THEORETICAL ASPECTS OF FINANCIAL LIBERALIZATION PROCESS

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Abstract: *Financial liberalization process and its implications on financial emerging markets have been multidisciplinary research since 1970. Reform of financial liberalization is a complex and long phenomena. This implies that the impact of this reform on financial markets should not be immediate, but rather gradually during a long time period. It is also important to note that liberalization does not occur in the same way on all financial markets. Each country, according to his specification regarding the economic climate and the specificity of financial markets, has differently set its progress of liberalization process. It is generally accepted that the process of financial liberalization is not composed of a single event, but a series of events. The idea is that market reform is a gradual process where the data identified above only refers to the most significant events. Regarding the effect of liberalization reform on emerging markets has been shown; on the one hand, that liberalization helps to reduce the cost of capital, helps to integrate the emerging markets in the global market, enhances economic growth and allows emerging markets to become more mature. On the other hand, financial liberalization process has a very ambiguous and inconclusive impact on informational efficiency and volatility in emerging markets. Launching liberalization reforms provided an analytical framework for studies that attempt to investigate the effectiveness of emerging markets and empirical links between liberalization and efficiency. The first reason is that with liberalization, the authors believe that emerging markets have become more speculative and more competitive. So there is a chance to see if the weak form market efficiency is verified. The second reason is that the authors explore the relationship between liberalization and efficiency. Researchers and regulators seek an answer to the fundamental question: financial liberalization helps the stock market become more efficient? Financial liberalization is not a riskless process.*

Keywords: financial liberalization; stock market; capital

Jel classification: O16; G10; G32

1. Introduction

Financial liberalization process is not a contemporary phenomenon. For decades, Western countries and companies were operating in a free economy. Thus, it is difficult to identify the beginnings of financial liberalization process. It is sufficient to recall the role of bankers in Europe Italian Renaissance in the nineteenth century in

order to illustrate the importance of English and French capitals in the world, especially in the colonial empires in Russia, and the influence of American capital movements following the crisis in 1929.
Financial liberalization includes several elements; it reflects a variety of restrictions that were imposed. This may includes: capital account liberalization, financial sector liberalization and capital market liberalization (Table 1).

Table 1: Elements of financial liberalization

Capital account liberalization	**Financial sector liberalization**	**Liberalization of stock markets**
Criteria for liberalization		
Bank loans and foreign companies	*Interest rates*	*Acquisition by foreign investors*
Banks and companies are allowed to borrow abroad. They should inform the authorities, however, a license is granted almost automatically. Required reserves are less than 10%. The minimum maturity is not more than two years.	There are no controls on interest rates.	Foreign investors are allowed to hold domestic equity without any restrictions.
And	And	And
More exchange rates and other restrictions	*Other indicators*	*Repatriation of capital, dividends and interest*
There are special exchange rates for both current account transactions, but not for capital account transactions. There are no restrictions on capital outflows.	There are no controls on lending (subsidies for certain sectors or certain credit allocations). Deposits in foreign currencies are allowed.	Capital, dividends and interest can be repatriated freely within two years of the initial investment.

Source: Souza (2004)

2. Literature review

Many studies have been made to highlight the impact of financial liberalization on the financial sector and the overall economic performance of emerging economies. Thus, some authors praise the benefits of financial liberalization. There has been shown that financial liberalization contributes on the one hand, to strengthen the functioning of financial systems, improving the competitiveness of the banking and financial sector and the transformation of savings into funds available for financing the economy. On the other hand, helps to promote international diversification and access to global capital markets. For example, Kim and Singal (2000) argue that abandoning controls on the financial sector leads to more efficient capital markets in emerging economies allows guiding existing funds and national economies to the most productive investments. Levine and Zervos (1998), Stulz (1999) and Mishkin (2001) argue that liberalization will improve transparency and reduce liquidity problems in developing countries. Other authors, such as Bekaert and Harvey (2000) and Henry (2000) claim that, particularly, in emerging markets participants can enjoy new gains from international diversification and cost reduction capital after liberalization. Also, Bekaert et al. (2001) argue that economic growth tends to be improved as a result of financial liberalization.

Financial crises of the 1990s show that financial liberalization is not a process without risk. Indeed, the banking system was fragile and collapsed in many emerging economies. Economies where there were high growth rates have become characterized by severe recession. Also, a negative phenomenon is to increase the risk of financial instability, which is caused by the free movement of capital. This is why, after the Asian crisis, many authors have found that financial liberalization took place too quickly and expanded too far, so there was a request for resetting up controls on the financial sector. Stiglitz (2000) suggest that there must be set some limits on capital flows to moderate excessive capital inflows and outflows due to problems of over-reaction to the shock and herding behavior of investors in periods of high uncertainty. Krugman (1998) considers that the free movement of capital flows was one of the causes of the Asian crisis, and recommends implementing controls to reduce the adverse effects.

Empirical financial literature, despite its abundance, failed to reconcile this conflict of opinions. Empirical results highlighted in the literature on financial crises suggest that financial markets have in center financial turmoil. Proponents of the theory of the occurrence of crises especially emphasized the destabilizing nature of financial deregulation [Corsetti et al. (1999), Kaminsky and Reinhart (1999)]. Instead, the financial literature suggests that removing controls from financial markets and capital flows are beneficial to emerging economies because they keep them most liquid and substantially reduce the cost of capital (Bekaert et al. (2002), Henry (2000)]. For Kaminsky and Schmukler (2003), the difference in views on the expected impact of liberalization on emerging economies could result from the fact that some articles are focused on short-term effect of liberalization, while others are focused on its effect on long term. The authors point out further that in most cases, empirical studies neglect the idea that liberalization is dynamic and progressive, for which should not be allowed to reach definitive conclusions.

3. Advantages and disadvantages of financial liberalization

3.1 Arguments in favor of financial liberalization process

In the early 1970s, the economic environment was very different from today. Many national economies were characterized by financial repression. This means to set constraints on financial system, such as taxation of bank reserve requirements (often large), to put barriers on the free movement of capital flows and restrictions on the access of foreigners in domestic industries. All these are the main obstacles to economic development, because they impeded the international exchange. The situation was even more critical as domestic resources were insufficient to finance the economic development. To avoid different crisis, all countries were subsequently forced to open its stock markets to foreign investors in order to seek external funds.

Liberalization was thus created and it started by removing regulations that constrain the international flow of capital (Stiglitz, 2000). Initially, this financial process was adopted by the largest economies in the world, like Germany in 1973, followed by United States in 1974. Emerging countries waited until the early 1980s, when the governments understand the role and importance of financial liberalization process. The main reason was that the loans granted by foreign banks in favor of emerging markets, which were the only source of external financing, fell sharply following the debt crisis in Latin America during the period 1982-1983 (Richard, 2002).

Among the arguments that favor the adopting the financial liberalization process, we can include monetary measures, namely: (i) the economic growth, that is driven by demand factors of production (capital and labor) and the rate of productivity growth, (ii) the currency supply, it is an exogenous variable of the system and it can be controlled by monetary authorities and (iii) inflation, it is attributed to an excessive increase in the money supply relative to the actual rate of production increase and it can be moderated by reducing the growth rate of money supply.

These arguments did not present a clear relationship between money growth rates and inflation, on the one hand, and real output growth on the other. The monetarist argument is based on the assumptions that are related to the degree of employment and aggregate money supply that is driven by macroeconomic policy. Neither of these assumptions is valid, because in a world of financial innovation, quasi-money can be created, global liquidity in the system cannot be rigidly controlled by the monetary authorities. Thus, we can say that the actual liquidity in the system is determined endogenously. Therefore, the real monetary variable that is in "government hands" is the interest rate.

There are some negative economic and social effects of financial liberalization, which are often so large that they outweigh any benefit that regards the access to more capital inflows. This refers to both financial markets and the economy. This means that financial liberalization creates exposure to the following types of risk: a trend towards financial crises, both domestic and foreign; a deflationary impact on real economy and limited access to funds for small producers. This in turn has major social effects in terms of job loss.

3.2 Disadvantages of financial liberalization process

Financial fragility and the tendency towards crisis

It is now widely accepted that financial liberalization has led to increased financial fragility in developing countries, which conduct them to periodic financial crises. These refer to the domestic banking crises and currency crises. The origin of many crises can be traced through the transition to a more open and liberal regime in financial terms, because it unleashes a dynamic that pushes the financial system to a poorly regulated and oligopolistic structure, with a corresponding increase in fragility. Greater freedom to invest, including in sensitive sectors, such as real estate and stock markets, the ability to increase exposure to certain sectors and individual clients and increase regulatory tolerance, all lead ultimately to increased cases of financial crisis.

Financial markets are known to be predisposing to crises, due to their public characteristics of information. Agencies must acquire and process all these information. They are characterized by insufficient monitoring by market participants. Individual shareholders tend to refrain from investing time and money in the acquisition of information regarding the management, hoping that others will do so, and they may benefit from the obtained information (Reinhart and Smith, 2002). Thus, it appears to inadequate monitoring information, which will lead to risky decisions and malpractice. Financial firms that want to reduce or avoid monitoring costs, they can simply follow the investment decisions of other financial companies leading to what we call "herd instinct", a feature of the market players. This does not limit the access to finance for some agents, but could lead to over lending entities whose failure could have systemic effects.

The effects of deflation and development

The strongest criticism of financial liberalization process refers not only to the increased possibility of occurrence of crises, but the argument that it has a clear bias against deflationary macroeconomic policies and force the state to adopt a deflationary position to appease financial interests (Patnaik, 2003). To begin with the need to attract international capital means that there are limits to the possibilities of intensifying taxation, especially on capital. The financial liberalization process has reduced indirect tax revenues of states that were under the financial liberalization. This imposes new limits on government spending because financial capital is generally opposed to large fiscal deficits. This affects the economic growth or development activities of the state.

Covering the deficit is seen as increase liquidity in the system and therefore is regarded as being potentially inflationist (Prasad et al, 2003). Inflation is the anathema to finance because erodes the real value of financial assets. However, government expenses are "autonomous" in character, so that the use of debt to finance such autonomous spending is seen as placing a arbitrary player in financial markets, which is not driven by profit reasons, whose activities may cause differences in rates interest, so further financial profits become more unpredictable. If the deficit leads to a substantial increase in debt, it is possible for the government to intervene in financial markets to reduce interest rates that can have an impact on financial returns.

4. Internal liberalization versus external liberalization

Financial liberalization refers to measures aimed at eliminating or reducing direct regulated controls on institutional structures, instruments and activities of agencies in different segments of the financial sector. These measures may relate to internal or external regulations [Chandrasekhar (2004)].

Domestic financial liberalization refers to financial reforms and involves, in particular, banking reforms and privatization policies. In theory, domestic liberalization should allow free-floating interest rates and central bank policy to manage credit and loans. However, fluctuations in interest rates are expected to depend on the currency demand and supply of traders.

Internal liberalization typically includes some or all of the following:

➢ Reduction or elimination of controls on interest rates and fees charged by financial agents. Of course, the central bank continues to influence or manage rate structure by adjusting the discount rate and its own market operations. But usually, deregulation eliminated interest rate ceilings and encourages competition among financial companies, which aimed to attract depositors, on the one hand, and to tempt the potential lenders in the loan contract, on the other hand. As a result, price competition limited expansion and forced financial firms (including banks) to depend on the volumes traded for ensure profits.

➢ Withdrawal of the state from financial intermediation by converting "developing banks" in regulated banks and privatization in the banking sector. It is usually accompanied by the decline of direct loans and eliminating the requirements for special credit allocations for priority sectors (whether they are public), agriculture, small producers, and other sectors regarded as for strategic priorities or economic development.

➢ Relaxing the conditions for the participation of both companies and investors on the stock market by eliminating or reducing listing conditions, by providing freedom in fixing the prices of new stocks, by allowing a greater degree of freedom to intermediaries such as brokers.

➢ Reduce controls on investments can be undertaken by financial agents. Most regulated financial systems have tried to keep separate different segments of the financial sector, such as commercial banks, mutual funds and insurance companies. Agents from one segment to another segment can not invest for fear of conflicts of interest which could adversely affect business. Removing the "wall" between these sectors leads to "universal banks". This means an increased interdependence of financial structures.

➢ The liberalization of the rules governing the various types of financial instruments that may be issued and purchased in the system. It transforms the traditional role of banks in the main intermediate that introduce the risk in the system. Conventional, banks have agreed liabilities with short maturities of small entrepreneurs who were highly liquid and involved lower costs and reduced risk capital, respectively that have made large investments, relatively illiquid and risky on the medium and long term.

External financial liberalization typically involves changes in the exchange rate regime. Usually full convertibility for current account transactions were accompanied by trade liberalization reforms either consecutively or simultaneously, which are then filled with different degrees of capital account convertibility. External liberalization is interested in policies that facilitate foreign capital inflows on domestic markets, and in this way, in the participation of foreign investors. This type of liberalization involves the following, but with a wide variety of implemented models:

➢ Measures allow foreign residents to hold domestic financial assets in the form of debt or equity. This may be associated with greater freedom for domestic firms to undertake external commercial borrowings, often without government guarantee. It may also involve the reduction or elimination of controls on the entry of new firms in the stock market.

➢ Measures allowing domestic residents to hold foreign financial assets. This is usually seen as a drastic liberalization method, because it facilitates capital flows to domestic residents in times of crisis. However, some countries that receive excessive capital inflows have resorted to such measures as a measure to reduce pressure on the exchange rate.

➢ Measures that allow to foreign currency assets to be held and traded freely in the national economy. This is the most extreme form of external financial liberalization, which has been implemented in a few countries.

➢ Expanding resources and tools through which businesses or financial agents can access funds .This leads to the proliferation of instruments, such as commercial papers and certificates deposit issued by domestic market and allows access of offshore products on secondary market such as ADRs (American Depository Receipts), and GDRs (Global Depository Receipts).

Financial literature focuses on external liberalization in general, and in particular, the policy that facilitates international investment portfolios (Nguyen and Bellalah, 2008). The purpose of these policies is to ensure that in a liberalized market, foreign investors hold, without having to be subject to restrictions, listed financial assets in emerging markets and domestic investors to hold the right to trade securities issued on foreign markets. Therefore, all deregulations that aimed the opening of national markets for non-resident investors are seen as the first elements characteristic of external liberalization process.

5. Indicators of financial liberalization process

Financial liberalization can be recognized by official data and the effects of liberalization occurred, such as the introduction of ADR and investment funds, or a significant increase in U.S. capital flows. To better understand this reform is important to study the shown effects (Arouri et al, 2010).

Foreign capital flows

Foreign capital flows to emerging markets reflects the effects of financial liberalization and is thus the first actual indicator of reform. These streams comprise mainly foreign direct investment flows (FDI), portfolio investment flows (international equity portfolio flows), cash deposits and bank loans (table 2).

Table 2: Capital inflows and outflows on emerging markets during 2000 - 2007

Capital flows (bil. $)	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Foreign direct investment	212	228	190	204	276	374	464	533
Portfolio investment	97	16	-8	92	139	213	347	475
Banking loans and deposits	2	-57	3	124	200	171	363	968
Total capital inflows	***311***	***187***	***186***	***420***	***615***	***758***	***1174***	***1975***
Foreign direct investment	-101	-52	-50	-43	-130	-145	-262	-332
Portfolio investment	-106	-110	-90	-130	-171	-264	-529	-511
Banking loans and deposits	-132	43	15	-140	-198	-261	-415	-782
Reserve assets	-140	-133	-191	-361	-502	-586	-752	-1258
Total capital outflows	***-478***	***-252***	***-316***	***-673***	***-1001***	***-1256***	***-1958***	***2884***

Source: Arouri et al (2010)

American Depositary Receipts (ADRs)

The introduction of ADRs is considered as an important event of the liberalization process. In many cases it may precede the official date of liberalization of the local market. ADRs were first introduced to Morgan Guaranty Bank in 1927 to help U.S. investors to purchase securities listed on foreign markets, these markets are closed to foreign residents. An ADR is a negotiable certificate of deposit issued by U.S. banks and represents a specified number of shares of a foreign market that are traded outside the United States. ADRs are denominated in U.S. dollars and traded on U.S. stock markets like New York Stock Exchange (NYSE) and American Stock Exchange (AMEX).

The introduction of closed funds

A closed-end fund is an investment company that issues shares in national markets and use various procedures to invest in shares of companies that are in a foreign country. Thus, investing in a closed-end fund allows exposure to local markets and international diversification. Before the liberalization of stock markets, unit trusts funds provide a measure for investors to gain access to some emerging financial markets where investors have no right, legally speaking, to deal with domestic stocks.

6. Conclusions

The impact of financial liberalization can be properly assessed only if the following aspects are considered:

- The market could have immediate reactions to the information disseminated;
- Market participants might anticipate and react before the event of financial liberalization process. Indeed, the market can be informed before deciding the financial reform, the rumors or the time lag between the announcement and effective liberalization date;
- The market could have delayed reactions to the events of financial liberalization. This idea comes from the fact that financial liberalization is not complete after the first event, and there are other subsequent events that follow;
- Financial liberalization is a part of economic and financial reforms from a package, which simultaneously affects the national financial system, the stock exchange market and capital account;
- Changes in the behavior of emerging markets are not only because of financial liberalization process. It is important to simultaneously monitor the impact of reforms;
- Country-specific factors such as political and economic conditions, could significantly influence changes in the banking and financial sector. Many countries have opened their stock markets to foreign investors in times of economic prosperity, to avoid selling securities at discount. These factors must also be controlled.

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