & Chowdhury, 1996).

Figure 3.1: Exchange rate reform

Source: World development indicator data base

Figure 3.2: Growth rate of GDP per capita



Source: World development indicator, World Bank, 2013.

Exchange rate is among the most important prices in an open economy. It influences the flow of goods, services and capital in a country. It also exerts strong pressure on the balance of payments, inflation and other macroeconomic variables. It is a critical aspect of economic management to safeguard competitiveness, macroeconomic stability and growth.

One of the pillars in a SAP is devaluation which is expected to encourage export and discourage import. Figure 3.1 shows exchange rate regime in Malaysia which is continuously decline (devalued) after 1984 and with that she achieves higher growth (see fig 3.2). Growth rate of GDP per capita of Malaysia reaches at a higher level (43%) since 1995.

At last, according to Ncube, (2007) a large number of countries in SSA have implemented financial sector reforms since the mid-1980s. Most of these reform programs have those main objectives: (a) to reduce financial repression by liberalizing interest rates and by eliminating the administrative allocation of credits; (b) to institute the transition from direct to indirect monetary policy; (c) to develop financial markets, mainly primary markets for treasury bills; and (d) to improve the financial infrastructure including bank supervision, auditing and accounting practice.

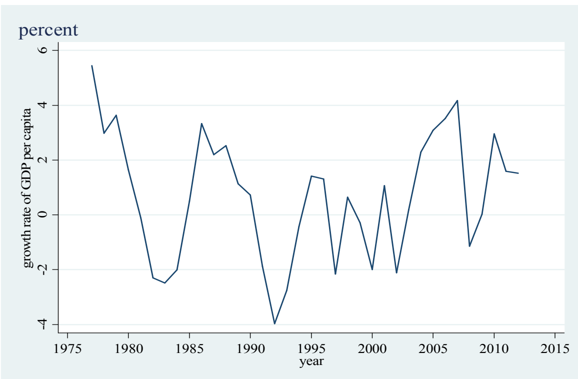
Kenya embarked on structural adjustment programs (in which deregulation is the one) in the early 1980s having an objective to mobilize and allocate domestic resources to productive ventures and realize economic growth. Most of developing nation government use interest rate controle as a way of revenue genration and servicing government debt. But in 1980s kenya libealizes interest rates as apolicy for growth. As the figure 3.3 shows starting from 1980s both real interest rate and nominal rates are increasing in kenya, to mean relaxed. But still at a lower percent and there are periods with negative real interest rate.

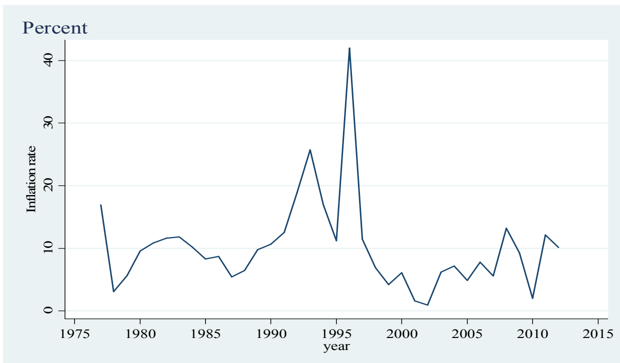
Figure 3.3: Interest rate reforms in kenya

Source: World development indicator, World Bank, 2013.

Although the aim was to realize economic growth the achievements were higher inflation and lower growth. GDP per capita declines (see fig 3.4) with an average rate of growth of 7.2% compared with 3.3% in 1986 and -3.9% in 1992. However, an improved growth rate was recorded in 1994/1 995 which is in line with Ngugi & J.W.Kabubo, (1998).

Figure 3.4: Growth rate of GDP per capiata in kenya   Figure 3.5: Inflation rate in kenya





Source: World development indicator, World Bank, 2013.

Ethiopia adopts SAP lopsidedly during 1992 and the reform ranges from partially liberalized to fully repressed sector. The reform characterized by domestic sector liberalization, entry barrier to foreigner banks, strong capital account controls, and absence of stock market (Kozo, et al., 2007). As Aragaw, (2016) Ethiopia is benefited from lower interest rate environment, which is a result of financial repression. Because the lower real interest rate environment results more of the currency to be outside the banking sector and fails on productive investments.

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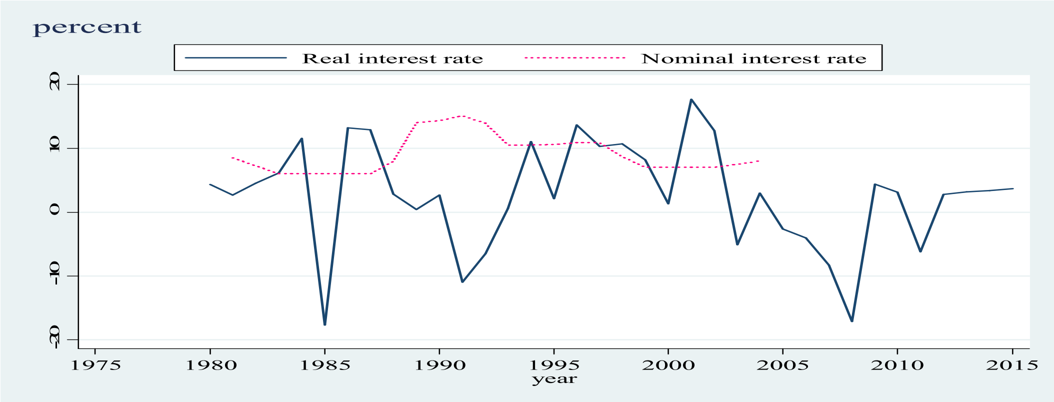
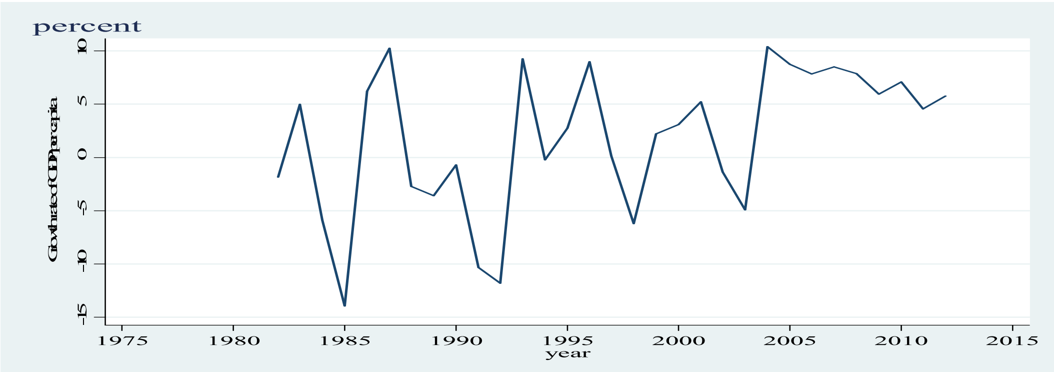
Figure 3.6: Interest rate in Ethiopia



Source: World development indicator, World Bank, 2013.

As the figure 3.6 shows, for a prolonged period of time real interest rate in Ethiopia is quite lower and negative (see, 1985&2008) and this shows that there is no full interest rate liberalization. This means depositors costs for their additional saving more of a time.

Figure 3.7: Growth rate of GDP per capita

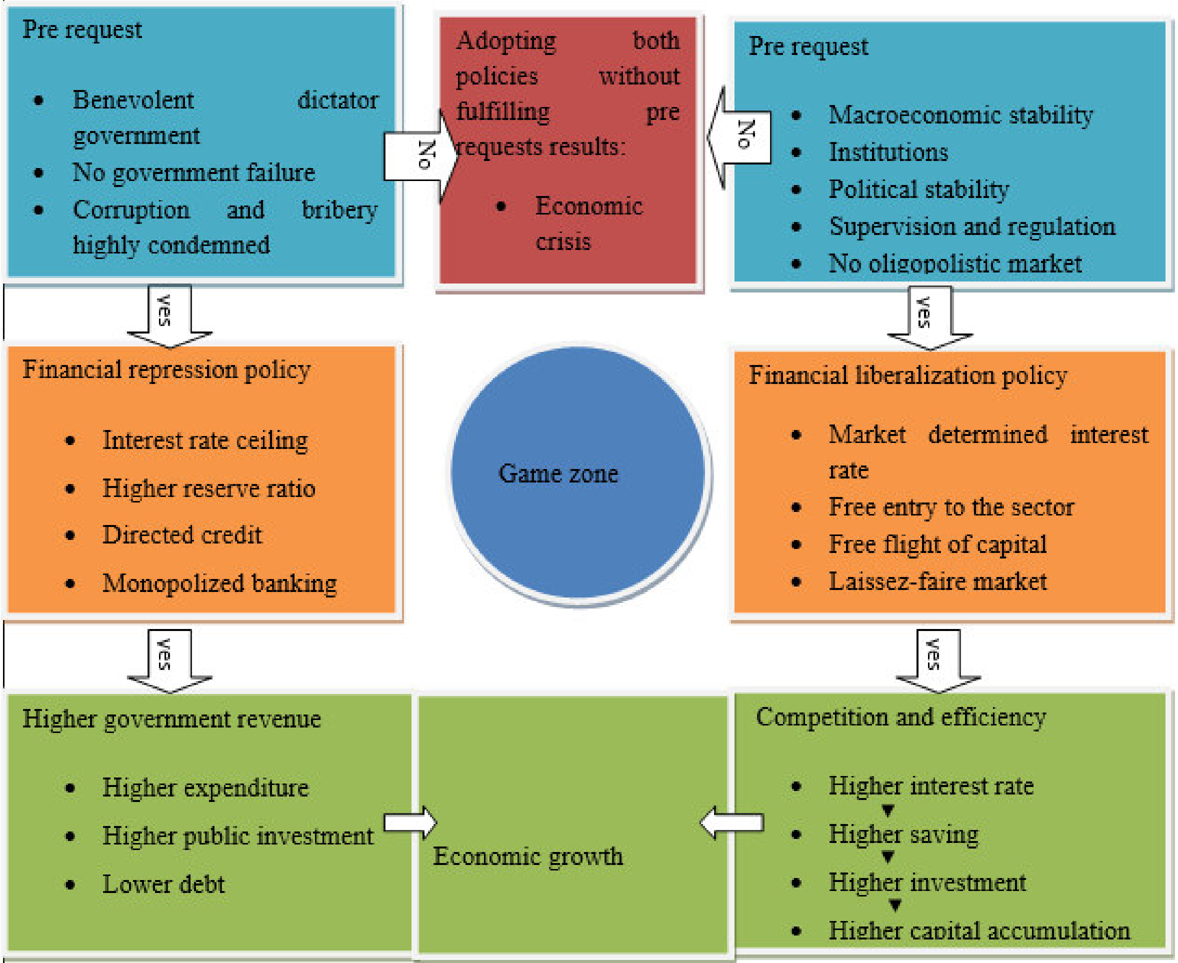


Source: World development indicator, World Bank, 2013.

Financial repression policy in Ethiopia affords expected growth, lower government debt and higher inflation. Figure 3.7 demonstrates that growth rate of GDP per capita in Ethiopia is increasing starting from 1992, except for a shocks existed in 1997/1998 and 2014. By repression (implicit tax on savers and lenders) policy the government generates revenue and then the revenue injected as public investment or helps for servicing government debt. Appendix four shows Ethiopian government debt, which was continuously declined from 1992- 2005 and because of mega projects after 2006 it raises. While the inflation rate of the country is increasing after 2001 (see appendix five).

4. Conclusion: The prerequisites for financial policies

Figure 4.1: Conceptual frame work; finance - growth nexus



Source: own compilation from Chowdhury (1996) ,Beim & Charles, (2001) and Gupta & Zirambay, (2008)

Figure 4.1 show that both policies can provide us the targeted growth, but what matters is looking the environment. As pre request we have to examine the stability issues, the law, the government, institutions and the system.

The better diagnosis, the better result or we can cure the patient easily having the tablet. Similarly weak diagnosis provides us a long day's sleep. Not only have that, diagnosis tablet contradiction provided us again some shock in our health. So, before liberalization policy, the economy needs macroeconomic stability, political stability, institutions, and better supervision and regulations. If not the economy will exercises crises (Hossain & Chowdhury, 1996).

The noble prize winner Stiglitz and Weiss as cited in Vogel & Adams, (1996) have provided important insights into the functioning of financial markets and their role in economic development, mainly that: (1) free markets do not necessarily result in a completely efficient allocation of resources and, (2) problems related to information and its use by participants in financial markets are the main source of the imperfections. Beside that if the requests are fulfilled, with the Efficient Market Hypothesis [9]it is possible to internalize growth. And exercising repression policy may have a negative effect on growth or the extent of growth lowers.

To economists the importance of efficient markets lies not in the markets pricing mechanism directly, but on its nock on effect maximum economic output (Cooper, 2008). Otherwise, viewing the information problem and transaction costs, repression can be best policy if optimization is possible with interference.

[9] Efficient Market Hypothesis states that asset prices are always and everywhere at the correct price. That is to say, today's market prices, no matter what they are, correctly reflect assets' true values, based on current economic conditions.

Additionally, repression policy also requires such benevolent dictator leaders ideally, and all these bureaucratic failures should be solved and the government should practice all policies for the massive population. Rather following this era philosophy night watchman state and repression policy is ideal match with the placebo (Gupta & Zirambay, 2008).

To sum up, it is better to investigate the economy initially, and then adopt better policy which gives our buzz word growth since we need to treat liberalization as a means rather than an end. Instead of pushing for immediate deregulation, we should be trying to understand the important role government plays in financial markets. These steps will not only result in the better and more stable allocation of domestic capital, but also help countries to manage international capital flows (Stiglitz, 1998).

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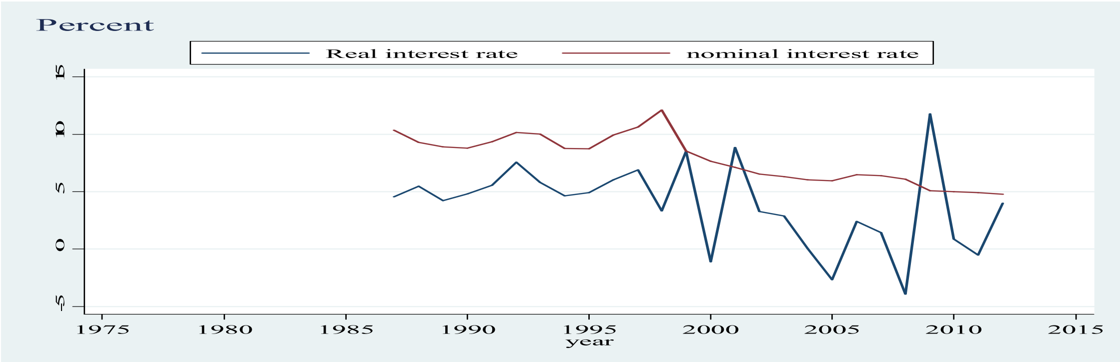
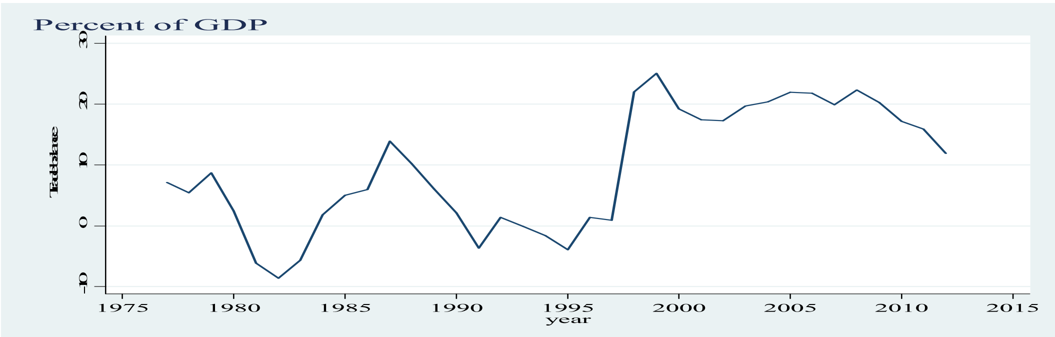
Appendix

I. Interest rate reform in Malaysia



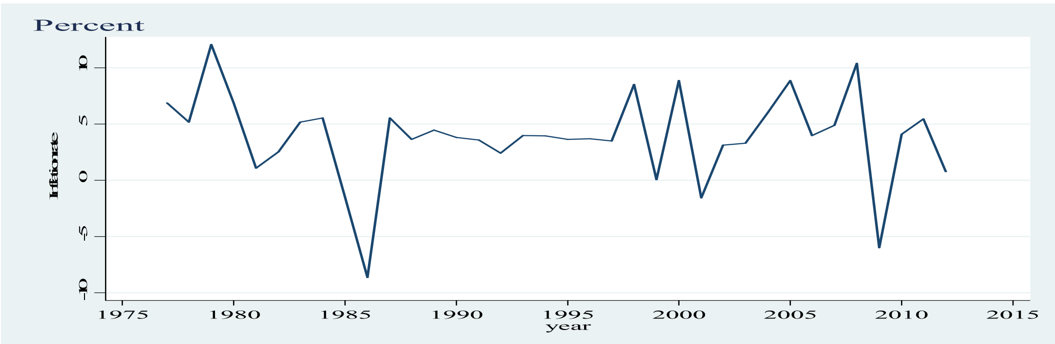
Source: World development indicator, World Bank, 2013.

II. Trade balance percent of GDP in Malaysia



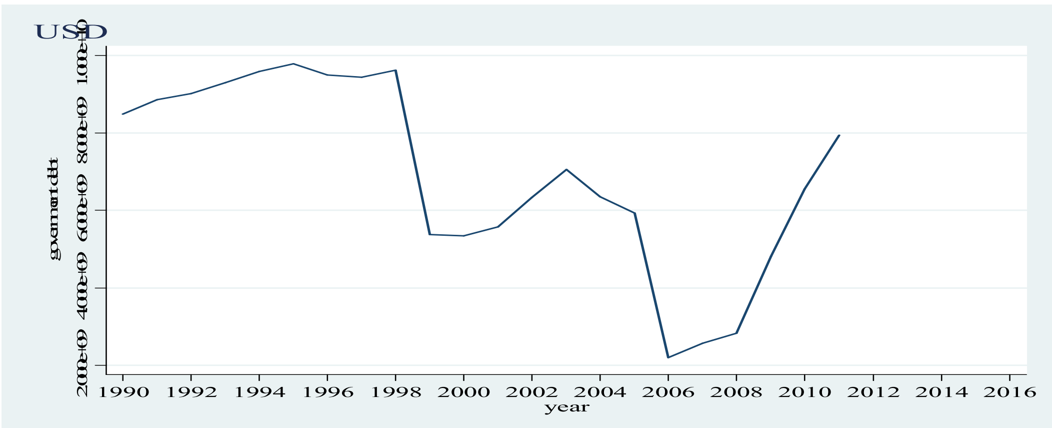
Source: World development indicator, World Bank, 2013.

III. Inflation rate in Malaysia



Source: World development indicator, World Bank, 2013.

IV. Government debt in Ethiopia



Source: World development indicator, World Bank, 2013.

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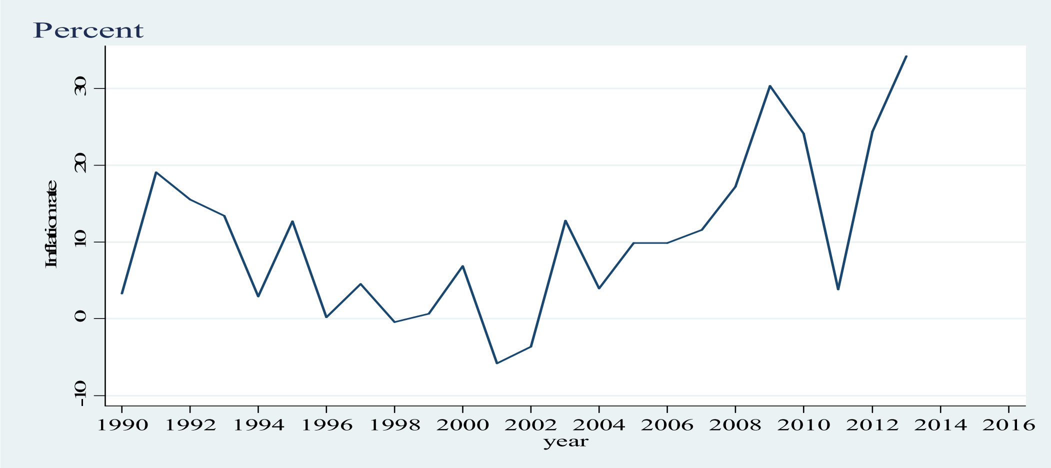
V. Inflation rate in Ethiopia



Source: World development indicator, World Bank, 2013.