Financial Liberalization, Financial Development and Economic Growth in Less Developed Countries:
Survey on the Literature

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I. Introduction

The relationships between financial development and economic growth have been discussed extensively in the literature. Since Schumpeter (1936) made an emphasis on the role of entrepreneurship and money capital for economic growth, synthetic analysis of relationships between
financial development and economic growth was made by Goldsmith (1969), Gurley and Shaw (1955, 1956, 1967), Patrick (1966) and Cameron et al. (1967).

These studies tended to analyze the relationships between financial development and economic growth based on the development history of the market-oriented developed countries (DCs). The development experiences of the financial sector and real output growth in DCs were difficult to apply, without adjustment, to the economic situation of less developed countries (LDCs), because of the strong repressive nature in the financial system.

Pointing out the deleterious effects of financial repression on economic growth, McKinnon (1973) and Shaw (1973) argued that financial liberalization of the repressed financial markets indeed led to a recovery of saving incentives and superior allocations of savings to efficient investments in LDCs. Moreover, they stated that financial liberalization contributed to the stability of growth in output and employment. However, their arguments appear to be inconsistent with experiences of many LDCs which initiated liberalization policies in the 1970s and 1980s. Furthermore, Keynesians and structuralists have criticized financial liberalization as a poor foundation for stable and sustained real sector economic growth, especially in the context of resource-scarce LDCs.

Recent research in the relationships between financial development and economic growth has been greatly inspired by the rapidly expanding endogenous financial growth literature initiated by Romer (1986, 1990) and Lucus (1988). Not focusing on financial liberalization of LDCs, however, the literature of endogenous financial growth theories provides a natural framework in which the financial sector affects long-run economic growth, and thus, suggests important policy implications for financial liberalization in LDCs.

This study is to provide a theoretical basis to analyze how financial liberalization induces financial development which affects economic growth in LDCs including Korea. For these purposes, relevant theories on general relationships between financial development and economic growth and those on the effects of financial liberalization on these two relationships will be examined. The aspects of financial intermediation and the stock markets in LDCs will be examined to determine their roles and characteristics in the context of financial development and economic growth by financial liberalization.

II. Relationships Between Financial Development and Economic Growth

All of the pioneering contributions on financial development literature implicitly or explicitly agree that there is a strong positive correlation between the extent of financial development and economic growth. While economic growth is commonly defined as a sustained increase in output per person, the characteristics of financial development and its channel of transmission to the economic growth
are emphasized in different ways.

Gurley and Shaw (1965: 515) emphasize the "institutionalization of saving and investment" that diversifies channels for the flow of loanable funds and multiplies varieties of financial claims. Goldsmith (1969: 26) defined the financial development change in financial structure by "presence, nature and relative size of financial instruments and financial institutions of various types."² Patrick (1966), accepting the definitions of the above, suggests how a financial system can influence the real output growth. First, financial institutions encourage a more efficient allocation of a given total amount of tangible wealth (capital in a broad way), by bringing about change in its ownership and in its composition. Second, financial institutions encourage a more efficient allocation of new investment—addition to capital stock—from relatively less to relatively more productive uses, by intermediation between savers and entrepreneurial investors. Third, they induce an increase in the rate of accumulation of capital, by providing increased incentive to save, invest, and work. As a vehicle to increase allocation efficiency and volume of savings, the financial intermediaries, especially the commercial banking system, are preferred among a variety of types in the financial system.³

This pioneering literature was mainly dependent on the experiences of the early stage of development in the market oriented industrial countries. This literature gave little consideration to the realities of LDCs. Nor did it put emphasis on the factors specific to LDCs. Thus, the theories based on this literature have limitations regarding the explanation of financial development and of development strategies for the LDCs.

Lack of studies on the financial development in LDCs led many economists to develop theories based on the experiences of LDCs. McKinnon (1973) and Shaw (1973), influenced to a large extent by the success stories of Southeast Asia, emphasize the role played by financial liberalization for financial development,⁴ which is defined as accumulation of financial assets at a pace faster than accumulation of nonfinancial wealth.

The economy analyzed by McKinnon and Shaw, pioneers of neo-classical financial liberalization theory and policy, is financially repressed. The central argument is that financial repression⁵ —indiscriminate distortion of domestic capital market and financial prices including interest rates and foreign exchange rates— reduces the real rate of growth and the real size of the financial system relative to nonfinancial magnitudes. In all cases, this strategy has gravely retarded the development process.

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1 Gurley and Shaw (1965, 1967) and Patrick (1966) show historical evidences for the positive correlation between financial development and economic growth.
3 Gurley and Shaw (1966) analyze the role of financial intermediaries in the economic growth. In particular, Cameron and Patrick (1967) emphasize the commercial banking system in the early stage of industrialization.
4 It is also termed financial deepening by Shaw (1973).
Many LDCs appear to have slipped into financial repression inadvertently. In this case, financial prices, for instance interest rates, are subject to the ceiling set by the government. If the ceiling is applied only to savers’ interest rates, which would be in equilibrium at a higher level than the ceiling, savings is discouraged, since low interest rates produce a bias in favor of current consumption and against future consumption. Furthermore, lower interest rates than the inflation rate induce savers to hedge against inflation in the form of unproductive tangible wealth, for instance, a fixed supply of land. Therefore, they may induce saving below the socially optimum level.

If there are loan rate ceilings they are set in the same way as deposit rate ceilings and if there are few competitive banking systems in the economy, excess demand of loanable funds is sure to make nonprice rationing of loanable funds to the extent that banks do observe loan rate ceilings. Credit is allocated not according to expected productivity of investment projects but according to transition costs and perceived risks of default. Quality of collateral, political pressure, “name,” loan size, and covert benefits to loan officers may also influence allocation. Loan rate ceilings discourage risk taking on the part of financial institutions; risk premia cannot be charged when ceilings are binding and effective. This itself may ration out a large proportion of potentially high-yielding investments.

Because the real rate of interest as the return to savers is the key to a higher level of investment and as a rationing device to greater investment efficiency, financial liberalization to abolish interest ceilings as well as repression on the financial institutions is suggested as the best policy to produce the optimal result of maximizing investment and raising investment’s average efficiency. McKinnon (1973) and Shaw (1973) provide a theoretical basis and policy prescription for financial development of LDCs.

All countries, however, which followed their prescription did not succeed in financial development and thus economic growth. Rather, many Latin American and Asian-Pacific countries, which initiated abrupt and comprehensive financial liberalization programs in 1970s and 1980s, suffered from financial instability and crises, reduced savings, and disappointing growth. Even the policies of LDCs keeping high economic growth have not been consistent with the core ideas of McKinnon and Shaw.

The experiences of LDCs led to many extensive theoretical frameworks and reinterpretation of the original work of McKinnon and Shaw throughout 1970s–1980s. However, despite the 20 year maturation of the neo-classical financial liberalization theory, the essential policy implication that derives from the original work of McKinnon and Shaw has remained intact.

6 In many cases, deposit rate ceilings are made to finance industrial development in LDCs. Thus, deposit rate ceilings are accompanied by loan rate ceilings in most financially repressed countries.
8 Díaz-Alejandro (1985) and Okuda (1990) make a detailed assessment of financial liberalization of Latin America and Asia.
Research on the relationship between financial development and economic growth has faced a new phase due to the emergence of endogenous growth literature. Even though financial development models using endogenous growth ideas put little emphasis on the dynamic process of financial liberalization, they provide many important policy implications for financial liberalization in LDCs by explicitly including the roles of financial institutions in their theoretical framework.

Endogenous growth approaches are mainly suggested for an alternative to the neo-classical growth model, to which McKinnon and Shaw also are in debt. The neo-classical growth model, pioneered by Solow (1956) and refined in the 1960s, has a number of basic assumptions: a closed economy with a competitive market, identical rational individuals, and a production technology exhibiting diminishing returns to each input separately and constant returns to all inputs jointly. Population and labor growth are exogenous to the model, as is disembodied technological change, and no distinct productive role is assigned to human capital or to government policy. Under these assumptions, the model gives rise to a balanced growth path in which capital per capita is accumulated at the same rate as output or consumption per capita, and in which the savings rate and the real rate of interest are constant along the equilibrium path. In this regime, technology, although exogenously given, is the only force that accounts for growth in per capita income. Accordingly, one is well justified to expect that growth rates across different countries would tend to converge on a common steady-state value.

Empirical results, however, show little evidence for the convergence of real domestic product per capita across the countries. Rather, there is evidence of persistent variance in economic growth rates, even across industrial countries, over the period 1870-1979. It is unlikely that such observed diversity on levels and rates of economic growth could be explained in the neo-classical framework.

In contrast to the neo-classical model, the endogenous growth regards the economic growth as an outcome of the internal economic forces at work within a decentralized market system. In other words, in the endogenous growth model:

1. both population growth and human capital formation, that is the economy’s effective human resources, are treated as individual choice variables;
2. the specific role of disembodied technology change is interpreted as the outcome of entrepreneurial decision motivated by market forces rather than the consequence of autonomous scientific discoveries;
3. the role of the government in the growth process is examined not only as possibly an

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12 See Baumol and Woff (1988) for details.
independent catalyst of growth but also as an initiator of policies that can exert salutary or deleterious effects on the economy’s growth rate, and not just its level.

Under these formulations, three major types of mechanisms can produce perpetual growth in per capita income. First, production may be subject to increasing returns in reproducible factors. Second, production may be subject to constant returns to scale and thus be compatible with a competitive equilibrium, but it may also involve external economies in production so that per capita output would exhibit constant or increasing returns in reproducible factors. Finally, production of consumption goods may be subject to constant returns, but the per capita production, and net accumulation, of a specific reproducible factor may be a linear function of the corresponding stock of that or other reproducible factors. Such a factor can become an "engine of growth" since its unbounded accumulation would trigger continuous growth in income.13

Literature on the relationship between financial development and economic growth based on the endogenous growth approach14 not only provides rigorous analysis of household portfolio behavior under uncertainty but also demonstrates how financial intermediation resulting from this portfolio behavior can accelerate the rate of economic growth. Here, the insight from endogenous growth models is combined with the behavior of financial intermediaries to show that increased quality or quantity of investment in the firms resulting from financial intermediation can produce externalities that make all firms more productive. Because these externalities ensure that capital is not subject to diminishing marginal returns for the economy as a whole, improved financial intermediation increase the rate of economic growth. The emphasis on the role of financial intermediation in the endogenous financial growth model gives rise to much contribution to the literature. These will be examined along with the traditional theories of financial intermediation in the next section.

III. Aspects of Financial Intermediation in LDCs

For an economy to grow in the LDCs, it is required that savers hold their saving in the form of financial rather than unproductive tangible assets, and that investment should be allocated efficiently to the most societal uses. In many cases, composition of individual savings in LDCs appears to consist mainly of tangible assets (e.g., real estate, durable consumer goods, and so on). This composition of savings resulting partly from the absence of suitable financial assets is disadvantageous to the economic growth, since, in this regime, the savers lack productive investment opportunities and ignore their existence.15

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13 The discussion on the Neo-classical growth theories and endogenous growth theories is largely dependent on Ehrlic (1990).
14 For a selective survey of this literature, see Fry (1995) ch.4 and De Gregorio and Guidott(1995).
15 Higher inflation rate than nominal interest rates of financial assets makes saver prefer tangible assets to
Goldsmith (1969) describes why introduction of financial assets are necessary for the economic growth. He assumes that entrepreneurial opportunities and abilities are unequally distributed among people, and that many investments with expected high returns are far in excess of the saving of any one economic unit (the indivisibility of investment). If this is the case, it is necessary to transfer savings from a large number of savers to a small number of investors with entrepreneurial opportunities and abilities. For this reason, the introduction of financial assets (or instruments) is the natural process in the decentralized economies. Gurley and Shaw (1960: 13) said, "With no financial assets other than money, there are restraints on saving, on capital accumulation, and on efficient allocation of saving to investment that depresses the rate of growth in output and income".

Gurley and Shaw (1955, 1956) also suggest the two major classes of alternative processes of putting saving to the service of selected investment: processes of internal finance and processes of external finance. Internal finance is thought to have almost identical meaning with self-finance, which implies that consumption is financed from income, investment from internal savings. In LDCs, self-finance makes an important contribution to finance the most of private investments. Self-finance continues to be important in the most sophisticated economic systems, say in the form of investment out of retained corporate earnings. But over the very long term, the trend has been away from self-finance. Government, business, and consumers alike have come to lean more heavily on external finance.

External finance may take either of two forms, direct finance or indirect finance. Direct finance involves borrowing by deficit spending units (or investors) from surplus spending units (savers). The former issues debt, direct debt. The latter buys and holds financial assets in the form of these direct securities. Indirect finance is the case that financial institutions intervene in the flow of loanable funds by issuing debt of their own, indirect debt, in soliciting loanable funds from surplus spending units, and by allocating these loanable funds among deficit units whose direct debt they absorb. In an economy, the financial institutions which are functioning for indirect finance can be classified as financial intermediaries. Direct finance may be generated efficiently in economies in which equity markets are well developed. In many cases, however, the LDCs do not have securities markets. If any, the securities markets in LDCs, with some exceptions of "emerging markets," have generally played only minor roles in the domestic resource mobilization.

For this reason, the role of financial intermediaries tends to be more emphasized in LDCs than in DCs. Gurley and Shaw (1960) characterize the financial development as the increasing role of indirect finance in channeling the savings flows to investment projects. Indirect finance necessarily involves financial intermediaries. Among many kinds of financial intermediaries, the banking system, especially the commercial banking system, has been regarded as the most important component.

financial assets in LDCs.
16 Gurley and Shaw suggests taxation as a variant of internal finance. For the details, see Gurley and Shaw (1967), pp. 262–264.
In general, financial intermediaries affect the economic growth with two major functions, mobilization of domestic savings and efficient allocation of capital. They provide a wide variety of financial claims (indirect securities) to serve as assets for savings, with claims differentiated by liquidity, yield, maturity, divisibility, risk of default or change in value, and other services. That is, financial intermediaries absorb and diversify the potential risks contained in direct securities, which, otherwise, individual savers have to bear. Even though savings are effectively mobilized, the increase in the economic growth depends largely on how the savings are allocated efficiently. Because of their large size relative to individual savers, the financial intermediaries can have the advantage of economies of scale in monitoring information about prospective loan applicants and in evaluating their investment projects.  

These two major functions appear to perform well in the competitive financial system. In most cases, however, financial systems in LDCs show uncompetitive and oligopolistic features. Fry (1996) describes in detail the financial situation in LDCs: The financial systems in developing countries are dominated by commercial banks. Assets of insurance and pension companies are minuscule in most developing countries. Development finance institutions such as agricultural and development banks are also small compared with the commercial banks. Commercial bond markets are typically thin, and government bond markets are often used only by captive buyers obliged to hold such bonds to satisfy liquidity ratio requirements or to bid for government contracts.

Abdul Turay (1991: 114-116) defines this system as a "government dominated oligopoly," which is a market structure where there is a small number of relatively large banks supplying most of the banking services. Besides this oligopolistic feature, financial systems in LDCs are characterized by a large proportion of public sector borrowing, existence of traditional money lenders or curb markets, and participation of government-owned banks in the selective nonfinancial public enterprises.

Based on the situations in LDCs, McKinnon (1973) and Shaw (1973) sought to understand the origins of financial repression on their financial systems, and to suggest means to alleviate repression. Shaw (1973: 14) regards the financial repression as a part of development strategy in many LDCs, in which "market forces" are mistrusted on the grounds that elasticities of response to relative prices are thought to be too high or too low for desired outcomes, that markets are vulnerable to exploitation or that "this country is different". In these cases, the strategy of interventionism with fixed nominal prices and rationing on some critical markets are chosen deliberately.

Selective or direct credit policies are used or have been used to implement planned sectoral investment programs derived from an input-output matrix. Savings and loan interest rate ceilings are set deliberately below the equilibrium rate so that the private sector can be encouraged to undertake the planned investment even though these projects might well be unprofitable at the

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17 Among these functions, financial intermediaries in LDCs are sometimes emphasized to perform the "maturity transformation function," whereby financial intermediaries borrow capital short-term and lend long-term.
competitive free market equilibrium rate of interest. That is, interest rates on loans for such approved investment are subsidized. Specialized financial institutions, along with a small number of commercial banks, are established with exclusive franchises for particular activities or particular sectors of the economy. These strategies require that the financial system (intermediaries) should be under control of the government. A relatively small number of financial intermediaries appears to be easier to control in the context of economic planning.

Selective and direct policy necessitates financial restriction, since financial channels would otherwise develop expressly for rerouting subsidized credit to uses with highest private returns through curb markets. In this circumstance, it is difficult to expect the strong incentives for financial intermediaries to attract private savings and to allocate their resources to investment projects efficiently. To get out of these structural problems, financial liberalization policies which promote competition (i.e., lowering entry barrier, abolishing interest rate ceilings and privatizing government-owned financial institutions) are suggested by McKinnon and Shaw. Shaw also argues that financial liberalization increases the unification of the financial market. It reduces interregional and interindustry differences in investment yield and increases mean yield. In the wider market, inferior investment opportunities have a smaller chance in the competition among savings. Moreover, policies that induce financial liberalization (growth) diminish uncertainty regarding forward rate of return so that more rational choice can be made between alternative financial assets.\(^\text{18}\)

As discussed in the previous section, the McKinnon and Shaw School has been criticized in various ways. Among these critiques, the absence of a curb market in McKinnon and Shaw models, in spite of their recognition of distortions by curb markets, is pointed out as a serious lacuna,\(^\text{19}\) since the existence of a curb market affects the behavior of organized financial intermediaries even though financial liberalization policy is implemented by legislation according to McKinnon and Shaw scheme.

Recent research on the financial intermediation in the economic growth owes a great deal to rapidly expanding endogenous growth literature. Many theoretical works have incorporated the role of financial intermediaries in models of endogenous growth in an attempt to analyze formally the interactions between financial markets and long-term economic growth. These studies tend to emphasize the role of financial intermediation in improving the efficiency of investment, rather than its volume.\(^\text{20}\) That is, financial intermediaries are supposed to play a central role in allocating capital to its best possible uses.

Greenwood and Jovanovic (1990) present a model in which both the extent of financial

\(^{18}\) Morisset (1993) argues that the financial liberalization in LDCs may make negative effects on the real investment by portfolio shift from capital goods and public bonds into monetary assets.

\(^{19}\) Neostructuralists treat curb markets as a critical feature of their models. For details, see Van Wijnbergen (1983) and Buffie (1984).

\(^{20}\) Goldsmith (1969) stresses that the role of financial intermediaries should be evaluated from the point of view both the total volume and its efficiency in allocating its resource to the investment.
intermediation and the rate of economic growth are endogenously determined. They emphasize the role that financial intermediaries play in collecting and analyzing information, thereby facilitating the migration of funds to the place in the economy in which they have the highest social returns. The role of financial intermediaries in information acquisition is also emphasized by Boyd and Smith (1992). Their model shows that financial intermediaries reduce credit rationing and (inefficient) interest rate differentials, relative to the situation in the absence of intermediation. The model also shows how large interest rate differentials can be observed when financial markets are not integrated.

Bencivenga and Smith (1991) present a model in which agents who face random future liquidity needs accumulate "illiquid" capital and "liquid" but unproductive asset. In this framework, the existence of financial intermediaries increases economic growth by channeling savings into the activity with high productivity, while allowing agents to reduce the risk associated with their liquidity needs. Although agents face uncertain liquidity needs, financial intermediaries, by the law of large numbers, face a predictable demand for liquidity and can, therefore, allocate their resources to the investment more efficiently.

Along similar lines, Pagano (1993) analyzes the effects of development in financial intermediaries on economic growth. In his framework, financial development can raise the proportion of savings funneled to investment, increase the social marginal productivity of capital, and may influence the private saving rate. Effects on the saving rate, however, are ambiguous in that financial development may also reduce saving, and thereby growth. As financial markets develop, households gain better insurance against endowment shocks and better diversification of rate of return, while credit becomes more readily and cheaply available. Financial development also narrows the wedge between the interest rate paid by a firm and that received by households. Each of these factors affect saving behavior, but in each case the effect is ambiguous.

In a somewhat different approach, Saint-Paul (1992) analyzes the interaction between financial markets and technological choice. In his model, financial markets allow riskier technologies, and technological choice affects viability of financial markets. King and Levine (1993) assert that financial development increases the ability of financial intermediaries to evaluate prospective entrepreneurs and improves the probability of successful innovation and thereby accelerates economic growth.

IV. Stock Market Development in LDCs

The security market is defined as a direct financial market in which deficit spending units
(investors) issue debt of their own, direct debt and surplus spending units (savers) buy and hold financial assets in the form of these direct securities. That is, there is no intervention of financial intermediation in the flows of financial resources. There are two types of securities markets. One is the primary market which is for newly issued securities. The other is the secondary market which is for the liquidity of these securities. In the developed countries, it is known that financial intermediation costs have been reduced by the substitution for bank credits transactions in securities, by reduced commissions, and by increased competition. In LDCs, however, securities markets are underdeveloped, shallow, and thus thought to play negligible roles in mobilizing financial resources for economic growth.

In recent years, stock markets in some LDCs are paid high attention for theoretical reasons as well as for practical purposes, since these markets, so called "emerging markets," have shown explosive expansions in the total value of the shares listed as well as in the trading volume. But it is not assured that the quantitative expansion of stock markets in these LDCs guarantees the positive role for economic growth, since the contribution of the financial system to the economic growth should be evaluated not only in terms of its volume but also in terms of allocation efficiency. Moreover, the expansion of trading volume in the secondary markets can not be said to be highly correlated with the capital amount financed in the primary markets. Therefore, there are different points of views on the effects of expansion of securities markets in LDCs: the neo-classical FL (financial liberalization) perspective and the Keynesian perspective.

Neo-classical models for securities markets have been greatly influenced by Modigliani and Miller (1958, 1961). They show that the stock market valuation of a firm is independent of its capital structure (debt/equity) and the extent to which it resorts to internal or external sources to finance its investment plans, under the assumptions: (1) the capital market is highly competitive, (2) shareholders can borrow on the same terms as firms, (3) there are no taxes and (4) there is no risk of bankruptcy, and shareholders can sell short. Under these circumstances, the efficient stock market will recognize the increase in risk where a firm borrows at a rate below the cost of equity, and will not increase the value of the shares as a result of the borrowing. That is, the higher expected

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21 See Gurley and Shaw (1955) for detailed analysis of direct and indirect financial markets.
22 To achieve efficiency through competition in financial system, it is required that competition should be increased within industries as well as with industries. The continued competition between financial intermediaries and the other financial institutions is well known history of financial systems of many DCs.
23 There are kinds of securities such as stock, bond, and other financial instruments which are traded in the markets in LDCs. Securities, however, other than stock, are not easy to access by individual investors in many LDCs because of large amount of par value, high trading costs per unit, and underdeveloped trading system. For this reason, the stock market will be mainly focused for the analysis of direct financing of LDCs.
24 Capital amount financed in the primary market is closely related to real investment by industrial corporations. However, the trading volume in secondary market is not necessarily related to investment in LDCs, since the volume tends to depend on the short-term trading for speculative purposes.
25 For excellent analysis of MM (Modigliani and Miller) propositions, see Kitchen (1986), ch. 10 and Ross et al. (1993), ch. 15.
returns on the equity as a result of gearing do no more than compensate for the increased risk.

Singh (1993: 6) provides a broader sense on Modigliani and Miller theorems, saying, "Their [Modigliani and Miller] theorems suggest a dichotomy between finance and the real economy: corporate growth and investment decision are dictated completely by 'real' variables such as productivity, demand for output, technical progress, and relative factor prices of capital and labor. Finance in this paradigm is always permissive and simply facilitates the investment process".

As can be seen, the Modigliani and Miller framework is clearly designed for the countries with large and efficient stock, and for firms with stock market quotations. Therefore, many of the important assumptions are not valid in the context of the LDCs. Most of the LDCs do not have a stock market. Of those which do, many have narrow markets which are not efficient and which have small numbers of quoted firms.

In relation to these LDCs, there is another explanation based on neo-classical literature that is relevant. This body of thought is associated with McKinnon (1973) and Shaw (1973), who concentrate on the imperfections and repression of the LDCs' credit markets. Certainly, McKinnon and Shaw themselves did not examine the role of stock markets in LDCs explicitly. Cho (1986), who is on the same line with McKinnon and Shaw, explains the importance of role of equity market for efficient capital allocation and risk sharing in LDCs. He shows that even if the banks are liberalized by eliminating interest rate ceilings and securing free competition among banks, the improvement of capital allocation is by no means assured if information constraints are very strong. That is, because of the operation of the adverse selection and the incentive effects, given several groups of clearly distinguishable borrowers, imperfect (or asymmetric, costly) information results in some groups being totally excluded from the credit, although the expected returns of the excluded group's investment may be higher than those of the groups that get credit. To reduce or to eliminate such inefficiencies, Cho (1986) argues that credit markets need to be supplemented by well-functioning equity markets.

With introduction of the well-functioning equity market, the financial deepening associated with financial liberalization will increase the allocation efficiency of capital and decrease overall volatility in the capital markets by increasing the number of both investors and tradable shares and encouraging the increased production and dissemination of reliable information via the increased profit opportunities which attend financial deepening. Furthermore, even if financial liberalization leads to an increase in volatility, the capital asset pricing model suggests that increases in volatility would not impair macroeconomic performance provided that stock returns incorporated appropriate risk premia.

26 Adverse selection may occur in the credit market if, as interest rate rise, the riskier borrowers rather than the more efficient borrowers are willing to contract loans at such interest rates.
27 Incentive effect means that, if borrowers have choices of projects, they will tend to favor projects with a higher probability of default when interest is increased.
Drake (1985), recognizing the existing many problems of infant security markets in LDCs, regarded these problems as obstacles to be avoided or overcome, rather than as reasons for opposing the development of securities markets in LDCs. Because the natural protection afforded to LDCs' securities markets by barriers to transport, communication, and information is being fast eroded, what is required is government policy which refrains from trying to control the market at its discretion.

The endogenous financial growth model provides a similar perspective to that of the neo-classical perspective on the role of the stock market in economic growth. Levine (1991), introducing both liquidity and productivity risk, demonstrates that the stock market accelerates economic growth by (1) facilitating the ability to trade ownership of firms without disrupting the production processes occurring within firms and (2) allowing agents to diversifying portfolios. Atje and Jovanovic (1993) estimate the effects of stock market on economic growth based on the endogenous growth framework. They find that stock market growth affects the economic growth in developed countries as well as in the LDCs.

In summary, in the Neo-classical point of view, introduction of stock market in LDCs is inevitable in the context of broader financial liberalization policy, which, if properly specified and timely implemented, induces a virtuous cycle of increased savings, investment, and economic growth. On the contrary, Keynesian perspectives show that financial liberalization, regardless of its specification, implementation, and timing, induces risky investment practices, shaky financial structures, and ultimately lower rate of real-sector growth than would prevail in the absence of liberalization. This is because these financial liberalization policies promote the creation of new opportunities for "directly unproductive profit-seeking (DUP)" activities and a corresponding misallocation of credit toward speculative activities, with destabilizing macroeconomic effects.

As a financial liberalization program in the LDCs deregulates the existing financial institutions and creates new types of privately-owned financial institutions, instruments and markets, agents are given more opportunities to invest in financial (especially stock) markets. As expectation of profit is realized over time, expectation of the future grow more optimistic, agents grow more secure in their projections and they reduce safety-margins. In this case, agents may move toward "speculative financing," the short-term financing of investment on the financial assets with long

28 Grabel (1995) calls it "speculation-led economic development "
29 Structuralists show similar perspective with Keynesians on the financial liberalization (FL) in LDCs. The structuralists argue that FL policy induces a vicious cycle of stagflation and reduces availability of loanable funds.
30 These activities yield pecuniary returns but do not produce goods or services that enter a utility function directly or indirectly via increased production or availability to the economy of goods that enter a utility function. See Bhagwati (1982) for detailed analysis of DUP activities.
31 Keynesians assume that the expectation is formed endogenously and stems from the inherent fundamental uncertainty regarding the present and future expected return/risk profiles. See Davidson (1991) for the expectation formation and uncertainty based on the Keynesian perspective.
maturity.\textsuperscript{32} This pattern of financing makes agents vulnerable to credit availability and to interest rate shocks, and makes financial markets more volatile and fragile.

The increasing instability\textsuperscript{33} in financial markets is detrimental to economic growth in that (i) it discourages risk-averse savers and investors, (ii) it also makes financial market indices much less useful as a guide to the allocation of resources, and (iii) it undermines the financial system as a whole. Based on this view, Keynesians argue that the degree to which expanded stock markets are impediments to real economic growth and stability depends on the level of volatility: markets with frequent and severe price swings might be much more apt to induce short-term speculative investment practices and might also be more likely to induce broader macroeconomic instability.

Singh (1993) shows that the stock markets of the LDCs exhibit much greater volatility than those of developed economies. Analyzing the 1980s’ stock market boom in LDCs, he argues that there is little or no evidence of an increase in aggregate savings for most LDCs as a result of greater new-issues activity on the stock market, nor there is evidence that the stock market expansion leads to a more efficient allocation of savings or to better corporate performance as a result of stock market exposure.

V. Concluding Remarks

Extensive literature has made emphases on the importance of financial development in the process of economic growth. It has been argued that there is a positive correlation between the extent of financial development and economic growth. However, the effects of financial development on economic growth of an economy seem to be different depending on the stage of economic development, economic policies, economic culture, and so on.

It is generally proved that development of financial intermediation has made positive effects on the economic growth in LDCs as well as DCs. However, agreement on the role of expanding stock markets in the LDCs is not made yet. The history of stock market development in LDCs would be still too short to provide sufficient data to prove which argument is more appropriate for LDCs. It would require more time and evidence to develop a theory which can be applied to the stock market of most LDCs.

\textsuperscript{32} Keynesians argue that the pressure to join in a speculative frenzy may stem from agents’ evolving boom-euphoric expectation and/or competitive pressure to engage in profit-seeking activities caused by coerced competition in capitalistic economy. See Crotty (1993) and Grabel (1996) for details.

\textsuperscript{33} According to Minsky (1986), the instability of a financial market heavily weighted by speculative and Ponzi finance is due to the impact of changing interest rates that develop as investment boom mature. See Minsky (1986) pp. 197–220 for details.
Stock markets in Korea have expanded since the mid-1980s. Even though Korean stock markets are classified as one of emerging markets, it is still difficult to say that Korean stock markets work efficiently enough to solve the problems common to stock markets in LDCs. It is required that the effects of financial liberalization on stock markets should be studied more carefully before further liberalization and internationalization.

Reference


