Financial Liberalization: Benefits, Risks and Country Experiences

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What Is Financial Liberalization?

- **Financial Liberalization is the process of reducing legal controls on capital movements in and out of a country**:
  - Foreign investors access to domestic assets and markets, reflected in capital inflows:
  - Domestic borrowers and investors being able to use international financial markets to borrow and save, reflected in capital outflows

- **Different from Financial Integration, which is the actual increase in capital movements**
  - Liberalization is a pre-condition for integration

- **Financial liberalization includes different types of flows**
  - Banking
  - Portfolio (equity and bonds, sovereign and corporate)
  - Foreign direct investment or FDI (greenfield and acquisitions)

Financial Liberalization: Benefits

- **Classic arguments supporting financial liberalization**
  - Capital-scarce emerging economies would receive capital inflows
  - Foreign financing augments domestic funds
  - Lower cost of capital, higher investment and growth
  - Better risk diversification and consumption smoothing

- **Other Indirect Effects**
  - Financial sector development
    - New financing instruments, improved regulations
    - Technological advances
  - Better institutions and macroeconomic policies
    - Competition for flows
    - Foreign investors have disciplining effect
  - Better firm governance

Financial Liberalization: Benefits – Empirical Evidence

- **Entry of Foreign Banks**
  - Increased competition, lowering costs across the board
  - Foreign banks are more efficient
  - But, evidence of "cherry picking"
    - Not necessarily bad – domestic banks could focus on smaller borrowers

- **Domestic Capital Market Liberalization**
  - Entry of foreign investors can reduce financial constraints
  - Firms increase investment and growth
  - Equity market liberalizations can lead to 1% increase annual economic growth (Bekaert et al., 2005)

Financial Liberalization: Benefits – Empirical Evidence

- **Capital Market Internationalization for Firms**
  - International finance can be cheaper and countercyclical
  - Support for “bonding hypothesis”
    - Better governance, improved reporting standards, media attention for international issuers
  - International issuers outperform non-issuers
  - But only large, well-known firms can go abroad
  - Migration of trading can negatively affect domestic markets

- **FDI Liberalization**
  - Can generate productivity spillovers
    - Vertical and horizontal linkages
  - More stable than other flows

Financial Liberalization: Risks

- **Countries face market discipline by domestic and foreign investors**
  - Foreign investors' beliefs concerns become important

- **Increased Risk of Crises**
  - Sudden stops
    - Can lead to large drops in GDP
  - Speculative attacks on the currency
    - Can lead to banking crises if maturity mismatches
  - Not always triggered by poor fundamentals
    - Irrational behavior and self-fulfilling prophecies
    - Exacerbated by herding and momentum trading

Financial Liberalization: Risks

- **Vulnerability to Contagion**
  - Increased financial links
    - E.g., portfolio rebalancing, margin calls, wealth effects, risk aversion

- **Vulnerability to Global Factors**
  - Change in global economic conditions can cause sudden shifts in foreign capital flows and lead to downturns
  - Changes in interest rates in developed countries
    - E.g., current debate about policy normalization in the U.S.

- **Examples of Financial Crises in recent History**
  - Mexico 1994, Asian Financial Crisis 1997, Russia, 1998, Argentina 2001, 2018-19, Turkey 2001, 2018, Global Financial Crisis 2008-09

Experiences with Financial Liberalization

- Different regions, different styles of liberalization
  - **Latin America in the 1990s**
    - Full-fledged in short-period of time
  - **Eastern Europe post Soviet fall**
    - Fast with institutional reforms
  - **East Asia before and after Asian Financial Crisis**
    - Before crisis: rapid, no reforms
    - After crisis: some controls and reforms
  - **China**
    - Slow, gradual opening with reforms

- Details of each type included in Annex

Experiences with Financial Liberalization

- **Rapid Financial Liberalization Typically Unsuccessful**
  - Initial inflows and high growth followed by outflows and crises
  - Reversals associated with large depreciations and output fall
  - Sudden stops in Latin America and Asian Financial Crisis

- **Most successful experiences include gradual approach and reforms**
  - Liberalize more stable flows first
  - Gradual opening to foreign investors
  - Strengthen financial regulation first
  - Macroeconomic reforms (fiscal discipline, independent monetary policy, flexible exchange rates, trade integration)

Discussion

- **What are the Net Effects of Financial Liberalization?**

  - No robust evidence that liberalization supports growth
    - Finer analyses tend to find positive effect
    - Net growth effect could be 1% annual (Ranciere et al., 2006)

  - **Composition of Inflows is Important**
    - FDI and equity seem more beneficial than debt

  - More indirect benefits might be important but hard to measure

  - **Threshold Effects**
    - Benefits might accrue after a certain level of development has been reached

Discussion

- **IMF's new Institutional View on Liberalization**
  - **Sequence of liberalization**
    - Full liberalization might not always be optimal
    - Liberalize more stable flows first
    - Liberalization coupled with supporting macroeconomic reforms
  - **Capital controls could be helpful in some circumstances**
    - Respond to large inflows or outflows rapidly affecting economic conditions
    - Part of a broader policy package
    - Controls need to be transparent, targeted, temporary, and non-discriminatory

The Case of Vietnam

- **Substantial Capital inflows in the Form of FDI since 2015,** while commendable, there is a need to strengthen the linkages with the domestic private sector with FDI.

- **Portfolio inflows/outflows constrained.** Potential new sources of stable capital investment to support development through global institutional investors (pensions funds and Insurance).

- **The Reform Vision for Financial Sector Reforms in Vietnam**

- Banking Sector: **Development Strategy of Vietnam Banking Sector Strategy 2025 with a view to 2030** sets out the vision for the banking sector in Vietnam.

- Capital Markets: Prime Minister's decision No. 242 of February 28, 2019 "**Restructuring securities and insurance markets by 2020 and vision to 2025**."

Thank you!

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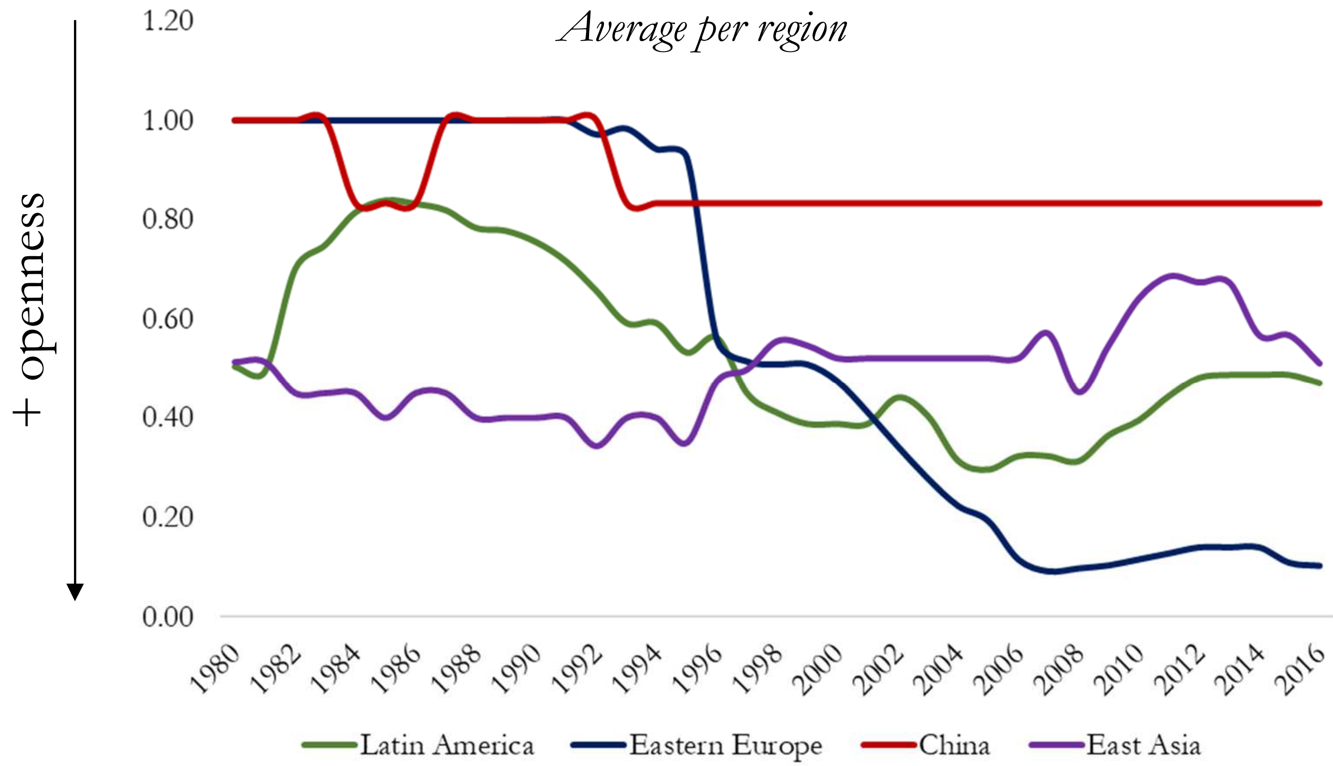
Annex:
Case Studies of Financial Liberalization

Case Studies

- Financial liberalization experiences provide insights on benefits and how to mitigate risks
  - Latin America in the 1990s
  - Eastern Europe post Soviet fall
  - East Asia before and after the Asian Financial Crisis
  - China's liberalization process

Chinn-Ito Financial Openness Index, 1980-2016

Average per region



Latin America in the 1990s

- Very fast financial liberalization
  - From external finance rationing (1980s) to abundant inflows (1990s)

- Initially, improved economic performance
  - High growth
  - Currency and price stability due to appreciation and reserve accumulation

Latin America in the 1990s

- But instability soon ensued
  - Current account deficits increased financial fragility
    - Aggravated by predominance of short-term of flows
    - Boom and boost cycles
    - Reversals associated with large devaluations and output decline

  - Crises exacerbated by lack of adequate institutional framework
    - Liberalization before structural reforms were in place
    - Weak financial regulations
    - Macroeconomic policy not ready to lead with volatile flows

  - Lack of experience with liberalization
    - Heavy reliance on foreign capital to finance consumption booms
    - Currency and maturity mismatches

Eastern Europe Post Soviet Fall

- Rapid liberalization
  - Similar to Latin American experience

- But process has been less crisis-prone
  - Anticipating accession to EU, reforms implemented in parallel to regulatory and supervisory reforms based on EU standards
  - Future EU membership anchored expectations
  - Not "all at once"
    - FDI liberalized before portfolio flows
    - Inflows liberalized before outflows
    - Long-term flows liberalized before short-term
  - Adoption of euro avoided currency crises
  - Access to Europe's financial system and lender of last resort

Eastern Europe Post Soviet Fall

- This is not to say that there were no crises

- Initially, liberalization led to widespread banking crises
  - No expertise in managing private, open banking sector
  - Unsuitable privatizations
  - Lax licensing practices
  - Weak supervision

- In 2000s, heavy reliance in borrowing from European banks, which led to significant contractions after the global financial crisis

- After series of crises, deeper reforms have led to modern and robust banking systems

East Asia Before and After the Asian Financial Crisis

- Steady liberalization during in 1980s and 1990s

- “Disorderly” process
  - Inadequate regulation and supervision
  - Lack of transparency and accountability
  - “Crony capitalism”
  - Market imperfections

- Uncontrolled financial liberalization led to Asian Financial Crisis
  - Large inflows during early 1990s inefficiently allocated
  - Bad investments and currency mismatches caused banking and currency crises

East Asia Before and After the Asian Financial Crisis

- After crisis, more prudent approach to liberalization
  - Introduced controls that were subsequently relaxed
  - Economic and financial reforms
    - Flexible exchange rates and reserves accumulation
    - Domestic market development
    - Improved financial regulation and supervision
    - Regional cooperation initiatives (ABMI, ASEAN)

- Although liberalization resumed, temporary controls during crises
  - E.g., 2007-08 Global Financial Crisis

China's Liberalization Process

- Slow liberalization
  - First establish market, then regulate, then open
  - Economic transformation started in 1978 and is still ongoing

- Banking sector
  - 1980s: Commercial lending through four state banks
  - 1990s: New commercial banks start operations
  - 2001: WTO accession – commitment to remove restrictions
    - By 2006, foreign banks allowed to conduct business in domestic and foreign currency with individuals and firms
    - Some restriction persist: limit on foreign ownership of domestic banks, services they can offer
  - 2003: China Banking Regulatory Commission (CBRC)

China's Liberalization Process

- Capital markets
  - 1990: Shanghai and Shenzhen stock exchanges
  - 1992: China Securities Regulatory Commission (CSRC)
  - 1999: China's Securities Law
  - 2002: Qualified Foreign Institutional Investors (QFII)
    - Foreign brokers can trade B-shares up to a limit
    - Quotas and types of shares expanded over time
  - 2006: Qualified Domestic Institutional Investors (QDII)
    - Domestic investors allowed to buy foreign assets
    - Initially, foreign-income fixed assets
    - Range of instruments expanded over time
  - 2007: Allow qualified foreign firms to list domestically
  - 2013: More domestic shares available to QFIIs