

# COULD FINANCIAL LIBERALIZATION IGNORE INFORMAL FINANCE? A COMMENTARY

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## 1. Introduction

With the decline of centrally planned economic systems and the advent of more market oriented ones, liberalizing financial sectors in many countries, especially developing and newly independent ones, has seriously moved to the forefront of economic policies. Policy changes have concentrated largely on liberalizing interest rates, introducing a wider spectrum of financial assets, and creating markets for various existing securities.

Many of the countries embarking on financial liberalization are characterized by informal loan markets involved in informal finance. Questions on the merits of liberalizing interest rates in the presence of informal loan markets have addressed the issues of whether such policies are unambiguously expansionary. It was argued in what became known as the neo-structuralist critique that financial liberalization could be contractionary and, in some cases, even stagflationary.

Advocates of liberalizing interest rates have stressed, following the McKinnon-Shaw school, that such policies ought to be pursued since formal financial intermediaries are more efficient in intermediation than informal markets characterized by numerous inefficiencies. Therefore, most of these studies have neglected to incorporate informal loan markets in their models and examined the impact of liberalizing interest rates on the economy by considering only the effects on formal finance rather than on total credit activity.

This commentary argues that even if the direction of the change in economic activity after liberalizing interest rates were to be in line with the results of the McKinnon-Shaw school, the literature as well as policy-makers could not afford to ignore the effects of the policy changes on informal finance. The magnitude of the deviation in real as well as monetary variables from their previous levels necessitates evaluating the impact on total rather than only on formal credit activity. Various policies cannot be effective by assuming that the relative efficiency in intermediation of the banking system neutralizes the neostructuralist critique. Unless studies address the effect on informal loan rates and activity, the length and the size of the impact of financial liberalization would remain unknown and the outcome of the policy could be destabilizing in the short-term.

The next section highlights the assumptions and arguments behind and the results of financial repression, financial liberalization, and the neo-structuralist critique. The third section addresses the main arguments in the current state of the debate on the merits of liberalizing interest rates. Section four relies on arguments from and results of various studies that have included informal loan markets to show why we cannot afford to ignore informal finance. Section five contains some concluding remarks.

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## 2. Financial Repression, Liberalizing Interest Rates and the Neo-Structuralist Critique

Liberalizing interest rates to expand economic activity was advocated in the works of McKinnon and Shaw (1973) as an answer to financial repression policies that kept interest rates well below market clearing levels. Policies of financial repression were based on placing ceilings on interest rates to provide firms with cheap capital since low loan rates motivate various borrowers by providing an environment conducive for capital investment. Similarly, financial repression advocated low deposit rates since high ones tend to attract funds away from productive investment in physical assets. Low interest rates were also believed to keep inflation under control through a cheap cost of capital effect.

Several secondary arguments were advocated in support of financial repression such as preventing monopoly power from determining the level of interest rates, proper monetary control and financial policy, and a direct government control over savings, investments, and the success of the savings-investment process. Whereas financial liberalization economists criticized the validity of these secondary arguments, their main concern pertained to liberalizing interest rates to promote development and growth. I summarize the arguments made by McKinnon, Shaw, and many economists that have followed their tradition regarding the relationship between freeing interest rates and output growth in five main points.

First, financial liberalization economists believe that developing economies suffer from a shortage of savings rather than investment opportunities. Market forces are ready and capable to work towards growth given enough funds and proper incentives. Second, the shortage of savings arises from a low real return on bank deposits, especially in high inflation countries, due to official policies of fixing interest rates below market clearing levels. Third, freeing the deposit rate encourages savings by motivating more funds to the banking system. These funds are attracted from alternative assets through a substitution effect and at the expense of consumption. Fourth, liberalizing the deposit rate is coupled with an increase in the loan rate which motivates banks to conduct more direct financial intermediation with the newly acquired funds. The increase in savings and financial intermediation increases capital accumulation and growth. Fifth, higher loan rates allow banks to make loans to risky investments in high yielding projects causing higher levels of capital formation. Ceilings on these rates may make banks less likely to undertake risky loans for a return measured by a low loan rate. Making loans to low risk investments with a low return could negatively impact capital formation.

Arguments of the McKinnon-Shaw school rest on the assumption that the banking

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system, as opposed to informal finance, provides the most efficient channel of financial intermediation. Loans channeled through informal finance may largely support sub-optimal and inefficient investments since informal credit markets suffer of many inefficiencies and monopolistic features.

The original McKinnon-Shaw models did not incorporate informal loan markets. Informal, unorganized or unregulated loan markets were incorporated in economic models in the works of, among others, Van Wijnbergen (1982, 1983a, 1983b), Taylor (1983), Buffie (1984), Kohsaka (1984), Cho (1986), Lim (1987), Liang (1988), Shahin (1990) and Daniel and Kim (1992). These studies, that became known as neo-structuralist ones, were largely developed to examine the impact of financial liberalization policies and some stabilization measures on economic activity when informal loan markets are incorporated in economic models. Common to these models was the fact that the informal loan rate is the only market determined one and that unorganized loan markets are fully efficient in channeling funds in the financial intermediation process. The earliest studies reached the following results on the impact of financial liberalization.

First, an increase in the deposit rate motivates unorganized market funds into the banking system. Since all assets held in informal loan markets are loaned out whereas only a portion of the ones deposited in the banking system is channeled into investments due to the rule of holding required reserves, increasing deposit rates may convey contractionary moves to economic activity. Second, the decrease in informal market funds increases the informal loan rate or the cost of financing working capital causing inflation. The combination of inflation and the possible contraction may cause stagflation (van Wijnbergen, 1982). Third, Increasing the deposit rate could be expansionary under three conditions: if funds were to move into savings out of unproductive assets such as currency or gold, if the substitution effect between informal loans and bank deposits is low, and if the required reserve ratio is low (Van Wijnbergen, 1983b, Taylor 1983) Kohsaka 1984). Fourth, in addition to the conditions mentioned in the third point, a high responsiveness of flow savings with respect to the real interest rate on bank deposits is also necessary for successful financial liberalization policies (Kohsaka 1984). Fifth, the short-term impact of increasing the deposit rate may not expand economic activity for the reasons mentioned in the previous four points. The long-term impact of savings though may become very powerful increasing real wealth and even overcoming the decrease in aggregate loan supply (Buffie 1984).

Based on the discussion of financial liberalization and its neo-structuralist critique, the results of increasing the deposit rate are shown to depend on many issues such as the

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degree of substitution between bank deposits and informal assets, the size of the required reserve ratio, the responsiveness of savings to the real interest rates and, most importantly, the relative effectiveness of informal credit markets in the financial intermediation process. If the banking system and informal loan markets were equally efficient in channeling funds to the most productive investments, increasing the deposit rate becomes contractionary due to the required reserve rule governing the banking system. This efficiency comparison is still awaiting empirical testing. The next section examines some of the latest issues developed in the debate between financial liberalization economists and neo-structuralist ones regarding the relative efficiency of informal loan markets and the economic functions of bank reserves.

### 3. The Relative Efficiency of Informal Markets and the Economic Functions of Bank Reserves.

The relative efficiency of informal markets in intermediating loans is still being examined and may vary across countries. Some believe that informal loan markets are characterized by monopolistic elements and suffer from many inefficiencies. These inefficiencies arise in the areas of risk pooling due to the fragmentation and the small scale nature of the loans, in loan administration and allocation, in the quality of various projects financed through informal loans, and in the nature of available information on borrowers. This belief holds among the McKinnon-Shaw economists despite the fact that lenders in informal loan markets may know some of their clients which reduces the cost of gathering information on borrowers in conducting credit analysis studies. Given that the banking system does not suffer from these inefficiencies, many advocates of financial liberalization believe that the formal sector is more efficient in channeling funds despite the required reserve rule.

Owen and Solis-Fallas (1989) have used one of the earliest neo-structuralist models (Van Wijnbergen 1982) to formalize this argument. Reworking the model, the authors introduce a variable  $\theta$  representing the mean proportion of informal loans that passes through to finance working capital. They also allow for the possibility that some proportion  $(1 - \gamma)$  of funds intermediated to firms through banks is used in non-productive ways. Given a required reserve ratio  $\rho$ , their analysis formally shows that financial liberalization is expansionary if  $\theta < \gamma(1 - \rho)$ . The authors believe that this is the case for most developing economies since it is highly unlikely, except for few informal urban markets, that the opposite holds. Therefore, they advocate financial liberalization based on the fact that  $\theta$  and  $\gamma$  could be interpreted as proxies for measures of efficiency of intermediation.

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Even though Owen and Solis-Fallas have theoretically formalized that the results of financial liberalization depend on the relative efficiency of intermediation, stating that  $\theta < \gamma(1 - \rho)$  remains an empirical issue that has yet to be confirmed. The lack of data on informal finance presents a major hurdle in any further consideration of the relative efficiency of intermediation. This seems to have created an impasse for many economists trying to shed more empirical light on this issue. The evidence that the banking system is more efficient despite the required reserve rule remains largely based on casual empiricism and observations regarding the nature of some informal loan markets in some developing economies.

The difficulty in measuring the relative efficiency of financial intermediation seems to have shifted the theoretical debate on financial liberalization to an issue that has not been formally addressed before regarding the economic functions served by bank reserves. In a very recent study by Kapur (1992), the author shows that incorporating some of the functions served by bank reserves such as those of liquidity enhancement and seignorage creation lends strong support to financial liberalization.

Using a fixed coefficient additively separable utility function in conjunction with a usually constant rate of time preference, a risk neutral consumer holding deposits in both banks and informal markets optimizes in a two stage intertemporal model. Whereas banks permit premature or within period withdrawals, informal markets do not allow within period withdrawal of deposits since informal lenders do not hold reserves. Given that the consumer desires liquidity to meet unexpected contingencies, an increase in the deposit rate caused by financial liberalization increases consumers' deposits in commercial banks providing asset holders with more deposits to draw upon. This fact coupled with the one that consumers having more deposits in the banking system need to borrow less to meet unexpected expenses create a liquidity enhancement which is welfare increasing.

Kapur argues further that even though less lending is available since funds moved from informal loans with zero reserve backing to the banking system holding required reserves, the increase in reserves causes an increase in the demand for high-powered money. As a result, the authority receives a seignorage gain measured by the amount in excess of the existing seignorage requirements reflected in the previous size of the monetary base. The authority could choose to use the windfall gain for additional lending. Therefore, based on the two functions that bank reserves serve, Kapur concludes that his results on seignorage gains have "neutralized" the neo-structuralist critique and that the ones on liquidity enhancement show that financial liberalization is welfare increasing.

Invoking the economic functions served by bank reserves seems to have moved the

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debate in a direction favoring financial liberalization. It may be argued that informal loan markets cannot be more efficient in intermediation than a liberalized banking system, given that bank reserves serve the seignorage function discussed in the previous section. The government, as Kapur (1992, 75) puts it, has the option of utilizing the seignorage gain for productive purposes by channeling the newly created funds to development banks or back to commercial banks. Kapur's statement, it could be argued, needs empirical support since the experience of many governments in developing economies does not favor the fact that, on the average, they would reallocate most funds back to banks but would spend them on various public projects. The argument made by kapur (1992, 75) that "should the government choose not to do this (reallocate funds to banks) but to use the seignorage for some other purpose, then implicitly it must view this alternative purpose as being possessed of higher social utility" could be misleading. What governments view as of higher social utility may not be productive and even welfare improving. Why should we believe based on the experience of many developing economies that moving funds from informal markets to the government could under most circumstances raise productivity? Therefore, Kapur's results do not "neutralize" the neo-structuralist critique but they affect it under some assumptions regarding the behavior of the government with the windfall seignorage gains and the relative efficiency of banks in intermediation.

#### 4. Could We Afford to Ignore Informal Finance?

The issue in my opinion does not boil down to whether we should pay attention to informal finance but to whether we could afford to ignore it. Even if we reach results showing that financial liberalization policies are expansionary, the question of the magnitude of the expansion as opposed to the direction of the output change remains unresolved if informal loan markets were excluded from various economic models. Financial liberalization has to be coupled with various stabilization programs, especially ones of monetary policy, that require a knowledge of deviation of real as well as monetary variables from previous levels. Some attempts to show the merits of financial liberalization in the debate over the relative efficiency of banks seem to have neglected the fact that even if banks were more efficient, there is a need to examine the magnitude of various changes in economic variables.

I illustrate the argument on the importance of including informal loan markets in economic models in order to examine the magnitude effect of various policies, by relying on a study by Lim (1987) and observations from few other studies. Lim examines the impact of contractionary monetary and credit policies on economic activity using the

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Philippines as a case study. In the absence of informal loan markets, the results are expected to be in line with various monetarists theories of inflation. That is, a contraction in money supply causes a decrease in aggregate demand, an economic contraction and an adequate decrease in prices.

The presence of informal loan markets leads to a different sequence of results due to the increase in the cost of working capital caused by contractionary monetary policy. Credit rationing in the formal sector forces many firms to seek informal loans. This behavior causes an increase in the informal loan rate and, thus, the cost of working capital. The results of contractionary monetary policy may turn out to be stagflationary in the short-run. Even if the economy were to move in the direction of the monetarists expectations when it comes to the changes in prices, the increase in the cost of working capital may be strong enough to prevent a fast decline in prices by the desired amount in the presence of informal loan markets. The net outcome of contractionary monetary policy becomes a less than adequate decrease in prices as compared to the desired level of price decrease.

Testing the theory on the Philippines using data from 1958 to 1980, Lim shows that in the short-run, the cost of working capital effect seems to dominate the monetarist effect. According to his results, a significant effect on inflation would not occur until permanent or expected income falls substantially to contract consumption. A heavy and costly recession may be required before the inflation rate could be decreased by the desired level. He concludes (1987,56) that by resorting to solutions based on simplistic models that exclude informal loan markets, "the policy-makers may go overboard and cause the medicine to be worse than the disease".

I briefly state some other findings from the many in the literature to further emphasize this argument. Incorporating the impact of informal loan markets has shown that the short-term results of some standard stabilization policies could be influenced or even reversed. Liang (1988) has shown that in an augmented IS-LM model incorporating loan market dualism, a fall in the marginal efficiency of capital, even in a system of rigid wages, has no real effect (as predicted by standard policy) as long as the informal market rate is higher than the formal one. In a study by Shahin (1989), it was shown that incorporating the effects of informal loan market activities may prevent money supply from expanding as a result of financing government debt through captive buyers of government securities in a dual loan system. Daniel and Kim (1992) showed that in the presence of informal loan markets, there is a level for the bank interest rate, below the free market rate, which maximizes savings and investments. According to their results, financial dualism can stimulate investment without sacrificing high marginal productivity projects when the bank interest

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rate is set at a disequilibrium below market-clearing level. Other observations from the literature show that the impact of several other policies could be effected by the presence of informal loans if they were properly incorporated in various models. This may increase the danger of excluding them.

Informal credit markets could not also be ignored based on their size. This size is an important issue to consider in the debate on the merits of financial liberalization and various other stabilization policies. It is commonly agreed upon that activities in these markets have largely become an urban phenomenon. The early views suggesting the rural nature of these markets have been negated in various studies conducted in the 1970's and 1980's. A 1969 survey conducted on Korea reveals that 86 percent of unorganized lending was conducted in urban areas, with the urban business sector accounting for 79 percent (Van Wijnbergen, 1982, 154-155). The size of informal credit markets was estimated to be 355 billion won in Korea in 1972, which was the equivalent of 80 percent of the money supply (Kwack and Chung, 1986, 21). A 1985 survey for the same country shows a figure of 5001 billion won which was equivalent to around one fourth of banking claims on the private sector (Layman, 1988, 372). In Taiwan, a survey conducted in 1984 on household portfolio holdings reveals that these households lent in the informal loan market around 60 percent of the money they deposited in banks (Liang, 1988, 540).

Future studies are bound to use more sophisticated techniques in measuring this size in comparison to early studies that have relied largely on sample surveys, corporate tax returns, and various financial statements. For example, a recent study (Lee and Han 1990) has examined the relative size of the informal to the formal loan market over time based on the theories of index numbers, monetary aggregation, and money supply. Applying the model to the case of Korea, it was shown that the size of the informal to formal loan market has decreased over time between 1976 and 1986. Still, the absolute size of the informal one was shown to have increased, which supports the argument calling for incorporating informal loans in various studies.

## 5. Concluding Remarks

The fact that the evidence on the relative efficiency of financial intermediation is inconclusive does not seem to have deterred various governments from embarking on policies of liberalizing interest rates. Therefore, the realistic policy question should not be whether or not to liberalize but whether we could afford to examine the impact of this liberalization on economic activity without considering and evaluating its impact on informal financial markets. These markets should not be excluded from various economic



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models even if the direction of the resulting change in economic activity from financial liberalization were to favor the predictions of the McKinnon-Shaw economists. The center of the debate ought to move in the direction of examining the magnitude of financial liberalization and various stabilization policies on real and monetary economic variables through their impact on total rather than only formal credit activity. Otherwise, the length and the size of the impact of liberalizing interest rates would remain unknown and the outcome of the policy could be destabilizing in the short-term. The neo-structuralist critique cannot be neutralized and ignored in any proper and accurate policy-making process requiring a determination of the size and magnitude of the deviation of various variables from their pre-liberalization levels as long as informal financial markets exist.

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**Abstract**

*This commentary argues that the literature as well as policy-makers could not afford to ignore the effects of financial liberalization on informal finance even if the direction of the resulting change in economic activity from liberalizing interest rates were to favor the predictions of the McKinnon-Shaw economists. The magnitude of the deviation in real as well as monetary variables from their previous levels necessitates evaluating the impact on total rather than only on formal credit activity. Policies cannot be fully effective by assuming that the relative efficiency in intermediation of the banking system neutralizes the neostructuralist critique. Unless studies address the effect on informal loan rates and activity, the length and the size of the impact of financial liberalization would remain unknown and the outcome of the policy could be destabilizing in the short-run.*

**LA LIBÉRALISATION FINANCIÈRE POURRAIT-ELLE IGNORER LES FINANCES STRUCTURÉES? UN COMMENTAIRE****Résumé**

*Ce commentaire témoigne que les études ainsi que les dirigeants ne peuvent pas se permettre d'ignorer les effets de la libéralisation financière sur les finances non structurées même si le sens pris par le changement obtenu dans l'activité économique, dû à la libéralisation des taux d'intérêt, favorise les prévisions des économistes du type McKinnon-Shaw. L'ampleur de la déviation des variables tant réelles que monétaires, de leurs niveaux précédents, nécessite l'évaluation de l'impact sur l'activité de crédit total plutôt que sur celle de crédit structuré. Les politiques ne peuvent pas être totalement efficaces si elles supposent que l'efficacité relative dans l'intermédiation du système bancaire neutralise la critique néo-structurelle. À moins que les études n'abordent l'effet des taux d'intérêt sur les emprunts et de l'activité économique non structurée, l'étendue et le volume de l'impact de la libéralisation financière resteront inconnus et le résultat de la politique économique pourrait être un élément déstabilisateur à court terme.*



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## Summary

The crucial aspect to focus upon in evaluating Africa's experience in financial sector development is its savings effort, the level and quality of financial intermediation and the efficiency in resource use. On all these scores, the African financial sector has performed very badly. Upon acceding to political independence, African governments decided to remodel their financial infrastructure by the establishment of a diversified set of financial institutions - viz - commercial banks, development banks, savings banks, co-operative banks, housing finance and postal savings banks, etc. Unfortunately, the ensuing benefits have not been commensurate with the enormous costs incurred. A great deal of effort was geared towards the provision of credit rather than the mobilization of resources. The official attitude to resource mobilization has been extremely lax partly due to foreign resource inflows and partly due to the inexpensive rediscounting terms and facilities provided by the central bank.

Commercial bank branches have not yet been sufficiently diffused in the rural hinterland with the result that Africa's resource potential in the rural areas still remains untapped. Development and Co-operative banks have literally become mere retailers of foreign loans and government funds even though many were empowered to mobilize resources in their statutes of establishment. The operations of specialised financial institutions are generally insulated from competition by various legislations, and are even provided with generous subsidies. Instead of undertaking much wider and more demanding tasks, (eg. bringing in financial innovation, developing money and capital markets, broadening the monetized sector of the economy, improving the unorganized segment), central banks

in developing Africa are confined to the narrow contours of a regulator, and are circumventing financial deepening through the provision of generous accommodation to the commercial banks and the government.

Bank credit still remains a financial appendage of certain enclaves: large-scale mineral exporters, highly protected manufacturing, foreign owned undertakings, and the parastatal sector. In contrast, small farmers and indigenous small-scale enterprises remain financially repressed although they possess quite a large share of the deposit resources on which bank credit is based. These repressive influences of the formal banking system are perpetuating the enlargement of the informal sector.

## The author:

**Dr. Abebe Adera** is currently Chief of the African Least Developed Countries Programme at the United Nations Economic Commission for Africa. Before assuming his present post, he was Chief of the Fiscal, Monetary and Financial Policy and Institutions Section at the same Secretariat. Prior to joining the United Nations in 1978, he served as Director of the Research, Planning and Policy Coordination Division of the Commercial Bank of Ethiopia. He was also part time lecturer in Money and Banking at the Addis Ababa University from 1972 to 1978 and at the Ethiopian Institute of Banking and Insurance from 1969 to 1974. **Abebe Adera** holds a B. Com. (Hons) degree from the University of Delhi; an M.A. and M.Sc. degrees from the University of Wisconsin at Madison and a Ph. D degree from Jadavpur University.

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## The authors:

**Dr. Monica S. Fong** is the Coordinator on Women in Development for the Europe, Middle East and North Africa region in the World Bank. Her long standing interest in the provision of financial services for poor rural women stems from her analysis and evaluation of development projects and programmes directed to the rural poor with the International Fund for Agricultural Development and the Food and Agriculture Organization of the United Nations. She has also written extensively on women in the agricultural labour force in the developing world.

**Dr. Heli Perrett** is an independent consultant, specializing in social aspects of development planning and implementation. She is the author of numerous books and reports on communication, education and behavioural considerations in rural development planning. In addition to her extensive writing, she has continued to pursue a career as educator and has taught at the Catholic University of Peru in Lima, and the American University in Washington, D.C. among others.

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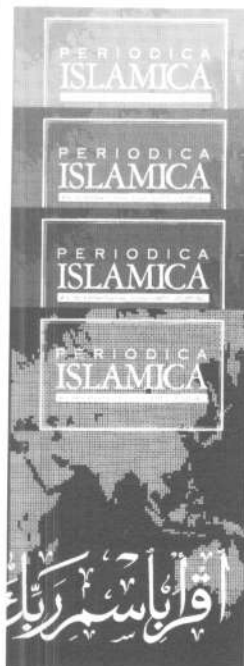
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