BOOK REVIEWS

Capital Markets and Development
Steve H. Hanke and Alan A. Walters, eds.
San Francisco: ICS Press, 1991, 385 pp.

Capital Markets and Development provides an excellent survey of theories and evidence for anyone who wants to be brought up to date on the movement toward more liberal financial markets now sweeping the developing countries. All of the authors of the papers and comments collected in this volume have had firsthand experience as advisers or officials, helping to roll back the thicket of financial controls and regulations that has stunted capital markets and development in much of Latin America and some Pacific Rim countries. The hard-won wisdom it contains could also be applied in the former Soviet Union and Eastern Europe.

In explaining why financial regulation and intervention became so omnipresent in developing countries, Steve Hanke and Alan Walters point out that many developing countries had been colonies of European powers. Their monetary and financial systems were linked to the financial systems of metropolitan centers in Europe. Currency boards limited monetary expansion in some of them. Inflation was modest; saving and investment were high; and a liberal economic order prevailed (whatever the political orders might have been). When colonies became independent states in the 1950s and 1960s, however, institutions identified as colonial were condemned. The new nations discovered central banks, which became instruments for generating seigniorage, financing deficits, and enabling officials to make capital allocation decisions.

The developing countries were told by economic theorists that they faced a "vicious circle of poverty," because their incomes and savings were too low to generate the capital necessary for development. To break the circle, with the help of foreign aid, governments should intervene, regulate, redistribute incomes, allocate credit, manipulate exchange rates and interest rates, and build public works projects to create the conditions for economic progress. Officials and their local and visiting economic advisers assumed that governments of developing countries must use various forms of forced saving, such as taxes and high reserve requirements on banks. The rulers of countries that had become independent much earlier, as in Latin America, also learned quickly how to use direct controls in their economies and financial systems to garner and

deploy political power. One result: some formerly rich countries such as Argentina became poor.

In a retrospective assessment of Ronald McKinnon's path-breaking *Money and Capital in Economic Development* (1973), a book which provided inspiration for much of the more recent research reviewed here, Lawrence White extends the Hanke-Walters argument that rent-seeking politicians exploited the financial controls and the money-printing presses of developing countries for their own benefit. McKinnon expresses a more charitable view of politicians in the present book when he argues that the motivation of the state for intervening was relatively benign. When the public believes domestic capital markets are malfunctioning, he writes (p. 105), "[T]remendous pressure is placed on government to get in there and replace the moribund capital market with some other incentives." This argument becomes important when assessing the prospects for liberalization. The resistance of entrenched rent seekers can be formidable. Therefore, research on the role of financial institutions and capital markets, such as the work reported in Hanke and Walters's volume, is essential for winning popular support for financial liberalization.

McKinnon's analysis of politicians' motivations for intervening in financial markets was not his major contribution to our understanding of capital markets and economic development. What he and his Stanford colleague, Edward S. Shaw (1973), accomplished was to demonstrate that private financial intermediaries and free capital markets are crucial to economic development. In short, they said, financial intermediaries and capital markets are more efficient in facilitating domestic saving and allocating scarce capital resources (including foreign capital) than any system of governmental regulations and financial controls.

In what McKinnon calls "repressed markets," direct controls and over-regulation inhibit evolution of the very institutions and financial services that developing countries need most for gathering and allocating capital. Costs of regulation and rate ceilings of various kinds cause banks and other conventional financial institutions to lose market share to informal "curb" markets that may in turn become targets for regulators.

The crucial role of financial intermediaries and capital markets in economic development may seem too obvious to be worth discussing now. But it was not obvious to many of the people advising or ruling developing-country governments at the time McKinnon and Shaw wrote their books. McKinnon says he came to the importance of finance as a revelation from his own experience as a tariff adviser in South Korea during the 1960s, not from reading economic history. "The key role of financial institutions in the late 19th century for European and American development was neglected in the postwar literature emphasizing economic theory," he writes in his reply in the present volume to White's review (p. 105).

The rich array of evidence this book presents on damage done by financial controls should provide governments with incentive for

continuing the current liberalization movement, if it is fully understood. However, there is another powerful incentive for financial liberalization. Governments are finding it more and more difficult to isolate their systems from financial markets in the rest of the world. Murray Sherwin, of the Reserve Bank of New Zealand, commented (p. 182), "The technological advances of funds transfers have really run way beyond any form of exchange control mechanism that I am familiar with at this stage. It is very easy to evade controls." Governments can no longer hold capital prisoner.

In some countries, the alleged "inadequacy of domestic financial markets" is still used to justify governmental interventions or as a reason for going slowly on liberalization. However, these arguments are losing force in the face of international competition. Capital flights can frustrate the efforts of the most zealous controllers. In effect, all governments today are challenged to allow their people and businesses free access to world capital markets if they want to develop their potential for economic development fully.

This book discusses advantages and disadvantages of various prescriptions for financial reform, fiscal and monetary policies, and the development of new institutions such as stock exchanges—too many to review here. Some of the most compelling arguments for reform come from Rolf J. Lüders, who was minister of finance and minister of economics in Chile during the 1982–83 crisis, and from Murray Sherwin, from the Reserve Bank of New Zealand, who played a leading role in the financial liberalization of New Zealand. From the Lüders account of liberalization in Argentina and Chile, one can get a sense of the sometimes maddening surprises that lurk in the path of reform programs. Nobody said it should be easy, and Lüders bears that out very well. Nevertheless, he stresses the need for sticking with the program, come what may. Argentina, he says, made the mistake of vacillating at critical moments, and so lost credibility in financial markets. Achieving credibility in liberalizing financial markets, as in fighting inflation, reduces adjustment costs.

Murray Sherwin comes to the same conclusion on the importance of credibility. He also makes some interesting comments on the difficult question of "sequencing" in reform programs, when to do what. Some economists, including McKinnon in this volume, argue that fiscal and monetary policies, and perhaps other policies, should be under firm control before it would be prudent to liberate exchange markets and commercial banks, for example. While in no way denying the need for sound fiscal and monetary policies, Sherwin says (p. 182), "My conclusion with respect to New Zealand is that the sequence of reforms was pretty much irrelevant. Speed and comprehensiveness were more important than the exact sequencing." He also makes an encouraging observation (p. 232), "The liberalization process, like the regulatory process that preceded it, feeds on itself. Just as regulations beget further regulations to close the inevitable loopholes and escape routes, the removal

of regulations puts pressure on those remaining." That should be posted on the wall of every ministry of finance and central bank.

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References

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Shaw, Edward S. *Financial Deepening in Economic Development.* New York: Oxford University Press, 1973.

The Enterprise of Law
Bruce L. Benson
San Francisco: Pacific Research Institute, 1990,
397 pp.

In the *Enterprise of Law*, Bruce Benson provides us with the most comprehensive treatise on private sector alternatives to government law enforcement available today. Benson systematically addresses all the issues, arguments, and objections surrounding the growing role of market institutions in the legal system. But his book is more than a mere defense of current privatization trends in protective services, corrections, and dispute resolution. The *Enterprise of Law* questions the seemingly axiomatic proposition that law and order are "necessary functions of government." Benson is fully aware that neither the policymaking community nor the general public is prepared to debate the *complete* privatization of all legal institutions. But the time is right, he argues, "to question the *presumption* that law and order must be governmentally provided." To Benson's credit, many readers will begin questioning that presumption even before completing the book.

The book begins with an examination of historical precedents of private, customary legal systems. Benson points out that many legal systems have developed "from below" as custom—as opposed to being imposed "from above," such as by a king or a legislature. This brief historical review, while sometimes tedious, is nevertheless a good starting point because the reader is forced to think about the basic premises of the American legal order.

Benson argues that customary legal systems are likely to include "an emphasis on individual rights because [in such a system] recognition of legal duty requires [the] voluntary cooperation of individuals through reciprocal arrangements." This is a persuasive argument, but the key word is "likely." One of Benson's own examples amply illustrates the exception.

Under the customary law of the Kapauku Papuans of West New Guinea, adulterous women were routinely executed by their husbands.