11. Financial liberalization, economic growth and rents

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INTRODUCTION

The rationale behind liberalization policies in general has been to get rid of distortions due to prices, which were different from those which would prevail under competitive conditions. These distortions in turn would encourage the so-called rent-seeking activities by interest groups. In some cases, these rent-seeking activities might reduce welfare (see Krueger, 1972; Tullock, 1982; Bhagwati, 1982). The idea should apply to all markets, though most studies refer to impediments to free trade via tariffs and quotas, and resulting lobbying activities. The abolition of such distortions should improve welfare and, according to some, through their direct effect on investment, favour growth and development. Further, it has been argued that development depends not only on real factors but also on the institutional environment. According to this view, both competitive markets and democracy would contribute to economic development. If conservative interest groups, which enjoyed rents from distortions, had lost their power because of liberalizations, development would become more likely (see Bhagwati, 2002). The results of empirical studies on liberalization in developing countries, however, do not offer much support for such optimistic views. The general objective of this chapter is to discuss the issue of rents in relation to financial liberalization and growth.

In the second section, we update and critically review the current debate on rents in financial markets, particularly in the banking sector. The main bulk of the existing literature, with some exceptions, believes that the abolition of rents will foster investment and productivity growth (or simply productivity growth), which should lead to higher output growth.

In the third section, we discuss the effects of financial liberalization on income distribution. The work on income distribution and growth concludes that an increase in inequality has a negative impact on growth. The empirical work on financial liberalization and growth suggests that financial liberalization may increase growth, while it worsens income distribution. Case studies of countries that have implemented liberalization show that investment is not an important source of growth of output; the most important contributions to output growth come out of consumption and public expenditure. The main observed changes in the functional distribution of income show an increase in the share of rental income over the shares of wages and profits.

In the fourth section, we examine two case studies, South Korea and Turkey. We argue that trade liberalization affects profits in different ways in those two countries. The reaction to these changes may depend also on the corporate governance regime. All this may explain the differences in investment patterns after liberalization. These differences notwithstanding, the most powerful interest groups seem to retain their power after liberalization in both countries and increase their share of national income. This share includes different sources of income like profits and rents.

In the last section, we imagine how the objectives of interest groups may evolve after liberalization. As we have already seen, changes in the balance of power towards more productive classes do not seem to happen. In particular, those elites which were gaining in the past from trade restrictions may easily switch to other rent-seeking activities. This time, however, they have to enter the financial sector, where the new gains are concentrated. They may purchase financial institutions or stakes in financial businesses. Post-liberalization interest rates and prices of financial activities are so high that they generate those gains.

HOW SHOULD RENTS ARISING FROM IMPERFECT COMPETITION OR PROTECTION IN FINANCIAL MARKETS BE CONSIDERED?

By sweeping out rents previously present in repressed or closed financial markets, financial liberalization should increase consumers' wealth, improve the allocation of resources and achieve general economic efficiency. It should also contribute, jointly with liberalization measures in other sectors – namely trade – to wipe out many potential sources of rents and let flourish more profit-oriented

businesses. That the abolition of rents on its own could improve efficiency is generally agreed, although there is some discussion that this increase in efficiency may be useful to foster growth unless there is a strong link between efficiency and productivity and investment or technological improvement. The old literature on the subject stemming from McKinnon's work stresses the financial deepening effect of liberalization rather than the efficiency argument. The new literature points more to the efficiency argument and both the improvement in allocative efficiency due to the freeing of rates, and in productive efficiency of banks due to the increase in competition.

Recently, Hellman et al. (1997, 1998) have offered a contrasting view, arguing that rents may be good to foster financial deepening; moreover a moderate degree of financial restraint, that is, a deviation of imposed rates of interest from their competitive equilibrium values, would support banks through its positive effect on bank's capital. Financial restraint is different from financial repression, for under the latter, high inflation created by the government transfers wealth from the households to the government, which in turn is the object of rent-seeking activities among various interest groups. The policy objective of financial restraint instead is to create rent opportunities within the private sector for financial intermediaries (see Aoki et al. 1997). Financial restraint would thus increase rather than decrease the mobilization of savings. Though the authors do not deal with growth, it could be reasonably argued that in this case the favourable effect of financial deepening on growth would be achieved in exactly the opposite way by retaining some degree of financial repression or restraint, as long as inflation remains low. The position defended by Hellman et al. departs from the basic proposition, implicit in almost all reform packages by international financial institutions, that allocative efficiency attained through free competition and flexible prices is always the best way to promote growth.

The basic model is the same as that of McKinnon's, although the beneficial effects are derived from the better position of banks. The rents in this case have a positive rather than negative effect since they allow banks to accumulate capital and to expand their supply. Accordingly, the gains to banks would be bigger than the losses to depositors (see Hellman et al. 1998, pp. 264–5), though the whole reasoning rests on the tacit assumption that depositors do not want to build up capital, otherwise the usual general equilibrium assumption that gains must equal losses in the economy as a whole must hold. They assume there is a unique bank in the system, capitalized with $10 equity and $90 deposits. In a free-market equilibrium without risk aversion both earn 5 percent. If, instead, the government imposes a ceiling of 3 percent on the yield of deposits what happens is that

depositors suffer a loss of 2 percent whereas the bank see the return on equity dramatically increase to 23 percent. The franchise value of the bank, that is the capitalized value of the return on equity, has dramatically increased. This is the reason why banks lose any interest in gambling, entering high-yield and high-risk investment, having a capital to lose. Though the argument may be right in telling that some government intervention in the free market may make the banking system safer than it would otherwise have been, it is quite strange that the loss suffered by depositors is less than the gain obtained by the bank. The authors make a numerical example reported in Table 11.1.

Table 11.1 Franchise value of a bank

	Free market			Financial restraint		
	Amount invested	Gross return	Rate of return	Amount invested	Gross return	Rate of return
Assets	$100	$105	5%	$100	$105	5%
Deposits	$90	$94.5	5%	$90	$92.7	3%
Equity	$10	$10.5	5%	$10	$12.3	23%
Franchise value of equity	$0.5/(5%) = $10			$2.3/(5%) =$46		

Source: Hellman et al. (1998), p. 265.

What the authors do not consider is that the depositors' loss is calculated just as a one-period flow whereas the gains to the banks is calculated as the franchise value, the capitalized value of the return on equity, which is a stock. If depositors would like to build capital by redepositing and adding to the initial deposit the yield obtained at the end of the first period, their loss would be as great as the gain to the bank. Moreover, if they were market investments with a yield of 5 percent, depositors, under the no-risk-aversion assumption, would switch to other investments. What is plausible, certainly, is that the loss suffered by the depositors may enhance welfare through the positive effect that the franchise value of banks has on their business strategy; however, the assertion that gains to the bank are bigger than the losses to the depositors stems from a numerical example, in which different standards are used to measure gains and losses. A

consistent conclusion from this argument is that in some cases allocative efficiency may not foster growth.

The direct link between efficiency and growth, beyond the effect of financial deepening on gross domestic product (GDP) growth through the investment channel, has been stressed by many – old and new – studies (see McKinnon, 1973; Levine, 2001; Demirgüc-Kunt and Levine, 1996). McKinnon claimed to show that financial liberalization, by abolishing rents in the banking sector arising from financial repression, could boost savings and consequently the accumulation of capital. Recently it has been questioned that the accumulation of physical capital really matters for economic growth. Economists who plead for financial liberalization have replied that the latter is useful, even if the transmission channel does not pass through capital accumulation, insofar as it increases economic efficiency and total factor productivity (see Levine, 2001).

Several econometric studies have shown that liberalization both in the banking sector and in the stock exchange after the opening of the capital account leads to major efficiency, which in the banking sector means lower profits and lower overhead costs as well (Demirgüc-Kunt and Levine, 1996), and in the stock exchange an increase in various variables among which the most important one appears to be stock market liquidity. Stock market liquidity may increase efficiency because it allows the sale of shares of ongoing investment without incurring heavy losses. This in turn would foster participation in the stock exchange and new business creation. Though there is nothing against this argument it is difficult that, even in a very liquid market, investments may be profitably sold if the corporate governance is such that shares are held in a web of reciprocal stakes in the corporate sector only and are not sold unless an agreement to change strategy has been reached in advance.

Financial liberalization would thus act through two channels: the direct effects on economic growth, which are stressed by econometric studies of the relation between financial deepening and GDP, and the indirect effects on output through the efficiency channel, that is, the increase in productivity caused by the lowering of profits and the abolition of unproductive rents.

The argument by Hellman et al. (1997, 1998) is that raising interest on bank deposits will lower profit margins for the banks and induce them to expand their activities by investing in risky high-yield assets. Thus, in the end, the message is that depositors should be sacrificed to enhance economic welfare. Levine (2001), on the contrary, asserts that the liberalization policy of raising interest rates and opening the sector to more competition both internal and external, say from foreign banks, lowers previously registered profits, stemming from the imposition

of a low rate on deposits. This increases the efficiency of the whole economy. Since, in most recent studies, growth appears to be related more to productivity increases than to capital accumulation, Levine (2001) claims that by making the banking sector more productive the beneficial effects will spill over to the whole economy. He studies the effects of liberalization on the banking sector of 80 countries between 1988–95, where the effects of liberalization policies are measured by the number of foreign banks. He shows, using ordinary least squares (OLS) regressions, that the entry of foreign banks increases efficiency, which means lower bank pre-tax profits over total assets and decreased costs measured as overhead costs over total assets, which include personnel expenses and other non interest costs. The independent variables are instead foreign bank share, the number of foreign banks to the total number of banks, over total assets and the number of foreign banks. It is shown that the foreign bank share decreases pre-tax profits by 0.027 percent and foreign entry by 0.028 percent. Overhead costs decrease respectively by 0.034 and 0.015. It could be argued that domestic banks facing a decrease in their profit margins due to the increase in competition decide to improve their management and organization and obtain an improvement in productivity. The improvement in productivity obtained by cutting costs should normally lead to an increase in profits, other things being equal, but in this case profits fall. Levine does not justify this conclusion but argues that profits must fall because of the increase in competition.

A further consideration, which is not drawn by the author himself, is that the improvement in productivity is not sufficient to offset the loss in market power, the decline in the mark-up. It is then assumed that this increase in productivity will foster growth. No econometric exercise is carried out to prove this assertion. The case in point is South Korea where the whole reasoning should, according to these studies, apply. In this particular case it is not very clear how the link between lower banks' profits and increase in efficiency should be interpreted. If the efficiency is just the efficiency of the banking sector, then its weight on the gross domestic product is very low so it is unlikely that it will boost growth. If instead it is meant that the improved performance of the banking sector will increase growth by its effects on the firms via lower debt costs, it is hardly conceivable that this has indeed happened in this country. First, banks were increasingly losing market share against non-bank financial institutions and moreover their share of loans to non-financial firms decreased (see Tropeano, 2001 on this point). Non-financial firms were either tapping international capital markets or resorting to securitized loans sold by non-bank financial institutions at

high interest rates. The decrease in profits made banks enter new activities, which were riskier than lending to domestic firms.

The argument by Hellman et al. (1998) that imposing ceilings on rates on deposits increases the bank welfare more than it decreases consumers' welfare is based on an ad hoc way of measuring gains and losses. Imposing ceilings on rates damages consumers and favors banks. This point, however, is not clearly made by Hellman et al. (1997, 1998), who write that banks make gains without telling the reader who loses. The point is which regime is more favourable to growth. Hellman et al. (1997, 1998) think it is the first under certain circumstances (no high inflation). Levine (2001) claims that the increase in productivity of the banking sector following the increase in competition will be sufficient to boost growth.

In the following section we will try to link this discussion with the debate on income distribution and growth. There are studies that link growth to more equitable income distribution (see Barro, 1999; Alesina and Rodrik, 1994). According to the hypothesis where banking productivity fosters growth, the distribution of income should change in two ways. The direct effect of relaxing controls and regulation is an increase in interest, so the reflection in output will be an increase in the share of interest income, other things being equal. However, if the main effect of this productivity increase is to boost growth, then the incomes from production, wages and profits should increase too. The result on the distribution of income could depend upon the initial increase in the share of rents at fixed output and the change in income distribution caused by the output growth. We should therefore observe an increase in the rate of growth of output accompanied by more equality in income distribution and a relative increase of the wages and profits shares with respect to rental income. This would in turn be consistent with the thesis that growth is positively affected by equality in income distribution.

THE POLITICAL ECONOMY LITERATURE ON LIBERALIZATION AND GROWTH AND THE ROLE OF INCOME DISTRIBUTION

A third and indirect effect of liberalization is stressed in the so-called 'political economy' literature where growth is positively linked to democracy. The abolition of unproductive rents, consequence of a process of liberalization within

a reform programme which includes both trade and financial liberalization measures, leads to a change in the balance of power in the countries concerned, with a shift in income distribution from unproductive elites profiting passively from protectionist measures in the real and in the financial sector to workers and potential entrepreneurs benefiting from the reduction in the prices of final and intermediate goods and from the increase in the remuneration of savings (for the definition of unproductive profit-seeking activities see Bhagwati, 1982). This change in income distribution would further contribute to economic growth.

Moreover the political economy literature stresses that the erosion of rents may foster democracy, which is beneficial to growth since it hurts the lobbies who derive their political and economic power from collusion with the state and are interested in retaining their current source of wealth, rather than implementing policies to promote output growth. According to this the liberalization process would cause a shift in income distribution away from rents, which may be extracted from different markets, and towards incomes more related to productive activities such as wages and profits. There is however the presumption that since financial liberalization is often accompanied by stock market booms and the owners of stocks are often the richest, often closely connected to the government, they could benefit more from liberalization thanks to better access to information (see Bhagwati, 1996).

A recent paper by Das and Mohapatra (2003) shows that the income distribution in a sample of 11 countries[1] that have undertaken liberalization in the capital account and in the stock exchange changes in the four years following the implementation of these measures, with a net increase in the share of the richest quintile and with a net decrease in the share of middle incomes, which are identified with the second, third and fourth quintiles. The poorest, that is the last quintile, do not experience any change in their relative share of income. Since the middle classes, the bourgeoisie, are particularly important in industrialization processes – because they are more endowed with knowledge and skills and more inclined to start entrepreneurial initiatives – this would not support the last thesis on the beneficial effect of liberalization deriving from the supposed increase in non-rent-oriented incomes and entrepreneurial classes. These new rents may take the form of capital gains from observed, large increases in stock market prices, which often do not bear any relation to better performances from listed firms. Rents in the banking sector and in the market for state debt may increase because of a positive differential between the domestic interest rate and the world interest rate, due to imperfect capital markets. The increase in the share of the highest quintile would support the hypothesis that the richest before liberalization

become richer after this has happened. This means that those who were favoured by the previously used protectionist measures are still more favoured by the new liberalized environment. How could this be reconciled with the literature on interest groups and the canonical representation of unproductive industrial lobbies as opposed to liberalization measures?

Das and Mohapatra (2003) argue that the improvement in the relative share distribution of the highest quintile is linked to their holdings of shares and to the stock market booms that usually follow liberalization. In many emerging countries shares are held most exclusively by the highest classes. The lowest quintiles may be damaged by exclusion from the credit market due to market imperfections and credit rationing. The stock market boom is accompanied, according to many studies, by an increase in investment triggered by the increase in profitability due to the lower cost of capital (see Henry, 2000), and by the increase in retained earnings. One could argue from these findings that firms, given the increase in profitability due to the lower cost of capital, do not distribute higher dividends but instead reinvest them. This process would also be accelerated by the fall in the share of loans in total financing of the corporate sector.

If the link from liberalization to growth passes through capital accumulation or better yet through productivity increases, it must increase investment or at least investment in research. From the country studies in Taylor (2001), the most common source of growth in income in liberalizing countries does not appear to be either investment or exports but quite surprisingly consumption and public expenditure. Among the countries examined in Taylor (2001),[2] the only countries where investment led to an increased contribution to output growth are India and Korea. In the latter country, however, the increase in investment rates after liberalization has been accompanied by declining profitability. Thus the explanation that links financial liberalization to a decrease in the cost of capital and improved profitability cannot be accepted.

The increase in public expenditure helps to explain why the income share of the lowest quintile does not decrease. The increase in consumption may be reconciled with a change in income distribution from profits to rents, the propensity to consume from rents usually being higher than that from other types of income. If the rise in income is to be imputed to consumption because of the wealth effect of rising stock prices and rising yields of financial assets with multiplier effects on non-traded sector goods production, the thesis that liberalization is beneficial to growth because it increases efficiency and thereby total factor productivity appears misleading since those sectors interested in the

expansion are by far the less productive ones. The increase in output which is registered among the main achievements of the liberalization strategy has to be considered jointly with the simultaneous increase in public and private debt. The deterioration in public finances, the increase in income notwithstanding, occurs often because of the qualitative changes in the structure of the employment and the distribution of income. The relative decrease in the middle incomes means that most incomes subject to taxation disappear, whereas the increase in the upper quintile due to capital income often does not contribute much to tax revenues because of tax evasion or elusion. The increase in the share of the non-traded sector share on gross domestic product means that most jobs are informal ones. The remunerations of these informal jobs are not taxed.

INVESTMENT DECISIONS UNDER BOTH TRADE AND FINANCIAL LIBERALIZATION

In this section, we consider that both trade and financial liberalization affect investment decisions. The sequence in which those liberalizations are carried out matters too. Investment decisions, however, depend also on the corporate governance regime ruling in each country. Thus, liberalization measures may affect investment in different ways.[3] We will examine two cases, South Korea and Turkey, which indeed show different patterns of investment after liberalizations.

Two possible scenarios are investigated, one in which trade liberalization, realized in many countries which at the same time pursue export growth strategies, depresses the price of products exported and thus profits, and the other in which financial liberalization raises the gains from investing in financial assets or in risky segments of the financial intermediation. If both events occur at the same time we can distinguish three cases. The differential between the rate of interest and the rate of profit may induce substitution between real and financial capital according to the neoclassical view; in this case the high real rate of interest would crowd out real investment. Nothing changes, rather if entrepreneurs are depicted as committed to pursuing the objective of growth in the market share in any case, even if this means not exploiting investments with higher yields. An increase in both real and financial investment may happen instead if they can profit from the increase in the financial resources and expand in both markets by raising more debt, thus decreasing the price of shares. This would not of course apply to a managerial economy, in which managers maximize the price of shares being subject to takeover threats. This case may apply to what happened in South Korea.

Trade liberalization has been implemented before financial liberalization but due either to non-tariff barriers to trade or to other impediments has not depressed profits of old industrial groups, which continue to enjoy the same rent as before with an unchanged mark-up or even an increased one, due to the repression of wage costs. The question to be asked then is how the old industrial groups will use these rents in a liberalized financial environment. If the rate of profit, though entailing a rent from insufficient de facto trade liberalization, is structurally low due for example to a lack of technical change and improvements in productivity, the profits and borrowed money may be invested in the flourishing financial markets or be used to finance a higher level of consumption, often oriented towards imported goods. This second case may apply to Turkey. In the latter case neither capital accumulation nor productivity increased, whereas consumption, yields of financial instruments, imports and external debt did.

TWO EXAMPLES: SOUTH KOREA AND TURKEY

South Korea and Turkey represent two cases in point since, though both of them present the same pattern of income distribution which is common to many liberalized countries, with an improvement in the first quintile and a worsening in the middle quintiles, the behaviour of different types of income according to the source is different. In South Korea the profit share is continuously falling and the wage share is rising jointly with the interest income share. In Turkey instead the profit share is rising or remaining constant, the wage share is decreasing in the first phase after liberalization and increasing in the second phase, and the interest income share is rising the whole time. Surprisingly enough, the contribution of investment to the growth of output is high in South Korea and low in Turkey.

In South Korea the business sector reacted to the fall in profits and the increase in rents by increasing investment but also debt, used both to finance investment and to increase financial assets and portfolio investment. Both balance sheets and national accounts data show this marked increase in the assets and liabilities of the business sector (see Tropeano, 2001, 2008b). In particular the financial liberalization by creating new bank and non-bank accounts with higher real yields than before favoured the accumulation of financial capital. The balance sheet data for the first four big chaebol show that the increase in the flow of debt was used to finance the acquisition of current assets (particularly bank assets), the

construction of new plant (tangible assets) and investment assets (among which participations in affiliated companies is the most important item).[4] This expansion of all assets was financed by raising debt, often in international capital markets. Since the debt ratio was already high this meant an increase in it and a fall in the value of the shares. Since the managers of the big groups were not worried about the value of their shares they did not care about. The crisis hit them not only for the part of debt denominated in foreign currency but also for the fall in the value of participations due to the collapse of the whole regional market. We can therefore argue that the fall in the profit rate set in motion, given the larger availability of credit due to the opening of the capital account, a process of expansion of the productive activity to prevent competitors from enlarging their market share but also an expansion of the acquisition of portfolio assets and bank assets whose proportions were never experienced in the past (while very high investment rates had already occurred at the beginning of the 1990s).[5] While the literature on the financial crisis has considered the moral hazard argument as the only possible explanation of such behaviour, the attempt to win an ongoing competition in an overcrowded market with falling prices and to profit from high real yield both on bank assets and on shares abroad could be, in my opinion, a more plausible explanation. The problem of debt was exacerbated by the low inflation of the 1990s whereas in the past an escape from debt problems has always been a moderate degree of inflation and government support.

The Turkish Case

The Turkish case is an example of both trade and financial liberalization in which the share of profits does not decrease with respect to the preceding period, although the share of interest income clearly increases. The high mark-up over costs shows that the trade liberalization notwithstanding, national firms enjoyed some preferential treatment in the domestic market. In this case the opening did not directly depress profits. In the first phase 1989–94 (before the first financial crisis) the wage share was declining and there was a depreciation of the currency which should help the policy oriented towards promoting exports. All this notwithstanding, the investment in the manufacturing sector declined instead of increasing. In the second phase 1994–2000 the investment was driven mainly by internal demand whose growth was related to the growth in real wages though the inflation was high. High inflation, increasing need for funds to finance the public debt and capital inflows drove the real interest rates very high and contributed to high interest income share over the national product (see Boratav et al. 2001;

Boratav and Yeldan, 2002). The informalization of labour and the tax evasion of capital income meant an increasing need for funds to finance public expenditure, particularly the part used to pay interest on public debt. In this case the change in the distribution of income stressed by Das and Mohapatra (2003) may be interpreted in the following way. The industrial lobbies never lost their power, thus retaining an oligopolistic position in the domestic market while at the same time profiting from the high real interest rates. In the second phase before the second financial crisis, the exchange rate appreciated due to the continuing inflow of capital and the export performance worsened. The new financial crisis in 2001, accompanied by a heavy depreciation of the currency, and a fall in output and real wages, ended this phase. The crisis was triggered by the successful strategy of disinflation and lower short-term interest rates on public debt which eventually destroyed the big part of the economy based on the high real interest rates and caused capital outflows. This sounds a bit strange if compared with the emphasis put on fundamentals by exchange rate theories as determinants of investors' expectations.

DO OLD LOBBIES INCREASE OR LOSE THEIR POWER AFTER FINANCIAL LIBERALIZATION?

This short look at what happened in two particular cases, Turkey and South Korea, in the distribution of income and wealth after both trade and financial liberalizations may help us to answer the question asked in the first section: how should rents arising in the financial sector be considered from the viewpoint of social welfare?

We have seen in the first section that quite different views on the rents in the financial sector are present in the literature. There is a strand of literature stemming with McKinnon which sees in these rents and in the insufficient financial deepening the main burden of financial repression. Liberalizations should then work exactly in such a way as to wipe out those rents, increase deposits and increase the efficiency of the whole productive system. This insight by McKinnon is shared by many other economists working on the nexus between finance and growth. Among them some recent work by Levine stresses the positive effects of the declining or disappearing rents in the financial sector as the main engine of growth, in contrast with the preceding view that linked growth to financial liberalization through financial deepening, and increase in saving, and in capital accumulation. Stiglitz argues in the opposite way, though carefully

distinguishing between financial repression and financial restraint. Others like Caprio et al. (2001a) argue on the one hand that financial liberalization is essential for growth; on the other hand they deny both that rents in the financial sector or even in the goods sector have in fact decreased after liberalization and that financial liberalization increases saving and real investment, as would be consistent with the story told by McKinnon. Their theoretical position is therefore not very clear unless their proposal is to implement liberalization only if adequate institutional structures are already available, for example anti-trust law and other legislative tools. Even if this could be true for the persistence of rents, it is doubtful that, even under a different institutional structure, saving will increase unless some sort of credit rationing is reintroduced. The conclusion in Bandiera et al. (2000) is that generally financial liberalization does not increase saving, rather the opposite happens. They argue however that this should not be worrying since the financial resources for investment are available through the increased supply of credit and the return of funds previously invested abroad.

The consideration of rents and distribution in this literature is only static, since it examines just the gains or losses from the change in the price of financial assets, which is supposed to increase from the low administered price to a higher market price, which should be the equilibrium one. In reality, however, this does not happen either, as is stated in Honohan's study of the behaviour of interest rates using cross-country estimates (see Honohan, 2001). Interest rates after financial liberalization rise well above the supposed equilibrium levels. At the same time old lobbies, especially industrial or agricultural producers, do not lose their privileges, as is stated in many country studies in the same book. This may happen because of the increase in debt, both private and public. The increase in debt at higher interest rates affects the functional distribution of income, favouring especially the holders of state debt. The nexus between liberalization and rents must not be dealt in a static partial equilibrium framework, but in a dynamic framework which takes into account the changes in income and the changes in the composition of gross domestic product. What matters empirically is not the static shift in the price of financial assets and its welfare effects, but the shift in the composition of gross domestic product as to the source of income after liberalization, with the increase in the share of non-labour income in comparison to pre-liberalization periods.

The idea underlying the contributions in the book by Caprio et al. (2001) is that financial liberalization is always better than repression and should be adopted by developing countries, but with caution, only after some structural reforms are implemented and only if macroeconomic stabilization has been reached. The hidden assumption here is that that macroeconomic instability and collusive behaviour are exogenous to the liberalization process, instead of being the very results of the liberalization process itself (see Tropeano, 2003). Public debt may increase because firms' or banks' debt, piled up after liberalization, is replenished by the state or because the government revenues decrease after the deregulation process has been implemented, since most regular jobs are replaced by temporary informal jobs and the rising amount of income from interest is not taxed (see Turkey for example). Public debt may be nourished by the necessity of funding rising interest expenses. This increase in interest expenses on public debt may be due to inflationary expectations alone, but also to the power of interest groups who own most of the state debt.

The interest groups, as can be seen from these empirical studies, may not have just static objectives, for example maintaining their mark up over costs in the agricultural or industrial sector, and thus opposing trade or financial liberalizations. They may adapt themselves to the change in the environment using their influence, not necessarily through corruption, to get the better possible outcome, the liberalization notwithstanding. Industrial groups may just increase their prices as response to an increase in costs, including interest costs, while at the same time benefiting from the high interest rates as holders of the increasing stock of debt in the economy. Alternatively if they sell products only in the world market and therefore have no market power they may resist interest rate increases on their debt and obtain delays in the implementation of the liberalization measures on one hand while on the other hand profiting from the increase in the yield of some new financial activities either as their direct purchasers or through the acquisition of financial companies. They may even make pressures to obtain regulations that increase their revenue from such expansion of their core business in other sectors.[6] The rise in real interest rates to very high levels after liberalization, as documented in Honohan (2001), may be a key element in explaining the change in the objectives of interest groups who use financial liberalization just as a means to increase or at least maintain the share of national product they own. This share consists of both profits and rents. The adjustment after financial crises happens in most cases through reductions in wages rather than in profits. This interpretation may be consistent with the results of the studies on income distribution changes after liberalization. This may explain why domestic interest groups in conservative countries may agree with so-called reform packages recommended by international institutions since the realization of these reform packages does not decrease their influence and their income. The observed fact that aggregate savings usually decrease in percentage of GDP after

financial liberalizations are implemented[7] should be linked not only, as is often the case in the empirical literature on the subject, to the relaxation of credit constraints for households, but also to the change in the composition of domestic product with the rise in income from interest. The higher the propensity to consume out of this income, the higher the decrease in aggregate savings, if a rising share of income comes from this source. Since most of this consumption is directed towards luxury goods, the overall propensity to import rises too.[8]

CONCLUSION

Most studies on financial liberalization have found that it affects growth positively through its effect on the availability of finance and its contribution to total factor productivity. The link between financial liberalization and growth would therefore pass through the investment or improvement in productivity link. If this thesis were correct, then it would be reasonable to expect a growth triggered by investment expenditure or expenditure in research and technology improvements, as well as from a change in the distribution of income that decreases the weight of incomes derived from rents, which should have been wiped out by the liberalization measures, and increasing the weight of incomes deriving from productive activities. Most empirical studies found that neither the first or second hypotheses are consistent with the data for most liberalizing countries.

In this chapter, it has been suggested that investment decisions after liberalization processes must take into account both the effects of the trade liberalization measures and the effects of the financial liberalization measures in the sequence in which they were implemented in different countries. The combination of different effects on the rate of profit and on the rate of interest combined with different corporate governance structures may explain the divergence in investment profiles. In any case what appears evident from the data is that in most cases the share of incomes from holding financial activities increases more the share of incomes from labour and entrepreneurial activity. A brief look at two cases, South Korea and Turkey, has helped to imagine explanations for these empirical findings, which contradict the most accepted theory on the effects of financial liberalization.

The role of interest groups in liberalization coalitions should be more carefully examined. In fact, if both trade and financial liberalization are implemented, existing strong interest groups may still retain their power by exploiting the gains

from the very high real interest rates that usually follow liberalization. They may not pursue policies that help promote the growth of exports, the subsidies notwithstanding, but enjoy a better outcome than in the pre-liberalization period by holding financial assets or by expanding in the financial business. The objective of agricultural or industrial lobbies should not be considered in a static way, as merely defending existing privileges, but also in a dynamic setting. Their strategy could be to increase their power in a changed environment by using new opportunities. In this case a coalition between international financial lobbies asking for liberalization and domestic conservative lobbies linked to agriculture or non-productive industries could arise. This could also explain why in fact economic liberalization is undertaken in countries with very conservative governments.

NOTES

1. The countries considered in this work are: Brazil, India, South Korea, Rep., Malaysia, Mexico, Nigeria, Pakistan, the Philippines, Sri Lanka, Thailand and Turkey. In some of these countries the highest quintile already owns around the 50 percent of total output (Brazil, India, Mexico).
2. The chapters of Taylor (2001) consisting of country studies regard Argentina, Colombia, Cuba, India, Mexico, Russia, South Korea, Turkey, Zimbabwe. Four countries, namely India, South Korea, Mexico and Turkey, are considered by both Taylor (2001) and Das and Mohapatra (2003).
3. For the relation between different types of liberalization policies in different institutional contexts see Tropeano (2008a).
4. Most studies on the financial crisis in South Korea support the thesis that the rising debt of the business sector in the years preceding the 1997 crisis was due to the excessive investment in real capital, which should be reflected in balance sheet data the item as 'tangible assets'.
5. The accumulation of financial assets may have different reasons for large enterprises and small and medium-sized ones. For the former, it was part of an industrial strategy while for the latter it was a sort of insurance policy against the very high variability of profit rates (see Tropeano, 2008b).
6. In South Korea, the main conglomerates first expanded in the new financial intermediaries sector (buying merchant banks), then pressed for and obtained that the commercial paper discounted by these new financial institutions could be purchased by the trust accounts of commercial banks, thereby giving the merchant banks more liquidity to be promptly reinvested.
7. See, among others, Bandiera et al. (2000).
8. See the country studies in Taylor (2001).

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