Policy brief

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Rethinking the Effects of Financial Liberalization

In brief

- Countries have liberalized and lifted restrictions on cross-border financial transactions due to a belief that they would receive capital inflows, insure against aggregate shocks and accelerate the development of a domestic financial markets. However, empirical evidence suggests that capital flows have been quite small or even negative.

- One of the robust findings in the literature is that the effects of financial liberalization vary across countries. This paper presents a model that seeks to account for the effects of financial liberalization - with an emphasis on the imperfect enforcement of domestic debts and the interactions between domestic and international financial transactions.

- **Key findings:**
    - **Financial liberalization puts strain on enforcement institutions** - increasing incentives to default on debt payments as a larger share is owed to foreign creditors.
    - **Capital controls may be desirable** - as a) private incentives to borrow from abroad are too high; b) private incentives to lend domestically are too low
    - **Financial systems should be tailored to the level of development** - countries at early development stages should adopt a financial system that facilitates discrimination.
    - **Some countries may be better off postponing financial liberalization** to allow domestic financial markets to develop

- Although capital controls may be desirable, this is difficult in reality as it implies that countries can discriminate between foreign and domestic creditors.

- The institutional setup for international borrowing by developing countries is to a large extent imposed by international markets and individual countries may not be able to borrow differently from the existing norm.

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Policy Motivation

"Capital flows to developing countries have been quite small or even negative and, overall, there is no evidence that financial liberalization systematically increases investment or growth"

During the last few decades, many developing countries have lifted restrictions on cross-border financial transactions. The conventional view was that this would allow these countries to:

- Receive capital inflows from advanced countries that would finance higher investment and growth
- Insure against aggregate shocks and reduce consumption volatility
- Accelerate the development of domestic financial markets.

However, mounting empirical evidence suggests that this conventional view was wrong. Capital flows to developing countries have been quite small or even negative and, overall, there is no evidence that financial liberalization systematically increases investment or growth in these countries. Capital flows have also been highly volatile and pro-cyclical and financial liberalization has increased both output and consumption volatility. Financial liberalization has made domestic financial markets more unstable and prone to crises. Perhaps the most robust finding is that the effects of financial liberalization vary across liberalizing countries. Specifically, the effects depend on the level of economic development of the country, on whether it has developed or underdeveloped financial markets, and on whether it has high- or low-quality institutions. In our paper, we present a simple model that can account for the observed effects of financial liberalization. The model emphasizes the role of imperfect enforcement of domestic debts and the interactions between domestic and international financial transactions.

Policy Impact

The conventional view was that a policy package that combines financial liberalization with structural reforms to raise productivity and improve institutions would put any developing country in a fast-track path to prosperity. The theory we develop qualifies this simple policy recommendation in a fundamental way by shifting the emphasis towards the importance of domestic financial markets. In particular, our research suggests that financial liberalization is not always desirable, that different financial systems might be appropriate at different stages of economic development, and that capital controls might be desirable under certain conditions.

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Audience

A natural audience for our research includes economists involved in the design of macroeconomic policy for developing countries. In particular, our research should be particularly relevant for research groups located at (i) international financial institutions such as the IMF, World Bank, and regional development banks; (ii) central banks and financial regulatory agencies; and (iii) finance ministries. Our research should also be informative for think tanks and other applied research groups.

Implications

Financial liberalization puts strain on enforcement institutions

Liberalization increases the incentives to default on debt payments as a larger share of those payments are owed to foreign creditors. Thus, even a country in which courts worked well and governments kept their promises while in financial autarky might find itself subjected to financial crises after financial liberalization. More positively, financial liberalization increases the incentives to improve enforcement institutions.

Controls on capital inflows and outflows might be desirable

"Liberalization increases the incentives to default on debt payments as a larger share of those payments are owed to foreign creditors"

Our model highlights two externalities associated with financial transactions. First, private incentives to borrow from abroad are usually too high because investors do not internalize the fact that the more they borrow from abroad the higher the incentives to default. To address this externality controls on capital inflows would be called for. Second, private incentives to lend domestically are usually too low because savers do not internalize that the more they lend domestically the lower the incentives to default. To address this externality controls on capital outflows would be useful.

Financial systems should be tailored to the level of development

The theory we propose has clear implications regarding the optimal degree of discrimination in debt enforcement. A country at an early stage of development should adopt a financial system that facilitates discrimination, since with discrimination domestic markets remain isolated from enforcement problems affecting foreign debts. Such a system was in place during the 1970s and 1980s, as governments borrowed abroad almost exclusively from banks using syndicated loans and the private sector was shut out from international financial markets. A country at a late stage of development should adopt a financial system that makes discrimination difficult since it can leverage on its domestic markets to take better advantage of international markets. Such a system is in place since the early 1990s as developing countries have lifted restrictions on private sector access to international markets and encouraged the development of secondary markets where domestic bonds and equity are traded.

Some countries might be better off postponing financial liberalization

"Low middle income countries...might be better off waiting until their domestic financial markets develop before liberalizing"

If financial systems cannot be tailored to the level of development, some countries might be better off postponing financial liberalization. Very poor countries are likely to benefit from liberalization even if it is associated with domestic financial disruptions. This is because domestic markets are too underdeveloped in these countries to matter. High middle income countries are also likely to benefit from liberalization. The reason is that domestic financial markets are already deep enough to generate incentives not to default in the future. Thus, in these countries liberalization is less likely to lead to financial disruptions. Low middle income countries, on the other hand, might be better off waiting until their domestic financial markets develop before liberalizing.

Summary of Research

As mentioned above, our research is motivated by the inability of conventional models to explain the effects of financial liberalization. What is the problem with conventional models? Our answer is that they failed to anticipate the full effects of financial liberalization on debt enforcement. These models certainly recognized the problems associated with the enforcement of foreign debts. After all, most financial liberalizations in emerging markets took place in the aftermath of the 1980s international debt crisis. But they ignored key interactions between foreign and domestic debts by implicitly assuming that the latter would be enforced even if the former were not. And yet such discrimination is hardly feasible in real-world financial markets. In the case of bonds and stocks, discriminating against foreigners is difficult because they can resell these assets to domestic residents in secondary markets. Even when asset trade is intermediated by banks and other financial institutions, discrimination is difficult since it is not possible to know the nationality of the clients of these intermediaries or how default losses would be distributed among them. Finally, courts often abide by equal-treatment rules that limit the possibility of discrimination based on nationality. The main contribution of our research is to show that a theory that recognizes the difficulty of discriminating between domestic and foreign creditors can explain the different country experiences after financial liberalization. To do this, we develop a tractable analytical framework that extends the popular Solow model to allow for imperfect debt enforcement. Despite its simplicity, this framework is a rich source of testable hypotheses linking the success or failure of financial liberalization to observable country characteristics such as initial income, savings, the level of productivity, the quality of enforcement institutions and luck.

"Imposing appropriate capital controls in reality is difficult. Capital controls can only be imposed if countries can discriminate between foreign and domestic creditors at the time of borrowing"

Implementation

Two of the policy implications of our research deserve some further comments. First, imposing appropriate capital controls in reality is difficult. Capital controls can only be imposed if countries can discriminate between foreign and domestic creditors at the time of borrowing. But this seems unlikely for the same reasons that discrimination at the time of enforcement is not realistic. For example, even if the country guarantees that entrepreneurs borrow from domestic savers, nothing prevents these savers from reselling the domestic assets to foreigners in secondary markets or swapping deposits in domestic banks with deposits in foreign banks. Second, the institutional setup for international borrowing by developing countries is to a large extent imposed by international markets and individual countries might be unable to borrow differently from the existing norm. For example, the type of large-scale bank syndicates that provided credit to developing countries in the 1970s and 1980s are not in place anymore. Despite these caveats, the policies our research suggests are possible to some extent, especially if international institutions facilitate the necessary coordination.

Further Readings

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