

Financial Sector Regulation in Developing Countries: Reckoning after the crisis¹

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Abstract

The global financial and economic crisis has cast serious doubts about the paradigm of market deregulation that dominated the last three decades. Although many developing countries, especially in Asia, became cautious following the Asian financial crisis, international financial institutions continued to advise developing countries to deregulate, albeit at a slower pace. However, this paper argues for re-regulating the financial sector with a view to preventing system-wide failures and fulfilling development needs. It highlights the importance of segregating different parts of the financial sector as well as controls over both deposit and lending rates, and the role of government-owned banks, especially for agriculture and SMEs.

Key Words: financial sector, economic regulation, prudential regulation, crisis

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Introduction

“The financial models of the advanced countries are now in some disrepute. What will replace them is still up for grabs. For poorer countries, seeking to develop their financial systems, that means the destination is no longer clear and will not be for some time. That anchor has been removed and will not be replaced until a new system is in place and has functioned for long enough to earn confidence.” (Growth Commission, 2010, p. 25)

Since the early 1980s an increasing number of developing countries embraced the mantra of ‘privatise, liberalise and globalise’ under the influence of the counter-revolution in economics,³ which came to be known as the “Washington consensus”. Developing countries which were forced to seek balance of payments supports from the International Monetary Fund (IMF) and aid from the World Bank had to agree to reforms, characterised by deregulation. As part of the reform package, they had to privatise their financial sector and deregulate interest rates. They were also encouraged to liberalise their capital account to allow free movements of short-term capital.

It was argued that control of interest rates and high inflation in developing countries in the 1950s and 1960s resulted in negative real interest rates, which discouraged savings and encouraged inefficiency of investment. The situation was called financial repression and was identified as one of the main barriers to financial deepening and hence to economic growth.⁴ Financial liberalisation and deregulation of interest rates are, therefore, expected to increase savings, improve intermediation between savers and investors, better spread risks and improve efficiency of investment.

However, the financial liberalisation theory – although premised on the incentive for savers – focused primarily on the selection and monitoring functions of financial markets which are basically concerned with providing and processing information. But information is imperfect, hence financial markets are characterised by market failure and imperfections (Stiglitz and Weiss, 1981). Therefore, the role of government is vital in financial markets, especially in the context of development (Stiglitz, 1989; 1994). However, the fact that market failures are pervasive in the financial sector has often been overlooked or ignored in the hasty pursuit of financial sector liberalisation.

There is now a near consensus that the current financial and economic crisis is the result of regulatory failure. In the words of the influential Growth Commission (2010, p. 3), housed in the World Bank, “The crisis delegitimized an influential school of thought, which held that many financial markets could be left to their own devices, because the self interest of participants would limit the risks they took.”

Financial sector regulation

There are two distinct categories of financial regulation according to its motive:

³ The stagflation of the 1970s following two major oil price shocks and the subsequent debt crisis in developing countries acted as catalysts for this counter-revolution. It also was aided by the political shift towards conservatism with the election of Margaret Thatcher in the UK and Ronald Reagan in the US. For a discussion of the implications of the 1970s’ turn on development economics, see Toye (1987).

⁴ McKinnon (1973) and Shaw (1973) were the originators of the financial repression/liberalisation theory.

1. Economic regulation (e.g. controls over interest rates and credit allocation)
 - aims to mitigate market failures in the allocation of resources.
2. Prudential regulation
 - aims to protect the stability of the financial system (i.e. prevent systemic failures or financial crises) and to protect depositors, especially small depositors.

In the haste to liberalise, this distinction was often missed or ignored. While the original theory of financial repression argued for liberalisation of economic regulation on the grounds of improving efficiency and financial deepening, there was no coherent theory for dismantling prudential regulation. Nonetheless, measures of prudential regulation were slackened on the grounds of encouraging innovation. It was also argued that a laissez-faire approach with an emphasis on self-regulation would encourage competition, while in fact this gave rise to “too big to fail” mega-banks and complex financial institutions through mergers and take-overs. Thus, instead of a competitive financial sector, what emerged was a highly oligopolistic market structure to the detriment of consumers.

Deregulation and crisis

Although deregulation is intended to improve efficiency in financial markets, it has made financial systems more vulnerable to financial crises. For example, in a deregulated financial sector, banks are allowed to hold more risky assets than would be the case in a regulated system. This exposes banks to greater competition, or to a greater degree of market risks, such as interest rate or exchange rate risks.

Since the dismantling or lack of strong prudential regulation is identified as the root cause, the discussion of regulatory reforms focuses mostly on prudential or macro-prudential ones. However, a laissez-faire approach to economic regulation and the deregulation of interest rates – motivated by the financial repression argument – can also be a contributory factor.

That is, excessive bidding for deposits leads to higher interest rates. Thus, banks must charge higher rates for loans which attract risky borrowers. The role of unregulated interest rates in causing a banking crisis or failure was recognised in the 1920s, leading to the Glass-Steagall Act in the US.

Glass-Steagall Act: what were the concerns?

The public officials and bankers themselves saw excessive interest on deposits as a threat to both the liquidity and solvency of banks. This was particularly the case when there were too many banks competing for deposits or when banks competed with non-bank financial institutions, such as credit unions, squeezing profit margin.

An additional factor was “stock gambling” associated with the Great Crash in 1929. Senator Glass as Chairman of the Committee on Banking and Currency asked George Harrison, Governor of the Federal Reserve Bank of New York, “Do you think the banks in money centers ought to be permitted to pay interest on bank deposits? ...does that not have a tendency to draw a vast amount of funds and credits from interior banks to money centers?”

The Governor responded, “I think it does, but unfortunately such a big percentage of the banks are not members of the Federal Reserve System...”

The present day equivalent of the above has been observed in developing countries after financial deregulation. Deposits/savings flowed from the rural economy to the commercial sector or to non-traded activities such as real estates.

How much of the above was in the Asian financial crisis?⁵

Evidence of the deterioration of asset portfolios of financial institutions was already emerging a few years before the crisis broke out. For example, in South Korea, banks suffered losses on their equity portfolios in 1996. In Thailand, one bank was taken over by the authorities in May 1996 after incurring heavy losses through a speculative and fraudulent lending policy. Some finance companies also suffered heavy losses in 1995 after lending for stock market speculation. In Indonesia, signs of distress in the banking system had begun to emerge in 1995, when one bank suffered a run on its deposits, and when the central bank intervened to support two distressed banks in the following year.

Opening up banking systems to new entrants lowered the franchise value (expectation of future profits) of existing banks. For example, in Thailand, the entry of foreign banks increased competition for prime customers. The increased competition squeezed the lending margins of the domestic banks, inducing them to move into more lucrative, but more risky, activities. This shift in activities by the domestic banks was facilitated by a relaxation of the regulations governing permissible activities of banks.

During the 1990s banks and non-bank financial institutions (NBFIs) in Southeast Asia expanded lending to the private sector at a very rapid rate – far above the growth rate of nominal GDP (see Table 1). Rapid growth in bank lending was itself a source of poor asset quality, as borrowers with more marginally viable projects were granted credit. In addition, it strained financial institutions’ capacity to appraise and monitor borrowers, leading to failure to keep pace with the expansion of their loan portfolios.

Table 1: Credit growth in Asian crisis countries (1990-96)

| Country | Nominal GDP growth | Annual loan growth | Loan growth/ GDP growth | Net domestic credit/GDP | |
|-------------|--------------------|--------------------|----------------------------|-------------------------|------|
| | | | | 1990 | 1996 |
| Indonesia | 17 | 20 | 118 | 45 | 55 |
| South Korea | 14 | 17 | 121 | 68 | 79 |
| Malaysia | 13 | 18 | 138 | 80 | 136 |
| Philippines | 13 | 33 | 254 | 26 | 72 |
| Thailand | 14 | 24 | 171 | 84 | 130 |

Source: Brownbridge and Kirkpatrick (1999).

⁵ For a comprehensive review of literature on the Asian financial crisis, see Islam and Chowdhury (2001).

The risks that rapid expansion of lending posed to financial institutions were further exacerbated by the nature of their lending and investment strategies. For example, banks and NBFIs lent heavily to the property sector in Thailand, Indonesia and Malaysia, with loans to this sector expanding at an even faster rate than total lending, and to excessively geared large commercial and industrial conglomerates (e.g. Chaebols in South Korea).

Because of over-investment in both the corporate and real estate sectors, returns to investment fell and many of the loans were extended to projects which proved non-viable. Average profit margins of the Chaebols fell to negligible levels in the mid-1990s and several went bankrupt. Much of the lending was collateralised by real estate, the value of which was dependent upon increasingly inflated, and unsustainable, property prices. Banks and finance companies also lent money for speculation in stock markets, or invested directly in stock markets, on which equity prices had been inflated to unsustainable levels. Once property and equity prices fell, banks and NBFIs incurred heavy losses.

Does the above sound familiar in the context of the current financial crisis? Have we learned from the Asian financial crisis? Alas, the answer is no, even for most developing countries. Unfortunately, there is not much enthusiasm to re-regulate the financial sector even after this crisis – in both developed and developing countries.

Lessons from the crisis for the financial sector in developing countries

The Asian crisis did not change the fundamentals of liberalisation paradigm and the push to restructure their financial sectors in the model of developed countries' deregulated landscape. The only change was seemingly in the pace. "The new advice was, therefore, 'You should look like us [advanced countries], **eventually**.' ... But even if countries plotted a slow and cautious route to financial development, their destination was always fairly clear: they would converge on some version of the advanced country financial system with open capital accounts, a floating exchange rate, and a sophisticated set of instruments to price risk and redistribute it." (Growth Commission, 2010, p. 24) [Emphasis added.]

Thanks partly to this gradualism, but largely to the scepticism of many developing countries about the benefits of a deregulated and interconnected system, their less sophisticated financial systems escaped the contagion from the crisis in more elaborate financial systems of the West. Unlike in the US or some European countries, developing countries do not have shadow banking systems of any size. Nor did their banks hold complex, toxic assets. This could be partly due to self-restraint; but it was mostly due to regulatory constraints. A number of developing countries, especially in Asia, became cautious in the wake of the Asian financial crisis. The Reserve Bank of India, for example, has been particularly vigilant against new financial products.⁶

⁶ See Reddy (2009) for an insightful analysis of how sound financial sector regulation has helped the Indian economy to weather the storm. According to Reddy, the regulators must be able to draw a distinction between good financial innovation and bad financial innovation.

On the other hand, during this crisis, almost all the channels for intermediating credit failed simultaneously in the advanced countries. Only through rapid and massive interventions by central banks, could a complete collapse of the system be prevented. However, such a rescue effort is beyond most developing countries. Therefore, the best defence for developing countries is prevention or guarding against system-wide failure. This is extremely important given the role bank-financing plays in developing countries with a very thin capital market.

Preventing system-wide failure

Segregation and restraint

A portion of the banking system should be segregated and heavily regulated. Banks in this segment should offer a limited range of services, such as deposit and savings accounts, and hold a restricted range of safe assets. This ensures that at least some channels of credit remain open, even if the rest of the system collapses.

In addition, there should be restraint on excessive bank competition and entry, tightening of prudential regulation, and a curb on financial products which are deemed difficult to evaluate and monitor. Hellmann, Murdock and Stiglitz (1997; 2000) called for “financial restraint”, that is, control over both deposit and lending rates to prevent excessive risk-taking and encourage long-term investment. Deposit rate controls and restrictions on competition create franchise value in financial markets that curtails moral hazard behaviour among financial intermediaries. Lending rate controls may also increase the efficiency of intermediation by reducing agency cost in loan markets.

Ownership matters

Banks in the regulated and segregated sector do not have to be government-owned, nor do they have to be natural monopolies. However, large state-owned banks provide a layer of reassurance or a safety-net. The state-owned banks may not be as efficient as the private banks and may lag behind in boom times, but their presence becomes crucial during bad times when they act as the main vehicle for maintaining the credit line.

Developing countries also need major domestic players, which can participate in implementing a crisis response. Therefore, domestically-owned banks must dominate the financial sector. Foreign banks are likely to be affected by the crisis at their headquarters and hence will be part of the problem rather than solutions.

Meeting development needs

Government-owned specialised banks

Bank-based finance plays a major role in developing countries. Therefore, the financial sector policy must fulfil the developmental needs and support structural change and industrialisation. The regulated and segmented sector must also include specialised banks for such sectors as agriculture and SMEs, which may not appear very attractive to private banks from the profit maximisation point of view. Financial sector deregulation has not served these sectors well. Financial deregulation reduced rural peoples’ access to banks – in some countries about 80-85% of the rural population does not have access to banks.

Profit-oriented private banks may not find it profitable to have branches at remote rural areas. Most rural borrowers in developing countries are not only small, and hence raise transaction costs of

lending, they also do not possess much collateral to protect banks from loan-defaults. Even if a private bank takes the risk and manages to thrive in a remote rural location, it cannot ensure its sustainability as other banks will soon enter the market, and reduce profit margins. In such circumstances, there has to be either government-owned banks or some restrictions on bank entry in rural and remote areas.

Financial restraint

This serves both stability and development needs. Unlike financial repression, where the government extracts rents from the private sector, financial restraint calls for the government to create rent opportunities in the private sector. These rent opportunities induce outcomes that are more efficient than either financial repression or laissez-faire policies. Emran and Stiglitz (2009) show that well-designed deposit rate policies and temporary restrictions on competition in banking are appropriate when the focus of development strategy is the discovery of entrepreneurial talents and stimulating dynamic learning. Through careful control of the financial sector (keeping the real interest rate low and encouraging/directing credit to priority sectors) Japan and other East Asian countries experienced enviable economic growth and structural transformation.

Concluding remarks

“Financial markets ... can be thought of as the ‘brain’ of the entire economic system, the central locus of decision making: if they fail, not only will the sector’s profit be lower than would otherwise have been, but the performance of the entire economic system may be impaired.” Stiglitz (1994, p. 23)

Therefore, developing countries must design their financial sector with enough *prudential regulation* aimed at preventing its failure. Given the importance of bank-based financing for long-term investment to accelerate structural change, there has to also be *economic regulation* of the financial sector. As the Growth Commission (2010, p. 25) observed, “Deep, wide, and liquid financial markets are desirable to promote savings and investment. But it is not clear that the growing trading superstructure adds enough social value (other than to its participants) to justify its costs and dangers. The balance probably needs to shift back toward the essential functions of the financial system: safe savings channels, credit provision to various sectors of the economy, and a means to spread risk to those best placed to bear it.”

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