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Globalization and financial development☆

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ABSTRACT

This paper argues that globalization is a key factor in stimulating institutional reforms in developing countries that promote financial development and economic growth. Advanced countries can help in this process by supporting the opening of their markets to goods and services from emerging-market countries. By encouraging these countries to increase their participation in global markets, advanced countries can create exactly the right incentives for developing countries to implement the reforms that will enable them to have high economic growth.

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Our parents drill into us that the key to success is hard work. Yet when we look at many developing countries, we see people who work extremely hard for long hours. Their wages are low, and so they remain poor. And as a whole, their countries remain poor. If hard work does not make a country rich, what does?

The right institutions are essential. Nobel laureate Douglass North defines institutions as the "rules of the game in a society, or, more formally, humanly devised constraints that shape human intervention." (North, 1990, p. 3). Among the institutions that are most crucial to economic growth are those that enable a country to allocate capital to its most productive uses. Such institutions establish and maintain strong property rights, an effective legal system, and a sound and efficient financial system.

In recent years, the field of economic development has moved toward the conclusion that "institutions rule" and are critical to economic growth.[1] An extensive literature focuses on financial development as a significant force driving economic development.[2]

However, developing good institutions that foster financial development is not easy: It takes time for institutions to evolve and adapt to local circumstances. In addition, vested interests in poor countries often oppose the necessary reforms because they believe that such reforms will weaken their power or allow other people to cut into their profits. How can poorer countries overcome these obstacles? How can they change the distribution of power to forge the political will to promote institutional reform? My reading of the literature suggests that a key part of the answer is globalization.

1. Elements of institutional reform

Before examining the role of globalization in promoting financial development, let's first look briefly at what elements are essential in building an institutional infrastructure that will ensure a well-functioning financial system.[3] Much research on this topic is ongoing, and there is no consensus on the exact mix of institutional characteristics that best promotes financial and economic development. Nevertheless, my reading of the evidence suggests that the

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[1] A large literature shows the importance of good institutions to economic growth. See, for example, North and Thomas (1973); Hall and Jones (1999); Acemoglu, Johnson, and Robinson (2001); Easterly and Levine (2001); Rodrik, Subramanian, and Trebbi (2002); Easterly and Levine (2003); Glaeser and others (2004); and the recent survey by Acemoglu, Johnson, and Robinson (2005). Kaufmann and others (1999) also point to the importance of various aspects of good governance.

[2] An excellent nontechnical survey of the extensive empirical evidence on the link between financial development and economic growth can be found in World Bank (2001). See also Levine (2004) and Schmukler (2004).

[3] Mishkin (2006) has a more extensive discussion of the elements of institutional infrastructure and references to the literature.

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factors listed below would draw support from most scholars in this area.

1.1. Property rights

Strong property rights encourage productive investment because it will not be undertaken if the returns on investment are likely to be taken away by the government or others. Hernando de Soto, in his important book *The Mystery of Capital* (de Soto, 2000), argues that the inability of the poor in developing countries to acquire property rights is a central reason that they are unable to gain access to capital and so remain mired in poverty. For example, the use of collateral is a crucial tool that helps the financial system make loans because it reduces losses when loans go sour. A person who would pledge land or capital for a loan must, however, legally own the collateral. Unfortunately, as de Soto has documented, legalizing the ownership of capital is extremely expensive and time consuming for the poor in developing countries. In one of his many astonishing examples, obtaining legal title to a dwelling on urban land in the Philippines required taking 168 bureaucratic steps through 53 public and private agencies over a period of 13 to 25 years.

1.2. Legal system

A legal system that enforces contracts quickly and fairly supports strong property rights and financial development. For example, lenders write restrictive covenants into loan contracts to prevent borrowers from taking on too much risk, but such covenants have value only if they can be legally enforced. An inefficient legal system in which loan contracts cannot be enforced will prevent productive lending from taking place. If setting up legitimate businesses or obtaining legal title to property is too expensive, the poor will never have access to the legal system and will be cut off from lending that could help them start small businesses and escape poverty.[4] Setting up a simple business in the United States generally requires only filling out a form and paying a nominal licensing fee. In contrast, de Soto's researchers found that legally registering a small garment workshop in Peru required 289 days; at 6 hours per day, the cost was about $1200, which was approximately thirty times the monthly minimum wage. The lack of property rights for all but the very rich, as documented by de Soto, is a serious impediment to financial development.

1.3. Corruption

Government is often the primary source of financial repression in developing countries. Governments whose rulers treat their countries as personal fiefdoms are not uncommon: We have seen these governments in Saddam Hussein's Iraq, Robert Mugabe's Zimbabwe, and Ferdinand Marcos's Philippines. Even officials in less tyrannical governments have been known to 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.

Eliminating corruption is essential in strengthening property rights and the legal system. When corrupt officials demand bribes, they reduce the incentives for entrepreneurs to make investments. The ability to buy off judges weakens the enforcement of legal contracts that enable the economic and financial system to function smoothly.[5]

1.4. Quality of financial information

High-quality financial information is essential to well-functioning financial markets. If lenders cannot figure out what is going on in a firm, they will be unable to screen out good from bad credit risks or to monitor the firm to ensure that it does not take on too much risk at the lender's expense. To make reliable and accurate information more accessible, accounting standards must be high enough so that prospective lenders can make sense of what is in a business's books. Rules that require businesses to disclose information must be enforced to enable prospective investors to make sensible decisions about whether the business deserves to get their hard-earned money.

1.5. Corporate governance

For people to be willing to buy stocks, another way to channel funds to business, rules must be established to ensure that the managers of corporations act in the stockholders' interest. If managers find it easy to steal from the corporation, or to use funds for their own personal use rather than for the benefit of the company, no one will want to invest in the company. Finding the right balance of control between management and stockholders is a challenge with which even advanced countries continue to struggle.

1.6. Sound, prudential regulation and supervision of the banking system

Banks are the main institutions that allocate credit in developing countries. The skills necessary for bank officers to assess risks and make good lending decisions are critically important and often scarce. Poor lending policies may cause too much capital to be channeled toward low-return projects and insufficient capital to be directed toward the high-return projects needed to propel income and growth. Moreover, deterioration in banks' balance sheets caused by insider lending or excessive risk-taking that leads to a proliferation of bad loans can cause banks to cut back sharply on lending, with negative effects on the economy. If the deterioration in banks' balance sheets is severe enough, it can result in banking and currency crises that substantially disrupt the economy, phenomena that unfortunately have been all too common in developing countries over the past several decades.[6] Preventing banking crises must start with prudential *regulation*, in which rules set by the government ensure that banks have sufficient capital and manage risks well. To guarantee that these regulations are enforced, the government must also engage in prudential *supervision*, in which it monitors banks by examining them on a regular basis to ensure that they are complying with government regulations.

The role of microfinance in developing countries is receiving much attention these days. Microfinance is a positive development; it has clearly helped substantial numbers of poor people escape poverty, and the Nobel Peace Prize awarded to Muhammad Yunus for his pioneering efforts in this area was certainly well deserved.[7] However, microfinance is not a substitute for the institution building I am discussing here.

2. Globalizing to advance institutional reform

Now that we have identified what kinds of institutions are needed to promote financial development and economic growth, let's turn to

[4] A discussion of how the costs of doing business vary across a number of countries is in World Bank (2005).

[5] Research finds that increases in corruption are associated with lower growth (for example, Mauro, 1995). Wei (1997) also finds that corruption significantly reduces foreign direct investment, which is generally considered to be beneficial to growth.

[6] A survey of the literature that links a lack of sufficient prudential regulation and supporting institutions to excessive risk-taking and the possibility of a subsequent banking crisis is in Demirguc-Kunt and Detragiache (2005). Dell'Ariccia and Marquez (2006) also argue that under certain circumstances lending booms can make the banking system more unstable and can lead to a higher probability of a banking crisis.

[7] The literature on microfinance is vast. One thorough discussion is in Armendariz de Aghion and Morduch (2005).

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