4. Financial markets, financial flows, and economic growth in LDCs

stimulate economic activity and growth. Finally, Fry argues that the empirical evidence shows that severe financial repression—measured as very negative real interest rates—and high rates of foreign borrowing negatively affect economic performance.

There are, of course, some limitations to the analysis. First, the econometric evidence needs to be qualified. Besides endogeneity issues, the paper uses annual data to investigate concepts associated with “long-run growth.” Annual data may capture business-cycle fluctuations, not long-run growth. Furthermore, Fry could be more circumspect in noting the problems associated with lumping together lots of very different countries in a regression (Harberger, 1998). This is especially true for Fry, who regresses growth on either real interest rates or foreign debt without controlling for any other country characteristics.

A second limitation involves the fiscal policy perspective. While Fry perceptively highlights the importance of considering financial repression within the context of the broader fiscal policy environment, he does not illuminate some natural avenues for future research. Namely, there are interesting tradeoffs and decisions that policymakers face. Should countries delay removing restrictions that force banks to lend to the government at below market rates until they have improved their tax systems? Or are the benefits of liberalization greater than the costs of potentially higher inflation rates produced by greater use of money creation to finance a given fiscal expenditure target?

Finally, Fry’s chapter implies that the critical question facing developing country policymakers today is: Should we reduce interest rate controls to foster (perhaps) marginally faster growth rates? There is considerable evidence that one should cast the net more broadly. Many factors beyond interest rate repression affect the development and functioning of the financial system. Legal, regulatory, and supervisory issues already enjoy the spotlight in the policy arena, and future research should guide policymakers. In terms of financial crises, regulatory inconsistencies and ineffective supervisory systems have helped produce banking sector failures in Chile, Mexico, and Thailand. In terms of establishing a healthy financial system for long-run growth, differences in legal and accounting systems help explain differences in financial development and long-run growth (Levine, Loayza, and Beck 1998). Also, international differences in regulatory systems clearly influence the structure and performance of commercial banks (Barth, Nolle, and Rice 1996). Thus, while financial repression certainly deserves careful attention, research on the legal, regulatory, and supervisory factors underlying financial development should be a part of the profession’s research agenda.
Chapter 4

References


Chapter 5

Institutional development and economic growth

Deepak Lal
James S. Coleman Professor of International Development Studies, University of California, Los Angeles

5.1. INTRODUCTION

With the current worldwide move from plan to market, questions about governance and culture have come to the forefront of debates on development. It is natural to think that the “habits of the heart” embodied in one’s own institutions are worth emulating by others, particularly if these habits and institutions have been conjoined with the material success sought by others. As such the West has been promoting its political and economic institutions and values—democracy, the market, protecting human rights, egalitarianism—as the route to prosperity in the rest of the world. But while accepting the instrumental value of the market as a necessary economic institution to deliver prosperity, many in the rest of the world (particularly in East Asia) are resisting any attempt to have Western “habits of the heart”

64 Even the Chicago school, which until recently ignored culture based on the Becker-Stigler (1977) manifesto “De Gustibus Non Est Disputandum,” seems to be coming around to this view. Thus Becker (1996) now emphasizes the notion of social capital first developed by the sociologist James Coleman (1990). Becker notes that culture is part of social capital and is likely to change only slowly (p. 16), that his and Stigler’s 1977 view applied only to meta-preferences, and that his later work shows “that the past casts a long shadow on the present through its influence on the formation of present preferences and choices” (p. 132). I have little quarrel with this new Chicago viewpoint. Moreover, for those who are persuaded only by cross-country regressions, a recent study by Knack and Keefer (1997) provides some evidence that social capital measured by indicators of trust and civic norms from the World Value Surveys for a sample of twenty-nine countries does matter for measurable economic performance.