

FINANCIAL LIBERALISATION AND LIQUIDITY CONSTRAINTS IN MYANMAR AND NEPAL: SOME EMPIRICAL EVIDENCE

Muzafar Shah Habibullah - Universiti Putra Malaysia

Peter Smith - University of Southampton

1. Introduction

The ability of households to borrow and adjust their financial portfolios has important implications for monetary aggregates and consequently for the conduct of monetary policy. If consumers are unable to borrow against future expected income to the degree they would like, they are said to be 'liquidity-constrained'. As financial systems become liberalised, it is to be expected that such liquidity constraints would ease as capital markets become less imperfect. This has been supported by empirical evidence for a number of developed countries, in which liquidity constraints are seen to have declined in importance during the 1980s, as financial deregulation has occurred (Blundell-Wignall *et al.*, 1995).

The purpose of the present study is to consider empirical evidence for two low-income countries, namely Myanmar and Nepal. The study examines two aspects of this issue. First, it considers the share of the consumers who are liquidity constrained in the two economies. Second, it investigates whether financial liberalisation has reduced liquidity constraints. Following the work of Jappelli and Pagano (1989), Campbell and Mankiw (1991) and Blundell-Wignall *et al.* (1995), we explore this idea by allowing the 'excess sensitivity parameter', λ , to vary over time. Generally, a reduction in the size of the λ parameter signifies that liquidity constraints have reduced as a result of financial liberalisation.

2. Financial Liberalisation in Myanmar and Nepal

During the period to the mid-1980s, Nepal is best described as a 'financially repressed economy'. The pervasive government intervention and involvement in the financial system through the regulatory and supervisory network, particularly in controlling interest rates and the allocation of credit, is a common feature of this type of repressed economy. As a result of the repressed regime, saving and investment decisions of market participants will be adversely affected and will lead to fragmentation of financial markets and financial disintermediation.

¹ Thornton and Poudyal (1990) have tested the McKinnon complementarity hypothesis on Nepalese monetary data. Their study provides strong support for McKinnon's complementarity hypothesis and therefore suggests that the Nepalese economy during this period is best described as a 'financially repressed economy'.

It has been recognised that financial markets play a central role in economic development. The McKinnon-Shaw framework has provided a recipe for developing countries to achieve fast economic growth. The removal of interest rate regulations and the subsequent success of South Korea's and Taiwan's economies in the 1960s put the financial liberalisation programme advocated by McKinnon (1973) into the limelight. Not surprisingly, the majority of the developing Asian countries, in particular Nepal, embarked on financial liberalisation programmes in the 1970s. For the first time, the saving deposit rate in Nepal was raised by 30 percent to 6.5 percent in 1974, and it was raised further to 8.0 percent in 1975. The objective was to enhance growth through increasing national saving and by raising the efficiency of investment.

This effort, however, has been a failure. According to Fry (1978), interest rate reform in Nepal failed because other government policies effectively destroyed profitable investment opportunities. The interest rate reform alone could not raise saving, investment and growth unless government policies on exchange rate, trade, budget and prices were also liberalised. Furthermore, higher lending rates during this period discouraged the flow of credit to the priority sectors (Bhattarai, 1993). As a result, interest rates were later revised downward in 1977.

However, it was not until the mid-1980s that the Nepal Rastra Bank (NRB, Central Bank of Nepal) took a major step towards deregulating the financial system in Nepal. Adhikary (1989) points out three reasons that prompted NRB to deregulate the Nepalese financial system. First, financial resources have been unevenly distributed among the financial institutions, whereby some have an abundance of resources while others face scarcity of the same resources. The rigidity in interest rate on deposits restricted the scope for institutions lacking resources to attract funds by offering higher interest rates². Second is the widening between deposit and lending rates, which does not help to foster healthy and competitive financial markets. And finally, with the establishment of foreign banks (joint ventures with local investors) in Nepal, the government is obliged to offer a more competitive financial environment for commercial banking activities. Thus, in November 1984, financial institutions in Nepal were granted autonomy to offer interest rates on savings up to 1.5 percent and 1 percent on time deposits above the prevailing interest rates as prescribed by the

² According to a study of Nepal by Yadav *et al.* (1992), regulated interest rates in the formal sector have also led to credit rationing and favours farm households with collateral. Borrowers without collateral are excluded and hence have to rely on the informal credit market.

Central Bank³. Since May 1986 financial institutions have been authorised to fix their own interest rates on both deposits and loans subject to a minimum rate on saving deposits and minimum lending rate on priority sectors as prescribed by the Central Bank. However, effective from July 1989, interest rates were completely liberalised and financial institutions were free to determine their own deposit and lending rates.

In Myanmar, as a result of financial liberalisation, the financial system has undergone a radical structural transformation. Prior to 1988, Myanmar was under a socialist economic system. Under this regime, all private domestic and foreign banks were nationalised. Furthermore, in order to have complete control over the financial sector, all nationalised banks, together with the central bank (then Union Bank of Burma), the State Commercial Bank, State Agricultural Bank, saving institutions, Union Insurance Board and small loans business were amalgamated to form a unique mono-bank system (see Lwin, 1993).

From September 1988, under a new regime, the socialist economic system was abandoned and Myanmar was redirected towards a market-oriented economic system. Since then, a major financial reform has taken place. In 1990, several new banking laws were passed with the objective of promoting and developing the present monetary system. Under the new law, private financial institutions were allowed to be established and to compete with the existing state-owned banks. Moreover, foreign banking was allowed to open branches or establish joint-ventures with local partners.

However, an important step towards financial deregulation in Myanmar was the revision of interest rates in September and October 1989. The Central Bank's bank rate was increased from 4 percent to 11 percent, that of Treasury bills from 1 percent to 4 percent, and those of Treasury bonds from 2.5/3.0 percent to 10/10.5 percent. At the same time, rates on call deposits and fixed deposits were also increased. The complete liberalisation of interest rate is, however, uncertain in the near future in Myanmar. This is best described by Lwin (1993: p. 302), "interest rates will be subject to ceilings to be imposed by the Central Bank for all banks established in the country. Moreover, these banks were required to maintain a reserve ratio of 35 percent of their liabilities. As Myanmar is in transition to a market economy and as the financial market is yet to be developed, deregulation of interest rates, less reliance on banks' reserve requirements and the introduction of open market operations by the Central Bank is

³For further discussion on financial reforms in Nepal, see Adhikary (1989), Demetriades and Luintel (1996) and Talib (1993).

not yet considered for the moment."

As a result of financial liberalisation, the Myanmar and Nepalese financial sectors grew at a faster rate than that of the real sector of the economy. The selection of indicators in Table 1 summarises the development of monetisation and financial deepening in both countries. The degree of monetisation in Myanmar and Nepal has been significant over the period 1966-94. The use of money (M1) relative to GNP has stabilised indicating that the public was economising in holding money in the economy. But an increasing use of broad money (M2) is evident in Nepal as well as in Myanmar as shown by the consistent rise in the M2/M1 and M2/GNP ratios during the period. This reflects the movement towards higher monetisation of the economy. During the deregulation period of 1986-94, Nepal registered a M2/M1 ratio of 2.40 compared with Myanmar's 1.44. The income elasticity of the financial assets, which can be used to measure the stage of financial intermediation in a country, was above unity in all three countries. Interestingly, the income elasticity of financial asset in Nepal which was 1.38 during the period 1971-94 is the highest compared to Myanmar. Thus, financial liberalisation in Nepal in recent years has resulted in depth and sophistication of the banking system. Furthermore, a recent empirical study by Demetriades and Luintel (1996) provides further support for the contention that financial deepening enhanced economic growth in Nepal in the period 1960-92.

3. Liquidity Constraints and Financial Liberalisation: A Review of Related Literature

Although numerous studies have been conducted to determine λ , that is the fraction of consumers who are liquidity constrained, few have attempted to relate λ to financial liberalisation. These studies include Jappelli and Pagano (1989), Bayoumi and Koujianou (1990), Campbell and Mankiw (1991) and Blundell-Wignall *et al.* (1995). Jappelli and Pagano compare the incidence of liquidity constraints in countries with imperfect capital markets and countries that are characterised by well-developed and highly competitive capital markets⁴. Except for Sweden (λ was not significantly different from zero), the values of λ parameter was relatively higher for Greece (0.54), Italy (0.58) and Spain (0.52), and lower for Japan (0.34), United Kingdom (0.40) and United States (0.21)⁵. These results are broadly in line with prior expectations based on the relative degree of liberalisation in the respective markets. Jappelli and Pagano further conclude that the inability to borrow from the capital markets will result in high

excess sensitivity of consumption to current income.

Bayoumi and Koujianou (1990) consider the effect of financial liberalisation in reducing liquidity constraints in six industrialised countries⁶, estimating all functions using the Generalised Method of Moments (GMM). Their estimates of the λ parameter record that except for Sweden (which was not significantly different from zero), Canada and United Kingdom have the lowest estimate of the proportion of liquidity constrained consumption with λ equals 0.18. This is followed by the United States (0.27), France (0.32) and Japan (0.51). Bayoumi and Koujianou investigate the effect of financial liberalisation on consumption using a dummy variable approach. This dummy was set to zero prior to deregulation, and from the start of deregulation, the value was made to increase in equal increments to unity after two and a half years. For all six countries, the fraction of consumption that is liquidity constrained declined after deregulation.

Campbell and Mankiw (1991) use the Instrumental Variables (IV) procedure to estimate λ for six developed countries⁷. In the majority of cases, the estimate of λ are both economically and statistical significant. Except for Japan (for which λ is unidentified), the estimates of λ range from 0.2 for Canada, through 0.35 for Sweden and the United States, to 0.97 for France. For the United Kingdom, λ is estimated at 0.35 for seasonally adjusted quarterly data and 0.65 when annual differences of seasonally unadjusted data are used. To determine the effect of financial liberalisation on λ , Campbell and Mankiw allow (i) λ to be a linear function of a time trend, and (ii) for a one-time shift in λ . However, their results failed to support the idea that liquidity constraints have declined over time.

More recently, Blundell-Wignal *et al.* (1995) examine whether excess sensitivity of consumption to current income has fallen over time as a result of financial liberalisation in eight OECD countries⁸. Blundell-Wignal *et al.* estimated two models -

⁶ The countries involved in the study were Greece, Italy, Japan, Spain, Sweden, United Kingdom and United States.

⁷ These results were obtained from their Non-Linear Instrumental Variable (NLIV) method of estimation. Their estimate using Full Information Maximum Likelihood (FIML) were quite similar.

⁸ These six countries were Canada, France, Japan, Sweden, United Kingdom and United States.

⁹ These countries were Canada, France, Japan, Sweden, United Kingdom and United States.

the standard Euler equation and an error-correction model. To allow for the effect of financial liberalisation, both models were estimated for different sub-samples - 1960s/70s and 1980s/90s. In the majority of cases, except for Australia and Germany, liquidity constraints have declined over time in line with the process of financial deregulation in these countries.

4. Testing for Liquidity Constraints

In testing for liquidity constraints, we follow the model of testing for life-cycle permanent-income hypothesis introduced by Hall (1978) and generalised by Campbell and Mankiw (1989, 1990, 1991). According to Hall, the consumption equation for a consumer can be obtained from the first-order conditions of an intertemporal maximisation problem under the following assumptions: (i) consumers can freely borrow and lend at the same rate of interest, (ii) consumers form expectations rationally, (iii) consumers have identical, time-separable preferences, with a quadratic utility function, and (iv) consumers cannot die in debt. Using these assumptions, the consumer's problem is then to

$$\text{Max } E_0 \sum_{t=1}^T [1/(1+\delta)]^t U(C_t) \quad (1)$$

$$\text{s.t. } A_{t+1} = (1+r)(A_t + y_t - C_t), \text{ for } t = 1, \dots, T-1. \quad (2)$$

$$A_T \geq 0 \quad (3)$$

where E is the mathematical expectation, conditional on information known at the beginning of the period; T is the length of life, δ is the constant rate of time preference, C is consumption, y is disposable income, A_t is asset holdings and r is the constant rate of return on assets. For a quadratic utility function, $U_t = -(\alpha - C_t)^2$, the first-order

* These countries were Australia, Canada, France, Germany, Italy, Japan, United Kingdom and United States.

condition for the consumer's maximisation problem is

$$C_t = \{1 - [(1+\delta)/(1+r)]\}\alpha + [(1+\delta)/(1+r)]C_{t-1} + \varepsilon_t, \text{ for } t = 1, \dots, T \quad (4)$$

where ε_t is the error term uncorrelated with all variables known to the consumer at time $t-1$. Equation (4) can be rewritten in a compact form as follows,

$$C_t = a_0 + a_1 C_{t-1} + \varepsilon_t \quad (5)$$

where $a_0 = \{1 - [(1+\delta)/(1+r)]\}$ and $a_1 = [(1+\delta)/(1+r)]$.

Equation (5) has been used in numerous empirical studies to examine the life cycle-permanent income hypothesis (Speight, 1990; Deaton, 1992). The implication of the life cycle-permanent income hypothesis (LC-PI) is that only consumption lagged one period should have a nonzero coefficient in a regression of current consumption on variables entering the lagged information set. However, in most cases, the LC-PI hypothesis has been rejected. Liquidity constraints have been recognised as one of the reasons for rejecting the LC-PI hypothesis.

According to Hall and Mishkin (1982) the population can be divided into two groups of consumers with shares $1-\lambda$ and λ of total disposable income. The first group, who receive $1-\lambda$ of the total income, behave according to the LC-PI hypothesis, that is, according to equation (5). Consumers in the second group are assumed to be liquidity constrained and therefore spend their entire disposable income. Consumption for the first group of consumers is represented as follows

$$C_{1t} = a_0 + a_1 C_{1t-1} + \varepsilon_t \quad (6)$$

Consumption for the second group of consumers is

$$C_{2t} = y_{2t} = \lambda y_t \quad (7)$$

where y_{2t} is disposable income for consumers in the second group and y_t is disposable income for both groups.

hypothesis is rejected for both Nepal and Myanmar. Our results are consistent with earlier findings of Thornton and Molyneux (1996) that the rational expectation permanent-income hypothesis (REPIH) is rejected for Asian developing countries. Furthermore, our estimates of the liquidity constrained consumers for Nepal and Myanmar are comparable with the estimates for the developing countries obtained by Villagomez (1997) which range between 0.37 to 1.26, and Speight and White (1995) which range between 0.38 and 1.12.¹⁰

Next we investigate whether financial liberalisation process in Myanmar and the Nepalese financial markets has caused liquidity constraints to be progressively relaxed, thus weakening the relation between monetary aggregate and income. Thus, estimating equation (13) for successive time periods should tend to indicate a reduction in the λ parameter. In this study, we follow Blundell-Wignall *et al.* (1995) by estimating separate λ equations for different time periods. For our tests, we have divided the time period into two sub-sample periods of 1963-79 and 1980-94 for Nepal, and 1955-79 and 1980-94 for Myanmar. The main reason we select these sub-sample periods is because in both Myanmar and Nepal, activities related to financial liberalisation have been more active in the 1980s and early 1990s. Thus, if deregulation played a role, we would expect to see a reduction in the point estimate of λ in the second sub-sample period. Table 3 presents the results from estimating equation (13) for the two sub-sample periods. The estimates from the Euler equation suggest that the point estimate of λ has in fact reduced in size in Nepal, but not in the case of Myanmar. The above result implies that as a result of financial liberalisation, the proportion of liquidity constrained consumers in Nepal has decreased to less than 60 percent of the population during the 1980s and 1990s.

6. Conclusion

Financial liberalisation has been recognised as an important step towards achieving economic progress by allowing financial markets to be determined by

¹⁰ The countries included in Villagomez's study were Brazil, Chile, Colombia, Greece, Indonesia, Korea, Malaysia, Mexico, Pakistan, Philippines, Singapore, Sri Lanka, Thailand, Turkey, Uruguay and Venezuela. The countries included in Speight and White's study were Cyprus, Dominican Republic, Ecuador, Greece, Guatemala, Honduras, Mexico, Nigeria, Sri Lanka, Turkey and Venezuela.

market forces. The proliferation of financial intermediaries, financial instruments and the development of money and capital markets will enhance the formation of an efficient and sophisticated financial system. Nevertheless, one important implication for financial liberalisation is to reduce liquidity constraints. As a result of financial deregulation, households will be able to smooth their consumption relative to income through borrowing as borrowing constraints were lifted.

Thus, the purpose of the present study is to investigate whether financial liberalisation has reduced liquidity constraints in Myanmar and Nepal. To do this, we have estimated an Euler equation and determined whether the estimate of λ (the excess sensitivity parameter) has reduced in the deregulation era. Our results suggest that the fraction of liquidity constrained consumers in Nepal, whilst being quite substantial, has reduced to less than 60 percent of the population in the 1980s/90s. We conclude that liquidity constraints have reduced as a result of financial liberalisation in Nepal. The result for Myanmar may reflect the fact that financial liberalisation is at its infant stage and the economy is in transition to a market economy.

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Table 1: Indicators of Monetisation and Financial Deepening in Myanmar, Nepal and Sri Lanka, 1966-1994

Financial indicators	1966-75	Myanmar 1976-85	1986-94	1966-75	Nepal 1976-85	1986-94
M1/GNP	0.23	0.21	0.21	0.09	0.12	0.14
M2/GNP	0.25	0.27	0.30	0.12	0.24	0.32
M2/M1	1.11	1.29	1.44	1.36	2.00	2.35
Currency/M1	0.83	0.91	0.91	0.69	0.64	0.69
M2 per capita (US\$)	22	44	175	10	31	55
Per capita total bank deposits (US\$)	6	14	58	4	21	40
Total financial assets/GNP	0.51	1.44	1.84	0.19	0.39	0.54
Assets/GNP:						
Central Bank	0.39	0.34	0.45	0.12	0.18	0.24
Commercial banks	0.13	1.10	1.39	0.07	0.21	0.30
Total banking system	0.51	1.44	1.84	0.19	0.38	0.54
		<u>1971-94</u>			<u>1971-94</u>	
Income elasticity of net issues:						
Financial system, of which:		1.15			1.38	
Central Bank		0.89			1.20	
Commercial banks		1.76			1.62	
Total banking system		1.15			1.37	

Source: International Monetary Fund, International Financial Statistics and author's calculations.

Note: For Myanmar, period ends 1993.

Table 2: Results for Equations (12) and (13)

Row	Estimation method	First-stage regression R-squared	Constant	a_1	λ	GR-squared	Sargan test
A. Nepal							
1	NLIV	0.863	-6.4019 (1.2578)	0.0957 (0.3047)	0.9338 (10.872)*	0.867	9.438 [0.582]
2	LIV	0.633	0.1008 (0.2801)	-	0.7431 (5.6439)*	0.514	3.152 [0.994]
B. Myanmar							
1	NLIV	0.797	-0.0837 (0.0772)	0.8452 (6.9144)*	0.8841 (4.3895)*	0.700	10.18 [0.514]
2	LIV	0.478	0.1651 (0.5319)	-	0.8515 (4.6193)*	0.359	5.378 [0.944]

Notes: The estimation methods are Non-Linear Instrumental Variable (NLIV) and Linear Instrumental Variable (LIV) procedures. All instrument sets include a constant, $\Delta C_{1,2}$, $\Delta C_{1,3}$, $\Delta C_{1,4}$, $\Delta Y_{1,2}$, $\Delta Y_{1,3}$, $\Delta Y_{1,4}$, $(C/Y)_{1,2}$, $\Delta X_{1,2}$, $\Delta X_{1,3}$, $\Delta X_{1,4}$, $\Delta pop_{1,2}$, $\Delta pop_{1,3}$ and $\Delta pop_{1,4}$. GR-squared denotes generalised R-squared. The Sargan instrument test is asymptotically distributed as χ^2 -square, and we report the probability value at which we can reject the null that the instruments are uncorrelated with the error term. Figures in parentheses () and square brackets [] are t-statistics and p-values respectively. Asterisk (*) denotes statistically significant at five percent level.

Table 3: Testing for Changes in λ over the Financial Reform Period

Methods of estimation	Sub-sample period 1	Sub-sample period 2
A. Nepal		
	1963-1979	1980-1994
NLIV (NL-2SLS)	1.3758 (7.1449)*	0.8562 (9.7611)*
LIV (2SLS)	0.9872 (4.9017)*	0.5737 (3.3443)*
B. Myanmar		
	1955-1979	1980-1994
NLIV (NL-2SLS)	0.6252 (2.4599)*	1.1383 (4.6315)*
LIV (2SLS)	0.6641 (2.6902)*	1.1498 (4.2034)*

Note: Asterisk (*) denotes statistically significant at five percent level.

Abstract

One important effect of financial liberalisation is to reduce liquidity constraints. The ability of households to borrow and adjust their financial portfolios has important implications for monetary aggregates and consequently for the conduct of monetary policy. To investigate whether financial liberalisation has reduced liquidity constraints in Myanmar and Nepal, we employ the Euler equation approach. Our estimate of the fraction of liquidity constrained consumers is about 0.7 – 0.8. Further, our result suggests that financial liberalisation has resulted in the reduction of liquidity constraints in Nepal but not in Myanmar.

LA LIBÉRALISATION FINANCIÈRE ET LES CONTRAINTES DE LIQUIDITÉ AU MYANMAR ET AU NEPAL : UNE ÉTUDE EMPIRIQUE**Résumé**

Un effet important de la libéralisation financière est la réduction des contraintes de liquidité. La capacité des ménages de s'endetter et d'adapter leurs portefeuilles financières a d'importantes implications pour les agrégats monétaires et, par conséquent, pour la conduite de la politique monétaire. Dans le but de vérifier si la libéralisation financière a réduit les contraintes de liquidité au Myanmar et au Nepal, les auteurs ont utilisé l'approche de l'équation d'Euler. Ils ont estimé que la fraction de consommateurs qui souffrent de contraintes de liquidité est de 0,7-0,8 et que leurs résultats indiquent que la libéralisation financière a allégé les contraintes de liquidité dans les pays considérés.