Financial liberalisation

The medicine Asia has to take

The annual conference of the Asian Securities Analysts Federation, held in Bangkok last November, enabled high-level commentators to explain how Asian nations are weathering the region's economic crisis. Here, Australia's LEIGH HALL delivers some hard truths about the growing pains of financial liberalisation. In following pages, extracts of conference addresses focus on Thailand, Korea, the Philippines and a relatively unscathed Taiwan.

We are living in a world changing more rapidly than one could ever have imagined. Countries, and even whole regions, which were previously inward-looking, such as the former USSR, China, eastern Europe and India, have in recent years opened their borders and economies to the trade and ideas of the outside world. Improved global communication networks such as state-of-the-art satellite links and the ever-expanding Internet have brought people from around the world closer together. We are living in an age of globalisation.

Degrees of financial liberalisation vary greatly across the APEC (Asia-Pacific Economic Co-operation) region. This paper will focus principally on the benefits of economic liberalisation and within this context examine the recent financial market turmoil across the ASEAN region. In hindsight, the current difficulties could have been more effectively dealt with had there been better and full disclosure, as well as proper standards of prudential care and risk management by the local authorities in Thailand, Indonesia, Malaysia and the Philippines. Much blood-letting might have been avoided.

What is meant by financial liberalisation? The aim of any financial reform is to let the market allocate resources to provide the basis for sustainable long-term growth. By acting on a few key variables and regulations, policy-makers should aim to improve the transparency and efficiency of a country's financial system.

If implemented successfully, such policies will have beneficial spill-over effects on the rest of the economy in areas such as the range and quality of financial services, competition and firm entry, and the more efficient use of savings. Financial development will also improve the probability of successful innovation and generates dynamic efficiency through, among other things, improved information-gathering and the pooling of resources.

My own country, Australia, has put this theory into practice. An important step towards financial deregulation was taken as early as 1973 when the interest-rate ceiling on bank certificates of deposit was removed. Thereafter came the removal of the remaining interest-rate ceilings on trading and savings bank deposits, the removal of exchange controls, the floating of the exchange...
rate, the entry of banks into the market for overnight funds, and the establishment of new domestic and foreign banks.

In Australia, as a direct result of the reforms undertaken thus far, there is now greater choice and availability of finance at all levels; increased product innovation; more flexible financial services; closer integration with international capital markets; and improved cost-efficiency in domestic markets and institutions.

The overall efficiency and competitiveness of the banking and financial system has been enhanced, with Australian banks now able to operate on a more equal and competitive footing with both non-bank financial intermediaries and foreign banks. This is not to say that all has been plain sailing, especially in the early stages of deregulation. With the influx of many offshore financial institutions scrambling for market share, much imprudent lending took place and some enormous losses piled up in the financial system. This took some time to work itself out.

Across Asia, financial liberalisation has also been progressing, albeit at a staggered pace. Before the crisis, the region’s major task in opening the financial sector was learning how to do it and at what pace, while maintaining financial system stability. As in many developed countries, including Australia, mistakes were made and the learning curve was steep. Post-crisis, the region must press on with the reforms even at some short-term expense. Some institutions have already fallen by the wayside, with more to come, and it is important that the governing authorities allow them to do so. The propping up of insolvent financial institutions has cost the region much. In the main, individual stability is not of overriding importance and the maturity to allow for the exit of insolvent financial institutions is a necessary discipline.

Contrary to the view of some commentators who have blamed the region’s financial market turmoil on the degree of financial liberalisation undertaken so far, we would in fact argue the opposite. Less official intervention and greater data transparency with improved overall supervision could have helped minimise the current difficulties. The crisis in part reflects the shortcomings of their respective financial systems. Thailand provides a useful insight.

The Thai financial system in the 1970s was dominated by a small number of commercial banks with a high degree of concentration of ownership, mainly domestic. Interest rates on lending and deposits were subject to ceilings while selective credit programs were used to allocate credit to “priority” sectors. Although the market for long-term capital was not well developed, the capital account was relatively open, especially for inflows. Outflows were closely controlled.

The Thai economy maintained a healthy rate of growth through the 1970s and into the early 1980s, when it came up against structural constraints resulting in a string of financial crises stemming from failures of finance companies and banks. Steps were taken to strengthen bank supervision and deal with weak financial institutions. In the early 1990s, as part of the Bank of Thailand’s three-year financial reform plan, interest rate ceilings were lifted on a range of deposits, domestic banks were allowed to offer foreign currency deposit accounts and capital outflows were substantially liberalised. Further liberalisation took place in 1992 with the elimination of ceilings on lending interest rates. In 1994, with the objective of upgrading Thailand to a regional financial centre, numerous exchange control regulations were relaxed.

While effective to a point, it was becoming apparent that certain distortions were beginning to erode the previously good economic fundamentals. The current difficulties have largely been the result of the excessive money and credit growth from 1993 onwards, misguided policy measures – specifically to deal with this massive capital inflow – and failure by the respective governments to adequately ensure that their financial sectors were strong enough to deal with a volatile cycle.

The existence of the pegged currency regime, and of de facto pegs for Indonesia, Malaysia and the Philippines, created a major distortion within their economies. While the pegs gave the ASEAN countries relative currency stability and a competitive boost for their exports, it also encouraged a massive capital inflow which itself encouraged wasteful and unproductive consumption. The pegged-currency regimes limited the domestic governments’ ability to cool their overheating economies because every time domestic interest rates were lifted without a corresponding increase in US interest rates, “hot money” would literally flood in from overseas.

As the ASEAN region was already in the midst of a cyclical slowdown, the existence of a strong domestic currency (due to the capital inflow) resulted in even slower export growth than what should have been the case. Current account balances deteriorated sharply. After much resistance by the domestic central banks, in particular that of Thailand, they bowed to the inevitable and decoupled their currencies from the US dollar. The rest, as they say, is history.

It is my view that the decision made by the respective authorities to allow their currencies to be set by the market – in what is effectively a dirty float – was the correct one. An important distortion has effectively been removed. The International Monetary Fund has apparently agreed, as it points to the continuation of the flexible exchange rate regimes as one of the more important conditions in its various bailout packages for the region. In this case, the benefits of the exchange rate come from its market-signalling function which, in turn, enables authorities to adjust policy in response.

The issue of up-dated and properly...
enforced prudential, regulatory and legislative frameworks in many East Asian countries remains the key. A recently released report by noted economists Claessens and Glassman on East Asian financial-sector weaknesses suggests that the rules be modernised and implies that a lack of transparency and adequate information, particularly in Thailand, hindered investor knowledge about the extent of the problems.

As a prerequisite for financial liberalisation, developing countries must pursue policies that will enable them to benefit from global capital flows. A sound macro-economic framework which covers a consistent fiscal, monetary and exchange-rate policy would be the best way to insulate against financial shocks and extreme capital movements. While business cycles are normal in any economy, be they mature or maturing, the objective must be to smooth the cycle as much as possible. Between 1960 and 1990, it is estimated that macro-economic volatility reduced developing-country growth by as much as 0.9% per year.

Countries of the region must also develop their financial infrastructure to sustain growth and cope with the globalisation of financial markets. The Asian crisis is forcing change in this regard. The internationalisation of financial services can bring sizeable benefits because it can speed up institutional development, including improved access to foreign capital, deeper financial integration, new and better domestic financial services and stronger financial infrastructure (consisting of better regulation and supervision). Countries with financial systems remaining unduly regulated will find themselves left behind.

Liberalisation would encourage greater competition and create incentives for prudent and sound banking. Strong and independent central banks must ensure that all banks operating within their borders adopt international best practice on disclosure and self-regulation, and that bank profitability and capitalisation should be strengthened. This is happening now. Sustained efforts to strengthen supervision along these lines will not only reduce the possibilities of unsound lending but will also help to build a shock absorber in the banking system so it can weather macro-economic swings that may be associated with increased financial openness.

Greater capital market development is also one of the more complex issues that the region is only now coming to terms with. A sustainable securities market requires a solid investor base which could be broadened by allowing the entry of foreign insurance companies, mutual funds and specialist onshore and offshore pooled investment vehicles (such as infrastructure debt and equity funds). Recent moves by the Indonesian government to open up the country’s equity market to foreign investors should be applauded.

Growing investor interest across Asia, principally a result of the perceived value now in the equity markets, will be a challenge for the region. How APEC best exploits this interest, and how to enter what the World Bank defines as the "virtuous cycle of productive financial integration" is a critical issue. Allowing greater integration and access to external private capital will in time lead to increased productive investment, momentum for policy and institutional reform, and greater resilience to potential instability.

Most commentators agree that the link between financial-sector reform and economic growth works mainly through the establishment of a more direct and efficient channel between financial saving and investment. In the past, Asia in particular has been extremely successful at establishing and utilising this link. Savings are about 35% of GDP across Asia — and specifically 41% in China, 30% in Taiwan and 40% in Korea — and the region has utilised these reserves to accumulate capital and develop economically.

Asian governments have shown the way by being consistently prudent fiscally, while they have also created the conditions for increased private savings, including favourable tax and welfare policies, and generally low inflation levels. Asia, and particularly South-East Asia, will find this attribute extremely useful in the next few years, should international capital be hesitant.

While it is important that countries reform their financial systems, it is equally important for them to understand the risks in doing so. In the short term, entry by foreign firms can lead to a decline in profits and a change in market culture for domestic firms which may cause some distress financially and in the labour market. However, the introduction of foreign firms into the market may also encourage higher levels of education and skills in the economy. The most obvious other risk — that of contagion — has been dramatically illustrated in recent times across the ASEAN region. In the same way that demand for a nation’s goods and services is influenced by the health of its trading partners, so too is the financial economy influenced by events offshore. We have seen the implications of this in South-East Asia, where the pressure felt by Thailand spread quickly across the region.

I hope I have been able to shed some light on the benefits of liberalising one’s economy and on the various processes that need to be followed to make the most out of the change. The less-mature economies of APEC need only look at their highly developed cousins to see the potential benefits from the continued liberalisation of their economies.

No doubt the road ahead will not always be smooth and there will be inevitable pot-holes with which to contend. I am convinced that as the process of globalisation continues, APEC, and specifically developing APEC, will have no alternative but to continue on its path towards complete and comprehensive financial liberalisation.