Economics focus

No pain, no gain

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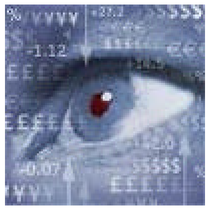
An occasional crisis may be a price worth paying for faster growth



DOES slow-and-steady win the race? When it comes to liberalising their financial markets and industries, many poor countries hope so. Remember the crises that have afflicted financially liberalised economies such as Mexico, Russia, Argentina and some in South-East Asia, and their caution is easy to understand. Why open the gates to foreign capital, only to invite excesses that will cause pain and disappointment later?

The fear of currency crises and the subsequent unemployment, bankruptcies and stalling of economic growth have made many developing countries' governments even more wary about the free flow of capital than they are about free trade in goods. Freely flowing capital can indeed be destabilising. So-called "hot money"—portfolio flows that can reverse direction at lightning speed—can send currencies spiralling up or down and play havoc with economic management. Such an experience during the Asian crisis of 1997-98 led Malaysia, for example, to introduce capital controls in order to thwart what it perceived as outsiders' nefarious schemes. Despite foreign scepticism when the controls were imposed, they seem to have done Malaysia little harm. A more general suspicion of foreign capital, going far beyond worries about flighty portfolio investment, was one reason behind developing countries' refusal to consider further financial liberalisation at the World Trade Organisation's failed ministerial meeting in Cancún in September.

But financial systems can be liberalised a lot without letting in hot money. If a government opens up to investment from abroad—allowing foreign banks to buy local institutions, say, or allowing domestic banks to raise money on international capital markets—local banks can lend more to businesses large and small. This matters, because bank credit is often the only source of finance for many firms. The downside is that banks may become over-eager and make loans on which the returns do not justify the risks. That can produce horrible busts.

So the slow-and-steady school seems to have a certain appeal. Nevertheless, it is wrong, according to a recent paper* by Romain Rancière, of Pompeu Fabra University in Barcelona, Aaron Tornell, of the University of California at Los Angeles, and Frank Westermann, of the University of Munich. They look at the performance of poor countries between 1980 and 2001 in order to assess the impact of financial liberalisation on economic growth. Their chosen measure of financial liberalisation is the stability of bank lending over time. India, for example, has kept banks' lending on a tight leash and thus has maintained a fairly stable rate of growth of credit. Thailand, in contrast, was a liberaliser. It let credit expand rapidly, right up until its crisis in 1997, when lending contracted sharply. Thailand suffered the typical fate of liberalisers: its companies owed debts in foreign currencies that their baht earnings could no longer cover.

India's safe approach was not as wise as it looks. Between 1980 and 2001 its GDP per head just about doubled. Impressive? Not next to Thailand's, which expanded by 150%, despite the deep recession induced by the 1997 crisis. Granted, there are many reasons for India's slow growth: its lack of economic liberalism has not been confined to finance. However, the authors estimate that Thailand's rapid credit growth explains between a quarter and half of the difference between its performance and that of India.

Across the 52 countries studied, the authors argue that there is a common trade-off between stability and average growth rates. They think that financial liberalisers grow by two percentage points a year more on average, with banks' credit growth alone accounting for perhaps one point. This is striking if correct: over a long period, an extra percentage point of growth a year can make a huge difference to living standards.

A Chinese conundrum

Yes, you might say, but does this trade-off really exist? China would seem to be an exception. Financial liberalisation has been slow—foreign banks are being let in only one step at a time—and yet China's economy is growing at breakneck speed. In fact, argues Mr Rancière, China's high growth rate has been driven by very incautious lending by domestic banks. The country has taken just as many risks as more liberal countries have, but is yet to pay the price. The scale of bad loans at the country's leading banks (almost a quarter of the total, says the government; much more, says everyone else) would seem to bear him out.

One reason why liberalisers do well, suggest the authors, is that crisis does not mean eternal chaos. Most of the countries covered suffered only once in the short period they studied. This is not to deny that the consequences of crises can be painful. Yet there are measures that liberalisers can take to avoid crises, or at least to lessen the resulting pain. They can strengthen their laws and courts to reassure investors that their loans will be repaid: that may dissuade some foreigners from taking their money away in a hurry. All too often, developing countries make the busts more painful than they need to be, for example by delaying inevitable devaluations. Argentina is one country that took longer to devalue than it should have done.

None of this means that countries ought to relinquish all controls over their capital account. Limits on capital flows, especially short-term, hot ones, can sometimes be a good thing. Over the long run, however, the lesson is clear. A more efficient financial sector, even when it leads to a widespread bust every decade or so, may well be worth the benefits it brings by lifting people out of poverty. The hard part is to make those inevitable contractions less painful.

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* “Crises and Growth: A Re-evaluation”. NBER Working Paper No. 10073: available at www.nber.org/papers/w10073