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Review paper

LIBERALIZATION OF FINANCIAL MARKETS: AN OPPORTUNITY OR RISK FOR DEVELOPING COUNTRIES

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Abstract. *The process of financial liberalization has created enormous opportunities for profit for banks and other financial institutions, but it has also led to an increased risk to their business and numerous banking and financial crises around the world. For decades, a considerable number of countries have isolated the economy and financial markets, resulting in greater protection from international financial shocks, but also reduced efficiency of local financial markets. In recent years more and more countries have chosen the liberalization of financial flows, reduction of government interference and have opened doors to foreign investors. These changes have led to increased opportunities for economic and financial subjects, but also to large exposures and frequent crisis. The paper considers different aspects of liberalization and analyzes positive and negative aspects of controlled and liberalized markets, as well as the consequences of institutional changes in the markets in the process of liberalization, with the aim to resolve the question of whether liberalization represents a chance or risk to financial markets of developing countries.*

Key Words: *liberalization, developing countries, banking crises, credit boom, institutions.*

INTRODUCTORY REMARKS

Due to political and economic changes that have swept the world in the late 80's, a large number of developing countries started the liberalization of its financial markets. This process in the world of finance was not new, since, a decade earlier, it affected the developed countries, which have thus begun the process of abandoning the Keynesian economic approach, which dominated the period of the Great Depression, and especially after World War II. The liberalization process has opened many opportunities for developing countries, enabling even more rapid development, creating more opportunities

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to make profit for all market participants, but at the same time, establishing an open market, despite numerous chances, and bringing significant risks, particularly in the form of rapid transmission of crises from one market to another. Since the late 80's communism, as one of the two dominant world political and economic ideologies, has suffered defeat and more and more countries are turning to capitalism, adjusting to its numerous demands. One of those requirements was the implementation of liberalization, above all, of financial markets, which was based on: 1) freely formed capital prices, 2) increased concurrence among various financial intermediaries, 3) the opening of financial markets to foreign actors. Some developing countries had already reached a considerable level of economic and financial development, while administering the state controlled their own version of capitalism and bank-centric financial system.

Liberalization, which was promoted by Western experts, who basically had the Washington Consensus, was to be conducted in the same way in all countries regardless of their specificity and the level of economic development. At first glance, the opening of alternative channels of financing and the creation of free-market stocks and bonds had to result in greater efficiency and more rapid economic development. However, in most countries, in response to the imposed changes, there were strong banking crisis, which left serious consequences on the economies of these countries. The question is, why did it happen, if it is a great part of diligently executing instructions proponents of financial liberalization? In this paper, through three interrelated parts, the attempt was made to answer this question on a deeper level. The first question was the lack of controlled financial system, then the quality of the process of liberalization and the end result, which is caused by liberalization in developing countries and their causes phenomenon.

1. DISORDERS OF REPRESSED FINANCIAL MARKETS

In developing countries, channels of financial intermediation, banks and institutions to finance development are responsible for the emission of loans. Banks are responsible for short-term loans, while the development of financial sector institutions is in charge of long-term loans. Development financial institutions issued, often politically directed, preferential loans to some industries. The money for these purposes was mainly obtained from international funds through loans and grants. These financial institutions were used by the government to fund the selected sectors (in Europe after World War II) and for giving the so-called "soft loans" (in Central and Eastern Europe). Commercial banks have to abstain from long-term loans, the maximum credit limit, with branch restrictions (Pill, Pradhan 1997).

Foreign banks were prevented from operating on the market in these countries, so the major role in this markets was played by domestic banks, which are usually state-owned. In this way, there was a monopolized structure of financial markets, where only preferred domestic banks could operate. Their freedom in business was very limited by the simple fact that they had management imposed by the state. The effects of monopolization and state control over the financial markets were extremely negative. The nominal interest rate fell below the level of inflation, there was a chronic lack of capital, and balance of payments equilibrium constant was achieved by borrowing funds from international funds and foreign financial institutions.

A similar situation was with the securities markets, because it had the small length and width, with the greatest government in the trade. These markets have had little impact on savings due to a lot of similar financial substitutes, such as the short-term government bonds. There are many reasons to expect that the wider public participation in these markets will be limited. Most depositors are not properly informed and familiar with the financial market system, so they are very cautious and risk-averse when investing money. The division of property by individuals tends to be limited to those with high incomes who can allocate their risks through a variety of portfolios. The factor of uncertainty is further enhanced by the commitment to cash in respect of securities, whose value varies. In less developed markets the state is the major buyer of securities, mostly through its investment funds, state enterprises and public financial institutions. On the other hand, commercial banks are the most important actor in financial markets from the private sector, while other financial institutions, businesses and, ultimately, individuals are of less importance for the functioning of these markets (Drake 1977).

In recent decades, a number of developing countries have gradually opened to foreign investment, so that many crucial sectors have been left to foreign firms. What proved to be a rule of thumb is that foreign companies would rather not raise funds on the local market, except if required, due to the regulations of local authorities. However, in recent years, multinational companies operating in developing countries have striven towards the least engaging of funds from domestic sources, preferring international sources and combining them in order to protect themselves from the risk of external borrowing. On the other hand, protection against inflation and political instability in the country in which they operate, multinational companies have found in collecting money in domestic currency.

Securities transactions are typically small in underdeveloped countries. From time to time, there is a most unexpected sharp acceleration of trade, however, these changes are results of speculative operations, which lead to additional markets and price volatility (Umutlu, Akdeniz, Altay-Salih 2010). Thus potential serious investors get another reason to bypass these capital markets. Over time, several experts have pointed to the negative consequences of financial repression. They presented cases of increased efficiency of asset using due to deregulation and liberalization of financial flows. Special focus is placed on the important elements of financial intermediation, such as deregulation of interest rates, reduction of reserve requirements, directed credit programs issue and interest rate ceilings. According to the advocates of liberalization, high interest rates for lenders and borrowers to introduce dynamism that is desirable in the development, which attracts a net savings and divert investment from inferior use to encourage technical improvement. High interest rates encouraged mature borrowers to seek funding rather than bank loans. The liberalization of interest rates strengthen savings and encouraged new private investment (Demir 2009).

To accelerate the development of financial markets and raise efficiency in trading securities, the state must take a stimulative policy. First of all, companies should be encouraged to collect funds through the issuance of securities, offering them legal and any other logistics until they enter the financial market, and a variety of tax relief of funds collected in this way. Moreover, the incentive must be given to potential investors, primarily through favorable tax treatment of the profit.

Demand for the securities will increase liquidity, which will, on the other hand, improve the readiness of the central bank to rediscount, and the willingness of commercial banks to accept securities as collateral for the overdraft. Finally, official surveillance of trading in the securities market is imperative if one wants stocks and bonds to become more attractive assets. The aim of the official regulation should provide full disclosure and dissemination of accurate information on companies, whose securities are traded. The ultimate effect of successful regulation should be to prevent various forms of market fraud and protect the interests of minority shareholders, as well as to encourage the development of specialized services and technology. These measures should be taken in the spirit of promoting capital markets, because regulations, which do not achieve these objectives, can actually prevent the development of capital markets.

2. Process of Financial Liberalization

In the previous section we have shown the shortcomings of the completely controlled financial system and emphasized the arguments in favor of liberalization of financial flows. Recent years in the world were marked by intense process of liberalization in the business world, which strongly affected financial transactions. Clear boundaries between the local financial markets are increasingly disappearing and the world is slowly evolved into a single global financial market. Restrictive policies that have been led by governments of developing countries, gave way to liberalization of financial market operations, which opened the way for privatization of existing banks and the creation of new domestic banks and entering of foreign financial institutions to the local markets, making the competition in this field significantly heightened.

Financial liberalization is a process, not a single event. It has two distinct dimensions: internal and external liberalization. The following table presents the elements of these two dimensions of liberalization and their specific effects on the functioning of the banking and stock market (Ameer 2003).

Table 1 The dimensions of the liberalization

		Banks	Stock Exchange
DIMENSIONS	INTERNAL	The entry of foreign banks in domestic banking market Removing ceiling interest rates ▪ Deposit interest rates ▪ Lending interest rates Reduction in reserve requirements ▪ Cash-reserve ▪ Legal requirements liquidity Reduction policy directed loans Privatization of state banks Prudential regulations for banks The scope of financial services	Opening the market to foreigners Trading systems Incentives for foreign investors Investment banks / non-bank financial institutions (NBFI) in securities Issuance of shares
	EXTER	Off-shore loans from international banks Currency convertibility	Cross listing, investment funds Mergers and acquisitions Portfolio investment Foreign direct investment

Source: Bandiera et al. (2000)

Internal liberalization is implemented due to local deregulation and reduced state involvement in direct financial operations and control of the financial flows. External liberalization is largely conditioned by the just implementation of the measures of internal liberalization and creating the conditions for entry of foreign companies on the domestic market. In addition, major measures of liberalization are: 1) macroeconomic variables, measured by trading volume of shares or cash flow, and 2) the date of liberalization. The first approach is more objective because it does not rely on the custom scheduling. Another approach relies on country reports, which provide updated information on the status of the reform program, either voluntarily or because of the demands of international financial institutions Time methodology is often used to identify when a component of liberalization adopted, then the frequency components in one year is added and is defined as an index of liberalization for the year. The table below gives the introduction of certain components of financial liberalization in the six countries (Ameer 2003).

Table 2 The dynamics of liberalization in some countries

Component liberalization	India	Indonesia	Malaysia	Pakistan	Thailand	South Korea
Deregulation of interest rates	1996	1983	1991	1995	1990	1991–93
Reduction in reserve requirements	1993	1988	1994	1993	1992	1996
The abolition of priority loans	1994	1990	1991	1995	1980	1992
Bank Privatization	–	1992	–	1991	–	1981–83
The entry of foreign banks	1993	1988	1994	1991	1995	1987
Range of banking	–	1988	–	1991	1995	1989–91
Prudential regulation	1996	1997	1989	1994	1997	1991
Opening the market shares	1986	1989	1987	1991	1988	1987
The incentives for foreigners	1992	–	–	1997	–	1992
Trading System	1992	1992	–	1997	-	–
Investing in NBFI	1992	1996	–	1997	1995	–
Issuance of capital	1992	1996	–	1996	–	–
Liberalization of exchange activity	1988	1970	1994	1994	1991	1989

Source: Laeven (2003)

It is very clear from the table that there are earlier and later liberalized countries in the sample. Indonesia, Korea and Thailand liberalized early, while Pakistan, Malaysia and India carried out liberalization later. Government intervention in the process of financial intermediation in many developing countries has been reduced, after the phase of reform, starting with the liberalization of interest rates in many countries in the sample. These measures followed a reduction in reserve requirements and opened the banking sector to foreign competition. These measures had to revive the offer of loans and ensure a better allocation in these countries. Similarly, the stock market was opened to foreigners in most countries, but incentives to increase foreign investment, as well as the installation of modern financial technology, were launched quite late in many countries in the sample (Ameer 2003).

3. Effects of Financial Liberalization by Developing Countries

The process of liberalization is often met with very diverse opinions, because there are different views and observations on successes and failures of internal and external liberalization. The concept of financial liberalization has also been targeted by critics neostructuralists (Morisset 1993), as well as modern economists, because many of the initial premises of the liberalization process, such as perfect information and perfect markets, were taken lightly by the advocates of liberalization, without further study of their reality. None of these assumptions existed in developing countries at the time of liberalization. Neostructuralists argue that the limited market has information advantage over the institution in a liberalized market, while borrowing funds and the monitoring of loans. On the other hand, supporters of the liberalization point out that the strictly controlled market is burdened with numerous restrictions and occasional shocks in the operation, so it is unable to effectively respond to requests for funds, necessary for individuals and businesses. Whose arguments are real can at best be seen through practical experience. According to the position of many prominent economists, liberalization is the cause of the recent disturbances in the money and banking crises. Liberalization has made the local economy threatened by a global infectious shock. Modern financial transactions, such as bank loans securitization, have led to credit and other risks, incurred in the business of a bank, it can easily be transferred to the buyer and the newly created securities, and thus undermine the market in which it operates. This kind of financial transactions has largely contributed to the consequences of wrong policies and credit risk of U.S. banks be felt fundamentally by the global market (Radević, Lekpek 2010). Therefore, many experts who have studied this issue say that financial liberalization has a cost in terms of increasing financial exposure. Do these attitudes and experiences of individual countries suggest that policy makers should abandon in favor of increasing liberalization of direct intervention in financial markets? Of course, the answer depends on whether the costs exceed the financial fragility of the social benefits of liberalization, as well as on whether the government can expect to design and implement regulations to correct market failures, rather than enhancing them. The answer to this question is complex and it is very difficult in a work or study to completely eliminate this dilemma. However, it is possible, using the results of some experiments, to analyze one aspect of this problem. This is primarily the question of whether financial liberalization and frequent banking crises affect economic growth through their impact on financial development. One of the most important sectors, which is directly touched by the process of liberalization is the banking sector. Many scientific studies that dealt with banking crises have become aware that there are channels of influence, through which the implementation process of liberalization may affect banking stability. This occurs for several reasons.

First, deregulation of interest rates in the initial period which leads to their significant increase. Because of the maturity gap, which is due to the process of maturity transformation, later performance can be worse, because deregulation led to an increase in funding costs of banks. At the same time, because of their long life, interest rates on loans do not adjust to that speed to market changes, which altogether leads to a significant reduction in grain yields in the bank.

Second, financial liberalization is associated with the opening of financial markets. For banks, the opening of the financial system has meant access to significant sources of funding, which could be obtained in foreign markets (Allegret et al. 2003). However, lending in foreign currencies are stable in the short term, and then placing the funds in the long run and often in a domestic, not so stable currency were the main cause embrittlement of the domestic financial system to capital outflows. Liberalisation provides great mobility of capital and elimination of obstacles to investment and withdrawal of funds. For economies that have just adapted to new rules of the game and are becoming increasingly dependent on foreign investors, changing the mood of investors has meant major upheaval and caused serious crisis. Such crises have afflicted Chile in 1981, Mexico in 1995, Southeast Asia in 1997, Turkey in 1994. The following chart clarifies the scope of the currency gap in some developing countries, considering the development of foreign activities of banks. Decline in the economy of some Asian countries on the eve of 1997, could be predicted by looking at increasing share of foreign liabilities in total liabilities.

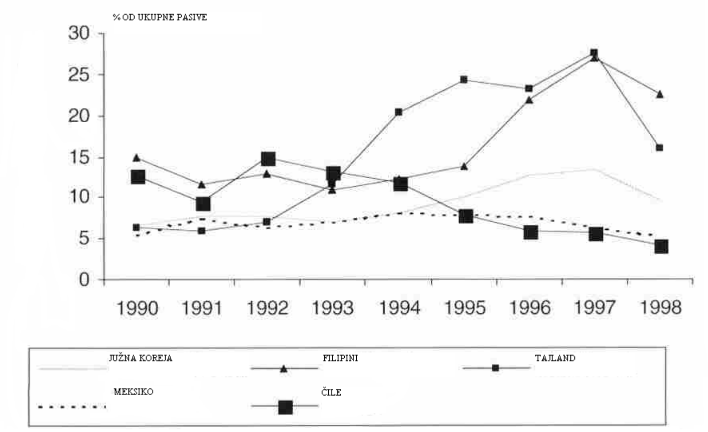

Chart 1 Ratio foreign banking liabilities to total banking liabilities
Source: IMF, International financial statistics

Third, lending process released of strict regulations and control significantly increases the number of commercial bank loans to the private sector. Chart 2 shows the increase in borrowing, that is. increasing the ratio of domestic credit to GDP.

Such an enormous increase in lending was seen by Mexican economy, with increasing ratio domestic credit to GDP by 21 percentage points between 1990 and 1994. Similar trends have appeared in many other countries, which started liberalization of financial markets, and are thus eliminated the political restrictions on commercial bank loans. This explosion of lending is only a short term solve problems that have arisen in the markets of these countries. In the long term, this phenomenon has led to increased credit risk, which banks took on themselves, which has reinforced the possibility of erosion of banking income.

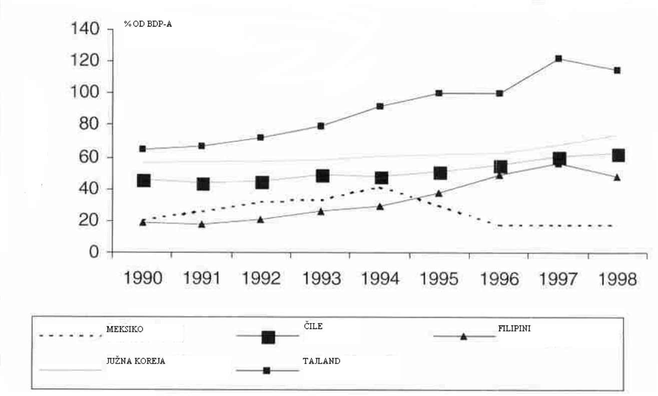

Chart 2 Lending boom
Source: IMF, International financial statistics

However, the occurrence of an explosion of credit, which many experts are often called "over-borrowing syndrome" in large part the result of the initial euphoria, the financial markets due to the transition from controlled to completely liberalized (Pill, Pradhan 1997). This phenomenon calls into question the efficiency and stability of the banking system. More specifically, the existence of government guarantees for bank deposits, causing counterproductive effect of bank stability, due to the presence of moral hazard (Allegret et al. 2003).

Any analysis of banking crises without considering the role of institutional factors would be incomplete. But, starting from the Washington Consensus, as a fundamental doctrine of global financial institutions, we come to different conclusions. Specifically, the Washington Consensus, which emphasizes liberalization as a necessary condition for global growth, has proven very often as completely inadequate for the simple reason as his agents claim that the very process of liberalization makes it unnecessary investment in the institution, which would be champions of change of the existing financial system before implementing radical reforms. It was precisely this approach that the market gives divine infallibility feature has led to the fact that the institutional vaakum created, because the former market institutions destroyed, while still not been made new, that would be replaced.

One of the main partner of developing countries in the process of liberalization has been the IMF, offering a sequential approach in the process of financial liberalization. This approach involves financial liberalization in a general program of macro-and microeconomic reforms. Accordingly, it is emphasized that macroeconomic stability is a precondition for financial liberalization. Some experts go further and argue that there are five prerequisites which must be met in order to be successful financial liberalization. These are (Allegret et al. 2003): 1) adequate prudential supervision and regulation of commercial banks, 2) a reasonable level of price stability, 3) budget discipline, which limits the negative effects of inflation tax, 4) behavior of commercial banks, in order to maximize profit, 5) the fiscal system, which is neutral on the issue of intermediary activities.

The major limitation of the sequential approach is the omission of an essential aspect of change that concerns of developing countries, and to institutional change, which underlies the process of financial liberalization. In this respect, Allegret et al. (2003) point out that financial liberalization in Asia led to destructive competition and excessive investment in some companies, because of the removal of coordination methods used by the government in economic decision-making. The financial crisis has occurred because of neglect of traditional coordination mechanisms, which existed in part planned and bank-based system of Asian capitalism, rather than because of inefficient financial supervision and regulatory capacity.

The causes of financial instability and perceptions of institutional infrastructure, which formed the basis of financial liberalization, shows how difficult it through (which exist in developing countries) and liberalization make coherent. Dominating the financial systems in most countries that joined the process of financial liberalization have been dominated by banks, ie. major role in the functioning of financial intermediation and banks have had. Thus, a centralized system would allow authorities facilitated control over economic and financial developments in the country. For this reason, many advocates of a radical approach to liberalization, they argued that the eminent role of banks is one of the major constraints in the process of liberalization of financial markets. They felt that the role of banks should be reduced so that they become just one of a wide range of stakeholders in the financial market. However, later confirmed that it was a completely wrong assumption. Blinded by the idea of a uniform approach to the development of financial flows in the country, they went from being the only copy the experience of most developed Western countries, whose market-based financial system, may be right for developing countries.

True, we have already emphasized the central role of banks, which are at the same time were under firm government control, often had a negative impact on the efficiency in the financial system and economy, because many times the economic motive remained on the sidelines when making investment decisions. These experiences, however, should not be viewed unilaterally. Many years of experience bank-centric system, which was used for decades in these countries and has become the engine of their development can not be completely dismissed as a failure. Change course need to be, but these changes should flow the other way, primarily to the abandonment of the banking system administered under strong government control, and implementation of marketization banks. it is necessary to transition from the model limited to the model bank, which is fully oriented to providing services and meeting the needs of its clients. In other words, it is strengthening the role of markets by enhancing market access to banks.

Regardless of these facts, the IMF, which largely represents the doctrine of free markets, while giving advice to developing countries, have remained completely blind to these facts, seeking abandonment of the practice, which so often has been successful and what were the needs of only some changes in order to be more successful. They still stubbornly offer, even countries that have reached a significant level of economic development, the Western form of governance, which even in economically and financially powerful and mature states, often showing their instability and lack of immunity to the crisis. Rational solution experts as a successful example rather point out Japan, which has developed a market-based bank-based system in which banks play a major role in the stabilization of financial companies, because as soon as the company sank into a crisis, the right management company switches from enterprise management to the bank, with which company work directly, and therefore emphasizes the central role of banks in the business discipline companies.

CONCLUSION

Expectations of countries that have entered the process of liberalization were to have a liberalized market, with increased competition participants and additional capabilities for collecting and placing the funds, give great impetus to economic development, most countries that have embarked on this process are directly faced with financial crisis primarily in the banking sector. There are more reasons for this phenomenon. The previous system, which was considered ineffective, based on the established institutions, laws and experiences, represented a great support. Advisors in developing countries completely neglected the need to build new institutions that would start to track changes so that the so-called "wild capitalism" occurred which had no clear rules and regulations. As a result, regulation of financial flows was left to still immature market and foreign speculators, who saw this country as an outstanding opportunity for high profits. However, these facts should not be an argument that the impact of liberalization process and to reject the favors of the concept of state-controlled financial markets. Complete state control of financial markets was proved to lead to inefficient investment, political and not economic to favor projects, as well as reduce the chances of a successful business. Liberalization that would primarily have a role to overcome the shortcomings and establish a stronger market orientation of banks, a concept that has been successfully used for decades in Japan. Liberalization is necessary but there must be a significant dose of caution regarding the pace and patterns of its implementation, not losing sight of specific countries and regions where they are committed.

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LIBERALIZACIJA FINANSIJSKIH TRŽIŠTA: ŠANSA ILI OPASNOST ZA ZEMLJE U RAZVOJU

Proces finansijske liberalizacije je stvorio ogromne profitne mogućnosti bankama i drugim finansijskim institucijama, ali i doveo do povećane rizičnosti njihovog poslovanja i brojnih bankarskih i finansijskih kriza širom sveta. Znatan broj zemalja je decenijama imao izolovanu privredu i finansijska tržišta, što je rezultiralo većom zaštićenošću od međunarodnih finansijskih potresa, ali i smanjenom efikasnošću lokalnih finansijskih tržišta. Poslednjih godina sve veći broj zemalja odlučuje se za liberalizaciju finansijskih tokova, smanjenje državnog uplitanja i otvaranje vrata stranim investitorima. Te promene su dovele do povećanih mogućnosti za privredne i finansijske subjekte, ali i do velike izloženosti riziku i učestalim pojavama kriza. U ovom radu razmatrani su različiti aspekti liberalizacije, analizirane su pozitivne i negativne strane kontrolisanog i liberalizovanog tržišta, kao i posledice institucionalnih promena na tržištima u procesu liberlizacije, a sve u cilju razrešavanja pitanja da li je liberalizacija šansa ili opasnost po finansijska tržišta zemalja u razvoju.

Ključne reči: *liberalizacija, zemlje u razvoju, bankarska kriza, kreditni bum, institutucije*.