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Financial Liberalization, the Finance–Growth Nexus, Financial Crises and Policy Implications

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Abstract The purpose of this chapter is to investigate the growth–finance nexus with reference to the 'financial liberalization' thesis. This thesis can be succinctly summarized as amounting to freeing financial markets from any intervention and letting market forces determine the size and allocation of credit. The history of banking, however, since the policymakers in both developing (emerging) and developed countries adopted the financial liberalization thesis tells a rather different and sad story. Ever since the adoption of the essentials of the financial liberalization thesis, banking crises have been unusually frequent and severe. In this contribution we discuss the financial liberalization aspect of crises, emphasizing two examples that led to crises: the Southeast Asian crisis and the 2007/2008 international financial crisis that led to the 'Great Recession'. We then discuss economic policy implications, along with relevant eco-

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nomic policy proposals that could support financial stability and avoid future financial crises.

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1.1 Introduction[1]

This chapter investigates the 'financial liberalization' thesis, within the growth–finance nexus. This thesis emerged in the early 1970s in view of a number of controls by the central banks on the financial markets, which had been fairly common practice in the 1950s and 1960s. The experience of that era with those controls was challenged by Goldsmith (1969) in the late 1960s and by McKinnon (1973) and Shaw (1973) in the early 1970s. Their argument was essentially that the poor performance of investment and growth, especially in developing countries, was due to interest rate ceilings, high reserve requirements, and quantitative restrictions in the credit allocation mechanism. Consequently, those restrictions were sources of 'financial repression', the main symptoms of which were low savings and investment levels. It therefore follows in this view that the focus of financial liberalization should be on the relevant removal of central bank controls over the financial sector, thereby freeing financial markets from any intervention and letting the market determine the allocation of credit.

The experience with financial liberalization as the policymakers in both developing and developed countries adopted the essentials of this thesis, and pursued corresponding policies, has not been what might be expected from this approach to financial policy. This experience points to two striking findings. The first is that over the period of financial liberalization, essentially from the early 1970s and subsequently, there have been banking crises, which have been unusually frequent and severe. The World

[1] I am grateful to Malcolm Sawyer and participants at the conferences held at the University of Cambridge, St Catharine's College, and University of the Basque Country, for helpful comments.

Bank (1989) indicates that the magnitude of the crises is obvious by the fact that at least *two-thirds* of the IMF member countries experienced significant banking-sector problems ever since the early 1980s. The second important finding is that there have been exacerbated downturns in economic activity, which have imposed substantial real economic costs for the local economies involved (Honohan and Klingebiel 2000; see, also, Arestis 2004, 2005; Arestis and Sawyer 2005; Arestis and Demetriades 1998).

The international financial crisis of 2007/2008 provides a relevant example of what has just been suggested. In a recent contribution Arestis (2016a) discusses the origins of the international financial crisis of 2007/2008 and the emergence of the 'Great Recession', making a distinction between the main factors and contributory factors. The main factors contain three features: distributional effects, financial liberalization, and financial innovation. The contributory factors also contain three features: international imbalances, monetary policy, and the role of credit rating agencies. In relation to the term 'financialization', this encapsulates the two features of the main factors, namely financial liberalization and financial innovation, since this term is defined for the purposes of the Arestis (2016a) contribution as the process where financial leverage overrides capital (i.e. equity), and financial markets dominate over the rest of the markets in the economy. Financialization, as it has just been defined, is in a broad sense of the term; it is, nonetheless, consistent with the definition of Epstein (2005), who defines it as "the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies" (p. 3; see, also Palley 2013, and Van Der Zwan 2014).[2] It is clear from these definitions that financialization "singles out financial markets and gives them special elevated standing" (Palley 2013, p. 2). Palley (op. cit.) also notes that financialization has had significant impact on income and wealth distribution. Capital's share has increased whereas labour's share has decreased. Furthermore, the share of financial sector's profits to total profits has increased while the non-financial sector's share of profits has decreased. An important lesson is that financialization increases financial fragility. The 1997 Southeast Asian

[2] See Sawyer (2014), for example, on the origins and usage of the term financialization.

financial crisis and the international financial crisis of 2007/2008, among other crises, clearly confirmed the financial fragility suggestion.

In discussing the origins of the international financial crisis of 2007/2008, we are very much aware of the limitations of current mainstream macroeconomic analysis. Indeed, we agree with Minsky (1982), who argued over three decades ago that "from the perspective of the standard economic theory of Keynes's day and the presently dominant neoclassical theory, both financial crises and serious fluctuations of output and employment are anomalies: the theory offers no explanation of these phenomena" (p. 60; see, also, Arestis 2009; Palley 2012). Needless to say that financialization as briefly discussed above, and in relation to the international financial crisis of 2007/2008, is very much along the lines of Minsky's (1982, 1986) ideas as developed in his financial instability hypothesis; along with the need for a key role for economic policy to thwart instability, and economic policy discretion (see Palley 2013, Chap. 8, for further details on Minsky's position on all these aspects).

We might add that with the emergence of the international financial crisis of 2007/2008, and the subsequent 'great recession', the Minsky (1982) statement, as stated above, is very valid indeed (see, also, Arestis 2016a). To clarify, the 'Great Recession' was caused by the US financial liberalization attempts, along with the significant income redistribution effects from wages to profits of the financial sector, and the financial architecture that emerged. A relevant statistic in this respect, and in the case of the USA, is reported in the Philippon and Reshef (2009) study, which relates to the above average rise in the salaries of the finance employees. The share of the ratio of the wage bill in the financial sector to its full-time-equivalent employment enjoyed a steep increase over the period from the mid-1980s to 2006 (wages in the financial sector were higher than in the other sectors, even after controlling for education; see, also Arestis 2016b). What explains this development is mainly financial deregulation (accounting for 83 percent of the change in wages) along with distributional effects in the USA (see, for example, Arestis 2016a, b), in a causal way, followed by financial innovation. Further data-based US evidence suggests that the size of the financial sector as a percentage of GDP grew from 2.8 percent in 1950 to 7.9 percent in 2012; in addition, incomes in the US financial sector increased by

70 percent relative to other sectors over the period 1980 to 2012.[3] Similar developments took place in the UK, Canada, China, Germany, and Japan, among others; although the financial shares in these countries were less pronounced, they were still significant.

Ever since both developing and developed countries adopted the essentials of the financial liberalization principle, banking crises have been unusually frequent and severe. The World Bank (1989) publication clearly demonstrates that since the early 1980s, the IMF member countries experiencing significant banking-sector crises amounted to at least two thirds of the total IMF country-membership. It is also true that downturns in economic activity, and substantial real economic costs, emerged as a consequence of the banking crises; this is clearly evident from the experience of the 'great recession' that followed the international financial crisis of 2007/2008 (see Arestis 2016a). We discuss after this introduction, Sect. 1.1, and in Sect. 1.2, the historical background, as well as the theoretical and empirical aspects of financial liberalization. Section 1.3 discusses the relationship between financial liberalization and crises, emphasizing two examples that led to crises, the Southeast Asian crisis and the international financial crisis of 2007/2008 that was followed by the 'Great Recession'. Section 1.4 discusses the economic policy implications of the crises, with an emphasis on the experience of the 'great recession', and on financial stability. Section 1.5 discusses relevant proposals for financial stability. Finally, and in Sect. 1.6, we summarize and conclude.

1.2 Historical, Theoretical, and Empirical Background of Financial Liberalization

We concentrate in this section on the theoretical and empirical aspects of financial liberalization. We begin, nonetheless, with a short historical background to financial liberalization.

[3] The relevant details and numbers referred to in the text are available at: http://www.investopedia.com/terms/f/financialization.asp. See, also, Greenspan (2010).

Historical Background

We may begin with what we might label as the most important intellectual development in terms of the finance–growth nexus, which came from Bagehot (1873), in his classic *Lombard Street*. In that contribution, Bagehot (op. cit.) highlighted the crucial importance of the banking system in promoting economic growth. Indeed, Bagehot (op. cit.) highlighted the circumstances when banks actively spur innovation and future growth by identifying and funding productive investments. The work of Schumpeter (1911), is also important in that financial services are paramount in promoting economic growth, since production requires credit to materialise. Indeed, one "can only become an entrepreneur by previously becoming a debtor. ... What [the entrepreneur] first wants is credit. Before he requires any goods whatever, he requires purchasing power. He is the typical debtor in capitalist society" (p. 102). In this process, the banker is the key agent.

Keynes's (1930) *A Treatise on Money* also highlighted the importance of the banking sector in economic growth. He suggested that bank credit "is the pavement along which production travels, and the bankers if they knew their duty, would provide the transport facilities to just the extent that is required in order that the productive powers of the community can be employed at their full capacity" (vol. II, p. 220). Robinson (1952) clarified by suggesting that financial development follows growth. However, Robinson (op. cit.) does not preclude the possibility that the causation may be bidirectional, in that growth may be constrained by credit creation in less developed financial systems. In more sophisticated systems, however, finance is viewed as endogenous responding to demand requirements. It therefore follows that the more developed a financial system the higher the likelihood of growth causing finance. Furthermore, Robinson (1952) argues that finance responds positively to technological innovation and development. All in all, Robinson's (op. cit.) argument is that "where enterprise leads finance follows" (p. 86).[4]

[4] Other contributors have argued that financial development and financial structure cause technological innovation and development. Yartley (2006), for example, presents panel regression results for a group of developed and developing countries to explain cross-country diffusion of 'innovation and communication technologies' to make the point.

More recently, however, McKinnon (1973) and Shaw (1973) put forward the 'financial liberalization' thesis. Their argument is that government restrictions on the banking system restrain the quantity and quality of investment. Even more recently, and with the development of the endogenous growth literature, the suggestion has emerged that financial intermediation has a positive effect on steady-state growth (see Pagano 1993, for a survey); and of equal importance from this argument's point of view, government intervention in the financial system has a negative effect on the equilibrium growth rate (King and Levine 1993b). There is also the view that finance and growth are unrelated. Lucas (1988) is probably the most frequently cited contribution on this score, who argues that economists 'badly over-stress' the role of the financial system. The difficulty of establishing the link between financial development and economic growth was also identified by Patrick (1966), and further developed by McKinnon (1988) who argued that: "although a higher rate of financial growth is positively correlated with successful real growth, Patrick's (1966) problem remains unresolved: what is the cause and what is the effect? Is finance a leading sector in economic development, or does it simply follow growth in real output which is generated elsewhere?" (p. 390).

The relationship between financial development and economic growth is, therefore, a controversial issue, with causality being an important aspect of the controversy. Attempts have been undertaken to resolve the issue of causality; not an easy exercise as the evidence shows. As noted above, the difficulty of establishing the direction of causality between financial development and economic growth was identified by a number of contributors, who actually questioned the direction of causation. An early attempt to tackle the issue of the strength and causation of the relationship between finance and economic development was undertaken by King and Levine (1993a). They provided empirical results, and argued that Schumpeter (1911) may very well have been 'right' with the suggestion that financial intermediaries promote economic development. The controversial issue of causality between financial development and economic growth could thereby be resolved potentially by resorting to empirical evidence. Arestis and Demetriades (1996) demonstrate that the empirical results of King and Levine (1993a), which were obtained from cross-section country

studies, were not able to address the issue of causality satisfactorily, and proceeded to produce two types of evidence in this context. The first is to show that King and Levine's (op. cit.) causal interpretation is based on a fragile statistical basis. Specifically, it is shown that once the contemporaneous correlation between the main financial indicator and economic growth has been accounted for, there is no longer any evidence to suggest that financial development helps predict future growth. The second type of evidence demonstrates that cross section data sets cannot address the question of causality in a satisfactory way. To perform such a task, time-series data and a time-series approach are required. Adopting the latter approach and using cointegration techniques, as well as time-series data for 12 representative countries, it is shown that there are systematic differences in causality patterns across countries. It thus emerges that, and as shown in another study by Arestis and Demetriades (1997), the proposition that causality from financial development to economic growth is not a straightforward answer; it is clear then that Arestis and Demetriades (1996) were initially correct in at least voicing concerns over causality.

A more recent, and extensive review of the empirical literature by Levine (2005), concludes that "A growing body of empirical analyses, including firm-level studies, industry-level studies, individual country-studies, time-series studies, panel-investigations, and broad cross-country comparisons, demonstrate a strong positive link between the functioning of the financial system and long-run economic growth. While subject to ample qualifications and countervailing views noted throughout this article, the preponderance of evidence suggests that both financial intermediaries and markets matter for growth even when controlling for potential simultaneity bias. Furthermore, microeconomic-based evidence is consistent with the view that better developed financial systems ease external financing constraints facing firms, which illuminates one mechanism through which financial development influences economic growth. Theory and empirical evidence make it difficult to conclude that the financial system merely—and automatically—responds to economic activity, or that financial development is an inconsequential addendum to the process of economic growth" (p. 921). However, there are relevant studies that reveal significant empirical problems. Favara (2003) fails to establish significant coefficients on financial variables in instrumented

growth regressions. Another study, by Rousseau and Wachtel (2001), reports that in high inflation countries the possible effects of finance on growth weaken substantially.

A further aspect of financial liberalization relies on the elasticity of the savings relationship, which is, of course, at the heart of the thesis. The elasticity of the savings relationship is either insignificant or, when significant, it is rather small. Fry (1995), after a comprehensive review of the literature, suggests that "the real interest rate has virtually no direct effect on the level of saving, but may exert an indirect effect by increasing the rate of economic growth" (p. 188). Warman and Thirlwall (1994) also question that part of the theoretical framework of financial liberalization that suggests that rising real interest rates induce more saving and investment and therefore act as a positive stimulus to economic growth. Warman and Thirlwall (op. cit.) provide empirical evidence to support this hypothesis in the case of Mexico over the period 1960–90. In this contribution the important distinction between financial savings (defined as the amount of total savings that is channelled via financial assets) and total savings is made. It is further shown that although financial savings are positively related to real interest rate, total savings are completely invariant to real interest rate; total savings are related to the level of income. Investment is positively related to the supply of bank credit and negatively related to real interest rate. It is also demonstrated that interest rates have no positive effect on growth. Overall financial liberalization and higher real interest rates could only have a positive impact on growth through raising the productivity of investment.

The contributions we have referred to in this section add to the controversial and indeed unconvincing empirical support of the financial liberalization thesis. However, with so much emphasis on the financial liberalization thesis in the context of the growth–finance nexus, a more focused review of its theoretical premise and its policy implications is required. This is undertaken in the section that follows.

Theoretical and Empirical Aspects of Financial Liberalization

The financial sector of an economy provides services to the rest of the economy, whereby financial instruments, markets, and institutions arise to ameliorate market frictions: they can mitigate the effects of incomplete information and transactions costs. It is also true that more recently further studies have accounted for other real sector variables in the relationship between finance and growth. Such variables include the pattern of countries' trade balance and changes in income distribution and poverty levels (see, for example, Beck 2012, who provides a short summary of developments on the finance-growth relationship that go back as far as Smith's 1776, publication). An important recent example in this respect, and as noted above, is the case of the international financial crisis of 2007/2008, where 'distributional effects' were an important main cause of the crisis. Distributional effects, along with financial liberalization especially the repeal of the US 1933 Glass–Steagall Act in 1999, produced the third main cause of the crisis, namely financial innovation (Arestis 2016a). This is a clear case where financial variables do cause crises.

Interest in financial liberalisation emerged from a number of writers who questioned the wisdom of 'financial repression', arguing that it had detrimental effects on the real economy. The relevant financial liberalization literature portrays regulation and control over interest rates as suppressing savings, investment and thereby growth. In this sense, Goldsmith (1969) argued that the main problem with financial repression was its negative effect on the efficiency of capital. McKinnon (1973) and Shaw (1973) stressed two further problems with financial repression: the first is that financial repression affects negatively the efficient allocation of savings to investment; and the second problem, in this view, is that through its effect on the return to savings, it has a restraining influence on the equilibrium level of savings and investment. As a result investment suffers not only in quantity but also in quality terms since bankers do not ration the available funds according to the marginal productivity of investment projects; their ration is according to their own discretion. Under these

circumstances, 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 even further; whilst 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.

A study that supports financial liberalization explicitly is by Miller (1998), which suggests that whether financial markets "contribute to economic growth is a proposition too obvious for serious discussion" (p. 14). The financial liberalization thesis contents that the removal of interest rate ceilings, reduction of reserve requirements and abolition of directed credit programmes are important ingredients; they would enable the free financial markets to determine the allocation of credit properly, thereby improving bank efficiency. As the real rate of interest adjusts to its equilibrium level, low-yield investment vanishes, with the overall efficiency of investment being enhanced, thereby increasing the average productivity of capital (McKinnon 1989). Moreover, the effects of lower reserve requirements reinforce the effects of higher savings 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. It is also argued that as the real rate of interest increases, savings and the supply of credit increase, thereby supporting a higher volume of investment (McKinnon 1973). It is the case, though, and as FitzGerald (2006) points out, the effect of interest rates on savings, which would contribute to investment and thus growth positively, is ambiguous in view of the wealth effect and the relative price effect. These effects are negative and positive respectively, thereby questioning the proposition that higher savings result from financial liberalization.

Still there are a number of studies that argue that the relationship between finance and growth is weak. One such study is by Lucas (1988), which suggests that finance is an "'over-stressed' determinant of economic growth" (p. 6). Another is the study by Robinson (1952), which assumes a passive role for finance with financial development simply following economic growth. Beck et al. (2013) suggest that the finance–growth link

has become weaker over time (see, also, Rousseau and Wachtel 2011). Cecchetti and Kharroubi (2012) argue that the financial sector is "a drag on productivity growth" (p. 14). This is confirmed in a subsequent study by Cecchetti and Kharroubi (2015), where they elaborate further to conclude that the rate of growth of the financial sector harms real growth. Using sectoral data, they also show that credit booms "harm what we normally think as engines of growth—those that are more R&D intensive" (p. 25). Furthermore, there is relevant literature that emphasizes the negative effects of financial liberalization in that it creates financial instabilities and crises with negative effects on economic growth. The early experience of countries with financial liberalization has been reviewed in a number of studies; see, for example, Arestis and Demetriades (1997, 1998), Arestis (2004, 2005), Demetriades and Luintel (1996). Arestis and Stein (2005) study the linkages between financial liberalization and subsequent financial crises, and report on the relevant experience of a total of 53 countries, covering the period between 1980 and 1995, which resulted in financial and banking crises. They conclude that "On the whole, financial liberalization in those and other countries had a destabilising effect on the economy and were abandoned" (p. 384; see, also, Creel et al. 2014). Those experiences lead to the conclusion that financial liberalization typically unleashed a massive demand for credit by households and firms that was not offset by a comparable increase in the saving rate. Loan rates rose as households demanded more credit to finance purchases of consumer durables, and firms plunged into speculative investment in the knowledge that government bailouts would prevent bank failures. In terms of bank behaviour, banks increased deposit and lending rates to compensate for losses attributable to loan defaults. High real interest rates completely failed to increase savings or boost investment—they actually fell as a proportion of GNP over the period. The only type of savings that *did* increase was foreign savings, i.e. external debt. This, however, made the 'liberalized' economies more vulnerable to oscillations in the international economy, increasing the debt/asset ratio and thus service obligations and promoting the debt crises experienced subsequently. Long-term productive investment never materialized either. Instead, short-term speculative activities flourished whereby firms adopted risky financial strategies, thereby causing banking crises and eco-

nomic collapse. Arestis et al. (2015) provide empirical results employing a meta-analysis of the existing empirical evidence on the effects of financial development on growth. They conclude that the meta-regression analysis shows that there are problems with the finance–growth relationship that do not allow positive conclusions in terms of this relationship. Most importantly, panel data, used frequently since the late 1990s, and time-series empirical evidence, produce smaller correlations between financial development and growth. An interesting and relevant empirical study in the case of Brazil is the one by De Paula (2011, Chap. 6) where the impact of financial liberalization on a set of economic variables (mainly inflation and economic growth) is examined. The study concludes that there is no evidence of financial liberalization producing positive effects on such variables. On the contrary, increased financial liberalization in Brazil since the early 1900s, as part of the development strategy of the Washington Consensus and the introduction of the economic policy of the New Consensus Macroeconomics, has had adverse effects on GDP and destabilizing effects on the rate of inflation and exchange rate (both increased over the relevant period of financial liberalization in Brazil).

A further theoretical aspect of financial liberalization is that capital account liberalization has positive effects on economic growth. Arestis and Caner (2005, see also 2010) suggest that removing restrictions on foreign direct investment flows are likely to have a positive impact on GDP growth. Indeed, removing restrictions that aim at prohibiting capital from flowing to certain sectors may lead to a better allocation of resources. However, there could be more costs associated with short-term capital inflows than benefits. For example, where it is not possible to invest short-term capital inflows in productive activities, they could end up creating asset price bubbles, especially when they are channelled into the stock market or the property market—this was the case, for example, with the financial crisis in Southeast Asia. It is also the case that while short-term capital inflows may, in principle, supplement domestic savings and lead to higher levels of investment and growth rates, this benefit is likely to be small in economies with already high saving and investment ratios. Tobin (1978) argues that excessive short-run capital mobility reduces the autonomy of national governments to pursue domestic objectives with respect to employment, output and inflation. Indeed,

Tobin (op. cit.) argues, "the mobility of financial capital limits viable differences among national interest rates and thus severely restricts the ability of central banks and governments to pursue monetary and fiscal policies appropriate to their internal economies" (p. 154). Arestis et al. (2001, 2003) show that during the early stages of this process capital inflows lead to unsustainable asset price increases, fuelling the euphoria of investors and leading to incorrect investment decisions. Relative price distortions and resource mis-allocations of this type are likely to impact GDP growth negatively. Arestis and Caner (2005) suggest that "It is, therefore, not surprising to discover that this is another aspect of financial liberalization that has not produced supportive causal evidence" (p. 101). When it comes to developing countries, the situation with capital-account liberalization entails further problems in view of the argument that markets are particularly imperfect and unstable in these countries. And as Eichengreen (2004) has observed, "if information asymmetries are endemic to financial markets and transactions, then there is no reason to assume that financial liberalization, either domestic or international, will be welfare improving" (p. 50).

There has been a great deal of empirical studies seeking to evaluate the relationship between capital account liberalization and economic growth/macroeconomic stability. Eichengreen (2004, Chap. 3) concludes that the empirical evidence between capital account liberalization and economic growth is not robust. Even earlier, Eichengreen and Leblang (2004) generalized this relationship by suggesting that "the impact of capital account liberalization is more likely to be positive when the domestic financial markets are well developed and regulated and the operation of the international financial system is smooth and stable. It is more likely to be negative when domestic and international financial markets are subject to crises" (p. 2). Kaminsky and Reinhart (1999) investigate financial liberalization when accompanied by capital account liberalization to conclude that such initiatives enhance the possibility of banking crises and/or currency crises. This is particularly relevant in view of the emergence and spread, and the speed at which this has taken place, of new financial instruments, such as derivatives. Speculative financial operations under this type of development increase substantially. It is clear from the results of these and other studies with similar results that the relationship

between capital account liberalization and economic growth is not robust enough, which confirm Eichengreen (2004) conclusions as suggested above. Capital flows in general terms tend to be unstable and can exacerbate both economic booms and recessions, followed by financial crises. It is also the case that excessive short-run capital mobility can, and indeed has had, harmful consequences, especially for developing countries.

There is also the question of whether financial structure, that is whether a country's financial system is bank-based or capital market-based, is able to promote growth. The study by Arestis et al. (2001) demonstrates theoretically and empirically, utilising time series methods and employing data from five developed countries, that the effect of banks on growth is more powerful than that of stock markets. However, there is the view that powerful banks can stymie innovation through protection of established firms and through colluding with firm managers against other creditors. Efficient corporate governance is thereby impeded. By contrast, there is also the view that competitive capital markets reduce the inefficiencies with banks and stimulate economic growth (Levine 2002). Levine (op. cit.) employs cross-country comparisons and concludes that the financial services view, which minimizes the importance of the distinction between bank-based and capital market-based developments, is analytically useful for economic growth. Clearly, and in this view, there is no evidence for significant difference between bank-based or market-based financial systems; the cross-country data strongly support the contention that overall financial development is firmly associated with economic growth. Stiglitz (2004) is critical of capital-market liberalization in more general terms in that it "inhibits the use of counter-cyclical monetary policy" and "leads to more overall economic volatility, and more volatility of consumption"; it also "exposes the country to new shocks, and weakens the built-in shock absorbers in the economy, provided by the price system" (p. 63). The overall conclusion is that capital-market liberalization does not lead to faster growth or higher investment; it might, indeed, affect growth and investment adversely. Stiglitz (2004) also demonstrates that the empirical evidence is also weak in terms of capital-market liberalization.

The problems and criticisms surrounding the financial liberalization thesis over the years since its inauguration have had some impact. This took place when events, following the implementation of financial lib-

eralization prescriptions, did not support the theoretical premises of the financial liberalisation thesis. There occurred a revision of the main tenets of the thesis. Gradual financial liberalization, especially so in developing countries, was to be preferred. In this gradual process a 'sequencing of financial liberalization' (for example, Edwards 1989; McKinnon 1991) is recommended. Employing credibility arguments, Calvo (1988) suggests a narrow focus of reforms with financial liberalization left to last. A further response by the proponents of the financial liberalization thesis has been to argue that where liberalization failed it was because of the existence of implicit or explicit deposit insurance, coupled with inadequate banking supervision and macroeconomic instability (for example, McKinnon 1988, 1989, 1991; Villanueva and Mirakhor 1990; World Bank 1989). These circumstances, it is argued, were conducive to excessive risk-taking by the banks, a form of moral hazard, which produced 'too high' real interest rates, bankruptcies of firms and bank failures. That experience led to the introduction of new elements into the analysis of the financial liberalization thesis in the form of preconditions, which should have to be satisfied before reforms are contemplated and implemented. These include `adequate banking supervision', aiming to ensure that banks have a well-diversified loan portfolio, 'macroeconomic stability', which refers to low and stable inflation, a sustainable fiscal deficit, and sequencing of financial reforms. It is also argued by the proponents that the authorities should move more aggressively on financial reforms in good times and more slowly when borrowers' net worth is reduced by negative shocks, such as recessions and losses due to terms of trade (see, especially, World Bank 1989). In a relevant study, Caprio et al. (1994) reviewed the financial reforms in a number of primarily developing countries with the experience of six countries studied at some depth and length. They concluded that managing the reform process rather than adopting a laissez-faire process was important, and that sequencing along with the initial conditions in finance and macroeconomic stability were critical elements in implementing successfully financial reforms.

Differential speeds of adjustment are now thought of as possible causes of serious problems to attempts at financial liberalization (McKinnon 1991). There are different speeds of adjustment in the financial and

goods markets, whereby the latter are sluggish. Thus, financial markets could not be reformed in the same manner and in the same instance as other markets, without creating awkward difficulties. Recognition of these problems has led the proponents of the financial liberalization thesis to reinforce the desirability of what referred to above as the *sequencing* in financial reforms. Successful reform of the real sector came to be seen as a prerequisite to financial reform. Thus, financial repression would have to be maintained during the first stage of economic liberalization. Furthermore, there is the possibility that different aspects of reform programmes may work at cross-purposes, disrupting the real sector in the process. This is precisely what Sachs (1988) labelled as 'competition of instruments'. Such conflict can occur when abrupt increases in interest rates cause the exchange rate to appreciate rapidly, thereby damaging the real sector. Sequencing becomes important again. It is thus suggested that liberalization of the 'foreign' markets should take place after liberalization of domestic financial markets. In this context, proponents suggest caution in 'sequencing'. This means in this case gradual financial liberalization, with an emphasis at the same time on the achievement of macroeconomic stability and adequate bank supervision as preconditions for successful financial reform (Cho and Khatkhate 1989; McKinnon 1989; Sachs 1988; Villanueva and Mirakhor 1990).

Sequencing, however, does not salvage the financial liberalization thesis for the simple reason that it depends on the assumption that financial markets clear in a Walrasian manner while the goods markets do not. But in the presence of asymmetric information, financial markets too are marred by imperfections. In any case, there is no clear empirical evidence to support the argument that once such preconditions are met countries benefit from financial liberalization. Indeed, and even when the `correct' sequencing took place (e.g. Chile), where trade liberalization had taken place before financial liberalization, not much success can be reported (Lal 1987). The opposite is also true, namely that in those cases, like Uruguay, where the 'reverse' sequencing took place, financial liberalization before trade liberalization, the experience was very much the same as in Chile (Grabel 1995).

Further problems can emanate from asymmetric information, which could very well produce monopolistic tendencies in view of the restric-

tions on competition amongst banks. The problems of *adverse selection*, when sellers have information that buyers do not know of (or vice versa), and *moral hazard*, when there is asymmetric information between two parties, are acute in the financial sector and have important implications for the effects of financial liberalization. These problems suggest that the existence of operators in the financial markets who are prepared to take excessively high risks implies higher interest rates than otherwise and, presumably, a lower total supply of funds, thereby inducing financial instability. This could emerge from inadequate measure by banks of risk associated with bank lending. In their attempt to compensate for this risk, banks' lending rates are increased, which deteriorates the creditworthiness of borrowers; also in addition, new firms with no past credit record would find funding difficult to obtain at any price. A further implication is that under these circumstances, banks gamble for higher profit by lending to the booming sectors, such as real estate, which could lead to an asset price boom, and thereby would lead to banking crises—the case of the international financial crisis of 2007/2008 is very relevant in this context (see, for example, Arestis 2016a).

A related problem is that of 'liquidity constraints', which both firms and households can be faced with; this can arise as a result of financial market imperfections. There is actually considerable evidence that households face liquidity constraints in developing countries in particular, caused by the presence of incomplete information in credit markets. These imperfections may be caused by asymmetric information in liberalized markets, which can lead to equilibrium credit rationing (Stiglitz and Weiss 1981). A further destabilizing effect in this context is that financial liberalization by producing higher interest rates is likely to be accompanied by destabilizing consequences for the macro economy. In addition, the thesis ignores the advantages of using low interest rates and, thus, credit selection especially for development purposes.

An interesting issue of both the theoretical and empirical literature is the attempt to study the impact of financial liberalization on income inequality and poverty. As the experience prior to the international financial crisis of 2007/2008 had shown, income inequality increased considerably along with the emergence of significant financial liberalization

attempts in the USA and elsewhere, which were two of the main causes of the crisis. Under such circumstances it is not really possible to conclude that financial liberalization has unambiguously reduced inequality. The opposite conclusion might be more relevant (Arestis 2016a). A recent study by the IMF (Naceur and Zhang 2016) provides evidence on the basis of a sample of 143 countries from 1961 to 2011 that shows financial liberalization, particularly capital account liberalization, increases inequality and poverty. Gini coefficients are estimated, which increase income inequality, along with the poverty gap index, which increases the average income shortfall of the poor from the poverty line. Both estimations clearly support the conclusion in Arestis (2016a). Another IMF study (Furceri and Loungani 2016) is also supportive of this conclusion in the case of capital account liberalization and inequality. Furceri and Loungani (op. cit.) suggest that in all recent episodes of capital account liberalization, increase in income inequality followed. In fact they argue that "The short-term impact after two years is similar in both advanced and emerging countries, but in the medium term, after five years, inequality widens more in emerging markets" (p. 44).

The post hoc theoretical revisions of the financial liberalization thesis, as discussed above, were thought sufficient to defend the original thesis of a disappointing empirical record. Despite all these modifications, still there is serious absence of sufficient empirical evidence to support them; for it is the case that empirical studies in general have not produced convincing empirical evidence that supports the proposition that financial liberalization has enhanced economic growth in developed and developing countries. However, no amount of revision has changed the objective of the thesis, which is to pursue the *optimal* path to financial liberalization, free from any political, i.e. state, intervention. But there are still further problems that relate financial liberalization to crises, which we discus in the section that follows.

1.3 Financial Liberalization and Crises

Ever since the early 1970s when financial liberalization was enacted, the frequency and depth of financial crises have been exacerbated. Laeven and Valencia (2012) record 346 financial crises in the period 1970 to 2011, of which 99 were banking crises, 18 sovereign debt crises and 153 currency crises, 11 banking and debt crises, 28 banking and currency crises, 29 debt and currency crises, and 8 crises that combined all three elements. A total of 25 banking crises are recorded for the period 2007 to 2011. Laeven and Valencia (op. cit.) show that output losses of systemic banking crises can be enormous. The fiscal cost of a systemic banking crisis is estimated to be 13 percent of GDP on average; and could be as high as 55 percent of GDP. Over the first four years of the crisis, output losses on average are estimated about 20 percent of GDP. Laeven and Valencia (2013) "identify 147 banking crises, of which 13 are borderline events, over the period 1970–2011" (p. 226). They "also count 211 currency crises and 66 sovereign crises over the period" (p. 226). Kaminsky and Reinhart (1999) show that in the post-liberalization period of the 1980s and 1990s banking crises increased considerably. Eichengreen and Arteta (2002) provide a survey of empirical studies, which provide strong evidence of the proposition that financial liberalization increases the likelihood of systematic banking crises. Indeed, and as the international financial crisis of 2007/2008 and the subsequent 'great recession' show, the costs of a systemic banking crisis to the affected economies is substantially high with lasting effects to their real sectors.

Majerbi and Rachdi (2014) study the link between financial liberalization and the likelihood of systemic banking crises by using measures of financial liberalization that account for the quality of the institutional environment at various stages of financial liberalization. Their model-estimation approach allows for the determinants of banking crises to vary depending on the country groupings that include homogeneous economies in each panel of their logit regressions. Majerbi and Rachdi (2014) use for their measure of financial liberalization the Financial Reform Index initially proposed by Abiad et al. (2008). The main advantage of this index is that it allows for cross-country variations of financial liber-

alization over time. A multivariate logit model is employed to estimate the probability of systemic banking crises, based on a sample of 53 countries over the period 1980–2005 covering 48 systemic crises. An inverted U-shaped relationship between financial liberalization and systemic banking crises is the overall conclusion of this study. Financial liberalization increases the possibility of a banking crisis at the early stages of financial reforms; at later stages advanced financial reforms tend to reduce the probability of banking crises. The turning point at which financial liberalization begins to be negatively related to the probability of banking crises varies depending on the type of the economy examined (high income-developed countries versus emerging/developing countries). It is also shown that the institutional environment and the quality of the banking sector governance in the country considered are very important. Indeed and also as demonstrated in the Majerbi and Rachdi (2014) study, stricter banking regulation and supervision reduce the probability of financial crises.

In what follows we concentrate on two of these crises, perhaps the most serious in terms of their impact, in an attempt to elaborate on the relationship between financial liberalization and crises. These crises, the Southeast Asian crisis of 1997/1998 and, especially, the recent international financial crisis of 2007/2008 and the subsequent 'great recession', have shed doubt on the previous findings of a positive impact of finance on growth.

We begin with the financial Southeast Asia of 1997/1998 crisis. In doing so, we concentrate on the study by Arestis and Glickman (2002), which attempts to clarify the finance/growth relationship, and in the case of the Southeast Asia crisis. In doing so, Arestis and Glickman (op. cit.) focus on the role of financial liberalization in the process. Southeast Asian countries (Indonesia, Korea, Malaysia, the Philippines, and Thailand) introduced and implemented financial liberalization programmes in the early 1990s. The Arestis and Glickman (op. cit.) analysis suggests that the threats to growth and employment emanating from the financial sector, which Minsky (1986) identified in the closed economy setting, are greatly intensified in the open, liberalized, economies. Financial liberalization is demonstrated to be a key factor in this process. The gist of the argument is that "financial liberalization produces an upward step-change

in the intensity of the domestic drive towards financial innovation, as it sweeps away the rules and conventions which previously governed the way banks related to one another and their customers. It thereby speeds up the process by which debt ratios of commercial concerns and financial institutions rise, escalating financial fragility, and it hastens the day when banking and financial crises loom" (Arestis and Glickman 2002, pp. 244–245).

A number of studies attempted to investigate the impact of financial liberalization between 1990 and 1997 on bank performance, efficiency, and productivity in the case of Southeast Asian countries. The majority of studies are country-specific and the results are summarized in the contribution by Williams and Nguyen (2005), who conclude that the empirical evidence of these studies is very mixed. The study by Williams and Nguyen (op. cit.) provides empirical evidence for the period 1990 to 2003 that relates to the 1997 crisis, and substantial bank restructuring that followed it, to conclude that bank privatization produced superior profit performance and strong productivity. Foreign acquisition, however, although it helped to improve profit efficiency, their productivity performance was not as strong. Indeed, and as elaborated earlier in this contribution, proponents of financial liberalization favour 'sequenced' programmes of 'free' market reforms. But such reforms only serve to weaken the barrier of financial conservatism, which acts to contain pressures leading to the fragility of the financial system. This, however, raises the feeling of invulnerability, weakening inhibitions against speculation and reinforcing the tendency towards euphoria and thereby leading to more speculation not less (Minsky 1986).

The Southeast Asian crisis provides a good example in terms of what has just been suggested in the case of an open economy. In the absence of capital controls, speculators turn their attention to the domestic economy, especially so if interest rate differentials are in their favour. Capital inflows offset any tendency for the domestic upswing to push interest rates higher. The exchange rate may be pegged without much difficulty, or allowed to appreciate. In either case, the external position is interpreted as evidence of 'economic' health, fuelling optimism further. Success is an endogenous factor driving financial innovation forward, and openness extends the scope of achievable success. Sooner or later the economy can

be led to one of the following: a crisis that is domestic in origin but impacts on its external situation; or a crisis that is external in origin but impacts on its domestic situation; or a crisis that is a combination of these two factors. Under these conditions, the exchange rate becomes a source of further uncertainty. Speculators begin to doubt the ability of the state to support its currency, and they may very well move against the currency concerned, possibly on a massive scale as in the case of the Southeast Asian crisis. This analysis clearly suggests that financial liberalization leads to crises.

Another relevant case we discuss next is the US financial liberalization experience prior to the international financial crisis of 2007/2008. Financial liberalization in the US began in 1977, when the US started to deregulate its financial system, and also as Galbraith (2012) suggests, "deregulation was followed by desupervision, as US regulatory authorities made calculated decisions not to investigate financial-sector practices" (p. 4). The apotheosis of the financial liberalization in the USA, however, took place in 1999 with the repeal of the 1933 Glass–Steagall Act. The 1933 Glass–Steagall Act was designed to avoid the experience of the 1920s/1930s in terms of the conflict of interest between the commercial and the investment arms of large financial conglomerates (whereby the investment branch took high risk tolerance). The ultimate aim of the 1933 Glass–Steagall Act was to separate the activities of commercial banks and the risk-taking 'investment or merchant' banks along with strict regulation of the financial services industry. In effect, the Glass–Steagall Act of 1933 broke up the most powerful banks. The goal was to avoid a repetition of the speculative, leveraged excesses of the 1920s/1930s. That Act also provided from around the mid-1930s to the mid-1970s a range of direct controls on bank lending and exchange controls on international flows. It is relevant to also note that the period of the late 1930s to the mid-1970s was free from serious banking crises as Bordo et al. (2001) demonstrate. Haldane (2010, Chart 2) also shows that the 1933 Act was effective from the 1930s to the late 1980s when the US authorities began to relax it. The repeal of the Act in 1999 enabled investment banks to branch into new activities; and it allowed commercial banks to encroach on the investment banks' other traditional preserves. Not just commercial banks but also insurance and other companies, like the American

International Group (AIG), and hedge funds, were also involved in the encroaching.

The repeal of the Glass–Steagall Act in 1999, thereby allowing the merging of commercial with investment banking, enabled financial institutions to use risk management in their attempt to dispose off their loan portfolio. This was also helped by "a greater willingness to supply credit to low-income households, the impetus for which came in significant measure from the government" (Rajan 2010, p. 40). House prices kept rising over the period 1998 to 2006 with an unprecedented height to the US housing price bubble during 2000–2006 primarily (Reinhart 2012, p. 17), which enabled households to borrow against home equity they had built up. Those developments led to an important financial innovation. Financial institutions engineered a new activity, through the 'shadow banking' system, that relied on interlinked securities, the Collateralized Debt Obligations (CDOs), mainly emerging from and closely related to the assets of the Subprime Mortgage Market. 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 rest of the world.

With the house-price increases coming to an end by the end of 2006 and the reversal of interest rates by August 2007, when long-term interest rates fell below short-term interest rates, the collapse of the subprime market emerged. As a result, the banks and 'shadow banking' stopped their lending procedures, which resulted to their grinding to a halt, along with the wider financial system also grinding to a halt. It all spilled over into the real economy through the credit crunch and collapsing equity markets; and all that led to the freezing of the interbank lending market after August 2007. A significant recession emerged: the 'Great Recession' (see, also, Arestis 2016a). An important implication is that when powerful financial institutions are allowed to behave recklessly "because the regulations that might have restrained them were negligently applied or missing entirely" (Jarsulic 2010, p. 127), serious implications follow. The idea that financial markets perform in a stable and self-correcting manner has been seriously challenged yet again. Policy implications need to be seriously considered.

1.4 Policy Implications

It follows from the above analysis that financial liberalization is not free of financial crises. We have demonstrated that unregulated markets, due to financial liberalization, have actually produced crises. Keynes (1936, pp. 100–101) observed that this tendency would be exacerbated in the case of financial markets. Furthermore, and as the two examples of financial crises discussed in the last section clearly imply, economic policy implications should be seriously considered. The current economic policy, known as inflation targeting, and its theoretical framework, under the auspices of the New Consensus Macroeconomics (see, for example, Arestis 2009, 2011), contain a number of relevant problems. The most serious one, from the point of view of this contribution, is that manipulation of the rate of interest to achieve price stability, the single objective of economic policy, which would enable markets to produce macroeconomic stability and growth, cannot be right. Indeed, the evidence from the international financial crisis of 2007/2008 and the subsequent 'great recession' strongly support this proposition (Arestis 2016a).

The IMF (2010b) study suggests that financial stability, in the form of macroprudential policies, should be implemented and replace interest rate policy measures, especially so if the current low interest rates were to produce excessive risk-taking or bubbles. The IMF (2010c) study proposes that a macroprudential approach to contain systemic effects of 'too-important-to-fail' institutions, including now non-bank financial institutions, is also an important policy initiative that should be seriously considered. Macroprudential policy to prevent asset and credit bubbles than merely monetary policy is another suggestion by Bean et al. (2010). It is to be noted, though, that even under the presence of macroprudential regulation, monetary policy affects financial stability (Agur and Demertzis 2015). A change in the rate of interest affects banks' behaviour through two channels: the profit and leverage ones, which can affect bank risk; with the direction of impact depending on the state of the financial cycle (Agur and Haksar, op. cit., p. 18). It is, though, the task of macroprudential authority to offset the negative effects of monetary policy on financial stability. Zdzienicka et al. (2015) provide empirical evidence

in the case of the United States that suggests, "monetary policy shocks have significant and persistent effects on financial conditions and can attenuate long-term financial instability" (p. 5). By contrast, and in the case of macroprudential policy measures, their impact "is generally more immediate but shorter-lasting" (p. 5). In addition, "monetary and macroprudential policy tightening measures tend to have larger effects than easing ones. Also, the effect of monetary policy shocks and macroprudential policy tightening measures tend to be larger during recessions than in expansions" (p. 5). An important implication of these contributions is then "that governments must bear a responsibility not only for allowing the recession to develop but also for the measures needed to counteract it. Governments can and must act to control market failure in ways that the market left to itself cannot" (Gould 2013, p. 164).

The conclusion from this analysis is then that financial stability and monetary policy should be the responsibilities of the central bank. This means, of course, that central banks would have an added objective—that of financial stability. Such an additional objective, though, raises the issue of how to incorporate financial stability in the loss function of the central bank in view of the fact that it is impossible to measure such a variable. Blinder (2010) raises the issue and wonders "whether the right loss function is actually lexicographic, with financial stability logically prior to the other goals" (p. 4). This is a serious challenge for those central banks that use the 'New Consensus Macroeconomics' modelling framework (see, for example, Arestis 2009, 2011). One might ask at this stage, as the ex-IMF Managing Director did, "What about fiscal policy? Under the old paradigm, fiscal policy was definitely the *neglected child* of the policy family. Its role was limited to automatic stabilizers—letting budget deficits move up and down with the cycle—and discretionary policy was regarded with deep suspicion. But fiscal policy had a *Sleeping Beauty* moment during the crisis, with monetary policy running out of steam, and with the financial system on its knees, the forgotten tool arrived to prop up aggregate demand and save the world from an economic freefall. We need to rethink fiscal policy" (Strauss-Khan 2011, p. 3). Indeed, we have to rethink fiscal policy seriously and suggest that the time has come to assign a strong macroeconomic role to it (Arestis 2012). We go further, nonetheless, and suggest that monetary and financial stability policies should be coordinated. In

addition, we argue that it is vital for full coordination of both policies with fiscal policy, along with discretion in applying them. Fiscal policy should be used both in the short term and in the long term to address demand issues (Arestis 2015). In this respect, relatively frequent adjustments to fiscal stance in the light of macroeconomic developments are necessary.

We may summarize the argument that the main operation of any central bank should be directed towards financial stability. The events leading to the 'Great Recession' testify to this important requirement. Financial stability has not been addressed properly, and as such it requires further investigation. The focus of financial stability should be on the proper control of the financial sector so that it becomes socially and economically useful to the economy as a whole and to the productive economy in particular. Banks should serve the needs of their customers rather than provide short-term gains for shareholders and huge profits for themselves. Indeed, it is paramount for a central bank "to maintain a proper prudential supervision of banks and of the financial sector more generally—something that has, as has become apparent, been sadly missed from the scene in many western countries over recent years. A central bank should regulate and enable the banks to interact with other sectors in the economy in an efficient way that benefits the economy as a whole" (Gould 2013, p. 113). De-financialization thereby would help to achieve the objective of shrinking the financial sector. In this sense the suggestion by Lawrence (2014) that de-financialization through measures such as targeting credit at the productive economy and a reassertion of the public interest in the financial system is very apt. We would further suggest that separating investment banking from commercial banking is the right step forward. Currently, most commercial banks sit alongside the risky activities of investment banking in pursuit of quick profits. The separation of the two types of banking should allow commercial banks to pursue the activities as suggested above, while the investment banks should be allowed to go bust, if necessary. Such separation should produce greater financial-sector discipline and also avoid moral hazard.

A further suggestion emerges from the following observations. Asset-price inflation can get out of control, with bubbles emerging and although while they grow they generate a lot of euphoria, ultimately they burst with devastating consequences not only for the investors in the stock

markets, but also for the economy as a whole. The experience of the last thirty years or so shows that the adverse consequences of the burst of a bubble hit not only weak economies, but also strong economies such as the USA and Japan. In addition, it may be that inflation-targeting type of policies is inconsistent with house price stability in that they exacerbate fluctuations in housing. Monetary policy should, therefore, target asset prices. Indeed, net wealth as a percentage of disposable income may be the ideal variable for targeting asset price inflation (Arestis and Karakitsos 2009). Net wealth is defined as the assets (financial and tangible) less the liabilities of the personal sector, which include mortgage debt and consumer credit. Net wealth is an ideal variable to monitor (and control) bubbles. A wealth target would not impede the free functioning of the financial system as it deals with the consequences of the rise and fall of asset prices in the economy and is not a target of asset prices—that is *e*quities or houses, per se. The central bank monitors the implications of financial innovations as they affect wealth, even if it is ignorant of these innovations, as for example in the case of the US 'shadow banking' activities.[5] It is a variable that affects demand directly in the economy. As such, it is at the heart of the transmission mechanism of asset prices and debt to consumption. Information on the constituent elements of net wealth is available and published regularly.[6]

[5] It should be noted that there has been explicit opposition to targeting asset markets and asset prices on two arguments. One argument suggests that trying to stabilize asset prices is problematic: it is uncertain whether a given change in asset values results from fundamental or non-fundamental factors or both. Proactive monetary policy would require the authorities to outperform market participants. Another argument is that the size of the change in the rate of interest to prick a bubble may be substantial and harmful to the real economy. Both Bernanke (2002) and Greenspan (2002a, b) argued against targeting asset prices with their views based on these two arguments. Neither of these arguments is relevant in terms of our suggestion to target net wealth as it is clear from the arguments as in the text. Asset price bubbles can be very harmful, a very good recent example is the international financial crisis of 2007/2008, and appropriate policies are very relevant and urgently required.

[6] Goodhart and Persaud (2008) propose a 'counter-cyclical capital standards' to tackle asset price bubbles. Capital standards would rise in booms to avoid excessive asset price increases and overexpansion of financial intermediary balance sheets; and would fall in the downswing to avoid excessive fall in credit provision. Another relevant proposal is by Palley (2013) who argues for an 'asset-based reserve requirements', which, it is suggested, "can enhance counter-cyclical monetary policy" (p. 165). Under such a system financial intermediaries would hold reserves against their assets and this should be applied to all financial intermediaries. Such a system would work through

With the objective of financial stability, the Central Bank would become more like a Central Financial Agency (CFA). It would be responsible for policies, which seek to influence the credit and lending policies of the full range of financial institutions. Re-establishing a system designed to meet the needs of the real economy and the users of financial services rather than to benefit financial intermediaries, is paramount. As suggested above, and in this context, full coordination of both monetary and financial stability policies with fiscal policy, along with discretion in applying them, is very important. Above all, however, the economic policy dimension of financial liberalization has not performed well and as such it should never be pursued. In view of such importance attached to financial stability, the interesting question is, then, the extent to which relevant proposals have been suggested and indeed pursued. This is the focus of the next section.

1.5 Financial Stability Proposals

Proposals that aim to ensure financial stability have been put forward and we briefly comment on them. The most important probably is the Dodd–Frank Act of 2010. The Act contains a number of important constituent elements; the ones relevant to this contribution are as follows. Eliminate proprietary investments (namely to prohibit banks that take insured deposits from running their own trading operations) and also no longer allow ownership of hedge funds by banks; in the final Act this was modified to the banks being allowed to hold proprietary investments of 3 percent of their core capital. Size matters: no financial firm should be allowed to become 'too big to fail'. End of taxpayer bailouts: the legislation grants government the power to wind down failing institutions, not just banks, if they threaten the financial system. A new 'orderly liquidation' authority is equipped with the power to seize a failing 'systemically important' institution. Another important aspect of the Dodd–Frank Act is the proposal that the 'shadow banking' and the non-bank finan-

the interest rate channel but changes in interest rates would be targeting a particular asset class with changing the rate of interest for that particular class.

cial service companies should be properly regulated. It also proposes the introduction of a new Office of Credit Ratings to supervise credit rating agencies. It should be noted that the Dodd–Frank Act has effectively left it to new regulatory bodies to decide further on all these issues.

This Act may not be the Glass–Steagall Act of 1933, but it is the most sweeping and wide-ranging overhaul of the US financial regulations since the 1930s. However, whether this Act would have prevented the 'Great Recession' is an interesting question. Our response is on the negative in view of the non-separation of commercial and investment entities, as the experience leading to the international financial crisis of 2007/2008 demonstrated.

Following the US initiative, a UK government-appointed commission on banking was set up in June 2010 to provide a year-long analysis of whether banks should be split up into commercial and investment entities, and whether a version of the Dodd–Frank Act would be appropriate for UK banking. Its final report and recommendations were presented in September 2011. The Vickers Report, as it is now known, recommends 'ring-fencing' banks' retail operations from their investment banking activities, whether conducted by UK or foreign-owned banks. The main problem of ring-fencing is that banks may be encouraged to take greater risk with the activities inside the ring-fencing, such as mortgages, corporate and personal assets. This may be so since such activities would be more likely to be bailed out.

A similar trading ring-fence proposal came from the Committee commissioned by the European Commission and headed by the Governor of the Bank of Finland (and ECB council member), the Central Bank of Finland, Erkki Liikanen. This committee was set up in November 2011 and The Liikanen Report or 'Report of the European Commission's High-level Expert Group on Bank Structural Reform' (known as the 'Liikanen Group') is a set of recommendations published in October 2012 by a group of experts led by Erkki Liikanen.

The Liikanen Report (2012) suggests ring-fencing but in the case of the European banks it should be the investment banking activities of investment banks' operations, not of retail activities as in the Vickers Report. In the report's view, similar to that of the Vickers Report, "The central objectives of the separation are to make banking groups, especially their

socially most vital parts (mainly deposit-taking and providing financial services to the non-financial sectors in the economy), safer and less connected to high-risk trading activities and to limit the implicit or explicit stake of taxpayer in the trading parts of banking groups. The Group's recommendations regarding separation concern businesses which are considered to represent the riskiest parts of trading activities and where risk positions can change most rapidly" (p. i). This report, like the Vickers one, has been criticized on a number of grounds: There is no predefined 'resolution regime', which can wind banks down in the case of a disaster scenario. Banks, even ring-fenced ones, may still be bailed out by governments in a crisis. Such a reform could disrupt the flow of corporate funding in that companies may very well turn away from bank loans to capital markets for bond funding; and ring-fencing trading assets, would limit the liquidity of corporate bond trading, thereby making this form of financing more expensive.

Further proposals that intend to deal with the size of financial institutions come from the IMF. These proposals include for the financial institutions more and higher capital requirements, as well as more liquid assets, along with the adoption of legal regimes that provide for the orderly resolution of failing institutions. Strong and effective supervision, along with political support, is an essential part of any serious and lasting reform of the financial sector. A complement to these regulatory reforms is to tax the financial sector. This would discourage excessive size as well as wholesale financing, two serious problems in the 'great recession'.

The IMF (2010a) bank tax proposals, for the G20 finance ministers, are relevant in this context and rely heavily on the need for a global approach. They are designed to ensure that financial institutions bear the direct costs of future failures or crises. In this way, future bailouts would be funded by the banks paying the costs of financial and economic rescue packages. These tax plans comprise of: (i) a financial stability tax, in the IMF language a 'Financial Stability Contribution' (FSC) tax, which would require banks and other financial institutions to pay a bank levy, initially at a flat rate. This would be later adjusted to reflect risk so that financial sector activities that pose a greater risk would pay a higher rate. This type of tax is designed to fund future government support, and thereby avoid 'moral hazard' problems. At a later stage, (ii) a financial

activity tax (FAT) is proposed, which is a tax on the sum total of profits and remunerations paid by financial institutions (see, also, Sawyer 2015). The sum would be a kind of Value-Added Tax (VAT), a tax from which financial institutions are currently exempt. So that imposing such a tax could make the tax treatment of the financial sector similar to other sectors. This would deter the financial sector from being too large on purely tax reasons. It would also contain the tendency of the financial sector for excessive risk-taking. Further proposals (IMF 2010b) include higher capital requirements and liquid assets; also the adoption of legal regimes that would provide for the orderly resolution of failing institutions.

It might be, though, that neither 'too big to fail' nor taxing the financial institutions should be considered in isolation. They are both necessary and should be treated as such, along with relevant international agreements. In this sense IMF suggest that global financial stability would help in that the reforms should be "nationally relevant and internationally consistent" (IMF 2010b, p. 26). Not likely, though, in view of disagreements among the G20 members.

Objections to this proposal have been raised by the central banks of mainly Australia, Brazil, Canada and Japan, the least affected countries by the 'great recession'. They argued that taxing banks would reduce in effect their capital thereby making them more, not less, vulnerable to financial crises. Banks have argued that taxing liabilities and transactions to stave off future financial crises carry their own problems. Most important of which is that taxes would not reduce risk in the system; on the contrary, it might increase risk by implicitly building in insurance for bank's risky behaviour. Another objection is that under such plans the financial sector would not be able to provide the products and services demanded by their customers. Such rules might create a new credit crunch if introduced without full consideration of these possibilities. Requiring banks to hold more capital could actually result in banks providing less lending than otherwise. Banks have, thus, resisted reform, on weak grounds in effect, but with powerful lobbying. And yet substantial and far-reaching reforms are absolutely necessary to avoid another similar crisis.

The 27 member countries of the International Basel Committee on Banking Supervision of the Bank for International Settlements with the Group of Central Bank Governors and Heads of Supervision at their

meeting on 12 September 2010 reached an agreement on regulatory issues. Further discussion took place at the first 2011 G20 meeting in Paris (see, for example, BIS 2011). The so-called 'Basel III Package' was concerned with bank capital and liquidity standards. The new ruling, phased in from January 2013 with full implementation to be achieved by January 2019, has only dealt with bank capital.

It requires banks to hold equity at 9.5 percent of their Risk-Weighted Assets (RWA); and liquidity standards include a liquidity coverage ratio, which requires banks to meet a 3 percent leverage ratio. The timetable is a victory for the banks, which gives them longer to earn profits to offset against losses accumulated during the 'Great Recession' and in the process tax advantages emerge. The new capital ratios are lower than they might have been and also they are not to be fully implemented until 2019. This long phase-in period seems to have been a concession to small banks, especially in Germany. These are the banks that would struggle with the new rules presumably because of undercapitalization. Another problem is that unlike the US Dodd–Frank Act, which provided relevant regulations in the case of banks migrating to the 'shadow banking' sector and to the lightly supervised non-bank financial services companies, Basel III does not contain such provision. A further problem concerns the definition of the capital ratio, which is defined in relation to RWA, not to total assets. An implication of this is that toxic leverage is highly probable, when the RWA is a small proportion of total assets; the exposure of the banking sector to risk would be very high under such eventuality.

The IMF in its 2012 Global Financial Stability Report (IMF 2012), argues that Basel III rules would exacerbate the 'too-big-to-fail' problem. It is suggested that "Big banking groups with advantages of scale may be better able to absorb the costs of the regulations; as a result, they may become even more prominent in certain markets, making these markets more concentrated". The IMF (op. cit.) is particularly concerned that banks with large shares of their activity in fixed income, currency and commodity markets would become even more dominant. The IMF also cautions that Basel III rules raise the incentive to develop new products to circumvent the framework. There is also a 'high chance' that the framework would push riskier activity into less regulated parts of the

financial system. Clearly, then, Basel III has failed to correct the mechanism through which the main cause of the 'great recession' emerged.

Radical measures to increase stability and competition in the financial sector have been bypassed. Under such circumstances it should not be surprising for another similar crisis to take place. All in all, and given the key role of Basel III in the global regulatory system, it would appear that financial stability remains unresolved and elusive. What is required is a complete institutional separation of retail banking from investment banking.

1.6 Summary and Conclusions

Our discussion in this contribution of the theoretical premise, and relevant empirical evidence, of what has come to be known as the financial liberalization thesis, has suggested that the critical issues of the thesis are marred by serious criticisms. Furthermore, financial liberalization has caused crises, as discussed in this contribution. Policy implications emerge, which are very different from those of the financial liberalization thesis. The financial system is unstable, and as such policies are needed. Relevant policy implications have been identified and policy proposals have been suggested. The most important policy proposals of this discussion is that financial stability focused on proper control of the financial sector is urgent along with coordination with monetary and fiscal policies.

Even so, and in terms of policy implementation despite the fact that a number of relevant proposals have been put forward as discussed in this contribution, relevant solutions are still waiting in vain; the banking reform remains a work in progress across the world (see, also, Arestis 2016a). It is the case that such inactivity is in place. For it is true that worldwide progress on financial reform is extremely slow; and a worrying poverty of action is in place. The IMF managing director (Lagarde 2014) suggests that "the behaviour of the financial sector has not changed fundamentally in a number of dimensions since the financial crisis"; and proceeds to complain that "The bad news is that progress is still too slow, and the finish line is still too far". We may thereby conclude by suggesting that the pre-2007 laissez-faire approach is in need of substantial

reforms. There is, however, a lesson from the failures of the various proposed reforms, which is that working within the pre-2007 paradigm, and yet suggesting policy proposals is simply not good enough. More effective financial stability policies are desperately needed.

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