BOOK REVIEW

Frederic S. Mishkin, *The Next Great Globalization: How Disadvantaged Nations Can Harness Their Financial Systems to Get Rich*. Princeton and Oxford: Princeton University Press. Paperback edition, 2008. 320 pp. ISBN: 978-0-691-13641-7

This book by a prominent economist and Fed Governor provides invaluable insights into the financial development process, drawing on theoretical research and country experiences to distill the lessons for policymakers. It explains how globalization—both real and financial—can bring prosperity, stability and wealth to emerging market countries (EMCs) that put in place the necessary institutional reforms when liberalizing their financial systems. *The Next Great Globalization* is intended not just for economists but also for broader audiences with an interest in financial issues.

There is little doubt that a stable and efficient financial system is key to a country's economic performance. Efforts to allocate capital to its most productive uses have been complicated by the gradual liberalization of cross-border capital movements over the past two decades. Daily news stories about large currency fluctuations around the globe—and occasional financial disasters like the Asian crisis of the 1990s—illustrate this point. The book argues that the next great globalization will be financial, as countries strive to allocate a growing pool of global savings efficiently. Mishkin provides a wealth of advice on how to get it right.

Although deregulation and liberalization are highly desirable objectives, the analysis of financial crises indicates that this process can be disastrous if not properly managed. The author points out that 18 out of 26 financial crises in the past twenty years occurred after the financial system had been liberalized both internally and externally. He provides useful historical background for understanding the factors that trigger financial crises and the appropriate policy responses by analyzing the crises in Mexico, Korea and Argentina in the 1990s and early 2000s. These episodes highlight the need to put in place the proper institutional structure before liberalizing capital flows. If the appropriate regulatory and supervisory framework, accounting and disclosure requirements, and well-functioning legal and judicial systems are not in place, the constraints on risk-taking behavior will not be binding and moral hazard will arise. Supervisors need to limit currency and maturity mismatches, ensure that banks have enough capital, restrict connected lending, and encourage disclosure. In addition to effective supervision, successful financial liberalization also requires responsible fiscal policy and strong monetary institutions.

Several prominent critics of globalization (Paul Krugman, Dani Rodrik, Joseph Stiglitz, et al.) regard capital account liberalization as a threat to economic and financial stability. By contrast, Mishkin argues that financial globalization—i.e. opening up the economy to flows of foreign capital and to foreign financial institutions—is necessary to achieve high growth and poverty reduction. The plight of countries in sub-Saharan Africa, for instance, is not due to globalization but rather to the failure to globalize. By contrast, the success of countries that were poor only a generation ago, such as Chile, Korea, Singapore and Taiwan, reflects the fact that they embraced globalization and built state-of-the art institutions.

Mishkin argues that globalization encourages institutional reform because it enhances the benefits of good policies and helps secure political support for the reforms. Opening up to foreign capital and foreign financial institutions brings in expertise and best practices developed abroad. It also helps promote institutional reforms, such as better accounting standards and disclosure requirements, that domestic financial institutions will need to attract capital from abroad and remain competitive. More broadly, globalization increases competition which weakens domestic business elites that benefit from connected lending and other restrictive business practices. Although these theoretical arguments are intuitively appealing, early empirical work did not yield a clear-cut relationship between financial openness and economic growth. The case studies of the financial crises in Mexico, Korea and Argentina associated with poorly managed financial liberalization illustrate why. However, more recent work by Peter Blair Henry, Kristin Forbes, Ken Rogoff and Luigi Zingales using firm- or industry-level data highlights the benefits of financial integration and the distortionary effects of capital controls.

Far from trying to promote a single blueprint for financial sector development, Mishkin stresses the need for homegrown institutional frameworks suitable for local conditions. Drawing on the experience of both advanced and developing countries, he provides examples of regulatory approaches that work well in some environments but not in others. For example, giving supervisors strong discretionary powers as suggested by Basel II, is beneficial only if they act in the public interest. This is more likely to be the case in advanced countries with a strong rule of law and an independent free press that holds supervisors accountable for their actions. For countries with weak institutional development, supervision may need to focus less on interfering with banks' management and more on encouraging market discipline by making sure banks comply with disclosure requirements.

Taking the argument for tailor-made policies a step further, Mishkin argues that critics of financial globalization who place the blame for financial crises on outsiders—specifically the IMF and the "Washington Consensus"—are simply wrong. For example, Stiglitz's call for expansionary macro policies in the face of a crisis makes sense for

advanced countries but not for EMCs, which have very different institutional features. In contrast to advanced countries, expansionary fiscal policy in EMCs creates fears of default and causes interest rates to shoot up, as happened during the Argentine crisis. Similarly, expansionary monetary policy has a perverse effect on demand, because the resulting currency depreciation damages the balance sheets of firms and financial institutions that typically have a large amount of foreign-currency debt. Mishkin's point is that expansionary policies in EMCs destroy confidence and exacerbate the crisis; governments need to restore confidence the hard way, through policy tightening and recapitalization of the financial system.

Not that the author lets the IMF off the hook so easily. He points out that the Fund's hierarchical structure leads to a fixation on one way of thinking about policy problems. For example, the fixation on fiscal issues led the Fund to misdiagnose the Asian crisis as being fiscal in origin, when in fact it originated in the financial sector. Although Stiglitz's recommendation to loosen macro policies was not the right call, the IMF's "bitter medicine" requiring a balanced budget went too far in the opposite direction. Indeed, the IMF's Independent Evaluation Office (IEO) has concluded that the tightening of fiscal policy in Indonesia and Korea was excessive, and it was in fact relaxed soon after the size of the output collapse became obvious.[1] It is also easy to agree with Mishkin that the Fund's "one-size-fits-all" view on the benefits of floating exchange rates has led to policy mistakes. When Uruguay was hit by contagion from Argentina in 2002, the Fund forced Uruguay to give up its dollar peg as a condition for providing financial support; this was poor advice to an economy with huge currency mismatches in its financial system. Where it is harder to agree with Mishkin is his assertion that the IMF recommended capital account liberalization to EMCs without considering the quality of their regulatory and supervisory frameworks. As the author recognizes, this view is disputed by the IEO, which found no evidence that countries were pushed to liberalize faster than they wanted.[2]

A key message of the book is that financial sector problems in developing countries arise primarily from conditions within the countries themselves rather than from outsiders like the IMF or the World Bank. Consistent with this view, the author believes that the main task of the multilateral institutions is to help developing countries design and implement effective institutions that would make globalization work for them. The goal should be to harness globalization, not to shy away from it. Advanced countries, for their part, should open up their markets to exports from the developing countries. The author stresses the inconsistency in the views of the political left in advanced countries, including the United States, which claims to deeply care about

[1] IEO, "The IMF and Recent Capital Account Crises," IMF, 2003.

[2] IEO, "Evaluation of the IMF's Approach to Capital Account Liberalization," IMF, 2005.

alleviating poverty in the rest of the world while also being against trade liberalization.

One issue the author does not address—presumably because it is too recent—is the ongoing US credit crunch, which has impacted Europe and countries as distant as Australia and Japan. Much of the current debate in policy circles and inside the Fed itself is framed in terms of the issues discussed by Mishkin, i.e. the need for better regulation and supervision, monetary and fiscal stimulus to prevent an output decline, and the danger that the rescue of financially distressed institutions may create moral hazard by encouraging greater risk taking. But there are new elements as well: what made this crisis particularly difficult to predict is that no one knows precisely where the risks, mismatches and leverage are in today's securitized markets. I look forward to his discussion of the lessons drawn from this episode in the next edition of *The Next Great Globalization*.

Miranda Xafa
Alternate Executive Director, International Monetary Fund