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Financial liberalization, bureaucratic corruption and economic development

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A B S T R A C T

We study the effect of international financial integration on economic development when the quality of governance may be compromised by corruption. Our analysis is based on a dynamic general equilibrium model of a small economy in which growth is driven by capital accumulation and public policy is administered by government-appointed bureaucrats. Corruption may arise due to the opportunity for bureaucrats to embezzle public funds, an opportunity that is made more attractive by financial liberalization which, at the same time, raises efficiency in capital production. Our main results may be summarized as follows: (1) corruption is always bad for economic development, but its effect is worse if the economy is open than if it is closed; (2) the incidence of corruption may, itself, be affected by both the development and openness of the economy; (3) financial liberalization is good for development when governance is good, but may be bad for development when governance is bad; and (4) corruption and poverty may coexist as permanent, rather than just transitory, fixtures of an economy.

1. Introduction

There is considerable debate about the merits of international financial integration. For many years, economists (both academics and practitioners) have continued to dispute the desirability of opening up financial markets and allowing free flows of capital between countries. The debate has been particularly pertinent to the case of less developed economies, for which there has been an urgent need

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to find appropriate strategies to promote growth and reduce poverty. In spite of all that has been written, there remains considerable disagreement about whether financial liberalization is one of these strategies. This lack of consensus is found at both theoretical and empirical levels, and there is little sign of it disappearing in the near future.

While the debate on financial integration has continued, another major issue has appeared on the international development agenda. This is the role of governance in determining the functioning of institutions, the effectiveness of policies and the prospects for growth and prosperity. The concept of governance has several dimensions to it, but one aspect, in particular, has commanded widespread attention - namely, corruption. Broadly speaking, corruption is defined as the abuse of power by public officials to make personal gains. There are numerous different forms that this can take and numerous different ways that it can impact on people's lives. In many countries the scale of corrupt activity is often quite staggering, as is the ingenuity of those who engage in it. Nowadays, more than ever before, corruption is regarded as one of the most serious threats to economic development and the alleviation of poverty around the world.

The debate on financial liberalization makes a few passing references to corruption, but there are good reasons for thinking that the issue deserves more than this. The present paper seeks to elucidate these reasons. Using a simple analytical framework, we study the potential linkages between financial integration, public sector corruption and economic development. The important feature of these linkages is that they are multi-causal with effects running from integration to development, integration to corruption, corruption to integration, corruption to development and development to corruption. To our knowledge, the analysis is the first to allow for such a multitude of interactions, the implications of which are a number of results which yield insights into the possible consequences of opening up financial markets. As background and motivation for the analysis, we devote the remainder of our introductory discussion to a brief review of the different literatures on which we draw.

1.1. Integration and development

There have been many theoretical arguments both for and against international financial integration, leaving opinion divided on the matter.[1] To some observers, there can be little or no doubt that liberalizing international capital markets leads to better economic outcomes. This view is often based on an analogy with trade liberalization, the benefits of which are rarely disputed. A more globally integrated and competitive financial system is similarly argued to improve resource allocations. Such a system is presumed to offer greater opportunities for sharing and diversifying risks, and to provide greater incentives to enhance and maintain efficiency. From the perspective of an individual economy, dismantling barriers to cross-border financial transactions may be seen as a relatively swift and painless way of boosting investment through increased capital inflows. To other observers, there are strong reasons for believing why financial liberalization may do more harm than good. In the presence of pre-existing distortions and weak institutional support mechanisms, de-regulating capital markets can exacerbate inefficiency and create instability. Countries that do de-regulate without appropriate safeguards are liable to increase their exposure to more intense, more frequent and more contagious bouts of adverse speculation that can fuel recurrent crises. Rather than attracting foreign savings, greater financial openness may induce a capital outflow from a country and leave it bereft of resources available for investment.

Empirical investigations have produced inconclusive evidence about which of the above views is closer to reality.[2] Whether international financial integration is good or bad for economic performance appears to be contingent on a number of context-specific factors. Not least of these is the extent to which financial markets, both at home and abroad, work smoothly and efficiently.[3] This is largely a matter of the quality and stability of institutional structures that govern the functioning of financial systems. The implication is that the effects of financial liberalization are more likely to be beneficial for more developed economies in

[1] For recent surveys of the literature, see Edison et al. (2002a) and Eichengreen (2002).

[2] See, for example, Edison et al. (2002b) and Eichengreen and Leblang (2003), and the references contained therein.

[3] According to Eichengreen and Leblang (2003), the effect of financial liberalization on growth is more likely to be positive when the domestic financial system is well developed and the international financial environment is stable, and is more likely to be negative when the converse is true.