Current Financial Crisis: The End of Financial Liberalisation?

The current financial crisis has called the role of the monetary policy into question and has also re-opened the debates about a new regulation and the need of prudential controls of banking activity. This paper argues that the origins of the current crisis can be found in two interrelated elements that have been operating since the decade of the seventies: the financial liberalization policies implemented in developed and developing economies, and the economic policy based on the new consensus in macroeconomics. This new macroeconomic policy was focused on the monetary policy, with the downgrading of fiscal policy, and in the use as a main instrument of the continuous changes in the interest rates in order to control inflation rates. As a result, a huge and unprecedented liquidity and household borrowing has been generated in the main world economies, mainly in the USA and the United Kingdom, that is in the origin on the current crisis.

La crisis financiera reciente ha puesto en tela de juicio el papel de la política monetaria al mismo tiempo que se han reabierto los debates acerca de una nueva regulación y la necesidad de los controles prudenciales de la actividad bancaria. Este artículo señala que los orígenes de la actual crisis financiera pueden explicarse por dos elementos interrelacionados que han venido funcionado desde la década de los setenta: las políticas de liberalización financiera implantadas tanto en las economías desarrolladas como en desarrollo y la política monetaria basada en la macroeconomía del llamado nuevo consenso. Esta nueva política estaba centrada en la política monetaria, con la casi total desaparición de la política fiscal, y, en concreto, su instrumentalización mediante los continuos cambios en los tipos de interés como forma de controlar la inflación. El efecto de ambas actuaciones ha sido crear una liquidez y una deuda familiar en las principales economías mundiales, en particular en EE.UU. y el Reino Unido de una magnitud extraordinaria, que está en el origen de la actual crisis.

Duela gutxiko finantza-krisiak zalantzan ipini du moneta-politikaren eginkizuna eta, aldi berean, berriro ireki dira erregulazio berriari eta banku-jardueraren zentzuzko kontrolen beharrari buruzko eztabaidak. Artikulu honek dio gaur egungo finantza-krisiaren jatorria hirurogeita hamarreko hamarkadatik dauden eta elkarren artean lotuta dauden bi elementuren bitartez azal daitekeela: garatutako zein garapen-bideko ekonomietan ezarrita dauden finantza liberalizazioko politikak, eta adostasun berria izenekoaren makroekonomian oinarritutako moneta-politika. Politika berri hori moneta-politikan zegoen oinarrituta, eta ia guztiz desagertu zen zerga-politika; halaber, interes-tasetako etengabeko aldaketen bitartez gauzatzen zen bereziki, inflazioa kontrolatzearren. Bi jardueren ondorioz, likidezia eta familia-zor oso handiak sortu dira munduko ekonomia nagusietan, batez ere AEBetan eta Erresuma Batuan, ikaragarriak izan baitira, eta horixe izan da gaur egungo krisiaren jatorria.

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1. **INTRODUCTION**

The world has faced recently strong financial crises as a consequence of a serious build-up of household debt and asset holdings. Household expenditure has been more sensitive to short-term interest rate changes, making the role played by monetary policy very delicate. Because of this, discussions about regulation and prudential controls become again extremely necessary. The experience shows that after the Great Depression many countries undertook various measures in order to prevent financial instability. In this context Arestis and Basu (2003) argue that "it was recognized that to prevent the latter, there was a need to control financial flows that were purely speculative in nature, and to ensure that possible expansion in aggregate expenditure in the productive aspect of the economy was not constrained by inadequacies in the financial flow. Consequently, regulations within national boundaries took the form of preventing financial flows that were mainly geared for speculative activity" (p. 2). The aim of those regulations was to bring financial stability and to ensure that credit would be allocated to industry and trade. The ineffectiveness of those interventions in terms of bringing allocational efficiency to the financial sector led one country after another to deregulate its financial sector (Arestis and Basu, op. cit.). The view was that government intervention itself distorts the determination of the price of loans, adversely affecting the allocation of loans and savings.

Highlighting the importance of financial services for economic growth, financial market development was proposed as an alternative to 'financial repression' and to the State intervention in the allocation of credit. In the latter, Central Bank and government controlled the level of interest

rates and the allocation of credit. Banking and financial systems were regulated, directing credit to specific sectors and purpose (Arestis, 2008). The financial liberalisation thesis proposed the removal of ceilings on interest rates and scrapping of credit policies to have a more efficient allocation of credit (Arestis, 2008). This would increase the quality and quantity of investments. Besides that, access to capital not available domestically would be possible. So, the consequence would be more investment, which would increase economic growth.

The literature on growth and development has long been dedicated to study the determinants of growth in different places. The majority of the more recent studies has not only been supporting the usual investigations over the capital-labour-output relation but also has enlarged the scope of such studies. The growth literature per se shows a growing concern about other determinants of growth such as human capital and institutional development levels. The search for broader economic growth perspectives has consequentially amplified the importance of the financial system as a new parameter on that framework. A deep search for the causes of economic growth would eventually lead to a better understanding of financial markets and financial institutions. Understanding the way financial markets operate is an important tool to analyze economic phenomena. If the financial system is so important for economic growth, then the improvement of the financial institutions is imperative for the functioning of the economic system. This is the idea behind the financial liberalisation policies.

It is the contention of this contribution that the origins of the current financial crisis can be explained by two interrelated features that have been going on since the 1970s. The first feature is the financial liberalisation policies supported by the finance-growth nexus and initiated by governments both in the developed and developing world since that time. And the second feature is the monetary policy that is embedded in the New Consensus macroeconomics adopted by a significant number of countries in the world. This new policy is entirely focused on monetary policy at the nearly total demise of fiscal policy, and more importantly from the point of view of this contribution, the emphasis on frequent interest rate changes as a vehicle to controlling inflation. The impact of both types of development has been the creation of enormous liquidity and household debt in the major economies, but in the US and UK in particular, which has reached unsustainable magnitudes and produced the current crisis. This contribution relies on these two features for a possible explanation of the origins of the current crisis. Ultimately we suggest that the interaction of these two features and the crisis that emerged out of them should produce the ultimate collapse of the financial liberalisation thesis, and its associate policies, as we have known them since the 1970s.

We begin with a discussion of the framework underpinning the relationship between financial systems and economic growth in section 2, followed by a sketch of arguments on financial liberalisation policies in section 3. Then we proceed with a discussion of the current monetary policy as a potential source of the current financial crisis in section 4. Section 5 summarises and concludes.

2. THE UNDERLYING CONTEXT: FINANCIAL SYSTEM AND ECONOMIC GROWTH

One may consider that, as a start point of discussion, different understandings over the treatment of money and financial systems emerge from the literature. Some economic theories do not even consider money and financial systems to have an active role in the framework. In a world without real or nominal asymmetries and rigidities, financial systems operate as simple given intermediaries between savings and investment. The better is the monetary intermediation process the less the economic system is affected. Nevertheless, if some theoretical assumptions are relaxed or simply modified, not only important inferences about the functions of financial systems can be drawn, but also some new insights may be obtained to help investigate the relation between the financial system and economic development.

If a different point of view is allowed for the comprehension of the economy, one of the main aspects that could be taken into perspective is the fact that economic agents often deal with uncertainty. If it is permitted in an economic system to include lack of information as an important feature, the role that financial systems play in such environment drastically changes. From a broader consideration it is possible to sustain two main theoretical approaches to address the financial system's role in the economy.[1] The first one takes uncertainty to a deeper level: economic agents face lack of information, thus only relying on previous knowledge and standard behaviour to address economic decisions.[2] The second approach stresses that markets are imperfect institutions and economic agents have to deal with informational asymmetry.[3] Uncertainty is considered as different levels of probability risk. The financial system is responsible for dealing with such asymmetries in order to improve resource allocation, increase financial efficiency and foster economic growth

At least initially, this contribution will not be based on the specifics of a theoretical discussion. Hence, our intention would be to solely focus on the financial system's operating devices. Our initial approach would avoid the above mentioned theoretical differences by considering the financial system in more basic terms: the financial system is to be deemed as the group of economic institutions related to the provision of financial services, including allocation of capital, financial products, and mobilization of savings. The purpose of this apparently independent concept is the simplification of the discussion.

The importance of the financial system for the economy has been highlighted by the economic literature. Based on a historical perspective, Rousseau (2003) showed that different historic episodes of economic growth were propelled by financial development. More precisely, the author used historical data series to study the relation between the development of the financial system and the economy in the

[1] It is not the purpose of this paper to address the alternative theoretical approach to the role of the financial institutions in the economic system. We rather scrutinize the first approach because it is the one connected to the financial liberalisation policies and their consequences.

[2] Davidson (2002); Chick (1986); Dow (1993).

[3] The majority of contemporary works have their roots grasped on Levine (1992) and King and Levine (1993). Pagano (1993) remembers the importance of previous papers to the current debate.

Dutch Republic (1600-1794), England (1700-1850), the United States (1790-1850), and Japan (1880-1913). The study shows that the financial system was a very important part in each of the economic booms considered.

Also from a historical perspective, Gerschenkron (1962) underlined the significance of the financial system for growth, especially in underdeveloped countries. According to him "all the basic tendencies inherent in industrial development in backward countries were greatly emphasized and magnified by deliberate attitudes on the part of banks" (p. 15). The author has also pointed out that, besides the requirement of a social attitude towards development (and also towards the acceptance of new development institutions against backwarding ones), underdeveloped countries without prior capital accumulation systems should also rely on a banking system to cope with efficient resource allocation as one of the ways to foster investment. Gerschenkron (op.cit.) main interest was the comprehension of the historical development characteristics of countries like Germany, France, Italy, and Russia. The comparison of those to the UK development process led him to conclude that if countries were to develop, they should rely on banking development as a trigger for economic development. As Gerschenkron (op. cit.) put it,

> "The industrialization of England had proceeded without any substantial utilization of banking for long-term investment purposes (…) By contrast, in a relatively backward country capital is scarce and diffused, the distrust of industrial activities is considerable, and, finally, there is greater pressure for bigness because of the scope of the industrialization movement, the larger average size of plant, and the concentration of industrialization processes on branches of relatively high ratios of capital to output" (p. 14).

From the above references, it is easily seen that financial systems is an essential part for the economic system. The subject was also relevant in the works of Keynes (1936) but its Hicksian revision has somehow delegated a secondary role for the financial institutions. Nonetheless, the research agenda on finance and growth was partially restored by a stream of works flowing from discussions over the monetary features of the Keynesian macroeconomic model. The agenda was basically set by authors such as Gurley and Shaw (1955), Patrick (1966), Goldsmith (1969), Shaw (1973) and McKinnon (1973).[4] Gurley and Shaw (1955) paper is a revision of the Keynesian macroeconomic model (the standard Hicksian version) and, according to them, its use of limited monetary concepts. The authors assume that, by considering a broader range of assets (loanable funds) than the usual ones (money and bonds), the financial systems' intermediary functions become a crucial dimension of the aggregate output determination. The intermediation feature is the main idea behind the majority of studies on finance and growth in the last couple of decades.

The notion of financial development as the "institutionalization of saving and investment", in the words of Gurley and Shaw (1955), is echoed in Patrick (1966). He raised causality issues by distinguishing the financial system role on development as being demand or supply-led. The causation definitions found in Patrick's (op.cit) and the

[4] Fry (1988) offers an extensive review of these studies.

basic characterization of the financial institutions' mechanisms in promoting growth are also currently embedded in a great deal of contemporary discussions about the financial markets. Indeed, the financial services definition is still a valid consideration; and as Patrick (1966) argues,

> "(...) the financial system obtains claims to resources which it provides, under optimal market conditions, to the most efficient user. Hence, the most efficient allocation of investment results. (...) financial institutions can achieve economies of scale in the costs of transferring saving to investors through the pooling of default risks of individual deficit spending units in order to determine the most appropriate terms of issuance, and in engaging in transactions among saving and spending units of diverse location, size, or other characteristics" (p. 182-183).

Despite some controversial inferences about the Japanese banking development as an example corroborating his ideas, Patrick (op.cit) suggests some interesting policy measures, especially for a 1965 paper. Even in a work embedded by liberal contemporary ideas, he was able to mention that developing countries should avoid monetary policies dictated by conventional rules of thumb imposed by developed countries; that financial institutions should be backed up by an institutional lender of last resort; and that government should take action in promoting a socially desired allocation of assets.

However, these policy recommendations were not in the same tone as the ones proclaimed by Gurley and Shaw (1955). They considered financial intermediation as an independent process affecting economic growth and the initial recommendations were that governments should use monetary policies according to a public-debt management since higher or lower rates of economic growth might impact the financial system differently. For instance, monetary expansion, in the work of Gurley and Shaw (op. cit), must lag behind income growth if the purpose is to diversify demand; otherwise, if the aim is to satisfy transactions demand, then monetary policies should be expansive in order to offset the effects of growing output capacity and growing debt on propensities to spend. It is the role of the central bank to control monetary policy according to government deficits, making them as lower as possible since higher deficits may affect portfolio decisions by banks, hamper monetary policy effects and also reduce the efficiency of the financial system to intermediate the economic growth process.

However, the above-mentioned monetary control is not the best policy simply because a sophisticated financial system is able to create financial assets in response to monetary control. The alternative policy would be financial control. In the words of Gurley and Shaw (op.cit) "(...) financial control, as the successor to monetary control, would regulate creation of financial assets in all forms that are competitive with direct securities in spending units' portfolios. 'Tight finance' and 'cheap finance' *are the sequels* of 'tight money' and 'cheap money' (p. 537, emphasis added). In this regard, financial control would create asymmetries among different groups of financial intermediaries. By regulating the financial markets, governments would be reducing incentives to create financial innovations and then generating, among other things, credit rationing and lower prospects for growth. Therefore, the best government actions are, on the one hand, the relaxation of legal restraints to avoid unbalanced structures in

the financial markets; and, on the other hand, the minimization of public interference in assets prices (interest rates). We will return to these points in the next section.

These initial papers about the relationship between financial systems and growth were basically concerned with the theoretical framework to support related public policies aimed at improving financial channels. The relevant empirical support was first given by Goldsmith (1969) in a study that scrutinized several cases of financial development. His work consisted of an assessment of financial and economic indicators and variables spanning over 50 years and pioneered not only in computing new forms to measure financial development but also in describing how financial phenomena unfold. The study consolidated the concept of financial deepening. Arestis et al. (2003) reminds us that Goldsmith (op.cit.) is one of the first authors to reiterate the difficulties arising in the analysis of different growth determinants among countries with similar rates of growth.

The empirical studies on financial systems have flourished after developments on the Solow-Swan growth model. A new such proposal concentrates on the technological growth treated as endogenously determined by increasing proportions of capital. The endogenous growth model, as visualized by Lucas (1988), Romer (1989, 1990), and Barro (1991), becomes a suitable structure to assess the role of financial systems in economic growth. Since technical growth is considered endogenous and financial institutions are, by nature, intermediaries in the process, then what is relevant is how an exogenous financial development may improve the linkages of the real processes among technology, capital and income accumulation. Levine (1992) presents the basic foundations of this finance-growth process in a more stylized language raised to fulfil the modern modelling requirements. It can be said in a rather general sense that, according to Levine (op. cit.), the financial system could alleviate productivity shocks and liquidity issues by providing specific financial services (portfolio diversification and liquid assets). By doing so, the financial system improves the investment channels through which the firms could increase their investment ratio, productivity and growth.

However, the building block for the contemporary research agenda has been a series of research studies that assembles and tests a number of parameters to deal with the financial markets asymmetries and consequent impacts on growth. As a result the financial system's contribution to growth as a topic has been repeatedly revisited, mostly by studies like King and Levine (1993), Levine (1997, 1999, 2002, 2003) and other closely related studies, such as Levine and Zervos (1996, 1998), Demirgüç-Kunt and Levine (1996, 2001) and also other studies related to World Bank concerns over countries' growth and institutional differences.

Basically, these works are attempts to model and test empirically the financial system and economic growth nexus by combining endogenous growth models with financial institutions' development parameters. The type of structure being evaluated determined the difference among them. The set was completely predetermined: works were based on a finance-growth theory with predetermined policy recommendations that shaped the basic model structure, giving the support needed for further empirical investigation. Unfortunately, the model still lacks a thorough investigation of the financial

market structures and institutions' functioning. Nonetheless, part of the discussion in the literature tried to cover this theoretical gap and proceeded to investigate and assess the differences between market- and bank-based financial structures, an idea that was initially presented by Gerschenkron (1962) and further discussed by Zysman (1983).

The bank-based view highlights the positive role of banks in mobilizing resource, identifying good projects, monitoring managers, and managing risk (Levine 1997, 2000). Banks are identified with a higher capacity to control financial development more effectively than markets; they can also better deal with agency problems and short-termism (Singh, 1997). As a initially alternative view, the market-based proponents claimed that well functioning markets foster economic growth by enhancing corporate governance, facilitating risk management, diversification and the customization of risk management devices (see, for example, Levine, 2002; Beck and Levine, 2004).[5]

Demirgüç-Kunt and Levine (2001) investigates these different views. Their study concludes that what matters is whether the system's overall financial services are developed or not. The empirical outcomes help support the market- and bank-based systems in conjunction, what was then labelled as the 'financial services view'; the argument is that

> "(...) theory suggests that financial contracts, markets, and intermediaries arise to reduce information and transaction costs and therefore provide financial services to the economy that facilitate the screening of firms before they are financed, the monitoring of firms after they are financed, the managing of risk, both idiosyncratic project risk and liquidity risk, and the exchange of goods, services, and financial claims" (Demirgüç-Kunt and Levine, 2008, p. 3).

The financial-services view stresses that financial systems as a whole provide the key financial services that are crucial for firm creation, industrial expansion, and economic growth. The division between banks and markets in providing these services, however, is of secondary importance. This is the basic argument behind Beck et al. (2001). They show that country-level, industry-level, and firm-level data provide no evidence for the distinction between bank- or market-based views. The prior separation of countries by financial structure does not explain cross-country differences in long-run GDP growth, industrial performance, new firm formation, firm use of external funds, or even firm growth.[6]

Despite all the evidence gathered around the financial-services view, the overall result is a failure to connect economic growth to different types of financial structures and indeed (and more importantly) is a failed attempt to bring forefront a detailed financial structural explanation for growth. The rejection of different financial structures' impacts and the subsequent homogenisation

[5] For shortcomings on both views see Rajan (1992), Morck and Nakamura (1999), Weinstein and Yafeh (1998), Bhide (1993).

[6] These results are corroborated by other studies: Levine (2000) shows that financial structure per se is neither a good predictor of real per capita GDP growth nor of capital accumulation, productivity growth or the savings rate; Beck and Levine (2002) show that financially dependent industries do not grow relatively faster in any of the financial structures; Demirgüç-Kunt and Maksimovic (2002) use firm-level data to confirm that the values predicted by firms own internal resources and short-term borrowings are of much greater importance to the growth process. In resume, all these works rejected the prior separation of financial structures in support of on a global proxy for financial development.

of parameters could only be carried away by further specifying countries' institutional aspects. They were included in the stream of finance-growth works by indicators of legal enforcement (La Porta et al., 1997; Demirgüç-Kunt and Maksimovic, 1998; and Beck et al. 1995) and of creditor protection (Djankov et al., 2007). The adjacent features were labelled as the Law and Finance view: it reiterates the legal system as the primary determinant of the efficiency of the financial institutions (La Porta et al. 1997, 1998, 1999). Such amendments state that legal differences among countries should be taken into consideration every time the finance-growth nexus is to be investigated. La Porta et al. (2000) also rejected the bank and market-based debate. According to him, legal systems that genuinely protect outside investors (both equity and debt holders) are those which promote overall financial development. The efficiency of the legal system is then positively related to innovation and growth.

Such results also changed the research agenda. As the focus on finance determinants to growth shifted from different structures (and their connections) to the links of general institutions to growth, the main investigations were mostly redirected to causality issues. New techniques and more precise measures are being aggregated to the studies in an attempt to support a given direction of causality between finance and growth, leaving the finance research agenda still very much open. The problems of considering financial structures neutrality to growth and the mixed results involving causality patterns still leave space for much debate in the field.

This growing concern over the institutional links between finance and development are constantly paralleled with Schumpeter's early theory of development (at least in reference to the financial system). In general terms, according to Schumpeter (1934) the economic system's development is triggered by an innovation process. Economic development relies on both the existence of an entrepreneur that foresees improvements in the production systems and also a banker that supplies credit for the innovation to be implemented.

In the same fashion, Arestis, Chortareas, and Desli (2006) assume that financial development affects growth by enhancing technology and efficiency of production. In summary, the financial development influence over Total Factor Productivity (TFP) is carried through several channels: it reduces the costs in acquiring information and conducting transactions; it enables better resource allocation by using more accurate information about production control; learning by doing might improve lending decisions; it improves the availability of liquid assets thus encouraging investment in high return activities by reducing cost and risks (facilitates risk management); it reduces market imperfections and constraints on borrowing; promote the development of related financial markets, which can further promote financial development by funding more innovation activities that lead to more productivity gains; and finally, the financial development effect on TFP also enables more economic agents to hedge, trade, and pool risk.

The Schumpeterian approach is also evident in works such as Arestis and Demetriades (1997, 1998), Arestis, Demetriades and Fattouh (2003), and Luintel et al. (2008). These studies review contemporary works by assessing the problems with country parameters'

homogeneity and specific causation between finance and economic growth. They also point out that methodology improvements should be made in the cross-country regressions to avoid misleading results and inferences. Moreover, some problems related to the determination of policies (mostly regarding financial liberalisation) may arise in response to diverse outcomes of the finance-growth relationship.

By conducting a more detailed approach, Luintel et al. (op. cit) are capable to find that, among other things, financial structures are indeed important for economic growth and that different idiosyncratic dynamics arise when countries are investigated by avoiding homogeneity of parameters. Under such results, an important conclusion is the need of financial policies that are closely related to the each countries own specificities.

Issues on causality determination between financial development and economic growth are the main points discussed in Demetriades and Hussein (1996) and in Arestis and Demetriades (1997). However, especially in the latter, an important argument on liberal financial policies is considered. Both papers assume that model misspecification and inappropriate statistical tools are responsible for misleading results in the literature on causality. Different countries show different institutional characteristics and structures that affect the relationship between finance and growth. Based on that, Arestis and Demetriades (1997) go one step further by addressing the validity of the supposed beneficial effects of homogeneous financial liberalisation policies in different countries. In Arestis et al (2003), the scope of investigation is enlarged by assessing more countries and by including important control variables on interest rates restraints, capital inflows restrictions, reserve and liquidity requirements, and capital adequacy requirements. Once again, variation in the results for the countries considered is an indicative of the importance of comprehending underlying country specific institutional characteristics. This conclusion also alerts to the different (and sometimes negative) outcomes of financial liberalisation policies in diverse countries.

This section has scrutinized the first part of our discussion. In the theoretical section of the relationship between the financial system and economic growth, the majority of studies have considered the intermediation role as the main linking function between these systems. We can say that since the first works in the leading contemporary line of thought started to appear in the sixties and seventies, there were always some attached policy concerns about the best way to promote financial development. The upsurge of a new modelling apparatus in the late eighties propelled a new round of empirical work seeking to corroborate the results of the previous studies. New policies regarding the best way to maximise the efficiency of the financial connections to growth are an integral part of the development agenda of virtually all countries around the world. Unfortunately, the liberal view has dominated the discussions. Based on the new developments of the research area, such view has been disseminating the idea that the financial systems can only efficiently function if there is no governmental interference. Therefore, before addressing the origins of the current financial crisis, we need to precisely define what financial liberalisation is. This is the topic of the next section.

3. **FINANCIAL LIBERALISATION**

The separation between financial market segments and the capital movement controls between countries were important aspects of the public regulation of financial sector competition. Since the Second World War, this regulation has tried to give stability to the financial system, permitting it to finance consumption, production and investment at the same time. The success of this public regulation of the financial sector competition was important in prompting greater economic growth together with low inflation, which happened in the 1950s and the 1960s. But the effectiveness of that regulation weakened in the 1970s in view of higher instability in the financial system and in economic activity, lower economic growth and higher inflation.

The loss of effectiveness gave rise to many controversies about the public regulation of the financial sector. The line of thought that prevailed geared the changes in the legal and institutional aspects of the financial sector on the premise that State interference repressed the development of financial activities. That line of thought about the State interference in financial activities was embedded in the hypothesis that the free market is efficient, and competition is able to arrest the problems related to the lack of complete information and transaction costs; especially so with the help of developments in information technology, storage and data processing and communication. The proposed reform was to break the financial activity repression, the separation of market segments, and the capital movement controls between countries, which should not happen anymore. Apart from that, private initiative and the competition in those activities were allowed to develop freely. Financial liberalisation did not mean total absence of regulation and supervision, but it highlighted the role played by the self-regulation of competition. And as Arestis and Basu (2003) suggest,

> " (...) the crucial message of the financial liberalisation thesis is that it is the lack of competition, which brings inefficiency to the financial sector. Interest rate liberalisation is a first step, but it was recognized that this alone would not generate competition in this market, since this market operates within the frame of oligopolistic competition. Consequently, not only is there a need to increase the number of players in this market, but also to tap a larger pool of savings, which a country may be required to seek beyond its own domestic boundary. To increase the number of players there is a need to remove entry restrictions so that other banks and Non-Bank Financial Intermediaries (NBFI) as well as overseas banks can enter into this market. In order to tap a larger pool of savings, there is a need to remove controls over the purchase and sale of foreign currency. There is also need to relax laws relating to takeover and merger activities, and, consequently, the requirement arises to liberalize the external sector of the financial system" (p. 5).

The recent upsurge of interest in these matters emanates from the fact that a number of writers question the wisdom of financial repression, arguing that it has detrimental effects on the real economy. Financial repression has a restraining influence on the equilibrium level of savings and investment and hence on economic growth. For these authors, "State intervention in capital markets is not justified by failures of intermediation due to incomplete markets. Rather, it is because of the intervention itself that markets remain incomplete" (Studart, 2005, p. 22).

Three main problems have been identified, and stressed, with financial repression. First, financial repression affects the propensity to save through its effects on the saving returns. Second, financial repression affects negatively the allocation of savings to finance productive investment, thereby diverting active purchases from items such as household purchases and international exchange. Third, the efficiency of the allocation of savings to finance investment activity is also perversely affected, since this allocation is politically determined, with the State itself identifying strategic projects (directed credit) rather than relying on the marginal productivity of investment projects. As a result of these problems, investment suffers not only in quantity but also in quality terms. Under these conditions the financial sector is likely to stagnate. The low return on bank deposits encourages savers to hold their savings in the form of unproductive assets, such as land, rather than the potentially productive bank deposits. Similarly, high reserve requirements restrict the supply of bank lending, and directed credit programmes distort the allocation of credit since political priorities are, in general, not determined by the marginal productivity of different types of capital.

The financial liberalisation thesis argues for the removal of interest rate ceilings, reduction of reserve requirements and abolition of directed credit programmes. In short, liberalise financial markets and let the free market determine the allocation of credit. With the real rate of interest adjusting to its equilibrium level, low yielding investment projects would be eliminated, so that the overall efficiency of investment would be enhanced. Also, as the real rate of interest increases, savings and the total real supply of credit increase, which induce a higher volume of investment. Economic growth would, therefore, be stimulated not only through the increased investment but also through an increase in the average productivity of capital. Moreover, the effects of lower reserve requirements reinforce the effects of higher saving on the supply of bank lending, whilst the abolition of directed credit programmes would lead to an even more efficient allocation of credit thereby stimulating further the average productivity of capital.

The financial liberalisation thesis also argues against the State interference in the foreign exchange market and in capital mobility between countries. The proposal is the free movement of capital and flexible exchange rates with minimum state interference. Macroeconomic policy should contemplate minimum political interference, with monetary policy conducted by an Independent Central Bank. The latter relies on manipulating the rate of interest to maintain low inflation. And fiscal policy passively operated should keep the relation between public debt and GDB stable (see Arestis, 2008, for a critique).

The proposal of free movement of capital and non-intervention in the foreign exchange market, points to a problem that has been recognized even by the defenders of the financial liberalisation. This complication happens when a country does not have an easily convertible currency. In these countries the flexible exchange rate is a source of economic destabilisation. Under such conditions, it is important for the exchange rate to be administered, with the aim of achieving low exchange rate volatility. The abundance of high quality assets in countries with convertible currency decreases the exchange rate volatility. In the case of countries with non-convertible currency, because of weak economy and

financial system, they do not possess high quality assets to enable them to avoid foreign exchange market volatility. In this case, alterations in the exchange rate tend to be stronger.

Then, entrance and exit of capital have greater repercussions in both financial and foreign exchange markets of developing countries, where convertibility of currency is weak. In these countries, the entrance of capital tends to have repercussions on financial asset prices and on the exchange rate. Increases in financial asset prices favour improvements in consumption, production and investment, thereby making it easier for economic activity to grow. While the national currency appreciation helps to contain inflation increases, greater economic growth tend to be followed by deficit in the current account of the balance of payments. But these deficits are compensated by capital inflows. However, the economic growth induced by the entrance of capital in a country with non-convertible currency tends not to be balanced and continuous. In this type of economic growth, investment develops non-tradeable production disproportionally, contributing to aggravate the trade deficit of the balance of payments. The effects of this imbalance are not manifested while the entrance of capital is happening, because the trade deficit is compensated and inflation is low. This imbalance is evident when the capital movement is reverted, which provokes decreases in financial asset prices and devaluation of the national currency. In this sense, economic growth is interrupted, economic activity is lowered and inflation is increased. According to Obstfeld (2009),

> "(…) if a more flexible exchange rate is necessary for safely managing an open capital account, one collateral cost is that shifts in the world demand for domestic assets (as well as other shocks) can very rapidly translate into substantial real currency appreciation. In the presence of nominal price stickiness, the currency may overshoot. Particularly if credit markets are imperfect, the resulting relative price configuration can send faulty price signals that damage international competitiveness, inducing costly intersectoral resource reallocations and unemployment. With an open capital account, the possibility of undesired real currency appreciation – and indeed, depreciation – is inherent in the trilemma. Because appreciations are associated with distress in the manufacturing sector and with current account deficits, however, it is these rather than depreciations that generally worry policymakers the most outside of crises periods" (p. 53 and 54).

The kinds of entrance of capital (loans, portfolio applications, external direct investment) are important because they stipulate the way in which capital movements revert. Loans are not renewed and new loans become more difficult and expensive. Portfolio applications are thin and funds are diverted in other countries. Direct investment is interrupted and remittances of profits and dividends increase. Nevertheless, the external passive accumulation without an adequate development of tradeable production tends to increase the deficit in trade, reverting the capital movement and interrupting the economic growth.

Experience of countries showed that financial liberalisation had limited success and suffered numerous and unambiguous failures (Arestis and Sawyer, 2007). It enhanced the integration of developing countries into global markets and governments and large firms could enjoy more finance from access to international credit markets. But liberalised economies

became more vulnerable to oscillations in the international economy. Indeed, the experience of some developing countries reveals a cyclical macroeconomic dynamic, with an initial expansionary phase followed by a period of stagnation or recession and growing financial weakness domestically and externally, culminating in financial and currency crises (Frenkel, 2003).

Because of this, new elements were introduced into the analyses of the financial liberalisation thesis, such as the preconditions before reforms are implemented. A sequence to the reform during the process of economic liberalisation was proposed. First, the liberalisation of international trade and domestic financial markets, with the aim of augmenting the competition and developing production, international trade and financial system, was important. For that to happen, meantime, it is necessary to maintain and even strengthen the public control of capital movements, with the purpose to administer the exchange rate, with national currencies relatively devaluated. The latter is important to induce tradeable production, thereby promoting a more stable and continuous growth, strengthening the country's international trade. When the economy and the financial system are developed and the country's international trade becomes stronger, it increases the degree of convertibility of its currency, in the way that increases high quality asset offers. In this case, it would finally be possible to liberalise capital movements, without provoking disturbances in the economy and the financial market. In Frenkel's (2003) words,

> "(…) the resulting policy recommendation was that capital markets should be opened only once the economy had been stabilized and was open to international trade, with a robust financial system, i.e., only once a sequence of policies had been applied (the policies that would later form the core of the Washington Consensus) and the effects expected from the first reforms had fully manifested themselves" (p. 44).

The early experience of countries, which went through financial liberalisation, leads to the conclusion that what happened in economies without convertible currency was that financial liberalisation typically increased a massive demand for credit by households and firms that was not followed either by substantial increases in the investment rate or by continuous economic growth. While the entrance of capital happens, consumption grow, and the maintenance of investment rate and increases in the current account suggest that financial liberalisation did not augment savings; it merely substituted domestic for international savings. In the reversion of capital, increases in default suggest the presence of inadequate supervision and regulation of the financial sector, blocking it to assume the risks of realized financial operations. However, as it was mentioned, there is a more important problem, related to the destabilising effects of free capital movements in an economy that does not have a convertible currency.

According to Arestis and Basu (2003), since the degree of currency convertibility power is low for all developing countries, all their foreign loans have to be paid in foreign currency. In this case, only the assets of their exporting sector are acceptable in the international credit standard requirements. If the foreign loans were not used for the enhancement of export facilities, then the loan repayments would no longer depend on investment project performances. This makes project evaluation irrelevant and credit

standard is not sufficient to protect the lender. Then the problem becomes one of the country's overall ability to attract such financial capital. The possibility to attract foreign financial capital depends on the country's ability to offer international marketable assets. In the case of developing countries, those assets are related to the exporting sector. So, it is not enough to the emergent country to liberalise its finance; it has to be able to attract financial capital. Its economic growth should generate sufficient exports. The entrance of capital appreciates assets and national currencies, but deteriorates export performance and produces a disproportional expansion of non tradeables, thereby unbalancing economic growth. Instead of continuous economic growth, free capital mobility brings strong oscillations to the level of economic activity, with a tendency to slow economic growth and produce a small investment rate. The emergent country needs to develop its infrastructure and production of goods. The financial system development together with liberalisation favour consumption financing, but the investment rate does not increase and economic activity becomes highly unstable.

The application of the financial development theoretical framework to the real world has found several difficulties over the last few decades. The finance-growth model has been proposed as the ultimate policy to promote economic development and international market integration. But, as the models could not produce satisfactory results and the actual macroeconomic interactions were more complicated than it had been initially thought, economies around the world, and over the recent past, have experienced a scenario, which is nearly as bad as the 1930s Great Depression. The next section will further deal with the relevant causes of the actual economic crisis from the monetary policy angle.

4. CURRENT MONETARY POLICIES

The financial liberalisation policies pursued since the 1970s has produced excessive liquidity (widely interpreted) in the system thereby increasing household debt substantially. The excessive liquidity, which became apparent by the early 2000s, was not merely the result of financial innovation, itself promoted by the financial liberalisation experience as discussed above. It has also come about from the type of monetary policy following the introduction of a new monetary policy framework, the focus of which is frequent manipulation of interest rates. In the US at the time, the Fed Chairman, Alan Greenspan, injected liquidity and cut interest rates following the Asian-Russian crises of 1997 and 1998, which was only partially drained later on. In view of the deflation dangers in the aftermath of the burst of the internet bubble in March 2000, Alan Greenspan cut interest rates in a sequence of steps from 6.5% to 1.0% and injected huge liquidity into the US economy. Moreover, he was late and slow in draining that liquidity and reversing the rate cuts. Ben Bernanke, the new Fed Chairman after Alan Greenspan proceeded along similar lines as his predecessor and injected further liquidity following the ongoing credit crisis that erupted in the summer of 2007.

It is also true that financial innovation that followed financial liberalisation, has played an equally, if not more, important role than easy monetary policy in creating the huge liquidity and debt of the 2000s. This era allowed

financial institutions to initiate a new financial activity, which was based on the discretion of the banks to dispose of their loan portfolio in accordance with risk management. That financial innovation relied heavily on interlinked securities and derivatives, all related to subprime mortgages. Subprime mortgages are a financial innovation designed to enable home ownership to risky borrowers. This financial innovation encouraged banks to provide risky loans without applying the three C's to each borrower – Collateral, Credit History and Character. This was so since banks could easily sell these mortgages or other loans to an underwriter, or act as an underwriter to sell to the public mortgages backed by low quality securities. This led to the unprecedented growth of the sub-prime market. That is a market where banks could provide loans to borrowers with poor credit history or with questionable ability to service their loans in adverse economic conditions. Banks set up trusts or just limited liability companies, what is known as Structural Investment Vehicles (SIVs), which required a very small capital base. This created parallel banking outside the regulatory umbrella and sowed the seeds for the current credit crisis. The SIV operations were financed by borrowing from the short end of the capital markets that is linked to the inter-bank rate of interest, the LIBOR rate. This short-term capital was then used to buy the risky segment of the loan portfolio of the mother company. The loan portfolio was then re-packaged in the form of Collateralised Debt Obligations (CDO), which was sold to other banks and to the personal sector. In the process and so long as the inter-bank LIBOR rate remained below the rates of CDOs, SIVs made profits. As a result, these days banks hold few traditional liquid assets, such as government bonds; they are loaned up with claims of varying quality on the private sector, largely based on residential or commercial property. The housing bubble burst when the yield curve became inverted with long-term interest rates lower than the inter-bank LIBOR rate of interest.

The complex structure and highly illiquid nature of the CDO market has complicated the task of credit rating institutions, which erroneously assigned AAA-status to many worthless papers. The overstated credit rating has contributed to the growth of the CDO market in the upswing of the cycle, but also to its downfall in the downswing. This aggravated the losses of financial institutions during the credit crisis. The CDO market injected huge liquidity into the system, which was not reflected in monetary aggregates and, therefore, not monitored by central banks with respect to its implications for financial markets and the economy. The sale of CDOs to international investors made the US housing bubble a global problem and provided the transmission mechanism for the contagion to the world economy and Europe, in particular. The banks were so greedy in providing risky loans that in the upswing of the cycle the pace of accumulation was faster than the pace of unloading them from their books. Thus, when the credit crisis started many banks found a higher than desired stock of CDOs in their balance sheets. The losses from CDOs exacerbated the losses of financial institutions. For reasons of reputation, many banks were forced to incorporate the balance sheets of the SIVs into their books.

In normal times financial innovations reduce risk and convince central bankers that there is a minimal systemic risk of contagion following the decline in house prices. On the occasion of the August 2007

credit crunch, central bankers on both sides of the Atlantic underestimated the systemic risk from the collapse of the sub-prime market. They claimed in the spring of 2007 that only a few individuals and institutions would be hurt with minimum damage for the economy as a whole. This led the Fed Chairman to keep interest rates high as late as August 2007. But there was a drastic reversal of that policy following the plunge of equity prices and the widening of credit spreads in August 2007. The Fed injected liquidity and cut interest rates aggressively from 5.25% to 2.0% over the period since August 2007. The Fed and other central banks have also taken extraordinary steps over this period to extend liquidity to brokers and investment banks in addition to commercial banks. Furthermore, governments around the globe, with US leading, announced sweeping actions to head off wider market disruptions, including plans to purchase distressed mortgage related securities on a massive scale, as well as a one-year guarantee of money market mutual funds. Since August 2007 what started with market turmoil surrounding US subprime mortgages, became a financial storm of historic proportions. Consequently, one may restate the problem by suggesting that financial innovations and closer links between banks transformed what started in August 2007 as a liquidity crisis into a solvency issue for the financial sector.

The model discussed in Arestis and Karakitsos (2004) provides an assessment of the short-term effects of this asset-debt deflation process. As reported in Arestis and Karakitsos (2010) US nationwide house prices (median price of existing homes) have so far fallen more than 10% and the model suggests that in the trough of the first (and last?) cycle house prices are likely to fall by 30%, from their peak, by mid-2009. Relative house prices have so far fallen 18% and will be eroded by another 18% by the end of 2009. The model suggests that the trough of the housing market is likely to be hit towards the end of 2009. A year after house prices peaked equity prices commenced to fall, thus putting further downward pressure to the wealth of households. Financial wealth has declined by 9% by the end of June 2008 from its peak in September 2007 and the model suggests that further losses are likely with the benchmark S&P 500 bottoming at around 900 by the end of 2009. In the second quarter of 2008 households reduced for the first time their mortgage debt by more than 3%. The model suggests that mortgage debt will decline by 13% by the end of 2009. The net effect of the decline in house prices and equities and the reduction of debt on personal sector wealth have so far been -10%, but it is likely to be slightly bigger by the end of 2009. Consumers are likely to retrench as a result of the decline in wealth, thus prompting firms to shed labour. The model suggests that job losses will mount in the next twelve months and bottom probably at the end of 2009. The combined effect of a fall in net wealth and real disposable income will curb consumption growth to 1% in 2008 and just 0.1% in 2009. Businesses are bound to curtail investment. The model suggests that investment will fall -6% in 2008, but increase less than 1% in 2009. Export growth, the only robust component of aggregate demand so far, will be halved in 2009. The overall effect on GDP is expected to be 1.5% in 2008 and just 0.6% in 2009. CPI-inflation will decline in the course of the next twelve-months in response to a widening negative output gap and because of the burst of the commodities bubble, as

the theory of decoupling between BRIC and western world has collapsed.

The process is likely to involve second-round effects. As house prices and equity prices continue to fall the losses of financial institutions are magnified with further deflationary effects on the economy. The risks are on the downside with house prices likely to overshoot their long-run equilibrium of 30%. In the absence of policy intervention these second-round effects take hold and the asset-debt deflation process deepens. Judging from the experience of past crises, such as Japan in the 1990s, the Great Depression in the 1930s and the railways in the late 1800s, the deflation process takes around ten years to unwind.

However, the policy initiatives both by the US authorities and by the rest of the world should speed up the process of adjustment and the asset-debt deflation process might take two-three years. Two parameters will shape the accuracy of the forecast – the extent of house price drop and the losses of financial institutions.

6. SUMMARY AND CONCLUSIONS

This contribution has outlined the finance-growth theoretical framework and its implications to the current economic crisis. We have showed that the finance-growth models were embedded by the neoliberal policy recommendations that have been implemented in countries around the world. This model promoted financial liberalisation as a panacea for economic growth. We have also shown the problems raised by financial liberalisation policies under the perspective of growing interactions at the international market level, especially for developing countries. We are now facing the perverse consequences of the increasing unregulated flow of funds among countries. It is time to reflect on the financial liberalisation legacy of the economies around the globe, and the possible policy actions to curb present and future problems that different countries might face.

We need to regulate financial engineering. Securitization implies a transfer of risk from banks to the personal sector and makes banks more willing to promote both lending and the sale of asset backed securities to the personal sector. We should avoid the problem of fraud in the sub-prime arena; the problem has never been with the sub-prime model per se. It is this financial engineering that allowed US housing to become a bubble. Ultimately, the root of the problem, though, is the financial liberalisation era, which promoted the financial engineering as discussed in this contribution. Financial engineering is so complex that central banks would have a tough time if they wanted to measure, monitor and control the total liquidity in the economy. New policies are desperately needed. Above all we should not lose sight of the fact that this crisis is the result of regulatory failure to guard against excessive risk taking in the financial sector. Policymakers must ensure that it does not happen again. Work has actually started to rebuild the architecture and the leading industrialised countries have already put forward recommendations for better prudential regulation, accounting rules and transparency. The role of credit agencies will also need to be rethought, with greater public scrutiny. In a globalised world, these efforts will have to be broad-based if they are to be effective. Above all, though, what is of paramount importance, as our title clearly suggests, is the end of financial liberalisation.

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