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Is Financial Liberalization a Flop?

An Africa Assessment

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Sub-Saharan Africa's long-term development, including attainment of the MDGs and continued progress beyond 2015, depends on mobilizing domestic financial resources and channeling them to productive private and public investment. From roughly the mid 1980s to the mid 1990s, many of the countries in the region undertook financial liberalization in order to promote such an objective. This One Pager evaluates the outcomes by examining the experience of 19 countries that have liberalized (see Serieux 2008).

During 1965-1985, almost all African countries followed what orthodoxy now labels as policies of 'financial repression', i.e., maintaining (administered) low interest rates and directing cheap credit to certain enterprises and sectors in order to foster rapid growth.

Between 1986 and 1995, many of these countries underwent a process of domestic financial liberalization, instituting market-determined deposit and lending rates, eliminating directed credit, creating more competitive conditions and reducing the flow of credit to the public sector.

In our analysis, we explicitly compare the record of our sample of 19 countries for the period before liberalization (1965-1985) and that afterwards (1996-2005), using regression analysis to identify impacts on private (and public) savings, private investment, the liquidity ratio, credit to the private sector, and economic growth.

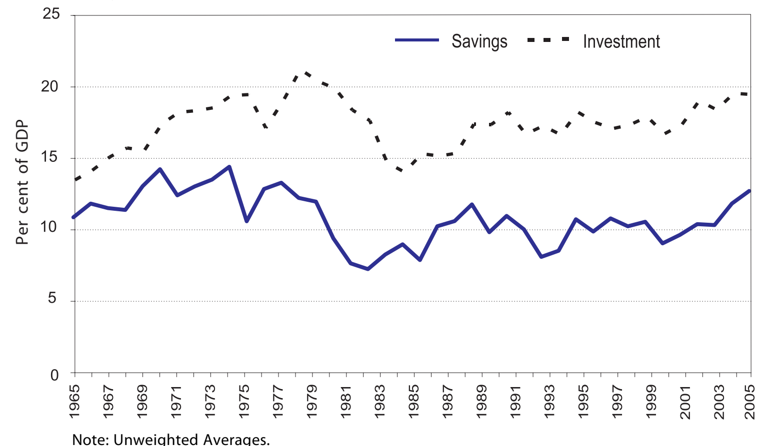
Private (and Public Savings): The Figure shows that total domestic savings for these countries peaked at 14 per cent of GDP in 1974 and declined to a nadir of just over seven per cent in 1982. It recovered modestly then stagnated at around 10 per cent through the 1990s, showing signs of a renewed rise only after 1999.

Thus, it is not surprising that our regression results suggest that neither liberalized nor 'repressed' financial regimes had a significant impact on private savings. Generally, factors such as terms-of-trade movements, the dependency ratio and inflation were the important determinants. Public savings were negatively related to private savings across both regimes, but were less so under liberalized finance.

Private Investment: Total Investment has followed a similar pattern to that of savings. But even a recent modest rise has not brought it back up to the peaks of the late 1970s, which exceeded 20 per cent. Nonetheless, our results show that 'repression' was negatively correlated with private investment while liberalization had no significant level effect. However, private credit did become more correlated with investment in the liberalized period.

The Liquidity Ratio: Under liberalized finance, the real rate of interest was the most important determinant of growth in liquidity whereas during financial 'repression', it was the level of income that mattered. However, overall, liberalization was correlated with slower growth in liquidity whereas 'repression' was correlated with faster growth.

Gross Domestic Savings and Investment for 19 Sub-Saharan African Countries, 1965-2005



Note: Unweighted Averages.

Private-Sector Credit Growth: Under liberalization, public-sector credit expansion and the real interest rate had significant effects on the expansion of credit to the private sector. During 'repression', there were no such significant determinants. However, 'repression' was still associated, overall, with faster growth of such credit while liberalization was associated with slower growth.

Economic Growth: Neither 'repressed' nor liberalized finance was correlated with growth. In general, the rate of investment and growth in OECD countries were the important determinants.

In summary, liberalization has modestly reduced the substitutive relationship between public and private savings and increased the correlation between private credit and investment. But it has been negatively correlated with both liquidity and private-sector credit expansion and has had no effect on growth. In short, the overall effect of liberalization on resource mobilization has been ambiguous and marginal. So, though much heralded, liberalization must be judged a flop—at least by our empirical results.

Since the 'repression' period did not perform well either, our findings point to the need for deeper structural changes—probably beyond financial-sector policies—in order to substantially improve resource mobilization in sub-Saharan Africa.

Reference:

John Serieux (forthcoming 2008). 'Financial Liberalization and Domestic Resource Mobilization in Sub-Saharan Africa: An Assessment'. Draft Working Paper, Brasilia: International Poverty Centre.

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