International Journal of Innovation and Applied Studies
ISSN 2028-9324 Vol. 19 No. 2 Feb. 2017, pp. 349-355
© 2017 Innovative Space of Scientific Research Journals
http://www.ijias.issr-journals.org/

The financial liberalization and the financial system: Is it a good or a bad symbiosis?

Sofiane Mostéfaoui and Ali Yousfat

University of Adrar, Algeria

Copyright © 2017 ISSR Journals. This is an open access article distributed under the ***Creative Commons Attribution License***, which permits unrestricted use, distribution, and reproduction in any medium, provided the original work is properly cited.

ABSTRACT: The financial system in any economy occupies an outstanding position in channeling the necessary funds to boost the economic growth. In this context, a critical debate had been launched in an attempt to reveal the mechanism of developing the financial system and increasing its performance vis-à-vis the other economic cycles' departments. Financial liberalization comes as a strategy to improve the funds pooling and channeling process and come up with the demands of the other economic agents (investors and consumers). The antagonists of the financial liberalization argue that this tactic whether takes the sequencing or big bang approach may lead to hard distortion within the system because it requires the lift up of the government hand on the financial system and let the latter working according to the market law. These laws may deprive a large portion of the society to benefit from the gains of the financial system. This paper tries to explain the interrelations between the financial system and the requirements of the financial liberalization paradigm, and how the latter impact the efficiency of the former.

KEYWORDS: financial system, financial liberalization, efficiency.

1 INTRODUCTION

The importance of the financial system in the economic cycle of any country had been the core point of various researchers and investigations for a long time. The main result of them is that the financial system takes the importance of blood for human being, and any country whether developed or underdeveloped cannot live or evolve without the services of this system. Therefore, the debate of how to develop and increase the efficiency of pooling and channeling funds between individuals becomes more than an important issue. This importance comes from the indisputable and absolute need of the economic agents to funds in order to fulfill their economic and social desires. At this point, liberalizing this system is conceived as a strategy to increase the flexibility of the system to collect and lend the funds; and improve the quality and the efficiency of the services presented. The liberalization process is determined via different angles of analysis. The tactical angle defines the liberalization as the process whether gradual or abrupt that aims to reduce or abolish totally the interest rate ceiling, reduce the direction of credit to such favored sectors (diminish the level of credit control), privatize banks and let them working according to the principle of cost-benefit and to the market ideology based on competitiveness and efficiency. Another explanation to this process takes its root from the context in which the liberalization is applied. Here, two levels of liberalizing the financial system are mentioned: domestic financial liberalization which tends to remove the controls of the interest rate and reduce the state credit allocation. The second level called the external financial liberalization. This phase comes sequentially after the first one and it looks at removing the controls of the capital account.

2 THE REMOVAL OF THE INTEREST RATE CEILING AND THE FINANCIAL SYSTEM

The financial system plays a critical role taking various forms in the economy. The financial form comes from the process of channeling funds from depositors to lenders. In this context, the financial system accepts deposits from money lenders (money surplus with no economic idea) to the money borrowers (money shortage with economic ideas). According to the financial theory, the main basic reward that encourages the bank to match the different two parties in their aspirations and desires is the margin of the interest rate between the depositors and the lenders. Here, the financial liberalization ideology considers that the interest rate of the different parties dealing their businesses with the financial system must submit to the market law based on competitiveness, efficiency and supply and demand forces. On this ground, the interest rate behaves not according to the *statism* philosophy that implies the heavy intervention of the authorities in setting the levels of the interest rate as well as the margins of spread; but according to unexpected states of the markets. This mechanism leads to another profile of the resources allocation between the agents based majorly on the profitability consideration. This profitability reshapes the interest rate as an indicator that reveals clearly both the scarcity and the profitability of the financial resources. Additionally, these new economic bases of the interest rate enhance the managerial and the institutional capacity of the financial system. The profitability point implies two impacts: pre-impact of the interest rate profitability and the post impact. The former effect means that the agents (money-lenders) are regulated vis-à-vis the financial system according to their own aspiration and the new working conditions of the system. The post impact implies the increase in the efficiency and the quality of the services presented. Consider the following model:

$$\sum_{t=0}^{\infty}\left\{\sum_{i=1}^{n}\sum_{j=1}^{k}(U_{i,j,t})-\int_{t=0}^{\infty}SW\ (N_{i,j,t})dt\right\}/(U_{i,j,t})=\frac{C_{i,j,t}^{1-\sigma}}{1-\sigma}\Lambda SW\ (N_{i,j,t})=\frac{\lambda\exp(N_{i,j,t})^{1+\varphi}}{1+\varphi}$$

$(U_{i,j,t})$ is the utility function of the financial system usage, $SW\ (N_{i,j,t})$ is the social welfare emanating from the efficient management of the financial system (the externalities), i , j number of depositors and lenders respectively, λ is the rate of the externality which depends on the development level of the country, φ the rate of the continual development of the financial system efficiency. This model shows that the market mechanism of the financial system management holds implicitly two strands of analysis: the inner strand determined by the utility function of both depositors and lenders from their dealing with the new profile of the financial system. The outer strand is revealed by the externality shared between the agents of the economic cycle. The purpose of letting the system working according to the basics of the markets is twofold: to increase the utility of the agents and to increase the performance efficiency of the system (this efficiency is cumulative process over the period of analysis and it is increasing as the gap between the two functions of the model widens). Thus, the purpose is technically represented by:

$$(U_{i,j,t})=\{\max\frac{C_{i,j,t}^{1-\sigma}}{1-\sigma}/0\leq\sigma\leq1 \tag{1}$$

$$SW\ (N_{i,j,t})=\{\max\frac{\lambda\exp(N_{i,j,t})^{1+\varphi}}{1+\varphi}/0\leq\varphi\leq1 \tag{2}$$

The benefits of letting the interest rate behave according the market law are shown as the following:

At time $t=1$:

$$Efficiency_1=Gap_1$$

$$Efficiency_1=\frac{1}{1-\sigma}\int_{t=0}^{t=1}C_{i,j,t}^{1-\sigma}-\frac{\lambda}{1+\varphi}\int_{t=0}^{t=1}\exp(N_{i,j,t})^{1+\varphi} \tag{3}$$

At time $t=2$:

$$Efficiency_2=Gap_2$$

$$Efficiency_2=\frac{1}{1-\sigma}\int_{t=1}^{t=2}C_{i,j,t}^{1-\sigma}-\frac{\lambda}{1+\varphi}\int_{t=1}^{t=2}\exp(N_{i,j,t})^{1+\varphi} \tag{4}$$

At time $t=n-1$:

$$Efficiency_{n-1}=Gap_{n-1}$$

$$Efficiency_{n-1}=\frac{1}{1-\sigma}\int_{t=n-2}^{t=n-1}C_{i,j,t}^{1-\sigma}-\frac{\lambda}{1+\varphi}\int_{t=n-2}^{t=n-1}\exp(N_{i,j,t})^{1+\varphi} \tag{5}$$

At time $t=n$:

$$Efficiency_n=Gap_n$$

$$Efficiency_n = \frac{1}{1-\sigma}\int_{t=n-1}^{t=n} C_{i,j,t}^{1-\sigma} - \frac{\lambda}{1+\varphi}\int_{t=n-1}^{t=n} \exp(N_{i,j,t})^{1+\varphi} \tag{6}$$

Then, the efficiency of the financial system that results from the removal of the interest rate is measured by the cumulative difference between the utility function and the welfare system over the period of the analysis. This difference is represented by the following equation:

$$InterestRateEfficiency = \sum_{i=1}^{n} Efficiency_i$$

$$InterestRateEfficiency = Efficiency_1 + Efficiency_2 + ... + Effciency_{n-1} + Efficiency_n \tag{7}$$

The effectiveness of the interest rate in enhancing the performance of the financial system is relied on the feedback coming from each phase of the gradual liberalization of the interest rate. This feedback is understood by the continual increase of the difference between the utility and the welfare function during the period of analysis. Graphically:

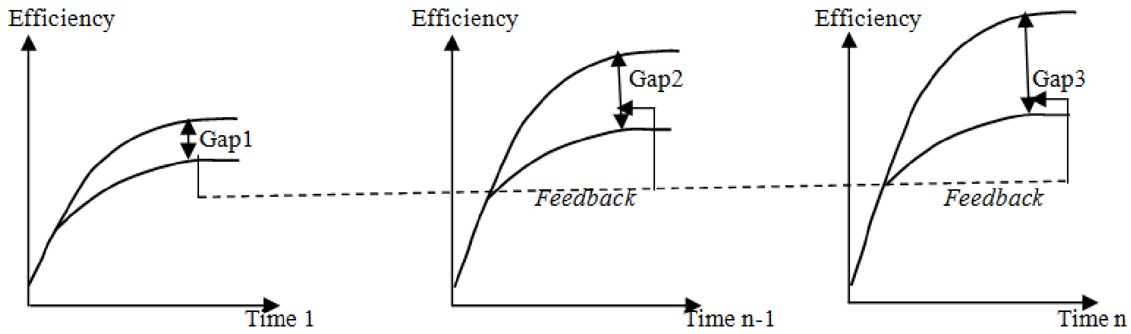

Fig. 1. The interest rate liberalization and the financial system performance

Source: *the researcher*

3 THE PRIVATIZATION OF BANKS AND THE EFFICIENCY OF THE FINANCIAL SYSTEM

The privatization is the process by which a part or the total of the enterprise or the institution shares are put up to be sold by the public. The latter becomes by this economic operation a partner or a customer and he will have the right to participate in the strategic decisions and the planning processes of the institution. In terms of growth and prosperity, privatization is considered as a strategic tool to boost the productivity and enhance growth even in the socialist countries. This market-oriented view supports the price mechanism and the forces of market in the conduct the business operations in general. According to the proponents of this view (the neoliberal school specifically) this paradigm is the most efficient one to improve the running of businesses and to predict the bankruptcy signals. In this context, John Moore had enumerated the benefits of the privatization as follow:

> Begun as a radical experiment, privatization works so well that it has become a practical process by which a state-owned industry can join the free market with visible, often dramatic gains for the industry, its employees, its customers, and for the citizens who set it free by purchasing its shares
>
> (Moore, 1992: 115-116)

The subject of the extent to which the firm or the bank is efficient as far as it is privatized is a controversial issue. It relies upon various considerations. The state of this topic is that the rule of the increase of the efficiency following the privatization process is clear but some cautions should to made as the efficiency itself requires the collaboration of the many variables not only the privatization one. Among these criteria, the privatization theory cited the structure of the organization, the state of the overall economy, the individuals' culture towards this paradigm. The privatization of the banks is similar to privatizing any economic institution. By this procedure, banks will be more competitive, profit-maximizing institution and works according to the market oriented perspectives. The competition of the banks implies that the interest rates are fixed according to the supply and demand forces and not by the government (avoiding the interest rate ceiling). Moreover, private banks compete to offer good services to their clients whether they are depositors or lenders and give the full guarantees to depositors as a way to increase their deposit ratio and improve their financial market share. Thus, the impact of the privatization on the banking system is twofold: the internal impact and the external one. The former impact relies on sustaining the organizational structure of the bank as the latter becomes a shareholder institution in which the strategic decisions and the planning processes are implemented differently. The outer impact implies the improvement of the business relations between the bank and its clients. This improvement comes from the guarantees offered and the increase of the monitoring capacity of the bank as under the privatization system it will be more capable to distinguish between the good borrowers and the band ones (decrease the effects of both the adverse selection and the moral hazard). The following figure shows the interactions between the inner and the outer impacts:

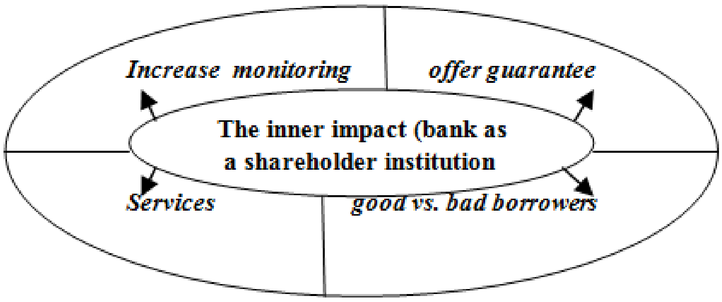

Fig. 2. The inner and the outer impacts of the banking privatization

Source: *the researcher*

4 THE CREDIT ALLOCATION AND THE EXPANSION OF THE FINANCIAL SYSTEM

The channels by which the credit allocation mechanism affects positively or negatively the development of the financial system are presented by the circuit of the risk accompanying the credit distribution between sectors and activities. This risk is divided into two parts: systemic and non systemic risk. The former kind includes the factors that are beyond the specificities to whom the credits are directed such as: macroeconomic variables (exchange rate, GDP, inflation rate…), political variables (change in aspirations of the political leaders), the alteration of the economic policies (taxation policy, monetary policy, financial policy…). The second kind of factors belonging to the unsystematic risk refers to the particularities of the customers who take credit or have already taken. These patterns are: the personality of the customer, the financial and the reporting position of this customer if it is an institution, the management efficiency of the firm taking the credit…In this context, the correlation between the allocation mechanism and the development of the financial system increases in cases when the bank can overcome or diminish the negative impacts of both the systematic and unsystematic risks. The core of this issue is that the credit risk in general leads gradually and implicitly or explicitly to the bank default. In order to avoid the probabilities of this situation, banks strive to *manage* all the surrounding risks in favor of the strategic goals of the bank (this trend is coined by the bank performance).

Let P_t the bank performance at time t , SR the systematic risk, UR , then the bank wants to achieve the points in which it performs efficiently its functions via the management and the profitability perspectives. Technically, the bank runs its business (accept deposit, lend credit, monitoring, participation in financial the beneficial and profitable projects…) in order to achieve the following optimal points:

$$\begin{cases} \dfrac{\partial P_t}{\partial SR} = 0 \quad \text{(the utmost capacity of overcoming the systematic risk)} \\ \dfrac{\partial P_t}{\partial UR} = 0 \quad \text{(the utmost capacity of overcoming the unsystematic risk)} \end{cases}$$

These optimal points are not achieved abruptly but gradually over time by a capable and an efficient system of management. This gradual process is figured by the continuing performance capacity at each point of time as a result of the management performance. In this respect, the gap between the benefits of the bank management and the inherent risks of the credits presented is widening as the period elapses:

$$\begin{cases} \dfrac{\partial P_t}{\partial SR} = 0 \Rightarrow \left[\dfrac{\partial P_1}{\partial SR_1} + \dfrac{\partial P_2}{\partial SR_2} + \dfrac{\partial P_3}{\partial SR_3} + \ldots + \dfrac{\partial P_n}{\partial SR_n} \right]_{t=1,2,\ldots,n} = 0 \\ \dfrac{\partial P_t}{\partial UR} = 0 \Rightarrow \left[\dfrac{\partial P_1}{\partial UR_1} + \dfrac{\partial P_2}{\partial UR_2} + \dfrac{\partial P_3}{\partial UR_3} + \ldots + \dfrac{\partial P_n}{\partial UR_n} \right]_{t=1,2,\ldots,n} = 0 \end{cases}$$

This gradualist movement is illustrated by the following diagram:

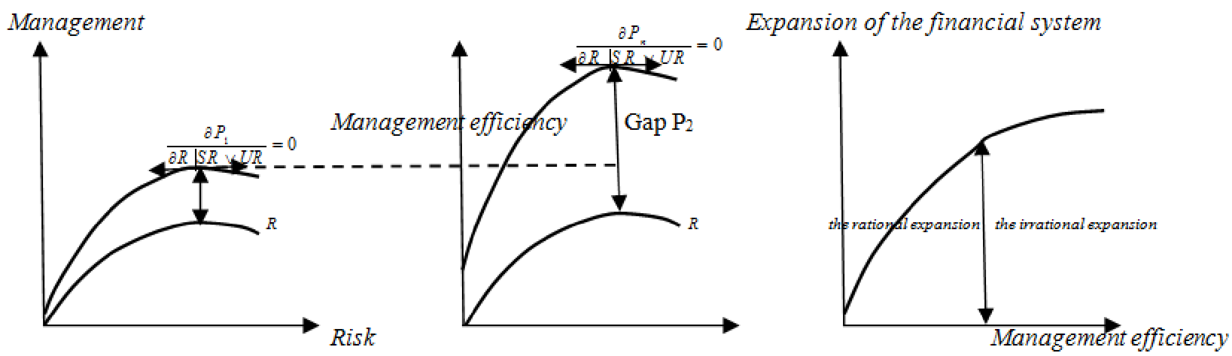

Fig. 3. The management performance and expansion of the financial system

Source: *the researcher*

5 THE SEQUENCING OF THE FINANCIAL LIBERALIZATION AND THE DEVELOPMENT OF THE FINANCIAL SYSTEM

In this respect, two mechanisms of liberalizing the financial system are mentioned: the gradual process and the big bang one. The former means that the deregulation of the financial variables that work within the context of the financial system takes steady and regulated steps of liberalization. This process is applied according to two basic considerations: the goals assigned to the liberalization and the level of the economic development. The latter conducts forcefully which variable should to be liberalized first and which ones that follow this procedure. The second approach implies that the economy lifts up all kinds of controls on the financial system abruptly. Here, the infrastructure development of the financial system and the development of the overall economy take less concern as the time needed to benefit from the specific feedbacks of each step of liberalization is short enough to design the appropriate strategy. The conception of the consecutive strategy is a remedial step to circumvent the probable pitfalls of the liberalization. In addition to this, the issue of the gradual liberalization focuses primarily on analyzing the various correlations between the variables of the financial development and the financial liberalization. This enables to conceive a financial network liberalization-development, and it sorts out the signals from each gradual stage that serves as strategic background to the further stages of the liberalization. This network is shown by the following figure:

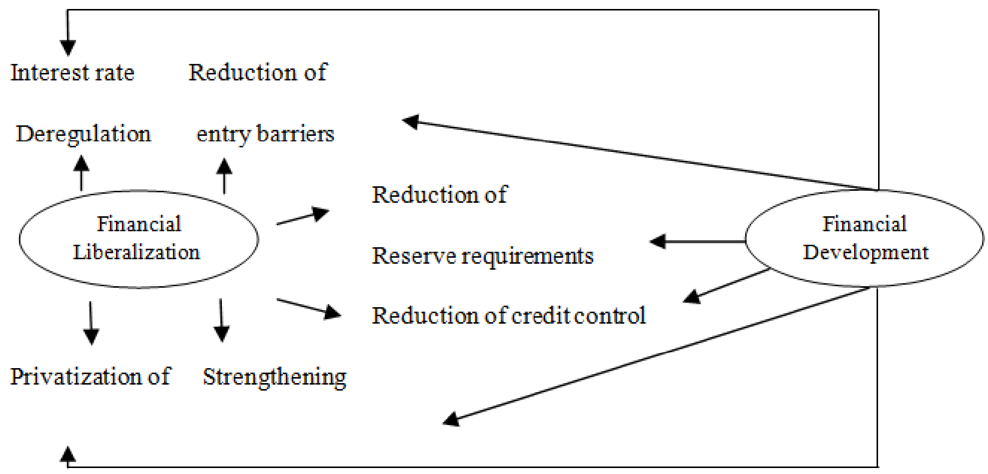

Fig. 4. Financial network

Source: *the researcher*

6 Conclusion

This paper tries to shed light on the mechanisms of liberalizing the financial system and their impacts on its development. The purpose of liberalizing the financial system is twofold: to increase the borrowing and lending capacities of the system (economic efficiency) and to conceive and apply the suitable strategies that ensure the survival of the system in a competitive environment (managerial efficiency). The former and the latter efficiencies correlate in such a way that increases the welfare gains and diminishes the distortions that may occur from the inappropriate adoption of the liberalization paradigm. The symbiosis between the financial development and the financial system is guaranteed only if the design of the liberalization process takes into account the economic and the financial level of the country (Macro-consideration), the level of the managerial development of the institution (institutional development), and the progress of the society towards the acceptance of the market oriented philosophies (societal development). These three components vary simultaneously conveniently with the general objectives of the liberalization philosophy.

References

[1] Alan Rugman. (1992), Entry Barriers and Bank Strategies for the Europe 1992 Financial Directives, *European Management Journal* 10(3): 327-333
[2] Betty C. Daniel & John Bailey Jones. (2007), Financial Liberalization and Banking Crises in Emerging Economies, *Journal of International Economics* 72: 202-221
[3] Christian Ronald. (2008), *Banking Sector Liberalization in India: Evaluation of Reforms and Comparative Perspectives of China*, Physica-Verlag A Springer Company
[4] E. Han Kim & Vijay Singal. (2000), Stock Market Openings: Experience of Emerging Economies, *The Journal of Business* 73(1): 25-66
[5] Eric Helleiner. (1995), Explaining the Globalization of Financial Markets: Bringing States Back In, *Review of International Political Economy* 2(2): 315-341
[6] Fabrizio Coricelli. (1996), Finance and Growth in Economies in Transition, *European Economic Review* 40: 645-653
[7] Geert Bekaert, Campbell R. Harvey, Christian Lundblad. (2005), Does Financial Liberalization Spur Growth? *Journal of Financial Economics* 77: 3-55
[8] George Alessandria & Jun Qian. (2005), Endogenous Financial Intermediation and Real Effects of Capital Account Liberalization, *Journal of International Economics* 67: 36-49
[9] George Selgin. (2002), *Bank Deregulation and Monetary Order*, Taylor & Francis Group
[10] Hiroshi Osano &Toshiaki Tachibanaki. (2001), *Banking, Capital Markets and Corporate Governance*, Palgrave Macmillan
[11] Ilan Noy. (2004), Financial Liberalization, Prudential Supervision and the Onset of Banking Crises, *Emerging Markets Review* 5: 341-359

[12] Joël Bessis. (2015), *Risk Management in Banking*, Fourth Edition, John Wiley & Sons, Ltd

[13] Jonah D. Levy. (1997), Globalization, Liberalization and National Capitalisms, *Structural Change and Economic Dynamics* 8: 87-98

[14] Jorge A. Chan-Lau & Zhaohui Chen. (2001), Crash Free Sequencing Strategies for Financial Development and Liberalization, *IMF Staff Papers* 48(1), 179-196

[15] Joseph E. Stiglitz. (2000), Capital Market Liberalization, Economic Growth, and Instability, *World Development* 28(6), 1075-1086

[16] Kenneth A. Frooth. (1988), Credibility, Real Interest rates, and the Optimal Speed of Trade Liberalization, *Elsevier Science Publishers*: 71-93

[17] Mark Armstrong & David E. M. Sappington. (2006), Regulation, Competition and Liberalization, *Journal of Economic Literature* 44(2), 325-366

[18] Michael R. Darby. (1986), The Internationalization of American Banking and Finance: Structure, Risk, and World Interest Rates, *Journal of International Money and Finance* 5: 403-428

[19] Moore J. (1992), British Privatization: Taking Capitalism to the People, *Harvard Business Review, January-February*: 115-124

[20] Paul D. McNelis & Klaude Schmidt-Hebbel. (1993), Financial Liberalization and Adjustment: The Cases of Chile and New Zealand, *Journal of International Money and Finance* 12: 149-277

[21] Paul Davidson. (2004), The Future of the International Financial System, *Journal of Post Keynesian Economics* 26: 591-605

[22] Peter Isard, Donald J. Mathieson, Liliana Rojas-Suarez. (1996), A Framework for the Analysis of Financial Reforms and the Cost of Official Safety Nets, *Journal of Development Economics* 50: 25-79

[23] Peter Lewis & Howard Stein. (1997), Shifting Fortunes: The Political Economy of Financial Liberalization in Nigeria, *World Development* 25(1): 5-22

[24] Philip Arestis & Santonu Basu. (2004), Financial Globalization and Regulation, *Research in International Business and Finance* 18: 129-140

[25] Philip Molyneux. (2011), *Bank Performance Risk and Firm Financing*, Palgrave Macmillan Studies in Banking and Institutions

[26] Rebecca M. Neuman, Ron Penl, Altin Tanku. (2008), Volatility of Capital Flows and Financial Liberalization: Do Specific Flows Respond Differently? *International Review of Economics and Finance* 18: 488-501

[27] Robert Wilson. (2002), Architecture of Power Market, *Econometrica* 70(4), 1299-1340

[28] Thomas Clarke & Christos Pitelis. (2005), *The Political Economy of Privatization*, Taylor & Francis e-Library

[29] Thomas Gris, Manfred Kraft, Daniel Meierrieks. (2009), Linkages between Financial Deepening, Trade Openness, and Economic Development: Causality Evidence from Sub-Saharan Africa, *World Development* 37(12): 1849-1860

[30] Umer Khalid. (2006), The Effects of Privatization and Liberalization on Banking Sector Performance in Pakistan, *SBP Research Bulletin* 2(2): 403-425.