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SOUND MONEY

By Christopher Farrell

History's Lesson for the Developing World

The U.S. experience teaches that financial liberalization and open equity markets bring more benefits than risks

The most pressing economic, social, and moral question of our time is what can be done to improve living standards in the developing world. Imagine if Nigeria's economy grew at Ireland's double-digit rate, or if the Ukraine somehow managed to match America's pace? There's no magic solution, but economic theory and history certainly suggest that a more open equity market is one of the best policy bets for jump-starting growth.

Financial-market liberalization in developing nations, however, came under a cloud in the '90s. Yes, in theory it made a lot of sense for emerging markets to welcome foreign capital, especially equity investments. But the Mexican peso crisis and collapse of the Asian currency, stock, and bank markets led a number of economists and international policy mavens to question the real-world benefits of wide-open capital markets.

GROWTH SPUR? Financial capital, the so-called "hot money," was simply too prone to waves of excess enthusiasm and sudden pessimism. Any mass exodus of capital inevitably overwhelmed an emerging market's fragile economy. Also disturbing were the many stories about foreign money financing a consumption and corruption binge in a number of developing nations over the past decade.

Questions about crony capitalism and the financial stability of emerging markets are understandable. But the problem may be exaggerated, suggests a recent study by Geert Bekaert of Columbia University, Campbell R. Harvey of Duke University, and Christian Lundblad of the Federal Reserve. More important, in *Does Financial Liberalization Spur Growth?*, the scholars make a compelling case that the economic benefits of equity-market liberalization outweigh the costs. (You can download their research paper at duke.edu/~charvey.)

Indeed, many people may be looking at the difficult relationship between quicksilver international-equity capital and emerging-market financial systems the wrong way. The concern is not too many financial gunslingers and too-open capital markets. The

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issues are the lack of liquidity and too-restricted financial systems. "Major investors don't think about investing in Mexico the same as they do about investing in Cisco," says Bekaert. "In a sense, there isn't enough international speculative capital."

DO THE MATH. The challenge is to isolate the impact of financial liberalization. Developing countries that have tried to wall off the global economy and then abandoned that strategy to embrace market capitalism typically pass a cluster of related reforms. These measures include a greater openness to international trade, the privatization of state-owned enterprises, and a welcome mat for foreign investors.

Under those circumstances, most economists tend to emphasize the gains from more international trade. What's intriguing about the Bekaert, Harvey, and Lundblad study is that, after using various econometric techniques, it concludes that opening up a country's equity markets pays off big in addition to any other market-opening moves for goods and services. For instance, equity-market liberalization is associated with a 1.1 percentage point increase in the per capita growth rate in gross domestic product over a five-year period, after adjusting for inflation, in a sample of 50 countries.

The source of that improved growth trajectory is mostly increased investment, not greater consumption. The flow of foreign money both funds new investment projects and lowers the overall cost of domestic capital, which, in turn, encourages even more investment.

THE AMERICAN EXPERIENCE. History offers an intriguing example that echoes their statistics-laden research. America was essentially bankrupt in the 1780s. Yet over the next four decades, the fledgling nation evolved into the most successful emerging market in history. Yet, as economists Peter L. Rousseau of Vanderbilt University and Richard Sylla of New York University point out in their paper *Emerging Financial Markets and Early U.S. Growth*, America, Canada, Mexico, Brazil, Argentina, and several other New World economies shared similar technologies, transportation infrastructure, and open frontiers. Why did the U.S. become the world's leading economic powerhouse?

They argue that only the U.S. had a vibrant stock market and competitive banking system. To be sure, the U.S. suffered through periodic financial crises. But the financial system also paved the way for a huge flow of investment capital from Europeans seeking higher returns in America. Many American entrepreneurs, business enterprises, and state governments enjoyed better access to domestic and foreign capital than other New World countries. Financial innovation "placed the United States of the early 19th century on a trajectory of economic growth higher than that of other nations," write the authors. (Their paper is available at vanderbilt.edu/Econ/workingpapers.html.)

Financial liberalization is only one step on the path toward the market capitalism that is the cornerstone of improving living standards. But it may be the most important step that emerging economies can take to nurture growth and wealth formation.

Farrell is contributing economics editor for *BusinessWeek*. His *Sound Money* radio commentaries are broadcast over National Public Radio on Saturdays in nearly 200 markets nationwide. Follow his weekly Sound Money column, only on BW Online
Edited by Beth Belton

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