UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

UNITED NATIONS

CENTER FOR
INTERNATIONAL
DEVELOPMENT
HARVARD UNIVERSITY

G-24 Discussion Paper Series

How Risky is Financial Liberalization in the Developing Countries?

Charles Wyplosz

No. 14, September 2001

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

CENTER FOR INTERNATIONAL DEVELOPMENT HARVARD UNIVERSITY

G-24 Discussion Paper Series

Research papers for the Intergovernmental Group of Twenty-Four on International Monetary Affairs

UNITED NATIONS
New York and Geneva, September 2001

Note

Symbols of United Nations documents are composed of capital letters combined with figures. Mention of such a symbol indicates a reference to a United Nations document.

*

*   *

The views expressed in this Series are those of the authors and do not necessarily reflect the views of the UNCTAD secretariat. The designations employed and the presentation of the material do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area, or of its authorities, or concerning the delimitation of its frontiers or boundaries.

*

*   *

Material in this publication may be freely quoted; acknowledgement, however, is requested (including reference to the document number). It would be appreciated if a copy of the publication containing the quotation were sent to the Editorial Assistant, Macroeconomic and Development Policies Branch, Division on Globalization and Development Strategies, UNCTAD, Palais des Nations, CH-1211 Geneva 10.

UNCTAD/GDS/MDPB/G24/14

UNITED NATIONS PUBLICATION

PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Macroeconomic and Development Policies Branch, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

The research carried out under the project is coordinated by Professor Dani Rodrik, John F. Kennedy School of Government, Harvard University. The research papers are discussed among experts and policy makers at the meetings of the G-24 Technical Group, and provide inputs to the meetings of the G-24 Ministers and Deputies in their preparations for negotiations and discussions in the framework of the IMF's International Monetary and Financial Committee (formerly Interim Committee) and the Joint IMF/IBRD Development Committee, as well as in other forums. Previously, the research papers for the G-24 were published by UNCTAD in the collection *International Monetary and Financial Issues for the 1990s.* Between 1992 and 1999 more than 80 papers were published in 11 volumes of this collection, covering a wide range of monetary and financial issues of major interest to developing countries. Since the beginning of 2000 the studies are published jointly by UNCTAD and the Center for International Development at Harvard University in the *G-24 Discussion Paper Series.*

The Project of Technical Support to the G-24 receives generous financial support from the International Development Research Centre of Canada and the Governments of Denmark and the Netherlands, as well as contributions from the countries participating in the meetings of the G-24.

HOW RISKY IS FINANCIAL LIBERALIZATION IN THE DEVELOPING COUNTRIES?

Charles Wyplosz

Graduate Institute of International Studies, Geneva
and Center for Economic and Policy Research, Washington, DC

G-24 Discussion Paper No. 14

September 2001

Abstract

Financial crises now seem circumscribed to developing countries. While contagion used to spread crises among the large financial centres, it now affects developing countries on a regional basis, sometimes even mysteriously on a worldwide basis. While crises could unmistakably be linked to serious macroeconomic policy mismanagement, now they hit countries with no serious imbalances. This paper looks at the effect of domestic and external financial liberalization. Using a sample of 27 developing and developed countries, it studies the exchange market pressure and output gap effects of liberalization. The results may be summarized as follows.

First, in and by themselves, the exchange market effects of liberalization are too small to generate a crisis, but the see-saw effect on exchange market pressure can easily wrong-foot the authorities. This is primarily the case with capital account liberalization, which emerges as the most sensitive step. Second, there is evidence that the capital inflow problem is less severe and better handled in developed countries where, in particular, credit growth is better held in check. It could be that developed countries face a harsher liberalization shock because of initial conditions: capital may flow more vigorously into where it is scant and where external private indebtedness is low. Third, liberalization is found to reduce foreign exchange pressure in the long run, but is initially a source of instability, which can last for several years. Fourth, it remains surprising how little we explain of crises. The estimates barely explains some 40 per cent of exchange market pressure fluctuations. The usual indicators of policy or banking sector misbehaviour are rarely found to be significant. Financial restrictions may not be the second best response to market failures, but measures that limit the collateral damage created when those failures should not be ruled out. Fifth, if liberalization is not doing much good, it is not found to do any harm either, at least in the long run. Sixth, the immediate aftermath of liberalization is characterized by a boom, especially strong in the developing countries (nearly 15 per cent of GDP following capital account liberalization) in the case of a liberalization of the capital account. The boom is followed by a sharp contraction. The overall impact – e.g. on the output gap cumulated over 10 years – is positive in the case of the developing countries (moderately negative in the case of the developed countries).

Table of contents

Page

HOW RISKY IS FINANCIAL LIBERALIZATION IN THE DEVELOPING COUNTRIES?

Charles Wyplosz*

I. Introduction

Something has changed in the world of financial crises.[1] While crises could occur anywhere in the world, they now seem circumscribed to developing countries. While contagion used to spread crises among the large financial centres, it now affects developing countries on a regional basis, sometimes even mysteriously on a worldwide basis. While crises could unmistakably be linked to serious macroeconomic policy mismanagement, now they hit countries with no serious imbalances.

These changes carry profound implications. They challenge the wave of capital liberalization observed over the last decade. They affect the way developing countries carry out policy, including at the deeper, structural level. They require new think-

Since the heydays of Reagan-Thatcher activism, developing countries have been encouraged to establish financial markets and integrate themselves into world markets. The reasoning behind the push is based on a straightforward implication of first economic principles: financial markets allow the proper allocation of savings to productive investment, be it at the national or international level. Financial repression discourages savings and/or encourages capital flight. Borrowing on non-market terms often results in investment spending of poor quality, since borrowers are not selected on the merit of their projects but on questionable criteria, which include particular connections with financial institutions and governments, sheer political power, or graft. Insulated financial markets prevent access to cheaper resources and are often characterized by poor competence borne out of lack of adequate competition and supervision.