

## **Financial Liberalization and Employment Effects**

In my thesis project I try to link two economic sub-markets – the labour and the financial market - which have been of highly interest for European economists during the last decade. The labour market made economist worry because of unemployment rates in the last 20 years, the financial market on the other hand faced rapid growth rates and opened discussions about financial stability and control of financial systems. The question that arises out of the combination of those two markets is, if there could be a positive employment effect caused by a growing and developing financial sector.

Following the Theory of Financial Liberalization the answer would be quite clear. According to the argument of Liberalization-Theorists made in the 60s and 70s, mainly by McKinnon and Shaw, the regulation of the Financial Markets - which imply among other measures: interest ceilings, high reserve ratios and implicit credit programs – will lead to lower investment ratios and have furthermore a negative impact on growth. Therefore, according to their view, the financial market should be liberalized to promote efficiency. This would lead to higher investment ratios and positive growth effects in the long run, which will further have positive impacts on the development of the labour market (see Dixon, 1997). Numerous empirical studies (see among others King, Levine, 1993; Gertler, 1996; Pagano 1993)) have shown the link between higher developed - in these studies development in financial markets can be achieved by liberalization – financial markets and growth, using endogenous growth models.

But empirical evidence has shown a different scenario in the 80s and 90s where many countries, which have followed the advice of liberalization theorists and have deregulated their financial markets, faced heavy financial crises followed by a breakdown of growth rates and raising inflation and employment rates. Examples often mentioned in this context are the banking crises of Japan, Argentina and Mexico in the 90s. But also many European countries faced increasing banking instability in this period, although they did not have to deal with such high costs of an economic breakdown like emerging markets had to deal with (see Demirgüç-Kunt, 1998).

It seems logical that due to growing instabilities in liberalized financial markets, economists – especially Post-Keynesian economists like Arestis and Demetriades (1999), have been heavily

criticizing the basic assumptions of perfect competition and perfect information among market participants made by Liberalization-Economists, as well as their institutional-free analyses. They come to the conclusion that the liberalization process has negative impacts on output and promotes financial instability.

As a reaction to these critiques the – what I call ‘new’ liberalization theorists, tried to incorporate a new set of conditions and established a new framework, which must be fulfilled so that a financial market liberalization can be successful. This framework consists of institutional indicators apart from macroeconomic indicators, which should show economic stability at the time of liberalization - that means low price stability, no economic recession and fiscal stability (see Hutchison, 1999; Demirgüç-Kunt, 1998). Institutional indicators contain among others the question of the effect of deposit insurances in the banking sector and the position of the national bank. In the opinion of liberalization-theorists the existence of explicit deposit insurance for example has negative effects on banking stability, because banks will get involved in riskier investment projects than they would without deposit insurance (see Demirgüç-Kunt). This increases the probability of accumulating bad loans and leads to banking insolvency. Another very important factor is the political and economic independence of a national bank, although indexes to measure the independence are not mentioned clearly in the literature (see Hutchison, 1999). The basic idea is that the role of institutions in the financial sector should be watched carefully and that even when a liberalization takes place the institutional framework itself can increase banking instability.

If all these institutional conditions are fulfilled also ‘new’ liberalization theorists see positive effects of financial liberalization for output and growth, because of increased investment efficiency.

So in my work I

1. try to see if I can find empirical evidence for the link between financial liberalization and increasing investment ratios that would lead to output and employment effects.
2. In a second step I try to search for other possible links between the financial market and the labour market, which are not directly mentioned by liberalization theorists.

It seemed plausible for me to search for a *case study*, which should be a country that has liberalized its financial market and has faced heavy regulations before, which should be the same like those mentioned by McKinnon and Shaw to be harmful for economic development (Katsioupis, 1984), be an emerging market in the financial market (because the studies made by McKinnon and Shaw deal with emerging markets (see Dixon, 1997; Fry, 1997)) and did

not have to deal with heavy problems of banking instability after liberalizing the financial market. To link the case study to the problem of high unemployment rates in Europe, which I have mentioned in the beginning, the country in question should be in Europe, which would make it also more easy to find relevant data. It seems to me as if Greece would fulfil all these criteria.

Therefore my research question is:

*Did the financial liberalization process have any positive impact on employment in Greece?*

As mentioned above in the first part of my study I will analyse the link between *financial liberalization and growth* that is given by the liberalization theorists. Although Greece seems to be perfect for a case study empirical studies (see Dutta, Polemarchakis, 1989) show that investment ratios did not grow due to the financial liberalization process like liberalization theorists stated. So the first step for me will be to follow the assumptions made by Dutta and Polemarchakis in 1989 and check if there has been a change in the situation till the beginning of the 90s. According to the opinion of liberalization theorists increasing investment ratios should follow immediately in the years after liberalization. Since the basic reforms took place in Greece 1987, the study made by Dutta and Polemarchakis in 1989 might not include all the relevant data yet and may therefore be less reliable.

In the second part of my study I will search for other channels through which financial market liberalization has an effect on employment.

Part of this will be the analyses of changes in *employment in the financial sector itself*, due to mergers that took place as a reaction to the liberalization process in the banking sector. Data concerning the employment development in the Greek banking sector I hope to find in various issues of Annual Reports of the biggest Greek Banks, especially in the statistics of the National Bank of Greece and the Commercial Bank, which count for most of the employees in the sector. This means that this part will consist of descriptive statistical analyses.

Further I will analyse the increasing role of the *stock exchange* due to the liberalization process in Greece. The link I hope to find goes via an increase in aggregate demand, due to an increase in income that people gain because of speculating at the stock exchange. I am aware of the fact that I have to check for negative 'side' effects when I look for employment effects like increasing income disparity. Of course the effect will depend on the income percentile that gains income surpluses, because economic theory states that the part of the income that is saved increases with higher income and reduces the effects on aggregate demand. The idea I

try to incorporate here is a clearly Keynesian approach. Although this part of my study is not fully conceived yet it is important to my analyses because it is a contradictional approach to liberalization theory, which argues in the orthodox economic framework.

## **Literature**

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