3 Macroeconomic Environment and Financial Reform

Several developing countries have been persuaded by the new orthodoxy of financial reform. This orthodoxy states that policies that allowed domestic interest rates to attain their true equilibrium level and credit, to be allocated on the basis of viability and productivity of business enterprises or projects, would enhance economic growth. However, the initial foray into financial reform during the 1970s and 1980s appeared to have succeeded in only a few of these countries. The relative failure of this new orthodoxy has, therefore, reopened the debate about the design and soundness of financial reform policies and the effect of these policies on developing countries' financial markets. It is true that the impact of financial reform on a country's financial markets depends on the principal components of the reform program, the methods used to implement the reform policies, and the interaction of these policies with the country's macroeconomic environment. The reform policies may themselves be well designed and sound, but they may fail to accomplish their intended objectives in the absence of an appropriate macroeconomic environment.

The failure of financial reform in several developing countries in the 1970s and 1980s and success in only a few have generated a set of reactions to the new orthodoxy. This chapter briefly reviews these reactions. To facilitate an understanding of financial reform policies and their consequences, the chapter examines the macroeconomic environment and reform experiences of Korea and Malaysia in the 1970s and 1980s when these countries initiated what are considered to be successful financial reform programs. It also examines the 1970s and 1980s macroeconomic environment and the financial reform experiences of Chile, Argentina, and Uruguay, which are considered to be countries with failed financial reform programs. The experiences of these two sets of countries are then compared to obtain a perspective on the implementation of financial reform policies in developing countries.

3.1 REACTIONS TO FINANCIAL REFORM

Since the mid-1970s, several Latin American and Asian countries have implemented financial reform policies aimed at reducing or eliminating...
government control of domestic interest rates and credit allocation. The outcome of these policies, however, has not been sufficiently uniform to support the position that financial reform alone would ensure economic success measured by such criteria as increased savings mobilization, positive real interest rates, financial stability, and sustainable economic growth. Korea and Malaysia, for example, have exhibited the beneficial impact of financial reform. The experiences of Chile, Argentina, and Uruguay, however, have been in sharp contrast with these two countries.

In the countries where financial reform has initially been unsuccessful, real interest rates became positive, but the levels of these rates remained too high or were so volatile that they became a disincentive to domestic investment. Banks extended credit to unproductive enterprises or projects, resulting in large and unsustainable bad debt portfolios, bank failures, and business bankruptcies. Eventually, government intervention was necessary to protect depositors and to assist the distressed banks and their borrowers. In response to these experiences, the initial enthusiasm for financial reform policies changed to skepticism or disillusionment about the effectiveness of such policies.

An interesting parallel may be drawn between the change in developing countries from enthusiasm to disillusionment with financial reform, and a similar change in attitude toward the deregulation of the US thrift industry. The 1982 Garn-St Germain Act aimed at deregulating the savings and loans industry; but almost as soon as the legislation took effect, the enthusiasm for the reform subsided in some quarters—mainly because the deregulation effort ushered in a period of waste and corruption unseen in the US financial system since the 1920s. The result has been described as the biggest financial disaster since the Great Depression. Eventually, the US government intervened to protect depositors and to reregulate the industry at a substantial financial cost to US taxpayers.

A reassessment of the philosophy of financial reform was considered necessary in view of its failure in so many countries. In this reassessment, two major reactions have been observed. The first emphasized the oligopolistic nature and imperfections of developing countries' financial markets and the inevitability of high levels of real interest rates accompanying financial reform. Chile's financial markets have been used to illustrate this reaction. With the implementation of financial reform policies and the restoration of the bank-holding company structure in Chile, groups of industrial and trading companies closely linked with the commercial banks exerted pressure on the banks to extend increasing amounts of credit to finance their business activities. This pressure increased credit demand and interest rates. To fund the increased credit demand, banks competed for