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**A REVIEW OF FINANCIAL REFORM IN  
DEVELOPING ECONOMIES -- WITH REFERENCE  
TO THE EAST AND SOUTH EAST ASIA**

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## **A Review of Financial Reform in Developing Economies with Reference to the East and South East Asia**

The role of financial sector in real economic development of a country is pivotal. The sector thrives on the financial intermediation process through which financial resources are mobilised from different economic agents and allocated to the real sectors of an economy. In the era of globalisation, its importance has increased manifold because of rapid surge in cross border capital flows and their far-reaching implications on trade and domestic investment pattern in a developing economy.

In recent time, the interest in the financial process stems largely from the international financial crisis which broke out in 1981-82 and during which external credit for the developing countries became increasingly expensive and scarce. As opined by Germidis et al (1991): "The consequent transition from strong reliance on external sources of finance to domestic financing served to underline the deficiencies and inefficiencies of developing countries' financial systems, the active development of which had hitherto been overlooked." This is critically linked with the presumption that monetary and financial development is a prerequisite of economic development and hence, developing countries need to undertake special efforts to develop their domestic financial systems with the ultimate aim of full integration with the world economy. Otherwise, foreign resources channelled through the underdeveloped domestic financial systems would in overall be inefficiently allocated. This would have serious repercussions on the productivity of foreign resources, resulting in periodic problems with repayments.

The aforesaid hypothesis calls for restoration of market mechanism in the domestic financial system by removing all sorts of distortions, held responsible for its inefficiency and underdevelopment. And the thrust is placed upon financial liberalisation with two principal objectives: to assist the macroeconomic stabilisation effort by facilitating transfer of resources

towards the traded goods and services sector; and to eliminate the distortions in the interest rates, in order to promote efficiency in resource allocation and thus facilitate the conditions for sustained growth. This has been corroborated by the Shaw-McKinnon hypothesis which advocates freeing up interest rates to their market clearing levels and complete elimination of administratively determined selective credit allocation.

The converse of the Shaw-McKinnon view is the hypothesis of "financial repression" which stands for below market clearing level interest rates and selective credit allocation that follows administrative rather than commercial criteria. Other symptoms of financially repressed economies include segmentation of the financial market into regulated and unregulated segments; disintermediation in the regulated segment; scarcity of savings and investment and low capital productivity. It is through financial deepening a competitive financial system is facilitated as propounded by Shaw (1973) and McKinnon (1973).

This paper intends to investigate some of the key issues related with the hypothesis of financial liberalisation in connection with actual experiences of the developing world, notably those located in the South East Asian region. Savings interest rate linkage i.e. freeing up interest rates from all sorts of regulations and distortions to mop up domestic savings in the belief that savings influence investment decisions constitutes the principal element of such hypothesis. Investment decisions, according to this hypothesis, are guided by the interplay of free market forces which ensure efficient allocation of financial resources to the different sectors of the economy, more specifically towards the traded goods and services sector in the context of domestic macroeconomic stabilisation and adjustment efforts.

In the backdrop of these arguments, it is important to see whether the basic tenets of financial liberalisation i.e. savings-interest rate linkage holds in the context of a developing economy. Section I disembarks upon identification of certain key roles and responsibilities of the financial intermediation and financial structure which stimulate economic growth in a developing economy. This is followed by a critical appraisal of the

financial liberalisation doctrine in Section 2, to indicate that market mechanism may not necessarily lead to efficient allocation of financial resources. This is supplemented by some alternative viewpoints in the following section which bring into disquisition the contextual necessity of sequencing order and regulations in financial sector reform for fostering real sector growth in a developing economy, and dwell upon the issue of state versus market dominance in the realm of finance, with particular reference to the East and South East Asia in recent time.

In an open economy context, financial liberalisation refers to "financial openness" of a domestic economy which in the backdrop of a globalised order stands for liberalisation of international capital inflows, and entails far-reaching implications for the balance of payments equilibrium, trade and domestic investment as well as macroeconomic stability of a recipient economy. The surge of private capital flows in the direction of developing economies since late eighties, particularly in the form of direct and portfolio investment flows, and their impact on trade and investment and thereby, on economic growth have gained significance in view of the divergent trends across the countries. In this respect, the issue which has assumed greater degree of prominence in recent time is the issue of current and capital account convertibility. These issues have been taken up for discussion in Section 4. Concluding section sums up the major observations of this paper.

#### **Section 1: Financial Intermediation and Economic Growth**

Financial systems ensure the working of a system of payments, mobilise savings and improve the allocation of savings to investment. Efficiency of a financial system is gauged how in terms of fulfilling these functions, it can contribute to real economic growth. A number of studies - notably those by Berthelemy and Varoudakis (1996), King and Levine (1993a, b, c), Levine (1992a) and Levine and Zevros (1993) - have sought to evaluate empirically the contribution of the financial system to growth in light of experiences of developing countries across the world. These studies are based upon compilation of some indicators regarding the volume of financial services produced in the economy. The construction

of synthetic indicators of this type nevertheless presents certain difficulties which raise some doubts about the validity of these studies.<sup>1</sup>

The above-mentioned studies have corroborated the positive relationship between financial depth ratio and economic growth in a number of developing economies since sixties.<sup>2</sup> However, one interesting fact which is missing in them is the initial composition of this financial deepening and how it was arrived at in different countries. Also, they do not indicate how "efficiency" was garnered in the case of those countries where this relationship was found very strong, notably those located in East and South East Asia. Table 1 gives an account of financial deepening and economic growth in these countries. Moreover, these studies do not provide adequate explanation behind weak growth dynamics as observed in certain countries.

Financial liberalisation was advocated in order to garner "efficiency" to the financial system where "efficiency" is gauged in terms of its ability to realise profits over time and market-determined allocation of resources. It is held profitability of the financial system would increase with setting the interest rates at their market-clearing levels. The key roles which an "efficient" financial system is supposed to play in connection with sustainable economic growth are distinguished as evolution of an efficient and adaptable system of payments and mobilisation of savings; and improvement in resource allocation as manifested through risk diversification, liquidity risk management and project evaluation. Also important, in this connection, is the link between the financial structure and economic growth to adjudge the efficacies of a market governed system as propounded by the advocates of financial liberalisation hypothesis.

#### **1.1: System of payments and mobilisation of savings**

An efficient financial system is characterised by the system of payments which is adaptable to the economic growth process over time. In the absence of a reliable means of exchange, prohibitive transaction costs would tend to cancel out any productivity gains linked to the division of

labour and prevent the beginning of any economic growth. Growth brings productivity gains, but also the continuous opening up of new markets and incessant diversification of the goods traded. The increasing complexity of trade brings a growing monetisation of the economy, which is necessary in order to sustain the volume of economic activity.<sup>3</sup>

Since monetary assets yield poor return, holding such assets entails opportunity cost. The need to reduce such costs brings a steady movement of the payments system towards credit relations managed by the banking intermediaries. This trend is reinforced by technical advances which reduce the information costs associated with the use of credits and make it easier to create financial assets which can substitute for traditional monetary assets. As a result of this, there tends to occur a secular increase in the weight of financial activities in GDP and also in the percentage of financial sector employment (Kuznets 1971). These developments take place simultaneously with economic development. Moreover, advances in information technology can counteract with the growing monetisation of the economy, measured by the ratio of narrow money supply to GDP, after a certain stage of development. However, the ratio of broad money aggregates to GDP can register continuous rise as it incorporates more sophisticated financial assets (Berthelemy and Varoudakis 1996, and Goldsmith 1969). These assets - notably commercial bills - can only emerge at certain stage of economic development owing to their high cost of utilisation because of which they remain inaccessible to a wide range of users in a developing economy.

Financial intermediaries ensure better mobilisation of the available savings by facilitating the agglomeration of the economy's financial resources. Through exploiting investment opportunities more efficiently, they can provide savers with a relatively higher yield, while at the same time contributing directly to a rise in the productivity of capital and hence to the acceleration of economic growth. The reorientation of savings in investment other than in unprofitable real assets like consumer durable can in turn reinforce the deepening of the financial system.



Financial deepening and rate of savings crucially depend on certain policies and macroeconomic factors influencing investment in real sectors which in turn generate demand for savings as the East and South East Asian experiences suggest. They include (a) maintenance of macroeconomic stability leading to positive real interest rates and often substantial public savings; (b) policies directly encouraging savings through improving regulatory supervision of banks; (c) reduction in transaction costs for small savers; (d) protection given to existing domestic banks against potential domestic and foreign competitors; (e) Governments' direct dealing with distress financial institutions; and (f) regulation of deposit and lending rates simultaneously and hence, the spreads of the financial intermediaries. Table 2 indicates savings and investment rates in some of these countries in the region. These policies with respect to savings contributed to the high rates of investment in these economies. Also, these countries encouraged investment with a wide array of other mechanisms designed to increase the attractiveness of private investment such as low corporate taxes, low pricing of capital goods etc. In addition, the Governments in East and South East Asia attempted to allocate credit directly to the priority sectors, which goes against the objective of market-governed financial system.

**1.2: Improvement in resource allocation - risk diversification, liquidity risk management and project evaluation**

Along with mobilisation of financial resources, the quality of their allocation to various investment projects is equally an important factor for economic growth. Difficulties arise in the allocation of resources to investment projects connected with productivity risks, incomplete information regarding future returns from the investments and imperfect knowledge of the entrepreneurs' real abilities. In this context, the role of financial intermediation process is better analysed in terms of risk diversification, liquidity risk management and project evaluation.

Owing to the presence of productivity risks connected with incomplete information regarding the quality of investment projects, returns on them are uncertain which may exert adverse effects on resource allocation as

a) risk-averse agents tend to hold substantial part of their wealth in less risky liquid assets which are mostly unproductive (Levine 1991, 1992a); and (b) it may lead to inefficient technological choices. It is generally presumed that more risky technologies bear a higher expected yield.

In a developing economy, investment-return risks are often diversified by adopting less specialised and hence, less productive technologies owing to the absence of proper financial intermediation process which would guarantee reduction in productivity risks while using more productive specialised technologies.<sup>4</sup>

Banking intermediaries and stock markets play important role in diversifying these productivity risks of investments. Stock markets facilitate this risk diversification process based upon market principles whereas banking intermediaries by diversifying their own portfolios guarantee returns to their clients. However, stocks are themselves subject to market risks in developed as well developing economies in terms of frequent fluctuations in their prices and yield.

Financial intermediation is also vital in connection with liquidity risk which arises as some productive investments are highly illiquid in terms of reduction in their yield whenever premature sale of these assets take place. The risk associated with investment with high gestation period often creates demand for liquidity which, in the absence of a proper financial intermediation process, discourages such investment which would otherwise be of vital importance from the developmental point of view.

Financial intermediaries allow the economy as a whole to manage these liquidity risk factors by permitting economic agents, who suffer from such liquidity shocks, to engage in exchanges with other agents. In a developing economy such exchanges are of paramount importance as most of the development projects suffer from such liquidity risk.<sup>5</sup> As pointed out by Levine (1991), liquidity risks can also be managed by stock markets which make exchanges possible between agents who suffer from liquidity shocks and those not suffering from such shocks but

intending to increase their share of productive assets in their wealth.

From the point of view of ensuring expected yield from a particular investment project, it is important to gather information on the competence of the entrepreneurs and expected future return on the projects. However, collection of such information entails a fixed cost which generally tends to dissuade individual investors from undertaking such project evaluation activities themselves. Financial intermediaries reduce this cost of information collection on behalf of the individual investors by spreading the fixed cost among many. Also, a financial intermediation system may constitute a network linking different economic agents facilitating the transmission of information on the profitability of individual investment projects.

### **1.3: Role of Financial Structure**

A well developed financial structure comprises money and capital market along with banking and non-banking intermediaries which play crucial role in investment financing. In this regard, the historical experiences of the developed industrialised economies are diverse. In USA and UK, capital market (equity and bond markets) played much greater role in mobilising funds for investment whereas in Germany and Japan this responsibility was delegated to the universal banking system.<sup>6</sup> The experiences of the developing economies are much more diverse than the developed countries. In recent time, a significant share of investment finance in developing Asia is coming from the stock market. In the case of developed economies at their early stages of development, internal funds constituted the principal proportion of their fixed capital formation whereas in the case of developing Asia external sources contributed significantly. During eighties the contribution of external sources to the fixed capital formation was well over 50%. In the case of Korean big enterprises it reached almost 90% (Singh 1992).

In the context of a developing economy, the capital market may encounter certain comparative disadvantages with respect to the banking system. Firstly, in the presence of high productivity risks, asymmetry of

Information between lenders and borrowers and costly monitoring process. debt contracts with fixed repayment schedule will tend to prevail over the equity financing which is subject to periodic payments of dividends constrained by productivity shocks. The advantages of the banking intermediaries over the securities market are also based on their greater efficiency in gathering costly information and reducing monitoring costs. As pointed out by Diamond (1984), banking intermediaries can guarantee a fixed return on their deposits with their large and diversified investment portfolios and by minimising the monitoring costs which are incurred only in the case of bankruptcy.

Both banks and capital markets perform the tasks of risk diversification and liquidity risk management, adaptation and enforcement of control mechanism to garner better resource management and project evaluation. Banks are better placed than the bonds and equities market when it comes to diversification of investment risks. Capital markets exert control over the productive resource management through the mechanism of mergers and acquisitions. Berthelemy and Varoudakis (1996) opined that incentives for sound management discipline can be effected through merger and takeover in the case of oligopolistic enterprises where the market cannot efficiently perform selection function. However, takeover and merger mechanism may generate unproductive investments whose aim is to create a size effect as a form of protection against hostile takeover and also may infuse "short-termism" in the capital market in terms of such mergers and acquisition (Singh 1992). This may lead to reduction in attractiveness of long term projects necessary for increasing the productivity of capital and thereby, accelerating economic growth.

As mentioned above, banks perform the task of project evaluation better than the capital market by minimising the fixed cost of monitoring and ensuring returns on investment. It is, however, alleged that capital market, which is based upon market governed principles, carries out this function better than banks in terms of continuous appraisal of the enterprises and their investment projects especially in an imperfect market. Allen (1993) argued that monitoring by banks can only be optimal in a competitive environment where production lead times are relatively short and the pace

of technical progress is slow. But the presence of information constraints may jeopardise efficient functioning of capital market in particular and market governed mechanism in general even in an imperfect market situation. At this juncture, this raises the issue of efficacy of market-governed system over state controlled system - the discussion of which is taken up in the following section.

## **Section 2 : Financial Liberalisation - A Critical Appraisal**

As said at the onset, financial liberalisation gained momentum following international financial crisis which surfaced in 1982 with the debt-ridden countries started undertaking domestic adjustment programme at the dictum of the multilateral agencies. In the East and South East Asia, however, interest in financial process stemmed from their export-led growth dynamics which created demand for financial openness with the relocation of foreign capital flows and industries within the region. In the theoretical plane, financial liberalisation doctrine was advanced to eliminate prevailing distortions in the financial market, which include high reserve requirements, interest rate controls and selective credit allocation. Two most notable features of financial liberalisation hypothesis include savings-interest rate linkage and interest rate deregulation.

### **2.1: Savings-interest linkage**

The central element of financial liberalisation hypothesis is based upon savings-interest rate link. As market takes care of allocation and thereby, of investment in the "productive" sectors, the onus of financial intermediation process falls on "increased" mobilisation of savings via the interest rate mechanism. It is held replacing artificially held below market clearing low interest rates by higher market determined interest rates would encourage savers to save more in liquid financial assets. In this respect, no distinction has been made about the savers' type which include household, private corporate sectors and government, and also, of their different motives for savings.

There does not exist much of theoretical and empirical evidence which confirms strong link between savings and interest in a developing economy.<sup>7</sup> The effect of rise in interest rate on savings is not easy to determine because of the presence of income and substitution effects on savings generated by a rise in interest rate. Savings increase if and only if positive substitution effects of rise in interest rate outweighs negative income effect. Moreover, it is the composition of savings than its volume which undergoes change in response to rise in interest rate as a shift tends to occur from savings in physical assets to financial assets.

Real interest rate is one of the many variables which affect savings behaviour in a developing economy. The variables other than interest rate are institutional in nature and signify the importance of financial structure in mobilising financial resources from different economic agents. For example, the expansion of banking in rural areas in East and South East Asian economies since sixties played a crucial role in tapping investible resources from the rural households in these economies. Private and public savings are also influenced by certain macroeconomic variables like fiscal position of the government, external indebtedness, rate of inflation and population dependency ratios (Fry 1991; and James et.al 1989).

## **2.2: Interest rate deregulation**

Early proponents of the financial liberalisation hypothesis held interest rates below market clearing levels discouraged savings and also distorted the choice of investment projects (McKinnon 1973; and Shaw 1973). However, the experiences of financial liberalisation across the world hollowed this earlier viewpoint. Financial liberalisation in some countries aggravated both macroeconomic instability and financial fragility at least in the immediate short run.<sup>8</sup>

The development of market failure literature weakened the logical basis of the interest control argument which pointed out that markets are also susceptible to major inefficiencies in allocation of resources owing to the presence of asymmetric information leading to adverse selection of risk

and moral hazard syndrome (Stiglitz .1993). In the presence of asymmetric information, competitive credit market may not always clear with equilibria being characterised by credit rationing (Stiglitz and Weiss 1981).

In a competitive credit market, interest rate affects the excess demand for loans as well as the average quality of lenders' loan portfolio. With rise in interest rate, the quality of loan portfolio deteriorates due to adverse selection of risks and moral hazard problem. Adverse selection takes place as sound borrowers are discouraged relative to unsound borrowers when interest rate rises. Moral hazard problem crops up as all borrowers have an incentive to undertake riskier project with rise in interest rate with the underlying presumption that riskier projects yield higher returns. Therefore, a divergence occurs between interest rate which clears market and that which maximises lenders' return. This results in credit rationing if the interest rate which maximises lenders' return is less than the market clearing interest rate.

Credit rationing argument, in a way, vindicates the inefficiencies of free market outcome in the presence of asymmetric information. The government may, however, face the same information constraint and worsen the situation by imposing an interest rate ceiling below the credit rationing equilibrium. In the presence of asymmetric information, the free market equilibrium is not constrained Pareto efficient (Greenwald and Stiglitz 1986). Moreover, optimum government intervention depends on certain factors like mean and variance of projects which are not easy to identify (DeMeza and Webb 1987). Note that credit rationing argument and hence, the market failure logic rests upon borrowers' intention only.

The case for government intervention from the point of view of credit rationing argument can be developed if moral hazard and adverse selection hypotheses are extended to the lenders. Financial institutions may become risk lovers as well in a free market devoid of any control and regulatory mechanism.<sup>9</sup> This is because in a favourable situation they can reap large profits whereas in adverse situation they simply walk away from the losses as they are to be borne by the monetary authority. In a

state-controlled economy also, the danger exists as losses are borne by the state, which is the owner of the financial intermediaries, and leads to an adverse fiscal impact and macroeconomic instability. These dangers are intensified by financial liberalisation as financial intermediaries obtain greater freedom with respect to interest rates and direction of credit.

Table 3 gives an account of interest rate regime between two sub-periods 1971-80 and 1981-90 for some East and South East Asian countries. Of the eight countries, financial reform was initiated in five countries. Barring China and Taiwan, increase in savings ratio in no other countries led to investment efficiency. In China, savings ratio did not register any rise. Moreover, interest rate regime in most of these countries remained positive except for Hong Kong.

### 2.3: Real-financial linkage

Excessive rise in interest rate following financial liberalisation may create problems for the real sector and results in financial distress. The situation may culminate into total financial collapse as the Latin American experience suggests. In an open economy having international trade and financial linkages and characterised by high inflationary expectations, exchange risk and oligopolistic financial markets (which are the salient features of most of the Southern Cone countries) deregulation of interest rates may accentuate the distress of the real sector even more.

Given the Latin American and East Asian experiences, early viewpoint regarding financial liberalisation was modified and replaced by a sequencing argument of the order of such liberalisation so as to avert any macroeconomic instability (McKinnon 1989, 1991). The revised viewpoint calls for imposition of prudential regulation and supervision on financial intermediaries to take care of the adverse selection and moral hazard problem. It states that some interest control at least in the short run is desirable to prevent any macroeconomic disorder and distress in the real sector and interest rate deregulation need to be pursued after macro management being set in order.



As far as the real financial sector link is concerned, it is not very easy to determine which way the causality runs. Both demand and supply driven explanations can be advanced in establishing the causality.<sup>10</sup> The experiences of different developing countries across the world in the post world war era suggest that causality may undergo changes over the course of economic development (Jung 1986). Financial expansion, being initially sparked off by real sector growth, at a later stage, supports a real growth process by supplying necessary financial inputs and services to the real sectors in an economy. Financial reform generally takes place at this later stage of development. This is most pronounced in the case of East and South East Asian economies where financial sector reform was pursued in response to the growing needs of real sector, most notably the expanding export sector.

### **Section 3: State versus Market in Financial Sector Reform**

The underlying premises of the financial liberalisation hypothesis rest on the neoclassical theme of *laissez faire*. In neoclassical view, government intervention is justified only to correct market failures resulting from externalities, dynamic rigidities, market power, and incomplete or missing markets. Thus the government may intervene only if the benefits of the intervention outweigh the costs of interfering with the market.<sup>11</sup>

#### **3.1: A genesis of government failure arguments**

The recent spate of enthusiasm in free market mechanism as opposed to state intervention negates the belief that where market fails the government should intervene: "From the correct observation that free markets often fail it is an easy but erroneous step to conclude that where the market fails the government ought to step in" (Basu 1992).

This revival of neoclassical hypothesis has its origin in the economic crisis of the last two decades, which often has undermined confidence in the interventionist policies in the West in the immediate post-war era. As Banuri (1991) opined: "During this period, the example of centrally planned economies lost some of its appeal as they began to run into

serious economic and social difficulties of their own. At the same time, Western countries witnessed an erosion of the Keynesian consensus and a growing criticism of stabilization policies, labour unions, social welfare institutions, and regulation of industrial and financial enterprises."

Literature dealing with governmental failure - a public sector analogue of private sector market failure - was developed during this period as an antidote to the belief that when market works less than perfectly governmental intervention automatically improves the situation. The fundamental argument runs in the cost-benefit framework which shows that the governments are likely to face similar problems if it intervenes.

This faith in market mechanism in recent time received boost from supply-side economics which constituted the theoretical underpinnings of the policies embraced in the early eighties by the Reagan administration in US (Nell 1984). Supply-side economists considered capitalism a natural and progressive form, expressing the individualism inherent in human nature and offering balanced economic growth in terms of the "harmonious equilibrating mechanisms of the free market". They invoked Say's Law to justify their exclusive focus on the incentives to supply. Neoclassical theories of the supply of and demand for labour were espoused. Government operations were held as largely harmful or useless. Inflation was thought to be ended by reinstatement of the principles of gold standard. More particularly, according to this view, taxes drove a "wedge" between the price a buyer must pay and the price that seller receives. With regard to the labour market, income and social security taxes constitute such a wedge which reduces both the amount of labour supplied and demanded. The policy recommendations, which followed from it, were aimed at drastic cut in governmental activities. Tax rates were reduced sharply on the presumption that it would provide greater incentives to work, save and invest. Governmental programmes were cut and all kinds of regulations on business and industry were done away with.

During the immediate post-war era in the capitalist West, "the rise of Keynesianism, the increasing legitimacy of social welfare institutions and

labour unions, and the acceptance of the need to regulate financial institutions provided justifications for interventionist policies and weakened the ideological support of the Western example for the free trade policies in the Third World" (Banuri 1991). As a contrast, the economic crisis of the last two decades, the downfall of the socialist bloc, the success of export-led economic regimes of the East and South East Asia, the emergence of supply-side economics and the public choice theoretic literature dealing with 'governmental failure' seem to have provided justification for the loss of confidence in government intervention.

### 3.2: Market failure arguments

The underlying premises of the liberalisation doctrine include the faith that (a) market mechanism would replace state intervention; (b) private investment would substitute public investment; (c) direct and portfolio foreign investment would be a substitute for debt creating capital inflows. Shaw (1973) opined that "financial repression" is part of a package which entails distortion not only in the financial market but also in foreign exchange markets, in the trade regime, in labour and goods market in general and generates macroeconomic instability. Therefore, removal of distortions in financial system without corresponding reform of distortions in the other markets stands for the "restoration of the classical theory of second best". However, this viewpoint abstracts from the problems arising out of market failure which could afflict financial system. Such failures stem from a number of sources including externalities, exercise of monopoly power by dominant banks and information asymmetries between borrowers and lenders (Kay and Vickers 1988).

Externalities causing market failure are associated with the risk of systemic failure and infection effect. Systemic failure may afflict the banking system if bank failures are correlated with the actual or threatened failure in one case raising the risk of failure of another. Infection effect results in when excessive competition leads to lowering in product and price standards. Moreover, as Vittas (1992) pointed out excessive competition may indulge dominant firms to exercise monopoly

power through excessive price-cost margins and erection of entry barriers to the overall detriment of dynamic as well as static efficiency. Stiglitz (1989) opined that in the presence of adverse selection of risks and moral hazard problem, interest rates generally tend to overshoot to cover the default risk and thereby, crowd out low-risk projects with high, *ex-ante* social rates of return. The problem of interest rate overshooting was evidenced in the case of Southern Cone countries during seventies. In the presence of macroeconomic instability, such information asymmetries may be more acute because of the risk of systemic failure. This was recognised by McKinnon (1984), an early advocate of financial liberalisation.

Given the experiences of the financial collapse in the Southern Cone countries, attention was laid upon sequencing of reforms which marked departure from earlier approach (McKinnon 1988). The sequencing logic advocates that domestic financial sector reform should be preceded by reform in trade and exchange rate regime and followed by liberalisation of capital account (McKinnon 1982; Edwards 1984). But it is not clear how far this logic is relevant today in the context of (a) changing pattern of external private capital flows which are subject to volatile fluctuations and (b) the experiences of the South East Asian countries during eighties, notably Indonesia, where sequencing was associated with some external costs.<sup>12</sup>

### 3.3: State vs. market - a synthesis

The arguments regarding financial liberalisation essentially boil down to the arguments regarding state versus market dominance in the realm of finance. In this respect, following Zysman (1983), two types of financial system can be distinguished - capital-based and credit-based financial system. In a capital-based financial system, securities (stocks and bonds) constitute the principal source of business finance where borrowers can choose from a wide spectrum of capital and money market instruments offered through a large number of financial institutions. In a credit-based financial system, as capital market is generally weak firms heavily rely upon credits from financial intermediaries, notably banks. Dependence of

firms on government in a state-based system stems from the fact that the banks themselves are heavily dependent on government.<sup>13</sup> Hence, in a credit-based system, which is dominated by state, credit allocation is subject to governmental decision with firms often exhibiting high debt-equity ratios. Most of the East and South-East Asian economies fall in this category. Debt-equity ratios, which are generally below 100 per cent in the advanced countries, were 300-400 per cent in Korea and 100-200 per cent in Taiwan as compared to 100-120 per cent in Brazil and Mexico during seventies.<sup>14</sup> In fact, in Korea, even after financial deregulation in 1983, state dominance over the banking system was retained through personal policies, appointment of senior managers and range of services. In Taiwan, entire banking system until recently was owned by the state.

Certain distinct advantages of the state-dominated credit-based financial system over the market-governed capital-based system can be distinguished at this juncture. They include investment requirements in a developing economy and the control apparatus necessary for implementation of a particular industrialisation strategy. A state-based system allows faster investment in those projects which are of utmost significance from the developmental point of view but which generally does not attract funds from capital market. Also, it provides a safeguard to productive investment against stock market speculations resulting in periodic booms and busts. Capital-based system is generally guided by short-term profitability, as noted down by Singh (1992). In the case of state controlled system, where long-term performance of the firms becomes the principal consideration and hence, firms, being not guided by the short-term speculative concern of the stock market, are better placed in terms of being able to adhere to a long-term strategy concerning technology, new product development, cost-competitiveness and so on. Furthermore, a state-based system permits the government to exert its political will and vision to implement its own industrialisation strategy.

In fact, state-based financial system is an essential feature of successful economies characterised by late industrialisation process. East Asian

economies, notably Korea and Taiwan, are classic examples in this respect as noted by Amsden (1989, 1991). In these countries, state-based financial system facilitated discriminatory use of selective credit allocation and thereby, augmented the pace of industrialisation which would otherwise not have been possible.

However, in a state-based system, danger lies if it provokes a subsidymality resulting in wasteful rent-seeking behaviour. This can be avoided, as in the case of East and South-East Asian economies, by adherence to strict performance criteria of the firms. Theoretically, socially profitable investments in industries and socially desirable sectors are possible using such criteria if they are based upon good approximations of *ex ante* social rates of return.

In the theoretical plane, information asymmetries leading to market failure has provided fillip to state-dominated credit-based financial system. The theoretical logic runs in terms of transaction cost economics and is termed as internal market hypothesis. It was developed in the course of analysing Korean state and its financial system vis-a-vis its large enterprises (Lee 1992). When information asymmetries are high and pervasive, firms generally rely upon "internal capital", comprising funds generated through their retained earnings and/or out of depreciation charges. In a state-dominated credit-based financial system, state, operating as a de facto internal capital market, minimises the risk of information asymmetries. State generally develops a long-term relationship with the borrowing firms. Lender monitoring as well as risk management and project evaluation, which are some of the key functions of an efficient financial system as indicated in Section 1, are carried out much more effectively in such a system by the "atmosphere of mutual trusts and co-operation" (Lee 1992).

#### **Section 4: Financial Openness and Liberalised International Capital Flows**

Financial liberalisation process, in essence, is geared towards the issues of financial openness of the domestic financial sector in connection with

trade and foreign capital flows with the rest of the world. Deregulation of international capital flows including foreign direct and portfolio investment flows, and particularly convertibility of capital account, remained at the heart of the financial openness in the developing countries. As per the advocates of such openness, its basic rationale lies in securing benefits of full integration with the world economy. It is envisaged that a fully liberalised capital account would ensure optimisation of savings and investment as well as full risk diversification. It is held that promoting integration of capital markets would allow the residents of each country to diversify their more risky investments internationally which would imply allocation of more resources to risky investments, presuming that more risky technologies bear higher expected yield, and thereby, would stimulate growth of the world economy (Obstfeld 1994).

The major concern with liberalisation of capital flows is the risk of volatile inflows and outflows which may destabilise the real as well as the financial sector in a developing economy. Danger of excessive capital inflows is that they can lead directly or indirectly to an excessive expansion of bank balance-sheets in terms of (a) deterioration in credit quality as banks increase their risk exposure and (b) maturity mismatch with long term investments being matched by short term deposits thereby, leading to debt explosion after certain period of time. Hence, the advocates of financial openness argue that a gradual and cautious approach should be followed in opening up the financial sector.

The most critical danger of capital account convertibility lies in the international transmission of shocks from one country to another. Recent surges in portfolio investment in the developing countries have intensified this possibility further as the experiences of Latin American and South East Asian economies in very recent time indicate. As opined by Sen (1996a), the impending danger of transmission of shocks from one market to another stems from a variety of factors including decline in interest rates in the major industrialised countries, notably US, a greater degree of volatility of stock prices in developing country financial markets as compared to those prevailing in the more advanced countries, a negative

correlation between stock prices in industrialised countries and those in emerging markets, and the tendency to low growth or stagnation in the developed regions making the emerging markets more attractive to international portfolio managers.

The international dimension of the policies regarding financial openness in the developing world stems largely from the development in the advanced economies in connection with financial deregulation therein, along with the international financial crisis caused by the large developing country debt overhang in eighties. This increased the fragility of the financial system in general and banking system in particular in the advanced countries during eighties, which was more accentuated with slowdown of economic growth and the declining trend of the interest income of the banks there. In the face of the competitive challenges from the non-bank financial intermediaries which accounted for a large share of gross bank income and growing funding costs, banks' interest margin was squeezed substantially during eighties.<sup>15</sup> As a result, the share of non-interest income grew rapidly while that of the interest income fell continuously over the decade. Table 4 gives an account of the rising trend of the non-interest income of the international banks as share of their annual gross income in the six major developed countries in eighties. One of the basic factors influencing the growth in non-interest income of the banks was that in eighties the banks increasingly got involved in activities other than the normal banking activities of deposit taking and credit extension owing to deregulation of finance in the major industrialised countries.<sup>16</sup> These included underwriting services, provision of back-up facilities and other advisory services which earned them fee income. Interest rate margins were sometimes adversely affected because of mismatches as long term loans were often matched by short term deposits. This was the case with the US money centre and small regional banks which had its severe repercussion on the US loan and investment industry in eighties. As a result of this, the pre-tax profits of the US banks became negative in 1988 (\$ -11.6 billion) from \$ 6 billion in 1985.<sup>17</sup>



In the six major financial centres, noted in Table 4, the pre-tax profits declined as proportion of the banks' gross income over the decade with a notable exception of the Japanese banks.<sup>18</sup> Operating costs absorbed the major portion of the banks' gross income - Swiss banks being the only exception. However, the Japanese banks could maintain their profit level because of their low loan loss provisions. German and French banks were better off than their counterparts in the US and UK as they had already made substantial loan loss provisions earlier, although the cost efficiency of the German and French banks deteriorated during eighties. Banks in the US and UK were compelled to step up their provisions in late eighties which sharply cut back into their net earnings. In Japan, the actual fear was with regard to the potential financial fragility, rather than actual one, following the steep drop in stock and real estate prices in the end of 1989.<sup>19</sup> Earlier Japan experienced a strong "asset inflation". Thus it was expected that the growth of foreign assets of Japanese banks would be reduced in the aftermath of the stock market plunge of 1990, which had made them to lose an estimated \$ 200 billion of their aggregate capital.

The perception that banks had become more vulnerable to the financial ups and downs had provoked regulatory responses across the countries and also called for a harmonised system of bank supervision internationally in the late eighties. The US and UK banks were more vulnerable than their European counterparts in terms of deterioration of their asset quality. By 1990-91, therefore, as a result of this and also, as a result of BIS capital adequacy norms, most of the international banks cutting across regions reduced their external asset profile substantially including their third world debt assets. Rather, more emphasis was laid upon risk-sensitive pricing, which reflected higher margins on corporate loans. Different debt conversion instruments helped the banks in reducing their developing country debt exposures, and simultaneously, allowed them to diversify their asset portfolio.

Developing country loan asset profile of the international banks was greatly reduced by 1990. The proportion of non-performing assets to gross loans declined substantially.<sup>20</sup> The banks rather got involved in

corporate lending including arranging mergers and acquisition for the corporate sector, real estate transactions and equity business.<sup>21</sup> Deregulation of finance in major creditor countries gave fillip to the off-balance-sheet activities of the commercial banks since mid-eighties. Banks started using derivative over the counter instruments (OTC) including warrants, asset-based securities (ABS) etc. These operations were no less risky than their developing country lending business in the seventies.<sup>22</sup>

In 1990, the size of the international equity market swelled to \$2315.1 billion as a result of a near 50% surge in the value of cross-exchange trading.<sup>23</sup> The early nineties witnessed a shift in the pattern of cross-border equity flows from within the OECD countries to the emerging markets in Asia and Latin America. Major investing institutions, such as pension and insurance funds in Europe and other countries in OECD, were the key intermediaries of these cross-border capital flows, not banks or multinational companies. Net equity flows rose from \$4 billion in 1987 to \$51 billion in 1991, while cross-exchange trading rose from \$508.6 billion in 1987 to \$873.9 billion in 1990.<sup>24</sup> Cross-exchange trading as per cent of total foreign share trading increased from 27.4% in 1987 to 37.7% in 1990. If in the seventies the non-securitised assets, mainly bank deposits, formed the main source of global capital flows the same can be said about the securitised assets since the late eighties.

In the context of financial deregulation in the major developed countries in the eighties, the distinction between banking, insurance, investment management trusts and securities have become blurred. Profitability became a problem among all the financial firms stretching from securities firms to banks and insurance. As a result of financial deregulation, the credit cycle of rapid expansion and contraction has been deepened and broadened and now has penetrated into all areas of financial services. Deregulation has heightened volatility. Banking franchises were lost and banks entered into markets with products they hardly understood. Reserve requirements changed. Business became more risky with tremendous rise in volatility, caused primarily by short-term nature of global capital flows. The junk bond market in the US, the equity warrant market in

Japan, and short-term bank loans in the UK and Australia have soured. From the late eighties, there were moves away from the highly competitive, low margin areas towards specialisation. In international banking, there was a return to "relationship" business.<sup>25</sup> On the other hand, by the late eighties international policy makers, such as the BIS, started their efforts to slow down the effects of deregulation<sup>26</sup>. Global regulation has been strengthened to counter the risks stemming from more intense domestic financial competition.

In 1991, most of the banks met the BIS capital adequacy requirements.<sup>27</sup> The improvement in capital ratios of the US money centre banks was attained through decreasing the high risk weighted assets of developing country and real estate loans. The US banks' capital asset ratio rose from 10.17% in the first quarter of 1991 to 10.78% in the third quarter of 1991. Japanese banks' capital ratio during the same period rose from 8.32% to 8.58%. This was largely attributed to an increase in the amount of subordinated debt raised in the stock and bond markets.

To a large extent international banking regulation, and also, creditor country regulation provided a protective umbrella to banks holding risky asset portfolio. Deregulation of finance at home had led to the banks' involvement in non-bank activities and at the same time it increased the competition from non-bank intermediaries. Third World debt exposure, also, raised the potential inter-bank rivalry and competition among banks (especially between large and small banks) for receiving shares of debt payments. Banking regulation came into force to meet these imminent needs of the banking sector. Deregulation of finance at home led to an end to the creditors' cartel of early eighties as the inter-bank fierce competition increased (for example, between Japanese and US banks). The impact of all these was felt through the declining profits of the banks and rising proportion of riskier ventures which aroused the demand from the financial intermediaries including the banks to seek re-regulation at the international level, and rapid growth in foreign exchange trading related with cross-border capital flows including direct and portfolio investment and bank loans in the direction of emerging markets of Asia and Latin America. Capital mobility across the border is manifested in

rapid growth in foreign exchange trading which more than doubled during 1986-89, a rate of expansion much faster than that of international trade in goods and services. By 1989, global foreign exchange trading is estimated to have amounted to \$ 650 billion daily, almost forty times the average daily value of world trade (BIS 1990b).

Net resource flows to the developing world, as indicated in Tables 5 and 6, registered sharp rise since 1990 with developing Asia receiving the lion's share. Investment flows including FDI and portfolio equity flows constitute the principal form of such capital flows to the developing Asia. Such capital flows in the direction of emerging markets in Asia have raised major concern in connection with corresponding balance of payment vulnerability arising out of a mismatch between investment income liabilities and capital account inflows. The problem has been accentuated by deteriorating terms of trade in the current account of these economies caused by drop in unit prices of exportable for most of the emerging economies in East and South East Asia (Sen 1996a). Steady increase in investment income liabilities and short-term portfolio and debt flows have raised the vulnerability further as such capital flows are subject to market, credit and exchange risks as the experiences of Southern Cone countries and financial deregulation in the advanced countries in the eighties suggest.

Market risks are most acute in the case of portfolio investments in terms of fluctuation in prices of equities and bonds, and also, in terms of yield in the case of equities. Given the thinness of stock markets in South East Asian economies, such danger has become real as the recent developments in Thailand suggest. Credit risks are associated with short term debt flows which may arise due to mis-matched liabilities and/or deteriorating external payment capacity of the borrowing countries resulting in a low credit rating in the international capital market - the lesson to be drawn from the Latin American debt imbroglio in the eighties. Moreover, most of these short-term capital flows are subject to exchange risks in terms of fluctuation in exchange rate leading to unanticipated capital flights from the host economies as the Mexican experience in 1994 indicates. In fact, there lies danger with sudden influx of capital to an economy culminating into a Dutch disease syndrome in

terms of an appreciating exchange rate exerting pressure on current account balance.

Advocates of financial openness have opined that "the resolution of market failure that afflicts financial systems needs an appropriate regulatory framework" (Islam and Chowdhury 1997). Table 7 gives an account of such prudential and other regulation which are regarded essential for "stable, efficient and fair financial system". In the East and South East Asian context, such regulations were necessary to restore public confidence in the financial system as the onset of more liberal financial regime in the early eighties in these economies triggered off bank failures and widespread financial fraudulence. These regulations vindicate the crucial significance of an effective surveillance at the national level of monetary and fiscal goals of price stability and credit allocation to achieve a diversified product base in this region. However, in the face of a potential withdrawal of portfolio investments in these economies the ability to enforce regulatory instruments may prove inadequate. Because when the state attempts to thwart any danger of financial instability money is transferred through the informal curb markets to the relatively free markets in the neighbouring countries as the experiences of South East Asian countries suggest. Both portfolio equity and foreign direct investment flows are subject to similar insecurity when credit standing of an economy declines in the international capital market with ensuing capital flight. That credit standing and market position of an economy, whose external economic dimension is fairly stable, may deteriorate in the face of a financial collapse in the region because of its being located in a crisis prone region was evidenced in the Latin American debt crisis in the eighties with Peru being the classic example (Cline 1983).

#### **Section 5: Conclusions**

Summing up the major observations made in this paper, it can be said that prophecies of financial liberalisation as a means to achieve growth via allocative efficiency and that of financial openness as a means to

rejuvenate effectiveness of monetary policy by permitting the free play of all markets was not fulfilled neither in the advanced nor in the developing economies. The success stories of the East and South East Asian economies in this respect, however, signify a particular role of state characterised by its strong will and discriminatory allocative mechanism and not the supremacy of market forces. However, in the face of international transmission of shocks in terms of potential capital outflows from the region, state's regulatory mechanism may become ineffective as the experiences of these economies tend to suggest. This fear has become real in recent time with financial downswing in the major South East Asian economies including Thailand, Malaysia and Indonesia and increased frequency of stock price fluctuations in the region.

Loopholes exist in a state-controlled financial system in connection with inter-linked domestic credit markets in a developing economy. Any analysis and policy imperatives relating financial market development in a developing economy must provide more focussed attention on informal segments of the market. A strong presence of informal market mechanism in the overall financial system of a country may frustrate any attempt to regulate or deregulate it effectively and may render credit diversion expensive as the Korean experience in the early seventies suggests. But the later developments in Korea and other emerging economies in the East and South East Asian region prove that a strong-willed state is capable of overcoming the inefficiencies of private capital market without corresponding risk of government failure.

The recent debacle of the South East Asian economies once again has brought to the fore the pertinence of the market failure arguments in a globalised context. As a noted exception to this debacle, Taiwan and China tend to reaffirm the supremacy of "state-dominance" over "market-governed" system.

**Table 1**  
**Financial Deepening and Interest Rate Regime**  
**in Selected Asia-Pacific Economies**  
**(1971-80 vs. 1980-90)**

Economy	M2/GDP (%) 1971-80	M2/GDP (%) 1981-90	Interest rate regime (real rate: +/-ve)
Hong Kong	85.7	155	-ve (1973-91)
Korea	33.7	36.8	-ve* (1971-90)
Singapore	61.7	78.8	+ve (1977-91)
Taiwan	58.1	110.2	+ve (1974-91)
Indonesia	16.1	24.3	+ve**(1970-90)
Malaysia	44.2	88.2	+ve (1976-91)
Thailand	35.8	57.6	+ve (1977-90)

Note: \* During 1973-79 and 1981-83 -ve  
 \*\* During 1973-76 -ve

Source: Islam and Chowdhury (1997); p.75.

**Table 2**  
**Savings, Investment and GDP Growth Rates in Developing Asia**  
**(1971-80 and 1981-90)**

(in per cent)

Period	1971-80	1981-90
Korea		
Real GDP growth rate	9	8.8
Gross domestic savings	22.3	30
Gross domestic investment	28.6	30.5
Taiwan		
Real GDP growth rate	9.3	8.5
Gross domestic savings	32.1	32.9
Gross domestic investment	30.5	22.6
Hong Kong		
Real GDP growth rate	9.3	7.2
Gross domestic savings	28.4	31
Gross domestic investment	27.8	28.2
Singapore		
Real GDP growth rate	7.9	6.3
Gross domestic savings	30	42.6
Gross domestic investment	41.2	42.2
Indonesia		
Real GDP growth rate	7.7	5.5
Gross domestic savings	21.6	31.8
Gross domestic investment	19.3	30.4
Malaysia		
Real GDP growth rate	7.8	5.2
Gross domestic savings	29.1	33
Gross domestic investment	24.9	30.7

Table 2 contd..



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Period	1971-80	1981-90
Phillippines		
Real GDP growth rate	6	1
Gross domestic savings	26.5	22.3
Gross domestic investment	27.8	21.9
Thailand		
Real GDP growth rate	7.9	7.8
Gross domestic savings	22.2	24.6
Gross domestic investment	25.3	26.9

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Note: Gross domestic savings and investment are expressed in per cent of GDP.

Source: Asian Development Outlook (various issues).

**Table 3**  
**Interest Rate Regime, Incidence of Financial Reform and the Behaviour of Savings and Investment Efficiency (1971-80: period 1 vs. 1981-90: period 2)**

Economy	Increase in savings ratio	Increase in investment efficiency Yes/No	Interest rate regime (real rate: +ve/-ve relevant period)	Financial reform initiated (Yes/No Not applicable)
Hong Kong	Yes	No	-ve	Not applicable
Korea*	Yes	No	-ve	Yes
Singapore	Yes	No	+ve	Not applicable
Taiwan	Yes	Yes	-ve	Yes
China**	No	Yes	+ve	Yes
Indonesia***	Yes	No	-ve	
Malaysia	Yes	No	+ve	Yes
Philippines****	No	No	+ve	Yes

Note: \* Interest rate regime was -ve for some periods  
 \*\* Interest rate regime +ve in recent years  
 \*\*\* For some distinct sub-period interest rate regime -ve  
 \*\*\*\* Interest rate regime exhibits significant volatility

Source: Islam and Chowdhury (1997)

**Table 4**  
**Net Non-interest Income as a Share of Banks' Annual Gross Income**

(in per cent)

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
France	16.0	16.2	16.8	13.2	14.1	14.4	17.0	17.0	21.2	20.1
Germany	29.1	26.8	24.8	25.9	30.1	29.5	29.8	30.4	36.0	35.7
Japan	17.8	13.9	14.7	17.7	21.1	19.7	25.1	25.8	23.8	24.1
Switzerland	47.7	44.2	46.5	45.7	47.4	49.4	51.6	47.1	50.9	49.1
UK	n.a.	n.a.	n.a.	35.6	34.5	36.3	38.1	37.6	39.2	40.1
USA	24.0	24.6	26.5	24.7	26.6	29.8	30.2	30.1	31.8	32.8

Source : Banks Under Stress, OECD (1992); pp. 125.

**Table 5**  
**Capital Flows to Developing Countries and Asia**

(in US \$ billion)

Year	1990	1991	1992	1993	1994	1995
I All developing countries						
1. Net resource flows	101.9	127.1	155.3	207.3	207.4	231.4
2. Investment	28.7	42.6	60.7	113.9	115.0	112.3
a) Foreign direct investment(net)	25.0	35.0	46.6	68.3	80.1	90.3
b) Portfolio equity flows	3.7	7.6	14.1	45.6	34.9	22.0
3. Debt	43.8	47.0	62.7	64.0	59.9	86.2
a) Official creditors	28.5	28.0	23.1	23.6	16.1	31.4
b) Private	15.3	19.0	39.6	40.4	43.8	54.8
4. Grants	29.4	37.5	31.9	29.4	32.5	32.9
II Developing Asia						
1. Net resource flows	38.3	45.4	62.8	83.2	99.1	120.8
2. Investment	13.8	15.4	27.8	58.8	63.1	69.4
a) Foreign direct investment(net)	11.4	14.3	22.3	38.7	44.3	55.7
b) Portfolio equity flows	2.4	1.1	5.5	20.1	18.8	13.7
3. Debt	19.7	24.5	30.1	19.9	30.5	45.6
a) Official creditors	10.7	11.6	10.3	11.2	8.9	19.9
b) Private	9.0	12.9	19.8	8.7	21.6	34.7
4. Grants	4.8	5.5	4.9	4.5	5.5	5.8
5. FDI Asia excluding PRC	7.9	10.0	11.1	11.2	10.5	17.7

Source : World Debt Tables (1996).

**Table 6**  
**Capital Flows to Developing Countries and Asia**  
 (as per cent of net resource flows)

Year	1990	1991	1992	1993	1994	1995
<b>I All developing countries</b>						
1. Net resource flows	100.0	100.0	100.0	100.0	100.0	100.0
2. Investment	28.2	33.5	39.1	54.9	55.4	48.5
a) Foreign direct investment(net)	24.5	27.5	30.0	32.9	38.6	39.0
b) Portfolio equity flows	3.6	6.0	9.1	22.0	16.8	9.5
3. Debt	43.0	37.0	40.4	30.9	28.9	37.3
a) Official creditors	28.0	22.0	14.9	11.4	7.8	13.6
b) Private	15.0	14.9	25.5	19.5	21.1	23.7
4. Grants	28.9	29.5	20.5	14.2	15.7	14.2
<b>II Developing Asia</b>						
1. Net resource flows	100.0	100.0	100.0	100.0	100.0	100.0
2. Investment	36.0	33.9	44.3	70.7	63.7	57.5
a) Foreign direct investment(net)	29.8	31.5	35.5	46.5	44.7	46.1
b) Portfolio equity flows	6.3	2.4	8.8	24.2	19.0	11.3
3. Debt	51.4	54.0	47.9	23.9	30.8	37.7
a) Official creditors	27.9	25.6	16.4	13.5	9.0	9.0
b) Private	23.5	28.4	31.5	10.5	21.8	28.7
4. Grants	12.5	12.1	7.8	5.4	5.5	4.8
5. FDI Asia excluding PRC	20.6	22.0	17.7	13.5	10.6	14.7

Source : Calculations based on Table 5.

Table 7

**Types of Financial Regulation – Objectives and Key Policy Instruments**

Type of regulations	Objectives	Examples of key policy instruments
Macroeconomic	To maintain control over aggregate economic activity and maintain external and internal balance	Reserve requirements, direct credit and deposit ceilings, interest rate controls and restrictions on foreign capital
Allocative	To influence the allocation of financial resources in favour of priority activities	Selective credit allocation, compulsory investment requirements, preferential interest rates
Structural	To control the possible abuse of monopoly power by dominant firms	Entry and merger controls, geographic and functional restrictions
Prudential	To preserve the safety and soundness of individual financial institutions and sustain public confidence in systemic stability	Authorisation criteria, minimum capital requirement, limit on the concentration of risks, reporting requirements
Organisational	To ensure smooth functioning and integrity of financial markets and formation exchanges	Disclosure of market information, minimum technical standards, rule of market-making and participation
Protective	To provide protection to users of financial services, especially consumers and non-professional investors.	Information disclosure to consumers, compensation funds, ombudsmen to investigate and resolve disputes

Source : Vittas (1992).

## Notes

1. First, the services provided by the financial system are diverse: an efficient financial system guarantees the proper functioning of the payments system, ensures the mobilisation of savings and their channelling into investment, makes it possible to diversify risk, collects information and constantly evaluates the quality of investment projects. Second, some of these services - such as management of the payments system - are very much of the nature of public goods, which prevents their being taken into account by market prices. Lastly, compilation of such indicators is further complicated by the diversity of agents and institutions involved in the financial intermediation process.
2. An indicator of the relative size of the financial system is the volume of financial intermediaries' liquid liabilities (measured in practice by M3 or M2) as a percentage of GDP which is also termed as financial depth or deepening ratio.
3. This view should not be mistaken as akin to the monetarist doctrine à la Milton Friedman which regards increasing monetisation as necessary prerequisite for economic growth. On the contrary, the causality runs here in the reverse direction where real growth process generates demand for increasing monetisation.
4. Saint-Paul (1993) analysed technological dualism, often found in developing countries, which stands for a diversification of technological risks in less productive technologies when it is not possible to diversify productive risks in modern sector and

thereby, in modern technologies due to the underdeveloped nature of the financial markets.

5. Banks may also suffer from liquidity risks but because of law of large numbers banks' exposure to liquidity risks is generally lower than individual investors.
6. Universal system of banking, as exercised in Japan and Germany, involved holding shares in the capital of enterprises and banks' representation in the companies' management boards. Hence it had comparative advantages over the equity finance when it came to the restructuring of enterprises and thereby, in reducing transaction costs and improvement in the investment quality.
7. See Barandiran (1987), de Melo and Tybout (1986), Fry (1984 & 1985), Giovannini (1985), Hanna (1994) Islam & Chowdhury (1997) and Leff & Sato (1980).
8. Financial fragility is defined as the deterioration of the financial intermediaries' balance-sheets over time owing to lower asset quality and lower net earnings. See Sen (1996b).
9. Advocates of financial deregulation argue that financial institutions may tend to become risk lovers in the presence of a bail out mechanism which is widely prevalent.
10. Demand driven explanation indicates expansion of financial sector fuelled by real economic growth whereas the latter is preceded by financial sector development in supply driven case.



11. See Cullis and Jones (1987) for an overview of the government failure argument
12. Indonesia had to revert its financial reform in early eighties as it entailed some external costs in terms of macroeconomic instability. For an overview of the Indonesian case see Cole & Slade (1992).
13. A credit-based financial system need not necessarily be state dominated.
14. Cited in Wade (1988).
15. During 1991, non-bank financial intermediaries income as proportion of the gross bank income was 41.1% in UK, 38.0% in US and 35.9% in Japan. See BIS (1990a).
16. See OECD (1992).
17. See OECD (1992).
18. The empirical facts about bank profitability and gross income are based on OECD (1991).
19. Real estate prices are important in the Japanese context as real estate is an important collateral for Japanese bank loan. A sharp drop in real estate price could force banks to demand higher collateral or a repayment of credit, resulting in higher bankruptcies. See Salomon Brothers (1991a).
20. See Salomon Brothers (1991a).
21. Banks financed mergers of 340 financial and 1044 non-financial institutes in the OECD countries in 1991. See Sen (1994).

22. See Euromoney, October 1989.
23. See Salomon Brothers (1991b).
24. See Salomon Brothers (1991b).
25. See OECD (1992).
26. In 1983 the US monetary authority introduced International Lending Supervisory Act (ILSA), which in effect created a creditors' cartel, to thwart the potential debt collapse of the US commercial banks.
27. See World Bank (1991).

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