WHY WE SHOULDN'T TURN OUR BACKS ON FINANCIAL GLOBALIZATION

by

Frederic S. Mishkin
Board of Governors of the Federal Reserve System

Draft
August 2008

This essay draws heavily on material from my book, *The Next Great Globalization: How Disadvantaged Nations Can Harness Their Financial Systems to Get Rich*. The views expressed here are my own and are not necessarily those of the Board of Governors of the Federal Reserve or the Federal Reserve System. I would like to thank Jane Haltmaier for her assistance.

ABSTRACT

This essay argues that financial globalization can be a powerful force in promoting economic growth and the reduction of poverty in emerging market countries. Financial development enables the financial system to allocate capital to its most productive uses and is crucial to the success of an economy. Financial globalization encourages financial development by weakening the power of groups such as government and entrenched private special interests, who have much to lose from an efficient financial system, and by encouraging support for institutional reforms to make the financial system work better. On the other hand, financial globalization, if it is not managed properly, has a dark side and can lead to financial crises that cause much economic hardship. Getting financial globalization to work well is no easy task and requires policies that promote property rights and good quality financial information, that encourage effective prudential supervision, and that promote a stable macroeconomic environment. Although these policies need to be home grown, international financial institutions like the IMF and the World Bank can create incentives to promote these policies in emerging market countries. Citizens in advanced countries can also help by supporting the opening up of their markets to goods and services from poorer countries, and thereby encourage expansion of their export sectors, which creates increased support for financial development and less vulnerability

to financial crises.

Many prominent economists, financiers, politicians, and other seeming authorities regard globalization, and, in particular, financial globalization, as a potential danger to the world's poor. For example, Joseph Stiglitz has been very critical of globalization in his best-selling book, *Globalization and its Discontents* (2002), because he sees the opening up of financial markets in emerging market economies to foreign capital as leading to economic collapse[1]. Even Jagdish Bhagwati, one of the most prominent economists defending globalization (with a book titled *In Defense of Globalization*, 2004), is highly skeptical of *financial* globalization, stating: "... The claims of enormous benefits from free capital mobility are not persuasive."[2] George Soros (2002), one of the world's most prominent financiers, opens his book, *On Globalization*, with an introductory chapter titled "The Deficiencies of Global Capitalism."[3]

Instead of a danger, globalization is an opportunity. The globalization of trade and information during the past century has lifted vast numbers of the world's people out of extreme poverty. In emerging market countries, financial globalization can help transform the labors of disadvantaged people into greater wealth for them and create greater prosperity and stability for the world at large.

In this essay, I will argue that for emerging countries to reach the next stage of development and get rich, financial globalization must go much further than it already has. In particular, the financial systems in emerging economies

must be more tightly integrated with those in the developed countries in order to partake in the benefits of financial flows, the lifeblood of the industrialized world.

Without financial globalization, developing countries will not be able to realize their potential, and their continued poverty will engender further instability and breakdowns in political relations with other nations. Although financial globalization is vital in promoting economic growth and reducing poverty, it is not a panacea. It can lead to economic crises that are destructive to a country and its citizens. Recent crises in emerging countries illustrate the costs and benefits of financial globalization and present some cautionary lessons for countries hoping to globalize successfully. Only by taking financial globalization seriously can we learn to reduce its destructive downside while promoting its remarkably productive upside.

Given how much globalization has progressed in recent years, it might seem that globalization, in this day and age, will move inevitably forward. But this forward march is not inevitable. To show why, I would like to first put the current Age of Globalization into perspective by discussing the first Age of Globalization, from 1870 to 1914.

THE FIRST AGE OF GLOBALIZATION: 1870-1914

The current Age of Globalization is actually the second great wave of globalization of international trade and capital flows. The first occurred from 1870 to 1914,[4] when international trade grew at a 4% rate annually, rising from 10% of global output (GDP) in 1870 to over 20% in 1914, while international flows of capital grew annually at 4.8% and increased from 7% of GDP in 1870 to close to 20% in 1914[5]. John Maynard Keynes captured the feel of this era with the following famous passage from his *The Economic Consequences of the Peace*, which was published in 1919:

> What an extraordinary episode in the economic progress of man that age was which came to an end in August 1914! The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages; or he could decide to couple the security of his fortunes with the good faith of the townspeople of any substantial municipality in any continent that fancy or information might recommend.[6]

This first wave of globalization was accompanied by unprecedented prosperity. Economic growth was high: from 1870 to 1914, world GDP per capita grew at an annual rate of 1.3%, whereas in the period from 1820 to 1870, it grew at a much smaller rate of 0.53% (Maddison, 2001, p. 94).

But did this higher economic growth translate into a better deal for the poor of the world? If economic growth during this Age of Globalization had been associated with growing income inequality, then the poor might not have benefitted. However, that is not what happened for countries involved in the globalization process. The income gap narrowed between wealthy and poor nations that actively participated in global markets (although there was little effect on income distribution within these countries) (Lindert and Williamson, 2003). Japan provides an extraordinary example. Starting in the 17th century, Japan completely cut itself off from the rest of the world, allowing only one Dutch ship per year to land in Nagasaki to engage in a small amount of trading. When Commodore Matthew Perry and his black ships arrived on Japanese shores in 1853 to force Japan to trade with the United States, Japan began to open up to the rest of the world. The resulting shakeup of Japanese society eventually led to the Meiji restoration in 1868, and Japan became fully engaged in the global economic system. In 1870, at the start of this period, Japan was a ~~backward~~ underdeveloped country with an average income per person that was less than a

quarter of that in the United Kingdom. From 1870 to 1913, Japan was able to increase its per capita income at a rate of 1.5% annually in comparison with a growth rate of 1.0% for the United Kingdom, thereby narrowing the gap. Argentina's growth experience during this period was even more extraordinary. From 1870, when its per capita income was a little over 40% of that in the United Kingdom, it grew at a 2.5% rate through 1913, raising its per capita income to over 75% of that in the United Kingdom. The Japanese and Argentine examples illustrate how poverty was reduced in the countries that were active in the globalization process.

However, not all countries engaged in the globalization process. Globalizers did well, but as critics of globalization point out, some countries were unable to take advantage of globalization. For example, countries like India and China actually deindustrialized during this period (Braudel, 1984, Bairoch, 1993, Baldwin and Martin, 1999), with China's per capita income falling from 24% of the United Kingdom's in 1870 to 13% in 1914 (Maddison, 2001). However, this increase in income inequality occurred not as the result of any adverse effects of globalization but because nonglobalizers did so badly relative to globalizers. Among countries that were able to take advantage of the globalization process, income inequality actually fell because globalizers that were initially very poor did so well relative to globalizers that started out rich. Increasing income

inequality between countries during that period was clearly not the fault of globalization, but it was, rather, a consequence of the inability or unwillingness of some countries to enter the global economic system.

THE END OF THE FIRST AGE OF GLOBALIZATION: THE GREAT REVERSAL 1914-1939

The first Age of Globalization came to an end with the advent of World War I. The war caused a disruption of capital flows and international trade between nations that continued even after the war ended. From 1914 to 1929, the average level of international trade fell from 22% of world GDP to 16%, capital flows dried up, falling from close to 20% to 8% of world GDP (Obstfeld and Taylor, 2003), and worse was yet to come. In 1929, the Great Depression started in the United States, and it quickly spread to the rest of the world. The economic devastation was immense. Unemployment reached a peak of 25% in the United States, and the income of the average person fell by 30% by 1933 and was only slightly above 1929 levels by 1939. However, the consequences of the Depression were far worse elsewhere. The economic collapse in Germany and Italy helped bring the fascists and Nazis into power, after which the world entered the worst nightmare imaginable: a second World War. From 1939 to 1945, over 50 million

people died, over half of whom were innocent civilians, and the inhumanity of the Holocaust resulted in the slaughter of 6 million Jews and 5 million people of other religious and ethnic backgrounds in concentration camps (Lukas, 1986).

The collapse of this first Age of Globalization, which has been given the name the "Great Reversal" by Rajan and Zingales (2003a), provides two important lessons: 1) Globalization is not an immutable economic force; it can be reversed. 2) The economic and political nightmares of the interwar period should warn us that a backlash against globalization can be disastrous.

THE SECOND AGE OF GLOBALIZATION: 1960-PRESENT

The aftermath of World War II has been an extraordinary period. Even before the war ended, the soon-to-be victorious allies saw that the mistakes of the interwar period should not be repeated. They met in Bretton Woods, New Hampshire, in 1944 to develop a new international system to promote world trade and prosperity after the war. They created two new international financial institutions (IFIs), both of which were headquartered in Washington, D.C., just across the street from each other: the International Monetary Fund (IMF), whose job was to oversee the international financial system and ensure that it would facilitate trade among countries, and the International Bank for Reconstruction

and Development, which became known as the World Bank, whose job was to provide long-term loans to war-torn Europe and to developing countries to aid in their economic development. An additional organization arising out of the Bretton Woods meeting, but not established until 1947, was the General Agreement on Tariffs and Trade (GATT), headquartered in Geneva; it was created to regulate the rules for the conduct of trade between countries. This organization evolved into the World Trade Organization (WTO).

These new institutions were created to promote globalization, and in this undertaking they were extremely successful. Once the world economy returned to normal by the end of the 1950s, globalization advanced at a rapid pace. Since 1973, world trade grew at pace of 11% annually, rising from just over 22% of world GDP to 42% currently (Estevadeordal and Taylor, 2003). Since 1975, the flows of capital between countries have also exploded, rising from 5% to 32% of world GDP in 2005 (World Bank, 2007). We are clearly in the second wave of globalization.

Have the participants in this new Age of Globalization had the good economic outcomes and a reduction of poverty associated with the previous Age of Globalization? Data suggest that they have. World economic growth from 1960 to today has been at the highest pace in the history of the world: world income per person has been rising at a 2% annual rate. Yet, critics of

globalization point out that world income inequality has grown, and so they argue that globalization has not been good for the poor.

But these critics have not looked carefully enough at the data. Income inequality across countries has indeed risen. However, this is only because, just as occurred before World War I, those countries that have been able to be active in global markets have grown very rapidly, while those that have not, such as most countries in sub-Saharan Africa, have seen their position relative to globalizers fall and also have experienced absolute drops in per capita income. Again, the globalizers have gained, and the nonglobalizers have lost. In 1960, the income of the average person in Somalia was 10% higher than his South Korean counterpart. Over the next 45 years, Somalians experienced a drop in their income so that now Somalia's per capita income is less than one-tenth that of South Korea's: Somalia's income decreased by 33% while South Korea's increased by more than 1,000% (Maddison, 2001).

What we have seen in this new Age of Globalization is a convergence of income per capita in countries that have been able to take advantage of globalization by becoming export-oriented; among this set of countries, income inequality has decreased; among the nonglobalizers, it has not (Dollar, 2003). Furthermore, there is little evidence that globalization has increased income inequality within countries (Dollar and Kraay, 2002, Winters, McCulloch, and

McKay, 2004)[7]. Thus, we are led to the same conclusion that we reached for the pre-World War I era: this new Age of Globalization has seen a reduction of poverty in countries that have been willing and able to globalize.

Another way of looking at the data also suggests that globalization has been associated with reductions in poverty. If, instead of looking at inequality across countries, where all countries are weighted equally and inequality has risen, we instead look at inequality across the world population, where each person is weighted equally, we get a very different picture. The great success stories in recent years have been in Asia, which includes the two most populous countries in the world, India and China. Both came to globalization late and have sometimes used unorthodox methods to develop their economies, but their embrace of globalization has had high payoffs. Rapid growth in China and India has sharply reduced the percentage of people living in extreme poverty. This reduction translates to over 500 million people, nearly 8% of the world's population (World Bank, 2007). Thus, it becomes obvious why research that weights every human being equally in computing inequality finds that income inequality has actually fallen, not risen, in recent years (Sala-i-Martin, 2002, Lindert and Williamson, 2003, Pritchett, 1997, Bourguignon and Morrisson, 2002). The great success story of India and China in reducing poverty is not just reflected in economic data, but also in life expectancy. In 1960, life expectancy in

India and China was 44 and 36 years, respectively; by 2005, life expectancy had risen to 64 in India and 72 in China (World Bank, 2007).

Of course, these success stories do not minimize the terrible plight of the parts of the world such as sub-Saharan Africa, poverty has remained stubbornly high, while life expectancy has actually fallen to disastrously low levels in recent years because of the AIDS epidemic. (Poverty, defined as income of less than $2 per day, was 75% of the population in 1981 and 72% in 2004, while life expectancy has dropped from 49 years in 1990 to 47 years in 2005 (World Bank, 2007). The plight of these countries, however, is due not to globalization but rather, to the failure to globalize. This has been put very nicely by economists Peter Lindert and Jeffrey Williamson: "As far as we can tell, there are no anti-global victories to report for the postwar Third World" (Lindert and Williamson, 2003).

A word of caution: The association of the reduction in poverty with countries that have globalized could be the result of reverse causality--that is, countries that had the capability of growing fast were also the ones that could take advantage of globalization. Other evidence, however, suggests that causality *is* likely to run from globalization to high economic growth and reductions in poverty.[8]

ANOTHER GREAT REVERSAL?

The second Age of Globalization, which we are in now, as we have seen, has many similarities to the first Age, which occurred in the late nineteenth and early twentieth centuries. Could there be another Great Reversal, in which globalization retreats again and the world suffers great political, social, and economic upheaval and destruction? Could we experience déjà vu all over again?[9]

Unfortunately, the answer is yes. The backlash against globalization in Latin America is very strong. Many of the residents in Latin America have turned against globalization because they have been disappointed in the amount of economic growth since 1990, when they opened up their economies, particularly to foreign capital flows. Some countries (such as Mexico, Ecuador, and Argentina) have also experienced recent disastrous crises that have led their countries into sharp recessions. In the immediate aftermath of its economic crisis in 2001-2002, for example, Argentina experienced an unemployment rate of nearly 20% and a per capita income that was 22% below the level it had reached in 1998 (World Bank, 2007).

Similarly, the public in many of the *transition countries*, former Communist countries that are a subcategory of emerging market economies, also

have doubts about the benefits of globalization. This is less of a problem for the transition countries in Eastern Europe that are entering or are likely to enter the European Union soon; by doing so, they will automatically become a part of a globalized economy. However, there is a danger that Russia and many of the other countries that were part of the former Soviet Union may turn inward and reject globalization and economic freedom in general.

The Asian public seems to be far more supportive of globalization because they have experienced rapid growth, but the backlash against globalization has reached them too. It would be premature to assume that they will continue down the globalization path.

The possibility of another Great Reversal is very real. It happened before, and it could happen again. I will argue below that turning back on globalization would be disastrous for both emerging market *and* rich countries and that globalization must go much further in the financial direction and be embraced by more developing countries so that they can reach their full potential and get rich.

FINANCIAL GLOBALIZATION IN EMERGING MARKET ECONOMIES

Although economic globalization has come a long way in recent years, in one particular dimension, it is very far from complete. As documented by

Obstfeld and Taylor (2004), financial globalization is primarily confined to rich countries. Despite the huge increase in international capital flows in recent years, they primarily flow North-North--that is, from rich countries to other rich countries, which are mostly in the northern hemisphere, rather than from North to South, from rich to poor countries (Obstfeld and Taylor, 2004, Alfaro, Kalemli-Ozcan, and Volosovych, 2008). Most international capital flows are exchanges of assets between rich countries and are undertaken primarily for diversification. The flows enable people in rich countries to put all their eggs in different baskets by holding assets from other rich countries. International capital is generally not flowing to poor countries to enhance their development in magnitudes that we might expect.

As Lucas (1990) has pointed out, this feature of international capital flows is a paradox: Why doesn't capital flow from rich to poor countries? We know that labor is incredibly cheap in poor countries, and so we might think that capital would be especially productive there. Just think of how hugely profitable a factory might be in a poor country, where wages are one-tenth of what they are in the United States. Capital should, therefore, have extremely high returns in poor countries, and we should expect massive flows of capital from rich countries (where the returns on capital should be far lower) to poor countries (where it should be higher). Although there has been a big increase in the amount of capital

moving to emerging market countries in recent years, capital primarily still flows from one rich country to another, where the returns on capital are similar[10].

The amount of private capital flowing to emerging market countries, which increased dramatically in the 1990s and is now over $300 billion at an annual rate, may sound like a lot, but it is only one-fifth of total international capital flows from private sources (Institute for International Finance, 2005). When governments are added into the picture, recent developments are even more surprising. Emerging market countries have actually been sending capital to rich countries. The United States is currently running enormous trade and current account deficits of over $700 billion because Americans are buying more goods and services from abroad than they are selling overseas. These deficits are being financed by loans from foreigners, with emerging market countries providing the United States with about $200 billion per year. The Chinese government, for example, has accumulated over $1 trillion in foreign assets and is now one of the largest holders of U.S. Treasury securities in the world.

Also remarkable is that capital flows from North to South relative to total capital are far smaller than they were in the first Age of Globalization in the late nineteenth and early twentieth centuries. By 1914, around half of the stock of capital in Argentina was supplied by rich foreign countries, particularly Great Britain (Taylor, 1992, and Obstfeld and Taylor, 2004.) Today, less than 6% of

Argentine capital has been supplied by foreigners. This change in the pattern of capital flows has not been confined to Argentina[11]. In 1913, over 25% of the world stock of foreign capital went to countries which had a per capita income of less than one-fifth of the United States; by 1997, this figure had fallen to around 5% (Obstfeld and Taylor, 2004, Figure 7.5, p. 242.)

As these figures show, financial globalization is far from complete. Will financial systems in emerging market economies become more integrated with the rest of the world? Will the backlash against globalization mean that we will turn our back on financial globalization? If financial globalization spreads to developing countries, will it be beneficial?

HOW FINANCIAL GLOBALIZATION CAN BE BENEFICIAL

The benefits of globalization of trade in goods and services is not controversial among economists. Polls of economists indicate that one of few things they do agree on is that the globalization of international trade, in which markets are opened to flows of foreign goods and service, is desirable[12]. *Financial* globalization, opening up to flows of foreign capital, however, is highly controversial, even among economists.

Financial Development and Economic Growth

To understand the possible benefits of financial globalization, it is first important to recognize that getting the financial system to work well is critical to the success of an economy.

When you ask average laymen what it will take for poor countries to get rich, they often will answer that these countries must make sure their citizens get a good education and are healthy, and so it is not surprising that so much charitable aid goes into improving health and education. Health and education are important to economic growth, but increasing public spending on health and education does not always produce higher growth[13]. I will argue that for poor countries to get rich, there must be incentives for capital (including capital devoted to health and education) to be supplied to where it will do the most good--to its most productive uses. This can only happen with a well-functioning financial system.

To understand why such a system is needed, we need to recognize that the financial system is like the brain of the economy: it is a coordinating mechanism that allocates capital to building factories, houses, and roads. If capital goes to the wrong uses or does not flow at all, the economy will operate inefficiently, and economic growth will be low. No work ethic can compensate for a misallocation of capital. By itself, working hard will not make a country rich because hard-

working laborers will not be productive unless they work with the right amount and kinds of capital. Brain is as important as brawn, and similarly an efficient financial system is as important as hard work to an economy's success. Indeed, workers in poor countries often work longer hours than their counterparts in rich countries, and yet they remain poor. When they emigrate to countries with a superior financial system, they often become very rich. For example, look at how successful immigrants from India have been in the United States: their average income now makes them one of the richest groups in the United States.[14]

The evidence that financial development and economic growth are linked is quite strong[15]. A pioneering study by King and Levine (1993) using a sample of eighty countries found that the greater the financial development back in 1960, as represented by a larger financial sector (known as *financial deepening*),[16] the larger the economic growth over the subsequent 30 years[17]. Later studies using more sophisticated techniques have confirmed this finding and indicate that a doubling of the size of private credit in an average less-developed country is associated with a 2 percentage point annual increase in economic growth (e.g., Levine, Loayza, and Beck, 2000). Furthermore, industries and firms that are more dependent on external sources of funds, and so would benefit more from financial deepening, are found to grow faster in countries that are more financially developed (Rajan and Zingales, 1998, Demirguc-Kunt and Maksimovic, 1998).

Similarly, more new firms are created in countries with developed financial systems[18]. The evidence also suggests that the way financial development raises growth is more through improvements in the allocation of capital that produces higher total factor productivity rather than through higher investment (Beck, Levine, and Loayza, 2000, Levine, 2005b). As stated by Honohan (2004), "The causal link between finance and growth is one of the most striking empirical macroeconomic relationships uncovered in the last decade."[19]

Although financial deepening improves an economy's rate of economic growth, it is possible that poverty will remain the same or increase because the resulting growth could lead to greater income inequality. However, this is not what research has found. In countries with better financial development, the income of the poorest fifth of the population actually grows faster than average GDP per capita (Hongyi, Squire, and Zou, 1998, Honohan, 2004, Beck, Demirguc-Kunt, and Levine, 2005a), indicating that financial development is associated with reductions in poverty and even with reductions in the use of child labor (Dehejia and Gatti, 2005). This finding is exactly what economic theory suggests because financial development increases the access of the poor to credit, and they have the disadvantage of having less access to credit than the rich (Banerjee and Newman, 1993, Galor and Zeira, 1993, Aghion and Bolton, 1997).

Getting Financial Development to Happen

If getting the financial system to allocate capital to productive uses is needed to promote economic growth and development, how do you get it to happen? The short answer is: Develop good institutions that enable the financial system to allocate capital efficiently. But what are these institutions?

The most basic set of growth-promoting institutions are ones that promote property rights (such as the rule of law, constraints on government expropriation, and absence of corruption)[20]. If you live in a country where it is easy for others to take your property away, either by the gun or by a corrupt government, you would be crazy to make investments there. Without these investments, workers in your country would be unable to earn high wages because they would not have sufficient capital to work with in the form of machines, buildings, and computers to make them highly productive. Poverty will be severe.

Even if investments are made, if they go to the wrong place, they will be inefficient. Thus, the second, but related, institutions are ones that make sure that those with the best investment opportunities are the ones that can actually get external funds to make investments--and this is the crucial role of the financial system. This second set of institutions are those that promote an efficient financial system (financial regulation to encourage transparency, good corporate

governance, prudential supervision to limit excessive risk taking, and good enforcement of financial contracts).

The problem for many poor countries is not that they cannot get money for investment but that the investment is counterproductive. In the 1970s, for example, the World Bank provided lending to finance a huge shoe factory in Tanzania that was to produce 4 million shoes, three-quarters of which were to be exported to Europe. However, the factory, with its aluminum walls and no ventilation system, was ill suited for Tanzania's climate, with the result that it never produced more than 4% of its installed capacity and never exported a single shoe (Easterly, 2001).

When we think of why nations are poor, the answer is that they are disadvantaged: they have weak institutions of the type mentioned above and are "institutionally challenged." We can classify poor countries into two types. The poorest are those that do not even have basic property rights, either because they are subject to civil strife or because they are run by rapacious governments. Many countries in sub-Saharan Africa, whose average income per person is less than one-twentieth of what the average American gets, immediately come to mind (World Bank, 2007). The second group of poor countries has basic property rights and are far better off and are far less poor. These emerging market countries are opening up their markets to the flows of goods, services, and capital from other

nations, but they do not have institutions that support a well-functioning financial system.

Who Impedes Financial Development?

If financial development is so beneficial to poor countries, why doesn't every country have its financial house in order and jump on the path to growth and prosperity? The answer is that there are powerful forces that work to keep the financial system underdeveloped, a condition referred to as *financial repression*.

Developing good institutions to support an efficient financial system is hard: it takes much time and effort for a country to plan, establish, experiment, evolve, and adapt its institutions to its historical, cultural, and political circumstances. It takes a long time for any nation to achieve strong property rights and an effective financial system: indeed, this took hundreds of years in the advanced countries of the West[21].

Although this answer provides part of the story, it is not very satisfactory. Because successful legal and regulatory institutions have already been developed in the advanced countries, why can't a country just borrow them? Indeed, this was what the Japanese did after the Meiji Restoration in the late nineteenth

century, and it has also been a feature of the development path in countries in East Asia such as Taiwan, Singapore, and Hong Kong. Technical assistance in establishing these institutions is also available from the developed countries and from institutions like the World Bank and the IMF.

One explanation is that the benefits of financial development are dispersed over a wide range of the population, whereas the costs are focused on narrow groups. These groups, which are quite powerful, will suffer losses from financial development and thus have incentives to try to impede its progress.

One such group is the government, often the primary source of financial repression. Although strong property rights are a crucial element in financial development, they severely constrain a government's ability to expropriate property and ideas whenever it wants to profit from them. Rapacious governments whose rulers treat their countries as personal fiefdoms are not uncommon: from Saddam Hussein's Iraq, to Robert Mugabe's Zimbabwe, to Suharto's Indonesia. Government officials, even in more democratic governments, often use the power of the state to get rich. Not surprisingly, then, many governments pay lip service to property rights but do not encourage a rule of law to protect them.

Although state ownership of financial institutions results in a less-efficient financial system, it enables politicians and government officials to channel funds, either to their families, to their cronies, or to business interests that support their

political campaigns. They, therefore, have strong incentives to establish and support state-owned banks. Politicians often couch their support for state-owned banks by saying that these institutions will direct funds to where they can do the most public good, but the reality is that they know that state-owned financial institutions enhance both their wealth and their power.

As has been emphasized in Rajan and Zingales (2003b), the second group that often supports financial repression is "incumbents," entrenched special interests who are threatened by free markets.[22,23] Large, established business firms often finance new investment projects out of their previous earnings and so do not need funds from external sources in the financial markets. Such firms have less to gain from financial liberalization and development and frequently have much to lose. Increased transparency through better accounting standards and disclosure requirements is required to foster financial development because it reduces asymmetric information problems. However, increased transparency may make it harder for incumbent businesses to exploit their connections and conduct business as usual, and so they will often oppose it. Incumbents also are likely to oppose improvements of the legal system that would promote financial development when these improvements would weaken their ability to sway the legal system to their own interests. If judges can be easily influenced, incumbents will be able to get favorable rulings that increase their power and wealth.

Financial development also allows capital to flow to entrepreneurs who might be able to compete with the incumbents. Incumbents, thus, are often perfectly happy to see the financial system remain repressed because this subjects them to less competition.

Incumbents also are likely to encourage barriers to setting up legal businesses. These barriers can be prohibitive for all but the very rich in most less-developed countries and can discourage and prevent new businesses from becoming established and perhaps growing to a large scale. Any new and large-scale businesses would eat into the incumbents' monopoly profits. The so-called "license-Raj" in India, which existed until the reforms of Rajiv Ghandi started to dismantle these regulations in the 1980s, is one notorious example[24]. New businesses had to obtain hard-to-get licenses before opening their doors, and incumbents frequently spent more time lobbying government officials to prevent entrepreneurs from setting up competing business than they spent on making their own businesses more productive.

Incumbent financial institutions have incentives to repress the financial system[25]. Through their connections, they may have the ability to collect information not available to the public that enables them to screen good from bad credit risks. Increasing transparency, which reduces asymmetric information and is thus necessary to the development of the financial system, may not be in their

interest because their best customers may then be able to bypass the incumbents' services and go to other financial intermediaries or instead use direct finance by issuing their own securities. Incumbent financial institutions also have incentives to discourage development of the legal system to enforce financial contracts fairly because they already have methods of enforcement through their influence over corrupt judges or by outright physical threats. Improving the legal system then would not help them very much but instead would enable competitors to enter the financial business and take away their customers.

Incumbent financial institutions often discourage effective prudential regulation and supervision over their activities. A government safety net, which insulates these firms from market discipline, enables them to take on risk, with most of the cost borne by taxpayers if their loans go sour. Thus, if financial institutions are poorly supervised, they can exploit the financial safety net to pursue risky strategies, such as rapidly expanding high-risk lending, on which they would make a lot of money if they bet right and lose only a small amount if they bet wrong. Rigorous prudential regulation and supervision would stop incumbent financial institutions from doing this, so naturally they would oppose such provisions. Indeed, opposition by financial institutions to rigorous prudential regulation and supervision occurs in rich as well as poor countries, but because poor countries have less transparency, this opposition is far more successful there,

with the result that the quality of prudential regulation and supervision is typically very low.

How Financial Globalization Encourages Financial Development

How can the obstacles to financial development posed by politicians and incumbents that support financial repression be overcome? Globalization, particularly financial globalization, can encourage financial development indirectly, by decreasing the incentives for financial repression outlined above.

Financial globalization, defined as opening up to foreign capital and foreign financial institutions, is a particularly strong force for institutional reform that promotes financial development as long as it is extensive enough so that the entry of foreign capital and foreign institutions increase competition in domestic financial markets. When domestic businesses can borrow from abroad or from foreign financial institutions that establish affiliates in the less-developed country, domestic financial institutions would start to lose many of their old customers. In order for the domestic financial institutions to stay in business, they would have to seek out new customers and lend to them profitably. And to accomplish this, they would need to have the information to screen out good credit risks from bad ones and monitor borrowers to make sure they don’t take on excessive risk.

Domestic financial institutions would thus find that they need to encourage institutional reforms, such as better accounting standards and disclosure requirements, that would make it easier for them to acquire the information that they would need to make profitable loans. Domestic financial institutions would see the need to improve the legal system so that they could enforce restrictive covenants or be able to take title to collateral if a borrower defaults. With globalization, domestic financial institutions would support legal reform because it would not only help them make profits but would also strengthen property rights that encourage investment directly.

When foreign financial institutions enter a country, domestic financial institutions have to become more efficient in order to survive, and this is exactly what happens (e.g., see Levine, 1996, Claessens and Jansen, 2000, Claessens, Demiriguc-Kunt, and Huizinga, 2000, 2001, Barajas, Steiner, and Salazar, 2000, Clarke, Cull, D'Amato, and Molinari, 2000, and Unite and Sullivan, 2003). Foreign financial institutions bring to domestic financial markets best practices--that is, expertise that has been learned from their past experience--and are likely to promote technology transfer to domestic financial institutions (World Bank, 2001, Goldberg, 2007). Entry of foreign financial institutions would help to improve domestic prudential supervision because supervisors would then be able to see what risk-management practices are successfully used in foreign

institutions and insist that they be adopted by domestic institutions (Mishkin, 2003). Foreign financial institutions also would act as a constituency for institutional reform aimed at improving the quality of information in financial markets because, as outsiders, they do not have access to the same inside information that domestic institutions do.

Although I believe that the most important benefits from financial globalization are those that foster financial development and so are indirect,[26] financial globalization has additional direct benefits. Allowing foreign capital to enter domestic financial markets increases the availability of funds and, thus, should necessarily increase liquidity and lower the cost of capital, which stimulates investment and economic growth.[27] This economic growth is indeed what has happened when countries have opened up their stock markets to foreign capital: Henry (2003) finds that, on average, dividend yields fall by 2.4 percentage points, the growth rate of investment increases by 1.1 percentage points, and the growth rate of output per worker increases by 2.3 percentage points.[28]

It should be pointed out that globalization of the nonfinancial kind is also extremely important in promoting financial development. Allowing entry of foreign goods and investment would produce a more competitive environment that would drive down revenue of incumbent firms and reduce their cash flow

(revenue minus outlays) so that they would have to seek out external sources of finance (Rajan and Zingales, 2003b). Because these sources of finance would only be available if the financial system had the wherewithal to solve asymmetric information problems, incumbent firms would then be more likely to support the necessary institutional reforms to make the financial system work better. In turn, the increase in the size of the financial sector would foster economic growth[29]. Greater openness to trade is indeed found to be linked to a larger financial sector (Rajan and Zingales 2003b, Svaleryd and Vlachos, 2002), and the increased competition from foreigners stimulates domestic firms to become more productive in order to survive.

Even without trade liberalization, encouraging an export orientation of domestic markets creates a greater need for a well-functioning financial system because, to compete effectively in the international arena, firms need better access to capital. If they can't get capital, they won't be able to make the investments they need to increase productivity and price their goods competitively. In this way, international trade creates a demand for reforms that will make the financial system more efficient.

WHY FINANCIAL GLOBALIZATION DOESN'T ALWAYS WORK

Even with all these powerful benefits, financial globalization is not always a force for good: it has a dark side and can go very wrong[30]. Opening up the financial system to foreign capital flows can and has led to disastrous financial crises, which have resulted in great pain, suffering, and even violence. (There was widespread ethnic violence in Indonesia after its crisis in 1997, and in the wake of Albania's financial crisis in 1996-97, there were around 2,500 casualties.[31]) Given a government safety net for financial institutions, particularly banks, liberalization and globalization of the financial system often encourages a lending boom, which is fueled by capital inflows. Because of weak prudential supervision by bank regulators and a lack of expertise in screening and monitoring borrowers, losses at banking institutions could begin to mount. With a weak banking sector, the government could no longer raise interest rates to defend the domestic currency because doing so would cause even more distress in the banking sector and precipitate a bank panic. Once market participants would realize that the government no longer can defend the currency, they would engage in a speculative attack, leading to a currency crisis and a large devaluation. Because so many firms in emerging market countries have their debt denominated in foreign currencies such as dollars, the currency collapse would produce a sharp increase in their indebtedness in domestic currency terms, while the value of their assets usually would remain unchanged. The resulting destruction of firms' balance

sheets then would make it more difficult for the financial system to solve asymmetric information problems, and lending to firms would contract sharply, leading to a seizing up of the financial system and often a devastating economic contraction.[32]

When instability follows financial liberalization and globalization, two problems are created. The most obvious one is the economic hardship following the resulting crisis, which particularly hurts the poor (Halac and Schmukler, 2004). The second is that the resulting financial instability gives financial globalization a bad name and can provoke a backlash against both financial globalization and liberalization, which retards financial development. This is why financial globalization is so controversial. It also explains why evidence using aggregate data on the benefits of financial globalization are mixed: there is no clear-cut relationship between international financial openness and economic growth.[33]

In recent years, the move by developing countries to more freely floating exchange rates, more disciplined monetary and fiscal policy, and widespread current account surpluses has substantially reduced the incidence of financial crises. Nevertheless, should efforts to strengthen and reform financial systems in developing countries flag, it is quite possible that we could see more such crises in the future.

The Bottom Line

Thus, the issue is not whether financial globalization is inherently good or bad; when it is done right, financial globalization has substantial benefits. But when financial globalization is perverted by policies that lead to an implosion of the financial system, it can go very badly.

GETTING FINANCIAL GLOBALIZATION TO WORK

I have argued here that financial globalization can be a powerful force in promoting economic growth and the reduction of poverty. On the other hand, financial globalization has a dark side and can lead to financial crises that cause much economic hardship. How can financial globalization be made to work effectively?

A full treatment of possible answers to this question are well beyond the scope of this essay. Indeed, I spent five chapters (8 through 12) discussing how financial globalization might be managed successfully in my 2006 book. Let me briefly sketch out the kind of policies that emerging market countries need to adopt to get financial globalization to work for them.

First, emerging market countries must promote financial development by taking the following steps: (1) developing strong property rights, (2) strengthening the legal system, (3) reducing corruption, (4) improving the quality of financial information, (5) improving corporate governance, and (6) getting the government out of the business of directing credit. Second, to prevent financial crises, emerging market countries need to encourage effective prudential supervision by: (1) limiting currency mismatch, (2) restricting connected lending and preventing commercial enterprises from owning financial institutions, (3) ensuring that banks have plenty of capital, (4) encouraging a focus on risk management, (5) encouraging disclosure and market-based discipline, and (6) allowing entry of foreign banks but in a way that increases competition in domestic financial markets. Third, emerging market countries need to make prudential supervision work by: (1) implementing prompt corrective action, (2) limiting implicit guarantees to entities that are too-big or too-politically-connected to fail, (3) giving adequate resources and statutory authority to prudential regulators/supervisors, (4) giving independence to regulatory/supervisory agencies while making supervisors accountable, (5) getting the government out of the banking business, and (6) using capital controls only as part of the prudential supervisory process. Fourth, emerging market countries need to pursue reforms that help manage the overall economy to prevent

financial crises by: (1) sequencing financial liberalization, (2) reforming fiscal policy to prevent excessive budget deficits, (3) promoting price stability through reform of the monetary policy framework, (4) avoiding pegging the exchange rate, and (5) opening up to international trade.

The list of policies above is very long and might seem insurmountable. Dani Rodrik and Arvind Subramanian's essay in this volume indeed argues against financial globalization on these grounds. However, I argue here instead that we should not give up on financial globalization because it can play such an important role in enabling countries to reach their full economic potential. Furthermore, many emerging market countries have made great progress in adopting policies along the lines outlined above, which is one reason why financial crises in these countries have been occurring less frequently of late. To reap the benefits of financial globalization does not require that these policies are treated as prerequisites to opening up the economy to international flows of capital and foreign financial institutions. These policies are complementary to financial globalization. Not only will they help make financial globalization work better, but financial globalization can help build support to adopt these policies because it creates incentives for institutional reform.

Indeed, the history in emerging market countries of inflation targeting, a reform to the monetary policy framework that promotes price stability, supports

this view. Despite concerns that inflation targeting would not work in emerging market countries unless they instituted a a rigorous set of institutional reforms beforehand (Eichengreen, Masson, Savastano and Sharma, 1999), Battini and Laxton (2007) find that even though inflation targeting has been adopted without these institutional reforms, it has been quite successful in controlling inflation in emerging market countries and those that have adopted inflation targeting have been more likely to implement these institutional reforms than those that have not.

But how can the international community help? This is a complex topic that I discuss extensively in my 2006 book, but I will touch on it briefly here.

Although less-developed countries need to build their own institutional frameworks to make globalization work, there is a lot of expertise in institutions like the IMF and the World Bank that these countries could draw on. Technical assistance from these organizations can thus be of great value and indeed has been in South Korea and Turkey, both of which asked for help after their financial crises. The right incentives from international financial institutions can also help encourage economic and political elements in the less-developed countries to overcome rich elites who may block good institutional development.

But what can advanced countries do to help promote institutional development? The answer is opening up our markets to goods and services from emerging market countries. By so doing, rich countries can provide exactly the right incentives to promote institutional reforms that will improve the functioning

of financial markets. If firms in emerging market countries have access to foreign markets, their increased need for capital means that they will demand that the legal system be better at enforcing property rights and financial contracts that will enable them to borrow. Similarly, these growing, exporting firms will want to see improvements in the availability and quality of information because fewer asymmetric information problems will make it easier for them to get loans. They will also be more supportive of improvements in prudential supervision because a more-efficient banking system can be a source of credit. Thus, opening up the markets in advanced countries to emerging market countries is the single most valuable thing the developed world can do to promote the necessary financial reforms. In turn, financial reforms can increase financial deepening and help allocate capital to its most productive uses.

More open trade with emerging market firms can also help promote financial stability and reduce the likelihood and severity of financial crises in emerging market countries by increasing the size of the export sector in these countries (Calvo, Izquierdo, and Mejia, 2004, Calvo, Izquierdo, and Talvi, 2003, Calvo and Talvi, 2005, Edwards, 2004, Cavallo and Frankel, 2007)**.** Firms that have debt denominated in foreign currency are more vulnerable to currency depreciations if the goods they produce are sold primarily in domestic markets and so are priced in the local currency. Under these circumstances, a domestic currency depreciation increases the value of their foreign-currency-denominated

debt in terms of the local currency, while the domestic currency value of their output remains unchanged. The discrepancy between the increase in what they have to pay on their debt (liabilities) and what their product sales will bring in (assets) is what destroys their balance sheets and produces financial crises. However, if the firm is selling its goods abroad, when there is a depreciation, the demand for the goods they produce rises in terms of local currency. The value of their production thus goes up, compensating for the increased value of the debt. When an emerging market country's export sector is larger, it is less vulnerable to a financial crisis because a currency depreciation will do less damage to the balance sheets of firms. Indeed, one of the reasons why Argentina was so hard hit by the collapse of its currency in 2001 was that it had such a small export sector.

CONCLUDING REMARKS

I have argued in this essay that we should not turn our backs on financial globalization. In my concluding remarks, I would like to leave the reader with six thoughts from this discussion.

Financial globalization is not *the* answer, but it is an important part of the answer.

An economy's ability to allocate capital to its most productive uses is what enables it to reach its full potential in terms of growth, high income per capita, and all the benefits that come with achieving these goals. Developing this ability takes dedication, hard work, commitment, and time. It also takes the development of institutions that promote strong property rights and a well-functioning financial system that moves funds to support productive investments. Institutional development is a complex process, and the one-size-fits-all approach of just taking institutions from advanced countries and plopping them down in poor countries has not worked[34]. Institutional frameworks need to be homegrown.

Strong domestic forces, however, are often lined up against financial development. By keeping property rights and the financial system underdeveloped, powerful, entrenched business and political interests are able to restrict competition and prevent entrepreneurs in poor countries from accessing the funds they need to put their ideas into practice. The entrenched interests will then keep the markets to themselves and will keep on earning high profits. The economy will remain unproductive, and no matter how hard the average person in the society is willing to work, the country will remain poor.

What is the solution? There are no easy answers, but the key is incentives.

By opening up the economy to foreign capital and financial institutions, financial globalization creates incentives for institutional development by increasing demands within a country for institutional reforms that promote

financial development. When domestic firms can borrow from abroad or from foreign financial institutions, domestic financial institutions will start to lose business. They will need to seek out new customers to whom they can profitably lend. Without good information to screen out good from bad credit risks and to monitor new borrowers to make sure they don't take on excessive risk, domestic financial institutions will not be able to make any money. Domestic financial institutions would then have incentives to encourage institutional reforms that would make it easier for them to acquire the information they need to make profitable loans. Instead of blocking financial development, they would become supporters and would begin to push for institutional reforms to improve accounting standards and disclosure of financial information. To make loans less risky, they would support reforms of the legal system to enhance the enforcement of contracts that protect property rights, thereby making it easier to enforce financial contracts.

Opening up financial markets to the outside world does not magically or automatically make a country rich. Financial globalization will only help promote institutional development if it is managed to promote more competition in financial markets. Financial globalization will only promote growth if the process is not perverted and thus does not lead to destructive blowups of the financial system.[35] Financial crises in the aftermath of financial liberalization and globalization, unfortunately, have been a fact of life for many emerging market

countries and have led to depressions that have increased poverty and have stressed the social fabric. *Successful* financial globalization, which avoids these crises, requires effective prudential regulation and supervision, responsible fiscal policy, and strong monetary policy institutions.

Throwing money at the problem won't work.

One objection to focusing on financial development and globalization as key factors in economic growth is that it is far from clear that emerging market countries are finance constrained, a point emphasized by Rodrik and Subramanian (2008): in other words, they often do not have trouble getting money for investments. The discussion in this essay supports the view that a lack of money flowing to investments is often not the problem in emerging market countries, but it shows that randomly throwing money at investments does not work. Indeed, as the emerging market financial crises in past years indicate, too much money flowing into these countries often resulted in bad loans and investments, which led to disastrous financial crises. The argument for the importance of financial development is not that it increases investment but that it promotes the allocation of investment to where it can do the most good for the economy. Research finds that financial development primarily increases growth not by increasing the amount of investment but by ensuring that investment is allocated to uses that

increase productivity.[36]

Disadvantaged countries must take responsibility for their own fate.

The ultimate responsibility for success or failure in poor countries is their own. There needs to be a political will in emerging market countries to promote institutional development. However, this is not the view that is heard when antiglobalization protestors rally in the streets. They see a cabal of sinister institutions, particularly those based in Washington, D.C. – the IMF, the World Bank, and the U.S. Treasury – as the source of the woes in poor countries. This view is not only held in the streets but is also supported by some of the leading academic minds. The most prominent critic of the IMF is Nobel Prize winner Joseph E. Stiglitz, who titled one of the chapters in his book, *Globalization and its Discontents*, "The East Asia Crisis: How IMF Policies Brought the World to the Verge of a Global Meltdown."[37] To put it bluntly, those who believe that Washington-based institutions are the reason why the developing countries stay mired in poverty, as Stiglitz and the antiglobalization protestors do, are just plain wrong.

International financial institutions and citizens in advanced countries can make a difference.

International financial institutions, like the IMF and the World Bank, and advanced government agencies, like the U.S. Treasury, have made mistakes in the past, but they can create incentives to promote institutional development in poor countries. The IMF, the World Bank, and the U.S. Treasury can admit that they don't know all the answers and can recognize that the answers to institutional development often reside in the emerging market countries themselves. They can give more ownership of policies to these countries by designing them jointly through a process of give and take. They can also provide the right incentives for institutional development by providing funds to countries only when they are serious about putting in place the kinds of reforms needed to establish strong property rights and an efficient and effective financial system. If special interests block these reforms, then institutions like the IMF and the World Bank have to pull back their funds and just say "no," thereby providing incentives to overcome the powerful forces of those who oppose the reforms needed for successful financial globalization.

Can we, as individuals, in the advanced countries help? Yes, by supporting the opening of our markets to goods and services from emerging market countries. By encouraging these countries to increase their export sectors, we create exactly the right incentives for them to implement the difficult measures that will enable them to grow rich. Exporters have strong incentives to be productive so that they can take advantage of access to our markets and thus

make the investments needed for growth. They also will push for the institutional reforms to make financial markets more efficient and promote financial deepening. By getting financial markets to work well, exporters will have access to the capital that they need to increase their businesses. A larger export sector in emerging market countries also helps make financial crises less likely and less severe: Firms that have their goods sold in foreign markets have found that declines in the value of the domestic currency help to raise the demand for their goods, which compensates for a higher value of their liabilities denominated in foreign currency

Opening up our markets to emerging market countries is an important way that those in advanced countries can help emerging market economies to become successful. Although providing more aid to poor countries seems like a good way to eradicate poverty, it rarely works because it usually does not create the right incentives to promote economic growth. A handout is almost never as effective as a hand up.

Arguing that we need to keep jobs in rich countries like the United States, and so have to bar imports or outsourcing, is just another way of saying that we want to keep workers in less-fortunate countries poor[38]. This doesn't mean that those who lose their jobs in advanced countries don't deserve our sympathy and our support in finding new jobs, but displaced workers can be taken care of in ways other than trade restrictions. In the long run, free trade raises productivity in

advanced countries like the United States and so eventually provides better jobs.

It's the politics, stupid.

Is making financial globalization work for emerging market countries easy to accomplish? Far from it. It is difficult because it requires development of institutions, which takes a lot of time and effort. Furthermore, it requires getting the political process in poor countries to support institutional reform. This is a difficult task, but it is not insurmountable, as the success of Hong Kong, Singapore, Taiwan, South Korea, and Chile have demonstrated.

The example of South Korea is particularly instructive. South Korea has pursued many different strategies to promote growth. When it started to focus on economic development after the Korean War, the South Korean government did not focus on reforms to develop an efficient financial system. The government was heavily involved in allocating capital, financial markets were highly regulated, and the domestic financial system was completely closed off from the rest of the world. Then, when it liberalized its financial system and opened the economy to flows of foreign capital, it did so in a particularly perverse way that culminated in a financial crisis of massive proportions. The Korean government, however, learned from its mistakes. After its financial crisis, the Korean government actively pushed financial reforms to make its financial system work

better and be less prone to crises. South Korea was then rewarded with a far stronger recovery than the other countries that suffered crises in the region.

There is no simple answer.

This essay argues that institutional development that promotes strong property rights and a financial system that directs capital to its most productive uses are crucial to achieving high economic growth and the eradication of poverty. This does not mean that other factors such as health, education, or income inequality are not important to economic growth[39]. They surely are. The importance of developing a well-functioning financial system, however, has not received sufficient attention in discussions about economic growth. This essay does not come up with ten easy ways to get financial globalization right. Globalization requires hard work on the part of emerging market countries. All that advanced nations can do is provide incentives that encourage policymakers, politicians, and citizens to support the kind of institutional development that will promote economic growth in poor countries. Getting governments to work in the interest of the public, so that the right kind of institutional reform occurs, is one of the toughest problems facing development economists and political scientists today[40].

REFERENCES

Abiad, Abdul, Nienke Oomes and Kenichi Ueda. 2005. "The Quality Effect: Does Financial Liberalization Improve the Allocation of Capital?" paper presented at the Journal of Banking and Finance/World Bank Conference on Globalization and Financial Services in Emerging Market Countries, June 20-21, forthcoming in *Journal of Development Economics*.

Acemoglu, Daron, Simon Johnson and James A. Robinson. 2005. "Institutions as the Fundamental Cause of Long-Term Growth," in Philippe Aghion and Steven N. Durlauf (eds.), *Handbook of Economic Growth*, vol 1, part A. Amsterdam: North-Holland, 385-472.

Aghion, Philippe and Patrick Bolton. 1997. "A Trickle-Down Theory of Growth and Development with Debt Overhang," *Review of Economic Studies*, 64(219), April: 151-72.

Aghion, Philippe, Howitt, Peter and David Mayer-Foulkes. 2005. "The Effect of Financial Development on Convergence: Theory and Evidence," *Quarterly Journal of Economics* vol. 120(1), February: 173-222.

Aizenman, Joshua. 2008. “On the Hidden Links Between Financial and Trade Opening,” *Journal of International Money and Finance*, 27(3), April: 372-86.

Alesina, Alberto, Vittorio Grilli and Gian Maria Milesi-Ferretti. 2004. “The Political Economy of Capital Controls,” in Leonardo Leiderman and Assaf Razin (eds.) *Capital Mobility: The Impact on Consumption, Investment and Growth*, Cambridge University Press: Cambridge.

Alfaro, Laura, Sebnem Kalemli-Ozcan, and Vadym Volosovych. 2007. “Capital Flows in a Globalized World: The Role of Policies and Institutions,” in Sebastian Edwards (ed.). *Capital Controls and Capital Flows in Emerging Economies: Policies, Practices, and Consequences.* University of Chicago Press for NBER: Chicago.

Alfaro, Laura, Sebnem Kalemli-Ozcan, and Vadym Volosovych. 2008. “Why Doesn’t Capital Flow from Rich to Poor Countries? An Empirical Investigation,” *Review of Economics and Statistics*, 90(2), May: 347-68.

Arteta, C., Barry Eichengreen and Charles Wyplosz. 2003. “When Does Capital Account Liberalization Help More Than it Hurts?” In Elhanan Helpman and Efrain Sadka (eds). *Economic Policy in the International Economy: Essays in*

Honor of Assaf Razin. Cambridge University Press: Cambridge.

Bailliu, Jeannine. 2000. "Private Capital Flows, Financial Development, and Economic Growth in Developing Countries," Bank of Canada Working Paper No. 2000-15, July.

Bairoch, P.1993. *Economics and World History: Myths and Paradoxes.* Harvester-Wheatsheaf: London.

Baldwin, Richard E. and Philippe Martin. 1999. "Two Waves of Globalisation: Superficial Similarities, Fundamental Differences," in H. Siebert (ed.) *Globalization and Labour*, J.C.B. Mohr for Kiel Institute of World Economics: Tubingen, 3 - 59.

Banerjee, Abhijit and Andrew Newman. 1993. "Occupational Choice and the Process of Development," *Journal of Political Economy*, 101 (2), April: 274-98.

Barajas, Adolfo, Roberto Steiner and Natalia Salazar. 2000. "The Impact of Liberalization and Foreign Investment in Colombia's Financial Sector." *Journal of Development Economics*, 63(1): 157-96.

Barth, James R., Gerard Caprio, Jr. and Ross Levine. 2005. *Rethinking Bank Regulation and Supervision: Till Angels Govern*, Cambridge: Cambridge University Press.

Beck, Thorsten, Ross Levine and Norman Loayza. 2000. ”Finance and the Sources of Growth,” *Journal of Financial Economics*, 58(1-2): 261-300.

Battini, Nicoletta and Douglas Laxton 2007, “Under What Conditions Can Inflation Targeting Be Adopted? The Experience of Emerging Markets?” in Frederic S. Mishkin and Klaus Schmidt-Hebbel (eds.) *Monetary Policy Under Inflation Targeting.* Central Bank of Chile: Santiago, Chile: 467-506.

Beck, Thorsten, Asli Demirguc-Kunt and Ross Levine. 2004. “Finance, Inequality and Poverty: Cross-Country Evidence,”NBER Working Paper 10979, December.

Bekaert, Geert and Campbell R. Harvey. 2000. “Foreign Speculators and Emerging Equity Markets,” *Journal of Finance*, 55(2): 562-613.

Bekaert, Geert, Campbell R. Harvey and Robin L. Lumsdaine. 2002. “Dating the Integration of World Equity Markets,”*Journal of Financial Economics*, 65(2), August: 203-47.

Bekaert, Geert, Campbell R. Harvey and R. Lundblad. 2005. “Does Financial Liberalization Spur Growth?”*Journal of Financial Economics*, 77(1), July: 3-55.

Bhagwati, Jagdish. 1998. “The Capital Myth: The Difference between Trade in Widgets and Dollars,” *Foreign Affairs*, 77(3), May/June: 7-13.

Bhagwati, Jagdish. 2002. *The Winds of the Hundred Days: How Washington Mismanaged Globalization*. MIT Press: Cambridge, Mass.

Bhagwati, Jagdish. 2004. *In Defense of Globalization*. Oxford University Press: New York.

Bourguignon, Francois and Christian Morrisson. 2002. “Inequality Among World Citizens: 1820-1992,” *American Economic Review*, 92(4), September: 727-44.

Braudel F. 1984. *Civilisation and Capitalism, 15th-18th century: The Perspective of the World*. vol. 3, Harper and Row: New York.

Calomiris, Charles W. 2002. *A Globalist Manifesto for Public Policy*. London: Institute of Economic Affairs.

Calvo, Guillermo A., Alejandro Izquierdo and Ernesto Talvi. 2003. "Sudden Stops, the Real Exchange Rate, and Fiscal Sustainability: Argentina's Lessons," in V. Alexander, J. Melitz and G.M. von Furstenberg (eds.), *Monetary Unions and Hard Pegs*, Oxford University Press: Oxford, U.K., 151-81.

Calvo, Guillermo, Alejandro Izquierdo and Luis-Fernando Mejia. 2004. "On the Empirics of Sudden Stops: The Relevance of Balance-Sheet Effects," NBER Working Paper No. 10520, May.

Calvo, Guillermo and Ernesto Talvi. 2005. "Sudden Stop, Financial Factors and Economic Collapse in Latin America: Learning from Argentina and Chile," NBER Working Paper No. 11153, February.

Cavallo, Eduardo and Jeffrey Frankel. 2007. "Does Openness to Trade Make Countries More Vulnerable to Sudden Stops or Less? Using Gravity to Establish Causality," *RES Working Papers 1063*, Inter-American Development Bank, forthcoming in *Journal of International Money and Finance.*

Claessens, Stijn, Asli Demiriguc-Kunt and Harry Huizinga. 2000. "The Role of Foreign Banks in Domestic Banking Systems," in Stijn Claessens and Marion

Jansen (eds.), *The Internationalization of Financial Services: Issues and Lessons for Developing Countries.* Kluwer: Dordrecht, Holland.

Claessens, Stijn, Asli Demiriguc-Kunt and Harry Huizinga. 2001. "How Does Foreign Bank Entry Affect Domestic Banking Markets," *Journal of Banking and Finance*, 25(5), May: 891-911.

Claessens, Stijn and Marion Jansen. 2000. *The Internationalization of Financial Services: Issues and Lessons for Developing Countries*. Kluwer Academic Press: Boston.

Clarke, George, Robert Cull, Laura D'Amato and Andrea Molinari. 2000. "The Effect of Foreign Entry on Argentina's Banking System," in Stijn Claessens and Marion Jansen (eds.), *The Internationalization of Financial Services: Issues and Lessons for Developing Countries*, Kluwer Academic Press: Boston

Cole, Harold L., Lee E. Ohanian, Alvara Riascos and James A. Schmitz, Jr. 2005. "Latin America in the Rearview Mirror," *Journal of Monetary Economics*, 52(1), January: 69-107.

Dehejia, Rajeev H. and Roberta Gatti. 2005. "Child Labor: The Role of Financial

Development and Income Variability across Countries," *Economic Development and Cultural Change*, 53(4), July: 913-932.

Demirguc-Kunt, Asli and Vojislav Maksimovich. 1998. "Law, Finance and Firm Growth." *Journal of Finance*, 53(6): 2107-37.

Dollar, David and Aart Kraay. 2002. "Growth is Good for the Poor", *Journal of Economic Growth*, 7(3), September: 195-225.

Dollar, David. 2003. *World Bank Policy Research Report on Globalisation*, in David Dollar, *Globalization, Investment Climate, and Growth*, World Bank Policy Research Paper, November.

Easterly, William 2001. *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics*, MIT Press: Cambridge, Mass.

Easterly, William. 2006. *The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done so Much Ill and So Little Good*, Penguin Press: New York.

Easterly, William and Ross Levine. 2001. "It's Not Factor Accumulation: Stylized Facts and Growth Models," *World Bank Economic Review*, 15(2):177-

Edison, Hali J., Michael W. Klein, Luca Antonio Ricci and Torsten Slok. 2004. "Capital Account Liberalization and Economic Performance: Survey and Synthesis," *IMF Staff Papers*, 51(2): 220-56.

Edison, Hali, Ross Levine, Luca Ricci and Torsten Slok. 2002. "International Financial Integration and Economic Growth," *Journal of International Money and Finance*, 21(6), November: 749-76.

Edwards, Sebastian. 2001. "Capital Mobility and Economic Performance: Are Emerging Economies Different?" in Horst Siebert (ed.), *The World's New Financial Landscape: Challenges for Economic Policy*, Kiel Institute of World Economics Symposia and Conference Proceedings. Hiedelberg and New York: Springer, 2001, 219-44.

Edwards, Sebastian . 2004. "Thirty Years of Current Account Imbalances, Current Account Reversals and Sudden Stops," NBER Working Paper 10276, January.

Eichengreen, Barry. 2001. "Capital Account Liberalization: What Do Cross-

Country Studies Tell Us," *The World Bank Economic Review*, 15(3), October: 341-65.

Eichengreen, Barry, Masson, Paul, Savastano, Migues and S. Sharma. 1999. "Transition Strategies and Nominal Anchors on the Road to Greater Exchange Rate Flexibility," in *Essays in International Economics*, No. 213. International Finance Section, Department of Economics, Princeton University: Princeton, N.J.

Engerman, Stanley and Kenneth Sokoloff. 1997. "Factor Endowments , Institutions and Differential Paths of Growth Among New World Economies: A View from Economic Historians of the United States," in Stephen Haber (ed.), *How Latin America Fell Behind: Essays on the Economic Histories of Brazil and Mexico, 1800-1914*, Stanford University Press: Stanford, CA.

Estevadeordal, A.B. Frantz and Alan Taylor. 2003. "The Rise and Fall of World Trade, 1870-1939," *Quarterly Journal of Economics*, 118(2), May: 359-407.

Fischer, Stanley. 2003. "Globalization and Its Challenges," *American Economic Review*, 93(2), May: 1-30.

Galor, Oded and J. Zeira. 1993. "Income Distribution and Macroeconomics,"

Review of Economic Studies, 60(1), January: 35-52.

Goldberg, Linda. 2007. "Financial Sector FDI and Host Countries: New and Old Lessons," *Economic Policy Review*, 13(1), March: 1-17.

Gourinchas, Pierre-Olivier and Olivier Jeanne. 2005."Capital Mobility and Reform," Paper presented at the Sixth Jacques Polak Annual Research Conference hosted by the IMF, November.

Haber, Stephen. 1997. *How Latin America Fell Behind: Essays on the Economic Histories of Brazil and Mexico, 1800-1914.* Stanford University Press: Stanford, California

Haber, Stephen. 2007. "Political Institutions and Financial Development: Evidence from the Political Economy of Bank Regulation in Mexico and the United States," in Stephen Haber, Douglass North, and Barry Weingast (eds.), *Political Institutions and Financial Development.* Stanford University Press: Stanford, CA.

Halac, Marina and Sergio L. Schmukler. 2004."Distributional Effects of Crises, the Financial Channel." *Economia*, 5(1), 1-67.

Henry, Peter Blair. 2000a. "Equity Prices, Stock Market Liberalization, and Investment," *Journal of Financial Economics* 58(1-2): 301-34.

Henry, Peter Blair. 2000b. "Stock Market Liberalization, Economic Reform, and Emerging Market Equity Prices," *Journal of Finance* 55(2), April: 529-64.

Henry, Peter Blair. 2003. "Capital Account Liberalization, the Cost of Capital, and Economic Growth," *American Economic Review*, 93(2), May: 91-96.

Hongyi, Li, Lyn Squire and Heng-fu Zou. 1998. "Explaining International and Intertemporal Variations in Income Inequality," *Economic Journal*, 108(446), December: 26-43.

Honohan, Patrick. 2004. "Financial Development, Growth and Poverty: How Close are the Links?" in Charles Goodhart, (ed.), *Financial Development and Economic Growth: Explaining the Links*, Palgrave: London.

Institute for International Finance, "Update of Capital Flows to Emerging Market Economies," March 31, 2005, (http://www.iif.com/verify/data/report_docs/cf_0305.pdf).

International Monetary Fund. 2001. *World Economic Outlook*, IMF: Washington, D.C.: October.

Jeong, Hyeok and Robert M. Townsend. 2007. "Sources of TFP Growth: Occupational Choice and Financial Deepening," *Economic Theory*, 32(1), July: 179-221

Kearl, James R., Clayne L. Pope, Gordon C. Whiting and Larry T. Wimmer. 1979. "A Confusion of Economists," *American Economic Review, Papers and Proceedings*, 69 (2), May: 28-37.

Keynes, John M. 1920. *The Economic Consequences of the Peace*, Harcourt Brace: New York.

Kim, E. Han, and Vijay Singal. 2000. "Stock Market Opening: Experience of Emerging Market Economies," *Journal of Business*, 73(1), January: 25-66.

King, Robert and Ross Levine. 1993. "Finance and Growth: Schumpeter Might Be Right," *Quarterly Journal of Economics*, 108(3), August: 717-37.

Klein, Michael. 2005. “Capital Account Liberalization, Institutional Quality and Economic Growth: Theory and Evidence,” National Bureau of Economic Research Working Paper No. 11112, February.

Klein Michael and Giovanni Olivei. 1999. “Capital Account Liberalization, Financial Depth and Economic Growth,” NBER Working Paper No. 7384, October.

Kose, M. Ayhan, Eswar Prasad, Kenneth Rogoff and Shang-Jin Wei. 2006. “Financial Globalization: A Reappraisal,” NBER Working Paper No. 12484. IMF mimeo. August.

Kose, M. Ayhan, Eswar Prasad, Kenneth Rogoff and Shang-Jin Wei. 2007, “Financial Globalization and Economic Policies,” IMF mimeo. November.

Kraay, Aart. 1998. “In Search of the Macroeconomic Effects of Capital Account Liberalization,” World Bank, Development Research Group, Washington, D.C. October.

Levine, Ross. 1996. “Foreign Banks, Financial Development and Economic Growth,” in Claude E. Barfield (ed.), *International Financial Markets: Harmonization versus Competition*, AEI Press: Washington, D.C.: 224-255.

Levine, Ross. 1997. “Financial Development and Economic Growth: Views and Agenda,” *Journal of Economic Literature*, 35(2), June: 688-726.

Levine, Ross. 2005a. “Finance and Growth: Theory and Evidence,” in Philippe Aghion and Steven Durlauf (eds.), *Handbook of Economic Growth*. Elsevier Science: Amsterdam 1(A), 865-934.

Levine, Ross. 2005b. “Law, Endowments and Property Rights,” *Journal of Economic Perspectives*, 19(3), Summer: 61-88.

Levine, Ross, Norman Loayza and Thorsten Beck. 2000. “Financial Intermediation and Growth: Causality and Causes,” *Journal of Monetary Economics*, 46(1), August: 31-77.

Levine, Ross, and Sara Zervos. 1998a. “Capital Control Liberalization and Stock Market Development,” *World Development*, 26: 1169-83.

Levine, Ross and Sara Zervos. 1998b. "Stock Markets, Banks, and Economic Growth," *American Economic Review*, 88(3), June: 537-58.

Lindert, Peter and Jeffrey Williamson. 2003. "Does Globalization Make the World More Unequal?" in Michael D. Bordo, Alan M. Taylor, and Jeffrey G. Williamson (eds.), *Globalization in Historical Perspective*, University of Chicago Press for the NBER: Chicago.

Lucas, Robert, Jr. 1990. "Why Doesn't Capital Flow from Rich to Poor Countries?" *American Economic Review*, 80(2), May: 92-96.

Lukas, Richard. 1986. *The Forgotten Holocaust: The Poles Under German Occupation, 1939-1944*, University Press of Kentucky: Lexington.

Maddison, Angus. 2001. *The World Economy: A Millennial Perspective.* Development Centre of the Organization for Economic Co-operation and Development: Paris.

Mishkin, Frederic S. 1996. "The Channels of Monetary Transmission: Lessons for Monetary Policy," *Banque de France Bulletin Digest*, 27(3): 33-44.

Mishkin, Frederic S. 2003. "Financial Policies and the Prevention of Financial Crises in Emerging Market Countries," in Martin Feldstein (ed.), *Economic and Financial Crises in Emerging Market Countries*. University of Chicago Press: Chicago, 93-130.

Mishkin, Frederic S., 2006. *The Next Great Globalization: How Disadvantaged Nations Can Harness Their Financial Systems to Get Rich*, Princeton University Press: Princeton.

Morck, Randall, Daniel Wolfenzon and Bernard Yeung. 2005. "Corporate Governance, Economic Entrenchment and Growth," *Journal of Economic Literature*, 43(3), September: 655-720.

Obstfeld, Maurice and Alan M. Taylor. 2003. "Globalization and Capital Markets," in Michael D. Bordo, Alan M. Taylor, and Jeffrey G. Williamson (eds.), *Globalization in Historical Perspective*, University of Chicago Press for the NBER: Chicago, 121-83.

Obstfeld, Maurice and Alan M. Taylor. 2004. *Global Capital Markets: Integration, Crisis and Growth.* Cambridge University Press: Cambridge.

Prasad, Eswar, Raghuram Rajan, and Arvind Subramanian, 2007. "Foreign Capital and Economic Growth," *Brookings Papers on Economic Activity*, Vol. 1.

Prasad, Eswar, M. Ayhan Kose, Kenneth Rogoff and Shang-Jin Wei. 2003. "Effects of Financial Globalization on Developing Countries: Some Empirical Evidence." International Monetary Fund, Occasional papers 220.

Prasad, Eswar, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose. 2004. "Financial Globalization Growth and Volatility in Developing Countries," NBER Working Paper No. 10942, December.

Pritchett, Lant. 1997. "Divergence, Big Time," *Journal of Economic Perspectives*, 11(3), Summer: 3-17.

Quinn, Dennis P. 1997. "The Correlates of Change in International Financial Regulation," *American Political Science Review*, 91(3), September: 531-51.

Rajan, Raghuram and Luigi Zingales. 1998. "Financial Dependence and Growth," *American Economic Review*, 88(3), June: 559-86.

Rajan, Raghuram and Luigi Zingales. 2003a. "The Great Reversals: the Politics of

Financial Development in the Twentieth Century," *Journal of Financial Economics*, 69(1), July: 5-50.

Rajan, Raghuram and Luigi Zingales. 2003b. *Saving Capitalism from the Capitalists: Unleashing the Power of Financial Markets to Create Wealth and Spread Opportunity.* Crown Business: New York.

Rodrik, Dani. 1998. "Who Needs Capital-Account Convertibility?" in Stanley Fischer et al, *Should the IMF Pursue Capital-Account Convertibility?* Essays in International Finance No. 207, Department of Economics, Princeton University, May.

Rodrik, Dani and Arvind Subramanian, 2008. "Why Did Financial Globalization Disappoint?" Harvard University mimeo. *IMF Staff Papers*, forthcoming.

Sala-i-Martin, Xavier. 2002. "The Disturbing "Rise" of Income Inequality," National Bureau of Economic Research Working Paper No. 8904, April.

Schmukler, Sergio L. 2004. "Financial Globalization: Gain and Pain for Developing Countries," Federal Reserve Bank of Atlanta *Review*, (Second Quarter): 39-66.

Soros, George. 2002. *On Globalization*. Public Affairs: New York.

Stiglitz, Joseph. 2002. *Globalization and its Discontents*. W.W. Norton: New York.

Svaleryd, H. and Jonas Vlachos. 2002. "Markets for Risk and Openness to Trade: How Are They Related?" *Journal of International Economics*, 57(2), August: 369-95.

Taylor, Alan M. 1992. "External Dependence, Demographic Burdens, and Argentine Economic Decline after the *Belle Poque*," *Journal of Economic History*, 52(4), December: 907-36.

Taylor, Alan M. 2003. "Globalization, Trade and Development: Some Lessons from History" in R. Devlin and A. Estevadeordal (eds.), *Bridges for Development: Policies and Institutions for Trade and Integration*, Inter-American Development Bank: Washington, D.C.

Tornell, Aaron, Frank Westermann and Lorenza Martinez. 2004. "The Positive Link Between Financial Liberalization, Growth and Crises," National Bureau of Economic Research Working Paper No. 10293, February.

Unite, Angelo and Michael Sullivan. 2003. “The Effect of Foreign Entry and Ownership Structure on the Philippine Domestic Banking Market,” *Journal of Banking and Finance*, 27(12), December: 2323-45.

Weil, David N. 2005. *Economic Growth.* Addison-Wesley: Boston

Winters, L. Alan, Neil McCulloch and Andrew McKay. 2004. “Trade Liberalization and Poverty: The Evidence So Far,” *Journal of Economic Literature*, 42(1), March: 72-115.

Wolf, Martin. 2004. *Why Globalization Works?* Yale University Press: New Haven.

World Bank. 2001. *Finance for Growth: Policy Choices in a Volatile World*, World Bank and Oxford University Press: Oxford.

World Bank. 2007. *World Development Indicators*, on-line Database, The World Bank, Washington, D.C.

ENDNOTES

1. Dani Rodrik is another prominent academic economist who is very skeptical of financial globalization. E.g., see Rodrik (1998) and the essay in this volume, Rodrik and Subramanian (2008).

2. Bhagwati (1998), p. 7. Also see Bhagwati (2002) and Chapter 13, "The Perils of Gung-ho International Financial Capitalism," in Bhagwati (2004).

3. An exception to popular books that criticize financial globalization is Wolf (2004). Also see Calomiris (2002).

4. There is some arbitrariness as to when to date the start of the first Age of Globalization. The rapid drop of transportation costs starting in the 1820s is often cited as starting the first Age (Baldwin and Martin, 1999). The 1870 date is the most commonly used starting date, however.

5.The international trade data are from Taylor (2003), the GDP data are from Maddison (2001), and the capital flow data are from Obstfeld and Taylor (2003).

6.Keynes (1920), pp.11-12. Note that this citation is to the 1920 edition, even though the book was first published in 1919.

7. However, wage inequality may have increased because there has been a fall in the wages of unskilled workers relative to skilled workers throughout the world,

including in developing countries that have actively entered global markets. The leading explanation for this phenomenon is that trade-induced technical change has been biased against wages of unskilled labor. Thus, the jury is still out on whether trade liberalization has increased income inequality within developing countries.

8. See the survey in Chapter 3 of Mishkin (2006).

9. This wonderful phrase was coined by the great American philosopher, Yogi Berra, a catcher for the New York Yankees.

10. As we will see, the main reason why capital doesn't flow from rich to poor countries is because of the weaker institutional environment in poor countries. Empirical evidence supports this view: Alfaro, Kalemli-Ozcan, and Volosovych (2007) and Prasad, Rajan, and Subramanian (2007).

11. The figure is the percent of gross capital formation supplied by foreigners for 2002 from World Bank (2007).

12. For example, in Kearl, Pope, Whiting, and Wimmer (1979) 97% of economists agreed (generally or with some provisions) with the following statement: "Tariffs and import quotas reduce general economic welfare."

13. For research showing that health is extremely important to economic growth, see Weil (2005). However, see Easterly (2001) for a skeptical view that spending on health and education promote economic growth. Dollar and Kraay (2002) also

find that public spending on health and education are not positively associated with declines in poverty.

14. U.S. Census Bureau, 2000 Census discussed in Project IMPACT (www.project-impact.org).

15. An excellent nontechnical survey of the extensive empirical evidence on this topic can be found in World Bank (2001). See also Ross Levine (2004) and Schmukler (2004). For a recent paper that also finds that financial deepening is crucial to economic growth for developing countries, see Aghion, Howitt, and Mayer-Foulkes (February 2005).

16. In some research, financial deepening is characterized as an expansion of the financial sector. Here, I am using the term financial deepening more generally to refer to financial development which includes not only an expansion in the financial sector but an improvement in its institutions so that it can allocate capital to its more productive uses more efficiently. Abiad, Oomes and Ueda (2005) find that financial liberalization, which improves the institutional framework of the financial sector, does lead to higher economic growth and is far more important to economic growth than just expansion of the financial sector.

17. One concern with this result is that high economic growth before 1960 could have led to high financial development and to further high economic growth, so that causality might not run from financial development to growth. To rule this

out, later papers have used instrumental variables techniques in which the origin of the legal system (English, French, German, or Scandinavian), which was determined typically hundreds of years ago, well before recent growth, is used as an instrument for financial development at the beginning of the period. The result is the same: economic growth is positively related to financial development. For example, see Levine, Loayza, and Beck (2000), Levine and Zervos (1998a,b), and Beck, Levine, and Loayza, (2000).

18. And this is particularly true in industries that depend more on external finance. See Rajan and Zingales (1998).

19. Honohan (2004), page 2. Case studies such as Jeong and Townsend (2007) also support the importance of financial deepening to economic growth.

20. These growth-promoting institutions are discussed more extensively in Chapter 2 of Mishkin (2006).

21. See Chapter 6, "The Taming of the Government," in Rajan and Zingales (2003b), pp. 129-156, for a description of this process in England.

22. The history of Latin America illustrates many examples of incumbents encouragement of financial repression. For example, see Haber (1997, 2007).

23. The Rajan and Zingales (2003b) view is backed up by a substantial body of research. The survey by Morck, Wolfenzon, and Yeung (2005) summarizes this literature as follows: "In many countries, large pyramidal groups effectively

entrust the corporate governance of substantial parts of their corporate sectors to a few extremely wealthy families. This can potentially magnify the poor governance of a few family patriarchs into inefficient economy-wide capital allocation, reduced investment in innovation, and retarded economic growth. Moreover, to preserve the *status quo*, these elite families sometimes appear to influence public policies so as to curtail private property rights development, capital market development and economic openness. We dub this situation *economic entrenchment*. We argue that much existing work points to economic entrenchment as a significant issue in many countries."

24. These restrictive regulations were actually not fully eliminated until the 1990s.

25. Rajan and Zingales (2003b) provide a graphic example in which incumbent financial institutions in Japan were able to repress the financial system with government help. In 1933, the Japanese banks were able to get the approval of the Ministry of Finance to set up a Bond Committee that decided which firms could issue corporate bonds and on what terms. As a result the Japanese banks were able to limit the issuance of corporate bonds to small amounts. With the opening up of the global financial markets in the late 1970s, this system broke down, and corporate bond issuance skyrocketed.

26. See also Kose, Prasad, Rogoff, and Wei (2007), who also come to this

conclusion.

27. Financial development also helps promote competition because it enables new firms to acquire firms so that they can compete with established firms. Increased competition is also a critical element in producing growth because it encourages efficiency and adoption of superior technology. Indeed, an important reason why developing countries like those in Latin America have done so poorly is their barriers to competition, among which is financial repression. For a discussion of how barriers to competition have stunted economic growth, see Cole, Ohanian, Riascos and Schmitz. (2005).

28. For additional evidence see Levine and Zervos (1998a,b), Bekaert and Harvey (2000), Bekaert, Harvey, and Lumsdaine (2002), Bekaert, Harvey and Lundblad (2005), Henry (2000a,b), International Monetary Fund (2001), and Kim and Singal (2000). Klein and Olivei (1999), and Bailliu (2000), however, find that these benefits are less clear for the poorest countries.

29. Trade openness also weakens the effectiveness of capital controls because firms engaged in international trade can avoid them by over and under-invoicing of exports and imports. With less-effective capital controls due to openness of trade, it is more likely that they will be abandoned, thereby promoting financial globalization. See Aizenman (2008).

30. Kose, Prasad, Rogoff, and Wei (2006) come to a similar conclusion that,

although financial globalization has many benefits, it can go very wrong because it can lead to financial crises.

31. This figure is cited in Barth, Caprio, and Levine (2005).

32. The above dynamics of financial crises in emerging market countries is discussed in Mishkin (1996) and Chapter 4 of Mishkin (2006), and case studies of these crises are found in Chapters 5-7 of Mishkin (2006).

33. For example, see the surveys in Levine (1997), Eichengreen (2001), Fischer (2003), Edison, Klein, Ricci, and Slok,(2004), and Prasad, Kose, Rogoff, and Wei (2003). Prasad, Rogoff, Wei, and Kose (2004) on page 31 summarize this literature by saying: "Table 3 summarizes the 14 most recent studies on this subject. Three out of the fourteen papers report a positive effect of financial integration on growth. However, the majority of the papers tend to find no effect or a mixed effect for developing countries. This suggests that, if financial integration has a positive effect on growth, it is probably not strong or robust." In a later paper, Prasad, Rogoff, Wei, and Kose (2004), have a more positive slant on financial globalization, stating "We do find that financial globalization can be beneficial under the right circumstances. Empirically, good institutions and quality of governance are crucial in helping developing countries derive the benefits of globalization." Some of the most cited papers in this literature are Alesina, Grilli, and Milesi-Ferretti (2004), Quinn (1997), Kraay (1998), Rodrik

(1998), Tornell, Westermann, and Martinez (2004), Arteta, Eichengreen, and Wyplosz (2003), Edwards (2001), and Edison, Levine, Ricci, and Slok (2002). More recent evidence in Klein (2005), however, finds that capital account liberalization in countries with better institutions does indeed lead to higher growth.

34. Easterly (2006) points out that when Eastern European countries adopted Western-drafted laws as part of the conditions to receive foreign aid, the new laws often did not work well. For example, Albania passed a bankruptcy law in 1994, yet only one case ever made it to the Albanian courts, even after a Ponzi scheme led to horrendous losses for Albanian investors in the mid-1990s.

35. Gourinchas and Jeanne (2005) provide a theoretical model that is consistent with the arguments in this essay. It shows that capital mobility encourages institutional reform because it enhances the benefits of good policies and helps lock in political support for reforms. On the other hand, capital mobility makes it more likely that there would be capital flight that could trigger a financial crisis that destroys the support for reform.

36. See Beck, Levine, and Loayza (2000), Easterly and Levine (2001) and Levine (2005a).

37. See Chapter 4 in Stiglitz (2002).

38. Jerry Caprio, in personal correspondence, suggested this way of expressing

this point.

39. Income inequality can also play an important role in hindering institutional development, which this essay argues is key to economic growth. For example, see Engerman and Sokoloff (1997). For an excellent nontechnical discussion of the other factors behind economic growth, see Weil (2005).

40. For a discussion of the recent literature on the politics of institutional development, see Acemoglu, Johnson, and Robinson (2005) and Morck, Wolfenzon, and Yeung (2005).