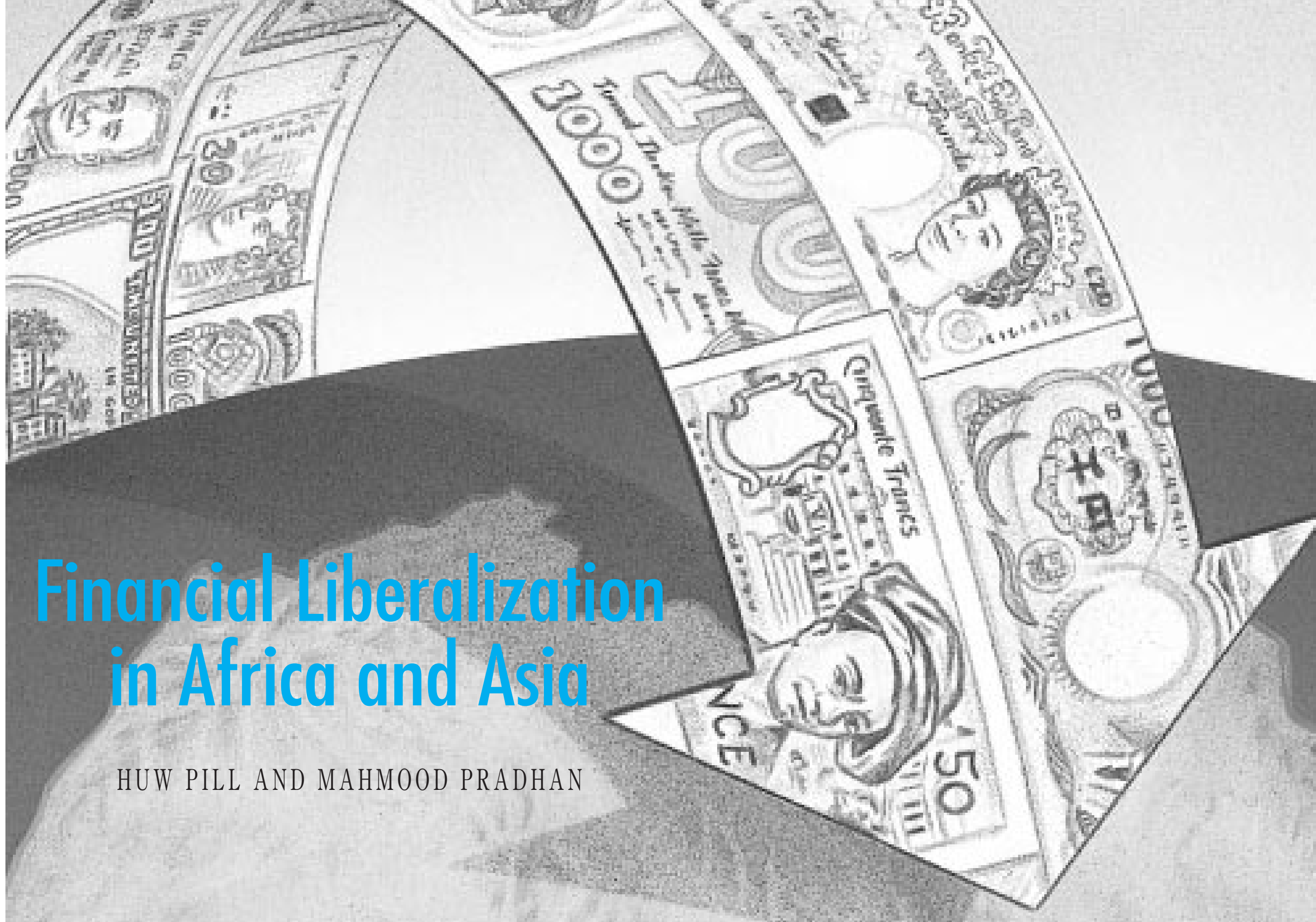

Financial Liberalization in Africa and Asia

HUW PILL AND MAHMOOD PRADHAN

Asian countries have generally been more successful than African countries in liberalizing their financial systems. Why have their outcomes differed? Asia's experience with liberalization offers some useful lessons for Africa.

BOTH ECONOMIC theory and practical experience suggest that financial liberalization can stimulate economic development. Until the 1980s, extensive government intervention was the norm in the financial markets of developing countries. Ceilings were imposed on bank interest rates; credit was allocated by administrative decision rather than market criteria; and inflows of foreign capital were strictly controlled. Over the last twenty years, however, many developing countries—persuaded by both the theoretical arguments made in support of liberalization and the experience of many of the rapidly growing countries—have begun to liberalize their financial markets by abolishing these types of controls.

The results of financial liberalization appear quite different for Asia and Africa. If one uses the ratio of broad money (cash *plus* deposits in the commercial banking system) to national income as a measure of financial deepening and the success of reform, liberalization appears to have been much more successful in Asia (see chart). However, this simple comparison can be misleading. Financial reform was implemented much earlier in most Asian countries than in Africa; for example, Malaysia liberalized interest rates in 1978. In contrast, even the earliest African liberalizers (The Gambia and Ghana) began to introduce reform only in the late 1980s. Moreover, financial development is only one part of a broader process of economic development, of which it is both a cause and a consequence. The generally more successful economic performance of Asian economies over the last two decades has underpinned and enlarged the benefits of financial sector reforms.

Nevertheless, the Asian experience offers some important lessons for Africa. Comparison of the experiences of the two continents suggests that if financial reforms are to succeed, they must be implemented in an appropriate macroeconomic, financial, and institutional environment.

Benefits of liberalization

In most developing countries, the banking sector dominates the financial system and securities markets are not well developed. Restrictions on bank behavior imposed by the government often result in negative real interest rates and an excess demand for credit, requiring banks to ration their lending. Consequently, credit is allocated to favored sectors and firms by

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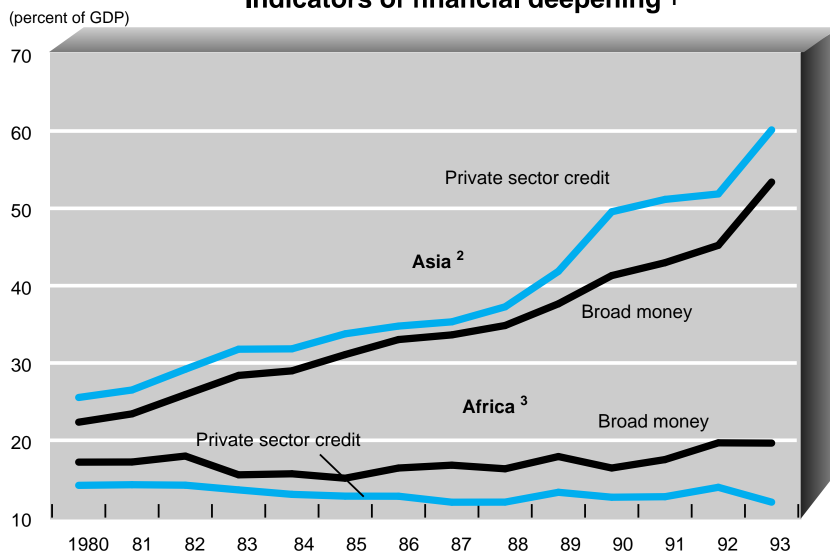

Source: Huw Pill and Mahmood Pradhan, "Financial Indicators and Financial Change in Africa and Asia," IMF Working Paper No. 95/123 (Washington: IMF, November 1995).

[1] All aggregates are constructed using 1987 GDP weights.

[2] Indonesia, Korea, Malaysia, the Philippines, Sri Lanka, and Thailand. Data for 1993 exclude Indonesia.

[3] The Gambia, Ghana, Kenya, Madagascar, Malawi, and Zambia.

administrative decision, rather than by market mechanisms.

Following financial liberalization, market determination of interest rates should result in modestly positive real interest rates. These, in turn, will increase the resources available to the financial system, since bank deposits offering a competitive return will attract savings that were previously held outside the formal financial sector (possibly as excess inventories of intermediate goods). Moreover, positive real interest rates will provide an incentive for borrowers to invest in more productive activities, thereby improving the productivity of the economy as a whole. Consequently, financial liberalization should lead to an increase in both the quantity and the quality of financial intermediation by the banking system.

Financial liberalization can therefore stimulate economic development through a variety of channels. Since the financial system performs the vital function of raising funds for, and channeling funds to, productive investment, successful financial liberalization is usually an important component of a country's strategy for economic growth.

Implementing liberalization

Financial liberalization entails the abolition of explicit controls on the pricing and allocation of credit. *Direct* government intervention in bank credit decisions is brought to an end. Liberalization may also involve the abolition of controls on international capital movements. However, government policies will continue to play a central role in determining how the financial sector performs. Financial liberalization does not mean "free banking." Governments will continue to intervene in the financial sector in a number of ways: banks will be supervised for prudential reasons; some banks may be publicly owned; and the government may be a major borrower. How successfully the authorities perform their role as supervisor, owner, or customer will be an important determinant of the success of reform. Moreover, financial liberalization is only one component of a successful development strategy. Appropriate macroeconomic policy, institutional development, and structural reform must accompany financial liberalization and create the stable context required for it to succeed.

Macroeconomic stability is a prerequisite for successful financial liberalization. In the generally successful Asian cases, macroeconomic imbalances were largely eliminated before financial reforms were introduced. Balance of payments and fiscal deficits were manageable, and inflation was relatively low. The Asian countries that were exceptions to this rule—the Philippines and Sri Lanka—were notably less successful in expanding their financial sectors following reforms. For example, in Indonesia, where macroeconomic conditions were favorable, the ratio of broad money to GDP rose dramatically, from a preliberalization level of 9 percent in 1983 to well over 40 percent in 1991. In contrast, in Sri Lanka, the ratio of broad money to GDP was largely unchanged after the reforms. Only credible and sustained macroeconomic stabilizations produce the increased demand for money that is the counterpart to financial deepening.

The situation is markedly different in Africa, where a number of countries have attempted to implement financial liberalization in an environment of ongoing inflation—largely a consequence of excessive fiscal deficits. In Ghana, inflation was more than 20 percent a year when interest rates were deregulated; in Zambia, inflation exceeded 100 percent at the time of reform. Attaining low but positive real interest rates is difficult when inflation is high and volatile.

While macroeconomic stability is essential for successful financial liberalization, a sound banking system is also extremely important. The benefits associated with financial reform are contingent on the financial system being "well behaved" throughout the liberalization process. Where significant market failures exist, or government intervention in the financial system continues, the freedom that liberalization offers banks may be exploited in ways that harm the overall development strategy.

For example, banks in many African countries are publicly owned and therefore remain susceptible to government interference even after controls on credit pricing and allocation have been formally abolished. Moreover, because of the stock of nonperforming loans inherited from the administratively directed lending programs of the prereform era, the solvency of many privatized banks may remain dependent on subsidized credit from the central bank even after liberalization. In these circumstances, loans provided by these banks are more akin to government subsidies. Liberalization will do little to improve credit allocation or spur financial deepening in such circumstances, since the banks remain wholly dependent on the government, and their lending decisions are subject to its discretion.

Similarly, if competition among banks in the newly deregulated financial sector is weak, liberalization may result in lower real deposit rates rather than the anticipated movement toward modestly positive, equilibrium levels. Monopolistic banks can exploit the opportunity offered by the abolition of interest rate controls to widen the margins between their deposit and lending

rates to increase profits. In those African countries where this has happened—Kenya, Madagascar, and Malawi in our sample—liberalization has resulted in little financial deepening, since the attractiveness of bank deposits to domestic savers has, if anything, been reduced.

When financial deregulation is implemented—and especially where nonperforming loans are inherited from the prereform era—interest rate liberalization should be accompanied by structural reforms, including restructuring bank balance sheets to remove bad debt, privatizing publicly owned banks, and introducing measures to promote competition in the banking sector. The implementation of concurrent structural reforms in several Asian countries explains an important part of their greater success compared with reform efforts in Africa.

Of course, deregulation also creates opportunities for banks to make poor lending decisions. If, prior to reform, banks have not made loans based on market criteria, their ability to manage credit evaluation and allocation is likely to have either atrophied or never been developed. Moreover, the process of financial liberalization itself will introduce new uncertainties into the economic system. Newly liberalized banks may therefore be prone to making poor lending decisions. Strengthening the management and risk evaluation capabilities of bank managers in a newly liberalized environment should be an integral part of the restructuring process. This is likely to require government action. For example, the government may relax restrictions on foreign ownership of domestic banks so that foreign "best practice" managerial and credit assessment techniques can be introduced.

Systemic risk also needs to be managed more carefully in a deregulated financial sector. Paradoxically, the need for effective prudential supervision of financial institutions may be greater in a liberal environment than under a government-controlled regime of financial repression. The existence of controls on bank behavior prior to reform may make the financial sector stable, albeit at considerable expense in economic efficiency. Deregulation will undermine this controls-based stability and therefore necessitate much greater emphasis on prudential supervision. If banks choose to use the new freedoms implied by liberalization to exploit potential market failures, the effects on macroeconomic and financial stability can be catastrophic.

Financial liberalization cannot be implemented in a vacuum. Macroeconomic stability prior to reform is essential. But policymakers also need to strengthen institutional development in the financial system before liberalization is introduced. If the legal, accounting, management, and supervisory infrastructures of the financial sector are weak, then deregulation alone is unlikely to generate the expected benefits and, in fact, highly destabilizing forces may be unleashed. Accompanying structural measures are therefore vital. This is most apparent in Africa, where economic institutions remain underdeveloped and highly fragile. Even in the more successful Asian cases, there is considerable scope for improvement. The large number of nonperforming loans on many Asian banks' balance sheets is testament to the difficulty of implementing effective banking supervision as liberalization proceeds, even in relatively benign macroeconomic environments.

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Measuring results

Conventionally, the success of financial liberalization has been assessed using two criteria: the extent of financial deepening and the evolution of real interest rates toward plausible equilibrium levels. Indeed, these criteria have been used in this article. These two measures, however, suffer from certain drawbacks that may obscure some of the important differences between the African and Asian experiences with financial reform.

Abstracting from institutional details, it is clear that reform occurs in several stages. Typically, *domestic* financial liberalization—the abolition of controls on interest rates and credit allocation—precedes *international* financial liberalization—the elimination of capital controls and restrictions on the convertibility of domestic currency into foreign exchange. Conventional measures of the success of financial reform focus on domestic deregulation, although in many cases international liberalization is at least as important.

For example, if abolishing capital controls on the balance of payments results in greater integration of domestic and international financial markets, arbitrage pressures may keep the domestic real interest rate close to world levels. Therefore, where domestic real interest rates are initially above world rates owing to a shortage of domestic savings, international financial liberalization that offers domestic firms access to international capital may lower, rather than raise, real interest rates.

Similar concerns affect financial deepening. Prior to international financial liberalization, broad money offers a good indication of the banking system's scope for credit expansion, since domestic bank deposits are the main source of finance for bank lending. When capital controls are abolished, however, capital inflows—in the form of deposits made by foreign residents in domestic banks—add to the funds banks have available for credit expansion but do not increase broad money (since they are excluded from it by definition). Money-based measures of financial deepening may therefore be misleading when capital inflows are important (see chart).

Capital flows are not the only reason why money and credit-based measures of financial deepening may diverge, however. In general, government borrowing from the banking system will, for a given level of broad money, reduce the amount of credit available to the domestic private sector. If private sector activity is more productive than government expenditure, then this *crowding out* of private borrowing may have strong negative repercussions for economic performance that would not, however, be reflected in the conventional measure of financial deepening.

The chart suggests that several financial liberalizations undertaken in Africa since the late 1980s—before fiscal deficits were eliminated—have been adversely affected in this way. In the absence of well-developed government securities markets, deficits were financed largely by government borrowing from banks. Consequently, these countries' apparent success in achieving financial deepening (as indicated by changes in the conventional money-based measure) during the early 1990s is belied by what private sector credit measures show. Since theory suggests that credit is likely to be more important for economic

Financial liberalization in Indonesia and Kenya

Indonesia

Foreign exchange controls were eliminated in Indonesia in 1971, partly at the urging of the IMF but also because these controls reduced the efficiency of international trade and payments, and were extremely difficult to enforce given Indonesia's proximity to an open international financial center in Singapore. However, extensive controls on the domestic financial system remained in place until 1983. Only then were interest rates liberalized and controls on credit allocation relaxed. Prudential supervision was strengthened in 1984, after the initial liberalization of the banking system. Similarly, after relaxing controls on the entry of new banks and easing restrictions on the extension of bank branches in 1988–89, stricter prudential regulations were introduced by the central bank to constrain the explosion of bank credit that followed deregulation.

Indonesia's experience is therefore characterized by the implementation of several large reforms, each followed by retrenchment and consolidation. Although problems have emerged because institutional development, especially in the area of prudential supervision, has tended to lag behind deregulation measures, the overall success of reform has been considerable. Real interest rates have been positive since 1983, and financial deepening has been extensive. Privately owned banks now constitute a much larger proportion of the banking sector, as the relative importance of publicly owned banks has declined, and securities markets, especially the Jakarta Stock Exchange, have become more important. Although there have been occasional setbacks, and institutional weaknesses in the accounting and legal systems remain, overall the financial liberalization strategy pursued in Indonesia has been supportive of wider economic development.

Kenya

Financial liberalization in Kenya is much more recent. Ceilings on bank lending rates were not removed until July 1991. The central bank continued to announce guidelines for the sectoral composition of bank credit expansion, although these were not strictly enforced after interest rate liberalization. International financial liberalization is even more recent. Offshore borrowing by domestic residents has been permitted only since early 1994, and portfolio capital inflows from abroad were restricted until January 1995. Supporting structural and institutional reforms have yet to be fully implemented. Many banks remain publicly owned and competition among them is limited.

Deregulation of interest rates in this monopolistic environment permitted banks to widen their margins such that real interest rates on bank deposits fell substantially. Partly in consequence, financial deepening has been modest, especially when measured by the ratio of private sector credit to national income. Although it is too early to evaluate the success of financial liberalization, the lack of accompanying institutional and structural reforms suggests that financial sector reforms will provide only modest benefits to the overall Kenyan development strategy.

development than the supply of broad money, these findings help to explain why the initial results of the African experiences with financial liberalization are generally regarded as disappointing, despite some progress on the usual financial deepening measure. In Asia, where fiscal deficits were reduced prior to financial reform, both money and credit measures indicate that significant financial deepening has occurred and the beneficial impacts of reform on countries' real economies have been greater.

As liberalization proceeds, banks cease to dominate the entire financial system. Securities markets emerge and become an increasingly important source of funds for many firms. This process is quite advanced in many Asian countries. As alternative sources of external funds become available to domestic firms, neither broad money nor bank credit will be an adequate comprehensive indicator of either the success of reform or its likely impact on real economic performance, because they do not include the financial flows that occur outside banks' balance sheets. In Asia, equity and bond markets now play an important role in financing domestic firms' investment projects, and the conventional measures of financial deepening will not capture their effects. In such circumstances, broader measures of credit, which encompass new issues on the securities markets, are better indicators of the success of financial reform.

Lessons for liberalizers

Financial liberalization is an extremely important component of a successful development strategy. If financial deregulation is implemented in isolation, it is unlikely to promote growth and may, in fact, impede economic development. The importance of achieving macroeconomic stability prior to reform is well known, yet structural reform and institutional development in the financial sector, especially prudential financial supervision, are equally essential as liberalization proceeds.

Liberalization has been implemented in a number of African and Asian countries. Reforms in Asia were introduced both earlier and in more favorable macroeconomic environments. Although the creation of effective supervisory institutions remains a challenge in some countries, the Asian experience has been very successful overall. In comparison, financial liberalization in Africa, where reforms were introduced more recently, has yielded modest results, although some of the benefits have yet to accrue. Nevertheless, concerns remain. The environment in Africa is far less favorable—considerable macroeconomic imbalances persist and institutional development is not well advanced. The Asian experience offers some important lessons for Africa in both respects.

Measuring the results of reform is extremely important if policy is to be well designed and implemented. The effects of liberalization itself may distort the inferences drawn from conventional measures of financial deepening about the success of reform. Consequently, a wide range of performance indicators should be monitored by policymakers. This is especially important in Africa, where conventional measures may exaggerate the success of countries' reform programs in their early stages and thereby obscure underlying problems—notably, fiscal imbalances—that will require attention if financial reform is to be successful in the medium term. F&D

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