

Financial Liberalization: Is it the Devil Always Triggering Financial Crisis?

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Between 1990 and 1996 world witnessed a spectacular change in the global financial system, as private financial flows from developed to developing countries expanded six-fold. This dramatic increase in financial flows triggered severe crises in developing countries leading many to question the desirability of financial liberalization. Should the countries hit by these crises blame financial liberalization and isolate their financial markets to avoid further turmoil? Or, should they reform their financial sector to maximize the benefits of domestic and external financial liberalization to this new global environment?

It is of a certain need to find out how we should deal with the financial liberalization. Is it really that evil? Man should handle it just like he makes use of fire. Fire is both a threat and a power tool for humanity. It has a vital role in our daily lives. It warms our homes. It cooks our food. Even though it can burn you down and cause a great damage, no doubt, fire is very useful, and we are determined not to give up its manifold benefits.

Many developing countries liberalized their financial sector in an attempt to integrate to the world by removing government interventions and restrictions. The reasoning behind this shift to financial liberalization is based on a straightforward implication of the following economic principle: financial markets allow proper allocation of savings to productive investments, which accelerates economic growth. Generally, countries wish to

have a smooth consumption path over time. Financial liberalization allows them to better smooth consumption through international risk sharing. In other words, they are less constrained by domestic endowments since they can borrow from global financial markets to avoid large falls in national consumption in case of dramatic decreases in their outputs.

On the other hand, liberalization in the financial sector in many countries is associated with economic disasters. Many developing countries jumped on the boat of financial liberalization without the skills needed to maneuver the boat on turbulent water. As ceilings on bank lending interest rates are lifted during domestic liberalization, the banks may finance riskier ventures to get higher returns. When the external restrictions are lifted, large capital may flow in with a risk of sudden outflows, increasing the vulnerability. If their portfolios are not well diversified and nominal interest rates become more volatile, the banks may face insolvency and liquidity problems triggering financial crisis. As a result, majority of pro-liberalization developing countries have faced devastating crisis and financial liberalization in these countries has become almost synonymous with financial instability.

I recently glanced through the World Bank's list of countries that have undergone financial crisis to find some common characteristics. What I found is not very surprising. In almost all of these countries the institutions and technology required to support the efficient functioning of financial markets were inadequate. Many empirical studies

support the proposition that the danger of financial liberalization is greater in countries with less developed financial sectors.

Premature liberalization increases a country's vulnerability to financial crises; however, postponing financial liberalization is not a desirable policy to pursue. Improvements in communication and information technology and ever increasing international trade make financial liberalization and integration inevitable. "Globalization is here to stay" as the IMF's Stanley Fisher says. Instead, taking lessons from previous crises, governments must strengthen the domestic financial system by establishing appropriate procedural and legal infrastructure for prudent regulation, supervision of the financial intermediaries and a well-functioning contract and regulation enforcement mechanism, gradually in a proper sequence. Moreover, they should invest in information technologies that reduce the asymmetric information and render the markets more efficient, transparent and less corrupt. These measures are essential for developing countries to benefit from participating in global capital markets. After the capsizing of a fishing boat and the death of its crew in Nova Scotia in 2004, should we condemn the harsh weather conditions? Of course not, the captain who set sail with an oversized boat without taking the necessary precautions should be the one to be blamed. He could have designed a boat more appropriate for turbulent water and storm and invested in emergency position indication radio systems. He could also have trained his inexperienced crew how to respond to emergencies for survival. If he had taken these safety measures this disaster could have been prevented.

Yet, people may draw wrong lessons from financial crisis, and blame financial liberalization. The best way to parry this threat is to admit the germ of truth that it contains. It would be a real tragedy if financial liberalization were to be jeopardized because of a refusal to concede that a premature liberalization poses big risks. Fortunately, almost all developing countries have chosen to remain engaged in the global capital markets after severe financial crisis. This clearly shows that the financial liberalization is not a devil, but a scapegoat selected by the governments to bear the blame for calamity.

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