FINANCIAL LIBERALIZATION IN THE DEVELOPING COUNTRIES: FAILURES OF THE EXPERIMENT AND THEORETICAL ANSWERS[1]

Dr. MAAZOUZ Mokhtar & Dr. ENAYATI Fatemah
maazouz@unice.fr & samira_enayati@yahoo.com
Center of macro dynamic and International Finance (CEMAFI)
University of Nice- Sophia Antipolis

Abstract :

During the 1970s and 1980s, many developing countries tried some policies of financial liberalization. Governments like those of Argentina, Chile and Uruguay released the interest rates, decreased controls on foreign capital, abolished programs of management the credits, privatized the commercial banks, and facilitated the entry of several national and foreign banks on the domestic banking market. But the results were the opposite of our expectations; these three experiments had serious problems. These countries were in a situation of financial instability in the financial as well as non-financial sectors.

Key words : Financial liberalization, Reform Policy

Introduction :

At the beginning of the 1980's, the Philippines also liberalized the interest rates and encouraged the installation of a universal banking system. The interest rates initially increased slowly. This experiment, however did not last a long time and the country passed through a serious financial crisis, due to the financial distress of the companies, political corruption and inadequate financial regulation. In the framework of the structural adjustment program launched in 1980, Turkey completely abolished controls on its financial system. Inflation passed from 100% in 1980 to 25% in 1982, and the growth rate became positive after a continuing decrease of the GNP between 1980 and 1982. Nevertheless, the substantial changes in the relative prices caused enormous difficulties for the companies. Moreover, the increase in unsuccessful financial investments in the portfolio of the banks led the later to be highly competitive on the interest rates. In addition the government intervened in 1983 by refinancing five banks which faced this major problem at a cost of the equivalent of 2,5% of GNP. The government fixed a new interest rate and set up some careful rules to control the financial institutions.

Despite all these failures in experiments of financial liberalization policies, according to some analyses the financial crises are not always directly ascribable to financial liberalization policies. According to the World Bank (1989), the financial difficulties in the majority of the developing countries had their true causes on the one hand, in the international shocks of 1980s and, on the other hand, in the economic policies interventionists directed towards the interior carried out for 30 years by the governments. In other words, the application of a discriminatory taxation to the detriment of the financial intermediates can also be regarded as a source of instability of the financial sector. Hind (1986) summarizes the reasons of the financial crises of the years 1980 in the following policies and facts: a heavy external debt followed by devaluation, local and domestic economic policies, expansionist monetary policies, an overvalued currency and financial policies concentrating the supply of credit in the hands of a limited number of borrowers. Corbo and Melo (1985) show that the phenomenon of financial distress is also the result of incompatible economic policies; in Argentina as in Uruguay, the budget deficits were enormous. In addition, Diaz Alejandro (1985) emphasizes that the problem lies mainly in the lack of confidence of the economic agents in liberalization policies.

Thus, as the difficulties faced by governments to stop these policies increase confidence in the local currency decreases and anticipation of new devaluations arises. All these last justifications indicate that financial liberalization supports the advent of financial crises, particularly for the periods of macroeconomic instability, and when the governments do not impose prudent rules on the whole of the financial system (Fry 1989). Indeed, the first followers of financial liberalization, by criticizing the negative interest rates prevalent in under developed economies, did not want to recognize that a free financial market, under some conditions, can lead to an unverifiable increase in the interest rates and cause financial crises. The revision of the "traditional" justifications by the neo-classic theorists constituted the first theoretical answer to the failure of policies of financial liberalization during the 1970s and 1980s. This revision consists of positive and normative analyses of the operation of the financial system in the developing countries. The second answer is somehow an answer to critics against the neo-classic approach of financial liberalization.

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I- The difficulties of domestic financial liberalization :

One of the insufficiencies of the traditional literature on financial liberalization is to neglect the microeconomic aspect of reforms in financial systems of developing countries (the World Bank 1989). In order to mitigate this insufficiency, certain authors moved away from the approach of "the elasticity of the interest rate" to the profit of a new "financial instruments" approach (Burkner 1980). In this new approach, according to McKinnon (1973), the problem is not related to the variation of interest rates or the rate of inflation, but rather relates to the probability of banks' bankruptcies, the risk of no refunding of the loans, the insurance of deposits, the structure of the banking market or the problems of asymmetry of information in stock markets. Within this framework where one studies exclusively the domestic financial system, the stock market constitutes the only form of studied financial intermediation.

1- The dysfunction of the stock market: a microeconomic analysis :

Two types of constraints block the competing operation of the stock market. The first are exogenic, whereas the seconds are endogenous. The exogenic constraints are primarily institutional and are often limited to the leveling off of the interest rates. But the endogenous constraints, they are inherent in the operation of the stock market. They are divided into 4 groups: problems of adverse selection and moral risk, concentration of the banking system and character of the "public good" of the financial system. The "traditional" literature on financial liberalization insisted on the elimination of the exogenic constraints in order to promote the allocative effectiveness of the capital. However, it completely neglected the endogenous constraints. Such constraints (in particular problems of information) can constitute significant barriers for effective allocation of credit, even if the exogenic constraints, like leveling off the interest rates, are eliminated.

This situation is particularly true in developing countries where capital is mainly affected by the instruments of the banking structure (the stock market). In this way, the approach “financial instruments” shows that the financial markets are obviously different from other markets and, therefore cannot be liberalized in the same manner. In other words, the representation of the stock market by conventional supply and demand curves is a debatable, starting point if necessary.

2- The question of the moral risk and the excessive rise of the interest rates :

As we mentioned before, financial liberalization in the developing countries often implies a rise of the real interest rates. Such a rise is limited in theory by two factors: the increase in banking competition and the reduction in ratio of obligatory reserves. Nevertheless, the experiments of some countries of the Southern Horn of Latin America proved that financial liberalization generates an excessive rise in the interest rates, which is the principal factor of instability in financial systems and under optimal allocation of the capital. By taking into account the specificity of the banking system operation, some authors, like Diaz Alejandro (1985) and McKinnon (1988), tried to explain this phenomenon.

They showed that the excessive rise of the interest rates is the consequence of an imprudent management of some banks, resulting itself from the moral risk problem. Indeed, the activity of financial intermediation and that of monetary creation cannot be easily separated; it is obvious that banking liability is implicitly assured. Under these conditions, a bank, seeking to increase its incomes, can be encouraged to take risks and to increase the debtor interest rate beyond the balanced interest rate, thus creating the moral risk problem. This problem of moral risk is worsened by macroeconomic instability which reinforces the interdependencies of bankruptcy.

In such circumstances, the monetary authorities, concerned with the stability of the financial system, are obliged to give up sanctioning the imprudent banks. The anticipated assistance of government takes the form of deposit insurance and consequently encourages the banking institutions to increase interest rates and to take more risks. Macroeconomic instability is presented then in the form of an additional insurance for the banks and further worsens the problem of moral risk. It results in more increases in the interest rates; several investors cannot obtain any more credit. In addition, inefficient loans constitute an increasingly significant share in the portfolio of these banks. Consequently, bankruptcies of the banks are generalized and destabilized financial systems and worsened macroeconomic instability appear.

3- Adverse selection, voluntary rationing of the credit and allocative inefficiency of the banking intermediation :

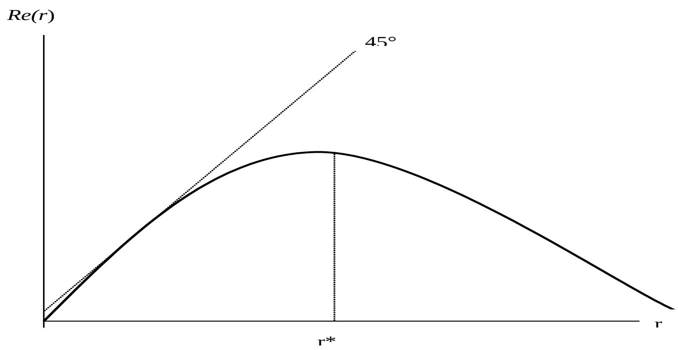
From here, we suppose the absence of moral risk in the banking structure and that all banks are managed perfectly by taking the minimum of risks. Under these conditions, even if we liberalize the banking market by dismantling the ceilings of interest rates and by ensuring free competition between the banking institutions, the allocative effectiveness of the capital cannot be improved because of the adverse selection phenomenon. We try to show here that the liberalization of interest rates does not necessarily imply the satisfaction of all the requests of the loans, nor financing of the majority of projects.

In fact, it is simplistic to think that when the ceilings of the interest rates are raised, the excess of application for credit is completely eliminated. Indeed, even if the application for credit is a decreasing function of its cost, the offer cannot increase indefinitely with the interest rate. In other words, each bank agrees to increase the credit supply only when the anticipated incomes of its loans continue to increase. Thus, in spite of interest rate liberalization, the banks voluntarily ration the supply of credit. In order to analyze the determiners of the voluntary rationing of the credit by banks, Stiglitz and Weiss discussed the theory of adverse selection. They showed that such a rationing is the consequence of adverse selection problem arising from some inciting mechanisms. As the interest rate increases, the companies are directed towards the riskiest projects. Indeed, if the interest rates are very high, the return to investment of all projects drops and the least risky projects will not be advantageous. These inciting mechanisms involve a problem called adverse selection.

The asymmetry of information is a character of stock markets, where the borrowers have an informational superiority to the lenders (banks) with regard to the profitability of their projects. The banks are conscious of the fact that each borrower has a different probability of refunding the loan and wish, to be able to identify their customers. If the banks use the interest rate as an indicator of the return on investment of the projects, they can attract only the risky borrowers who do not fear the prospect for non refunding of the credits. Under these conditions, if the actions of the borrowers can be perfectly controlled without any cost, then the interest rate can be used to evaluate the risk of each loan. However, information is neither perfect nor inexpensive.

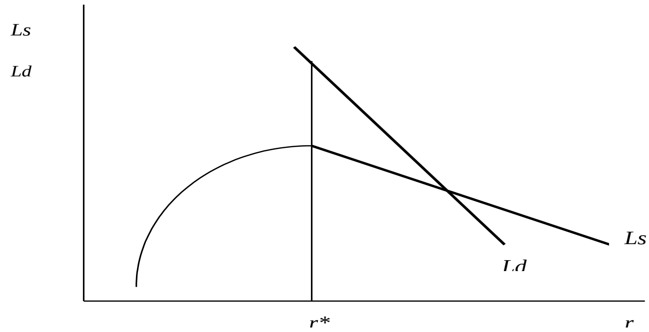
Consequently, the banking institutions are unable to distinguish the "good" from the "bad" borrowers. Therefore, the maximization of the return on investment of the bank cannot be ensured by the rise in the interest rates, but rather, by the rationing of credit. It is because of this problem of adverse selection rising from some inciting mechanisms (i.e.the investments become more risky with the rise of interest rates) that anticipated income by the bank can increase less quickly than the interest rate: beyond a certain rate R*, it starts to decrease *(figure 3 .1).* On the top of *R**, any increase in the interest rate is insufficient to compensate for the losses of the bank resulting from the insolvency of borrowers.

Figure 3.1 : Interest rate and income anticipation of bank



Under these conditions, if the interest rate which equalizes supply and demand on the credit market is higher than the rate which maximizes the anticipated income of the bank *R**, the banking institutions will be obliged to ration the credit. F*igure (3.2*) illustrates this situation, where *LS* is the supply of loans, Ld is the demand, *R** is the balanced interest rate which maximizes the anticipated income of the bank, and where *EPD* represents the surplus demand for loans which appears in the situation of balance.

Figure 3.2. : The voluntary rationing of credit in imperfect information case.



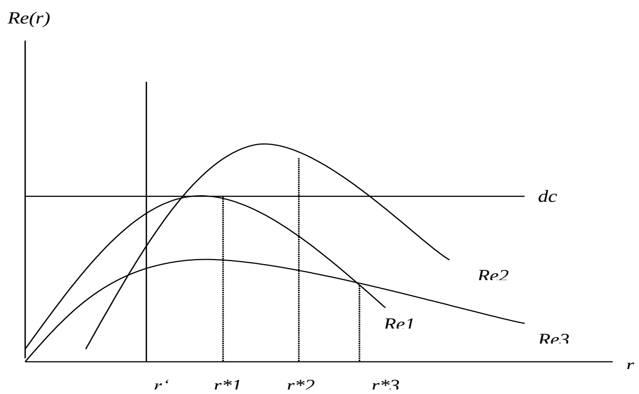
The bank refuses to grant credit to an individual willing to pay an interest rate higher than *R** because it judges that this loan is riskier than those which were granted at the *R** rate.

"The credit rationing of the thus appears as a rational behavior of the lenders when the costs of information are high". Under such conditions, even if a surplus demand for loans emerges, a lender maximizing his anticipated income finds it more advantageous to ration the credit than to increase the interest rate. In this case, the anticipated return on investment of the excluded projects can exceed those projects obtaining the loans.

Consequently, credit will be badly affected. Let's suppose that the banks can distinguish between various groups from borrowers, but not between the borrowers within the same group. In this situation of incomplete information, the banks require the payment of an identical interest rate for similar borrowers (pertaining to the same group). At this interest rate, the investors of the same group choose to borrow or not. Among those who decide to borrow, one finds the investors characterized by a significant risk. When the number of risky projects is high within the group, the banks are unable to differentiate the borrowers and receive only a low return compared to the anticipated return of the projects. The difference between the output of the bank and the average output of the projects in the group widens as the information of the bank concerning the borrowers is insufficient.

Consequently, even if a group presents investment opportunities higher than those of another group, it can generate for the bank a weaker anticipated output and consequently be excluded from the loan. This idea is illustrated in *figure (3.3)* where the anticipated output of bank R^e in each of these three groups of borrowers is a function of the debtor interest rate (r). The most productive borrowers are those of group 3, and the least productive are those of group 1. Let's suppose that the government fixes a debtor interest rate in r' (see figure 3.3) and also limits the credit supply. Only some borrowers of group 1 (the group whose projects generate a lower productivity) will be able to obtain credit. If the levelling off is eliminated, the preferences of the bank will go initially to group 2, then to group 1 and group3. The allocation of the credit is then improved even if it remains less than optimal. Indeed, although this allocation of credit is higher than the one corresponding to the situation of financial repression, it is not therefore optimal because it excludes the most productive projects (group 3) from the loan. As an example, if the credit interest rate of the market is at the level of dc, the loans are granted for all the investors of group 2 and some investors of group 1, whereas the members of group 3, having the most productive projects, are completely excluded.

Figure 3.3. : The allocation inefficiency of the banking intermediation



In a situation of incomplete information, the abolition of the ceilings of interest rates is not a sufficient condition to achieve an optimal allocation of funds.

4- **The “oligopolistic” structure of banking system in developing countries** :

Galbis (1986) stressed another type of constraint in domestic financial liberalization, namely the oligopolistic structure of the financial markets in the developing countries. It admits that, in the majority these countries, the banks are organized within the framework of qualified special institutional structures of banking holdings.

However, contrary to the situation in the United States, such institutional forms are rather informal in the developing countries and their name of “banking holdings” is little applied. The presence of these structures in the developing countries was noted mainly in a specialized literature which is interested in a general form of industrial organization and is commonly known under the name of "group". This phenomenon of “banking holding,” is added as another characteristic of the financial markets in the developing countries, namely their concentration. In fact, the financial institutions (banking) attached to the groups have tendency, in the absence of adapted regulations, to be integrated in a horizontal way. This tendency to horizontal consolidation is explained particularly by financial institutions’ overdebedtness, translated by high ratios of debt/bonds. Under these conditions, it would be relatively easy for an individual who controls a financial institution, but is the owner of only one small fraction of the total resources, to use these resources of this institution to control other institutions. By repeating this process, he could possibly manage to control the totality of the financial system, even if such behavior can be limited as soon as several physical people simultaneously desire to control more financial institutions. The widening of concentration in the financial sector (banking) being added to the structure of the banking holding establishes the bases of a oligopolistic behavior in the financial sector.

According to the theory of oligopolistic competition, this form of market structure led to two extreme and undesirable solutions: ineffective collusion; and unstable prices, involving a bad allocation of financial resources (Clark 1988) and a reduction of quality and availability of the financial services (Spierings 1990). Collusion is usually the typical solution chosen by the companies of banking holdings. That is particularly true when they claim financial interventionist’s policies such as the leveling of the interest rates in order to grant credit to the companies and affiliated subsidized loans and consequently, to collect oligopolistic profits. By choosing this collusion solution, the holdings thus do not seek to increase the oligopolistic profits of the financial institutions (increase the banking margins), always lower than the profits obtained in the productive sphere.

Nevertheless, when the financial sector is liberalized, a price war between the banking holdings is the most probable solution. Competition between these holdings to attract the most possible funds can lead, as in the countries of Latin America during the 1970s, to an immoral rise in the interest rates. According to Galbis (1986), competition between the banking holdings constitutes a plausible justification of the rise of the interest rates over the long period (several years), contrary to the justifications in terms of inflationary anticipations and macroeconomic instability, whose explanatory capacity is limited to a short term horizon (the initial period of the reform). Thus, the persistence of high interest rates in a liberalized financial sector can be explained by the existence of banking holding companies (groups), which emerge often following a movement of denationalization affecting the financial institutions as well as the companies of the productive sector.

Under these conditions, the maintenance of the high real interest rates, for example in Chile during the 1970s, can contribute to bankruptcy in broad segments of the industrial sector narrowly integrated within banking holdings and consequently involve the proliferation of insolvent loans and a quasi generalized instability of financial system.

5- **The character of public good in the financial system and the problem of negative externalities :**

The asymmetry of information on the stock market and the oligopolistic structure of banking environment, analyzed above, constitute a particular aspect of the negative externalities generated by the liberalization of the banking structure. This observation rises from a current theory which considers the financial system as a public good and which the use of a common currency like Unit of Account and means of exchange generates significant positive externalities (Tobin 1985, Diaz Alejandro 1985). Thus the government should specify the characteristics of the Unit of Account in the common national currency and organize the activity of financial intermediation. Or else, the positive externalities can disappear following failures from a component or from the financial system totally. Particularly, the instability of the banking structure constitutes a negative externality of the financial system and an obstacle for the effective operation of the banking market. According to Park (1991), this instability is the result of two phenomena suitable for the operation of a banking market :

- The first is associated to the banking activity for transformation of financial assets. Indeed, when a bank is obliged to transform an illiquid credit into a liquid liability, it can be exposed to crises of liquidity particularly resulting from the behavior of race to the deposits. Moreover, when the failure of a bank can involve the failure of other banks, this negative externality can just spread.
- The second phenomenon of the instability of the banking structure is attached to the technology of intermediation which requires only one relatively weak physical or financial capital. The natural barriers at the entry being reduced, the capacity to lend thus constitutes the only condition required to enter banking activities (Greenbaum and Higgins 1983). This facility at the entry, also at the exit, is an additional source of undesirable externalities. It implies frequent adjustments of the banking output which can result in breaches of contract. Moreover, such adjustments are more disturbing than the adjustments which are done within the framework of a stable banking structure, characterized by entries of new and little frequent firms.

a) Problems of macroeconomic instability :

It is commonly known that price stability and macroeconomic stability is the pivot of success in financial liberalization (McKinnon 1989, Cho and Khatkhate 1989). Indeed, the instability of prices and the level of activity increases financial fragility, creates a situation of uncertainty , increases interest rates and shortens the temporal horizon (Akyüz 1994). Macroeconomic stability itself is influenced by the financial policy (difficulty in determination of a suitable interest rate), but monetary and budgetary discipline does not remain less crucial. Thus in an inflationary environment, it is harmful to liberalize the financial system and it is necessary to reduce the budget deficit and to control the money supply. If these conditions are not met, financial reform will then be doomed to failure.

b) Inflation and perverse effects of financial liberalization :

The inflation acceleration involves an immediate orientation of the financial sector towards liberalization. Indeed, financial repression worsens the social costs of inflation, whereas financial liberalization lets the financial sector improve its intermediation task and compensate the costs of inflation (Dornbusch and Reynoso 1993). In the event of no liberalization, the costs are certainly significant (capital flows), but the alternative of liberalization can be also perilous. One of the perverse consequences of financial liberalization consists in the fall in banking deposits and particularly, in the development of the monetary market.

Under these conditions, the monetary base (the demand for currency) is reduced, and especially governments will be obliged, in the countries in the first phases of stabilization, to quickly increase the monetary financing of their budget deficits. Indeed, in this situation, governments often wish to preserve the same level of seignorrage or are unable to reduce instantaneously their budget deficits (Adam 1995). Thus, financial liberalization worsens inflation unless it is accompanied by a budgetary discipline. In other words, a period of strong inflation and budgetary crisis is incompatible with the implementation of a financial liberalization.

b) Budgetary discipline and the monetary policy :

Budgetary discipline and monetary stability are two interdependent phenomena. Also, in the situation of controlled budgetary skids, the installation of a successful monetary policy becomes feasible (Fry 1988). In the majority of industrialized countries, the central Banks choose open market operations as the indirect instrument of monetary control. However, such markets are quasi non-existent in the developing countries where monetary control is exerted rather through rediscount mechanisms and control of the obligatory reserves. Generally, the central Banks of the developing countries use their means of rediscount to support the policies of directed or selected credit. Hence, the mechanisms of rediscount cannot play the role of an instrument for controlling the increase of the money supply. In addition, even if such mechanisms are used for monetary control objectives, they are not effective. Indeed, instead of establishing a rediscount rate and satisfying the banks' demands at this fixed rate, the central Banks fix the rediscount rate lower than the market rate and consequently, ration the excess of application for credit. A more effective control can however be reached by fixing the volume of rediscounted credits. The fixed demand and supply of these credits will then be balanced by the means of the market interest rate.

Budgetary discipline and monetary control, being the two principal instruments of the stabilization policy, must intervene before starting liberalization policies (McKinnon 1991). Indeed, the simultaneous application of two types of reform proves to be expensive at the economic level as well as political (Edwards 1986). However, even if the developing countries can ensure price stability while following budgetary discipline and by adopting an adequate monetary policy, this stability can be caused by policies of incoherent exchange rates or simply by external shocks.

Generally, the majority of the developing countries encounter significant deficits of their payment balances which are metamorphosed in an inflationary period. In this context, a premature and complete opening of a capital account worsens the situation more and endangers the advantages of internal financial liberalization.

II- The difficulties of external financial liberalization :

Among all the developing countries, only the countries of the Southern horn of Latin America have tried out external financial liberalization policies. For exemple, Latin American three countries of the , known for their restrictive controls on the movements of capital, chose to give them up. Uruguay started to do so in 1974 even before liberalizing its domestic financial system. Argentina liberalized its capital account at the time of its domestic financial reforms of 1977. As for Chile, it started external financial liberalization five years after the release of the process for domestic financial deregulation. For multiple reasons, all these experiments resulted in considerable failures which were blamed on the feasibility of the financial opening. These experiments taught the difficulties of external liberalization to the partisans of financial liberalization. Such difficulties being added to the structural problems can even waste the advantages of domestic financial liberalization and lead the country towards a durable economic recession.

1- External shocks :

The neo-classic theory teaches us that a complete movement's capital liberalization by a country which succeeded in stabilizing its economy is completely beneficial. In this case, there would be neither escapes nor massive entrance of capital. On the one hand, the capital outflows encourage their entries and, on the other hand, the phenomenon of massive entries of capital will be obviously reduced if the country adopts monetary policies, coherent interest rates and exchange rates. However, the 1970s arose as the least favorable period for a liberalization of capital movements in the developing countries. In this period, international liquidity was abundant following the two consecutive oil crises of 1973 and 1979 and so the external opening which happened afterwards translated into massive entries of capital. This phenomenon caused two major problems, namely external overindebtness and the capital flight.

a) External overindebtness :

During the 1970s, the international response to external liberalization in some developing countries was immediate and braod. The relative rise of real interest rates in these countries, as consequence of a internal financial liberalization and of the fall in the interest rates in the industrialized countries (in particular in the United States), attracted considerable flows of foreign capital. The financing by obligations, the loans granted by foreign banks, foreign direct investment and official loans constitute alternative modes of capital entries. However, during the 1970s, the loans coming from foreign trade banks seemed to dominate the shape of capital entries in the developing countries, also contributing to their external overindebtness. External overindebtness resulting from financial opening can be explained by an alternate mechanism.

According to Cottani and Covallo (1993), when the budget deficit is significant, the liberalization of capital movements, by reducing domestic demand currency and by limiting the capacity of the government to collect inflationary tax, thus encourages the government to borrow from outside. Under these conditions, even if the budget deficit can be financed by the emission of the public fund, the entries of private capital will be stimulated and foreign debt will be worsened following a rise in the interest rates. In addition, some distortions on the international capital market can inform us about the problem of excessive foreign debt. On the one hand, by considering the risk of insolvency of a private borrower as an increasing function of country debt to which it belongs, the international **backers** are incited to grant funds to the least indebted countries, thus supporting their indebtness.

In addition, as the governments guarantee the solvency of the private debtors implicitly, flows of external debt develop. However, the massive entries of capital in the short term, in the form of foreign loans, cause fluctuations in the exchange rate (initially the appreciation of domestic currency, then its depreciation) and worsen with the problem of foreign debt. Indeed, the debt makes some difficulties for the State budget and even the domestic financial system. On the other hand, when the government accumulates reserves in the form of foreign debt, the currency value will increase and the budgetary cost of debt servicing will be reduced. This increase encourages the banks to offer loans and to collect deposits made out in dollars. Under these conditions, if the external problems appear (i.e.,worsen the deficit in balance of payments), the government refuses to adjust the exchange rate (devaluation) immediately in order to preserve the profits resulting from the increasing value of currency. But, with the stressing of the crisis, the government should assume its own costs as well as those of the domestic private sector. It results in higher inflation and less monetary stability.

b) Capital flight

According to Diaz Alejandro (1985), the massive entries of capital, by immediately involving a significant appreciation of the domestic currency, can only reduce the confidence of the public, in the capacity of the government to control exchange rates and worsen the problem of capital flight. In addition, the negative shocks, the fall in principal exportable good price, the rise in principal importable good price, the increase in international interest rates, or the increase in the taxes affecting the output resulting from entries of capital can encourage the foreign investors to leave their capital in these countries. That results in a fall of the general price index, a fall in exchange reserves, an increase in the domestic interest rates, and/or a depreciation of the domestic currency. All these price movements support the uncertainty of the investors and discourage domestic investment as well as foreign investment.

In the same way, these movements can be harmful for the whole of the economy if the interest rates, the price credits and exchange rates fluctuate enormously by involving the instability of the financial system (banking bankruptcies and hysteric effects). In order to face this problem of capital flight, some countries like Uruguay, Peru, Argentina and Mexico encouraged polarization while allowing the commercial banks and the nonbanking financial institutions to grant funds and to collect deposits made out in dollars.

It is true that polarization initially aims to prevent against capital flight. However, after a few years, it undoubtedly becomes a principal source of instability (Cottani and Cavallo 1993). Indeed, by exposing the financial system to the excessive risks of the exchange rate (appreciation), polarization delays the necessary adjustments of this rate. If the government finally decides to intervene, it faces a heavy task which consists in reducing the budget deficit to compensate the losers among the depositors, and also to protect the solvency of the financial institutions and to rebuild the credibility of the monetary policy.

Capital flight and external overindebtness one are the direct consequences of the financial opening in the developing countries in a destabilized international context (external shocks). In both cases, the principal reason lies in currency appreciation following the massive and temporary entries of foreign capital. It is important to specify that during the 1990s, the most manifest problem of liberalization capital movements lay in the increase of capital entries in the form of foreign direct investments or of financing by obligations. However, this capital is less harmful than the external overindebtness by causing intense financial crises such as the last Mexican crisis (Corbo and Fernandez 1996).

III : The optimal scheduling of financial reform :

1- Economic analyses of an optimal and sequential nature of the reforms :

Partisans of financial liberalization attributed the failure of financial reforms at the beginning of the 1980's not only to the basic recommendations of McKinnon and Shaw and their disciples, but rather to the order in which measurements of liberalization had been applied. Thus, the optimal chronological sequence of liberalization became the first anxiety for this idea which seeks to fill a vacuum in the literature of financial liberalization (traditional and new), which implicitly recommends the simultaneous application of all the financial reforms. On the basis of the analyses of Lipsey and Lancaster (1956), showing that as long as there are some distortions on other market, the elimination of the distortions in one market inevitably do not improve welfare. Hence, partisans of the optimal sequential order try to establish a second level optimum. That means to find a gradual program of optimal routing of financial reforms which will be able to minimize the costs of welfare.

In other words, from a theoretical point of view, the literature of optimal sequential order of reforms tries, to fill a vacuum concerning the study of deregulation effects in a context of imbalance. Actually, the new theory faces two challenges: in addition to the establishment of order between the commercial and financial reforms, it is a question of defining the necessary sequences within each reform and also their rate/rhythm of application (slow or fast). Still, the literature has not dealt with this last problem.

As an example, according to the World Bank report (1989), the passage of a reform 1 to a reform 2 is often justified by a good advance of reform 1, without more precise details. The majority of the authors, with rare exceptions (Lal 1987), agree on the existence of four great sequences in the process of liberalization. It is generally shown that in a stabilized economy, domestic financial liberalization (sequence2) must follow domestic real liberalization (sequence1) and precede liberalization of foreign trade (sequence3), like that of the capital movements (sequence4). Table (3.2) summarizes the reforms of liberalization of the various sectors : the figure in each box indicates the order of reforms recommended by the majority of authors (Edwards 1986, 1990; McKinnon 1982, 1991b; Krueger 1986).

Secteur	***Domestic***	***Extern***
Real	*- stability-oriented policy* *- liberalization of prices* *-elimination of implicit and explicit taxes and subsidies* *- privatization* ***1***	*-liberalization of current transactions (raised trade barriers)* *-creation of foreign currency exchange market and currency convertibility.* ***3***
Financial	banking privatization and structure domestic *- restructuration /privatization of the domestic bank system* *- création /réactivation of the money market* ***2***	*- control elimination on capital mouvement* *-total currency convertibility* ***4***

2- The problem of causality between sequence 2 and sequence 3 :

If there is a great controversy around the order of stabilization policies and liberalization of the foreign trade (Funke 1993), the direction of causality between the latter and domestic financial liberalization is not less clear. On the one hand, if a country liberalizes the domestic financial sector before the foreign trade sector, then the credits will be forwarded to the sector of exchangeable goods which are advantageous only because of the maintenance of trade barriers (as for industries of substitution for the imports). In the opposite case, when the foreign trade sector is liberalized before the financial sector and when price distortions are eliminated, domestic industry, in lack of necessary financial resources, is probably unable to keep up with competition on the international markets. Therefore its collapse is certain (McKinnon 1991b).

Reconciling the two points of view, the world development report affirms that there is not only one optimal way of commercial reform, and also this way depends largely on the economic conditions which characterize each country (the World Bank 1987). In all cases, it is necessary for commercial liberalization to be compatible with the balance of current accounts (Michaely 1986).

3- The liberalization of capital movements :

The liberalization of capital movements, known as the ultimate sequence of a total financial reform, and is the consensus object among the authors studied. If the process of external financial liberalization is started, while the domestic interest rates are lower than international levels, significant escape of capital is expected.

Moreover, the banks can enter in to competition with the foreign banks with difficulty; they are subjected to a panoply of controls and regulations which increase the costs of intermediation. Consequently, internal financial liberalization is presented as a precondition to external financial liberalization. Moreover, external liberalization without the complete stabilization of the economy is likely to generate entries of capital in the short term and make stabilization more difficult.

III- The limits of the new approach to financial liberalization :

At the end of reviewing the new analysis of financial liberalization, we can only realize the complexity of the financial reforms and appreciate the distress in which the literature was specialized. From a microeconomic point of view, we noted all the problems of information which characterize the banking markets, as well as the difficulties of controlling the financial system. From a macroeconomic point of view, the recommendations are often rather fuzzy and sometimes simplistic; we recommend coherence among various economic policies which sometimes present conflicting objectives. Realizing these difficulties, some more pragmatic authors focused on the problem of the chronological order of the reforms. However, this new aspect of the literature did not improve the state of the new approach, particularly with regard to fixing a precise calendar for all the reforms. Also, such an aspect of the literature discusses the basic arguments of financial liberalization considered before merely as a strategy of development.

Indeed, when the new literature insists on the importance of the stability and the maturity of the economy before financial liberalization, the latter becomes an indicator and not an engine for development (Fanelli and Frenkel 1994). Thus current work has moved away from the fundamental work of McKinnon (1973) and Shaw (1973) while being to some extent devoted to determining the methods of a financial system management with a view to development. In other words, defining the economic conditions preliminary to financial liberalization. Consequently it becomes an extremely expensive luxury for the unstable countries. Moreover, if we consider the fact that the financial markets function in an imperfect way (Stiglitz and Weiss 1981), it seems not very probable that the optimal sequential order can eliminate this imperfection (Grabel 1994). From another aspect, some recommendations of this school of thought have become null, particularly in regard to external liberalization (ultimate sequence of liberalization).

Indeed, during the 1990s, the fear of external opening did not lie in the massive entries of capital, but rather in the deficiency thereof and the capital flight. Today, governments fear that the strict control of the outflows of capital will be responsible for a reduction in capital entries. The dynamic model of Bacchetta (1992) confirms these fears while evaluating the recommendations about the literature of the optimal sequential order particularly relating to the idea of gradualism. It was shown that in the long run, sequential implementation of the internal and external financial reforms, in a small open economy, leads inevitably to capital flight. However, in the opposite case of the simultaneous application of the two reforms, such a result seems much more mitigated; capital flight in the long term can probably be avoided and investment opportunities in the country become significant for foreign investors.

The role of the State in this literature also remains the subject of controversy. Some pioneer authors of the financial liberalization literature admitted the need for the intervention of the State in the financial system, but only in the event of macroeconomic instability.

Lastly, some more pragmatic specialists support the idea of a compromise between market and State in order to ensure, develop and stabilize the financial markets. Indeed, until now all the empirical studies did not draw the systematic statistical regularities in spite of the many experiments covered.

Whatever the country or continent or the various applied techniques, the results are at best ambiguous (Souissi, Martin and Decaluwe 1994). The often evoked reasons related to errors of specification in the various equations, of which the most significant resides in the significant number of the omitted variables (Gibson and Tskalatos 1994). Also, Giovannini (1985), DeMelo and Tybout (1986), Gupta (1987), Snowden (1987), Cho and Khatkhate (1990) and Warman and Thitlwall (1994) hardly find positive correlation between the interest rate and the total savings or the investment. As a result, the complementarities hypothesis of McKinnon (conduit effect) for example, called into question again. In addition, Dornbusch and Roynoso (1993) moderate the results which confirm the existence of a positive effect of the financial development (financiarisation) on the economic growth.

In sum, the various empirical verifications relating to the impact of financial liberalization on savings, investment and growth are evaluated more than ever. Today, many authors wonder about the validity of the new approach of liberalization which moved away from its theoretical aspect of the 1970s to become more pragmatic. Some authors, like Hergli and Belhareth (1993), think that the safety of financial liberalization theory probably lies in the reformulation of its three conventional bases, namely

- The positive effect of the financialization on development;
- Strong positive elasticity in the interest rate and savings;
- Perfect complementarities between monetary cashing and investment. The reformulation of such a hypothesis reduces their reductionist character while adapting them to realities of the under developed economies. The Recent work of Burkett and Vogel (1992) and Morisset (1993) goes in this direction while trying to moderate certain results of the hypothesis of the financial liberalization theory; thus, the new approach of financial liberalization is still quite far from being able to propose the final necessary therapy to the stability and development of the financial system. The last Mexican financial crisis in 1994 or Asian crisis in 1997 and 2000 are an illustration.

Conclusion :

In this paper, we have tried to study all the economic analyses which on the subject of financial liberalization. Theoretical justifications and their criticism are also presented. However, although they are significant in our opinion, these analyses often remain insufficiently normative. Indeed, even at the end of this study, we are unable to clearly understand why many developing countries well established one or those in the process of being established are turning to financial liberalization policies, on the one hand, and why some experiments failed and others succeeded, on the other hand. We have tried to note that the authors of these analyses were satisfied to criticize or justify the application of these reforms while bases themselves on the usual criteria of economic effectiveness and of growth and without seeking to explain the determinants of that adoption from financial reforms in developing countries. In addition, according to these reforms, the political component of their determinants was completely neglected; the normative analysis was limited to a narrow framework aiming to approve or disapprove the intervention of the State in the financial sphere. However, is it possible to believe that the governments simply seek economic benefit associated with such policies ?

The response in the affirmative seems unsatisfactory, particularly in the absence of a broad consensus on the economic merits of financial liberalization and with the proliferation of failures in many experiments. On the other hand, McKinnon (1989), the head of liberalization partisans, even implied that the adoption and success of these policies, in spite of the theoretical justifications, have been reduced to a question of political will. That lets us think that the determinants of the implementation of financial liberalization programs are economic and political as well. And from the start, an economic analysis policy seems to be inevitable to compensate for the insufficiencies of normative analyses.

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