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Financial Liberalization and Employment Effects / The Case of Greece

Abstract

After numerous banking crises since the early 90s economists have been critically analysing the effects of financial liberalization on real factors of the economy of a country. A positive linkage between financial liberalization and economic growth has been promoted by Liberalization-Theorists ever since the early 60s (McKinnon and Shaw). Although “new” Liberalization-Theorists updated their economic assumptions according to the critiques of mainly Post-Keynesian economists, the positive linkage between financial liberalization and real factors of the economy are to be questioned. In my work I try to analyse financial liberalization effects for the case of Greece, a country which fulfils all criteria, for the promoted positive linkage.

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 raising 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 the 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. Liberalization Theorists answer this question with a clear yes and construct a revised neoclassical money theory. The main point in their argumentation is the “complementarity hypothesis” which promotes the complementarity between money and physical capital in less developed countries.

Facing the development of Greece it seems as if this county can serve as a critical case study for my analyses. To make my main points clear I will first give a brief overview over the theoretical background and show the evolution of Liberalization Theory. Then I will analyse the development of the Greek economy and search for growth effects due to financial liberalization.

1. Theoretical Background

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 implies 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).

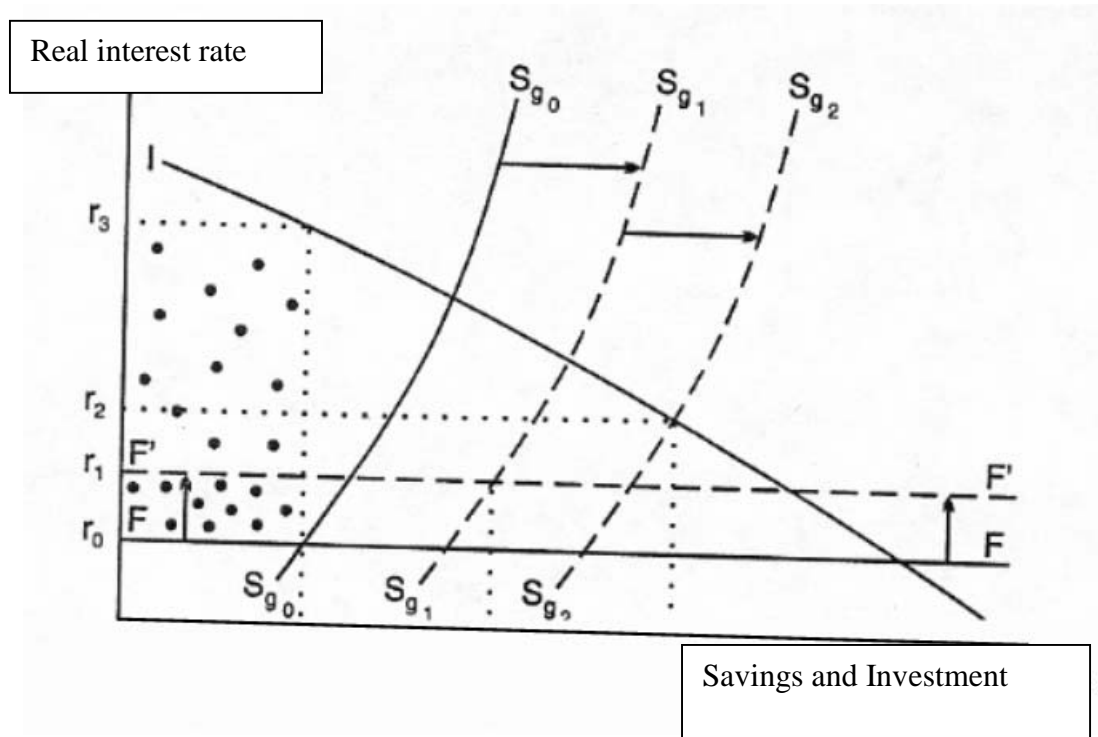
Numerous empirical studies (see among others King, Levine, 1993; Gertler, 1996; Pagano 1993) have shown the link between higher developed - in these studies development in financial markets can be achieved by liberalization – financial markets and growth, using endogenous growth models. Due to numerous financial crises in developed and less developed countries, liberalization theorists reformulated their argumentation in the last years and incorporated the main critiques in their theoretical framework. What I call “new” financial liberalists are now concerned about the institutional settings in liberalised financial markets.

1.1. Liberalization Theory – McKinnon and Shaw approach

The roots of a clear formulated liberalization theory for financial markets goes back to the work of McKinnon and Shaw in the early 70s (see McKinnon 1973, Shaw 1973) which tried to find a reason why less developed countries are lagging behind in economic growth and do not seem to catch up in economic development. They thought to have found the reason for the poor performance of less developed countries (McKinnon calls those countries “fragmented economies” due to the special structure of economic interdependence between firms, households and the state) in the role of the state on the domestic financial market. Especially methods like administrative fixed interest ceilings and the allocation of credit in certain industrial areas seem to cause “financial repression” – that means a qualitative and quantitative reduction in investment that should cause economic inefficiencies and repress the economic development of less developed countries. Graph 1 shows the negative effects that administrative fixed interest rates might have. In this neoclassical approach to investment and saving a fixed interest rate leads in the first place to a reduction in the quantity of realised investment since the intersection of Sg_0 with r_0 indicates the possible outcome of investment in a repressed economy whereas without administrative fixed interest ceilings the level of g_2 at the intersection of r_2 with Sg_2 would have been reached. Additionally also a qualitative

repression of investment projects takes place since banks are now not able to compensate projects with higher risks with higher interest rates and will as a consequence only finance projects with a low risk. In Graph 1 realised investment projects are indicate the points.

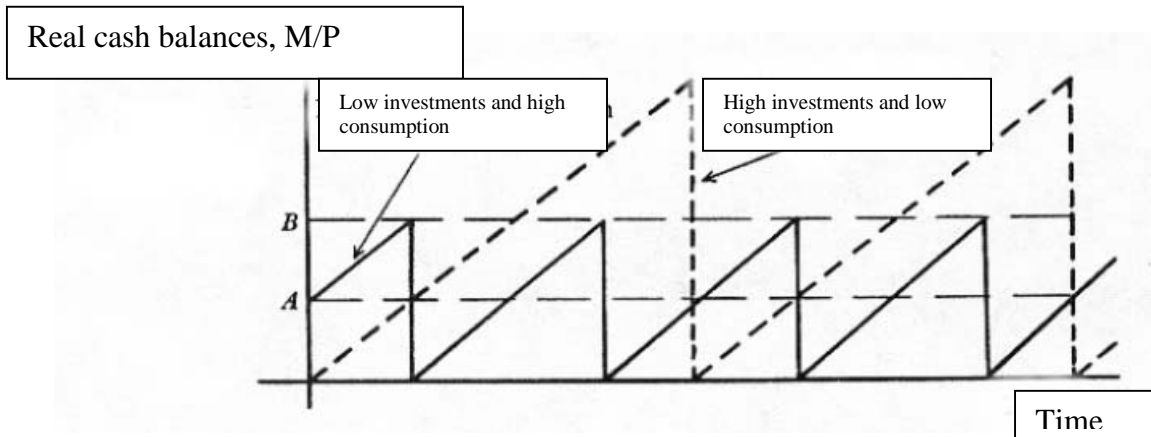
Graph 1: "Financial Repression"



Source: Fry (1988), S.24

In the following McKinnon reformulates the neoclassical money theory and identifies a complementarity between money and physical capital in fragmented economies. Since a firm is restricted to self-financeⁱ in a fragmented economy McKinnon states that higher real cash balances of the firm will also lead to higher investments. Graph 2 shows the performance of two firms following different strategies in holding money. The solid line indicates a firm that increases its cash balances and in the following its investments, whereas another firm (in Graph 2 indicated with a dotted line) has higher consumption, lower real cash balances and in the following also less net-investments.

Graph 2: Consumption and Investment of firms



Source: McKinnon (1973, S.58)

McKinnon is aware of the fact that this link does only hold up to a certain level of returns of real cash balances, therefore he sees in the search for this critical point the main work that has to be done by monetary authorities in less developed countries to promote growth.

1.2. Critique and adapted Liberalization Theory

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 the conclusion that Liberalization Theory derives from the banking crises in the 90s is not that the promoted links might not work out the way they should, but that further liberalizations have to take place to stabilize economies and that financial fragility will only occur, if monetary authorities do not follow the advice of liberalization Theorists properly.

2. Greece as a case study

In my search for empirical evidence for the link between financial liberalization and employment, it seemed plausible for me to look 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.
- It should 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
- It should not have faced 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.

2.1. Heavy regulations

The Greek banking regulation system was established in the 50s to stabilize the economy after seven years of civil war. The measures were concentrated mainly on 3 areas. Administratively fixed interest rates, a credit allocation system and additional restrictions to special banking institutions, like the investment banks or the agricultural bank (see Mannaskis, 1986, Katsioupis, 1984).

The credit allocation system covered three measures: Banks had to undertake *compulsory investments* in interest bearing treasury bills, *compulsory deposits* at the central bank, which exceeded normal reserve rates at the central bank and had to give *additional rebate ratios* on lending. Those ratios were depending on the industrial sector the credit was given. With those

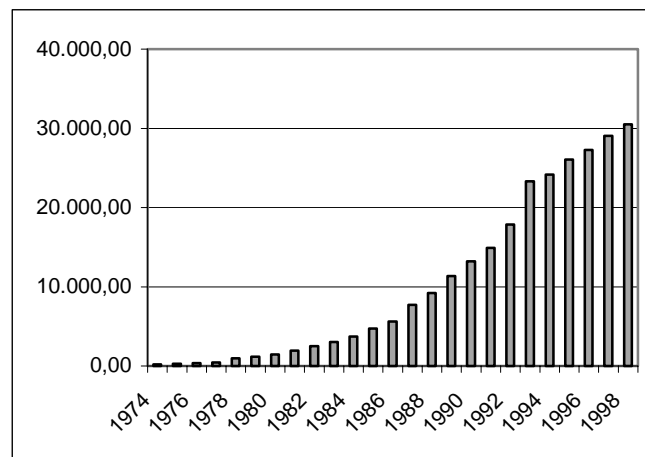
three measures the currency committeeⁱⁱ wanted to direct investments from “unproductive” to more “productive” industrial sectors.

All in all it turns out that the measures undertaken in Greece to promote growth have been the same that Liberalization theorists identified as methods of “financial repression” with negative consequences for economic development.

2.2. No banking crises after regulation

According to a study by Demirgüç-Kunt and Detriagiache (1998) Greece did not have to experience a banking crises after the liberalization of the banking sector. A continuously increasing credit expansion, as it can be seen in Greece (Graph 3) can give evidence to this more or less stable development. A sudden decrease or weaker increase of domestic credit expansion can show years of high banking fragility and crises.

Graph 3: Greek domestic credit (Billions \$)



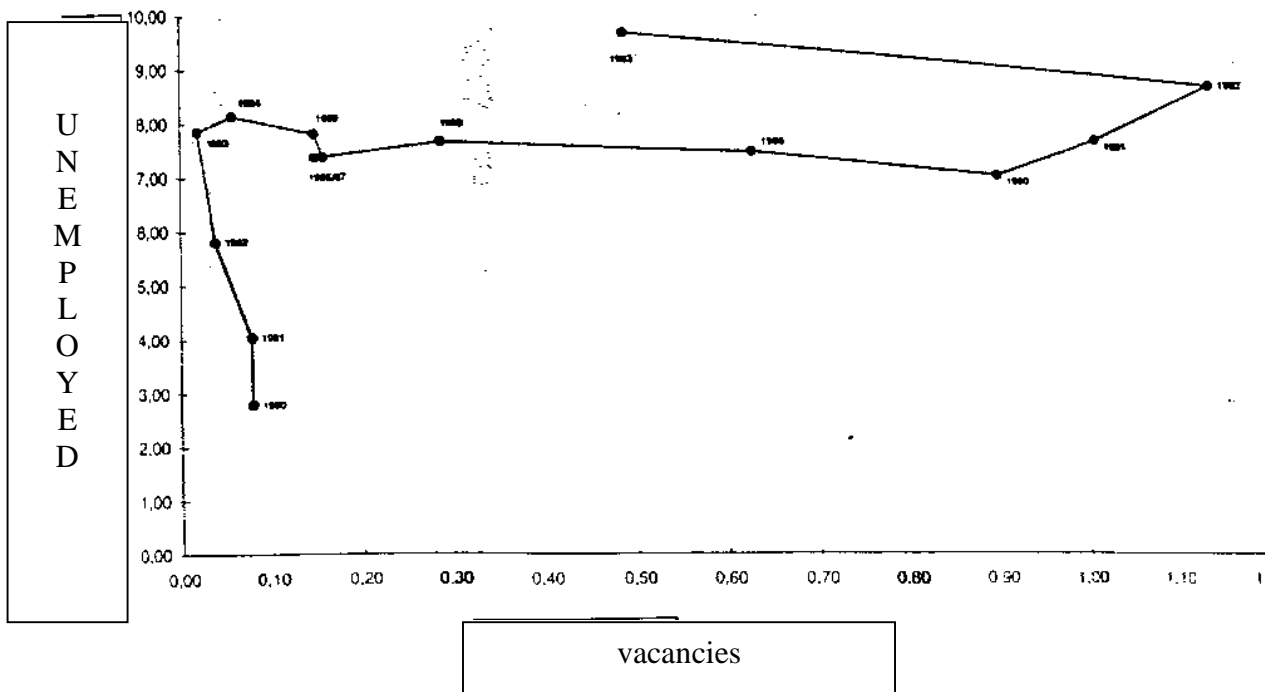
Source: International Financial Statistics, derived from: WIFO database

2.3. Linkages between unemployment and the financial markets

Having a look at the unemployment rates in Greece it turns out that the country has faced a sharp increase in unemployment rates in the early 80s. In contrast to many other European

countries Greece has overcome the first oil price shock quite well regarding its labour market, but in the middle of the 80s the good performance from the 50s up to the end of the 70s found an end. Since then the unemployment rate has been continuously raising. Apart from that the Greek labour market shows some characteristics that lead us to the conclusion that unemployment is structural and cannot be overcome by lowering wages but special measures to promote employment have to be undertaken. The shift outward of the Beveridge curve shows the increase of structural unemployment.

Graph 3: Beveridge Curve in Greece



Source: Kottis, Kottis, 1996

Searching for the reasons of this development it turns out that Greece has on the one hand still a very strong agricultural sector in comparison to other European countries and a strong industrial production in areas where third world countries have significant comparative advantages on the world market – the consequence is a reduction of labour - on the other hand Greece is characterised by mainly small firms that recently have undertaken mergers to be more competitive and reduce labour as well. (OECD, 1996, Priounakis, 1997, S.198)

Since these problems of the Greek economy are linked with the financial sector due to the measures of the monetary authority before liberalization (the agricultural sector and those industrial sectors which turned out to be uncompetitive in the world market have been highly promoted with measures of direct credit allocation and low interest rates on loans) those methods seem to have had at least indirectly negative effects for the Greek economy.

But still it has to be asked:

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

3. How to solve the problem?

In a first step I try to analyse the link between financial market development and employment, the way financial theorists argue.

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.

3.1. Financial Liberalization Arguments

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.

3.2. Possible Links apart from Liberalization-Theorists Arguments

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.

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ⁱ The self-finance restriction on fragmented countries gives a firm that wants to increase its investments only the choice between increased stocks, that will be sold when the firm needs the money to invest, or the immediate accumulation of cash balances. Which possibility the firm use depends on mainly in the returns of cash balances.

ⁱⁱ The currency committee was the monetary authority of the country before banking sector liberalization.