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WP/87/23

Subject: Liberalization Policies and Welfare in a Financially Repressed Economy

CORRIGENDUM

Page iii, para. 1, line 8: for "policies in the most"
read "policies have been examined...in the most"

A corrected page is attached.

Att: (1)

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Summary

In recent years, a great deal of effort has been devoted to analyzing so-called financially repressed economies, that is, economies in which relatively few types of assets are available to economic agents and in which interest rates are controlled at artificially low levels by the authorities. A standard policy recommendation emanating from the literature on these economies is to liberalize financial markets by raising the institutionally fixed interest rates. While this and other liberalization policies have been examined in various contexts, previous studies of financially repressed economies seem not to have analyzed the desirability of liberalization policies in the most direct and natural way, namely by investigating the effects of those policies on welfare.

This paper attempts to do just that. It studies the effect on welfare of three types of liberalization policy (financial deregulation, relaxation of capital controls, and trade liberalization) assuming realistically that in the short run all markets cannot be liberalized simultaneously. An intertemporal general-equilibrium model with two traded goods (importables and exportables) shows that partial reforms, which in the long run are beneficial, may well cause welfare losses in the short run. In particular, it is shown that, contrary to earlier results, raising an artificially low domestic deposit rate in the presence of high tariffs may lower welfare. It is also shown that tariffs can raise welfare when financial repression discourages saving. As for the effects of relaxing capital controls, the study concludes that welfare will improve even if trade and domestic financial markets remain controlled. On a more general level, the study indicates that gradual reforms tend to be superior to abrupt ones and that financial deregulation and the opening up of trade are so interrelated that the optimal order of liberalization is a nontrivial issue.

The paper is based on the assumption that complete liberalization of all markets will maximize welfare in a financially repressed economy. If complete liberalization is not possible at once, as is likely to be the case, policymakers should note that meanwhile partial reforms may involve temporary welfare losses.