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GOVERNMENT POLICIES TOWARDS FINANCIAL MARKETS

Report on a joint meeting of management and trade union experts
held under the Labour/Management Programme

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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(Paris, 6 May 1996)

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FOREWORD

Under the OECD Labour/Management Programme for 1996, a joint meeting of management and trade union experts on "Government Policies towards Financial Markets" was held in Paris on 6 May 1996. The meeting was prepared in collaboration with the Business and Industry Advisory Committee to the OECD (BIAC) and the Trade Union Advisory Committee to the OECD (TUAC).

Below is the discussion paper for the meeting, along with an overall report of the discussions of the meeting of experts. Both papers were prepared by Mr. John Thornton, Principal Administrator in the Economics Department of the OECD.

THE OPINIONS EXPRESSED AND ARGUMENTS EMPLOYED IN THIS REPORT ARE THE RESPONSIBILITY OF THE AUTHOR AND DO NOT NECESSARILY REPRESENT THOSE OF THE OECD.
I. INTRODUCTION

1. The purpose of this issues paper is to outline the major areas in which financial deregulation has taken place, examine some of its economic consequences, and review the lessons that can be drawn, particularly for economic policy.\(^1\) Comments on an earlier version of this paper have highlighted areas in which there is debate that could well be continued as part of the 6 May 1996 Labour/Management Programme meeting; some of these areas are indicated in the current version of the paper. The paper is organised as follows. Section II outlines the main areas of financial deregulation in OECD economies. Section III examines some of the economic consequences of financial deregulation. Section IV looks at some examples where financial deregulation had adverse short-run economic consequences that were not foreseen at the time of deregulation. Section V draws some conclusions for the conduct of economic policy.

II. FINANCIAL DEREGULATION IN OECD COUNTRIES

2. Financial deregulation in OECD economies has given financial institutions more freedom to conduct their business at market-clearing prices and has removed many institutional boundaries and other barriers to market competition. The main areas of reform have been as follows:

i) **Interest rate controls:** until the early 1970s controls on the borrowing and lending rates of banks in most OECD countries held bank interest rates below what would have prevailed in a free market. These controls protected banks from interest rate competition, helped to secure their profitability, led to credit rationing as a result of banks’ internal risk criteria and other regulations which directed bank credit to particular borrowers (including governments), discriminated against small companies which had little bargaining power vis-à-vis banks, and diverted credit demand to less regulated intermediaries who extended credit at higher (market-related) rates of interest. The most important steps in interest rate deregulation came in the 1970s in the United Kingdom, in the 1980s in the United States, the Nordic countries, Australia, New Zealand, and later in continental Europe\(^2\) and Japan. By the early 1990s the majority of OECD countries had abolished virtually all interest rate controls.

ii) **Mandatory reserve requirements:** until the early 1980s virtually all banks were required to maintain a substantial proportion of their liabilities on deposit at the central bank. This obligation involved an opportunity cost that provided a major incentive for shifting deposits and loans to offshore banking centres (the so-called “Euromarkets”) that were not subject to domestic regulation.

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\(^1\) These issues are discussed extensively in, for example, Edey and Hviding (1995) and Andersen and White (1996).

\(^2\) With the major exception of Germany, where deregulation was completed by the early 1960s. Canada has also deregulated interest rates by the late 1960s.
and where more favourable lending and deposit rates could be offered.\(^3\) A major effect of reserve requirements was the shrinkage of the regulatory base (reflected in the rapid growth of the Euromarkets) and distortions to the domestic monetary aggregates (Dufey and Giddy 1994). Since the early 1980s many countries either have virtually abolished reserve requirements (the United Kingdom) or reduced them substantially (the United States and several European countries).

iii) **Quantitative investment restrictions:** these restrictions on banks included compulsory holdings of government securities (Italy, Sweden, Norway, Australia, Belgium, Spain, Turkey and Greece), credit allocation rules or guidelines (the United States, France, the United Kingdom, Norway, Australia, New Zealand), compulsory lending to special credit institutions charged with directing credit to favoured sectors (Sweden, Italy, Greece, Turkey, Spain, Iceland), and controls on the total volume of credit expansion for macroeconomic purposes (the United Kingdom, France, Italy, the Netherlands, Sweden, Denmark, Norway, Austria, Portugal, Spain, Mexico). In some cases compulsory security holdings were partly intended for prudential purposes but they also served as a vehicle for financing government deficits and kept security yields artificially low. Credit allocation rules and guidelines were generally abolished by the early 1980s and, in most cases, the compulsory financing of special credit institutions was abolished or replaced with explicit subsidies.

iv) **Capital controls:** these generally reflected concerns by national authorities to prevent the outflow of domestic savings and to protect their currencies from the possibility of speculative attacks depleting official reserves. Such controls tended to focus on securities transactions and short-term credits unrelated to the financing of trade flows. Some countries already had fairly liberal capital-account policies by the early 1960s (e.g. the United States, Germany, Canada and Switzerland); liberalisation was implemented in the late 1970s in the United Kingdom and Japan, in 1984 in Australia and New Zealand, 1985 in Denmark and in the second half of the 1980s in Italy, France, Finland, Norway, Sweden, Belgium and Austria. EU countries which retained significant controls on short-term capital movements going into the 1990s (Ireland, Portugal and Spain) abolished these by the end of 1992 in accordance with single market directives, notwithstanding the temporary reintroduction of these controls during the severe ERM pressures in late-1992. Some controls remain on long-term capital movements in many OECD countries, particularly with respect to foreign ownership of real estate and foreign direct investment and there remain restrictions on international portfolio diversification by pension and insurance funds.

v) **Securities market regulations:** liberalisation has included removal of barriers to entry, deregulation of fixed commission rates and of various other price and quantity controls, and measures to promote internationalisation and the development of new instruments. Early moves toward reform came in the United States with the removal of government regulations on securities firms' commissions in 1975. The main wave of reforms in other countries occurred in the mid-1980s, including in the United Kingdom, Canada, Australia, New Zealand, Ireland, Sweden and Finland. In continental Europe, Japan and Mexico, reforms came around the end of the decade or in the early 1990s, but thus far have been somewhat less sweeping. In a number of countries (e.g. Mexico, Greece, Spain, Sweden and Norway) the terms at which private debt securities could be issued were also subject to direct control. These operated as part of the more general network of interest rate controls and were largely

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\(^3\) For example, suppose a domestic bank receives $100 in domestic deposits and the reserve requirement is 5 per cent. The effective funds received by the bank amount to only $95 but the bank must pay interest on the full $100. At interest rates of 15 per cent, for example, the effective cost of funds to the bank is \((15 \text{ per cent}/1-0.05)=15.79\) per cent. Thus the additional cost of reserve requirements is 79 basis points -- this is the additional amount that an offshore bank can afford to pay on “eurocurrency deposits”.

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eliminated as other interest rates controls were also removed. In Germany, the requirement of
government approval of private bond issues was abolished in 1991. Also, market-based mechanisms
for the sale of government securities were introduced in many countries, in part in response to interest
rate flexibility on private debt instruments. This was also related to the abolition of the requirement
to invest specified proportions of portfolios in government securities (implying that government
securities had to pay competitive returns).

vi) **Restrictions on line-of-business and ownership linkages:** regulations limiting the areas of business
in which different classes of financial institutions can operate generally were aimed at enhancing the
safety of institutions (e.g. by limiting their exposure to more risky sectors), preventing excessive
concentrations of financial power through the development of financial conglomerates, and
channelling finance to particular sectors (particularly housing) through specialised institutions. The
legal separation of banking and securities businesses in the United States has been eroded as a result
of Federal Reserve and State policies, a series of court decisions, and the growth of banks' subsidiary
companies engaged in securities business, and has been abolished in Canada and Japan. Numerous
prohibitions on the types of accounts that could be offered by US banks were largely removed in the
early 1980s; the separation of the financial institutions traditionally concerned with savings or
mortgages from commercial banks has been abolished in France, Spain, Belgium, Denmark, Finland,
Austria, Australia and New Zealand; the separation of long-term and short-term credit institutions
was abolished in Italy in 1993; the separation of various types of specialist credit suppliers in Japan
was largely abolished in the late-1980s/early-1990s; and bank branching restrictions were phased out
in France, Spain, Italy, Austria, Norway and Sweden in the 1980s and early 1990s while recent
legislation will eliminate remaining branching restrictions in the United States by 1997.

vii) **Restrictions on foreign bank entry:** the past decade has seen considerable liberalisation of
cross-border access to foreign banks in Canada, Australia, New Zealand, Sweden, Norway, Finland,
Mexico and Portugal (other OECD countries already had fairly liberal access policies for foreign
banks). In Europe the Second Banking Directive, effective from 1993, has had a liberalising effect on
European Union and EEA member countries, allowing banks operating in any member country
(including non-European banks) to establish branches in the others. Most OECD countries now allow
the operation of at least some foreign banks, usually on a national treatment basis (i.e. competing on
equal regulatory terms with domestic institutions).

### III. ECONOMIC CONSEQUENCES OF FINANCIAL DEREGULATION

3. Discussion of the economic effects of financial deregulation tends to fall into six broad areas:

i) **Structural changes:** an issue is whether deregulation, having increased competition, also has
increased the range and quality of services available. Notable changes include: the increased use of
securities in the intermediation of finance (“securitisation”), including the development of markets for
commercial paper and corporate bonds and notes in a number of countries; the growth of collective
investment institutions (e.g. mutual funds, unit trusts and investment trusts) which have eased the
access to capital markets for small savers, and the development of money market funds (mutual funds
with highly liquid, high quality assets with short maturity or variable interest rates); the development
of derivative markets which have enhanced investors' ability to manage portfolio risks; easier access
to the Euromarkets, mainly reflecting the abolition of capital controls; and the increased
internationalisation of financial markets, as reflected in the growth of cross-border transactions in
bonds and equities and a growing international diversification of asset holdings by institutional
investors. In spite of these changes, structural characteristics of financial systems still differ across OECD countries in a number of important ways, particularly with respect to the relative importance of securities markets, banks and other financial institutions as sources of finance for investment.

ii) **Efficiency and resource allocation:** several factors suggest that increased competition in the banking sector has driven down costs and margins: in many countries banks' total incomes from fees and net interest earnings have declined relative to the overall capital of the banking sector; banks' staff costs as a ratio to total gross income have declined in almost all countries; banks' operating expenses also have declined in relation to gross income in many countries. Also, there are indications of reduced transactions costs in securities markets (declining average commissions) and eurocurrency markets (a reduction in average bid-ask spreads). Measuring productivity in the financial sector is problematic but *ad hoc* measures of bank output such as transactions volumes, the real value of financial assets under management, or indicators of customer service outputs such as the size of the automatic teller machine network, all imply increases in productivity. Improvements in allocative efficiency are likely to have occurred in several areas: the removal of direct interest rate controls and regulation-driven credit rationing should have removed distortions in relative funding costs, thereby improving the allocation of investment; and capital account liberalisation has opened up significant opportunities for international portfolio diversification. On the other hand, the case studies reviewed in Section IV make clear that some institutions engaged in increased risk-taking following deregulation and that this does not appear to have been consistent with improved resource allocation.

iii) **Effects on consumption and saving:** by removing liquidity constraints, financial deregulation may have raised private consumption and lowered private savings, at least temporarily. In the Nordic countries personal savings rates turned negative and the ratio of debt to net disposable income of households in the 1980s doubled (Drees and Pazarbasioglu, 1995). Although some of the increase in consumption may have been transitory, there is also some evidence that household saving has fallen permanently (Bayoumi, 1993, and Jappelli and Pagano, 1995). At the same time, the easing of liquidity constraints is likely to have allowed greater smoothing of consumption by households and firms over time. For example, some estimates of consumption functions show a significant decline in the coefficient on current disposable income in periods following deregulation in the United States, Japan, Italy, Canada and Australia (Blundell-Wignall, Browne and Cavaglia, 1991).

iv) **Effects on financial stability:** there have been a number of cases where instability appeared to be either linked to deregulation or to have been made more difficult to manage as a result of the structural changes that accompanied it. Examples include crises in financial institutions in several countries, severe debt problems in some countries' corporate and personal sectors following financial liberalisation, and the intense exchange rate pressures that affected European countries in 1992 and 1993 and Mexico in 1995: several of these cases are discussed below in Section IV. There is also a widespread perception that financial markets in general have become progressively more volatile, with global bond market volatility during 1994 an important recent example. However, an assessment of movements in stock, bond and foreign exchange markets suggests that there has been no general trend increase in volatility in these core financial asset markets within the post-deregulation period. Finally, some commentators have suggested that short- and long-term interest rates have increased following deregulation beyond that warranted by economic fundamentals.

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4 On the other hand, some non-OECD countries have become high-saving economies following deregulation, notable examples being Chile (Edwards and Edwards 1991) and Korea (Mckinnon 1973).
v) **Effects on speculation:** much of the financial deregulation took place in the context of a shift from fixed to managed or floating foreign exchange regimes. There is a perception that financial deregulation has led to an increase in speculative attacks on exchange rate systems by making it easier for speculators to test the authorities’ policy commitment. Evidence compiled by the Secretariat (and by others) suggests that attacks on fixed exchange rate systems are related more to a deterioration in fundamental economic conditions such as deteriorating fiscal positions, credit expansion and increases in unemployment.

vi) **Effects on monetary policy:** financial deregulation and associated structural changes in financial markets have complicated the implementation of monetary policy in at least three ways (Andersen and White, 1996). First, traditional monetary aggregates have become less useful as intermediate targets of monetary policy as money demand functions became increasingly unstable and as competition between banks and non-banks increased. As a result, most OECD countries have either abandoned or significantly de-emphasised monetary targets to focus on a wider range of indicators in order to direct monetary policy at ultimate macroeconomic goals. Second, the greater reliance on market processes implicit in deregulation has meant that policymakers need to take greater account of the financial market’s perceptions and concerns than before. This has led to greater transparency on the part of policymakers in the use of policy instruments and with respect to their ultimate objectives. Finally, there is some evidence that the sensitivity of the real economy to changes in interest rates may have increased following deregulation.

IV. **COUNTRY CASE STUDIES: SOME ADVERSE EXPERIENCES WITH DEREGULATION**

4. During the transition to less-regulated financial systems a number of countries experienced serious economic difficulties with regard to capital flows and the soundness of the banking sector. Important examples of the former include Turkey and Mexico, while major banking sector difficulties occurred in the United States, the Nordic countries and Japan. In all cases, these difficulties had important economy-wide ramifications.

1. **Capital flow problems in Turkey and Mexico**

5. Sudden international capital movements can have severe disruptive effects on markets and macroeconomic performance. In the 1990s, the Turkish economy was characterised by high rates of growth of real output, but also by a widening current account deficit and an expanding public sector borrowing requirement, monetisation of which contributed to rapid money stock growth and to inflation rates in the 60-70 per cent range. There was a loss in confidence and a run on the Turkish lira in early 1994, resulting in its sharp depreciation, an acceleration of the inflation rate to over 100 per cent and a large decline in real output. The authorities implemented a programme, with the help of an IMF standby arrangement, to reduce the public sector deficit and the inflation rate. More recently, Turkey has had to deal with a surge of capital inflows which has put upward pressure on the real exchange rate and monetary aggregates.

6. **Mexico** had pegged the peso to the US dollar to reduce inflation over time, a policy which enjoyed considerable success. The current account deficit had become quite large by 1993, but there seemed to be no difficulty in financing it. On the contrary, the concern was to mitigate the economic impact of capital inflows by a combination of fiscal tightness and sterilisation. However, several political

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5 This section draws in part on OECD Economic Outlook 58, December 1995.
and economic events progressively undermined confidence in the course of 1994 and led to capital outflows, a decline in foreign exchange reserves and substantial issues by the government of short-term dollar-indexed bonds. In late 1994, exchange market pressure intensified and the government eventually floated the peso; this was followed by a sharp fall in the value of the currency, a large increase in inflation and a fall in real output and living standards. To restore order in foreign-exchange and financial markets, international credit facilities were extended and the government tightened monetary and fiscal policy.

7. Both crises were triggered by capital outflows, but the underlying causes were macroeconomic imbalances aggravated by unfavourable structural factors, though these factors were more pronounced in Turkey than Mexico. In Turkey, large budget deficits and high inflation were deeply entrenched and substantial reductions in both were urgently needed. However, control of the money supply was made difficult by the government's use of central bank credit for deficit financing. In Mexico, in contrast, the budgetary position was much sounder, but private saving remained insufficient to sustain investment and the current account deficit widened. In both countries, the financial sector was fragile and relatively underdeveloped, complicating the financing of budget deficits in Turkey and limiting the scope for monetary policy action in Mexico. In spite of the severity of the crises, however, neither Mexico nor Turkey chose to reintroduce capital controls, partly because their previous experience with such controls has been disappointing and their introduction would have sent adverse signals and undermined confidence further.

2. Banking sector difficulties in the United States, Nordic countries and Japan

8. Savings banks and savings and loan associations in the United States experienced a severe crisis during the early and mid-1980s. The initial cause was the sharp rise in short-term interest rates in the United States in 1979: thrift institutions were locked into long-term lending commitments with fixed interest rates but were funded by variable rate deposits, so the rise in short-term rates led to a sharp decline in their profitability. The foundations for this mismatch between the interest sensitivity of assets and liabilities had been laid during the latter half of the 1970s, with the gradual deregulation of deposit rates, while variable rate mortgages were either prohibited or discouraged.

9. Initially, only a relatively small number of institutions were rescued or closed, as the regulatory authorities judged that others would recover once interest rates fell back to a more normal level. Restrictions on assets were relaxed over the period 1980-1983 allowing them to diversify into commercial real estate and below-investment grade (“junk”) bonds; investments in both areas expanded rapidly. To some extent, the strategy of regulatory forbearance had the intended results: average net after-tax income had turned positive by 1983 and a number of institutions were restored to solvency during the following years. But there is also evidence that the failure to intervene where net worth remained low or negative, combined with other features of regulatory policy, led to excessive risk-taking. In particular the combination of deposit insurance (which insulated thrifts from financial discipline by depositors) with regulatory forbearance, low net worth and relaxed investment rules, created the opportunity for a "one-way bet" for shareholders where institutions which had low or negative net worth had little or nothing to lose from increased risk taking. These incentive problems contributed to the build-up of risk exposures forming the background to a second, more severe, round in the crisis, which began in 1986 with the collapse of property prices in several states. The accumulated budgetary costs of rescue operations over the period 1980-1992 have been estimated at around US$ 180 billion.

10. Sweden, Finland and Norway experienced severe banking crises in the late 1980s and early 1990s, largely as a result of excessive exposures to commercial real estate, which experienced a severe downturn following the boom conditions of the mid-1980s. The interplay between financial deregulation and capital taxation probably amplified cyclical effects on property prices and on residential construction:
until tax reform measures were introduced in the late 1980s, interest payments were fully deductible from the income tax base and had a high tax value, and the removal of quantitative restrictions on lending in the mid-1980s unleashed a large pent-up demand for debt-financed real estate investment. Structural changes in the financial sector, particularly in the form of increased competition from non-banks in financial markets, also played a role in making banks more vulnerable to adverse shocks. During the late 1970s and early 1980s, gradual deregulation of deposit interest rates and increased competition from finance companies had led to tighter intermediation margins and reduced quality of loan portfolios. In addition, the removal of quantitative lending restrictions and line-of-business constraints on banks led to a general expansion into new and more risky business areas. Bank managers were inexperienced with assessing credit risks in deregulated markets and the objective of increasing lending volumes was often pursued at the expense of sound risk management. Also, reserve requirements may have remained geared to a more regulated climate for too long.

11. Banking crises emerged in the three countries when their economies moved into recession and real estate prices began to fall sharply. The Norwegian economy entered a prolonged recession in 1987, after the sharp fall in oil prices, while economic activity peaked somewhat later in Sweden and Finland. In Finland the downturn was amplified by a severe terms-of-trade loss and by the collapse in trade with the former Soviet states. The extent of government rescue operations was particularly large in Norway: all three of the largest Norwegian banks were taken over by the government in 1991 and 1992, effectively raising the level of state ownership in the banking sector from around 20 per cent to more than 50 per cent. The cost of the rescue operations may reach Nkr21 billion or about 3 per cent of GDP. Although fewer banks were taken over by the regulatory authorities, bail-out costs were even larger in Finland and Sweden. In 1992, the Swedish government gave a blanket guarantee covering all liabilities of Swedish banks, except subordinate debt and equity. In addition to a similar guarantee, the Finnish government helped the banking system with various types of capital injections. The total estimated cost of rescue operations amounts to about 5.2 per cent of GDP in Sweden and 7 1/2 per cent of GDP in Finland.

12. In Japan, the slide in asset prices in the early 1990s has affected the capitalisation of a large number of banks. In particular, the fall in equity prices had a direct impact on banks' tier-two capital as it reduced the size of banks' unrealised capital gains, previously a large part of their capital base. Non-performing loans have also increased substantially. Partly reflecting stringent tax rules, however, loan loss provisions have remained at a very low level, generally far below those of other OECD countries. In an effort to improve their financial health, several larger Japanese banks established a company with the objective of purchasing problem loans from banks at a discount, thereby allowing the banks to obtain tax relief. Recently, two small credit unions failed and a rescue operation was launched by the Bank of Japan at a cost of Y20 billion in public funds. The forces behind the large swings in assets prices in Japan appear to have been similar to those operating in a number of other countries: monetary policy easing in the aftermath of the slowdown in the early 1980s created some potential for asset price inflation, which was reinforced by competition for business in the financial sector in the less regulated environment. The inflation of land prices may also have been amplified by heavy restrictions on land use. Most of the credit losses in recent years have occurred in financial institutions specialising in real estate and consumer loans, which are less heavily supervised than banks.

V. FINANCIAL DEREGULATION AND ECONOMIC POLICY

13. The process of financial deregulation in OECD countries was driven by two broad sets of forces: at the passive level, regulatory authorities were often reacting to developments (e.g. financial innovations) that put increasing pressure on the existing regulatory system and rendered many regulations ineffective,
costly to enforce, or grossly distorting to competition in the financial sector; at a more active level, deregulation was expected to improve efficiency by promoting competition and by removing artificial constraints on the allocation of finance.

14. Financial deregulation appears to have contributed to major growth in both the scale and scope of financial activity during the past two decades; also, there is some evidence that the efficiency of financial markets has increased, with respect to both internal cost efficiency and the impact on resource allocation. On the other hand, a number of cases of financial fragility have been associated with financial deregulation, a permanent decline in private savings may have occurred, and the implementation of monetary policy has been made more complicated. The latter two effects, however, have not led to major economic problems.

15. At least three important lessons can be drawn from experiences with financial deregulation. First, financial innovations and competition between offshore banking centres have made many types of regulation increasingly difficult to enforce so that strategies of reversing the deregulation process to deal with any consequences perceived as unsatisfactory may not be workable. For example, a widely reported proposal aimed at reducing foreign exchange market speculation is the use of compulsory (zero interest) margin deposits against net foreign exchange positions (Eichengreen and Wyplosz, 1993) and/or a tax on gross foreign exchange transactions (Tobin, 1978; and Eichengreen, Tobin and Wyplosz, 1995). The likely effects of such measures are controversial. However, a major stumbling block would appear to be competition between offshore financial centres: if any major financial centre does not comply with the regulations then unbalanced foreign exchange positions and foreign exchange transactions will be booked to offshore institutions in that centre. To the extent that risks to financial stability are a key concern of regulatory policies, new policies need to be directed at limiting the sources of excessive risk-taking in the least distorting ways possible.

16. Second, the difficult experiences of several countries following financial deregulation shows that deregulation interacts importantly with macroeconomic policy. In particular, monetary and fiscal policies that support a stable and credible economic and financial environment are needed to forestall potentially destabilising financial market developments. For monetary policy, the priority is to maintain low and stable inflation rates. Greater autonomy for central banks in their operations could enhance institutional pressure to achieve and maintain reasonable price stability. Also, sound fiscal policy also is crucial to macroeconomic stability and policy credibility. Thus the institutional and political capacity to control public-sector outlays and ensure predictable revenue collection is fundamental to ensuring a sustainable fiscal position.

17. Third, financial deregulation can have adverse economy-wide effects if it is not accompanied by complimentary structural reforms. The individual country experiences highlighted above illustrate how deregulation without strengthened financial sector supervision and increased monitoring, greater labour flexibility and tax reform can be fertile ground for future banking as well as more general economic crises.

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6 For discussion of other difficulties with these particular taxes see Garber and Taylor (1995).
Selected Bibliography


The meeting was organised into three parts: a discussion of general features of deregulated financial markets; an analysis of some specific country experiences with financial sector deregulation; and a review of some of the lessons for policy-makers from the experience of deregulation to date.

1. GENERAL FEATURES OF Deregulated FINANCIAL MARKETS

The discussion reflected differing views on the necessity and effects of financial market deregulation. There appeared to be general agreement that some deregulation had been unavoidable given the shrinkage of the regulatory base, the credit market distortions associated with highly regulated regimes, and the need to increase competitive pressures in the financial sector. In general, however, there was little agreement as to the effects of deregulation: management experts generally were of the view that, despite some setbacks, deregulation was proving to be highly beneficial and should be taken further, whereas the trade union experts felt that deregulation had proceeded too far, taken place too quickly, and had resulted in serious difficulties for the financial sector and the real economy.

The management experts argued that financial deregulation to a large extent had been unavoidable and that generally it had been beneficial to consumers, investors, and borrowers. A principal remaining difficulty was the need for a clear demarcation of public sector regulatory responsibilities. The view was expressed that governments continued to intervene unnecessarily in financial markets thereby stalling market-led solutions to problems. For example, it was argued that the intervention of governments and international financial agencies in the 1995 Mexico crisis had been unnecessary and mistaken and that market-led solutions would have been available without endangering the international financial system.

Some concern was expressed about the ability of regulators to be effective given the pace of financial innovation, the complexity of some of the financial instruments and the apparent inability of the public sector to attract and/or keep suitable personnel. In the latter context, there was some feeling that, as a general rule, the public sector was unable to attract the most talented people, partly because of the unwillingness to pay competitive salaries. However, others argued that the public sectors in many countries had no difficulty in attracting senior and highly qualified people from the private sector, at least for temporary assignments (the United States was cited as a specific example where many senior public sector positions were filled by people previously employed in the private sector). In addition, it was argued that there was a tendency to overstate the difficulties faced by financial regulators in that the roots of many recent financial crises lay in bad management practices in traditional financial sector activities, such as property lending, or in fraudulent practices, rather than being attributable to new complex financial innovations that were not properly understood.

The trade union experts generally were of the view that the central role of financial markets and the inherent instability of financial markets (reflected, for example, in large private capital flows and exchange rate movements) justified substantial regulation of the financial sector. Deregulation to the extent that had taken place appeared to have contributed to greater financial sector instability and to have had adverse effects on the real economy. Moreover, it was far from clear that deregulation had resulted in many of the intended benefits: it appeared to have resulted in higher interest rates, it was not clear that
financial sector costs had been lowered or that institutional efficiency and resource allocation had been improved; rather many financial institutions had failed to respond by strengthening their internal management controls. (In the United Kingdom, where deregulation had proceeded further than in many other economies, it was argued that there had been substantial problems in the home mortgage and private pension sectors, and small and medium sized companies continued to face difficulties in raising medium-term bank financing.) A contributory factor also may have been the generally rapid pace of deregulation which had resulted in insufficient time for the private sector to adapt to the new environment. Concern also was expressed that deregulation had been at the expense of other broader social goals, particularly employment, an assessment of which should have been included in the background paper provided by the OECD Secretariat.

The trade union experts suggested that an important difficulty stemmed from the fact that while economies had become more closely integrated, economic policy continued to be made primarily at the national level (although the goal of European Monetary Union in forcing some policy co-ordination in Europe was noted). They argued for greater co-operation in economic policy making and for an enhanced role for official international institutions in overseeing financial sector activity. While not advocating a return to the previous regulatory regimes, it was argued that there was scope for central banks to manage exchange rates to a greater extent, that there was a role for limited capital controls, and that financial leveraging should be reduced.

2. SPECIFIC COUNTRY EXPERIENCES WITH FINANCIAL DEREGULATION

The experiences of Finland, Sweden, Norway, New Zealand, the Czech Republic, and Turkey were discussed in some detail. The discussion centred on:

- The difficulties posed when pursuing deregulation prior to achieving macroeconomic balance (discussed particularly with reference to Sweden and Turkey);
- The need for an accompanying broad consultative process with affected parties prior to deregulation (discussed with reference to Finland);
- The appropriate speed and order of deregulation (highlighted by the contrasting cases of New Zealand, where deregulation had proceeded rapidly, and the Czech Republic, where it had been pursued more slowly) and the relationship between policy credibility and the speed of reform (particularly in times of crisis, reforms may have to be implemented quickly if policy is to be perceived as credible);
- The serious difficulties that can be caused by external economic shocks (particularly the Nordic countries);
- The sometimes lengthy time period before clear benefits of deregulation are seen in terms of enhanced economic performance (New Zealand);
- The greater account that had to be taken of financial market perceptions about economic policy (all countries) and the related fact that policy making had become much more transparent in less regulated environment (particularly in Turkey).

It was suggested that some of the difficulties arising after deregulation had their origin in the previous regulatory regime: for example, in Mexico bank nationalisation and the subsequent concentration of banking business on government securities had meant that the newly re-privatised banks were poorly equipped to assess private sector credit risk and carry out other banking functions related to private sector activities. Some trade union experts expressed concern that the greater influence of financial market expectations had had adverse consequences in that markets were often mistaken in their assessment of
government policy; others felt that the official international institutions too often recommended liberalisation at the expense of countries’ other objectives.

3. LESSONS FOR POLICY-MAKERS

There was a substantial divergence of views on the lessons for economic policy to be drawn from the experience with more deregulated financial systems to date.

In general, the management experts were of the view that experience suggested that financial deregulation required accompanying support from monetary and fiscal policy and from structural reforms in product and labour markets. While financial markets sometimes “overshoot” in their response to government policies, in general market instabilities reflected difficulties with underlying policies. Too often excessive financial sector regulation had been prompted by malpractice in a small number of cases; experience had shown that increased regulation did not prevent financial crises from emerging (the case of a crisis in the relatively highly regulated Japanese banking system was cited as an example); finally, the governments limited knowledge of financial markets was viewed as a strong factor in favour of reduced government intervention.

The trade union experts felt that the major lesson was the need for greater policy co-ordination between governments, particularly through the forum of official international organisations. Measures to limit or discourage speculative capital flows were advocated, including greater exchange rate management, limited capital controls and taxes on net foreign exchange positions and/or foreign exchange transactions (the so-called Tobin-type taxes). In the latter context, it was argued that imposing the taxes could be made a requirement for membership of official international organisations such as the International Monetary Fund so as to limit the scope for competitive deregulation. (The management experts generally were strongly opposed to such taxes partly because short-term transactions, which would be strongly affected by such taxes, were not necessarily “speculative” and to the extent they were related to “real” transactions there could be adverse consequences for trade and investment, and because of practical problems of enforcement).

There was some general agreement that particular problems stemmed from information asymmetries in financial markets, both as regards relations between private sector transactors and between the public and private sectors in relation to economic policy implementation; as such, ways might be sought of reducing these asymmetries.
# ANNEX - LIST OF PARTICIPANTS

## MANAGEMENT EXPERTS

<table>
<thead>
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## BUSINESS AND INDUSTRY ADVISORY COMMITTEE TO THE OECD (BIAC)

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## TRADE UNION EXPERTS

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**TRADE UNION ADVISORY COMMITTEE TO THE OECD (TUAC)**

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Directorate for Financial, Fiscal and Enterprise Affairs

Mr. John Thompson Head of the Financial Affairs Division
Mr. Stephen Harris Principal Administrator, Financial Affairs Division

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