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28 May 2013

Online at https://mpra.ub.uni-muenchen.de/50031/
MPRA Paper No. 50031, posted 21 Sep 2013 09:40 UTC

The Political Economy of Trade-Financial Liberalization and Financial Underdevelopment: A perspective from China

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Abstract

Although financial development may facilitate economic growth over the long term, financial underdevelopment remains a salient feature of even leading emerging or transition economies. In principle, openness to both international trade and finance may weaken resistance to major financial reforms; however, the apparent failure to consolidate political support for such reforms in practice is not completely understood. This paper develops a simple model of the political economy of trade-financial liberalization that offers insights into this phenomenon. When applied to China, it not only facilitates a better understanding of its approach to financial integration in the global economy and why its relatively fragile state-bank dominated financial system has persisted; but more generally, it raises the question of whether limited de facto political competition in the domestic electoral system may be a binding constraint on the quantity and quality of the policies required to foster financial development.

Key words: *China; Economic Growth; Financial Openness; Financial Development; Political Economy; Trade Openness.*

JEL: F36, G15, O16, O24, O43, P2

The Political Economy of Trade-Financial Liberalization and Financial Underdevelopment: A perspective from China

1. Introduction

Over the last few years, there has been a lively debate on the merit of financial globalization in the case of emerging or transition economies. On the one hand, some have questioned whether financial liberalization pay dividends that sufficiently compensate for the risk of financial crises and their associated costs (Bhagwati, 1998; Rodrik, 1998; Stiglitz, 2002). In addition, it remains unclear whether greater financial integration in the global economy generally raises social welfare through international risk-sharing, capital accumulation, or both (Kose, Prasad, and Terrones, 2003; Lucas, 1990).

Still, another dominant view suggests that the indirect economic-growth enhancing benefits associated with financial globalization may sufficiently compensate for its associated risks (Kose, Prasad, Rogoff, and Wei, 2009). Specifically, it is argued that financial openness may foster financial development (Chinn and Ito, 2006; Levine and Zervos, 1998; Mishkin, 2008); financial development in turn will support economic growth and thereby improves a country's standard of living (Demirgüç-Kunt and Maksimovic, 1998; King and Levine, 1993; Jayarantne and Strahan, 1996; McKinnon, 1973; Rajan and Zingales, 1998). Moreover, since financial development may mitigate the likelihood of a twin-crisis in the banking sector and the foreign exchange market as the domestic economy becomes more financially integrated in the global economy, it provides a basis for stable economic growth trajectory (Kaminsky and Reinhart, 1999; Mishkin, 2008).

If according to this latter perspective, financial development may place emerging or transition economies on an upward and potentially less risky growth path, why is there apparently so little, if any, domestic political support for financial reforms? According to the

interest group theory of Rajan and Zingales (2003), private interests have an incentive to resist financial development because the competitive forces that it unleashes are likely to erode their monopoly privileges, and the associated rents that they receive. However, while private interests may successfully frustrate domestic efforts to reform the financial system, they are unlikely to successfully resist reforms that are externally imposed. Specifically, the competitive forces that are unleashed from international trade and finance, the argument goes, may undermine domestic opposition to financial development.

The primary purpose of this paper is to explain why political support for trade-financial liberalization may be systematically lacking in emerging or transition economies. It attempts to do so by explicitly considering the income distribution effects of trade and financial liberalization policies. For instance, to the extent that international trade facilitates the efficient use of resources worldwide, standard trade theories suggest that the least productive firms will lose market share, and may even go out of business (Bernard, Eaton, Jensen, & Kortum, 2003; Melitz, 2003). In addition, when there are significant adjustment costs (i.e. retraining costs), displaced workers in declining industries may not be well-placed to immediately take advantage of employment opportunities in thriving ones.

Meanwhile, financial openness may not only engender diffused benefits at best (Kose et al., 009), but also leaves those outside the financial sector unambiguously worse off in the event of a financial crisis (Baldacci, de Melo and Inchauste, 2002; Bourguignon, Robilliard and Robinson, 2001; Diwan, 2002; Friedman and Levinsohn, 2002; Halac and Schmukler, 2004; Lustig, 2000). Thus, even if an incumbent government has a favorable disposition toward both trade and financial liberalization, it may be ultimately constrained by its inability to consolidate political support for both trade and financial openness.

Importantly, this paper develops a simple model of the political economy of trade-financial liberalization to refine this general understanding of the income distribution effects of international trade and finance policies. Specifically, it sheds light on the underlying properties of a political-economy "equilibrium" in which international trade-only policy is adopted and financial underdevelopment is persistent. It does so by showing that trade liberalization will be favored over financial liberalization, or a combination of trade and financial liberalization, if it yields relatively large, concentrated net gains to those with the power or influence to preserve the political *status quo*. When applied to China, it not only offers insights into its approach to financial integration in the global economy; but supports the more general proposition that limited *de facto* political competition in the domestic electoral system may be a binding constraint on the quantity and quality of the policies that are required to foster financial development.

This paper contributes to the extant literature in several ways. First, it extends Kornai (2000) and Acemoglu and Robinson (2013) by providing an example of the kind of political feasibility test that major economic reforms must pass if they are to succeed in transition economies. Specifically, it investigates the political economy of trade and financial liberalization in the Chinese context. The Chinese case is interesting for several reasons. Perhaps the most compelling reason is that it illustrates an extreme case of limited de facto political competition; and insofar as this constitutes a major constraint on financial development, there may be important general lessons for emerging or transition economies with weak political institutions. Another reason for focusing on China is that it appears to provide a counter-example to the conventional view that financial development is a precondition for long-term economic growth.

Finally, although this study generally agrees with Rajan and Zingales (2003) that vested interests may frustrate domestically initiated efforts to transform the financial system, it contributes to this line of research by calling into question the notion that emerging- or transition-economy governments will generally employ trade-finance liberalization as a mechanism for fostering financial development. What the authors appear to overlook is the fact that trade and financial openness will alter the distribution of national income, and thereby subject to political considerations. Once this is explicitly taken into account, it is shown that the problem of financial underdevelopment may ultimately depend on indigenous solutions rather than international ones.

The remainder of this paper is organized as follows. The next section develops a simple model of the political economy of trade-financial liberalization that is motivated by China`s economic performance. This theoretical framework is then applied in the next section to determine the potential role of politics in the persistence of a relatively fragile state-bank dominated financial system in China. The final section summarizes and concludes.

2. Background

The discussion above generally points to financial development as one of the key preconditions for economic growth over the long term. Yet, China appears to constitute a counter-example; that is, its relatively weak state-bank dominated financial system has apparently not significantly constrained its growth trajectory over the last three decades. However, this macroeconomic outlook is misleading.

One of the manifestations of financial underdevelopment in China is the importance of informal (relationship-based) finance relative to formal (bank) finance. One way to show that financial underdevelopment is costly is to demonstrate that the fastest growing firms primarily

depend on formal finance. There is evidence for this in the Chinese context. Specifically, even among private and semi-private Chinese firms that tend to generally outperform state-owned enterprises (SOEs), there is evidence that the fastest growing firms tend to primarily rely on formal rather than informal finance (Allen, Qian, and Qian, 2005; Ayyagari, Demirgüç-Kunt, and Vojislav Maksimovic, 2010). If non-SOEs, which now account for a significant share in industrial output and employment, are forced to disproportionately rely on informal finance, then economic growth trajectory is actually lower than its potentially higher path.

Alternatively, to the extent that bank credit is disproportionately allocated to capital-intensive SOEs with relatively low productivity, the Chinese economy is unlikely to remain on its current growth trajectory all else equal. In other words, if the growth of the capital stock is not complemented by technological innovations and human capital development, then higher levels of capital relative to labor will become less productive at the margin over time (Collins and Bosworth, 1996; Krugman, 1994). This in turn will lead to a decline in the per capita income growth rate. Thus, a domestic investment boom that merely raises the existing capital stock relative to the labor force will not be sufficient to keep the Chinese economy on its current growth path (Prasad, 2009, 2011; Prasad and Rajan, 2006).

Central to the notion of financial development in this paper is the basic principle that capital should be allocated to those who can use it most productively or profitably. Alternatively, risks should be assigned to those with the greatest capacity to bear them for the least compensation. The latter is consistent with financial innovation that leads to the creation, for instance, of new financial products that facilitate the effective management of systematic financial risks (i.e. unexpected changes in foreign exchanges, interest rates and commodity

prices). When financial development is advanced along these lines, a country has a solid platform for economic growth over the long term.

These foregoing arguments suggest that the Chinese economy has major shortcomings in the area of financial development with adverse implications for its growth trajectory. Since Rajan and Zingales (2003) suggest that trade-financial liberalization may serve as a catalyst for financial development, it is worthwhile to investigate this in greater detail based on an appropriate theoretical framework. To do so, I develop a simple model of the political economy of trade-financial liberalization in the next section. This theoretical framework explicitly accounts for the income distribution effects of trade-financial liberalization that appears to be overlooked in Rajan and Zingales (2003). As will be illustrated, this has implications for whether an incumbent government promotes either trade or financial liberalization, or both.

2.1. Theoretical Framework

Consider an incumbent government that has to decide on an international trade and financial policy in a multi-party electoral system, and a closed economy populated by *N* voters. Specifically, suppose the incumbent government is contemplating whether to open the economy to international trade, international finance, or both. On the one hand, trade liberalization or trade openness will allow domestic residents to buy and sell goods and services abroad, while financial liberalization or financial openness will allow them to buy and sell foreign financial claims.

Suppose the adoption of trade openness (TO), financial openness (FO) or both ($TO \cap FO$) will give rise to the following three different states of the world: $\boldsymbol{s}_{TO} = \{s_{TO,1}, s_{TO,2}, \dots, s_{TO,M}\}$, $\boldsymbol{s}_{FO} = \{s_{FO,1}, s_{FO,2}, \dots, s_{FO,M}\}$, and $\boldsymbol{s}_{TO\cap FO} = \{s_{TO\cap FO,1}, s_{TO\cap FO,2}, \dots, s_{TO\cap FO,M}\}$ with corresponding sets of probabilities $p(\boldsymbol{s}_{TO})$, $p(\boldsymbol{s}_{FO})$, and $p(\boldsymbol{s}_{TO\cap FO})$, respectively. The initial

autarky position of the economy is assumed to be characterized by state $\boldsymbol{s}_0 = \{s_{0,1}, s_{0,2}, \dots, s_{0,M}\}$ with a corresponding set of probabilities $p(\boldsymbol{s}_0)$.

In this setting, we suppose that voters care about policy outcomes because the returns on their economic activities are contingent on the policy-induced states of the world. Voters are assumed to know the probability distributions associated with international policies and the autarky state. Political parties are assumed to know voter international policy preferences, the probability distributions associated with international policies and the autarky state, and are willing to compete for votes through international policy proposals. A single opposition party may be sufficient in this case to motivate the incumbent government to offer an international policy proposal that satisfies the policy preference of an influential set of voters who are willing to trade political support for a favorable policy-shift from the initial autarky state of the domestic economy. To secure the broadest possible support for the incumbent government, it is assumed that this group of voters makes side-payments to other voters with a different policy preference; otherwise, the latter will vote against the incumbent government.

Consider the following single-period international policy decision problem. The incumbent government implements its international policy at the start of period; and knowing the probability distribution associated with the international policy decision, the incumbent government's supporters instantaneously undertake an identical productive activity. The state of the world and the payoff from the productive activity are realized at the end of the period. Specifically, if we suppose that all the potential supporters of the incumbent government have the same preference over policy-induced wealth outcomes, then the policy preference of a representative supporter of the government is ordered by the discounted sum of the expected utilities; that is:

$$E\left[u\left(\boldsymbol{s}_{\tau}, a_j, N_{\tau}, T, \beta\right)\right] = \beta \sum_m p\left(s_{\tau,m}\right) u\{[r(s_{\tau,m}, a_j) - T]/N_{\tau}\} \quad (1)$$

where $\tau \in \{TO, FO, TO \cap FO\}$; $\beta \in (0,1)$ is the single-period constant discount factor; a_j is the single economic action (i.e. production or investment decision) that is undertaken by the voters; $r(s_{\tau,m}, a_j)$ is the payoff function that gives the gross returns that government-supporters receive as a group from an identical action a_j under state $s_{\tau,m}$; N_{τ} is the minimum number of voters from the population of N voters that the incumbent government requires to maintain its hold on power; T is a one-time lump-sum side-payment by N_{τ} government-supporters to $N - N_{\tau}$ non-supporters. To capture the contingency of gross returns on the choice of the international policy, it is assumed that the gross payoff function is such that $\partial r(\cdot)/\partial s_{\tau,m} \partial a_j \geq 0$ or $\partial r(\cdot)/\partial s_{\tau,m} \partial a_j < 0$ when evaluated at some realized value of $s_{\tau,m}$. Finally, assuming that all voters are risk averse, the utility function, $u(.)$, satisfies the standard assumptions; that is, $u'(.) > 0$ and $u''(.) > 0$.

According to equation 1, a representative government-supporter ranks the government's policy on trade and financial openness based on the discounted sum of expected utilities derived from the policy-contingent net payoffs. For any realized state of the world, the representative government-supporter receives an appropriation, $r(s_{\tau,m}, a_j)/N_{\tau}$, from which she pays out T/N_{τ} in a single side-payment to non-supporters. Now, suppose the expected reservation utility under the autarky position is given by $E\{u[\, r(\boldsymbol{s}_0, a_j)]\}$ at the start of the period, then the government rationally expects political support for an international trade or finance policy that satisfies:

$$E\left[u\left(\boldsymbol{s}_{\tau}, a_j, N_{\tau}, T, \beta\right)\right] = E\{u[\, r(\boldsymbol{s}_0, a_j)]\} \quad (2)$$

The incumbent government has an incentive to undertake both trade and financial liberalization if for $\hat{\tau} \in \{TO, FO\}$, the policy preference of its political base satisfies:

$$E\{u[\,r(\boldsymbol{s}_0, a_j)]\} \leq E[u(\,\boldsymbol{s}_{\hat{\tau}}, a_j, N_{\hat{\tau}}, T, \beta\,)] < E[u(\,\boldsymbol{s}_{TO\cap FO}, a_j, N_{TO\cap FO}, T, \beta\,)] \qquad (3)$$

Consistent with the virtual absence of entirely closed economies, integration in the global economy through either trade, or financial linkages, or both, seems to be revealed preferred to economic isolation; hence, it is implicitly assumed that the supporters of the incumbent government at least weakly prefer some form of openness to the initially closed-economy state. But equation 3 goes further by specifically showing that the supporters of the incumbent government derive the highest discounted sum of the expected utilities from both trade and financial liberalization relative to either a trade-only, or a financial-only liberalization policy. As a result, the incumbent government can rationally expect to consolidate political support for the simultaneous implementation of trade and financial liberalization policies.

To anticipate the discussion in the next section, I consider an analytical result that is consistent with trade openness and limited financial openness that will be shown to be characterize China's approach globalization. To counter the potential objection that this multi-party theoretical framework is inappropriately applied to China's single-party political system, I evoke the notion of "contestability". Specifically, although the Chinese Communist Party is not directly competing against other formally organized political parties, it is plausible that it considers the political appeal of latent political organizers or revolutionary forces when deciding on a range of domestic and international policies. However, the question is raised later on whether the inherent suppression of political competition under single-party systems may compromise the capacity of a country to generate the domestic and international policies required for financial development.

For $\tilde{\tau} \in \{FO, TO \cap FO\}$, the following result is most consistent with China's apparent approach to globalization:

$$E\{u[\, r(\boldsymbol{s}_0, a_j)]\} \leq E[u(\, \boldsymbol{s}_{\tilde{\tau}}, a_j, N_{\tilde{\tau}}, T, \beta\,)] < E[u(\, \boldsymbol{s}_{TO}, a_j, N_{TO}, T, \beta\,)] \quad (4)$$

According to equation 4, the representative government-supporter derives the highest discounted sum of expected utilities from trade liberalization relative to financial liberalization or the joint implementation of both trade and financial liberalization. Since the trade-only liberalization scheme also leaves the representative government-supporter better off relative to the initial autarky state of the domestic economy, the incumbent government can rationally expect to consolidate political support for trade liberalization.

In theory, there are at least two fundamental reasons why the government's political base may prefer trade liberalization relative to either financial liberalization, or the joint implementation of trade-financial liberalization. First, Pareto-improving outcomes may be more likely under trade liberalization. This is so if high probabilities are assigned to the above-average positive realizations of the net payoffs under trade liberalization, $r(s_{TO,m}, a_j) - T$, relative to the net payoffs under financial liberalization, $r(s_{FO,m}, a_j) - T$, or the joint trade-financial liberalization scheme, $r(s_{TO \cap FO,m}, a_j) - T$. Insofar as financial liberalization elevates the risk of financial crises (Aghevli, 1999; Bosworth and Collins, 1999; Kaminsky and Reinhart, 1998, 1999), another possibility is that low probabilities may be assigned to high-impact events under financial liberalization relative to trade liberalization. This implies that financial liberalization may expose government supporters and others to far more extreme risks, or discontinuity in the returns from their economic activities compared to trade liberalization.

Finally, if for $\tilde{\tau} \in \{FO, TO \cap FO\}$, $N_{TO} < N_{\tilde{\tau}}$, then a trade-only liberalization policy not only has the potential to generate high-probability, above-average Pareto-improving outcomes, but also more concentrated gross gains net of side-payments for the group of government-

supporters that prefer trade-only liberalization to either financial-only liberalization, or both trade and financial liberalization. As a result, the incumbent government's pro-trade political base has an incentive to organize, and consolidate political support for the incumbent government (Olson, 1965; Stigler, 1971).

3. The Political Economy of Financial Globalization in China

The theoretical framework developed above provides a basis for evaluating the nature of business-government co-operation that seems to undergird the Chinese government's apparent approach to globalization, as well as the persistence of a relatively fragile state-bank dominated financial system (Barnett, 2004). Since the Chinese government initiated its market-based reforms in the late 1970s, the most sweeping changes have largely been confined to the economic sphere under China's one-party system. The progressive integration of the Chinese economy in the global economy has been marked by several important developments.

Among the key developments is China's accession to the World Trade Organization (WTO) in 2001. Since then China's participation in international trade has intensified and remains significant considering the size of the Chinese economy. For instance, China's trade-to-GDP ratio (i.e. sum of imports and exports divided by GDP) increased from an average of approximately 15 percent over the period 1980-84 to almost an average of 65 percent during 2005-08 (Marelli and Signorelli, 2011). Thus, the Chinese economy appears to be well networked in the global economy through trade linkages.

However, a much different picture emerges when one considers the extent to which the Chinese economy is embedded in the global economy through financial linkages. For instance, the Chinese authorities closely manage the capital account by imposing limits on the international transactions of domestic residents, as well as by promoting inward foreign direct

investment (FDI) rather than portfolio investments (Wong, 2006). At the same time, China's "Big Four" state-banks - Agricultural Bank of China (ABC), China Construction Bank (CCB), Bank of China (BOC), Industrial and Commercial Bank of China (ICBC) - control about three-fourths of the assets in the domestic banking sector, with only a handful of foreign investors – including Citigroup, HSBC, Deutsche Bank, Royal Bank of Scotland - allowed to hold minority equity stakes in state-banks (Berger, Hasan and Zhou, 2009).

Altogether, the Chinese government appears to favor trade openness over financial openness in its approach to globalization. China's state-bank dominated financial system has grown considerably over the years in terms of domestic savings under financially repressive policies that not only historically channeled funds away from the domestic stock markets, but also limit international portfolio diversification among private residents (Wong, 2006).

According to Rajan and Zingales (2003), trade liberalization alone cannot be expected to unleash the competitive forces needed to undermine vested interests that stand to gain from China's fragile financial system. While international financial integration together with trade liberalization may do so, the former may not materialize. According to the theoretical framework developed in the previous section, the Chinese government may promote trade liberalization alone if it constitutes the policy preference of its supporters who are willing and able to organize, and consolidate broad support for political continuity. In principle, this raises the question of why Chinese exporters that primarily favor trade liberalization do not similarly express a policy preference for financial openness.

It is perhaps surprising that Chinese exporters have not strongly pushed for a dismantling of a state-bank dominated financial system that disproportionately benefits the largest SOEs, and particularly national champions that invest abroad (Nolan and Zhang, 2002). To the extent that

Chinese exporters serve internationally competitive markets, better access to low-cost credit could go a far way in improving their competitive position and profitability. Meanwhile, financially repressive policies that force Chinese exporters to disproportionately hold low-yield bank deposits rather than high-yield (risk-adjusted) foreign assets is costly in terms of foregone interest earnings. These costs to Chinese exporters could be mitigated under a financial liberalization policy that not only fosters competition in the banking sector, but also permits international portfolio diversification; yet, Chinese exporters seem to exhibit a policy preference for trade liberalization only.

The theoretical framework developed above supports two explanations for what may be a trade-only policy preference among Chinese exporters. First, the gains that they realize from trade liberalization are apparently large enough to pacify the "losers" through transfer payments. In practice, these transfer payments may be financed through a tax on the earnings of exporters. Given China's relatively underdeveloped tax system, the Chinese government may very well depend on an implicit taxation scheme. For instance, over the period 1991-98, Gordon and Li (2003) find that the real interest rate on bank deposits is not only negative, but is also on average significantly below the foreign borrowing cost of the Chinese government. Thus, exporters that hold bank deposits may be subjected to a potentially large implicit tax on their savings.

Another reason for the apparently singular preference for trade liberalization in the Chinese context is that it is likely to yield large concentrated net gains relative to financial liberalization. For the most part, the most thriving Chinese exporters constitute township and village enterprises (TVEs) that are primarily involved in light manufacturing as opposed to heavy industries (i.e. steel and chemical) that are dominated by Chinese SOEs. While most TVEs are owned and operated by local governments, they may constitute Sino-foreign joint ventures,

and even private enterprises in some cases (Nolan and Wang, 1999). Interestingly, too, TVEs are primarily located along the coastal areas that disproportionately benefit from favorable investment and trade policies (Yang, 2002). Finally, TVEs' exporting activity is primarily linked to assembly work that is contracted out by multinational corporations (MNCs) that co-ordinate their value chain across different countries (Grossman and Rossi-Hansberg, 2006).

According to the foregoing arguments, Chinese exporters seem to favor trade liberalization over either financial liberalization, or both trade and financial liberalization, because the former yield relatively high concentrated net gains. The Chinese government in turn has an incentive to promote trade-only liberalization. This consistency in policy preference and policy choice ensures that the Chinese government has allies among the emerging class of light-industry exporters. At the same time, insofar as the Chinese government is keen on maintaining control over credit allocation, Chinese exporters may face a more limited set of international policy proposals than is depicted in our theoretical framework; specifically, the Chinese government may not incorporate financial liberalization, or both trade and financial liberalization in its international policy plans.

In addition, to the extent that financial liberalization tends to disproportionately attract foreign-currency denominated short-term debt inflows relative to FDI, or create financial channels that propagate external shocks, the Asian experience in the latter half of the 1990s confirms that the likelihood of financial crisis may be particularly high. This is especially so in the presence of unsustainable macroeconomic policies and underdeveloped domestic financial markets (Aghevli, 1999; Bosworth and Collins, 1999; Goldstein, 1998; Kaminsky and Reinhart, 1998, 1999). Considering China's relatively inflexible exchange rate regime and its fragile state-

bank dominated financial system, the likelihood of a financial crisis under financial liberalization would almost certainly preoccupy the Chinese authorities.

Although the fiscal costs of financial crises are oftentimes large enough to warrant concern about financial liberalization (Hutchinson and Noy, 2005), the Chinese government may also be equally concerned about the potential loss of political autonomy if a major financial crisis unfolds (Bhagwati, 1998). This concern is warranted if, for instance, an externally organized financial rescue package is expected to come with certain conditions including the privatization of large SOEs, major financial reforms, among others. Such conditions would almost certainly limit the ability of the Chinese authorities to control the allocation of credit and determine social priorities.

4. Conclusion

This paper illustrates what appears to be a political-economy "equilibrium" in which China's financial system may persist in an underdeveloped state. Central to this equilibrium is business-government co-operation that favors trade liberalization only. In theory, this is attributed to the relatively large and concentrated gains that trade liberalization yields relative to financial integration. Besides, the Chinese authorities may be keen on insulating the domestic banking system from the international financial system to mitigate the risk of a financial crisis, which may undermine their control over credit allocation and the determination of social priorities. Ultimately, financial integration may be largely avoided by the Chinese authorities to secure political autonomy over the long term.

Insofar as the preservation of political autonomy is important, the limited range of international policy choices in a political-economy equilibrium may be a salient feature of single-party systems, or even democratic ones with limited de facto political competition.

Perhaps the most relevant policy implication is that political reform, in the direction of greater de facto political competition, may be very important for financial development. However, a complete economic-political analysis along this line is beyond the scope of this paper. Thus, an outstanding issue that warrants further theoretical and empirical analysis is the impact of de facto political competition on the quantity and effectiveness of domestic and international policies that are geared toward financial development.

Acknowledgements

A previous version of this paper was presented at the Canadian Economics Association (CEA) conference, HEC Montréal, Québec, May 30-June 2, 2013. I would like to thank the discussants and other participants for thoughtful comments that helped to improve the quality of the paper. All remaining errors are mine.

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