

# FINANCIAL GLOBALIZATION AND ECONOMIC DEVELOPMENT: TOWARD AN INSTITUTIONAL FOUNDATION

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## INTRODUCTION

There has been an unprecedented proliferation in foreign direct investment and non-foreign direct investment flows in the past two decades.<sup>1</sup> Orthodox economists and international financial institutions have argued that developing countries carefully following a proper sequence of internal and external financial liberalization would be able to access these capital flows to enhance welfare and development. Indeed, the promise of higher growth and welfare combined with the conditionality of international financial institutions, has led to the widespread adoption of financial liberalization in developing countries. Unfortunately, the promise had proven empty.

Thus, despite the dramatic increase in gross capital flows, economic growth in developing countries in the 1980s and 1990s has actually been half of the level of the 1960s and 1970s. At the same time, the pattern of cross-border financial flows has been extremely skewed and uneven. Few developing countries have been able to access these flows, with the bulk of non-foreign direct investment and foreign direct investment flows going to a handful of emerging market economies. Moreover, the period of increased global flows has been associated with an unprecedented increase in instability and crisis. While orthodox economists have used a variety of approaches to explain these crises along with offering remedial policy proposals, these explanations and solutions suffer from the same static conceptual tools embedded in their arguments for financial liberalization.

We argue that financial transformation in an era of global flows requires an entirely different theoretical understanding. This paper critically examines the mainstream rationale for financial globalization and openness as well as its explanations for the financial instability and crises associated with financial openness. The mainstream claim for the close association between financial globalization and economic development is then challenged in light of empirical observations on the pattern of global finance and the financial globalization-growth nexus, while the diagnosis of

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the crises and policy proposals are juxtaposed with alternative theoretical perspectives.

Based on alternative dynamic analyses of the symbiotic relationships between finance and economic development, we propose an institutional-centered approach that forms a basis for understanding the institutional transformation required for financial development. In this context, we argue that financial flows can be seen as a series of domestic and international circuits that intersect among themselves and with the real flows of commodity and productive resources. Institutionally, each flow has a set of internally interconnected capacities, incentives, norms, regulations and organizations. For development to occur, financial flows need to feed into real sector circuits to enhance expansion and accumulation, whilst national flows need to tap into international flows to complement the speed and capacity of the domestic flows to feed into the real sector circuitry.

We begin by presenting a critical review of mainstream theories on the welfare gains from financial globalization as well as the emerging pattern of global financial flows and their developmental consequences. We then discuss the standard interpretations of the dynamics of financial crises in emerging market economies along with policy recommendations to counter crises. These explanations and prescriptions are then contrasted with alternative approaches that locate the source of financial fragility and instability in the functioning of a market economy itself. We continue by developing further an alternative conceptual framework and exploring possible policy alternatives to facilitate the transformation of financial institutions for development. In the conclusion we evaluate some of the institutional mechanisms for accessing global financial flows.

## GLOBAL FINANCIAL FLOWS AND ECONOMIC DEVELOPMENT

### *Mainstream Theories on Welfare Gains from Financial Globalization*

The key function of financial systems in the saving-investment-growth nexus is to act as an effective conduit for: (a) channeling funds from surplus to deficit units by mobilizing resources and ensuring an efficient transformation of funds into real productive capital; (b) the maturity transformation between savers and investors, while providing sufficient liquidity to the system as the need arises; (c) reducing risks from the system through diversification and techniques of risk sharing and risk pooling.

Following Goldsmith's [1969] study of the effects of the financial deepening on economic growth, a large number of econometric exercises have been conducted to examine the relationship between financial sector development and economic growth. Many recent empirical studies have been motivated to test the financial repression hypothesis that has provided an analytical platform for financial liberalization policy [McKinnon, 1973; Shaw, 1973].<sup>2</sup> Recent theoretical studies have tried to establish precise mechanisms through which financial systems influence economic development.<sup>3</sup> For example, while Gertler and Rose [1994] examine the symbiotic relationships between finance and growth, others emphasize specific roles of financial intermediaries such as: lowering the social cost of investing in intangible capital [King and Levine, 1993]; pooling idiosyncratic investment risks and eliminating *ex ante*

downside uncertainty about rates of return [Greenwood and Jovanovic, 1990] and the growth-inducing role of financial innovation [Pagano, 1993].

The functions of capital markets are also identified as a mechanism of an easy asset/portfolio allocation and diversification for the public, providing efficient and transparent price signals and liquidity in the secondary market, where savers/investors with a strong preference for holding short-term liquid assets could participate in markets of long-term securities and bonds issued for illiquid productive investment. Thus, an active and broad-based capital market is thought to mitigate the acute shortage of term loans and equity financing, and transform maturities.

Extending these lines of arguments spatially to cross-border financial transactions and intermediation, the effects of financial globalization on economic development and world welfare are tacitly assumed to be positive through the same saving-investment-growth nexus. Thus, Rousseau and Sylla [2001] claim financial globalization ensures an efficient intermediation between saving and investment on a global scale. Specifically, an intertemporal borrowing/lending model as applied to cross-border capital trade is used as a theoretical basis to demonstrate benefits from financial globalization in allowing capital to seek out its highest rewards while providing developing countries means for higher investment as well as consumption smoothing and insurance against shocks [Obstfeld and Rogoff, 1996].

Indeed, in the extreme version of the neoclassical world with no information friction and no transaction cost, once impediments to free capital mobility are removed, funds are seen to flow from low marginal product of capital-rich countries to high marginal product of capital-poor countries as the capital market works to equalize risk-adjusted marginal products of capital across borders. It is claimed that as financial globalization proceeds, the efficiency of global resource allocation increases, and that developing countries emerge as winners.

Further, the model of global portfolio diversification is used to emphasize the welfare gains associated with global risk sharing and shifting, that is, a possibility arising from portfolio diversification through internationally integrated markets. The model predicts that international asset trade allows each country to hold a globally diversified portfolio of risky investments, resulting in substantial risk reduction through sharing. This is claimed to lead to an increase in world economic growth and national welfare. It has provided economists with an added reason to push an agenda of financial globalization, which is claimed to serve the interest of developing countries.

In this context, the rapidly rising share of emerging markets in world stock market capitalization since the late 1980s was presented as one of most promising ways for developing countries to join the rich countries' club. Among many others, Demirgüç-Kunt and Levine [1996] interpreted this trend as a "win-win" situation resulting from mutually beneficial actions by two parties: (a) international investors seeking a globally diversified portfolio, promising higher returns; and (b) developing countries removing barriers to international capital flows and expanding domestic stock markets in their efforts to accelerate economic development. The sharp resurgence of international portfolio flows (bond and equity) to emerging markets since the late 1980s is then popularly examined in terms of both pull factors and push factors [Taylor and Sarno, 1997; Calvo, Leiderman, and Reinhart, 1996]. Pull factors are coun-

try-specific conditions in emerging market economies that reflect opportunity and risk for international investors, while push factors are global conditions such as cyclical movements in returns or interest rates or business conditions in developed market economies.

All in all, Obstfeld concludes, "Economic theory leaves no doubt about the potential advantages of global financial trading" [1998, 10]. He further suggests that the international capital market plays a role of disciplining policymakers "who might be tempted to exploit a captive domestic capital market" [ibid.]. However, this disciplining role is also closely related to the severe constraints that financial openness places on macroeconomic management of emerging-market economies—a condition known as the *macroeconomic policy trilemma for open economies* or inconsistent trinity thesis. The thesis stipulates that an open capital market deprives governments of the ability simultaneously to target its exchange rate and to use monetary policy in pursuit of other economic objectives.

Besides, as Obstfeld [1998] himself notes, there are further costs associated with financial globalization: (a) a loss of fiscal autonomy, since financial openness makes it hard to tax internationally footloose capital relative to labor due to the competition for foreign savings through tax incentives;<sup>4</sup> (b) negative income distribution effects through changes in relative factor prices associated with factor movements; and finally (c) the increased susceptibility of participating countries to financial instability, often culminating in severe financial crises. Thus, financial globalization is well recognized to entail genuine costs, risks and hazards.

### ***Liberalization Experiences and Results***

On the basis of the promise of significant *net* gains for productive investment and economic growth, however, many developing countries have embraced, with open arms, financial globalization by adopting internal and external financial liberalization policies. They have also taken regulatory and fiscal measures to encourage the development of money and stock markets, often in association with large-scale privatization programs. Under the encouragement and supervision of international financial institutions, the policy of liberalization/deregulation has been a cornerstone of their development and growth strategy over the last two decades.<sup>5</sup>

Responding to these favorable pull factors, there was a surge in international capital flows to emerging market economies in 1990-97. Yet there has been a rather weak link, if at all, between investment-growth performance on one hand, and domestic and external financial liberalization on the other. Eatwell suggests that "free international capital flows" have been "associated with a deterioration in economic efficiency as measured by growth and unemployment" [1997, 2].

Domestic financial sector reform, whether comprehensive and sweeping or measured and gradual, has not, as a rule, made any significant difference to the saving and investment activities in the liberalized economies. A sharp increase in nominal interest rates following liberalization tends to worsen the risk composition of banks' loan portfolios, giving rise to the well-known problem of adverse incentives and selection as well as aggravating the moral hazard problem [Stiglitz and Weiss, 1981]. In many countries, high and volatile interest rates in relation to real returns on capital

have resulted in a dramatic increase in the share of non-performing loans in bank portfolios. Systems of supervision and regulation have been weakened considerably due to a proliferation of banking and non-banking financial institutions [Chang, 1998]. Furthermore, in the absence of adequate supervision and regulation, close politico-business coalitions can be forged under liberalization through money politics and patronage [Stein et al., 2002].

Liberalization, in the form of increased competitiveness of the banking system, has not led to an increase in long-term finance, or the reduction of intermediation costs. Further, there is little evidence to support the proposition that stock market development would lead to higher productive investment [Singh, 1997]. The stock market boom in emerging market economies, supported by speculative asset shuffling, could be far removed from real productive investment activities.

All in all, cross-border capital mobility has significantly increased the degree of instability in macroeconomic conditions of emerging economies, rather than providing the promised stable source for productive investment. Indeed, the surge in capital inflows has led both to real exchange rate appreciation (harmful for tradable sectors) and to a creation of disproportionately large *financial excess* (typically epitomized by asset price bubbles in the real estate sector and stock markets).

Moreover, the large discrepancies between *gross* capital flows and *net* capital flows reflected in countries' current account positions point to the condition where *diversification* finance far overwhelms *development* finance in cross-border capital transactions [Obstfeld and Taylor, 2001]. In other words, international capital markets in the recent decades have not performed an intermediation function between saving supply and investment demand on a global scale. Rather, as Obstfeld and Taylor observe,

(t)oday's foreign asset distribution is much more about asset swapping by rich countries - diversification - than it is about the accumulation of large one-way positions - a critical component of the development process in poorer countries in the standard textbook treatments. It is more about hedging and risk sharing than it is about long-term finance... [ibid., 64]

Thus, in our view, cross-border capital flows have been largely driven by *push* factors reflecting international investors' interests, because international financial integration has proceeded under uncovered real interest parity conditions as an arbitrage mechanism. In this process, emerging economies have merely accommodated international investors' diversification needs, governed by economic cyclical conditions in developed market economies. Emerging economies have *de facto* provided international investors with attractive *pull* conditions, by adopting financial liberalization policies.

Thus, despite the rhetoric surrounding net benefits of financial globalization, it is difficult to obtain hard empirical evidence establishing the positive link between financial globalization and economic development. Moreover, the social and economic costs posed by the macroeconomic policy trilemma is unacceptably high for develop-

ing countries, as witnessed repeatedly in the recent financial crises that have submerged almost all the developing countries.

Yet, after admitting that financial globalization involves both “enormous benefits and non-negligible downside risks”, mainstream economists continue to argue that “the duality of benefits and risks (in financial transactions) is inescapable in the real world of asymmetric information and imperfect contract enforcement,” and that “the best way to maximize net benefits is to encourage economic integration, while attacking concomitant distortions and other unwanted side effects at, or, close to” their sources... in confronting the global capital market there is no reason to depart from conventional economic wisdom” [Obstfeld, 1998, 10]. Similarly, Aizenman presents the problem arising from financial globalization as a complex trade off between the adverse short- to medium-term effects and the beneficial long-run effects of financial opening.<sup>6</sup> From this perspective, he argues, “the challenge is to design a liberalization program that does not bring a financial crisis in its wake” [2002, 6].

Policy stances of this nature are, in our view, often a reflection of their limited understanding of the real origins and true dynamics of financial crises that have threatened emerging economies in recent years. To support our argument, we now turn to a brief review of literature on the nature and causes of recent financial crises.

## **DYNAMICS OF FINANCIAL CRISES IN EMERGING MARKET ECONOMIES**

### ***The Conventional Interpretations of Financial Crises***

According to the standard interpretation, the chain of events leading to the financial crisis in East Asia was the use of a predetermined nominal exchange rate, combined with large capital inflows that were intermediated by a weak banking system, generating a situation of exchange-rate overvaluation, a vulnerable financial sector and eventually the collapse of the currency.<sup>7</sup> This had subsequently evolved into a general economic crisis with a severe decline in the net worth of both borrowers/savers and financial institutions. Indeed, the Asian crisis started as a crisis that primarily arose from *financial excess* and took the form of a twin crises—currency crises and financial sector crises as interrelated phenomena [Corsetti et al., 1998, Mishkin, 2001]. As such, it shared a commonality, in several aspects, with previous financial crises: speculative attacks on pegged exchange rates, asset price bubbles, market crashes, and bank runs resulting from the combined effects of overinvestment, underregulation, and overvaluation [Miller and Luangaram, 1998].

Yet, it is worth emphasizing one of the specific features of the Asian crisis: the crisis happened as a direct result of *overinvestment* by private agents, rather than overconsumption or government overspending as is said to be the case with many Latin American crises before. In this sense, the crisis was the least anticipated. Many studies have emerged to examine this overinvestment condition. For example, McKinnon and Pill [1998] explain overborrowing/overinvestment and the twin crisis in terms of *moral hazard* problems inherent in weak domestic financial systems and exacerbated by implicit or explicit deposit insurance domestically, as well as international rescue operations. They suggest that overborrowing occurs when the nonbank

private sector becomes euphoric about the success of reform (that is, liberalization policy in their context) because of the overly optimistic signal about macroeconomic developments contained in loose credit conditions. When credit booms eventually end in bust with unrealizable expectations and increasingly risky bank assets, the probability of bank failure will be increased: banks would suffer additional capital losses following devaluation from the currency mismatch on their balance sheet, precipitating a general financial crisis.

Miller and Luangaram [1998] augment the above explanation by adding asset market conditions as an endogenous part of financial crisis dynamics, noting that currency crises have been preceded by a boom-bust cycle of asset prices. They suggest a close link between the performance of the financial sector and asset prices through collateral. As Asian firms are highly geared with financial institutions, the link between asset prices and banking performances may have tightly prevailed.

In all these models, it is an eventual realization of banks' negative net worth that triggers bank runs. Bank runs could induce, and escalate into, an open currency crisis, since a central bank's ability to defend a currency becomes increasingly questioned as a result of considerably increased vulnerability of the financial sector caused by the currency/maturity mismatch problem that is exacerbated by a large devaluation. Thus, Miller [1998] notes that there are important linkages between bank solvency and currency stability and that causation may run in either direction.

The rapid pace and the wrong sequence of liberalization are blamed as key culprits [Mishkin, 2001]. Upon capital account liberalization, a credit boom in a number of miracle Asian economies in the 1990s was stoked by large short-term private capital inflows [Goldstein, 2001]. Sterilization policies applied to neutralize the monetary impact of large inflows aggravated the situation by raising domestic interest rates and inducing further inflow of interest-sensitive capital [Calvo, 2001]. This also created an additional incentive to domestic borrowers in raising funds in international capital markets. A crisis condition then arose from a sudden large-scale capital outflow triggered by a wake-up call. Precipitous surges and withdrawals of international capital had contributed to asset price bubbles in their boom as well as to price crashes.

Furthermore, under *de jure* or *de facto* fixed exchange rate regimes, little management of currency exposure was undertaken despite potentially hazardous currency/maturity mismatches. Speculative attacks on the currency, triggered by sudden reversals of market confidence, directly hit this vulnerable balance-sheet position, turning banks and corporations that were solvent in the pre-currency-crisis period into insolvency and bankruptcy.

Clearly, the recent financial crises are very much a crisis of globalizing capital, with large contagion effects throughout emerging market economies at large. Radelet and Sachs [1998], emphasizing this aspect, argue that the Asian crisis is "a testament to the shortcomings of international capital markets and their vulnerability to sudden reversals of market confidence" and that "the unwillingness or inability of the capital market to provide fresh loans to the illiquid borrower is the nub of the matter" [1998].

***Policy Perspectives Arising Out of Standard Diagnoses***

The variety of policy reform proposals reflect the differences in understanding the causes of the financial crisis. Those who view the crisis more as resulting from the deficiency of the global financial system, have emphasized the need for a New International Financial Architecture, encompassing measures for more effective *ex-post* crisis management as well as more prudent *ex-ante* allocation of credit [Eichengreen, 1999; Aizenman, 2002]. For example, the illiquidity-coordination failure hypothesis stresses the need for orderly workout mechanisms or an establishment of an International Bankruptcy Court. Among *ex-ante* crisis prevention measures to address the high volatility of international capital flows, there are a number of proposals dealing with regulation and supervision of international capital flows at the national and global levels. The New Basle codes or the Tobin tax proposal is discussed in this context.

Others tend to confine their discussion on policy reform more to domestic measures [Mishkin, 2001]. An emphasis is placed on improving supervision and the regulation of financial institutions in emerging market economies, so as to ensure greater transparency and the proper monitoring of bank portfolios with an improved flow of timely and quality information. Many of them forcefully argue that a root cause for repeated financial crises facing emerging economies is domestic. In their view, the Asian crises are essentially caused by the problem of insolvency rather than illiquidity. It is argued that the domestic banking system in the crisis-afflicted economies had long been aggravated by the moral hazard problem due to perverse financial incentives, distorted asset prices, and misallocated resources associated with connected or political lending. This condition is said to have encouraged banks to gamble for resurrection, leading ultimately to a creditor panic.

A *two corner-solution view* has also emerged as a dominant position in the debate on the appropriate exchange rate regimes for emerging market economies prone to financial crises. Resorting to the impossible trinity thesis, this view (or the *hollowing-out* thesis) states that intermediate regimes are not viable under financial globalization, because of their vulnerability to speculative attacks (self-filling or otherwise). For example, Eichengreen concludes that “a middle ground of pegged but adjustable exchange rates and exchange rate target zones will hollow out and policy makers will be confronted with a choice between floating and monetary union” [1999, 134].

However, this debate on appropriate exchange rate regimes is driven by the imperative of financial globalization. Their arguments rest on the assumption that financial openness alone should not be challenged in the *trinity*, either because of the considerable benefits that openness is promised to produce in emerging economies, or because free capital mobility is inevitable due to changes in global technology, market structure or politics. As Frankel [1999] suggests, however, the inconsistent trinity thesis does not, in principle, imply that countries cannot have a half-independent monetary policy and a half-fixed exchange rate by adopting intermediate regimes such as target zone; nor does it imply that countries cannot have both an independent monetary policy and a fixed exchange rate by imposing effective capital controls.



### *Alternative Approaches to the Analysis of Financial Crises*

In our view, the conventional analyses of financial crises does not really provide us with an in-depth understanding of how endogenous forces of market economies could give rise to financial crises. Hence, the prevailing policy discussion on crisis prevention and management reflects the rather shallow analysis of the dynamics of financial crisis. To initiate a more constructive policy discussion, we have to understand first, at a deeper level, the dynamic interaction between financial and real factors in the process of economic development in a Schumpeterian or Gerschenkronian tradition [Kregel and Burlamaqui, 2000].

Schumpeter [1911] views finance as the motor force that allows firms to appropriate the resources necessary to introduce new technological innovations, since he regards technological innovations based on the accretion of knowledge as the engine for economic development, long before the birth of the endogenous growth model. In his analysis, finance is the handmaiden of the creative destruction that allows industry to produce technological advances and economic development. Yet, technological innovation has to be financed by the issue of financial liabilities that can be honored only if the innovations are successful. In this very sense, financial transactions involve inherently high uncertainty and risks, creating *systemic* instability. The direct link between finance and production involves, by nature, a dynamic but destructive financial instability. This type of instability would inevitably be manifested in continuous fluctuations in economic activities accompanied by unemployment, bankruptcies and structural transformation.

Schumpeter's approach to understanding the growth dynamic of the economic system and its dependence on the financial system shares a commonality with Marx's analysis of capitalist economies. They both view capitalism as an historical process characterized by constant changes rather than by equilibrium conditions. At the same time, Schumpeter's perspective on uncertainty and risk is a precursor to Keynesian macroeconomics. Gerschenkron [1962], and to a certain extent, Gurley and Shaw [1967] carried through the Schumpeterian approach to understanding the role of finance in economic development.

Keynes' understanding of uncertainty and risk originates from an explicit recognition that financial transactions are underpinned by intertemporal contractual commitments made on agents' expectations that are subject to extremely volatile, continuous revisions over time as unforeseen changes take place. This subjectivity and volatility of expectations is a key to Keynes' concept of uncertainty and risk, since it is this attribute of real world transactions that makes financial asset prices more volatile. Thus, the analysis concerns directly with *systemic* risk, not with *idiosyncratic* risk stemming mainly from the problems associated with moral hazards and agency costs in a world characterized by asymmetric and imperfect information.

Drawing on this Keynesian concept of risk and uncertainty as an analytical base, Minsky [1978; 1986] advances the *financial fragility* thesis, which complements the Schumpeterian perspective for advancing our understanding of financial crisis dynamics. Operating in the world of highly volatile macroeconomic conditions subject to agents' constantly revising expectations, financial fragility is an attribute of the financial system, which is *systemic*, and presents itself in the normal functioning of a

capitalist economy. According to his thesis, the degree of the robustness-fragility of a financial system depends on: (a) the mix of hedge, speculative, and Ponzi finance in the economy; (b) the various mixes of yield, carrying cost and liquidity in asset portfolios; (c) the extent to which ongoing investment is debt financed [Minsky, 1978]. These conditions, often driven by financial innovation, constantly shift around and evolve over time.

While procyclical bank lending and asset price movements are rather a norm, Minsky argues, once the fragility becomes a pronounced feature of financial structure, the incoherent behavioral characteristic of a financial crisis can develop with some endogenous displacements. This could, by engendering a liquidity crisis, easily transform financial institutions and markets from a fragile to an unstable condition, which can in no time turn into an insolvency problem. Thus, financial fragility with highly volatile asset prices tends to produce periodic crunches, squeezes and debacles and at times triggers a debt deflation process.<sup>8</sup> Financial crisis ensues as credit risks increase with a general decline in asset quality and a flight for liquidity intensifies, followed by a severe destruction of borrower net worth.

Critically, in both the Schumpeterian and Minskian models the source of financial fragility is endogenous to the capitalist accumulation process in a Keynesian and Marxian tradition. Arestis and Glickman appropriately stress this distinctive aspect. They note that Minsky's central thesis is the revelation that "forces capable of producing financial fragility are built into the system itself" and that "financial fragility is not due to accidents or policy errors" [2002, 238]. They contrast his thesis with the mainstream analysis that locates the causes of crises either in government failure or shocks, which are exogenous to the functioning of markets.

Drawing on Minsky's fragility thesis, Kindleberger [2000] develops the panic model of financial crisis, where asset prices are inherently volatile. They go through psychological boom-bust cycles: on the one hand, the irrationally optimistic psychology of the boom renders loans, securities and real estates severely overvalued, and debt is often contracted to leverage the acquisition of speculative assets for subsequent resale. Thus, the phase of overinvestment/overborrowing observed in the crisis-hit economies are fuelled and sustained by excessive asset inflation in the booming years. On the other hand, when fundamental valuation returns to asset pricing, investors overreact in the opposite direction to real or imagined adverse shocks to the repayment prospects of the borrowers. Panic ensues and asset prices experience ruinous declines. Thus, the market crashes with collapse of speculative bubbles. Reflecting these highly volatile movements of asset prices, capital markets and financial systems, both domestic and international, are inherently unstable, as surges of euphoria and despair alternate in shaping market conditions.<sup>9</sup> Thus, Kindleberger concludes that markets can be *irrational*, even when each participant in the market is acting rationally.

Relating the financial crisis to the cyclical nature of market-based economies in general, this kind of model locates one of the primary explanations for crisis in a Keynesian-type herdism linked to "irrational" investors' behavior *a la* Kindleberger. In international capital transactions in particular, as portfolio managers are punished for continued exposure in regions with failing prospects, investors tend to use the behavior of others as a proxy for accurate information, all heading for the exit by

simply following the herd. This kind of herd behavior creates a condition of overshooting, amplifying the effect of initial events and turning collection into collapse.<sup>10</sup>

These alternative perspectives, hence, doubt the risk-assessment capacity of market participants, even if relevant information is made available. In this context, Palma suggests that under underregulated, overliquid international financial markets, “both lenders and borrowers seem unable to assess and price their risks properly, and end up accumulating more risk than is privately efficient (let alone socially efficient)” [1998]. Indeed, according to Chang et al., “the key problem (in East Asia) was the *evaluation* of the information available: as in most of financial mania, market operators were simply unwilling to focus on the downside risks as the upside was more attractive” [1998].

### **Synthesis**

In our view, compared to these alternative approaches to understanding the dynamics of financial crises, mainstream understanding of the sources of financial fragility is essentially static and trivial. For modelling periodic crises, the latter has to resort to the static concept of market failures that arise exclusively due to asymmetric and costly information or imperfect institutional environments such as adverse selection and bankruptcy constraints.<sup>11</sup>

Furthermore, the frequent susceptibility of emerging market economies to global financial and currency crises should be examined from both historical and institutional perspectives. Eichengreen and Hausmann advance the *original sin* hypothesis, which suggests that their incomplete domestic financial markets are at the root of financial fragility. The hypothesis refers to “a situation in which the domestic currency cannot be used to borrow abroad or to borrow long term even domestically. In the presence of this incompleteness, financial fragility is unavoidable because all domestic investments will have either a currency mismatch...or maturity mismatch...” [1999, 3]. Critically, as they note, these mismatches exist not because banks and firms lack either the prudence to hedge their currency exposures or the foresight to maturity mismatch, but because they are unable to do so due to their emerging markets status.

The thesis provides an interesting perspective for explaining the disadvantage position of emerging market economies in global finance. Indeed, the financial fragility and instability of emerging market economies is closely related to their asymmetric position relative to advanced countries in international finance. As Bordo and Flandreau [2001] note, the degree of financial maturity—the ability to issue international securities denominated in own domestic currency—is a key factor in distinguishing core from periphery countries for exchange rate regime choices over the past century. The prevalence of their “Fear of Floating” [Calvo and Reinhart, 2000] or “The Case of Hard Pegs” [Calvo, 2000] is also closely related to: (a) *liability dollarization*, that is, the condition in which financial contracts are expressed in foreign currency; (b) fear of inflation due to the high pass-through coefficients (measurements of the speed of transmission of devaluation to inflation); and (c) their nascent capital markets.

While pointing to the precarious position of emerging economies, the debate centered around this thesis confines itself to exchange rate choices or policies towards improving regulation and supervision of domestic financial institutions almost exclusively to deal with moral hazard problems stemming from “perverse corrupt practice.”

We argue that the inability to issue debt contracts or bonds in their own currency and with long maturity in international capital markets is fundamentally linked to the asymmetric power relationship in the international monetary system as it has evolved historically. It is also a reflection of the stage of economic development. If so, the condition cannot be addressed by simply making a second-best choice for the exchange rate regime, or by tackling a moral hazard problem only at a superficial level. A real solution should be found in reforms of the international monetary system so as to regulate procyclical global liquidity conditions. Urgent attention should also be drawn to developing institutional arrangements at both global and domestic levels, which creates conditions conducive to stable long-term finance for productive investment.

Clearly, financial liberalization policy is based on an impoverished, static understanding of the finance-growth nexus. It is by now well established that the financial repression school underestimated the problems arising from the effect of imperfect information in credit transaction and associated incentive problems. However, all problems in finance cannot be attributed simply to the adverse selection or moral hazard issues. Similarly, international finance is not just a mere extension of domestic finance from a perspective of policy formation. Yet, a better-designed liberalization program, tinkered with the strengthened institutional environment, is seen as a way forward by mainstream economists, for whom institutional measures mean just efficient enforcement of law and contracts and effective prudential regulation and supervision [Aizenman, 2002; Mishkin, 2001].

In our view, these policy stances are based on a shallow understanding of the finance-growth nexus. We argue that the mainstream theory of finance at large, let alone the repression school, misspecifies the truly dynamic simultaneous nature of the interactions between financial and real sector activities, which is at the heart of the alternative theories of finance. Accordingly, the two contrasting perspectives differ considerably with regard to institutional requirements for linking finance to development.

From our alternative perspective, the failure of internal and external financial liberalization policy cannot be adequately analyzed in terms of either perfecting the timing, sequencing or pacing of financial reform processes, or choosing the optimal combination of exchange rate regimes and monetary-fiscal policy configuration. Designing financial policies should involve all-encompassing efforts to develop the capacity of domestic and international financial systems to deal with the issue of financial fragility and instability at its core. At the same time, more appropriate and innovative institutional arrangements should be in place to create mechanisms for maturity transformation and liquidity regulation, so that systemic liquidity crises are collectively dealt with and long-term finance is supplied for productive investment [Nissanke and Aryeetey, 1998; Nissanke, 2001]. We explore some of these themes in the next section.

## ALTERNATIVE POLICY POSSIBILITIES FOR DEVELOPING COUNTRIES

### *Plumbing vs. Architecture*

Instead of fundamentally challenging financial liberalization, most proposals to deal with financial instability in emerging market countries tend to focus on issues of sequencing or the need for more regulatory authorities. Grabel [2001], in contrast, argues it is neoliberalism that has engendered a series of interrelated risks including: currency risks; flight risk (the mass selling of assets), the fragility risk (the vulnerability to external shocks stemming from maturity mismatches), contagion risk, and finally sovereignty risk (policy options for a crisis-inflicted country delimited by externally imposed conditionality or policies aimed strictly at dealing with the instability).

Grabel assesses a series of possible measures to counter these neoliberal-induced risks. She evaluates the potential impact of trip wires and speed bumps, Tobin type taxes on financial transactions, the Chilean and Columbian options of taxing, limiting or setting reserve requirements on some transactions, restrictions on currency convertibility and publicly managed closed-end mutual funds investing in emerging markets. While she doubts the effectiveness of many “orthodox” measures, including a uniformly levied Tobin tax, she believes the other “heterodox” policies could have prevented or at least ameliorated the Asian crisis.

Questioning also the effectiveness of the Tobin tax, Davidson [2000] utilizes a plumbing vs. architecture metaphor to differentiate the policy recommendations that arise from an efficiency market perspective (embedded in the mainstream proposals) vs. a liquidity view of financial markets. The plumbing perspective sees the current situation as basically sound and requiring only a bit of patchwork. In contrast the liquidity view of markets and their associated volatility requires a rethinking of the structure of global financial markets. Using this framework, he dismisses the plumbing options, placing the Tobin tax and the currency board proposals in this category.

Davidson suggests that the most viable solutions that have worked successfully so far fall into the realm of architecture. They include: temporary administered controls on capital outflows as in Malaysia, permanent restrictions on types of foreign exchange transactions including foreign ownership of stocks as in China, the differentiation of foreign exchange at different rates; differentiated taxes on different kinds of transactions (not an across the board Tobin tax) such as is used in Chile, and the differentiation of reserve requirements on banks reflecting the extent of foreign exchange exposures.

As Stiglitz has pointed out “it is no accident that the two countries that survived the crisis—and continued with remarkable strong growth in spite of a difficult global economic environment—were India and China both countries with strong controls on...capital flows” [2000, 1075]. In the case of China, the restrictions on the short-term capital account seem not to have affected its capacity to attract foreign direct investment and perhaps might have helped it by avoiding associated instability.

While the architecture approach or Grabel’s intervention to reduce systemic risks are clearly superior to plumbing approaches, because they recognize the need to go

beyond a few salutary measures to deal with the challenges of instability created by neoliberalism, neither has an explicit theory of institutions or institutional transformation. Their policy recommendations are preventative or reactive rather than constructive in building the institutional foundations of a financial system that is developmental. To use the architectural metaphor, while they go beyond the plumbing of the house, their solutions are more in the vein of strengthening walls or putting up the shutters in the face of potential hurricanes. What we propose is to think about the foundation, the purpose of the structure and the interaction of all the components. Moreover, their focus is on emerging market countries that are already integrated to a great degree in global finance. This unfortunately leaves out the majority of developing countries that must deal not with instability but with accessibility in a manner that will be developmentally propitious.

### ***Architecture and Institutions***

***New Institutional Approach to Financial Development.*** To deal with these challenges, we require a deeper understanding of institutions for financial development. For this, we need to focus more on the interaction of the form, content and context of the transformation of institutions, where institutions are understood not only as constructs defined by these subcomponents but also relative to other institutions. Thus, by nature, institutions are path-dependent, requiring legitimacy. For legitimacy they must relate to internal norms [Sindzingre and Stein, 2001].

In this framework, the state, by providing an array of support such as infrastructure, licensing, regulations, and legal systems, is clearly central to both the operation and alteration of financial markets because it is embedded in most markets. The state also provides constructs that are internalized in markets. For example, while legal systems provide recourse to market participants, it is frequently their existence rather than their utilization that influences transactions. These entities become mental constructs that are institutionalized within financial markets.

In dynamic terms, state regulations can set the quality and standards, which can slowly influence the character of financial products as expectations adjust over time, with incentives as well as threats of punitive measures. However, before designing any path of transformation, there needs to be a full assessment of the form, operational content and interaction with other institutions. What is absolutely central to the development of financial systems are the linkages with other institutions that directly produce goods and services in the economy. Historically there has been an array of models of interaction at the financial, information and monitoring levels [Stein, 2002].

Thus, one must carefully consider the design of institutions that will ensure that savings will flow into the most productive sectors for development. For transformation of financial systems, one must first design a parallel track of institutions that have the potential to influence financial markets (such as corporate structures, industrial-financial ownership linkages, legal systems, international trading institutions and regimes, and so on). Their rules of operation must be carefully designed and institutionalized. State intervention and new institutions must gain legitimacy

by building up credibility through continuity, consistency, inclusiveness and interaction in a manner that involves key players and the exchange of information. Financial transformation is a prerequisite for the increasing sophistication of production and exchange that will help reverse the marginalization of many developing countries (such as those in Africa). There is little historical evidence for the spontaneous transformation of production and exchange in general, and financial markets in particular.

***Institutions and Circuits.*** From an institutional perspective, the challenge of finance in the poorly formed markets of developing countries in a world of rapid global flows is much more profound than simply the issue of bonds vs. stocks vs. bank lending as a financial source for productive investment. Financial flows can be seen as a series of domestic and international circuits that intersect among themselves and with the real flows of commodity and productive resources. Institutionally, each flow has a set of internally concatenating capacities, incentives, norms, regulations and organizations. The mere existence of institutions says nothing about their meaning, their legitimacy and the degree of internalization among the participants of each circuit. Moreover, each flow can also be defined relative to other flows, which helps to give them scope, content, and meaning. The totality of all of these dimensions constitutes a financial system. A shift in the institutional dimensions of any one flow, such as the regulations or relative penalties governing some form of financial device or behavior, has direct implications for the nature of the interaction with other flows. This is one reason why liberalization of domestic banking, along with foreign exchange transactions, has created some rather perverse consequences in the way that domestic financial flows interact with international flows.

For development to occur, financial flows need to feed into real sector circuits to enhance expansion and accumulation, and national flows need to tap into international flows to complement the speed and capacity of the domestic flows to feed into the real-sector circuitry. Neoliberal policies have changed the direction and purpose of these flows. McKinnon-Shaw-inspired liberalization alters existing incentive structures through an increasing emphasis on short-term profits, introduces shifts in organizational structures through privatization or new licensing and can disrupt the operational norms of banking systems. Frequently, even if new regulatory structures are put in place, they take time to move from the formal realm to be internalized.

We can observe a common pattern of financial flows in developing countries subject to orthodox financial liberalization [Stein et al., 2002]. First, liberalization has led to a rapid flow of resources from other sectors into finance, in a search for short-term profits. Second, as banks moved toward speculative activities focused on the global financial markets and capital flight and the certainty of government paper, real lending to the private sector plummeted in many developing countries. Third, the already short-term orientation of loan portfolios in developing countries has escalated. This short-termism has contributed to an erosion of bank-supported investment activities and in turn helped disrupt the developmental impact of real sector flows. The restructuring and cleanup costs have been disproportionately large. The impact of these bailouts on the real sector is debilitating and has led to an increase in

taxation, rises in interest rates, increases in international debt and a crowding out effect caused by the flotation of government paper to finance bailouts. Asset price deflation caused by speculative run-ups following financial liberalization has negative effects on private sector balance sheets that can inhibit investment and real sector flows.

The main mechanism of interaction with global flows, particularly in the poorer developing countries, has been through bilateral and multilateral debt accumulation, servicing, rescheduling, and finally debt forgiveness mechanism like the World Bank's Debt Initiative for the heavily indebted poor countries (HIPC) [Nissanke and Ferrarini, 2001]. Financial liberalization has intensified this dynamic through the additional debt associated with sectoral adjustment loans to the financial sector and the frequent need to take on additional debt to deal with the resuscitation of the financial sector after liberalization. Instead of focusing on accessing global financial flows in support of real sector circuits, governments have been preoccupied with dealing with the array of conditionality associated with maintaining access to the official aid dimension of global capital flows.

***Toward the Transformation of Financial Institutions.*** All of this must change. The key is the reorientation toward the transformation of new norms, incentives, regulations, organizations, and capacities. Table 1 below specifies the types of attributes associated with the institutional dimensions for financial systems that are more developmental. The starting point is to evaluate each of these five institutional areas with clear identification of the goals of any institutional transformation. Unlike orthodox financial repression theory, however, an institutional approach avoids universalizing policies to cover the vast differences between various developing countries and the path-dependent nature of any institutional transformation. Policies must be contextual and arise as a result of a careful evaluation of existing financial systems. However, at all levels it should be apparent that the state is embedded in the operation and transformation of any financial system on multiple levels.

The key concepts used here are defined as follows: *Norms* are habits of thought arising from social sanction and esteem, and are built up from an established pattern of life and associated ways of thinking [Rutherford, 1996]. *Incentives* are the rewards and penalties that arise from different forms of behavior. Unlike marginally calculating *homo economicus*, material rewards and penalties are recognized to be one of several social factors influencing behavior, having more of an effect in reshaping habits of thought, including people's ideals and aspirations, hopes and their sense of what is true, beautiful and good [Veblen, 1961]. *Regulations* refer to the legal boundaries that constitute the rules of operations. *Organizations* are entities that concatenate the operation of groups of people with narrowly defined common rules and purpose. *Capacities* refer to levels or abilities of individuals, groups and organizations to operate effectively under rules to reach particular organizational goals.<sup>12</sup>

From Table 1, the key to harnessing finance for development is by altering the dynamic interface between the financial and real circuits. An enumeration of financial norms requires an understanding of their stability and uniqueness relative to



**TABLE 1**  
**Evaluation and Goals of the Transformation of Financial Institutions**

Institutional Category	Evaluation	Institutional Goal
Norms	<ul style="list-style-type: none"> <li>• time horizons</li> <li>• degree of trust</li> <li>• extent of professional norms</li> <li>• stability</li> <li>• uniqueness</li> <li>• degree of formalism vs. internalization</li> </ul>	<ul style="list-style-type: none"> <li>• extend time horizons and trust</li> <li>• augment professionalism</li> <li>• stability of new norms that are more developmental</li> <li>• creating uniqueness to avoid competing norms</li> <li>• increasing the internalization of developmentally enhancing norms</li> </ul>
Incentives	<ul style="list-style-type: none"> <li>• internal success criteria</li> <li>• external success criteria</li> <li>• penalties</li> <li>• rewards</li> </ul>	<ul style="list-style-type: none"> <li>• consistency between internal and external criteria of success with an emphasis on behavior consistent with finance for development</li> <li>• the existence of a reward and penalty system (emphasis on social sanctions and rewards) to enhance this behavior</li> </ul>
Regulations	<ul style="list-style-type: none"> <li>• degree of clarity</li> <li>• enforcement mechanisms</li> <li>• the homology among formal vs. informal</li> <li>• the homology among the operational, judicial and legislative levels</li> </ul>	<ul style="list-style-type: none"> <li>• ease of accessibility and understanding of regulatory climate</li> <li>• consistency between formal regulation and the rules of operation</li> <li>• consistency of the regulatory level to create a more consistent climate of regulations of banking</li> </ul>
Organizations	<ul style="list-style-type: none"> <li>• financial types (merchant, development, commercial, finance houses etc)</li> <li>• ownership</li> <li>• linkages (formal and informal, domestic and international, financial and real)</li> <li>• public regulatory; supervisory/monitoring (<i>ex ante</i>, interim, <i>ex post</i>; risk sharing; safety nets; and information facilitation)</li> </ul>	<ul style="list-style-type: none"> <li>• creating a propitious mix of organizations that are consistent with the needs of production and accumulation</li> <li>• ensuring the consistency between the regulatory and supervisory structures and financial institutions</li> <li>• expanding and creating new state organizations for increasing information flows, improving monitoring, creating safety nets and socializing risk</li> </ul>
Capacities	<ul style="list-style-type: none"> <li>• regulatory and other supervisory training</li> <li>• labor force and management training in banking and other financial institutions</li> <li>• effectiveness and efficiency of public intervention</li> <li>• capacity to stabilize relative to global and internal shocks/shifts</li> <li>• quantity and types of access to global financial flows-informational access to loan recipients</li> </ul>	<ul style="list-style-type: none"> <li>• ensuring a supply of well-trained regulators and bankers broadly defined</li> <li>• ensuring that the rate of private sector capacity growth and supporting public sector structures are consonant</li> <li>• increasing the access to less volatile long-term capital flows</li> <li>• increasing the depth and options available to shifting global and internal flows</li> <li>• new organizations to audit and evaluate accounting practices and procedures</li> </ul>

financing development. Competing norms can dissipate any effort in this direction. To be effective, norms must be internalized with an emphasis on trust and an extension of time horizons on lending. Both are important to reducing transaction costs and enhancing development. This effort must be coordinated with other institution capacity-building measures, which will both help to create new norms and enhance their overall effectiveness.

Incentives must be designed to be consistent with the new norms and to encourage their internalization. Incentives should be aimed at extending the time-horizons on lending. In the early phases of development, risk will need to be socialized and shared with the public sector in line with a clear and explicit consistency between internal and external signals of success. Lending to areas with a much greater social return (employment generating investment, new export capacities in new industries, and so on) should be a focal point of any success criteria. Both moral and punitive sanctions need to be put in place to discourage financial speculation, fraudulent behavior and lending to enterprises with little social and developmental value.

Legal boundaries must be clearly defined with an emphasis on consistency between operations and the regulatory climate. Moral suasion rather than formal enforcement of regulations needs to be emphasized with punitive options used when operational behavior is grossly inconsistent and threatening to regulatory stability.

The focus on organizational dimensions of institutions is in creating a propitious mix of ownership and financial types that can service the multifaceted needs of developing countries. This includes organizational structures with the potential to access global finance. The recent tendency in many developing and transitional economies is to fall back to a singular organizational mode largely made up of commercial banks owned by multinational institutions, whose asset structure is skewed towards government paper and loans to wealthy clients and other multinationals. They often do the very opposite of tapping global finance by exporting national savings.

Finally, capacities are perhaps the biggest challenge of the development of financial institutions, since having the rubric of laws is meaningless unless the capacities to enforce them and interpret them exist. Similarly, organizational forms that have the right to access global finance say nothing about their ability to exercise that option in a manner which avoids instability and ensures that finance flows to developmentally propitious activities.

## CONCLUSION

Developing countries were promised to emerge as winners from financial globalization as efficiency in the global allocation of resource improves. The reality has been quite different. Capital flows have been driven mostly by *push* factors (that is, market conditions prevailing in developed countries) while favorable *pull* conditions in developing countries, created by liberalization and privatization programs, have served international investors' needs for quick returns well. There is little indication that financial globalization will lead to enhanced development, yet we have considerable evidence of high social and economic costs including the circumscribing of domestic policy options for development.

Standard explanations for financial crises have focused on moral hazard and adverse selection problems or coordination failures. In particular, the crisis is seen as a domestic phenomenon associated with the macroeconomic policy trilemma. What is recommended is following a proper liberalization sequence and moving to two corner solutions: pure floating or hard peg. It is difficult, however, to see how domestic objectives can be met in a climate where financial regulation, both global and domestic, is poor and where capital flows can be overwhelming.

In our view, neoliberal policies have changed the direction and purpose of these flows with the kind of perverse consequences observed in many developing countries. It is necessary to go beyond the static approach in mainstream analysis, which underlies both the thinking about the relationship between capital flows and development and the understanding and dealing with financial crises. Following works by Schumpeter, Keynes, and Minsky, the systemic nature of instability embedded in the nexus between finance and production is recognized. The same dynamic relationship should be at the center of mechanisms for dealing with instability and improving the linkages between the financial and real sector for development purposes.

Referring to the plumbing vs. architecture metaphor used for dealing with the problems of global finance, we argued that while the architecture approach more clearly reflects an understanding of the systemic challenges, it lacks a theory of institutions or institutional transformation, that is, a new theory of institutions for financial development. Within such a framework, financial flows are seen as a series of domestic and international circuits that intersect among themselves and with the real flows of commodity and productive resources. Institutionally, each flow has a set of internally concatenating capacities, incentives, norms, regulations, and organizations.

Complex multifaceted institutional requirements are also needed to integrate domestic and global financial circuits. Integration must be circumscribed by high degrees of regulation governing the categories and terms of access to global finance. Since capacities and expertise are likely to be in limited supply, the organizational structures will move towards the creation of valve mechanisms that carefully control the linkage between internal and external financial circuits. The valve can also influence the direction of the flows towards the internal financial circuits that are propositionally connected to real circuits.

The challenge of asymmetric power relations in international finance is profound, requiring a new set of theoretical tools. While it is essential to reform the international financial system in a fundamental way to deal with financial crises, developing countries will also need to find institutional mechanisms at the domestic level to counter the asymmetries of the system. We should explicitly recognize that asymmetric power relations are partly the result of asymmetric institutional development. One of the focal points should be on institutional development in a manner that deepens the linkages between finance and development. Capital flows should serve the needs of developing countries rather the perverse inversion that we have witnessed in recent years.

## NOTES

1. World foreign direct investment stock relative to GDP increased from 4.6 percent to 14 percent between 1980 and 1998. A similar trend has occurred in non-foreign direct investment flows with cross border transactions in bonds and equities relative to GDP. In developing countries as a whole, the ratio of foreign direct investment stock relative to GDP grew from 4.2 percent in 1980 to 19 percent in 1998, while non-foreign direct investment flows increased eight-fold between 1990 and 1996 alone.
2. See Arestis and Demetriades [1997] for the synthesis of the empirical evidence.
3. Many economists of the early days such as Schumpeter [1911], Gerschenkron [1962], and Gurley and Shaw [1967] emphasized the truly dynamic nature of the finance-growth nexus, to which we shall return in the next section.
4. This means less freedom for providing social safety nets to people adversely affected by globalization.
5. At the annual meeting in Hong Kong in 1997, the IMF sought an amendment to its Articles of Agreement, which would codify the Fund's role in promoting open capital markets, as well as member countries' obligation to work toward the same goal [Fischer, 1997].
6. Aizenman acknowledges that while there is solid evidence that financial opening increases the chance of financial crisis, there is more tenuous evidence that financial openness contributes positively to long run economic growth.
7. As the Asian financial crisis unfolded it was claimed to be specific to the East Asian Model due to crony capitalism, riddled by insider dealings, corruption and non-transparent corporate governance. The economic policies in East Asia, which were previously regarded as a key ingredient in creating a miracle, were suddenly written off as a curse for engendering the disaster.
8. Fisher [1933] defined debt deflation as a condition when highly leveraged borrowers receive a small shock that can affect their net worth and trigger a series of bankruptcies. This in turn reduces investment and demand, and leads to cumulative price deflation. Under this condition, we observe the combination of rising excess supplies, falling prices, and a further collapse in demand.
9. Extending Minsky's analysis to the open economy case, Arestis and Glickman [2002] examine how openness creates a state of internationalized financial fragility, and apply this model to explain dynamics of the financial crisis in Southeast Asia.
10. Kregel [1998] suggests that derivative contracts may have played an integral role in creating a cumulative causation that produced unexpected declines and excessive instability in both currency and asset markets during the height of the Asian crisis.
11. For example, the dynamic model of credit cycles [Kiyotaki and Moore, 1997] is built on these concepts to describe three types of financial shocks: a credit crunch, collateral squeeze and savings squeeze.
12. Capacity building has become a focal point in the World Bank's recent publications, whose formulation has centered on building "good governance" structures in states through the improvement of "accountability, transparency and the rule of law" [World Bank, 1992]. These vacuous terms reflect a neoclassical economic vision of neutral states as the guarantors of property rights and contract enforcement [Stein, 2000]. In contrast, our concept developed here refers specifically to the purposeful capacity building of institutions and systems that could lead to enhanced *development* finance.

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