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**Financial Liberalisation, Stockmarkets
and Economic Development¹**

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During the 1980s and 1990s, many developing countries (DCs) have been engaged in far-reaching reforms of their financial systems, liberalising them and making them more market-oriented. This liberalisation, involving inter alia 'financial de-repression' has been inspired partly by the work of the McKinnon (1973) and Shaw (1973) [M-S] school.

This paper suggests that, in addition to financial de-repression, there has been a major new element in the development of DC financial systems in recent years - the establishment and fast expansion of stockmarkets. These markets have played a key role in the internal as well as external financial liberalisation processes in leading DCs. Further, the paper finds that the actual behaviour of these markets in many countries has led to outcomes which undermine the effects of the higher real interest rates arising from 'financial de-repression'. These important empirical phenomena have received scant attention from M-S economists, who need to incorporate them into their analysis of financial liberalisation. However, for DCs, the essential question is: what will be the impact of these

¹ Helpful comments from Mr. Bruce Weisse are gratefully acknowledged; the usual caveat applies.

developments on industrialisation and long-term economic growth?

This paper argues that in general financial liberalisation and the associated expansion of stockmarkets in DCs is likely to hinder rather than assist their development.

The paper concentrates on the role of the stockmarkets in the liberalisation process in DCs in the 1980s and 1990s, and explores, among other things, their effects on the financing of corporate growth. The observed financing patterns will be seen to contradict the predictions of most economic models, and are therefore surprising not just for the M-S, but also for other economists.

At the macro-economic level, the paper considers foreign portfolio flows, the interactions between the stock and the currency markets, and their implications for the stability of the real economy and its long-term growth.

I: FINANCIAL LIBERALISATION AND STOCKMARKET EXPANSION IN DCs

Financial reforms in semi-industrial countries in the last decade have been characterised by an enormous growth of stockmarkets. Between 1983 and 1993, the combined capitalization of companies quoted on the 38 emerging markets in the Economist's list rose from less than a hundred billion to nearly a trillion US dollars (Feldman and Kumar (1994)); the corresponding growth of industrial country markets was a little over three-fold - from three to ten trillion dollars. Several leading individual emerging markets (eg. Mexico, Korea and Thailand) recorded during this period a twenty-fold increase in market capitalization, which made them larger than

the average medium-sized European stockmarket.

Relative to GDP, market capitalization rose at an unprecedented rate in leading DCs during the 1980s. Mullin (1993) notes that it probably took eighty-five years (1810-1895) for the US capitalization ratio to rise from 7% to 71%, whilst the Taiwanese ratio rose from 11% to 74% in just ten years (1981-1991). Feldman and Kumar's data show that the corresponding ratio for Chile increased from 13.2% in 1983 to 78% in 1993; for Mexico from 2% to 43%; for Thailand from 3.8% to 55.8%, etc. Other development indicators for emerging stockmarkets reveal similar growth. For example, the total value of shares traded on DC markets rose over twenty-five fold between 1983 and 1992, from two to ten percent of the global total (IFC, 1993).

However, despite their recent rapid development, even the most advanced emerging markets are not yet mature. Typically most trading occurs in a few stocks which account for a considerable part of the total market capitalization. Leaving aside these actively-traded blue-chip shares, there are serious informational and disclosure deficiencies for other stocks. There are similar weaknesses in the transparency of transactions on these markets. The less developed of the stockmarkets suffer from a far wider range of such deficits.²

² Feldman and Kumar (1994) divide emerging markets into four groups according to their stage of development.

Apart from their role in domestic financial liberalisation, the stockmarkets have also been very important in recent years in external financial liberalization of DCs. In the 1990s, these markets have emerged as a major channel for foreign capital flows to DCs. International equity flows to the Economist's 38 emerging markets increased from \$3.3 billion in 1986 to \$61.2 billion in 1993.³ Indeed, as the IMF economists El-Erian and Kumar (1995) note "when compared to other episodes of large private capital flows to developing countries in the last 20 years, the [present] phenomenon differs in one basic respect: the dominant role of foreign portfolio flows as opposed to bank financing". These portfolio flows have taken place through several channels as external liberalization has progressed: country or regional funds; direct purchase of DC stocks by industrial country investors; the placement of DC equities on industrial country markets. Both "push" (e.g. lower U.S. interest rates in the early 1990s) and "pull" factors (e.g. external liberalization in DCs) have contributed to these huge portfolio flows to emerging markets (Fernandez-Arias and Montiel, 1996; Smith and Walter, 1996).

II: THE STOCKMARKET AND THE MCKINNON-SHAW ANALYSIS

Despite their substantial present and growing practical significance for DCs outlined above, stockmarkets have received little empirical attention from M-S economists.⁴ This is puzzling

³ El-Erian and Kumar, 1995, table 3.

⁴ An apparent justification provided for this neglect is that in the DCs there

since at the theoretical level, stockmarket development is acknowledged to be of critical importance to M-S analyses (Cho, 1986; McKinnon, 1988). In their seminal paper, Stiglitz and Weiss (1981) showed that under imperfect information, because of the "adverse selection" and "incentive" effects, credit-rationing may not just be due to financial repression but could also arise from the normal competitive operations of the credit markets. Accepting this criticism, M-S economists therefore now suggest that credit-rationing reduces economic growth only if the "financially repressed" interest rate is below the competitive equilibrium credit-rationing rate; they, however, provide no guidance on how to distinguish in practice between the two rates.

Be that as it may, Cho (1986) showed analytically that to achieve efficient resource allocation, credit markets need to be supplemented by a well-functioning equity market. This is because, unlike bank borrowings, equity finance is not subject to adverse

is only a small or negative flow of net resources from the household to the business sector via the stockmarket. It is further suggested that the stockmarket affects only the largest firms. However, following this logic, the stockmarket would not be regarded as important in the world's leading stockmarket economies, i.e. the US and the UK. Corbett and Jenkinson (1995) suggest that over the period 1970-1989, the stockmarket made a net negative contribution to the financing of corporate investment in the UK, and a small positive one overall in the US. Moreover, in both countries, only a relatively small number of large firms tend to be listed. Nevertheless, these listed companies account for a considerable proportion of industrial production, as indeed such firms do in leading DCs.

More importantly, stockmarkets can influence the economy through a variety of other channels, some direct (e.g. takeovers) and some indirect (e.g. macroeconomic signalling, interactions between the foreign exchange and the stockmarkets). Such channels have become increasingly important for DCs in the recent period as discussed in the text.

selection and moral hazard effects under the conditions assumed.

Cho, therefore, concluded that substantial development of equity markets is essential for successful financial liberalisation⁵ and in the absence of such markets there is a case for government intervention. However, there are difficulties with Cho's theoretical formulation. It overlooks (a) the fact that even with well-functioning stockmarkets there is an agency problem with respect to management-controlled large corporations; and (b) the problems arising from asymmetric information between corporate management and investors about project returns. As Myers and Majluf (1984) showed, in these circumstances, rational managers will adopt the 'pecking order' pattern of finance - preferring retained earnings to debt and only as a last resort tapping the equity market to raise finance for their investment needs. Thus, firms under asymmetric information can effectively be equity-rationed. If they are also credit-rationed and have insufficient retained profits to finance worthwhile projects, such projects will not be undertaken, resulting in socially sub-optimal investment.

As for the actual operation of DC stockmarkets, section V will show that in the 1980s these markets did not complement the effects of credit market reforms but rather in important respects subverted them. During that decade many DCs implemented credit market

⁵ See also McKinnon (1988).

liberalisation and raised real interest rates. However, this increased only the price of debt capital, but not all capital. For the reasons presented in section IV, there was a share price boom in many of these economies. The consequent sharp fall in the price of equity capital seriously undermined and indeed allowed large private corporations to bypass altogether the main channel of high real interest rates through which the M-S effects are supposed to operate.

Fry (1996) argues that the new work on finance and economic growth based on endogenous growth models strengthens the theoretical foundations of M-S analysis.⁶ This work suggests inter alia that stockmarkets lead to faster economic growth - a thesis contested below.

III: WELL-FUNCTIONING STOCKMARKETS AND ECONOMIC DEVELOPMENT

In principle, a well-functioning stockmarket should affect economic development through channels similar to those by which the equilibrium interest rate is expected to influence it in M-S models⁷, i.e. through raising (a) the savings rate, (b) the quantity and (c) the quality of investments. However, unlike the interest rate, the stockmarket can in addition ensure through the takeover

⁶There is an important difference of emphasis between the M-S economists and the new endogenous financial models. Some of the latter propose a fast and deliberate development of stock markets in developing countries in contrast to the traditional view of slow evolutionary growth favoured by Fry and others.

⁷The precise mechanisms are different in the two cases; on interest rates see Fry (1995); on the stockmarket see Singh (1993).

mechanism that past investments are (d) also most profitably utilised.

In the recent endogenous models of finance and development, King and Levine (1993) emphasise the merits of financial intermediation with respect to the promotion of technical progress and entrepreneurship. Others have stressed the risk-sharing, monitoring and screening functions which the stockmarket may perform with respect to new investment projects (Allen, 1993). Levine and Zervos (1995) suggest that the two main channels of financial intermediation - banks and the stockmarket - complement each other. Atje and Jovanovic (1993) however conclude that whilst stockmarkets positively effect growth, raising it by a huge 2.5 percent p.a., banks have little influence.

The empirical work in the above contributions is mostly based on Barro-type inter-country cross-section analysis. Arestis and Demetriades (1996) note its important methodological limitations with respect to establishing causality. The limitations are particularly serious in the present context since these empirical exercises represent reduced form analyses, and do not consider the precise channels through which the stockmarket performs its tasks (a to d). The relevant channels are (1) the pricing process and (2) the takeover mechanism.

The stockmarket critics contend that contrary to the theory, these two mechanisms in practice operate imperfectly so that even well-functioning stockmarkets (such as those in the U.S. and the

U.K.) do not perform the monitoring, screening and disciplinary function at all well. For example, both analytical work and evidence suggest that the actual stockmarket prices, although they may be reasonably efficient in Tobin's (1984) 'information arbitrage sense', are subject to whims and fads, are often dominated by the "noise traders" and are therefore not necessarily efficient in the critical sense of reflecting fundamental values.⁸ Similarly, on the takeover mechanism, empirical evidence suggests that competitive selection in the market for corporate control takes place much more on the basis of size than performance. Due to various capital market imperfections, a large unprofitable firm has a greater survival probability than a small efficient firm.

Indeed, the former may increase its chances of survival by further increasing its size through the takeover process itself.⁹

The critical school further contends that the actual operation of the pricing and takeover mechanisms in the well-functioning U.S. and U.K. stockmarkets leads to short-termism and lower rates of long-term investment particularly in firm-specific human capital.¹⁰

It also generates perverse incentives, rewarding managers for their success in financial engineering rather than creating new wealth through organic growth. These deficiencies are thought to put the Anglo-Saxon economies at a competitive disadvantage with

⁸For a review of the issues and evidence see JEP (1990).

⁹For a recent review of corporate takeovers see Singh(1992).

¹⁰For a review of the issues see Singh (1995b), Porter(1992): For an opposite perspective, see Marsh (1992).

respect to Japan and Germany which operate without hostile takeovers and where historically various other institutional structures (e.g. group-banking relationships) have insulated industrial firms from the vagaries of the stockmarket.¹¹

IV: STOCKMARKETS AND DCS: RECENT EXPERIENCE

There are important implications of the above analysis for DCS which require examination.

Stockmarkets and Economic Development

If even well-organised stockmarkets do not perform their disciplinary, allocative and other tasks satisfactorily and may impair international competitiveness, DC markets are likely to do worse in these respects. This is because even leading emerging markets (e.g. Taiwan or India) do not possess the regulatory infrastructure for well-functioning markets¹², or adequate information-gathering and disseminating private firms. Moreover, the young listed firms on these markets will not have long enough records for their reputations to be accurately assessed. All this will lead to a noisy stockmarket environment, with arbitrary pricing and considerable volatility (Tirole, 1991). In such circumstances, the monitoring, screening and disciplining

¹¹Porter (1992); Dore (1985).

¹² With respect to Taipei, the Economist (9 September, 1989) noted, "Taiwan's stockmarket is a rigged casino with a phenomenal turnover...Its family-controlled firms equate accountancy with tax-evading creativity. Its courts react...to the nudges of the influential. ...it is as free-wheeling and corrupt as the Philippines, but ... is a free-wheel that works." (p. 20)

functions of the stockmarkets may be more efficiently performed by certain kinds of financial intermediaries, e.g. the group-banking system traditionally found in Germany and Japan (Mayer, 1989).

A central weakness of a stockmarket system with respect to finance-industry relationships is that it provides investors with almost instant liquidity. Although seen as a virtue by orthodox economists, this liquidity also means that the investors need have no long-term commitment to the firm (Bhide, 1994).¹³ By contrast, the group-banking dominated financial systems can ensure such commitment. Further, because of the close bank-corporation relationships in these systems, group-banks can cope much better with asymmetric information, agency costs and transaction costs than the Anglo-Saxon stockmarket system (Hoshi et al., 1991; Allen and Gale, 1995).

¹³ Levine and Zervos (1995) and Atje and Jovanovic (1993) find in their *econometric* work a positive relationship between stockmarket liquidity (proxied by turnover) and economic development. However, as noted earlier, the question of causality there is problematical. For example, in some high-growth countries such as Taiwan it may be perverse to ascribe causality to stockmarket liquidity even if there is perfect co-movement between the two variables. This is because the Economist's description of the Taiwanese stockmarket as a "rigged casino with a phenomenal turnover" in note 10 is an apt one. In 1989 the average value of shares traded for each three-hour trading day on the Taipei stockmarket was nearly three billion dollars. That was one billion dollars a day more than in London, and more than half of New York's trading. On 28 August 1989, Taipei recorded a trading volume of 7.6 billion dollars. The world's biggest stockmarket, Tokyo, traded just 4.2 billion dollars worth of shares on the same day. Share prices on the Taiwanese market in the relevant period were subject to huge medium-term swings which were not justified by changes in economic prospects. Singh (1993). This kind of high turnover of shares may be generated by a public taste for speculation and gambling. It is likely to diminish rather than promote economic growth as it undermines the capitalistic ethic by destroying the link between effort and reward.

Stockmarket Volatility, Corporate Finance, Savings and Investment

For the reasons outlined above, share prices in emerging markets may be expected to fluctuate more than those in well-developed markets. However, a high degree of volatility is a negative feature of a stockmarket for several reasons: (a) it can undermine the financial system as a whole; (b) it makes share prices much less useful as a guide to resource allocation; (c) to the extent that it discourages risk-averse savers and investors, it raises the cost of capital to corporations; (d) it may also stop risk-averse firms from raising funds, or (e) even from seeking a listing on the stockmarket (Pagano, 1993).

Evidence supports the prediction of much higher share price volatility in DCs compared with industrial countries (Davis, 1995).

In extreme cases El-Erian and Kumar (1995) report that between 1983 and 1993 stockmarket volatility in Mexico was nearly fifteen times and in Turkey more than twenty times as large as that in the U.S. or Japan. There is also evidence of information-arbitrage inefficiency in DC share prices (Claessens, 1995). More significantly, share prices in many emerging markets would appear to have deviated considerably from fundamentals in the share price booms of the last decade (see below).

However, some of the implications of stockmarket volatility are not supported by the DC experience during the last 15 years. During this period, not only has there been a big increase in emerging

market activity and listings, but DC firms have been raising considerable capital on stockmarkets.

In the first large-scale empirical studies of corporate finance for DCs, Singh and Hamid (1992) and Singh (1995a) examined the financing of corporate growth of net assets (i.e. the long term capital employed in the firm) in the 1980s in several countries - India, Turkey, Brazil, Malaysia, Thailand, Zimbabwe, Korea, Jordan, Pakistan and Mexico. Singh's (1995a) sample normally consisted of the top 100 listed corporations in each country. This research showed that large DC corporations rely heavily in general on (a) external funds, and (b) new share issues to finance their growth of net assets. In five of the ten sample countries, over 70 percent of corporate growth during the past decade was financed from external funds. In another two, the external financing proportion was more than half. Similarly, the importance of equity finance for DC corporations is indicated by the fact that in five of the nine sample countries with the relevant data over 40 percent of the growth of net assets in the 1980s was financed by new share issues. In another two countries, equity finance accounted for over 25 percent of corporate growth during the relevant period.

These results are surprising for several reasons, including some suggested earlier. The DC financing pattern is not only different from that observed in advanced countries, it is also counter-intuitive and contrary to the predictions of most economic models. Advanced country corporations normally follow the

"pecking order" and issue very little equity, being funded largely by retained profits.¹⁴ In view of the serious capital market imperfections and high volatility, DC corporations may be expected to rely much more on internal rather than external funds, and resort far less to equity finance than industrial country firms. Further, since the former are more likely to be family-controlled than the latter, this should also discourage corporate equity issuance for fear of losing control.

How then are the anomalous phenomena of the fast expansion of stockmarket listings in DCs and the heavy reliance on equity finance by the big DC corporations in the recent period to be explained?

Singh (1995a) provides a set of interlinked hypotheses to account for these observations. Briefly, the stage of development theory of equity financing is rejected. It is argued that unlike the U.S. and the U.K. in the 19th century, stockmarket development in DCs today is not simply an evolutionary response to market forces. Rather, for various reasons (e.g. privatisation programmes), many DC governments have played a major proactive role in the expansion of these markets.

Further, Singh (1995a) suggests that an essential reason why DC corporations resorted so much to equity financing in the 1980s was that the relative cost of equity capital fell significantly during these years. This was due to a large rise in share prices which

¹⁴ Mayer (1990); see however Meeks and Whittington (1975) and Singh (1995a).

was in turn brought about by both internal and external financial liberalization.¹⁵ At the same time, the relative cost of debt financing increased because of the steep rise in international interest rates as well as financial de-repression measures which several countries embarked on during this period. Thus, the cost of equity capital relative to that of debt became much more favourable to equities during the course of the 1980s. To illustrate, Amsden and Euh (1990) note that in 1980 the average price/earnings ratio on the Korean stockmarket was about 3, and therefore roughly, the cost of capital through share issues was 33%. By 1989, the average price/earnings ratios had risen to 14 reducing the cost of equity capital to 7.1%. Euh and Barker (1990) estimate that in terms of cash flow, taking into account the tax element, the latter cost to the Korean corporations in 1989 was only 3%. This compares with a figure of 12.5% for preferential commercial bank loans.

Thus, contrary both to M-S and other economists' expectations, DC stockmarkets have contributed significantly to corporate growth in the 1980s and 1990s. However, important questions from the perspective of long-term economic growth are: has this led to increased aggregate savings and investments, or raised the

¹³ Prior to liberalization, most DC savers had limited returns and avenues for savings due to financial repression. With internal liberalization and easier access to the stockmarket, share ownership and stockmarket participation greatly increased in many countries in the 1980s. Further, a significant additional source of demand for DC corporate equities came from advanced country institutional investors seeking to achieve portfolio diversification (Singh, 1995a).

productivity of investments. These issues have not been systematically investigated for most DCs (Claessens, 1995). Some useful evidence for India, however, is provided by Nagaraj (1996).

This shows that financial liberalisation and capital market growth in the 1980s in that country led simply to portfolio substitution from bank deposits to tradeable securities rather than greater aggregate national or financial savings.¹⁶ Nagaraj notes that despite the stockmarket boom of that decade and the substantial resources raised there by Indian corporations, corporate investment in fixed assets declined. Nor does he find evidence of increased output growth in the private corporate sector. Both Singh (1995a) and Nagaraj report a secular fall in corporate profitability in India during the 1980s, which could in principle be due to product market liberalization. However, it then becomes difficult to explain the stockmarket boom except in terms of market psychology and speculation (see also below).

External Liberalisation, the Stockmarket and the Real Economy

Foreign portfolio investment, following external financial liberalisation in DCs, has been particularly important for the foreign exchange-constrained Latin American economies in the recent period. The enormous portfolio flows to these countries in the 1990s helped to alleviate the constraint and enabled a modest economic growth (about 3.5% p.a. during 1990-94) after the 'lost

¹⁶ For scattered evidence on these issues for other countries, see Singh (1993, 1995a).

decade' of the 1980s. At the microeconomic level, the portfolio inflows helped generate the stockmarket boom, lowering the cost of capital to Latin American corporations. In Mexico, considerable inflow went into the stockmarket and leaving aside the question of fluctuations, the share price index rose from 250 in 1989 to around 2500 in 1994.

However, as Rodrik (1994) and Krugman (1995) point out these portfolio flows to Latin America were not responding to fundamentals but represented a misplaced euphoria and a 'herd' instinct. The market was not rewarding virtue, frugality and restraint, but in many countries subsidising consumption at the expense of investment. Despite evidence that countries like Mexico were running huge current account deficits and using inflows largely for current consumption, such flows continued. The Mexican trade balance shifted from a small surplus in 1988 to a deficit of US \$20 billion in 1993; the current account deficit was about 6% of GDP in 1993 and 9% in 1994. Financial and trade liberalisation policies led to a fall in private savings from roughly 15% to 5% of GDP despite high interest rates (Taylor, 1996). Notwithstanding huge capital inflows in the 1990s, Mexico's rate of economic growth during 1990-94 was only 2.5% p.a.- barely equal to the rate of population growth.

The speculative bubble burst in December 1994 when portfolio flows to Mexico suddenly stopped. Share prices fell sharply not only in Mexico but also, through the "contagion" effect, in most emerging

markets.¹⁷ The impact on the real economy was devastating - real GDP fell by 7% in 1995 in Mexico and by 5% in Argentina. Thus, even when financial markets have been expansionary¹⁸, their bandwagon and herd characteristics generate considerable instability for the real economy.

Portfolio capital was recommended to DCs for being less vulnerable to external interest rate shocks than debt (WIDER, 1990). However, in practice these inflows have proved to be just as destabilizing.

As Akyuz (1993) points out, external liberalisation through opening stockmarkets to non-residents leads to close links between two inherently unstable markets even when the capital account is not fully open - the stock and currency markets. Faced with an economic shock the two markets may interact with each other in a negative feed-back loop to produce even greater instability for the markets and the whole financial system. Moreover, the gyrations in these markets may discourage aggregate investment through various channels, e.g. depressing business expectations because of greater uncertainty; greater instability in aggregate consumption because of wealth effects caused by large fluctuations in stockmarket prices. These factors contribute to the instability of the real economy and may also reduce long-term economic growth.

¹⁷"The Mexican financial crisis...resulted in a linked collapse of stockmarket values in almost all developing countries, regardless of economic policies and performance. The 'contagion' effect was clear..." (Smith and Walter, 1996, underlining added)

¹⁸ In advanced countries, financial markets have generally worked in a "deflationary" way, penalizing governments which follow expansionary policies. Singh (1996a).

Such negative feedback effects will be particularly pronounced if external financial liberalisation is carried out in 'dis-equilibrium' conditions of high and unpredictable inflation and fluctuating exchange rates. However, because of the structural characteristics of DCs which makes them more subject to external and internal shocks than advanced economies, many of these unfavourable outcomes are likely to prevail even under "normal" conditions, and even if there were a correct "sequencing" of financial reforms.

V: CONCLUSION

Stockmarket development has been an important part of both internal and external financial liberalization in DCs in the 1980s and 1990s.

The process is continuing with the encouragement of the Bretton Woods institutions - several more stockmarkets are being currently established in Africa and in transition economies.

This paper concludes that these developments are unlikely to help in achieving quicker industrialisation and faster long-term economic growth in most DCs. This is for several reasons. First, the inherent volatility and arbitrariness of the stockmarket pricing process under DC conditions make it a poor guide to efficient investment allocation. Secondly, the interactions between the stock and currency markets in the wake of unfavourable economic shocks may exacerbate macroeconomic instability and reduce long-term growth. Thirdly, stockmarket development is likely to

undermine the existing industry group-banking systems in DCs, which, despite their many difficulties, have not been without merit in several countries, not least in the highly successful East Asian economies.¹⁹

This is not to overlook the problems with such systems in other DCs (e.g. monopolistic abuses; inadequate government regulations (Singh, 1993)). However, even these countries would have been better off reforming and expanding their extant industry group-banking systems rather than establishing stockmarkets.²⁰ Reforming the existing system would not only have absorbed less resources directly, it would also have been an easier option in terms of institutional capacity for the concerned DCs²¹, compared with the infrastructure required for well-functioning stockmarkets.

Stockmarkets are potent symbols of capitalism but paradoxically capitalism often flourishes better without their hegemony. Contrary to World Bank (1989), stockmarket expansion is not a necessary natural progression of a country's financial development. Historically, such progression has not occurred in leading

¹⁹ On the relationships between banks and industry in East Asian economies, see for example Cho (1989), Amsden (1989), Wade (1990), Kojima (1995), Singh (1996b).

²⁰ See further Akyuz (1993).

²¹ If an DC is not capable of running an above-board banking system, the establishment of a stockmarket is unlikely to help and may compound the problem. The recent history of both DCs and advanced countries is rife with stockmarket scandals, e.g. the huge 1992 stockmarket scam in India and regular scandals in Taiwan and Japan.

continental European economies. In the more recent post-World War II period countries like Germany and Italy have been able to achieve their economic miracles with little assistance from the stockmarket (de Cecco, 1993; Pagano, 1993). Stockmarkets have also played little role in the post-war industrialisation of Japan, Korea and Taiwan (World Bank, 1993). There is evidence that Japan deliberately encouraged the development of the banking system rather than the stockmarket after World War II (Somel, 1992). Developing countries simply cannot afford the luxury of stockmarkets. As Keynes (1936, p.159) noted, "when the capital development of a country becomes the by-product of the activities of a casino, the job is likely to be ill-done."²²

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²²This paper is concerned with analytical rather than policy issues. However, in the post-cold-war international economic order, since realistically, whatever their merits, DC stockmarkets are now here to stay, Singh (1993, 1994) has suggested two areas of immediate concern. The first involves the control of portfolio capital flows. Many countries, including notably Chile and South Korea, restrict such flows to their economic advantage (Akyuz and Cornford 1994). In the wake of the Mexican crisis, now even the IMF and the BIS accept the wisdom of such controls (BIS, 1995). The important analytical point here is to throw sand into the interactions between the foreign exchange and the stockmarkets, even if it may be infeasible and/or undesirable to sever the connection altogether. The second area concerns the market for corporate control which can compound the negative effects of stockmarkets. Singh (1994) suggests there are structural factors which make the "spontaneous" emergence of such a market imminent in many DCs. He argues on efficiency grounds that such an evolution should be curbed. The cross of the stockmarket is heavy enough for the DCs to bear without being landed also with an Anglo-Saxon-type market for corporate control.

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