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Open economy and financial burden of corruption: theory and application to Asia☆

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Abstract

We discuss why corruption remains high and show that corruption contributes to the Banking distress and to the rapid transmission across international stock and currency markets. Undeveloped 'derivative securities' markets make the risk from stress-induced volatility difficult to manage. Vinod's (1999) closed economy model is extended to indicate the asymmetry of 'home bias' and the effect of corruption on the value at risk (VaR). Our theory predicts that capital flight controls will be many, foreign direct investment (FDI) will be low and cost of capital will be high in corrupt developing countries, which is supported by Asian data. We include some policy recommendations regarding financial institutions and markets.

JEL classification: F30; H82; O19

Keywords: Asian crisis; Value at risk; Derivative securities; Diversification; Hedging; Generalized Pareto

1. Introduction

Corruption is defined as abuse of public office for private gain and it is often symptomatic of wider governance problems. From references in Bardhan's (1997) review and Vinod (1999) it is clear that corruption hurts economic development. However, typical arguments

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in this literature are based on closed economy models, largely ignoring open economy aspects and both domestic and international financial sectors. This paper fills the gap, covers the financial sector including money laundering and discusses how corruption contributes to some open economy market failures. These failures help create inefficient financial markets, reduce foreign direct investments (FDI) and increases cost of capital in developing countries.

Transparency International's (TI) corruption perception index (CPI) confirms that corruption remains high, especially in developing countries. The question is: Why? We suggest that it is because of missing or inadequate consensus against corruption in three specific areas mostly due to conflicts of interest.

(1) Economists define that a country has a "middle class consensus" when the share of income for the middle class is high and the degree of ethnic polarization is low. Such a consensus is known to favor greater democracy, more health, better infrastructure, and above all, greater success in economic development. In corrupt countries many middle class members themselves are corrupt bureaucrats or small businessmen who maintain a high income by using bribery, money laundering and tax evasion.
(2) In 1999, TI started publishing Bribe Payers Perceptions Index (BPI), which ranks 19 leading exporting countries in terms of the degree to which their corporations are perceived to be paying bribes abroad. Many rich countries such as Japan, which are not corrupt in terms of CPI or a similar index ICRG (2001), are shown to be big bribe payers abroad. There is no strong consensus in rich countries that they need to open their own markets, especially to products in which the poorest countries have a comparative advantage; to prosecute those who pay bribes abroad; to forego bribery-infested export promotion, which encourages wasteful military buildups in developing countries.
(3) The Banking privacy laws are used by corrupt entities for money laundering. Since money laundering can be profitable to the Banks, they have little incentive to report them and lose their business. In July 2000, the G7 organization of seven leading industrialized nations announced a new campaign to deter money laundering. Their Financial Action Task Force (FATF) on money laundering named 15 countries protecting money launderers. DJN (2001) notes that about US $1 trillion per year is laundered in an increasingly borderless world, aided by criminal development of new and more sophisticated methods for moving money, even as countries develop counter measures. Exploiting vulnerabilities in the financial system is an area of rising concern as Internet Banking transactions are quick, easy, and anonymous. Adequate customer identification and account monitoring procedures to fight corrupt money laundering will reduce Bank profitability leading to a conflict of interest.

We may loosely call the missing consensus as market failures, since the invisible hand of market forces will not cure these conflicts of interest. Proper realignment of private and public interest requires greater education and enforcement of government regulations. For example, we need a better understanding of how corruption increases the cost of capital, slows economic growth and hurts everyone. We postpone till Section 3 our evidence regarding how corruption increases the cost of capital. The following four subsections discuss various items ignored in the traditional corruption literature.