

Capital Markets And Economic Development: A Framework For Newly Liberalized Economies

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ABSTRACT

One of the main objectives of this study is to show the necessity of capital markets and the sine qua non condition for their effective and efficient use for economic development. I relied heavily on a large body of scientific literature and empirical evidence to support my assertions. The implementation of capital markets requires time and more importantly cooperation between the government authorities and the private sector. I believe that the efficient functioning of capital markets presupposes a favorable economic and political environment and a corresponding appropriate institutional support for this environment. The confidence in the future and the confidence of the investors in this future are the sine qua non for the success of these capital markets. Thus, the role of the government in providing this confidence is pivotal to the implementation of efficient capital markets and to the propelling of economic development.

Keywords: capitalism, capital markets, economic development, socialism, communism

INTRODUCTION

The collapse of communism and socialism, particularly in the former Soviet Union and Eastern European countries, has apparently ended the economic debate between the roles of the state versus the market in driving economic development. The virtue of privatization and free markets - despite its serious drawbacks - as shown by the 1930s Great Depression and the current serious global economic and financial crisis- has regained its vigor and its dominion over other alternative means of allocation of economic resources.

Recently, there has been an unprecedented rush to implement market mechanisms- not only in Latin America, Africa, and Asia, where controlled economic systems have been in place for decades, but even in the former communist countries. As a result, interest rates and commodity prices have been progressively deregulated, and governments in the newly liberalized economies, are implementing, albeit slowly, the policy of privatization of public enterprises.

Economic growth, driven by market forces, has become the main economic pursuit of modern states and of the aspiring emerging countries. It is regarded as one of the ultimate economic measure of countries' competitiveness and economic performance. Capital markets are viewed as the sine qua non for economic development. The usefulness of capital markets is pretty much established. There is no advanced economy that has achieved a remarkable economic development without the establishment and the development of capital markets. Thus, an emerging economy, which aspires to emulate the achievements of advanced economies must establish and develop its capital markets.

What are the necessary conditions for these markets to contribute significantly to economic development of the emerging economies? Are there lessons to be learned from advanced industrialized countries which used successfully and efficiently their respective capital markets for their respective development? These questions are explored in the sections below.

SECTION 1. ROLE AND IMPORTANCE OF CAPITAL MARKETS

Recently there has been unprecedented rush to implement market mechanisms - not only in Latin America, Africa, and Asia, where controlled economic systems have been in place for decades, but even in the former communist countries.

The communist China developed its capital markets in 1991 and Russia in 1992. By the end of 2004, the Chinese equity markets was valued at Yuan 3.71 trillion and the Chinese bond market at Yuan 3.82 trillion (At this writing the Chinese Yuan is approximately equal to 0.146521 per US Dollar).¹ And by 2006, the Russia and China equity markets became almost equal in size at respectively US\$ 620 billion and US\$ 600 billion each. It is appropriate to note that these markets are still in their infancy.

The capitalization of East Asian markets was estimated at US\$ 1240 billion in 1997. By 2006 it had increased to US\$ 7.7 trillion. The market capitalization of the East Asian market was valued at US\$ 840 billion in 1997 and at US\$ 4.7 trillion in 2006. Similarly the East Asian Bond market was valued for the respective dates at US\$ 400 billion and at US\$ 3 billion. The growth of corporate bonds rose significantly during this period. The projected growth of East Asian bond market for the next decade is estimated to increase significantly. South Korea is projected to have one of the largest bond markets.

If we turn to other developing countries, we find an overwhelming number of countries adopting very rapidly these financial institutions. For instance, the size of India's mutual funds was US\$ 20 billion in 1994 and its annual growth was reported to be 25 percent.²

Even countries as diversified in their economic landscape, as Pakistan, Bangladesh, Philippines, Columbia, Peru, Egypt, Indonesia, Israel, Thailand, Turkey, Malaysia, Poland, and Argentina, have established capital markets. The fervor toward the capital market rush has embraced even Mongolia, which is attempting presently to establish capital market with the help of the Asian Development Bank (ADB, 2008). Similar trends are observed in the African continent, albeit with much slower pace.

The observation that one can make from the sheer increasing number of capital markets in the world is their perceived usefulness for economic development, usefulness mainly triggered by the successful economic experiences of the advanced industrialized countries.

SECTION 2. REVIEW OF THE LITERATURE AND SUPPORTING EVIDENCE

The importance of financial factors in economic development was either ignored by the mainstream economists, particularly by the Keynesian theories, or minimized by Modigliani- Miller's (Modigliani and Miller, 1958)³ and Solow's seminal papers (Solow, 1956)⁴. In the last two decades, a plethora of theoretical and empirical studies on corporate structure and on economic development has shown the critical importance of finance on corporate behavior and on economic development (Patrick, Hugh T. (1966); McKinnon, Ronald I. (1973, 1989); Thornton, John (1996); Levine, Ross (1997); Apergis, Nicholas; Filippidis, Ioannis; Economidou (2007); and Klein, Michael W.; Olivei, Giovanni P (2008).

Detailed studies on corporate capital structure show that changes in the level of debt, as well as changes in the

1. The Economist, November 12, 1994.

2. Ibid.

3. Modigliani, Franco and Merton H. Miller. "The Cost of Capital, Corporation Finance, and the Theory of Investment." *American Economic Review* 48:3 (June 1958): 261-297.

4. Solow, Robert. "A Contribution to the Theory of Economic Growth." *Quarterly Journal of Economics* 70 (February 1956): 65-94.

nature of the firm's assets (Scott, 1976)⁵; Myers and Majluf, 1984⁶; changes in the firm's growth (Jensen and Meckling, 1976)⁷; and Green (1984)⁸; changes in the firm's profitability (Myers, 1984)⁹; and changes in the firm's debt financing are found to influence the firm's investment behavior¹⁰.

Section 2 A. The Role Of Capital Markets In Economic Development

The main role of capital markets is to make funds available for investors undertaking long-term projects at a competitive cost of capital. Why do we need capital markets when the task may be accomplished with the already existing banking institution? First, most of the banks in an economy are lenders of short-term. And banks that are specialized in long-term financing are few and usually not equipped with either human or financial resources to handle the financing of all the long-term development projects, especially those related to agriculture, education, and other social development projects of a country. Second, most of these so called "Development Banks" which are specialized in long-term lending will be interested only in projects which are less risky and which generate cash flow. Third, these banks will undertake only projects that are deemed profitable.

The accountability of the banks to their shareholders and creditors and the pressure on the banks to show profits on their income statements explains their aversion to the risk inherent in long-term projects. The risk of default will always haunt the banking industry, as shown by the recent financial crisis, or any industry that is liable to its creditors. Traditionally, the banking industry is not known for risk-taking industry- except in the recent financial crisis. On the other hand, capital markets institutions are not liable to investors in case of default. This "Non-Liability" to investors is one of the major advantages of capital markets.

Capital markets were shown- as early as 1960s- to offer tremendous potential to economic growth (Patrick (1966); Goldsmith (1969); McKinnon (1973); Shaw (1973); Levine (1997); and Taylor (1983). These markets tap not only into domestic financial resources, but also into international financial markets. If these capital markets are relatively efficient (Arestis, Philip; Chortareas, Georgios; Desli, Evangelia (2006) - as they are shown in most of the advanced industrialized countries- they will provide liquidity to investors and make funds available for the undertaking of long-term projects.

However, the financial literature on capital markets and development is ambiguous and of mixed results with respect to the role of capital market in economic development. The seminal work of Mckinnon (1973) and Shaw (1973) has provided the theoretical framework by which issues of financial liberalization and economic growth are discussed. Mckinnon and Shaw argued that liberalization of financial system provides both financial deepening and promotes economic growth. Several studies, such as those conducted by Jung (1986); Levin (1988); Thornton (1996); Apergis, Filippidis and Economidou (2007); Hasan, Wachtel, and Zhou (2009); Klein, Olivei and, Giovanni (2008) have lend support to this view. These authors have conducted empirical studies, which show there is a significant relationship between liberalization of financial system and economic growth. Other empirical studies such as Taylor (1983); Buffie (1984); Patrick (1966), and Dornbush (1989) have found no relationship between these two variables.

Section 2 B. Impact of Financial Liberalization On Mexico and Argentina

Although both of the above views have merit, I believe that the main difference between these views resides in

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5. Scott, James H. Jr. "A Theory of Optimal Capital Structure." *The Bell Journal of Economics* 32 (1976): 33-54.
 6. Myers, Stewart and Nicholas S. Majluf. "Corporate financing and Investment Decisions When Firms Have Information that Investors do not Have." *Journal of Financial Economics* 13 (1984): 187-221.
 7. Jensen, Michael C. and William Meckling. "Theory of the Firm: Managerial Behavior, Agency Costs and Capital Structure." *Journal of Financial Economics* 3 (1976): 305-360
 8. Green, Richard C. "Investment Incentives, Debt, and Warrants." *Journal of Financial Economics* 13 (1984): 115-136.
 9. Myers, Stewart C. "The Capital Structure Puzzle." *Journal of Finance* 39 (1984): 575-592.
 10. For a comprehensive review of each of these determinants of capital structure, see Sheridan Titman and Robert Wessels, "The determinants of Capital Structure Choice," *The Journal of Finance*, XLIII, No. 1 (March 1988).

the differences in countries' competitiveness and their level of development as well as in their institutional, political, legal, economic, and social-cultural institutions. Countries such as Argentina and Mexico are illustrative examples.

Before Mexico and Argentina joined the group of market oriented economies, the deregulation of their respective financial systems has not been accompanied, as expected, by significant economic growth. On the contrary, their liberalization policies have generated inflationary pressures which have led to extremely high interest rates, which in turn stifled investment, hence, the growth of the private sector. But this negative effect, which apparently was caused by the financial liberalization, was the likely result - as shown below- of a rigid legal and economic institutional framework which was not adapted to the policy of financial liberalization. The same countries, after adopting relatively democratic system of government and market oriented economies, are experiencing a rebound in their economic growth.

For instance, Argentina has reduced both its high inflation rates and its budget deficit. By the mid-nineties it had achieved one of the lowest inflation rates in the world (4%) compared to its previous rates of 5000% per year during the 1980s; it experienced a budget surplus within the aforementioned period (Feldstein (2002; and Baer, Elosegui, Gallo, 2002). The reduction in inflation and budget deficits was the result of the reduction of the role of the state, the deregulation of major sectors of the economy, transparency in the banking sector, financial liberalization and the increasing role of the private sector, as a result of aggressive privatization policies.

Before joining the market oriented economies, Mexico was experiencing similar story to that of Argentina. Mexico was plagued with high inflation in the 1980s. In 1994, the year Mexico joined the North American Free Trade Agreement (NAFTA), Mexico reduced its inflation to 7% and let its currency fluctuate in the foreign exchange markets (Gruben and McComb, 1997). As a result of NAFTA, Mexico has opened its economy to the world markets and has undertaken an extensive policy of privatization.

This openness to the world of finance and capital markets had come with a cost to both Mexico and Argentina. Because the financial liberalization in these respective countries was not previously grounded in sound financial and economic institutions, each country had experienced a serious financial crisis in the late 1990s and early 2000s. A plethora of other examples of emerging economies are replete of such experiences. A lesson that can be drawn from these experiences: a financial liberalization to be successful has to be preceded by sound economic and financial institutions, reinforcement of private property rights, transparent banking system, and an economy driven by market forces.

Mexico and Argentina are illustrative examples in which different institutional frameworks have generated similar development outcomes as a result of the implementation of their respective private market and financial liberalization policies. Does this mean also there was a definite relationship between stock markets and economic growth?

Section 2 C. Relationship Between Stock Markets And Economic Growth

Levin (1996, 2001, 20003), who relied on numerous empirical studies, examined the relationship between stocks markets and economic growth; he concluded that countries with developed banking system and liquid stock markets grew faster than countries with less liquid markets and less sophisticated banking systems. He even goes further to add that "...Greater stock market liquidity is associated with faster growth no matter what the level of banking development. Similarly, greater banking development implies faster growth no matter what the level of stock market liquidity."¹¹

Although this sweeping generalization has yet to be supported by empirical evidence, the present author believes that neither stock market liquidity nor the level of banking development can be used to predict economic growth. Thornton (1995) used Granger causality test to examine 22 Asian, Latin American, and Caribbean developing countries that had experience with financial deepening and economic growth. He ends up with mixed results. He found that

11. Ibid, p. 9.

financial deepening made a difference in economic growth for only eight counties out of 22. In the remaining 14 countries that he examined, he found no evidence of unidirectional causality from financial deepening to economic growth.

Which should precede macroeconomic stability or financial liberalization? This is another sequencing policy issue that is pressing on governments of developing countries, and that is also perplexing financial scholars and practitioners alike. Basing his views on Chilean experience of liberalization, McKinnon (1973, 1989) believes that stabilization should precede liberalization of financial system, if economic growth is expected to be of significant magnitude; and the present author supports this view, which is based on the outstanding successful experiences of countries like Japan, South Korea, and Taiwan, which are examined below, and whose repressive financial systems produced respectively a significant economic development.

Since our framework for capital markets and economic development for new liberalized economies is derived mainly from the experience of the aforementioned Asian countries, the following Japanese case of financial liberalization, which has been followed closely by South Korea – and Taiwan, should serve as an inspirational model for new liberalized economies.

SECTION 3. JAPANESE CAPITAL MARKETS MODEL AND ECONOMIC DEVELOPMENT

Japanese capital markets were highly regulated and less developed before the financial liberalization. Most of the interest rates, before the 1980s, were set by government guidance (Feldman, 1986). Despite its repressive financial system, the Japanese economy was able to surpass in a relatively short period of time most of its western counterparts.¹² South Korea and Taiwan, which had similar financial repressive systems, have also enjoyed, during the same period, significant rates of economic growth.

Japanese capital markets, before the financial liberalization, were very limited. They were not a major corporate source of financing. The bank financing was the dominant source of corporate financing (Feldman, 1986) and Choy (1993). South Korea and Taiwan had similar experiences.

The experiences of these Asian countries do not apparently support the arguments of financial repression made by McKinnon (1973), Shaw (1973), and their followers. Based on these experiences, one is tempted to conclude that financial repression has produced economies with sustained rates of growth, view that is shared and supported by the institutionalist school of thought. However, the experience in repressive financial systems of other developing countries has either failed or resulted in meager economic gain. What has caused the differential results between the aforementioned Asian countries and other developing economies? I believe that institutional frameworks, international economic and financial climate followed by extensive policy of privatization, the adoption of the market rule in pricing in major product and services markets, the development of strong banking institution, and the guidance of government authorities were all at the origin of this differentiation. Japan, South Korea, and Taiwan have all laid the foundations for their market economies much earlier, before their respective industrialization process has taken off. And the international financial and economic climate was also favorable to these countries 'pursuit of economic growth.

Japan faced new economic challenges in the 1970s. It faced inflation, slower economic growth, pressure from Western countries to open its economy and the inevitable path towards globalization. The only viable option for Japan was to open its economy and to liberalize its financial markets.

Japan started slowly the process of financial deregulation. By the late 1980s most of the interest rates in the money markets were set by the market forces -not as in the past by the government (Feldman, 1986). New capital markets such as Future Market were added to the Japanese financial landscape. Furthermore, The Amendment of the foreign Exchange law of 1980 removed most of the restrictions on capital flows, on foreign direct investments, and on

12. Ito, Takatoshi. *The Japanese Economy*. Cambridge: The MIT Press (1992): 3.

foreign exchange markets (Feldman , 1986); The Bank of Japan (1991,1992,1993). South Korea and Taiwan had followed closely the Japanese experience.

The experiences of Japan, South Korea, and Taiwan are clear examples of countries that have chosen selective policies of repressed financial systems and succeeded. The success, according to our view, is not due only to repression, but to a combination of factors, some of which are recommended to be included in a framework of capital market and economic development for the newly industrialized countries. These factors include but not limited to:

- Institution of private markets, protection of private property, and enforcement of the rule of law
- Let market forces determine the allocation of economic and financial resources
- Open economy and removal of trade barriers across markets
- Fiscal and monetary policies consistent with market driven economy and with the domestic objectives of economic development.
- Sound financial institutions and financial and economic liberalization
- Democratic system of government

All these factors are obviously interconnected. South Korea and Taiwan had followed economic liberalization before financial and political liberalization. A country must tailor its development path to its specific social, economic cultural and political historical context. However, the priority must be given to an institutional and legal framework in which privatization, the rule of law, and economic and financial liberalization take precedence. The viable choice facing countries that are emerging and those that are contemplating to emerge is to liberalize their respective economies as well as their respective financial markets. These are necessary but not sufficient conditions for capital markets to play a significant role in economic development. Transparency, rule of law , recognition and protection of private property, and a conducive environment for the private sector to become the main propeller of economic growth; only when these conditions are fulfilled, will the emerging economies enjoy the benefits of economic growth, achieve higher standards of living, and join the rank of advanced economies. The emerging countries must also be ready to face the challenging problems of unequal distribution of income and wealth, which are becoming familiar characteristics of advanced market economies.

CONCLUSION

One of the main objectives of this study is to show the necessity of capital markets and the sine qua non condition for their effective and efficient use for economic development. I relied heavily on a large body of scientific literature and empirical evidence to support my assertions. The implementation of capital markets requires time and more importantly cooperation between the government authorities and the private sector. I believe that the efficient functioning of capital markets presupposes a favorable economic and political environment and a corresponding appropriate institutional support for this environment. The confidence in the future and the confidence of the investors in this future are the sine qua non for the success of these capital markets. Thus, the role of the government in providing this confidence is pivotal to the implementation of efficient capital markets and to the propelling of economic development. A field of interest for future research is to explore the impact of international capital markets versus regional capital markets on the development of the emerging countries respective domestic capital markets.

AUTHOR INFORMATION

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