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Emerging Market Economies: Liberalization and Performance Nexus

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I. Introduction

In this paper the author makes an attempt to explore the impact of liberalization on the economic and financial performance in emerging market economies. To keep the scope of the paper limited and focused, he deals only with the financial sector liberalization. Its next major focus is on exploring whether financial sector and capital account liberalization results in growth in the emerging market economies. Another important issue at the beginning of the twenty first century is that of volatility in the emerging markets. This paper delves into the rationale behind volatility, and how liberalization of capital account causes it.

The principal thesis of this paper is that financial development and liberalization affect the growth rate in a significantly positive manner. Deregulation creates an environment that that greatly facilitates economic growth. Although there is no consensus on the impact of capital account liberalization on growth, the allocative efficiency hypothesis still holds. Many analysts support it. It was believed that capital account liberalization leads to volatility, which led to a support of policy to restrict global capital flows. However, this support was limited. If capital account is liberalized in a planned and sequential manner and if short-term capital flows are liberalized last, and kept under limits, the risk of volatility in the economy declines considerably. Similarly, it was believed by some that liberalization of equity markets causes volatility. However,

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the equity markets' volatility was not intensified by financial liberalization. If anything, the opposite was true. The cycles of upswing and down swings in equity markets become smoother after they are liberalized. There are intertemporal differences in the impact of financial liberalization over the equity market. Integration of domestic equity markets in the emerging market economies with the global financial markets contributes to a decline in volatility.

The structure of this paper is as follows: Section II. delves into the recent liberalization endeavors in the emerging market economies. In Sections III. and IV. answer the following queries: whether there is a link between liberalization and GDP growth on the one hand and capital account liberalization and growth on the other. The next two sections concentrate on the analysis of how capital account liberalization as well as liberalization of domestic stock markets affects volatility. Section VII. provides a brief summary.

II. Liberalization of the Financial Sector

The financial distortions that commonly affect functioning of financial systems in most developing and industrial economies are well known, the former suffer far more than the latter. Until the early 1970s, domestic financial repression was widespread. Industrial economies suffered from some features of financial distortions and repressions. Controls on interest rates, size of bank loans, prohibitions on foreign currency denominated deposits and loans, dual currency markets, were endemic. Typically, repressive policies included controls over interest rates on both deposit and loan as well as over exchange rates, capital markets and capital flows. Government policies of directing credit were an important part of financial repression. Therefore, often government-favored sectors and industries obtained credit at negative real interest rates, while others had to depend upon the expensive and unstable informal credit market.

Policies related to directing credit segmented domestic financial markets. In addition, in many developing economies the banking sector had either partial or complete public ownership. It typically led to negative real interest rates for the depositors, eventually discouraging savings. Equity markets in the developing economies were small, underdeveloped and restricted. That is, non-residents were not allowed to participate in the domestic equity markets. Due to ceilings on interest rates capital accumulation was severely restricted in the developing economies. These economies were by definition capital scarce. Cumulative impact of financial repression was emaciated domestic saving rates, inefficient capital allocation, and languished financial intermediation. Economic growth endeavors suffered. During this period, policy mandarins incorrectly considered financial repression an accepted policy stance for economic growth during this period and academics were yet to raise their dissent strongly.

Many developing economies took note of the adverse macroeconomic impact of financial repression, albeit belatedly. The ones that were subsequently classified as the emerging market economies began to liberalize their financial sector and markets in the mid-1970s. This liberalization was characterized by, first, reforming the banking sector with the deregulation of domestic interest rates. Second, by opening of capital account in varying degrees. Third, restrictive measures on domestic equity markets as well as those on foreign ownership of financial assets, began to be dismantled. The elimination of interest rate controls not only affected the market on bank loans and deposits but at a later stage also attracted international capital flows. Elimination of credit rationing and controls contributed to expansion of stock markets. Thus, in the liberalization process, liberalization across individual segments of financial market matters as much as liberalizing the one that triggers all financial markets and the economy.

The financial liberalization measures alluded to above included lifting of various financial controls, eliminating restrictive policies like credit rationing to favored sectors and industries, dismantling foreign currency related regulations and relaxation of official barriers to consolidation. In addition, liberalization also allowed foreigners to own domestic securities. Removal of prohibitions on repatriation of dividends and interest followed. These reform measures brought about a radical change in the complexion of financial systems and macroeconomic management. With multiple exchange rates gone and capital controls dismantled, domestic firms began to borrow abroad. Liberalization of equity markets provided global investors opportunities to invest in the emerging market economies securities. The domestic investors in these economies were able to transact in global securities. It was believed that financial liberalization reduced costs of financing, in this case external financing, for the firms and therefore promoted growth (Rajan and Zingales (1998)). Or one can say that firms that needed external finance in economies that were liberalizing their financial sector during this period grew disproportionately faster than those in economies that were not liberalizing their financial sector.

Over the last two decades, many emerging market governments have gradually deregulated. They have relaxed official barriers to consolidated, noted in the preceding paragraph. Deregulation has influenced the restructuring process through changes in entry conditions and market competition. In the new deregulated environment, legal and regulatory framework has been reconsidered and given a new focus. In the past its focus was consumer protection and prevention of institutional failures. As opposed to this, the more recent focus of the legal and regulatory framework is no longer strict regulatory control but creating a system that is based on enhancing market and institutional efficiency through competition. The principal elements of the new system are market discipline, supervision and risk-based capital guidelines. This system is obviously less concerned with the prevention of institutional failure. Instead of being protective of financial services providers, the new environment encourages banks to fend for themselves in the marketplace – as the non-financial businesses have always done.

Kaminsky and Schmukler (2001) studied the progress of financial liberalization over 1972–99 period in both the G-7 industrial economies and various regional sub-groups in the developing world.[1] They prepared a composite index of liberalization of various segments of financial markets, including the capital accounts, domestic financial systems, and stock markets. They found that during the period under review removal of financially repressive measures was slow but continuous globally. They also concluded that the G-7 industrial economies were the first to liberalize their financial sectors. It is possible that disenchantment with the restrictive policies of the interwar years had something to do with their eagerness to financially liberalize at the first possible opportunity. By mid-1970s, the financial sector in the G-7 economies was considerably liberalized and not many restrictive practices were left untouched. Financial liberalization in the West European economies was also adopted early and followed through in a rapid manner.

Several emerging market economies of Asia, particularly those of East Asia, steadily liberalized their financial sector after 1972. They were followed by the emerging market economies of Southeast Asia. After 1995, progress in further liberalization slowed down these economies. It seemed that their liberalization endeavors reached a plateau after this time point.

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1 The G-7 group of countries comprises Canada, France, Germany, Italy, Japan, the UK and the US.

In the emerging market economies of Latin America, financial repression was removed in an uneven manner. In the early 1970s, this country group liberalized its financial sector rapidly. During this period, it was spearheaded by the southern cone economies. They advanced towards adopting *laissez faire* financial policies that encouraged private sector participation as much as possible. Governments in the southern cone economies tried to adopt a hands-off stand. However, the outcome of rapid and extensive liberalization was a large number of bankruptcies and generalized financial crisis in Latin American economies. After the debt crisis of 1982, financial liberalization was neglected in this country group. However, during the 1989–92 period maximum progress took place in this direction (Kaminsky and Schmukler (2001)). In the latter half of the 1990s, the emerging market economies of Latin America not only returned to liberalization in right earnest, but also implemented regulatory and supervisory mechanisms so that crises could be avoided.

III. Is There A Liberalization and Growth Nexus?

Effects of controls on financial markets, capital flows and economic growth have been a prolific area of empirical research in international economics. Researchers in economic growth have also addressed the issue of financial liberalization and development of the financial sector. Whether liberalization has contributed to fast-clip growth in the emerging market economies is an important, albeit difficult, question to answer. Although researchers in several disciplines have studied the financial liberalization-economic growth nexus both theoretically and empirically, there is no categorical conclusion regarding the contributions of financial liberalization to economic growth in the emerging market economies. Neither theory provides a clear answer regarding how liberalization impacts growth nor do empirical studies. Many of these studies remained inconclusive.[2] Most researchers have tended to focus on the effects of deregulation of domestic financial markets, like the stock markets and banking sector. Besides, capital account liberalization *per se* remained a controversial policy measure and its effect has been little understood. While several attempts were made, measuring its impact has remained a problem-ridden task.[3]

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2 Williamson and *Mahar* (1998) provide a detailed survey of financial liberalization endeavors.

There are four important causes behind this disappointing state of affairs. The first hurdle was the lack of homogeneous measures of financial liberalization policies across countries and time.[4] Second, in general the scope of the empirical studies was limited. They focused on one kind of reform measures, or elimination of controls on one particular financial market. Some of these studies concentrated on the elimination of controls on the banking sector, others on stock markets, and yet others on capital account liberalization. However, financial repression can take many forms. Restrictive measures on one market not only affect it directly but also the other financial markets indirectly. As expected, narrowly focused studies produced inadequate evaluation of the effects of financial liberalization.

Third, in almost all the empirical studies problem of omitted variables was found. Financial liberalization is seldom adopted as a solitary or exclusive policy measure. This policy measure is generally a part of a comprehensive liberalization policy package and includes measures like trade liberalization, improved investment policies, privatization and strengthening of private property rights. Sachs and Warner (1997) emphasized that policy choices in these areas are important determinants of long-term growth. Therefore, to calculate the impact of financial liberalization on economic growth it is important to controls for all the other reform measures that were adopted as a part of the larger policy package. In addition to these shortcomings, Eichengreen (2002) pointed out that different emerging market economies have different macroeconomic, financial and political traits. Each economy has its idiosyncratic institutional strengths and weaknesses. While quantifying the growth impact of financial liberalization, these differences must be taken into account. A lack of this perspective, further adds to the difficulties of the empirical studies as well as calls into question the acceptability of their results.

Models based on perfect market assumptions conclude that liberalization has welfare-inducing implications for market participants, both lenders and borrowers. Theories posited by McKinnon (1973) and Shaw (1973) as well as others have pointed out that welfare enhancing effects of financial liberalization can work through interest rate mechanism. In

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3 *Rajan* and *Zingales* (1998) and *Eichengreen* (2002) provide a literature survey of the empirical studies that attempt to quantify the growth impact of capital account liberalization.

4 This was a common weakness of empirical studies, although *Kaminsky* and *Schmukler* (2001) did manage to develop a homogeneous dataset for several dimensions of financial liberalization.

a liberalized regime, the interest rates rise (or fall) to their competitive market equilibrium level, which leads to efficient allocation of productive resources. The second channel of welfare gains could work through capital account liberalization. Third, in a developing economy setting, it is not inappropriate to assume that financial markets are imperfect and that capital constraints are endemic (Hubbard (1998)). Given these circumstances, external finance will be typically more expensive than domestic finance, which in turn would make the rate of domestic investment sensitive to external capital flows. In such developing economies, if equity markets are liberalized, one of the direct effects should be easing of capital constraint because more global capital can flow in. A possible indirect effect would be improvement in the quality of corporate governance. Improvement in corporate governance is sure to lead to improvement in risk sharing. Together these two effects should force the cost of capital down.

Among the financial economists, Goldsmith (1969) was the first to address the issue of growth impact of financial liberalization, followed by seminal contributions of McKinnon (1973) and Shaw (1973). Their proposition regarding this relationship was simple and positive. They concurred that liberalization favorably affects economic growth by, first, strengthening the size and improving the efficiency of the domestic financial system, second, by allowing domestic firms to access the global financial markets, and third, by improving the level of corporate governance in the domestic financial system and thereby reducing the agency problems. The focus of McKinnon (1973) and Shaw (1973) was also the advantages of reducing financial repression prevalent during their period. They pointed out that among advantages of reducing financial restrictions were higher savings rates, improved allocation of resources and a lack of compulsion to adopt dualistic growth policies.

Including static and dynamic factors subsequently refined this scenario. Financial liberalization promotes foreign competition in the domestic banking and non-banking financial sectors, reducing cost of capital. It allows the financial institutions in the emerging market economies to adopt the newest financial know how, instruments, products and technologies. Financial deregulation and reforms fuel institutional reforms. Additionally, when domestic firms begin accessing the global capital market, their cost of capital declines and raises the level of domestic investment. There can be little doubt that there are static and dynamic impacts of these developments as well, which in turn buttress GDP growth rate.[5] As firms begin to tap global capital and securities markets, a large font of capital and stockholder base becomes available to them. Domestic financial constraints are eased by the availability of the greater quantum of capital (Gilchrist and Himmelberg (1998)).

In addition, there is an important indirect effect. Capital allocation by markets improves the efficiency of allocation and financial resources head for sectors having comparative advantage that were constrained during the period of financial repression (Sarkissian and Schill (2001)). A good deal of evidence of these static and dynamic effects was provided by several emerging market economies. The liberalized emerging markets came to have an opportunity to grow and develop like their counterparts in the advanced industrial economies.

Recent studies have supported what McKinnon and Shaw posited three decades ago, that is, corporate governance in the emerging market economies was favorably affected by financial liberalization. Competition from foreign banking and non-banking firms did exert pressure on their domestic counterparts to adopt *a la mode* financial and banking practices as well as internationally accepted accounting standards, regulatory practices, and supervision norms. Financial liberalization also promotes transparency and accountability, reducing adverse selection and moral hazard problems. These improvements in corporate government tend to reduce the cost of borrowing in the banking sector and securities markets.[6] Other than promoting competition, liberalization enhances the opportunities for smoothing out the effects of real shocks. In this respect liberalization, including capital account liberalization, plays a stabilizing role.

However, this line of logic has been challenged. Skeptics argued that it is not necessary that access to global capital market would increase availability of capital. When firms are allowed to list on bourses abroad, it can potentially inhibit the development of domestic financial markets and reduce domestic liquidity. The depth of the domestic financial markets suffers. The inverse correlation between the amounts of aggregate capital raised by firms in emerging market economies in Latin America in the American Depository Receipt (ADR) market and the number of initial public offerings (IPOs) in the domestic markets corroborates this argument (Moel (2001)).

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5 Several recent studies provide evidence to these static and dynamic effects. For instance, refer to *Klenow* and *Rodriguez-Clare* (1997); *Bekaert* and *Harvey* (2000); *Bekaert* et al. (2001); *Henry* (2000a); *Henry* (2000b).

6 Some of the recent studies that bring out this point are *Claessens* et al. (2001); *Galindo* et al. (2001); *Moel* (2001); *Mishkin* (2001).

Skeptics also argue that efficiency in capital allocation cannot come about by mere removal of distortions caused by financial repression. As alluded to earlier, removal of one set of distortions cannot be welfare enhancing when many others remain intact. For instance, there were cases when capital account was liberalized during the period of high tariff barriers for protecting import competing industries. In such a case, capital went to industries that did not have comparative advantage, which was not welfare enhancing. If anything, it was welfare diminishing.

Additionally, Stiglitz (2000) has argued that in an environment of information asymmetries in the financial markets, there is little possibility of financial liberalization leading to welfare improvement. Moral hazard should be added to asymmetric information in the developing economies.[7] Stiglitz's contention applies *aforetiori* to an environment where corporate governance is weak and property rights are not strongly held. Only liberalizing financial markets would never ensure flow of capital to uses where its marginal product exceeds its opportunity cost. Therefore, Stiglitz supported certain forms of financial repression and credit rationing. He argued that if credit is channeled towards export sector or towards those with high technological spillover, the final result could no doubt be acceleration of growth rate (Stiglitz (1994)). However, his argument is not without its downside. This kind of financial repression increases the power of bureaucracy and promotes rent seeking. In capital allocation decisions, competence of bureaucrats was generally found to be less than that of imperfect markets.

Information asymmetry, alluded to in the preceding paragraph, is perhaps the most often cited asymmetry in the capital markets. They exist in the goods markets as well, but they are far more in number as well as more pronounced in asset markets. Due to information barriers, geographical distances and cultural differences, the problem of information asymmetry is exacerbated in the international capital markets. In addition, market imperfections of this genre are further magnified in the international capital markets due to difficulties in entering and enforcing contracts across borders. Information asymmetries do lead (and have led) to over reactions by global investors on both sides, investing freely and withdrawing massively (Zeira, 1999). Growing globalization of capital markets and declining transaction costs can (and did) make global investors rationally "exuberant". In such an environment, information asymmetry leads to herding behavior, which manifests itself in "excesses", or

7 See *Hellman*, *Murdock* and *Stiglitz* (2000).

booms and bursts in the international capital markets (Calvo and Mendoza (2000)).

Numerous empirical studies of the impact of financial liberalization on growth are available in the literature. Several of them have been cited below. They essentially took two routes for selecting variables to deploy and for quantifying their results. Some of them selected one proxy variable or the other for financial liberalization, while the other studies focused on specific liberalization strategies for quantifying how liberalization affected growth. Earlier empirical studies were narrow and considered the real interest rates as an adequate measure for financial repression. These studies considered the sign of the interest rates an important indicator and assumed that economies with negative real interest rates were financially repressed while those with positive real interest rates were not.[8] These studies concluded that growth rate in economies with negative real interest rates suffered. They found that its opposite was equally true. This indicator of financial repression was subsequently rejected as inadequate and some studies adopted the ratio of credit to the private sector to GDP as a measure of financial liberalization (De Gregorio and Guidotti (1993)). Other indicators of financial development were also taken as proxies of liberalization.

After several cross-country studies with large numbers of sample countries, a gradual consensus emerged on financial development and liberalization affecting growth rate in a significantly positive manner. Deregulation creates an environment that that greatly facilitates economic growth.[9] As discussed below in this section, the evidence on the benefits of financial liberalization and deregulation on real per capita GDP growth was found to be strong. Reinhart and Tokatlidid (2002) not only supported this result but also added that financial liberalization delivers a higher level of foreign direct investment (FDI) and gross capital flows. But the catch is that it occurred only in the higher income emerging markets. Financial liberalization appears to deliver financial deepening, but again in the higher income emerging markets. Economies that shunned financial repression – or more realistically dropped it at an early stage of development – and liberalized their financial sector stood a better chance of turning into emerging market economies.

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[8] Refer to studies by the *World Bank* (1989) and *Roubini* and *Sala-I-Martin* (1991).

[9] Results of several empirical studies can be cited for this purpose. For instance, refer to *Ghani* (1992), *King* and *Levine* (1993), *Levine*, *Jayaratna* and *Strahan* (1996); *Loayza* and *Beck* (1999) and *Beck*, *Levine*, and *Loayza* (2000).

Although the general acceptability and robustness of these results was high, they need to be taken with a degree of skepticism. While they related financial liberalization with growth, they ignored other structural and macroeconomic developments that were progressing with the implementation of financial liberalization measures. Simultaneity of reform measures was a capital issue, which made it difficult to isolate the effects of financial components of the reform package. While it was possible that financial liberalization played a leading role, it certainly was not the most crucial one and never the only strategy affecting growth rate in the economies being studied. Under certain circumstances, financial liberalization can have no impact on financial development at all. Emerging economies in Latin American have provided an evidence of this. Using thirty-year data from the *World Development Indicators* Galindo, Micco and Ordonez (2002) demonstrated that all regions experienced a significant impact on their financial systems as they liberalized. Latin American economies were an exception to this generalization. They recorded a decline in the size of their financial system during the financial liberalization period in Latin America.

Empirical research focusing on specific liberalization strategies for quantifying how liberalization affected growth has not made a great deal of headway. Not many researchers have tried this route essentially because of the constraints related to liberalization data. Bekaert, Harvey and Lundblad (2002) is one of the few comprehensive cross-country studies of this kind. They took a dynamic panel of industrial and developing economies and conducted a number of empirical exercises that instill confidence in their results. They survived several econometric robustness experiments, including controlling for the global business cycle. In addition, their results were found to be robust to alternative measurements of the liberalization variable. Although their liberalization variable was a 0/1 indicator, they also used a number of variables that measured the intensity and comprehensiveness of the equity market liberalization. They concluded that stock market liberalization affected growth permanently. When they augmented the standard set of variables used in economic growth research with an indicator variable for equity market liberalization, they found that liberalization of equity markets led to a one percent increase in annual real per capita GDP growth over a five-year period. This increase was found to be statistically significant. They also showed that financial liberalization increased the investment/GDP ratio and factor productivity. The one percent increase in real GDP is surprisingly large, even counterintuitive. However, it can partly be explained by the fact that equity market liberalization measures are intertwined with both macroeconomic reforms and other financial sector developments.

Indirect transmission channels between financial liberalization and growth rate have also been studied. Important among these studies is one by Laeven (2000), which took twenty-year data for thirteen emerging market economies to conclude that liberalization process eased financial constraints, particularly those faced by large domestic firms. Results of Galindo, Schiantarelli and Weiss (2001) are important in that they inferred that financial liberalization enhances the allocative efficiency of investment. Although some of these studies have been controlled for parallel on going reforms, the simultaneity of reforms argument applies to this set of studies also because it is unclear how large the controls were. It was difficult to determine whether these controls were large enough to isolate the effects of financial liberalization.

Galindo, Micco and Ordonez (2002) addressed this issue from a cross-industry-country panel data perspective. They improved upon the methodology of Rajan and Zingales (1998); their approach allowed isolation of impact of financial liberalization on growth. Using time series of cross-industry-country data for 28 economies, they estimated the same empirical model as Rajan and Zingales (1998). Their inference was that financial liberalization is an instrument that under certain conditions can promote financial sector development, which in turn "can stimulate the relative growth rate of sectors that rely on external funding". However, they found that a caveat is essential, that is, for rapid growth other structural reforms that ensure proper behavior of financial markets are also essential. Financial liberalization is necessary, albeit not sufficient for rapid growth. In a fully liberalized economy, "the impact of liberalization on domestic credit market growth can be null" if regulatory and institutional support are lacking.

Integration with the global markets and institutions tends to speed up the reform process to achieve a resilient financial system. Summing up these arguments, one can conclude that the emerging market economies have benefited from financial liberalization in two ways. First, by having an increased access to global pool of capital, which helped raise the level of investment and output. The second channel of benefit was improvement in the efficiency of capital allocation. Both of these are known to underpin economic growth. Despite the polemists, current drift of opinion among the international economists is towards financial liberalization and deregulation. They still endorse removal of capital controls because they consider capital markets work in an efficient manner without them. In a control free financial environment capital is likely to flow towards the most lucrative destination. The obstreperous view, that supports controls or gradual liberalization, argues that financial liberalization amounts to lurching into excesses of trans-border financial movements. This logic in the international economics literature as well as in the capital market literature is based on the view that market failures and distortions pervade capital markets around the world.

If, as stated above, a consensus has emerged on financial development and liberalization affecting growth rate in a significantly positive manner, why so many economies still have an under developed financial sector? A common, if simplistic, answer is that it is due to a lack of demand. Demand for financial development is determined by economic growth and industrialization. It has been observed that economies at the same level of development differ widely in the level of financial development. Several alternative explanations have been provided including lack of social capital necessary for financial development and weak legal, cultural and political systems. Countries with a Common Law and strong minority investor protection have better developed financial, particularly securities, markets. Structuralists also try to provide an explanation for the differences in the level of financial development. According to them, in some economies there can be real structural impediments to the development of financial sector. Once these impediments are surmounted, the supply of finance should rise to meet demand.

Experiences of the last two decades have demonstrated that financial liberalization is not risk free. It has been observed that it leads to overborrowing. McKinnon and Pill (1999) have presented a formal framework demonstrating how and when financial liberalization may lead to bouts of over borrowing. This propensity was found to be magnified when domestic financial liberalization was undertaken along with, or a little before, capital account liberalization. As the rising levels of debts are in foreign currency, the economy soon becomes vulnerable to exchange rate fluctuations. Thus, financial liberalization becomes the cause of volatility. This issue has been discussed in Chapter 5.

IV. Is There A Capital Account Liberalization and Growth Nexus?

Although capital account liberalization is subsumed in financial liberalization, it has been an important issue for the emerging market economies and deserves to be analyzed as a distinct policy move. During the last quarter century, several emerging market economies, that were capital-poor, permitted non-residents to participate in their domestic stock markets. In the wake of recent economic and financial crises in several emerging market economies capital account liberalization has taken on additional importance. Some of the blame for the recent crises went to premature or poorly sequenced liberalization of capital account, which has been dealt with below.

Over the years, two broad views have emerged regarding how capital account liberalization affected an economy, particularly the financial sector. The allocative efficiency view is the older one and better debated of the two. To state it briefly, when capital account barriers on the flow of capital are removed, trans-border capital movements begin. Capital tends to move from capital-abundant economies, where the marginal rate of return is lower, to capital-scarce economies where the marginal rate of return is rationally expected to be higher. In the latter country group, the cost of capital declines which in turn favorably impacts investment and output. (Fischer (1998); Stulz (1999); Mishkin (2001)).

The newer view was put forward by Rodrik (1998) and Stiglitz (2000a and 2000b). It was christened the "animal spirit" and treated the older view of the impact of capital account liberalization simplistic, if not downright fanciful. The proponents of this view, as opposed to the old one, believe that capital account liberalization does not result in efficient allocation of financial resources because international capital movements have little connection with real economic activity in the host economies. They posited that capital account liberalization has no impact on domestic investment, output or any real variable with non-trivial welfare implications.

Opening the stock markets for non-residents comprises a discrete change in the degree of capital account openness. As several emerging market economies liberalized their capital accounts and allowed non-residents to purchase shares in their stock markets, statistical data to empirically examine the two above-mentioned hypotheses regarding the impact of capital account liberalization are readily available. Allocative efficiency hypothesis can be tested in two ways with the help of time series data for the prices and quantities of capital during the liberalization period (Chari and Henry (2002)). The first method could be to examine whether cost of capital has been driven down and Tobin's q has been driven up by the inflows of global capital after the liberalization of capital account. Tobin's q stands for the asset market value of installed capital goods relative to their replacement cost. The second testing method could be that profit-maximizing firms may respond to a rising level of Tobin's q by increasing investment in physical capital. This increase in the level of investment would continue until the asset market value of capital goods and their replacement costs are equalized. If the allocative efficiency hypothesis is correct, data should reveal a temporary increase in Tobin's q as well as in investment after capital account is liberalized. However, if the animal spirit view of things is correct, there should be no discernible increase in prices and quantity of capital inflows during the liberalization episode.

Chari and Henry (2002) made time series and cross-sectional estimates on data for the 1980–94 period for 369 firms in India, Jordan, Korea, Malaysia, and Thailand and found that time series results were more consistent with allocative efficiency hypothesis than with animal spirit hypothesis. They concluded that a typical firm does experience both an increase in Tobin's q and investment during the liberalization episode. For their sample firms they found that during the year the capital market was liberalized, the growth rate of capital stocks exceeded their pre-liberalization mean by 4.1 percent. During the next three years the average growth rate of capital stock for the 369 firms in the sample exceeded its pre-liberalization mean by 6.1 percent. As opposed to this, cross-sectional estimates were found to be more consistent with animal spirits hypothesis. Other recent studies reached same or similar results. For instance, Bekaert and Harvey (2000) and Henry (2000a and 2000b) provided evidence of capital market and stock market liberalization leading to higher stock prices and more investment in the economy. Conversely, Rodrik (1998) provided evidence from aggregate cross-sectional data of no significant relationship between the investment/GDP ratios in the sample economies and openness of capital account, supporting the animal spirit hypothesis.

These results need to be carefully interpreted. The two sets of results suggest that neither of the two hypotheses provide a completely accurate view of the impact of liberalization of capital account. Although liberalization of capital account may encourage the movement of capital from capital-abundant to capital-scarce economies, only this policy measure is certainly not enough to ensure efficient allocation of productive capital between firms and sectors.

V. Capital Account Liberalization and Volatility

Macroeconomic and financial volatility are a well-known downside of financial liberalization. As alluded to earlier, in the early 1970s, the emerging market economies of Latin America liberalized to end their much-criticized financial repression. Soon these economies found themselves in the midst of macroeconomic crises and hoards of bankruptcies. After the emerging market financial crises of the 1990s and early 2000s – which claimed a good number of emerging market economies as their victims – this characteristic of financial market liberalization acquired a new significance.

Kaminsky and Reinhart (1999) have established a link between financial liberalization and economic, financial and balance-of-payments crises. All of these crises were traumatic and had high economic and social costs. The individual emerging market economies suffered as much as the global economy. The emerging market economies of East and Southeast Asia had successfully established their reputation as high performers. In 1997, several of them succumbed to their worst recessions in decades. The global banking and financial system was also adversely affected during several occasions during this period. Global capital market flows to emerging market economies, which were booming in the early and mid-1990s, declined to a trickle by 1997 and 1998. Until 2002, capital markets flows to emerging market economies in the form of bank lending, bond lending, equity flows and other flows had not recovered, although foreign direct investment (FDI) had held firm.

An important casualty of these crises was the rising trend towards financial liberalization, both at the domestic and global tiers. Opinion leaders like Paul Krugman (1998) and Joe Stiglitz (1999) began opposing financial liberalization and supporting restrictive global capital flows.[10] They began to blame unrestricted trans-border capital flows for disorderly capital market behavior, both domestically and globally. Their logic was that restrictions on global capital flows would help in moderating "excessive boom-burst" pattern in financial markets so prevalent in the 1990s and early 2000s. Krugman[11] (1998) even suggested controls on capital outflows, which sounded like an archaic notion. In the early 1970s, this and similar propositions were opposed as inefficient and counter productive. Indiscriminate advocacy of greater financial liberalization

10 Other economists who proposed limiting capital flows included *Rodrik* (1998).

11 *Krugman* strongly supported Malaysia's adoption of capital controls in 1998.

and development virtually stopped. Saving grace behind the proposals of restrictions over capital flows was that they were more of less intended for a short-term, for the purpose of handling a crisis situation and for obstructing disorderly retreat of global investors in a crisis-ridden economy. As a permanent policy measure, these proposals did not win many supporters.

Distortionary macroeconomic policies and volatility have been found to be closely related. Inapt macroeconomic policies like excessive government spending, high inflation, and over-valued exchange rate render an economy prone to crisis. Demirguc-Kunt and Detriagiache (1998) blamed macroeconomic and financial instability on the lack of institutional development in an economy. The likelihood of financial crisis in the wake of financial liberalization declines with the rising level of institutional development. Creating and strengthening institutions is the task of the governments. Thus, government intervention in the system in the form of (a) institutional development, (b) prudential regulation and (c) supervision has a convincing justification. At least in the early stages, governments in the emerging market economies need to ensure proper functioning of the financial system and therefore intervene more than in the later stages when these developments have made a reasonable progress. If regulation and supervision progress hand in hand with financial liberalization, the negative impact of financial liberalization on the emerging market economy can be reined in (Das (2002)).

In the early stages, liberalization can have a destabilizing effect over the financial sector because it abruptly increases the exposure to credit risk and foreign exchange risk – *a fortiori* when liberalization is undertaken in an environment of macroeconomic stability. In a newly liberalized financial environment, managers lack the experience to manage the two risks named earlier and have a tendency to push towards riskier investments. In such a financial environment even soundly managed banks feel it to be a good strategy to build up large open foreign positions abroad to finance domestic assets, or to engage in foreign exchange lending to domestic residents. As stated in the preceding paragraph, this situation calls for government intervention and strengthening of regulatory and supervisory framework.

VI. Liberalization of Equity Markets and Volatility

During the recent episodes of crisis in the emerging market economies, stock markets displayed an excessive boom-burst behavior. Many asked the question, "Did liberalization of the equity market cause it?" To answer the question whether liberalization of equity markets triggered recent spate of financial excesses and crises in the emerging market economies, Kaminsky and Schmukler (2002) examined the possible time-varying pattern of financial cycles before and after financial liberalization in 28 emerging market and industrial economies since 1973. They focused on the duration of upturns and downturns in financial markets, and the magnitude of cycles, taking into account the fact that characteristics of stock market cycles have changed over time. They compared the characteristics of these cycles during episodes of repression and financial liberalization.

Kaminsky and Schmukler (2002) answered the rhetorical question raised above in a negative manner. They took into account the financial crises in the emerging and industrial economies, including the crises of the 1990s, before concluding that financial cycles in the equity markets were not intensified by financial liberalization. If anything, the opposite is the truth. Equity market cycles become smoother after liberalization. Interestingly they found intertemporal differences in the impact of financial liberalization over the equity market. Liberalization tended to trigger more explosive financial cycles in the immediate aftermath of financial liberalization. However, in four years after liberalization the equity market volatility became markedly less pronounced. This observation applies to both emerging market economies as well as the matured industrial economies.

In this scheme of things, integration of domestic equity markets in the emerging market economies with the global financial markets contributes to a decline in volatility. The expectations of non-resident investors have something to do with this development. Better skills and information enable the non-resident investors to monitor the management of firms in which they are purchasing stocks. Before liberalization, the domestic investors were unable to do so because they did not have this capability. Equity market liberalization also allows domestic firms, at least the large ones, to access matured capital markets for capital. When firms list on the large global bourses, they find themselves within the jurisdictions of a superior legal system than the one they had at home. They need to become more transparent and respond to higher information disclosure standards of their new hosts. During the 1990s and 2000s a good number of firms from the emerging market economies, particularly from the Asian and Latin American emerging market economies, began to list on foreign stock markets. These developments and new institutional norms tend to attenuate "excessive" financial cycles. In addition, as this kind of two-way expansion and diversification progresses, equity markets in the emerging market economies become less sensitive to actions of single large investors, which also dampens the tendency towards market volatility.

VII. Conclusions and Summing-up

Evidence suggests that financial repression and resulting distortions affected functioning of financial systems in most developing economies. Until the early 1970s, domestic financial repression was widespread. Even some of the industrial economies suffered from some features of financial distortions and repressions. They caused emaciated domestic saving rates, inefficient capital allocation, and languished financial intermediation. Economic growth suffered. Several emerging market economies of today earnestly adopted liberalization of their financial sector as a strategy.

Although economists of differing hues have extensively studied financial Liberalization and growth Nexus, there were several difficulties in establishing a direct link. Early studies of scholars like Goldsmith, McKinnon and Shaw considered this link to be a direct, simple and positive one. It worked by strengthening the size and improving the efficiency of the domestic financial system, by allowing domestic firms to access the global financial markets, and by improving the level of corporate governance in the domestic financial system and thereby reducing the agency problems.

This scenario has been studied and refined by including static and dynamic factors. A good deal of evidence was provided by several emerging market economies regarding foreign competition promoting in the domestic banking and non-banking financial sectors, reducing cost of capital. Also, when domestic firms begin accessing the global capital market, their cost of capital declines and raises the level of domestic investment. There can be little doubt that there are static and dynamic impacts of these developments. Efficiency of capital allocation by markets improves and financial resources head for sectors having comparative advantage that were constrained during the period of financial repression tress growth rate. Recent studies have also supported what McKinnon and Shaw posited three decades ago, that is, corporate governance in the emerging market economies was favorably affected by financial liberalization. Financial deregulation and reforms fuels institutional reforms. Integration with the global markets and institutions tends to speed up the reform process to achieve a resilient financial system. Thus, liberalized emerging markets came to have an opportunity to grow and develop like their counterparts in the advanced industrial economies.

However, this line of logic has been challenged. Skeptics argued that it is not necessary that access to global capital market would increase availability of capital. They also argue that efficiency in capital allocation cannot come about by mere removal of distortions caused by financial repression. In an environment of information asymmetries in the financial market, there is little possibility of financial liberalization leading to welfare improvement. Moral hazard should be added to asymmetric information in the developing economies.

A gradual consensus has now emerged on financial development and liberalization affecting growth rate in a significantly positive manner. Deregulation creates an environment that greatly facilitates economic growth. Evidence on the benefits of financial liberalization and deregulation on real per capita GDP growth was found to be strong. But it was possible that financial liberalization played a leading role, it certainly was not the most crucial one and never the only strategy affecting growth rate.

Two clear and opposing views emerged regarding how capital account liberalization affects an economy, particularly the financial sector. The allocative efficiency view holds that when capital account barriers on the flow of capital are removed, trans-border capital movements begin. Capital tends to move from capital-abundant economies, where the marginal rate of return is lower, to capital-scarce economies where the marginal rate of return is expected to be higher. The newer view was christened the "animal spirit" and treated the older view of the impact of capital account liberalization simplistic, if not downright fanciful. The proponents of this view believe that capital account liberalization does not result in efficient allocation of financial resources because international capital movements have little connection with real economic activity. However, most empirical studies concur with the allocative efficiency hypothesis.

It was believed that capital account liberalization leads to volatility, which led to a support for restrictive global capital flows. The unrestricted trans-border capital flows were blamed for disorderly capital market behavior, both domestically and globally. Their logic was that restrictions on global capital flows would help in moderating "excessive boom-burst" pattern in financial markets so prevalent in the 1990s and early 2000s. An important result of this view was that financial market liberalization and reforms should be slowed down. However, as a permanent policy measure, these proposals for not liberalizing the capital account did not win many supporters. However, there is support for the view that capital account liberalization should be well planned and sequential, with short-term flows being liberalized last.

During the recent episodes of crisis in the emerging market economies, stock markets displayed an excessive boom-burst behavior. Some believed that it was the liberalization of equity markets, which was to be blamed for their volatility. Empirical studies showed that the equity markets' volatility was not intensified by financial liberalization. If anything, the opposite is the truth. Equity market cycles become smoother after liberalization. Interestingly they found intertemporal differences in the impact of financial liberalization over the equity market. Liberalization tended to trigger more explosive financial cycles in the immediate aftermath of financial liberalization. However, in four years after liberalization the equity market volatility became markedly less pronounced. In this scheme of things, integration of domestic equity markets in the emerging market economies with the global financial markets contributes to a decline in volatility.

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Summary

Emerging Market Economies: Liberalization and Performance Nexus

The principal thesis of this paper is that financial development and liberalization affect the growth rate in a significantly positive manner. Deregulation creates an environment that greatly facilitates economic growth. Although there is no consensus on the impact of capital account liberalization on growth, the allocative efficiency hypothesis still holds and it is supported by many analysts. It was believed that capital account liberalization leads to volatility, which led to a support of policy to restrict global capital flows. However, this support was limited. If capital account is liberalized in a planned and sequential manner and if short-term capital flows are liberalized last, and kept under limits, the risk of volatility in the economy declines considerably. Similarly, it was believed by some that liberalization of equity markets causes volatility. However, the equity markets' volatility was not intensified by financial liberalization. If anything, the opposite was true. The cycles of upswing and down swings in equity markets become smoother after they are liberalized. There are intertemporal differences in the impact of financial liberalization over the equity market. Integration of domestic equity markets in the emerging market economies with the global financial markets contributes to a decline in volatility. (JEL F0, F3, F4, F21, G15)

Zusammenfassung

Die Volkswirtschaften der Schwellenländer: Beziehung zwischen Liberalisierung und Leistung

Die Kernaussage dieses Beitrags besteht darin, dass der Fortentwicklung und Liberalisierung der Finanzsysteme von Schwellenländern signifikante Wachstumsimpulse beizumessen sind. Deregulierung schafft ein Umfeld, das dem Wirtschaftswachstum sehr förderlich ist. Obwohl es keinen Konsens bezüglich der Auswirkungen einer Liberalisierung des Kapitalverkehrs auf das Wirtschaftswachstum gibt, ist die Hypothese der allokativen Effizienz dennoch gültig und wird von vielen Analytikern gestützt. Es wurde davon ausgegangen, dass eine Liberalisierung des Kapitalverkehrs zu Volatilität führt. Vielfach herangezogen wurde dieses Argument zur Rechtfertigung einer Politik der Eindämmung internationaler Kapitalströme. Jedoch kann es nur in Grenzen als stichhaltig beurteilt werden. Wenn die Kapitalbilanz nach Plan und schrittweise liberalisiert wird und wenn kurzfristige Kapitalströme zuletzt liberalisiert und innerhalb gewisser Grenzen gehalten werden, nimmt das Volatilitätsrisiko für die Volkswirtschaft in starkem Maße ab. Dagegen wird die Volatilität der Wertpapiermärkte durch die Liberalisierung des Finanzsystems nicht wesentlich stärker. Wenn überhaupt eine Wirkung zu verspüren war, dann die gegenteilige. Nach der Liberalisierung sind die konjunkturellen Auf- und Abwärtsbewegungen auf den Wertpapiermärkten eher sanfter ausgefallen. Es gibt von Zeit zu Zeit Unterschiede in den Auswirkungen einer Liberalisierung des Finanzsystems auf die Wertpapiermärkte. Eine Integration der inländischen Wertpapiermärkte der Schwellenländer in die globalen Finanzmärkte trägt zu geringerer Volatilität bei.

Résumé

Les économies de marché émergentes: Liens entre libéralisation et performance

La thèse principale de cet article est que le développement et la libéralisation financiers affectent le taux de croissance de façon très positive. La dérégulation crée un environnement qui facilite fortement la croissance économique. Bien qu'il n'y ait pas de consensus sur l'impact de la libéralisation des comptes de capital sur la croissance, l'hypothèse de l'efficience d'allocation est toujours valable et est défendue par beaucoup d'analystes. On croyait que la libéralisation des comptes de capital entraîne la volatilité, ce qui a amené à appuyer les politiques visant à restreindre les flux globaux de capitaux. Pourtant, cet appui est resté limité. Si les comptes de capital sont libéralisés de manière planifiée et séquentielle et si les flux de capitaux à court terme sont libéralisés en dernier et limités, le risque de volatilité dans l'économie diminue considérablement. De même, certains pensaient que la libéralisation des marchés des actions provoque la volatilité. Cependant, la volatilité des marchés des actions ne serait pas intensifiée par la libéralisation financière. Le contraire serait plutôt vrai. Les cycles de hausse et de baisse des marchés des actions deviennent moins prononcés après la libéralisation. Il y a des différences inter-temporelles dans l'impact de la libéralisation financière sur le marché des actions. L'intégration des marchés des actions nationaux des économies émergentes aux marchés globaux financiers réduit la volatilité.