States, Banks, and Markets

Mexico's Path to Financial Liberalization in Comparative Perspective

Nancy Neiman Auerbach

The Political Economy of Global Interdependence

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Nancy Neiman Auerbach

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For Mama Toña
(who prayed for my brain)

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Acronyms

GNP	Gross National Product
BDI	Federation of German Industry
BDA	Federation of German Employers' Association
DIHT	Diet of German Industry and Commerce
NICs	newly industrialized countries
LDCs	less developed countries
IPE	international political economy
IMF	Internaional Monetary Fund
DIC	directed investments in the form of credits
DIS	directed investments in the form of securities
EMU	European Monetary Union
PRI	Party of the Institutionalized Revolution
PAN	National Action Party
GDP	Gross Domestic Product
ECIC	Expot Credit Insurance Corporation
NAFTA	North American Free Trade Agreement
ABM	Mexican Bank Association
GATT	General Agreement on Tariffs and Trade
PRD	Democratic Revolutionary Party

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I became interested in financial matters before I attended my first economics or politics course because of my parents, both bankers by trade. Yet, I owe them for far more than my interest in the subject matter of this book. Their boundless generosity of time, attention, and encouragement during my childhood has formed the foundation of any professional success I have achieved. My grandmother, Antonia, to whom this book is dedicated, more than anyone is responsible for instilling in me a passion for learning. Though she attended school only through the second grade in her native Mexico, she is one of the most intelligent and inquisitive people I have known. My daughter Dalia, born in the midst of this project represents by far my greatest achievement. Her very entry into this world kept this book from taking over my life. Last but not least, words cannot do justice to the sense of gratitude I feel toward my husband, Jeffrey. His extraordinary commitment and talent as a scholar and a teacher has given me something to aspire to. But his contribution to this project has taken a much more tangible form. He has read and re-read every word of every chapter at every stage of this project, offering indispensable suggestions throughout. Quite simply, this book would not exist without him.

Introduction

Through a comparative lens, this book explains why the transition to financial liberalization beginning in the 1980s was accompanied by economic crisis and declining growth rates in countries such as Mexico, whereas the same policy was associated with high growth rates and a relatively more equitable distribution of income in other countries such as South Korea and Hong Kong. It argues that the financial liberalization process can and should be understood as a strategic interaction between two sets of actors: private financiers and state officials. Attention to these actors' interaction helps explain disparate results from seemingly similar policies within different developing economies.

Although there is strong evidence that a well-functioning financial system can promote long-term economic growth, there has been no consensus among political scientists or economists as to how financial liberalization affects economic performance during the transition.[1] Because the timing and nature of financial liberalization differs considerably from case to case, it is often difficult to determine whether poor economic performance resulted from the fact that the country liberalized at all or whether it resulted from a sub-optimal reform path. This book will argue, in fact, that the timing and duration of the liberalization process has frequently been a more important element differentiating the performance of newly industrializing countries than financial liberalization itself.

The observation that most developing country financial systems have followed similar developmental patterns has provided the motivation for the comparative analysis presented here. As countries become richer, the role of the state in allocating credit becomes less important and private banks become more important. Later in the development process, stock markets and other non-bank financial institutions flourish in relation to private banks.[2] This later phase, however, did not occur in several advanced industrial countries, notably Germany, France, and Japan, where their respective financial systems appear to have remained bank-led.[3] Yet these developed country examples make even more clear the development path that newly industrializing nations share in common; that because of market size and external pressure, first state-led finance and

then bank-led finance have given way to equity markets, and financial liberalization has become the norm. The Mexican peso crisis of 1994 and the Asian financial crisis of 1997 are prime examples of bank-led financial structures giving way to equity markets.

It is precisely because most newly developing countries follow a similar pattern of transitional phases from state-led finance to bank-led finance to market-based finance that the differences in context, timing, and duration of those transitions become critical to our understanding of the relationship between liberalization and economic performance. That is, "[t]he order and speed with which government controls are decreased, markets liberalized, and prudential regulations introduced remain vital issues, even though most countries are striving to build market-oriented rather than government-controlled financial systems."[4] Even more important than the timing and nature of financial liberalization policies themselves is the political context, reflecting the interests and influence of key market actors, that gives rise to such reforms. Because even if it is agreed that a certain sequence is economically optimal, the practical implementation of such a sequence requires a supportive political climate. For example, in cases where corruption is rampant, as with crony capitalism, the sequence of liberalization is unlikely to matter because the quality of leadership during transitional phases is critical for economic performance.

No case underscores this pattern of financial system transition more vividly than Mexico. Both its transition from state- to bank-dominated finance, and its subsequent transition to market-led finance, have become the focus of worldwide attention. Mexico's 1982 announcement that it could no longer make interest payments on its large foreign debt not only signaled that the era of state-led finance was over in that country; it marked the beginning of a prolonged and painful debt crisis in the developing world. Following the onset of the crisis, Mexico adopted a financial reform package for which the international financial community heralded it as a model debtor. Mexico had set the standard for developing country financial politics, first through the severity of its crisis, and then through the widespread acceptance of its recovery plan. In a sense, Mexico not only began the debt crisis, it also began the financial liberalization trend. With the 1994 peso crisis, Mexico found itself at the center of developing country financial politics once again. This later crisis, as with its predecessor, reflected a major shift in financial system structure, this time from bank-leadership to equity- and currency market-orientation. Although the 1994 peso crisis gave rise to a much milder and more limited contagion effect, it turned out to be the first of a number of developing country currency crises (mostly in Asia) that seemed to exhibit similar characteristics. Prior to most of the crises, cur-

rent account deficits widened, external liabilities rose dramatically (especially short-term liabilities), and most currencies gave way to speculative attacks as monetary authorities depleted foreign exchange reserves.[5] Another striking common feature has been the way in which these crises have exposed the weaknesses of domestic banking systems. Yet most of these countries have continued to adopt structural reforms aimed at strengthening the role of market forces, despite the devastating crises that accompanied increasing capital mobility. Together these common characteristics seem to point to an underlying shift in the structure of developing market financial systems from bank leadership to market leadership.

Some recent scholarship on financial system transition has suggested that "[e]ach country has political, economic, sociological, legal, and institutional conditions that are unique to it, all of which will influence its development approach."[6] While this may be true, the cases presented here suggest that there are patterns of political and institutional change that can help explain similarities and differences across financial liberalization experiences. The comparative analyses that follow center around Mexico because its transitional phases demonstrate the central and recurring themes most vital to an understanding of financial market politics in newly industrializing countries. For example, Mexico's experience suggests that state autonomy and capacity may be necessary ingredients for successful reform as well as for the operation of a state-led financial system. Here state autonomy is taken to mean insulation not necessarily from the popular sector but from powerful domestic financial interests. Defined in this way, state autonomy seems to be an important indicator of financial sector performance, because it promotes good leadership in the form of prudential regulation and timely response to potential financial crisis. Mexico also highlights the potential costs of financial system concentration and the wedding of financial and industrial capital. Finally, Mexico demonstrates that in the absence of clear and predictable policy leadership of the financial system, economic growth and stability will suffer.

This book not only demonstrates that the timing and duration of the liberalization process is a more important element differentiating the performance of newly industrializing countries rather than financial liberalization itself, it takes the analysis a step further by attempting to explain the economic and political preconditions that put a country in the position to *choose* a reasonable reform path. Financial policy results from the strategic interaction between state and domestic market elites within the context of a given financial market structure. This interaction ultimately determines the impact of global market forces on the domestic economy and its ability to weather financial crises.

Empirical Puzzles

Few topics have captured the attention of political scientists and economists as much as the transition from state-interventionism to liberal market policies, especially when that transition concerns financial markets. While the financial liberalization literature varies widely with respect to approach, certain empirical questions have remained the focus of lively debate: What are the economic welfare consequences of financial liberalization? How do newly emerging financial markets differ from more established ones? Do financial-industrial conglomerates play similar roles across developing country cases, or across developed and developing country cases? What accounts for the incredibly high percentage of newly industrialized countries (NICs) that underwent financial liberalization beginning in the 1980s? These questions will be addressed in the context of several comparative case studies that focus on financial politics in newly industrialized countries.

Is Financial Liberalization a Good Thing or a Bad Thing?

Development economists have focused a great deal of attention on the issue of financial liberalization. Their primary concern has generally been with the analysis of financial liberalization as a policy tool. The structuralists argue that financial liberalization has had ill effects on developing economies, whereas the monetarists counter that financial liberalization is the only viable answer to developing countries' woes in the long run.[7] Their basic position is that any move toward freer markets and away from government intervention is likely to increase efficiency, because market signals are bound to lead to better investment decisions than state credit allocation. The structuralists, on the other hand, contend that government intervention may be efficient within certain parameters, and that given pre-existing and remaining market failures, financial liberalization will not necessarily be Pareto-improving. The theory of second best, still based on neoclassical assumptions about market efficiency, is one manifestation of structuralist thought. This theory argues that a move from an interventionist to a free market policy will always be efficient if there are no pre-existing market failures. However, it does not follow that in an already flawed market removal of state intervention will move the economy toward the desired efficient outcome. McKinnon, representing the monetarist position, argued originally for total and rapid financial liberalization despite the existence of flaws in other related markets. But Diaz-Alejandro showed for the Chilean case that the attempt at liberalization in the 1970s failed to increase savings in spite of the astronomically high interest rates that prevailed as a result.[8] In light of this

and other similar episodes, a large literature on the sequencing of economic reforms has emerged.[9] Even McKinnon has retreated somewhat, arguing that liberalization should proceed more gradually, and that trade liberalization should precede financial liberalization.[10]

There are also those who argue that finance should simply not be liberalized due to the inherently destabilizing nature of financial flows. Keynes and White, the architects of Bretton Woods, negotiated the treaty based on the belief that open trade depended on countries' abilities to control financial flows and maintain exchange rate stability. On the other hand, increasing capital mobility in the 1960s and 1970s made it very difficult to maintain the Bretton Woods adjustable-peg exchange rate mechanisms, which increasingly came under attack by currency speculators attracted by the one-way options. In light of the relative ineffectiveness of capital controls, both to stop evasion and to discourage disruptive capital flows, many economists dispute that there even exists a fundamental trade-off between liberal finance and liberal international trade.[11]

In his 1996 review of financial literature, Cohen posed the question of whether we are better off with market-determined finance or whether we simply have no choice. At the macro level, liberalizing financial flows makes it difficult for governments to achieve exchange rate stability while maintaining national policy autonomy. That is, if we take capital mobility as a given, governments that wish to target exchange rate stability will have to deal with a loss of policymaking autonomy in the domestic sphere. However, Cohen points out that this loss is only really a loss if policy instruments (money supply and government budget) can be assumed to have a genuine influence on "real" economic variables like inflation and unemployment, which he believes is not the case.[12]

While there continues to be a healthy debate about the speed and extent to which governments should liberalize external capital flows and attempt to maintain exchange rate stability, there does tend to be widespread agreement that as international capital mobility increases, the costs of pursuing capital and exchange rate controls also increases.[13] Goodman and Pauly have argued that global financial structures affect the dynamics of national policymaking by changing and privileging the interests and actions of certain types of firms. Once these interests become embedded in policy, it later becomes very difficult to move back toward more restrictive financial policies.[14] This explanation rings true as a way of understanding the path toward increasing liberalization of finance in the vast majority of industrial and industrializing countries. Yet it neglects to consider the role of domestic financial structures in addition to international financial structures.

In fact, while most of these debates over the causes and consequences of financial liberalization have contributed significantly to the under-

standing of financial liberalization policies, they fall short in two important ways. First, scholars have not paid enough attention to the concentration and centralization process, which in most late developing countries has resulted from a conscious state effort to promote the growth of a powerful oligopolistic financial sector that could serve as a channel for state-directed credit policies.[15] Under this type of financial structure, the short-run (which can last several years) costs of liberalizing can be significant. Second, only recently have analysts begun to focus on political context rather than on the advantages and disadvantages of financial liberalization in a vacuum.[16] Regardless of the overall welfare effects of financial liberalization, it constitutes a political decision from which some sectors stand to gain and some stand to lose. Goodman and Pauly explain the emergence of financial liberalization in advanced industrial countries as precisely this kind of political decision. The approach taken here has its roots in the political economy of liberalization literature pioneered by Haggard, Lee, and Maxfield, focuses on newly industrializing countries, and is premised on the idea that even the welfare effects of financial liberalization which concern economists cannot be understood without scrutinizing the process by which such policies come about.[17]

My analysis is based on the notion that financial liberalization combined with the appropriate incentive structures, such as a competitive domestic financial market and prudential regulation, will improve economic welfare and promote long-run growth. On the other hand, partial liberalization combined with crony capitalism, financial-industrial-conglomerate domination of the financial sector, and poor regulatory oversight of banking practices, can lead to financial crises with often devastating ramifications for the real economy as well. This study will attempt to explain the trend toward financial liberalization and analyze its consequences under various political and economic conditions.

Is There a Need for a NIC-Based Analysis of Financial Market Development?

Zysman's seminal work, *Governments, Markets, and Growth*, epitomizes the financial policy literature. He examines the politics of financial policy and its relationship to industrial policy in advanced industrial countries. Employing a domestic structures model of industrial adjustment and growth, he suggests ". . . that the form of policymaking affects the purposes pursued; structure affects not only outcome but also the goals themselves."[18] In Zysman's analysis, a country's institutional financial structure helps determine its industrial adjustment and growth process. His typology places countries in one of three groups: those with capital-based financial markets, where the industrial adjustment process is com-

pany led, those with credit-based financial markets where the industrial adjustment process is bank-led, and those with credit-based financial markets where the industrial adjustment process is state-led. According to Zysman, the United States most closely fits into the first group, France and Germany the second, and Japan the third. His analysis implies that a credit-based, state-dominated financial structure is most conducive to economic growth and successful industrial adjustment precisely because it allows the state to control sector-specific investment and hence guide the industrial adjustment process.

While this book employs Zysman's institutional framework as a starting point, it is explicitly critical of several of his assumptions. First, he puts forth what appears to be a generally applicable model of financial politics based on advanced developed country cases alone. Here Zysman is in good company with Gerschenkron, Katzenstein, Henning, and others, but their lack of attention to developing countries constitutes a significant omission, especially in light of the growing financial liberalization trend among newly industrializing economies.[19] Zysman's analysis, in particular, presents two major problems if one wishes to understand the politics of finance in developing economies. First, his market-based category assumes a competitive market structure. Yet, almost without exception, Latin American financial markets are characterized by a significant degree of oligopolization. Thus, in unaltered form, the market-based category is not applicable to any Latin American cases. Second, by advanced industrial standards, nearly all LDCs exhibit the characteristics of credit-based systems because of the relative underdevelopment of securities markets. However, the scope of government involvement and control over credit allocation on a sector-specific basis varies substantially among developing economies. This variation needs to be examined in detail. Lastly, while the context of financial structure constitutes a necessary starting point for analyzing the potential success of economic policy (as Zysman suggests), the successful implementation of financial policy, orthodox or heterodox, also depends heavily on political context. Where there exists a high degree of state autonomy, state-led finance can be growth-promoting. Conversely, declining state autonomy under conditions of financial market concentration and centralization constitutes a formula for economic crisis and stagnation. Despite Zysman's neglect of developing country experiences, the following analysis suggests that financial structure models based on industrialized country experiences, suitably adapted, can lead to a better understanding of the policy trends among developing countries. This book is premised, in part, on the idea that if one were to apply Zysman's framework to the Mexican case in an unaltered form, it would lead to certain false conclusions.

What Are the Consequences of Wedding Between Finance and Industry?

One example of such false conclusions is that Zysman's analysis of the German case suggests that the wedding of financial and industrial capital as well as the concentration of finance leads to a policymaking context conducive to long-term economic growth. Henning also examines the relationship between banks and industry, in Germany, Japan, France, the U.S., and Britain, and suggests that when industry and banks have close ties, the policy pattern that results is a competition-conscious, stability-oriented external monetary policy that discourages the international use of the domestic currency.[20] Taking into consideration only advanced industrial countries, as Zysman and Henning have done, the evidence seems to suggest that the wedding of finance and industry may actually promote long-term growth. Yet, the Mexican case fails to bear out this hypothesis because of the lack of competition among Mexican banks as compared with German banks, and the historical lack of state policymaking credibility on the part of the Mexican monetary authorities as compared with their German counterparts.

Whereas these differences stem, in part, from Germany's status as an industrialized country as compared with Mexico's NIC status, for the most part, they can be explained as a result of the divergent policymaking histories of the two countries. The case of South Korea, however, where the concentration of finance did not lead to the same problems as it did in Mexico (at least until the 1990s), suggests that developing country characteristics cannot be the sole explanation for divergent economic performance. In order to capture this variation between cases, this book introduces dynamism into the analysis by endogenizing the structural variable. The politics of financial policy literature tends to fall into the institutionalist trap of treating structure as immutable. By viewing structure instead as constituted through action, this book investigates how agents through their actions constitute structures and structures in turn limit or mold the actions of agents.[21] For example, a comparison between Mexico and Korea suggests that the underlying structure of the Korean financial system did not shift from state-led to bank-led despite the introduction of financial liberalization policies, whereas the structural shift from state- to bank-led finance preceded the adoption of financial liberalization in Mexico.

Why Are So Many NICs Liberalizing Their Financial Markets?

Much of the politics of financial policy literature explains the relative openness of monetary and financial policy as a result of international forces. For example, Helleiner credits the recent worldwide trend toward

financial liberalization to the ascendence of international capital.[22] He argues that bankers and financiers have become all-powerful with the increased mobility of international financial capital, the erosion of domestic financial regulatory structures, the increased volume of short-term capital in international financial markets, and ultimately with the loss of macroeconomic policy sovereignty implied by these phenomena.

Some scholars have attempted a combination of internationalist and domestic approaches to explain financial policy openness. For example, Maxfield argues for the Mexican case that cross-national variation in policy patterns explains the differing impact of international financial integration on the domestic economy, and that macroeconomic policy patterns are shaped by domestic policy alliances. Policy alliances, in Maxfield's analysis, are the domestic structures that determine policy and ultimately determine the extent of a country's vulnerability vis-à-vis the international economy. While the structure of policy alliances do not really change over time, the relative power of one alliance over another is determined by international capital market conditions, so that ultimately the policy outcomes in the Mexican case are still determined by international variables.

Maxfield's work, as well as other domestic structures arguments, came about in part as a reaction to dependency models of developing economies, which offer an inevitably pessimistic view of development. All peripheral countries, because of their position in the international system, are doomed to remain underdeveloped. Thus, dependency cannot explain cases of dependent development: NICs such as Brazil, Mexico, Korea, or Taiwan. Through modeling an interactive relationship between the international economic system and domestic structures, Maxfield accounts for significant variation among developing country cases while still being able to speak to the concerns of dependent development. Furthermore, this emerging scholarship has transcended simple state- or society-based theories by incorporating cross-cutting alliances into the analysis. Both of these innovations represent significant improvements over pre-existing models of economic policymaking in developing countries.

Yet the domestic structures approach shares an important drawback with the literature that preceded it. For example, Maxfield's domestic policy coalitions do not change over time, they simply react to different external conditions. This means that, as with dependency theory, domestic structure/internationalist scholarship tends to over-emphasize the role of the international economy in the determination of developing countries' domestic policy choices. This book employs a combination of a domestic structures and a sectoral interest-based argument, not to supplant internationalist models, but to fill a void left by their predomi-

nance. Additionally, this type of application can lead to new insights about financial regulation, especially under conditions of market concentration.

This book rejects the notion that the global trend toward financial liberalization among newly industrializing countries stems from international pressure alone. While there is no question that the internationalization of capital and international political pressures have given great impetus to the financial liberalization trend worldwide, the focus on international variables fails to explain the various and different economic consequences of liberalization experiences. The investigation of financial liberalization experiences provided in this book will not only account for the incredible variation in timing and scope of liberalization, it will also take account of the similar trajectory of financial market structural shifts in newly developed countries.[23] [24]

Approaches

As the preceding discussion suggests, the approach taken to the question of how economic policy comes about can determine the explanatory value of an analysis. The following discussion, organized according to levels of analysis (state, society, and international), underscores both the intellectual foundations and the theoretical contributions of the approach taken here.

The Statist Approach

Statists or state-centered approaches explicitly reject the idea that state or 'national' interests are reducible to the goals of any single group or societal coalition.[25] They claim that states have varying degrees of autonomy from societal forces. Policymaking can, thus, be viewed as a top-down process that can and does at times originate within the state apparatus. Statists concentrate primarily on state characteristics for the purpose of explaining economic policy outcomes.

The statist literature on the politics of financial policy formation has tended to employ a domestic structures framework. It follows in the tradition of Katzenstein's landmark work, *Between Power and Plenty,* which provides a general model for explaining what type of foreign economic policy path a country will follow. Katzenstein argues that the relative degrees of centralization within both the state and society determines whether a country's foreign economic policy will be liberal, neo-merchantalist or somewhere in between. Zysman also employs a statist approach to suggest that the structure of financial institutions and the extent of state involvement determines the nature of financial politics. He

concludes that financial systems dominated by "strong states" such as Japan have experienced the smoothest industrial adjustment and growth process.

In explaining financial policy outcomes in Mexico, this book draws heavily on statist approaches, yet differs from them in two respects. First, it rejects the zero-sum power-based relationship between state and society upon which most state-centered approaches are based. State and society are not always competitors in the policymaking process. Instead, financial policy is assumed to be a result of the mutual interaction of public and private actors. The outcome of such interaction is affected in part by the attributes of each actor, but one side's loss is not necessarily the other side's gain. For example, state actors may be aided or hampered in their efforts to put through a certain policy by the strength of the business sector. Japan's successful industrial policy has been linked to the strength of the business sector, although it is clear that much of the industrial policy platform originated within the state apparatus.[26] Similarly, what is now perceived by some scholars as the failure of industrial policy has also been linked to close state-business ties.

Secondly, whereas statists tend to focus solely on the institutional or structural characteristics of the state, this book will include the structural characteristics of society, or in this case the market, in the explanatory framework.[27] The resulting approach can explain the incidence of financial liberalization policies in countries with diverse market and political structures, such as Mexico and Hong Kong, without having to rely on a strong state versus weak state argument.

Society-Centered Approaches

For both classical liberals and traditional Marxists, the state can be viewed as a reflection of societal demands. It follows that economic policy choice should be interpreted either as a result of a competitive process among interest groups or as a manifestation of ruling class interests expressed through the instrument of state policy. Neither approach admits any significant degree of state autonomy from society in economic policymaking. Put another way, the state does not constitute an independent variable; societal variables alone hold the key to understanding policy choices.

The model presented in this book, in contrast to a Marxist analysis of financial policymaking, does not assume a monolithic elite. It is the diversity of interests both between and among state and private-sector elites that helps explain the variation in outcome across developing countries. Partly because of the divided nature of the domestic elite, the inevitable triumph of domestic capitalists over other actors is not assumed. This

book is fundamentally concerned with explaining the degree to which elites influence financial policy in different countries and over time.

The approach taken here also differs sharply from pluralist models in that it assumes societal interest groups other than the financial elite do not have much influence over financial policy. The first reason is that financial policy tends to be couched as a complex and inaccessible issue better left to financial elites. Although the popular sectors, in fact, are seriously affected by the choice of financial policy, it remains the case that few grassroots political movements concern themselves with the issue.[28] But also, the underlying assumption of multiple and competing interest groups does not fit the corporatist type structure of the Mexican political system.

Internationalist Approaches

There has also been a strong tradition among political economists attempting to explain Latin American economic policies of focusing on international constraints as explanatory variables. Whereas liberal international political economy (IPE) and dependency theorists differ on many counts, they do share in common a strong emphasis on the international economy in explaining domestic policy paths.[29]

The real question remains: what has led some countries to adopt financial liberalization and others to adopt more heterodox approaches in the face of similar international pressure? The most general statement of dependency would paint a picture of domestic policy in peripheral states as being completely determined by the international capitalist system. More specifically, economic policy reflects the interests of dominant states in the system, an argument analogous to dominant classes determining policy in the Marxist model.[30] More sophisticated *Dependistas* have carved out a role for domestic business in peripheral states but that role is predetermined by the business class's structural position within the domestic economy and the world economy more generally.[31]

In his critique of dependency theory, Tony Smith claims that ". . . dependency theory in general substantially overestimates the power of the international system . . . in southern affairs today. . . . Dependency theory has systematically underestimated the real influence of the South over its own affairs."[32] In fact, the record tends to support Smith's complaint. Although Northern influence, either direct or in the form of international agencies, has brought a lot of pressure to bare on developing country financial policies, each country has reacted differently to such pressure. This analysis represents an attempt to explain this variation.

The liberal IPE approach views the internationalization of capital as a positive force for development, suggesting that financial liberalization

policies are a result of international imperatives that make it increasingly costly and perhaps foolish for a developing country to put obstacles between itself and the international financial system. The positive effects of international capital are premised on two assumptions: comparative advantage and convergence of growth. Put simply, comparative advantage postulates that all countries gain from free and open trade. The more integrated the international economy becomes, the more developing countries will gain in absolute terms. However, in relative terms, there is nothing that says developed countries will not prosper more than developing countries. In short, comparative advantage guarantees a growing pie of which the developing country will share some part. Convergence of growth theory not only claims that developing countries will gain as a result of economic and financial integration but that developing economies will gain more in relative terms than developed countries. Underdeveloped economies, because they are at a lower stage of development, will provide the investor with a wider variety of profitable investments than the developed countries, where most profitable investments have already been taken advantage of. The idea is that there are decreasing returns to growth, and domestic interest rates in the developing country will reflect the availability of profitable investment. Hence, high interest rates will attract investment funds from all over the world and will eventually cause growth rates in developing countries to overtake growth rates in developed countries.

There is a great deal of disagreement over the impact of financial liberalization on developing economies, even as most scholars agree that international imperatives affect financial policy formation. This analysis accepts the notion that external pressures play an important role in policy formation, but suggests that this pressure gets filtered through public and private domestic elites who possess their own agendas not solely determined by external pressures. Perhaps more importantly, the financial policymaking process and the realities of the domestic financial system itself play a role in determining the nature, good or bad, of the effects the international financial system will have on the domestic economy. These insights suggest the importance of all three levels of analysis—state, society, and international—for the purposes of understanding financial policy. Nevertheless, committing to any one of these approaches seems inadequate for the task at hand.

Shedding the Levels of Analysis

The preceding discussion of statist, society-centered, and internationalist approaches illustrates that financial politics cannot be easily slotted into one of these levels of analysis. Policy preferences and degrees of influ-

ence vary across and within these categories. Moreover, policy outcomes do not simply reflect the interests of the most powerful set of actors—the state, domestic capitalists, or international financiers. Rather, policy must be understood as a strategic interaction between entities whose behavior, or potential behavior, affect the very preferences and behavior of other influential actors. This approach is most aptly described as an eclectic public choice approach.

Between State and Society

Interest-based preferences in the financial realm cut across state and society. An interest-based analysis of financial politics should be capable of examining the drives and desires of actors within both state and society. The broader theoretical approaches to explaining economic policy take either the state or society as given, and focus analysis only on one set of variables. The goal in this book is neither to treat the state as a reflection of purely societal forces, as the liberal IPE and the dependency theorists have tended to do, nor to treat the state as completely autonomous and the primary force in policymaking, as statists have tended to do. Although this book utilizes Zysman's structuralist typology, it deviates from a purely structuralist analysis in two principle ways. First, it views institutional change as endogenous, arguing that institutional change comes about through the actions and interactions of the agents involved. Secondly, it suggests that structure alone does not determine outcomes, but rather constitutes an arena in which agents make decisions. Through an analysis that allows for institutional change, this book explains how similar institutional structures have led to significantly different policy outcomes.

Fundamentally, financial sector reform everywhere is a political process that involves power and profits. In this sense, neither institutional structure nor state political capacity can by themselves determine the character and effectiveness of financial policy. States and markets interact not simply as administrative institutions that set the rules of the game and profit maximizing firms. Each entity faces incentives that it then acts upon. Moreover, these incentives are fundamentally intertwined. Profit maximization for firms depends on their expectations of what state policies will be adopted, and whether these policies will be effective. Likewise, the optimal policy path for state policymakers depends on their expectations of market reactions. But mutual incentives only provide a part of the picture. The relative power of state and market actors also matters. Within the strategic relationship between states and markets, financial market structure, or institutional structures more generally, condition the relative decision making power of each entity. Thus,

the analytical approach taken here will integrate both statist and interest-based methodologies.

Although much of the explanation offered here for the adoption of financial liberalization, at least for the Mexican case, is based on the strength of the state relative to societal actors, the argument tends to focus on the mutual interaction between state and private elites, not on the ability of one set of actors to dominate the other. In this formulation, the institutional capabilities of the state, or private bankers for that matter, can and will affect the core interests and policy desires of the other set of actors.

As an alternative to the "strong state equals successful industrial policy" hypothesis (a compelling statist explanation of Japanese and sometimes Brazilian growth rates), some poltical scientists have focused on mutual interactions between state and societal forces.[33] For example, Richard Samuels in *The Business of the Japanese State* argues that an emphasis on states can understate the preferences of market players. He advocates instead a relational approach to state and market in which policy is viewed as a process involving mutual bargaining between state and market actors.[34] David Friedman, in *The Misunderstood Miracle*, rejects both the theory that market forces drove Japan in the most efficient direction, and the theory that bureaucratic regulation directed the development of Japan's high growth economy. Rather, he claims that the form of production and policy choices are determined by a complex process both among societal actors and between society and state.[35] Michael Barzelay has taken a similar approach in his book, *The Politicized Market Economy*, in which he explains Brazil's energy policy as a process of mutual adjustment between state and market.[36] He thinks that " . . . [p]olitical scientists tend to focus on the policy-making process rather than on the continuing interplay between market and political forces."[37]

Certainly, in light of the Asian financial crisis and the prolonged Japanese recession, there is good reason to question the "strong" developmental state thesis.[38] Yet, it is still worth exploring the relationships between state and society that set the context for over three decades of unprecedented growth in Asia, as well as the severe financial crises that swept the region in 1997. For example, industrial policy successfully promoted industrial growth and relative efficiency because the industrial sector was exposed to market discipline through international competition.[39] This situation contrasts sharply with that of the Japanese banking industry which, having been protected by the government, now suffers from a bad loan problem as well as a vacuum of governance.[40]

The idea that economic policy results from the continuing interaction between state and society is not new. Karl Polanyi argued that the state both reacts to market forces and, in turn, shapes the direction of those

forces.[41] Still, specific applications of these concepts, especially as it relates to Latin American financial policy, are few. Certainly Maxfield's work, explaining Mexican financial policy through a focus on policy alliances which cut across state and society, has moved the literature in this direction.[42] However, the approach taken here departs from Maxfield's in that it focuses attention on the characteristics of the domestic financial market and its interaction with the state, rather than treating the state as the intermediary between the international market and the domestic market and viewing policy as the state's chosen response to the pressures imposed by international financial integration. I contend that financial market structure, the mutual interaction of state and domestic market elites, and outside forces all combine to determine financial policy outcomes.

Political Economy of Financial Markets Literature

In its approach to financial liberalization, this book most closely fits into the recent political economy of financial markets literature characterized by works such as Haggard, Lee, and Maxfield's *The Politics of Finance in Developing Countries*. Haggard refers to this literature as the political economy of liberalization efforts. He and his co-authors ask under what conditions governments are motivated to initiate liberalization attempts, and what determines the pace and scope of liberalization efforts?[43] This book is similarly concerned with those questions, in sharp contrast to earlier financial market literatures which either assumed that state intervention in financial markets was justified on the basis of market failure, or that it led to financial repression and rent-seeking. One key issue is whether financial market policy sprang from political pressures or from economic constraints on state officials.[44] The case studies presented here suggest both forces have played important roles.

A crucial theme that recurs throughout the Haggard, Lee, and Maxfield case studies is that concentration has important consequences for the political dynamics of financial market policy. Economic concentration increases the power of the concentrated segment of the private sector vis-à-vis the government as well as other market sectors. They highlight the issue of bank-led conglomerates by arguing that conglomerates affect the allocation of sectoral credit. For example, industrial concentration increases industries' political strength because it mitigates the collective action problem and increases their capacity to blackmail government during periods of distress.[45] Also, moral hazard problems arise from the incentives inherent in partially liberalized and highly concentrated financial markets. This analysis not only corroborates these findings, but also suggests that variables previously examined in purely economic analyses,

like degree of competitiveness within concentrated sectors and the exercise of monopoly power, significantly affect policy outcomes.

Even though this political economy literature has moved beyond an accounting of the costs and benefits of financial liberalization, it nevertheless remains committed to the market/state dichotomy. For example, Haggard asks under what conditions governments relinquish their control over the allocation of credit in favor of a more market-based system?[46] Clearly, the financial policy arena is still being treated as a bipolar system in which either state intervention or the free-market win out. This book approaches the world of domestic finance from a different perspective. By employing Zysman's three-part typology–state-led, bank-led, and market-based—this book can more fully describe and explain the transition to financial liberalization in the developing world. In fact the trends that have occurred over the last twenty years in developing countries show a distinct trajectory from state to bank to market, although the timing, duration and consequences of each stage have differed significantly across cases. Few have attempted to analyze financial liberalization in the context of these broader stages, treating it as a structural shift from state-led to bank-led, and later to market-based finance.

Interest-Based/Sectoral Analysis

This book employs an interest-based or sectoral analysis to examine both the opportunity costs of maintaining preferential credit policies on the part of the state, and the policy preferences of societal groups that stand to gain from reduced government intervention.[47] But it goes a step further by introducing the strategic element to illuminate mutual incentives that affect each other. As a government loses its ability to control circumvention, inflation and capital flight ensue, which in turn affects the business environment in which bankers make decisions. Government intervention can serve to limit competition among banks, boost profits, and restrict capital mobility. Under relatively stable economic conditions, bankers might prefer a certain degree of intervention in the financial market. However, when the government loses its ability to control capital flight and inflation, bankers' preferences are likely to shift decidedly toward financial liberalization in order to have the freedom to hedge against currency devaluation. Game theory offers the perfect tool with which to analyze such a strategic relationship. This study is not the first to apply a game framework to the political economy of policymaking, but the political economy of financial reform literature has thus far not gone in this direction.[48]

Milner suggests that policy preferences do not translate directly into policy, but instead, that policy is determined by the strategic interaction

among actors' preferences, given institutional context.[49] Not only does the treatment of financial policy formation in this book adhere to this principle; it also applies strategic analysis to the very formation of policy preferences and institutional structure. For example, expectations play an important role in determining the policy preferences of economic elites. If bankers expect state policy to be effective in controlling inflation, their financial policy preferences will actually be different than if the state had no credibility in the eyes of financial elites. With respect to institutional context, Milner seeks to develop a strategic model, "given institutional context." While there is little doubt that this context plays an important role in determining policy outcomes, Milner views it as exogenous and immutable, leaving unexplored the causes and effects of financial system structure or leadership of the financial market. This book will attempt to do so by shedding the old state/market dichotomy and asking what the qualifications are for successful financial sector leadership, regardless of whether the source is the state or private banks. The theoretical origins of this approach are in many ways analogous to Williamson's application of an institutional analysis to markets, which moved beyond the question of whether interventionism or free market orientation is better.[50] Instead, he showed that it depended upon the context and characteristics of the particular market.

Modeling the Strategic Relationship Between State and Market

Strategic modeling of financial policymaking represents a departure from the current literature from an explanatory or predictive as well as from a theoretical perspective. That is, modeling the institutional capabilities of the state and the interests of powerful private actors as a dynamic strategic or mutually determined policymaking process results in several conclusions that challenge Haggard, Lee, and Maxfield's political economy of financial policy approach.

First, Maxfield hypothesizes that demand for preferential credit policies increases as the domestic manufacturing sector becomes politically powerful. But the preferences of manufacturers are not formed in a vacuum. Rather, the structure of the domestic market and manufacturers' relations with other market actors play a part in determining both policy preferences and the extent to which preferences become policy. One important aspect of the domestic market structure is the extent to which the manufacturing sector is dominated by export- versus import-oriented businesses. The other important domestic market relationship is that between the manufacturing sector and the financial sector. Taking both of these relationships into account leads to a different interpretation of Mexican as well as several other countries' financial policymaking. Whereas

Maxfield suggests that Mexico's powerful, import-oriented manufacturing sector created the demand for preferential credit that led to Mexico's highly interventionist financial policy, this book argues that the impetus for financial liberalization, indeed the increasing impotence of state interventionism in the financial market, came from a powerful banking sector that increasingly profited from the movement of short-term capital, e.g., currency trading, rather than longer-term lines of credit with domestic manufacturers.

This interpretation of Mexican financial politics suggests several important guidelines for applying a sectoral interest-based analysis. First, one must differentiate between financial and nonfinancial interests with respect to policy preferences in order to determine the conditions under which financial and nonfinancial interests are compatible. This will depend on the extent to which banking profits are correlated with manufacturing profits, or the real economy.[51] This correlation, in turn, depends on the characteristics or orientation of each of these sectors. For example, Mexico's banking sector happens to be highly indebted to foreign banks, which means that they have tended to have a significant stake in keeping the peso overvalued. Until the Mexican peso crisis in 1994, Mexican bankers went largely unchallenged in expressing these preferences, because while Mexico may have a strong manufacturing sector as Maxfield claims, what matters more is that the manufacturing sector until very recently was more import- than export-oriented. Export-oriented manufacturers would have had good reason to challenge a noncompetitive exchange rate policy. In short, Mexican financial policy reflected the interests of a powerful financial sector because exporters constituted only a weak countervailing domestic force to challenge finance and because the state had a mutual interest in keeping debt payments low.

Second, Maxfield predicts that the government will be less susceptible to demands for preferential credit policies when central banks are independent.[52] That is, independent central banks are more likely to encourage financial liberalization because they tend to discourage the rent-seeking associated with preferential credit policies. But this book predicts a different outcome, because independent central banks tend to have more credibility with respect to inflation-fighting, and inflation more than anything else means that banks will prefer financial liberalization because it allows them to move capital as a hedge. Hence, a weak central bank is more likely to come under pressure to liberalize finance, whereas a strong central bank is more likely to get private-sector support for preferential credit policies because private actors are more likely to profit under this scenario. This applies at least to the liberalization of capital flows into and out of the country. Whether or not financiers will prefer internal financial liberalization (e.g., calling an end to preferential credit policies)

really depends on the state's capacity to guarantee bank profits over and above what banks can expect under market-led finance. Again, the greater the capacity of monetary authorities to direct finance effectively, the less likely they are to meet resistance from financial elites.

Finally, with a combination of sectoral analysis and international constraints Maxfield predicts an oscillating policy, from intervention on the one end to market liberalization on the other end. But this misses the major institutional/structural changes in financial markets that form the underlying trend identified here from state-led to bank-led to market-led financial systems. It becomes much more difficult for a country to adopt interventionist financial policies once it has liberalized to a certain point.

Organization of the Book

Chapter 1 begins the comparative case analysis with Mexico as it explores the interaction between financial elites and state officials with respect to Mexican financial policymaking over time. It contrasts economic performance, the structure of the financial sector, the orientation of financial policymaking, and the degree of concentration within financial markets during the period from 1940–1960 with that from 1980–1994. The magnitude and breadth of these changes underscore a fundamental transformation in the politics of Mexican financial policy, from state-led to bank-led finance. This chapter then examines two primary relationships: that between financial system structure (i.e., state-leadership versus bank-leadership) and the orientation of financial policy; and that between financial policy orientation and economic performance. A shift in the structure of the financial system from state domination between 1940–1960 to private bank domination from 1980–1994 explains the adoption of financial liberalization policies in the later period, after a period of relative heterodoxy that was characterized by a high degree of state intervention in the financial market. Additionally, the interventionist financial policies under state-led finance in the 1940–1960 period provided a basis for Mexico's extraordinary economic performance in that period, while financial liberalization, under conditions of growing economic concentration and centralization, contributed to the economic downturn and financial crisis of the post–1980 period.

Chapter 2 compares the effects of a bank-dominated financial market structure on the politics of financial policy in Germany and Mexico by focusing on two independent variables: the degree of economic competitiveness in the financial sector, and the extent of state policymaking credibility. Whereas until recently Mexican policymakers have tended to adopt short-term oriented monetary policies which have tolerated extreme exchange rate overvaluations, German policy makers have favored

competitiveness-conscious exchange rate policies together with stability-oriented monetary policies. The evidence suggests that this divergence in monetary and exchange rate policies can be attributed primarily to the historical lack of state policymaking credibility, based on the inability to control inflation, in Mexico as opposed to Germany. But it also appears that the relative lack of competition among Mexican banks as compared with German banks tends to alter bankers' preferences toward short-term investment. Comparing German and Mexican bank-led finance underscores the importance of market concentration and the degree of competitiveness in any attempt to understand the differences between financial markets in developed countries and those in developing countries. Depending upon the political and economic environment in which the financial sector develops, market concentration may result in varying degrees of market competitiveness, which in turn affects financial policymaking effectiveness. And although market concentration and centralization are phenomena that affect both advanced industrial countries and developing countries, the subject has been largely ignored in the literature on the politics of financial policy.[53] Given the concentrated nature of both the German and the Mexican financial systems, competitiveness cannot be taken for granted. This comparison of the German and Mexican cases helps illustrate when and how concentrated finance affects market competitiveness and economic welfare more generally. For example, despite the concentration of finance in Germany, the banking sector exhibits strong signs of competitiveness, with banks competing vigorously for industrial borrowers and individual depositors. In Mexico, such competition is rare, in part because of the extent to which industrial and financial capital are wed through ownership ties. While there is some degree of wedding of industrial and financial capital in Germany, legal restrictions are much stricter and more effective than in Mexico. Hence, when a conflict of interest does arise between banks and industrial firms, the interests of German industry are likely to be vigorously represented. The same cannot be said for Mexico. To the extent that industrial earnings translate into more widely shared benefits for the economy as a whole than banking profits, the differences between Mexico and Germany highlighted here can help to explain the conditions under which concentrated finance affects economic welfare.

Chapter 3 examines the conditions under which financial liberalization is most likely to succeed. It compares an apparently successful case of liberalization with government guidance— South Korea—with an unsuccessful case of liberalization without government guidance, namely Mexico. While the equity and exchange rate market crises of 1997 raise questions about the ultimate success of financial liberalization in Korea, this does not detract from the fact that Korea managed the transition to fi-

nancial liberalization more smoothly than Mexico, as evidenced by more than a decade of low average inflation, high average growth, and relatively equal income distribution. The central thesis of this chapter is that declining state autonomy in Mexico was responsible for the weak implementation of financial liberalization as well as the poor economic performance that is associated with it, whereas state autonomy remained relatively intact through the initial stages of financial liberalization in Korea and resulted in better economic performance and stability. The evidence suggests that the declining ability of the Mexican state to direct finance, together with the increasing power of societal actors (financiers) in relation to the state, as well as in relation to other societal actors (industrialists), first made heterodox financial policies untenable and later made financial orthodoxy incompatible with growth promotion.

On the other hand, Korea liberalized without the state turning over leadership of the financial system to private banks, which is evident in four key areas: (1) the gradual, partial, and, at times, illiberal nature of liberalization; (2) the tempering of big business power; (3) the nature of industrial policy in the pre-reform period; and (4) the privileging of the real economy over finance, as demonstrated in the sequencing of trade liberalization before financial liberalization, and the promotion of financial sector competition. While Korea pursued some elements of financial liberalization throughout the 1980s, the underlying structure of the financial system was still state-led. This state-led structure allowed the Korean state to pursue dual policy goals of growth-promotion and financial market stability.

Chapter 4 suggests that the transition to liberalization can and should be understood as a strategic interaction between market actors and state actors. Whereas Chapter 3 focuses on the relationship between the market and the state, this chapter focuses on the issue of policymaking leadership more broadly. It demonstrates that state autonomy is important not because strong states are necessary but because financial markets require high degrees of purposeful leadership. Through a comparative study of transitions to liberalization in four newly industrialized countries—Turkey, South Korea, Hong Kong, and Mexico—Chapter 4 investigates the various potential sources of such leadership. It demonstrates that economies exhibiting clear leadership roles, whether they are state-led or market-led, are more likely to experience successful policy outcomes than countries in which key players are vying for leadership. Hence, Mexico has suffered from having a simultaneously powerful state and powerful private financial sector; Korea has benefitted from strong and purposeful state leadership; Hong Kong has benefitted from an extremely strong and relatively competitive private market, and a state with a hands-off philosophy; and Turkey suffered in the past from a situ-

ation similar to Mexico's, but has recently entered into a cooperative power-sharing relationship with a relatively efficient state-fostered exporting sector, which has managed to challenge entrenched and relatively inefficient economic sectors.

Chapter 5, the final comparative case study, returns to Mexico and South Korea. It suggests not only that Mexico may have moved into a new phase of financial politics as a result of the peso crisis but also that the more recent Asian currency and equity market crises may indicate similar transitions from bank-led to market-led financial systems. This chapter investigates the politics behind the Mexican peso crisis as chapter one does for the transition to financial liberalization. In both cases the preferences and influence of powerful bankers appear to be a major catalyst for financial policy reform.

Conclusion

Financial market structure, regardless of whether it is characterized by state-leadership, bank-leadership, or market-leadership, shapes policymaking and responses to policymaking by empowering certain actors or making certain policy options appear more lucrative. Financial liberalization can be defined as a transition from one type of financial market structure, state-led, to another type of financial market structure. The chapters that follow investigate financial market structure as a context for financial liberalization and compare that context across several country cases.

They do so by approaching financial liberalization from an interdisciplinary perspective, by integrating political science and economics not just in terms of subject matter, but also in terms of methodology. One of the fundamental premises forming the basis for this book is that state and market actors each possess both economic and political power, the exercise of which determines policy outcomes. For example, under state-led finance the state's financial control is not based on its political authority as it is for other policy areas that are supported by legislation. Rather, financial control is based on the state's economic power, which is either associated with its ownership of banks or with regulation and guidance that gives the state virtual control over bank management, as in South Korea.[54] So although we might think of the state as possessing primarily political power, states often possess economic power as well, especially in the realm of finance. Likewise, market actors, particularly banks, often exercise political power. As we shall see, Mexican financial-industrial conglomerates (*grupos*) were able to translate market power into policymaking leverage. One recurring element in this book will in fact be the fungibility of market power, a point often overlooked by political econo-

mists.[55] Of course, the degree of economic and political power varies across country cases and across time which constitutes a starting point for this study.

This study also integrates economics and political economy methodology by employing modeling techniques more common to economics but necessary to understand fully the strategic dynamics involved when state and market actors shape financial policy outcomes. Two chapters rely heavily on game-theoretic modeling in order to analyze the dynamics of state-market strategic interaction. Chapter 2 applies an extended-form game model to Mexico and Germany respectively, in order to analyze the multiple choices facing bankers and government policymakers under different sets of expectations. Chapter 4 borrows the logic of the Stackelberg-Leader model, known mostly for its application to two-firm markets in the field of industrial organization, in order to inform the study of leadership roles among state and market actors. This sort of interdisciplinary approach brings together the insights of political contextualization and the rigor of interest-based analysis.

By making market structure a central part of the analysis, this book bridges another gap between economics and political science. Until very recently, political scientists typically have not treated market structure as an explanatory variable in its own right.[56] Yet, the effects of market concentration on state-market relations with regards to newly industrializing countries should not be overlooked, since such concentration tends to be a defining characteristic of these economies. No analysis of such an economy would be complete if it where to ignore market concentration. Because economic elites within concentrated and centralized economies exercise both economic *and* political power both vis-à-vis each other and vis-à-vis the state, the exercise of this power takes center stage in this analysis. Nowhere is this more apparent than in the Mexican case which constitutes both a starting point and a springboard for this analysis.

Notes

1. Levine [1997], 17; Loriaux et. al., [1997]; Harwood and Smith [1997], 2; Haggard [1997]; Wang [1994]; Hugh and Park [1994]; Capri, Atiyas, and Hanson [1994]; Haggard, Lee, and Maxfield [1993]; Vittas [1992]; Perkins and Roemer [1991]; Zank [1991]; Tseng and Cooker [1991]; Maxfield [1990]; Urrutia [1988].

2. Levine [1997], 17.

3. Though according to *The Economist* [August 14, 1999], the traditional links between Germany's banks and its industrial companies are being transformed.

4. Harwood and Smith [1997], 6.

5. Smith [1998], 67; McLeod and Garnaut [1998], 67.

6. Harwood and Smith [1997], 2.

7. Dornbusch & Reynoso [1989]; Galbis [1986]; Diaz-Alejandro [1985] and are examples of the diversity of scholarship which has contributed to the structuralist argument. McKinnon [1973] and Shaw [1973] contributed seminal works which defined the monetarist camp for development economists. Within the field of economics, monetarism remains the mainstream perspective.

8. Diaz-Alejandro [1985].

9. See for example: Wihlborg and Dezseri [1997]; Wihlborg and Willett [1997], 115; Harwood and Smith [1997]; Edwards [1995]; Edwards [1994].

10. McKinnon [1991].

11. Andrews and Willett [1997], 483.

12. Cohen [1996], 282.

13. Goodman and Pauly [1993], 50.

14. Goodman and Pauly [1993], 50.

15. Although Diaz-Alejandro mentions it, it is not a central part of his analysis.

16. Wei and Lian [1998]; Krause [1998]; Aizenman and Isard [1993].

17. Haggard, Lee, and Maxfield [1993].

18. Zysman [1983], 79.

19. Zysman [1983]; Gerschenkron [1962]; Johnson [1982]; Katzenstein [1978]; and Henning [1994].

20. Henning [1994].

21. Polanyi [1944] employed such a view of the emergence of market capitalism.

22. Helleiner [1994].

23. Milner defends the domestic actor approach against scholars who privilege the systemic level of analysis by pointing out that the level of analysis matters less than whether the effects of a variable are systematic and cross-national.

24. Here Milner [1997], 10, is directly challenging Waltz [1979].

25. Zysman [1983]; Evans [1979]; O'Donnell [1972].

26. Samuels [1987].

27. It is my contention that the oligopolistic structure of the Mexican domestic market is an important factor in the determination of financial policy.

28. Again, there is evidence that this may be changing even in elite-dominated countries like Mexico. See Sheridan [1998].

29. This group is very loosely defined for me. I am basically referring to the tendency of late among international relations and international political economy scholars to focus on the growing internationalization of world markets as the primary and irresistible force behind individual country's policy decisions. Ironically, this is an argument is analogous to the linear historisist component of Marxism which views the growth and spread of capitalism as inevitable. Frank [1970]; Cardoso, and Faletto [1979].

30. This argument applies more to Frank [1970] than to Cardoso and Faletto [1979].

31. Cardoso and Faletto [1979] make this type of argument.

32. Smith [1986].

33. Johnson [1982].

34. Samuels [1987], 3.

35. Friedman [1988], 14.
36. Barzelay [1986], 14.
37. Barzelay [1986], 248.
38. Bayoumi [1999]; Henderson [1998]; McLeod and Garnaut [1998]; *The Economist*, March 1998; Carlile and Tilton [1998]; Katz [1998]; Freedman [1998]; Argy and Stein [1997]; Wood [1994].
39. Horiuchi [1998], 195.
40. Horiuchi [1998], 204.
41. Polanyi [1944], 129; and see also Hall [1986], 18.
42. Maxfield [1990]
43. Haggard, Lee, and Maxfield [1993], 4–5.
44. Haggard, Lee, and Maxfield [1993], 8.
45. Haggard, Lee, and Maxfield [1993], 16.
46. Haggard, Lee, and Maxfield [1993], 294.
47. Milner [1997]; Haggard, Lee, and Maxfield [1993], 295; Frieden [1991].
48. Barzelay [1986].
49. Milner [1997], 17.
50. Williamson [1975].
51. Haggard, Lee, and Maxfield [1993], 301.
52. Maxfield [1997].
53. Haggard [1997]; Haggard, Lee, and Maxfield [1993]; Zysman [1983].
54. Lee [1993], 22.
55. For example Zysman [1983] never addresses the issue of market concentration and its political consequences.
56. Henning [1994] is a notable exception.

1

The Rise of Bankers' Hegemony

Financial Policymaking and Economic Performance in Mexico

This chapter explores the politics of Mexican financial policy and its growth-inducing potential over time. In attempting to explain both the genesis of financial liberalization in Mexico as well as its relationship to economic performance, this analysis bridges the economic and the political economic literature on financial policy. One explanation offered of the recent worldwide trend toward financial liberalization has viewed it as a result of the ascendence of international capital, arguing that bankers and financiers have become all-powerful because of increased international financial mobility, the erosion of domestic financial regulatory structures, the increased volume of short-term capital in international financial markets, and ultimately because of the loss of macroeconomic policy sovereignty implied by these phenomena.[1] Yet, notwithstanding pressure from the International Monetary Fund (IMF), international constraints alone cannot explain the increase in financial liberalization efforts among less developed countries throughout the 1980s. First, not all LDCs that came under IMF pressure took the orthodox path.[2] And second, this chapter will demonstrate that domestic influences played an important role in the move toward liberalization of the Mexican financial market.

The two related arguments of this chapter examine two primary relationships: the relationship between financial system structure and the character of financial policy; and the relationship between the character of financial policy and economic performance. The first argument suggests that a shift in the structure of the financial system from state domination between 1940–1960 to private bank domination from 1980–94 explains the adoption of financial liberalization policies in the latter period after a period of relative heterodoxy, characterized by a high degree of state intervention in the financial market.[3] The second argument is that the interven-

tionist financial policies under state-led finance in the 1940–1960 period provided a basis for Mexico's extraordinary economic performance in that period, whereas financial liberalization, under conditions of growing economic concentration and centralization, contributed to the economic downturn and financial crisis during the years from 1980–1994.

As a whole, the politics of financial policy literature has provided important insights as well as useful frameworks for further analysis. There are, however, certain failings in the literature as it stands now. First, it has paid relatively little attention to developing countries.[4] This is especially noteworthy given the financial liberalization trend among newly industrializing economies. While this literature has proved useful for predicting policy outcomes in industrialized countries, this chapter is premised, in part, on the idea that if one were to apply these analyses, in unaltered form, to a developing country case such as Mexico, they would produce certain false conclusions.

This chapter starts with Zysman's domestic financial structures approach in which he examines the politics of financial policy and its relationship to industrial policy, but it expands it to analyze the transition from state-led to bank-led finance that characterized Mexico's financial liberalization process.[5] Zysman suggests that a country's institutional financial structure affects, or possibly determines, its industrial adjustment and growth process. Here industrial adjustment is taken to mean the process by which industry adjusts to market changes, a process that can vary from completely decentralized decisions made by individual companies (company-led) to a relatively centralized process overseen by the state. Each country falls into one of three categories: those with capital-based financial markets, where the industrial adjustment process is company led (e.g., the United States); those with credit-based financial markets where the industrial adjustment process is bank led (e.g., France and Germany); and those with credit-based financial markets where the industrial adjustment process is state led (e.g., Japan). Zysman's analysis implies that a credit-based, state-dominated financial structure is most conducive to economic growth and successful industrial adjustment precisely because it allows the state to control sector-specific investment and hence guide the industrial adjustment process. This study of Mexican financial politics will attempt to identify the structural characteristics of Mexican finance over time. In addition, it will examine the relationship of financial market structure to economic performance, financial policymaking, and concentration within and between financial and industrial markets. The magnitude and breadth of the changes that took place in these key variables, between the 1940–60 and the 1980–1994 periods, underscore a fundamental transformation in the politics of Mexican financial policy.

This chapter is divided into four analytical sections and a conclusion. The first section argues that prior to 1960 the Mexican financial system clearly exhibited characteristics consistent with state-led finance, while from 1980–1994 it more closely approximated a bank-led system. The decades from 1960 to 1980 represent a period of gradual transition in which state autonomy slowly declined and bankers' hegemony took root.[6] Each period will be treated as discrete for the purpose of analysis, although policy outcomes can be traced to continuously changing dynamics between market actors and state officials throughout the post-World War II era. Similar to Zysman, this analysis will employ financial structure as an independent variable in order to explain the financial policymaking process. However, it departs significantly from Zysman in that financial structure changes over time within the same country, whereas Zysman treats financial structure as fixed within countries. This constitutes an important distinction because this pattern of state-led finance giving way to bank-led finance appears to be a relatively common development experience among the NICs. The second section explores the shift in financial policy from the relative heterodoxy of the first period to the relative orthodoxy of the second. The third compares the performance of the Mexican economy in the 1940–1960 period with that of the 1980s. The fourth section argues that bank-leadership of the financial system led to financial policies more conducive to short-term rather than long-term investment strategies which had disastrous effects on the Mexican economy. The concluding section attempts to generalize from the Mexican experience with respect to the process by which financial structures evolve and the policy implications of that process.

The Shift in Financial System Structure

The shift from state-led finance in the 1940–1960 period to bank-led finance in the 1980s is reflected in three primary areas: financial intermediation, regulation, and the relationship between banks, the state, and industrialists. Despite the 1982 bank nationalization, which represented an act of desperation on the part of a state that had increasingly lost control over the financial system, state-led finance was giving way to bankers' hegemony by 1980, a phenomenon to which a number of scholars attest.[7] In the context of the severe crisis facing the Mexican financial sector in 1982, bank nationalization constituted more of an attempt on the part of the state to rescue the financial system from bankruptcy than a flexing of state policymaking muscle vis-à-vis private banks. Moreover, the process of reprivatization began only one month after the banks were nationalized and continued uninterrupted through the 1990s with the privatization of historically state-owned banks.

State-Led Finance

In addition to its ability to regulate private sector financial flows throughout the 1940s and 1950s, the government enjoyed direct control over a substantial proportion of financial capital through state-owned banks. Government-run banks controlled on average 57.7 percent of financial resources between 1940 and 1960.[8] The *Banco de Mexico* alone controlled an average of 35.5 percent of total financial-sector resources. From 1940 to 1950, the government financed nearly 70 percent of public spending and state-owned banks accounted for 40 percent of the financial sector's loans to and investments in the securities of businesses and individuals.[9]

According to Zysman, "selective credit allocation is the single discretion necessary to all state-led industrial strategies."[10] The Mexican government influenced the allocation of financial resources through reserve and capitalization requirements designed to channel funds to designated sectors of the economy. The *Banco de Mexico* controlled the level of private investment by altering the levels of reserves private banks were required to deposit in the central bank. Under the General Law on Credit Institutions and the Organic Law of the *Banco de Mexico*, banks were required to maintain a fraction of their liabilities at the *Banco de Mexico*. But unlike most central banks, the *Banco de Mexico* had the power to raise the maximum established reserve requirement to 100 percent of any increase in liabilities. The manipulation of reserve requirements at the margin was so effective as a means of directing funds that it approximated a command and control mechanism through which banks were told to make certain loans under penalty of law.[11]

The *Banco de Mexico* utilized the flexible reserve requirement to fine-tune the state's development strategy and direct investment funds into specific areas as needed.[12] A comparison of changes in reserve requirements to changes in the level of financial-sector credit going toward high-priority sectors suggests the success of this strategy in the 1940–60 period. Required reserves fell into one of three categories: directed investments in the form of credits (DIC), directed investments in the form of securities (DIS), and cash.

The state first employed DICs in 1948, requiring deposit banks to hold 10 percent of deposits in this form. In general, banks were free to choose among loan applicants so long as the claims acquired related to activities that the *Banco de Mexico* designated. The DIC was, however, primarily employed to direct credit toward the agricultural sector.[13] Figure 1.1 shows the share of private-bank financing toward the agricultural sector increasing in 1948 when the DIC requirement of 10 percent was first instituted. In 1949, when the DIC requirement increased to 50 percent and

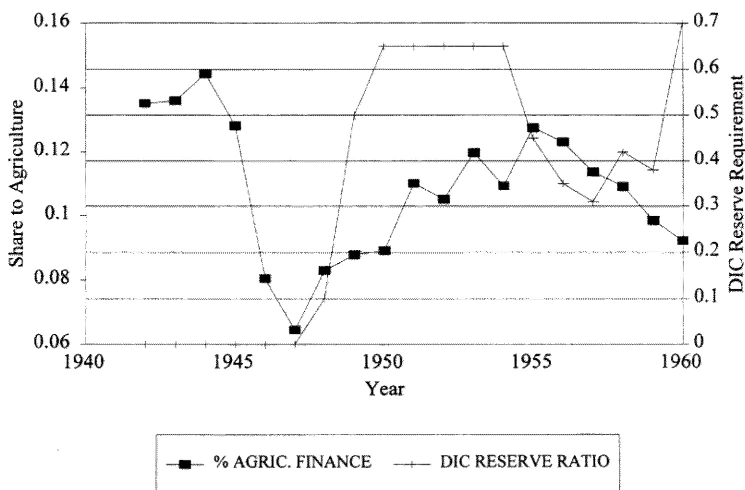


FIGURE 1.1 Percent of Finance to Agriculture v. DICs, 1940–1960
SOURCE: Banco de Mexico. *Indicadores Economicos*, 1985–1991, and *Informe Anual*, 1942–1984

later to 65 percent, the percentage of private financing going to agriculture increased again. When in 1955 the requirement was decreased first to 45 percent and then to 35 percent, the share of agricultural sector finance declined. In 1958 monetary authorities made a limited attempt to increase agricultural financing by raising the DIC to 42 percent. This attempt failed, as did later attempts, suggesting that the ability of monetary authorities to direct finance on a sector-specific basis was waning.

DISs were employed in order to encourage banks to hold government bonds. In this way, private sector banks indirectly financed public spending throughout most of the 1940–1960 period. Figure 1.2 shows how, with a slight time lag, changes in the DIS level affected the share of private-bank financing of government expenditure. Figure 1.3 illustrates the same with respect to cash reserve requirements, which the *Banco de Mexico* manipulated frequently in order to control the total amount of credit in the financial market and in order to increase the pool of public investment funds.

Clearly the nascent private-banking sector had neither the power nor, more importantly, the desire to challenge state leadership in the financial sector, in part because one of the state's central goals was to promote and strengthen the private financial system.[14] In the minds of the private sector financial elites, a 'coincidence of interests' between themselves and the state existed despite the burdens of selective financial regulation.

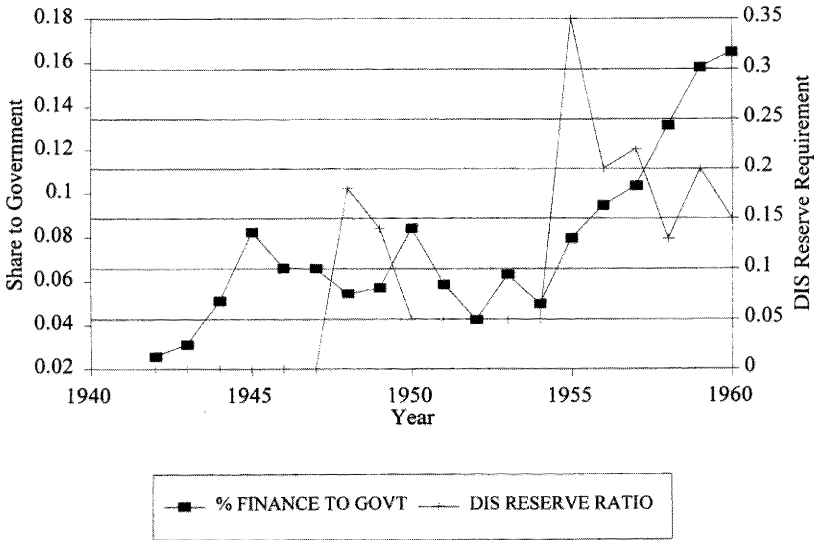


FIGURE 1.2 Share of Finance to Government v. DISs, 1940–1960
SOURCE: Banco de Mexico. Indicadores Economicos, 1985–1991, and Informe Anual, 1942–1984

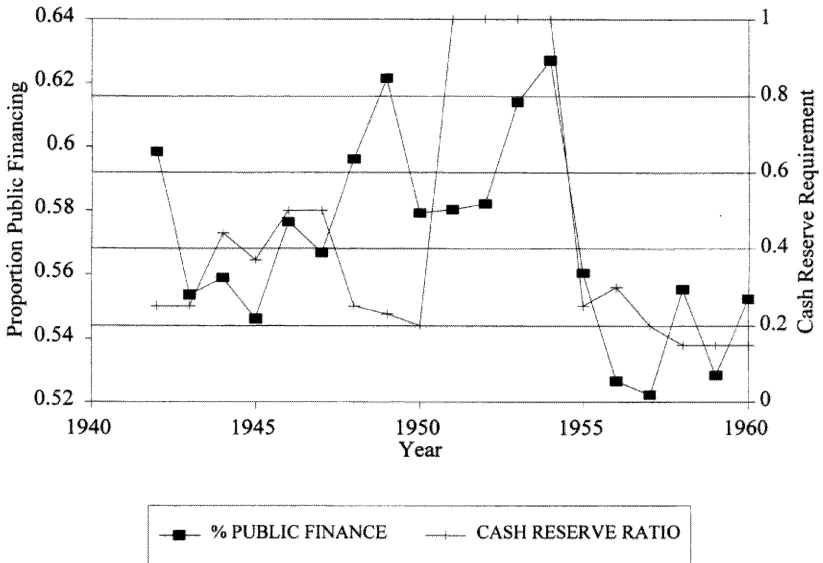


FIGURE 1.3 Public Financing v. Cash Reserves, 1940–1960
SOURCE: Banco de Mexico. Indicadores Economicos, 1985–1991, and Informe Anual, 1942–1984

Nevertheless, the 'coincidence of interests' was tenuous by 1961. Ironically, it was the government-promoted process of private capital accumulation in the 1940s and 1950s that eventually strengthened a small group of financial capitalists in relation to the market as a whole and ultimately in relation to the state.[15] In short, the state, which sat firmly in control of the financial system until the late 1950s, ran the system mostly to the benefit of the private financial sector, which eventually became powerful enough to challenge state policy when it failed to reflect the historical 'coincidence of interests'.

Bank-Led Finance

Between 1940–1960 and 1980 the structure of Mexico's financial system shifted from state-led to bank-led. Scholars disagree as to exactly when the decline of state autonomy vis-à-vis financial elites occurred, but the evidence overwhelmingly suggests that by 1980 a change in structural conditions, especially in the financial sector, had led to a decline in the relative autonomy of the Mexican state.[16] By 1980 the relative size of the state-owned financial sector had shrunk considerably in comparison with the private sector. Private banks' share of resources increased from 35.9 percent in 1940 to 55.7 percent in 1990, and then jumped to 62.6 percent in 1991. Steady and rapid growth of the private financial sector followed bank nationalization in 1982, driven by intensified state efforts to re-privatize nationalized banks. This privatization trend constituted, in part, a shift toward orthodox financial policy as well as a shift toward bank leadership.

Other measures of financial intermediation yield similar results. Whereas in the 1950s and 1960s public-sector sources of savings averaged about 3.6 percent of GDP and private sector sources of savings averaged about 6.8 percent of GDP, in the 1970s and 1980s the public-sector percentage dropped to about 3 percent while the private-sector percentage climbed to almost 18 percent.[17] One reason for the increase in private-sector savings and capital formation was the rapid expansion, during the 1955–1965 period, of the principal financial groups, which channeled an increasing proportion of private savings through the financial system.[18] Privately owned financial institutions accounted for almost 90 percent of all increases in peso deposits by 1982.[19]

During the 1970s, the banking elite began to challenge the state's political and economic dominance in the regulatory sphere as well.[20] By transferring and allocating funds among themselves, the *grupos* increasingly avoided state oversight of, or involvement in, sector-specific credit allocation. Bankers bypassed selective credit controls by relying on interbank lending, transferring funds to financial firms within the conglomer-

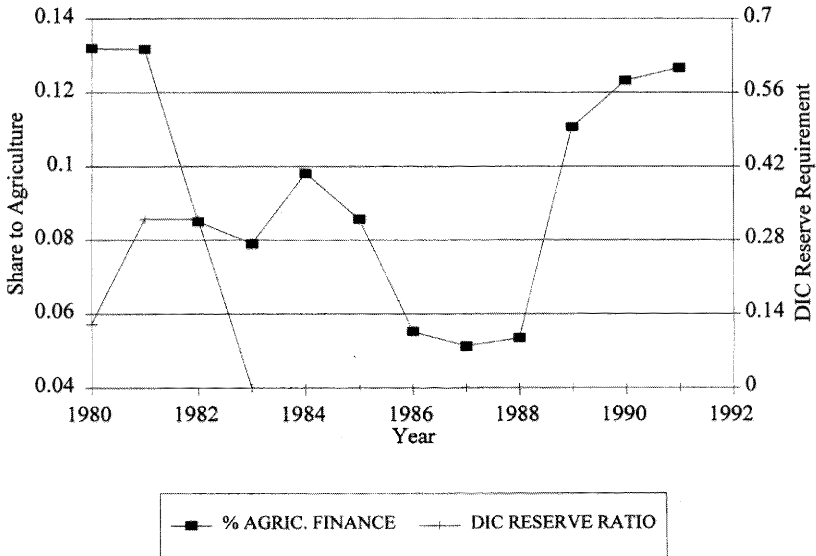


FIGURE 1.4 Percent of Finance to Agriculture v. DICs, 1980–1991
SOURCE: Banco de Mexico. *Indicadores Economicos*, 1985–1992 and *Indicadores de Moneda y Banca*, 1980–1984

ate, thus reducing the state's ability to control the allocation of private credit. For example, a bank would channel short-term *fideicomiso* loans from savings and deposit banks to financieras, which discounted the deposit bank's portfolio as a contingent debit exempt from reserve requirements. Between 1958 and 1964, internal financing totaled 74.5 billion pesos and represented 87.4 percent of the financing of private-sector gross fixed investment.[21] Integration of private financial networks promoted the transfer of resources through interbank lending for the purpose of obtaining the most profitable rates of return and, more importantly, to circumvent regulations that affected some types of banks more than others. Financial–industrial groups could evade government attempts to allocate credit by using available funds for expenditure not sanctioned by monetary authorities and then borrowing money from a group member to finance its productive investments.[22] Often, private financial institutions found it worthwhile to band together for the purposes of reducing competitive pressures, increasing banking-industry profits, and reducing the impact of financial regulation.[23]

In short, the *Banco de Mexico* became increasingly less effective at channeling financial resources to specific sectors after 1960. Figure 1.4 demonstrates two important differences between the 1940–1960 period and the post–1980 period. First, the DIC, a successful tool employed for resource

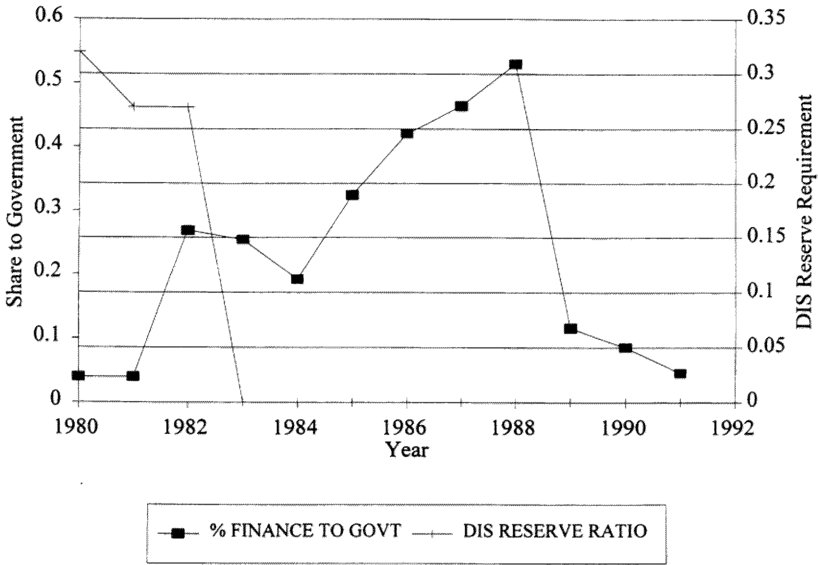


FIGURE 1.5 Share of Finance to Government v. DISs, 1980–1992
SOURCE: Banco de Mexico. *Indicadores Economicos*, 1985–1992 and *Indicadores de Moneda y Banca*, 1980–1984

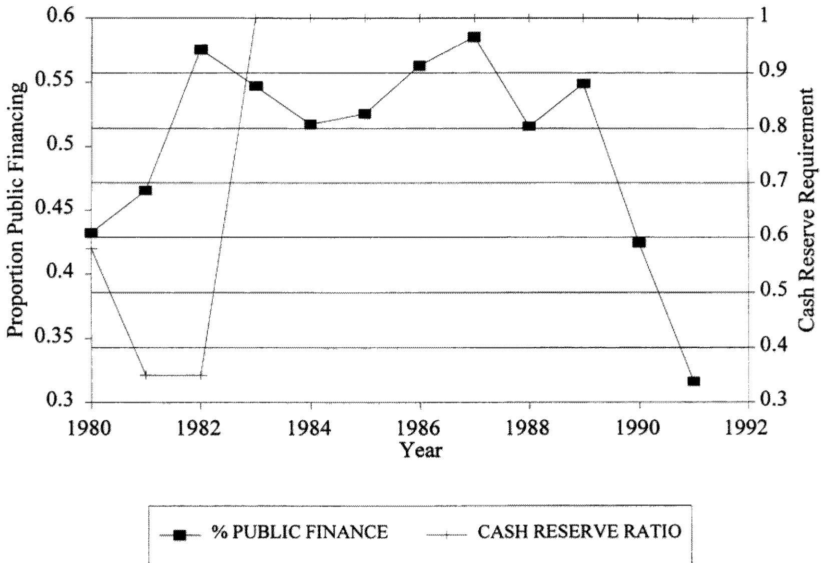


FIGURE 1.6 Public Financing v. Cash Reserves, 1980–1992
SOURCE: Banco de Mexico. *Indicadores Economicos*, 1985–1992 and *Indicadores de Moneda y Banca*, 1980–1984

allocation in the former period, did not played a significant role in the state's post–1980 regulatory framework. Second, even when the DIC was employed in the post–1980 period in an attempt to expand agricultural financing, it failed to achieve significant increases. The same can be said for the DIS with respect to its importance and effectiveness in securing finance for government expenditure (Figure 1.5). Finally, according to Figure 1.6, by 1980 monetary authorities could no longer manipulate the level of cash reserves in order to control the level of financial system credit or the amount of resources available for public expenditures.

The relationship between financiers and other economic elites followed a similar pattern. Beginning in the late 1950s, and increasingly in the decades that followed, finance capital played a hegemonic role among other domestic elites. That is, industrial firms were dependent on banks for loans and as intermediaters between them and the state. Moreover, in the 1980s bankers were viewed by other firms as leaders within the business community and as the most politically influential part of that community. When asked who benefited the most from state policy, Mexican businessmen ranked bankers highest among the private-sector groups.[24] This status stemmed from the resource dependence of Mexican business on bank finance, which resulted partly from the relative underdevelopment of a competitive securities market.[25] The Mexican securities market has remained relatively underdeveloped due to the fact that Mexican-owned firms have been reluctant to issue securities to the general public. They have preferred instead to finance investment through group-affiliated financial intermediaries so as not to share control of their enterprises.[26]

As the private financial system's control over credit allocation grew, so did its degree of concentration and centralization. Some have estimated that the privatization of parastatals during the Salinas administration fostered the creation of at least fifty big economic *grupos*.[27] Despite slower growth in the real sectors of the Mexican economy, the financial sector grew and profited through currency speculation and capital flight. The distinction that has often been made in the political economy literature between liquid and fixed capital holders is particularly useful here. During economic slowdowns, liquid capital holders have the option of exit, whereas fixed capital holders must weather the storm. In this case, capital flight and short-term speculation among banks not only increased bank profitability, but also reduced the supply of loanable funds for industry, thus exacerbating the effects among small and medium-sized industrial enterprises. In addition, the 1970 and 1974 reforms of The General Credit Law allowed for the formation of multi-banks with the ability to form ownership ties with the industrial sector, which promoted financial sector concentration. In 1950, 42 banks controlled 75 percent of finan-

cial sector resources, whereas by 1979 only 6 banks controlled 75 percent of financial sector resources, even as the total number of banks decreased from 248 in 1950 to 100 in 1979. This growing concentration characterized the emergence of bankers' hegemony in Mexico.

Financial Policymaking

The character of Mexican financial policy in the post–1980 period differs significantly from the first period's state-interventionist brand of financial policymaking. Three laws passed in 1940–1941 undergirded the heterodox policy mix of the 1940–60 period. *Nacional Financiera's* charter law changed in 1940 making it the most important long-term credit institution in the capital market, strengthening the state's control over credit allocation by giving it a direct means of channeling private finance toward government expenditures.[28] Yet despite *Nacional Financiera*'s monolithic position in the capital market, there is little evidence that the state's role in the financial market during this period was perceived as crowding out private investment and intermediation. Second, in mid–1941, policymakers changed the *Banco de Mexico*'s charter law to enhance official coordination of the money market. As detailed earlier, the central bank orchestrated the financial system to the point of circumscribing the loan portfolios of individual private-sector banks. And finally, monetary authorities substantially rewrote the General Law of Credit Institutions in 1941 to provide for a greater degree of specialization among private intermediaries and to limit the activities of others.[29] Taken together, these changes constitute an explicitly interventionist approach to financial policymaking on the part of Mexican state.

Deviating from these earlier interventionist policies, in early 1982 the state implemented radical, orthodox stabilizing policies to counteract economic recession and ostensibly to bolster public confidence.[30] In contrast with the 1940s and 1950s, monetary authorities designed financial policies in the 1980s with an eye toward gaining the acceptance of the international financial community as well as domestic financiers. In 1983 and 1984, President de la Madrid implemented orthodox adjustment policies specifically tailored to be agreeable to the IMF.[31] He had little choice given that in late 1982 Mexico had declared its inability to meet interest payments on its massive debt. At that time, Mexico had agreed to abide by IMF policy guidelines in exchange for new loan guarantees. These policy efforts included the privatization of state-owned enterprises, trade and exchange rate liberalization, the deregulation of commerce and investment, the elimination of legal restrictions against foreign ownership, and severe cuts in government expenditure.[32] These changes, together with the growing ineffectiveness of selective credit

controls and the increasing hesitancy of monetary officials to rely on financial intervention, signal a change in the nature of Mexican financial policy toward increasing orthodoxy.[33]

Mexico's Economic Performance

Economic performance fell sharply from the first period to the second with respect to growth and productivity, measures of equity, and economic stability.[34] Of course, these macro-economic conditions cannot be attributed to any one factor. And in fact they can be attributed to many factors, not the least of which is the debt crisis, which Mexico touched off in 1982. Nevertheless, the evidence suggests that changes in the relationship between the state and bankers, as well as changes in the pattern of finance, took place before the onset of the debt crisis. One can argue that the debt crisis itself simply magnified a process that was well underway. First, it weakened the state considerably because policymakers had to accept some responsibility for the condition of the Mexican economy, and because agreeing to IMF conditions meant a loss of sovereignty and credibility in the eyes of the Mexican people. Second, it strengthened the position of bankers because the debt crisis lead to a shortage of loanable funds.[35] So despite the multiple causes behind the slowing of the Mexican economy, there is reason to investigate further the connection between financial structure, liberalization, and slow growth. Such an investigation will follow this short descriptive section that delineates the sharp contrast between pre–1960 and post–1980 economic performance in Mexico.

Common descriptors of the Mexican economy for the 1940–1960 period include 'miracle,' and 'growth,' while the 1980s are described more often by words such as 'distorted' and 'crisis.'[36] Mexico's GNP, in real terms, grew at an average rate of 6.44 percent a year throughout the 1940s and 1950s, whereas between 1980 and 1987 it fell to 1.74 percent. Not only did growth rates drop dramatically, the yearly variability in growth rates increased after 1980 as well, indicating mounting instability.[37] Unemployment rates underscore the contrast in economic performance as well. While urban open unemployment rose steadily throughout the 1980s, from 5.8 percent in 1982, to 10 percent by 1984, and to over 17 percent by 1988, the 1940–1960 period experienced historically low and falling levels of unemployment, from a little over 4 percent in 1940 to just under 3 percent by 1960.[38] The economic crisis also affected consumers' purchasing power, which fell some 35 percent throughout the 1980s, suggesting that the economic crisis had a disproportionate impact on the Mexican lower classes.[39] Although per capita incomes grew rapidly during the first period and moderately into the late 1970s, the

overall pattern of income distribution, as indicated by the Gini-index, did not change significantly. However, between 1950 and 1977, the poorest 20 percent of families experienced a deterioration in their standards of living, and the share of the poorest 10 percent of families declined from 2.4 percent to 1.1 percent of total income.[40] Moreover, during the 1980s, consumption of staple foods such as milk, meats, eggs and even beans fell sharply, while production and consumption of luxury automobiles rose. A leading cause of this asymmetry was declining real incomes for the poor combined with continued prosperity for those business groups that survived the 'crisis'.[41]

Scholars have characterized the 1940–1960 period as the period of 'stabilizing growth.' They have credited monetary authorities with holding capital flight in check, keeping inflation rates down to manageable levels, and maintaining an overall business climate considered conducive to stable growth. In comparison, the post-1980 period has been highly unstable, characterized by high inflation rates, capital flight, and a financial system on the verge of collapse. Between 1940 and 1960 the net inflow of capital averaged $27 million. In dramatic contrast, there was a $106 million a year net outflow of capital between 1961 and 1979, and a net outflow of $1.226 billion a year between 1980 and 1991.[42] This dramatic increase underscores the extreme instability of the Mexican financial system. By some estimates, from 1983 onward, all of annual net private savings was being invested abroad as some people actually liquidated their productive assets for expatriation.[43] Besides the obvious problem of a reduced pool of domestic savings to fund investment projects and spur growth, capital flight jeopardized macroeconomic stability more generally. The Mexican experience suggests that heightened inflationary pressures and accelerated erosion of living standards are unavoidable consequences of capital flight.[44] Not only does capital flight tend to spur inflation, fear of inflation can be identified as a major incentive to send capital abroad. This created a vicious cycle of capital flight and inflation, which contributed to the economic instability.

The Mexican macro-economy appears to have been considerably more stable from 1940 to 1955, when inflation averaged just over 10 percent, than it was in the 1980s, when inflation averaged over 75 percent. There is some indication that inflationary pressures lessened after 1955 because selective credit controls became very effective at forcing private sector banks to finance government spending.[45] This suggests that the state-led nature of the financial system in the 1940–1960 period was an active ingredient in keeping the inflation rate down to manageable levels. Moreover, the monetary authorities' maintenance of a virtually-fixed exchange rate during the earlier period required the forced financing of public debt by the private sector in order to keep inflation down to U.S. levels.[46] Be-

cause the average level of inflation tends to be higher in Mexico than in the United States even in the best of macro-economic climates, in order to maintain a fixed exchange rate with the dollar, monetary officials had to avoid any type of policy that would create inflationary pressure, such as financing the public debt by printing money. Instead, the Mexican state chose to force the private domestic banks to finance government spending. Under bank-led finance this strategy could no longer be maintained, which was just one of many factors contributing to the economic downturn in the 1980s. The following section attempts to illustrate the connection between the shift in financial system structure and economic performance.

Analysis

In the industrialized country context, Zysman's analysis suggests that the structural shift from state-leadership to bank-leadership is likely to have led from a somewhat successful state-led industrial policy, similar to Japan's, to an equally successful bank-led industrial policy, similar to Germany's. However, the "Mexican Miracle" was followed by a period of extremely low growth rates, high unemployment and a severe foreign debt crisis. Instead of fostering industrial promotion policies, as it did in Germany, bank-led finance in Mexico fostered a policymaking process which favored the holders of liquid capital, usually at the expense of industrial promotion. Zysman's analysis fails to be predictive here because declining state autonomy is only half of the story. When state dominance declines, the relevant issue becomes how a financial structure dominated by private banks and industrialists will formulate, or fail to formulate, a growth-inducing financial policy.

The Effect of Financial Structure on Financial Policy

This section argues that the structural shift from state-leadership to bank-leadership caused the policy-making shift from relative financial policy heterodoxy in the 1940–1960 period to the financial policy orthodoxy of the post–1980 period. Bankers, who increasingly possessed both the means and the motive to influence financial policy in the direction of liberalization, constituted a powerful domestic constituency.

From 1940–1960, Mexican economic policies focused on stability and growth simultaneously. Monetary authorities managed to maintain a fixed exchange rate with the dollar, low inflation, and low levels of capital flight, all of which fulfilled the goal of preserving the peso as a store of value. The *Banco de Mexico* lubricated the economy by providing ample credit and by promoting high profits and growth within the private fi-

nancial sector. While the state's promotion of private-sector finance provided a basis for the 'coincidence of interests' in the first period, it set the stage for the erosion of state autonomy in the 1980s. In the latter period financial liberalization resulted from private financiers who were increasingly able to circumvent state policy, and who profited considerably from doing so. In other words, the shift in financial policy from heterodoxy to orthodoxy was a product of two variables: state autonomy and societal interests. The state-centered approach rests on the idea that state autonomy declined in the post–1980 period compared with the 1940–1960 period. The society-centered interest-based approach suggests that the 'coincidence of interests' between state policymakers and bankers had begun to breakdown as early as the 1970s, so that bankers, who remained relatively neutral in the earlier period, sought financial liberalization by the 1980s. Hence, some de facto liberalization, in the form of internationalization of banking practices, took place in the 1970s as a direct result of regulatory circumvention on the part of banks. Official financial liberalization began with the government announcement that the newly nationalized banks would be sold off to private owners only months after the nationalization itself. The actual implementation of financial liberalization began in 1985 when banks were first allowed to engage in market operations. In 1988–89 reserve requirements and interest rates on loans and deposits were liberalized, although as was demonstrated earlier, these had become ineffective as a means of directing credit well earlier. In short, official financial liberalization in Mexico could be interpreted as little more than a reaffirmation of the fact that an increasingly bank-led financial structure had already made financial heterodoxy unworkable and ineffective.

One aspect of declining state autonomy was that bankers' growing power in relation to the state and other societal groups positioned them to influence state policy. According to one recent study, "access to state policymakers by leaders of large business and financial concerns was greatly enhanced during the Salinas period. Collaboration between business and state elites in the design of economic policy 'became unprecedentedly tight, fluid, and public.'"[47] Business, particularly financiers, gained influence in the appointment of officials and even acquired veto power, in some cases, over objectionable financial policies. As the core of the state apparatus itself came to be dominated by efficiency-minded technocrats, state policy gradually became more orthodox and pro-business in orientation.[48]

The growing influence that financial elites enjoyed in the 1970s not only affected the degree of state autonomy; it had a concrete effect on the character of financial policy. Even Mexican industrialists concede that bankers have exerted an unusually significant influence over Mexican fi-

nancial policy.[49] The economic power financial elites exercised over other economic elites also bolstered their influence and control over government policy decisions.[50] Financial elites gained influence over financial policy decisions by playing a strategic role as political intermediaries between the government and the business community.[51] Because financial groups controlled such a large percentage of the financial market, they exerted a great deal of control over the availability of credit, much as the government did in the earlier period. Typically, firms that were not associated with a financial–industrial group had a difficult time finding adequate sources of financing for their activities. Thus, there was an incentive to become associated with a *grupo,* which put these conglomerates in a position to wield a great deal of power within the private sector and also as brokers between the private sector and the state. In this way, the economic ascendancy of Mexican *grupos* quickly translated into political ascendancy, meaning that they gained increasing power to realize their political objectives by influencing state policy.[52]

As the state lost its ability to direct private finance through directed reserve requirements and other regulatory processes beginning in the early 1960s, it turned increasingly toward borrowing from abroad and printing money in order to finance government spending and development goals. Both of these options tended to increase inflationary pressures. Yet government expenditure continued to rise in an attempt to maintain political viability. Expectations for economic growth remained high among the Mexican people. Because the Mexican political system is corporatist in nature, the state has relied heavily on the "carrot and stick" strategy in order to maintain political control over society. By co-opting potential opposition the state could insure a certain amount of decision-making autonomy. The inability to channel private finance significantly reduced the state's political capital, making it more vulnerable to criticism of its fiscal policy from the popular sectors as well as economic elites.

As state autonomy declined, private bankers moved increasingly into a hegemonic position among the state and other economic elites. Bankers' hegemony by the mid–1980s was based on two key factors. First, beginning in the 1960s, the state became increasingly dependent on private banks for the financing of government expenditures. In the 1940s, *Banco de Mexico* financed over 70 percent of government expenditures itself. With a shrinking public banking sector and a declining ability to regulate financial flows toward public works, the state had to borrow funds from private banks. This situation added significantly to the political clout of private banks throughout the 1960s, 1970s, and 1980s. Second, the state's growing dependence on foreign bank capital augmented the influence of Mexico's private banking elite. Private banks in Mexico assumed the role of liaisons between the Mexican state and the interna-

tional banking community. Between 1974 and 1978 private Mexican banks participated in international banking syndicates that supplied Mexico with 35 percent of its total international borrowing needs.[53] The state, with the stamp of approval from its own private financial community, attracted considerable amounts of foreign financing from international organizations—the IMF and the World Bank—as well as from private foreign banks such as Bank of America and Citibank. Also, Mexico's conglomerate banks tended to be well connected in the international banking community which allowed them to facilitate foreign loans. Banks exercised considerable political leverage because they held seats on state policy and development boards and many were unofficially consulted on financial policy issues.

Although bankers were becoming increasingly powerful both with respect to state policymakers and other societal groups, the question remains why financial liberalization policies and not a different set of financial policies were consistent with bankers' influence. I would argue that within a concentrated and centralized financial market, bankers prefer financial liberalization because they, as liquid capital holders, are ideally positioned to profit from financial liberalization. The evidence suggests that Mexican financiers did, in fact, profit from financial liberalization in the 1980s, and that these profits were foreseeable and constituted powerful incentives for bankers to exert their influence.[54] Perhaps as importantly, the banking sector's success in circumventing financial regulation, in rendering such policies ineffective, also diminished the state's interest in financial intervention.

Mexican *grupos*, financial–industrial conglomerates, managed to consolidate oligopoly power after financial deregulation by controlling access to the international capital market. *Grupos*, through their control over domestic banks and overseas contracts, obtained dollar credits at below prevailing domestic market interest rates to re-lend at extremely high interest rates denominated in pesos.[55] This process tended to favor those with access to international financing and drive out smaller competitors. Also, removal of interest rate ceilings, under financial liberalization, tended to benefit conglomerate bankers. Under more competitive conditions, bankers may benefit from interest rate ceilings on loans and deposits because they do not have to offer higher rates on deposits in order to attract funds away from their competitors. And as long as loan rates are set high enough to ensure substantial profits (which they were in the first period), then bankers can operate comfortably under what McKinnon calls a 'repressed system'.[56] However, once they have achieved a degree of market power in financial markets, *grupos* have the ability to keep interest rates low on liabilities without government help because of the relative lack of competition, while they can simultane-

ously charge high rates on loans to nongroup members. This increases the profit margin for all conglomerate banks that stay in business.

Beginning in the late 1970s, Mexican *grupos* also took advantage of relaxed regulatory procedures regarding the riskiness of banks' loan portfolios. The combination of decreased regulatory vigilance, extreme macroeconomic instability, and governmental fears of bank failures induced a form of moral hazard in bank behavior. After financial deregulation, banks were inclined to undertake very risky lending at artificially high real loan rates of interest because under favorable macroeconomic conditions the loans would be paid back, and the bank would make extremely high profits. Conversely, under unfavorable macroeconomic conditions, defaults tended to be highly correlated among bank borrowers, potentially causing a breakdown in the whole banking sector. This situation would require the monetary authority to bail out the banks. Hence, there was little or no downside risk. The moral of this story is that ". . . when most everyone (who counts) is bankrupt, nobody is!"[57]

While Mexican financiers stood to profit from financial liberalization, it remains unclear why the financial–industrial conglomerates would on the face of it prefer such policies because they should represent the interests of *industrialists* as well as bankers. Why should Mexican *grupos* prefer financial liberalization? This question can be answered by comparing the rational motivations of financiers and industrialists both separately and under conditions when they are wed. Liquid asset holders such as bankers tend to favor market-oriented policies, while fixed-asset holders such as industrialists favor sectoral intervention, because liquid asset holders are in a position to profit from unrestricted capital movements, while fixed asset holders can neither take advantage of free market policy when things are going well by shifting assets quickly, nor protect themselves when things are going poorly by shielding assets. Mexican *grupos* hold both financial and nonfinancial assets, but their financial interests win out over fixed-capital interests when financial and non-financial capital are wed because they have the means to exploit opportunities for profit under financial liberalization. Even as early as the 1970s, the structure of Mexican *grupos* would have allowed them to foresee that they would be in a position to take advantage of liberalized capital movements and the absence of interest rate ceilings by exploiting their access to international capital markets and their cross-sector ownership ties. This access and freedom to set interest rates would allow conglomerate banks to obtain low interest funds on the international market and make loans on the domestic market at much higher interest rates. In fact, in the decade preceding financial liberalization, Mexican banks were already using interbank loans to escape regulations and enhance profitability and liquidity.[58]

As one would expect, Mexican *grupos*, in an environment of increasing inflation and ineffectual financial regulation, earned huge profits by shifting their investment focus from long-term to short-term speculative activities. In 1982, just prior to bank nationalization, 49 percent of bank profits came from exchange operations. Some banks actually earned more money from currency speculation than from gross profits.[59] And because different types of banks were owned by the same firms, it made little difference whether a bank was officially classified as a commercial or as an investment bank; all of these institutions tended to use a short-term rather than a long-term framework.[60] Thus, the absence of an effective financial regulatory structure allowed banks to profit while the 'real' economy—industry and agriculture—suffered.[61] This suggests two things. First, financial deregulation resulted from an underlying shift in the relationship between the state and the private financial sector which had been building for at least fifteen years before the official policy was implemented. Second, the behavior of the banking sector, under de facto as well as official financial deregulation, can best be described as speculative and short-term oriented. The following section explores this contention further.

The Effect of Financial Liberalization on Economic Performance

One reason for the higher growth rates in the 1940–1960 period as compared with the post–1980 period is that investment in the manufacturing sector dropped dramatically in the latter period. Undoubtedly, government spending in key areas aimed at sparking the industrialization process was a major ingredient in the Mexican miracle, and state control over financial markets facilitated that spending. *Nafinsa*, the largest state-owned investment bank, had to finance most of the new industries during the industrialization drive because the old financial/industrial groups were unwilling to take risks on new industries.[62] By 1961 *Nafinsa's* investments were supporting 533 industrial firms, and its long-term investments were twice as large as the sum of such loans deriving from the private banking system.

But by the early 1960s, not only had the state lost the ability to direct private sector investment, it had also lost control over government investment, indebtedness, and ultimately economic stability.[63] As previously illustrated, the state employed variable reserve requirements to influence the composition of bank assets toward productive sectors such as high-growth industries and construction of low-cost housing. In this way, the state promoted short-run economic stability, and a method for generating long-term investment toward productive capital formation.[64] As a result of the growing ineffectiveness of these allocation tools, the

proportion of private investment dedicated to productive sectors declined significantly after 1965.[65] The decline can be traced not only to the government's loss of control over sector-specific allocation of funds, but also to the increasing incentives for conglomerate banks to take advantage of short-term financial investments.[66]

Under a bank-led financial structure, not only did industrial growth slow, the financial intermediation process suffered, as did the economy as a whole. According to some observers of the Mexican banking system, bankers used inappropriate accounting techniques, provided employees with interest-free credit, and furnished special clients with interest rates above the legal ceiling on savings and time deposits.[67] From an efficiency standpoint, bank practices under financial deregulation did not necessarily constitute an improvement over state-leadership. The shift in financial policy from state intervention to financial liberalization cannot be considered a shift from state-administered investment decisions to free market signaling. Instead, financial liberalization entailed a shift from state-administered decisions to conglomerate bank discretion, which promoted speculative activity over long-term productivity. According to Tello, bank exchange operations were primarily responsible for the speculation and capital flight problems experienced by the Mexican economy in the early 1980s.[68] The departure of financial resources severely restricted the opportunities for productive investment, which had been more plentiful in the 1940–1960 period under state leadership.[69]

Moreover, the *grupos* destabilized the domestic financial system by concentrating credit risk and increasing the likelihood that returns would be highly correlated within the Mexican economy. Under these conditions, when interest rate restrictions were lifted, a widespread moral hazard problem ensued. The exorbitant interest rate levels that followed liberalization systematically increased the level of risk-taking and instability inherent in the financial sector.[70] Also, the combination of implicit, or sometimes explicit, government guarantees on loans, and mostly unregulated risk portfolios, combined to destabilize the financial system. Liberalization tended to de-emphasize regulation of the banking sector while inducing destabilizing risk-taking behavior and leaving implicit government bailout guarantees intact.[71]

Conclusion

In sum, the evidence clearly suggests that the state had a direct role in spurring 1940–1960 economic growth and industrialization and lost that ability under bank-led finance. Furthermore, financiers, in a hegemonic position after 1980, faced economic incentives to take actions that destabilized the financial system and reduced the growth potential of Mexican

industry. This chapter has demonstrated that these effects of financial liberalization are integrally tied to, and cannot be understood without, scrutinizing the process by which such policies come about. The structural shift from state-led to bank-led finance in Mexico resulted in the adoption of financial liberalization policies both because it became increasingly costly for the weakened state to maintain financial heterodoxy, given the growing ability of market actors to circumvent regulation, and because newly empowered agents (private financiers) preferred financial liberalization. Given the structural constraints on the Mexican state, the relevant question is why Mexico adopted financial liberalization when it did, rather than whether financial liberalization was the right policy.

This study of the Mexican case generates several new insights. It suggests that the nature of financial sector development and concentration can dramatically affect the efficiency of the shift toward bank-leadership, and even financial liberalization. The harmful effects of financial liberalization in Mexico, for example, stem primarily from the nature of financial-sector development, because the state itself fostered a powerful and highly concentrated banking sector and subsequently lost control over the allocative process. Private control over financial allocation, however, need not entail a transfer of resources from the real economy toward bankers and speculative activity as it did in Mexico.

As we shall see, the norm among Asian NICs has been financial liberalization with a mitigated loss of state autonomy, resulting in better economic performance. For example, in South Korea, financial liberalization has been implemented gradually and, within the context of state-led finance, has taken place without the dramatic shift to bank-led finance that occurred in Mexico. Thus the benefits or drawbacks of specific financial policies depend greatly on context, shaped by specific developmental, institutional, and policymaking histories. This analysis also raises questions about the dynamics of historically state-led systems like that of Japan. Zysman's case study of Japan implies that its period of rapid growth stemmed largely from the state-led nature of financial allocation. Yet, the Japanese economy has not faired well as it has lost some of its ability to direct finance. Moreover, the Japanese banking system is showing signs of weakness and inefficiency, suggesting that the Japanese state did not do much better than the Mexican state at promoting competition among private financial institutions under state-led finance. The lengthy and severe recession that has plagued the Japanese economy has caused some observers to rethink the idea of state-led development altogether.[72]

The results of the analysis presented in this chapter give rise to a number of important questions concerning the implications of financial liberalization more broadly. For example, one wonders why the policymaking influence of Mexican bankers has gone largely unchallenged by other

market actors who might benefit from long-term growth-promoting financial policies. Here the lack of a dynamic domestic exporting elite is evident, because this group, in particular, would presumably have challenged the overvaluation of the peso that led to the 1994 exchange rate crisis. Also, does the short-term nature of investment and the tendency toward speculation follow naturally from the financial liberalization process? Is declining state autonomy a cause of, or a consequence of, financial liberalization? Is declining state autonomy a necessary element of the financial liberalization process? The answers to these questions will not only help us better understand the dynamics of Mexican financial reform, but they can also improve our understanding of the global trend toward financial liberalization. Downplaying or ignoring the political context which gives rise to financial policy reform can only lead to an incomplete understanding of the phenomenon, because the variation in financial policy outcomes is a consequence of the specific relationship between state and financial market actors within each country. The chapters that follow represent an attempt to explore these issues within the context of several country cases chosen both to contrast with, and to highlight, certain aspects of the Mexican case. We begin by comparing Mexican bank-led finance with a classic case of a bank-dominated economy, Germany, in order to underscore the nature of bankers' hegemony and its ramifications for economic growth and stability.

Notes

1. Helleiner [1994]; Cohen [1996]; Goodman and Pauly [1993].
2. For example, Brazil maintained heterodox policies throughout the 1980s in spite of its heavy debt and pressure to liberalize, whereas Argentina and Chile followed a more orthodox path.
3. In this case, financial heterodoxy involved high and variable reserve requirements, interest rate ceilings, and micro-level credit allocating type policies.
4. Some noteworthy exceptions are Haggard, Lee, and Maxfield [1993]; Frieden [1991]; Maxfield [1990]; and Woo [1991]. And empirical work by Quinn [1997]; Quinn and Inclan [1997].
5. Zysman [1983].
6. On this period of transition, see White [1992]; Anglade and Fortin [1985]; and Cypher [1990].
7. Maxfield [1990], 2; Cypher [1990], 32 & 61–62.
8. King [1970], 67.
9. Bennett [1965], 45.
10. Zysman [1983], 76.
11. Philip [1988], 21–22.
12. Cypher [1990], 46.
13. Solis and Brothers [1966], 51.
14. Hamilton [1982], 209, 215.

15. King [1970], 68–69; Vernon [1964], 236.
16. Cypher [1990], 32.
17. Anglade and Fortin [1985], 238.
18. Anglade and Fortin [1985], 223. *Banca Serfin, Multibanco Comermex, Banamex,* and *Bancomer* are some of the primarily financial groups. The biggest privately owned financial–industrial group as of 1989 was *Grupo Industrial Alfa.*
19. Ladman [1986], 37.
20. White [1992], 74.
21. La Cascia [1969], 54.
22. Vernon [1964], 161.
23. Ross [1971], 50.
24. Camp [1989], 109.
25. Zysman [1983], 123–124.
26. La Cascia [1969], 53.
27. Gibson [1997], 357.
28. La Cascia [1969], 2.
29. Bennett [1965], 45, 50.
30. White [1992], 99.
31. Philip [1988], 96.
32. Cook, Middlebrook, and Horcasitas [1994], 3.
33. Haggard, Lee, and Maxfield [1993], 231.
34. Anglade and Fortin [1985], 212, 219.
35. Maxfield [1990]
36. Hansen [1971]; Lopez. et. al. [1967]; Reynolds [1970]; Aguilar et.al. [1983]; Cardero and Dominguez [1982]; Barkin [1990]; Ramirez [1989]; Ladman [1986].
37. Wilkie [1987]; U.S. Dept. of Commerce [1989].
38. Wilkie [1987]; U.S. Dept. of Commerce [1989].
39. Barkin [1990], 113.
40. Buzaglo [1984], 35–36.
41. Barkin [1990], 103.
42. Barkin [1990], 103.
43. Barkin [1990], 108.
44. Barkin [1990], 71.
45. Solis and Brothers [1966], 82.
46. Urrutia [1988], 110.
47. Gibson [1997], 356.
48. Cypher [1990], 52.
49. Camp [1989], 175.
50. Ladman [1986], 30.
51. Urrutia [1988], 119.
52. Cypher [1990], 100–101.
53. White [1992], 73.
54. Gibson [1997], 357.
55. McKinnon [1988], 400.
56. McKinnon [1988], 400.
57. McKinnon [1988], 95.
58. White [1992], 62.

59. White [1992], 113.
60. White [1992], 57.
61. White [1992], 78.
62. Cypher [1990], 44.
63. Cypher [1990], 51, 61–62.
64. La Cascia [1969], 38.
65. Anglade and Fortin [1985], 223.
66. White [1992], 100.
67. White [1992], 105.
68. Tello [1984], 65.
69. In the *Diario Oficial* of 1 September 1982 President Lopez Portillo laid the blame for the crisis squarely at the feet of Mexican banks.
70. When the interest rate charged to any one class of borrowers increased, so did the probability of default on loans because when interest rates rise the borrower tends to change the nature of his own project (given that the bank cannot perfectly monitor this beheavior) to make it riskier.
71. Aristobulo [1990], 348.
72. Henderson [1998]; McLeod and Garnaut [1998]; *The Economist*, March 1998.

2

Promoting Growth or Encouraging Speculation?

Bank-Led Finance and Financial Policy in Germany and Mexico

This chapter compares the effects of a bank-dominated financial market structure on the politics of financial policy in Germany and Mexico and asks whether German big banks constitute a counterpart to the Mexican *grupos.* Although the Mexican and German economies exhibit similar characteristics that are indicative of a bank-led financial structure, patterns of behavior exhibited by policymakers and financiers differ markedly. Until recently, Mexican policymakers have tended to adopt short-term oriented financial policies, such as maintaining an overvalued exchange rate, that favor financiers over exporting industrialists. German policymakers, on the other hand, have tended to favor monetary policies that encourage longer-term industrial export growth. The distinction is similar to Henning's analysis of competitiveness-conscious exchange rates, and stability-oriented monetary policies which discourage the international use of the currency, as compared with changeable, unstable monetary policies which have tolerated extreme overvaluation of the currency.[1] The analysis presented here suggests that these divergent financial polices reflect the lack of competition among Mexican banks as compared with German banks, and the historical lack of state policymaking credibility on the part of Mexican monetary authorities as compared with their German counterparts.

The German financial system remains the standard case of bank-led finance among developed market economies.[2] In his analysis of the German financial system, Zysman implies that a credit-based, bank-dominated financial structure is conducive to growth-promoting financial policy and successful industrial adjustment.[3] Based on an initial applica-

tion of Zysman's model, it appears that Mexico exhibited most of the characteristics of state-led finance through the early 1980s. After 1982, the number of private banks in relation to public banks began to rise rapidly, and the percentage of capital controlled by the private sector also rose steadily, indicating a shift toward a bank-led financial structure.[4] The emergence of bank-leadership in Mexico brought with it high levels of capital flight, short-sighted financial policymaking, financial crisis, and low levels of industrial investment. In fact, it appears that bank-led finance has fared considerably worse than state-led finance, which presided over the "Mexican Miracle" between 1940–1960. Instead of fostering industrial promotion policies as Zysman argues it did in Germany, the bank-led financial structure in Mexico fostered a policymaking process which favored the holders of liquid capital, usually at the expense of industrial promotion. A desire to explain the differences between Mexican and German experiences with bank-led finance constitutes the main motivation for this chapter. This cross-national comparison between Mexico and Germany attempts to explain why, paradoxically, the close linkage between banks and industry in Germany led to a pro-industry stance on the part of financial elites and to an export-promoting external financial policy, while the same linkage, in Mexico, led to a short-term pro-finance policy preference on the part of financial elites and to a persistent overvaluation of the exchange rate, at least until 1994.

Several elements must be incorporated simultaneously into an analysis of bank-led finance in order to capture the dynamics of financial policymaking outcomes. First, one must determine the decision matrix faced by financiers, because the degree to which the banking sector exhibits competitive tendencies affects the choices available to banks and even affects the relative payoffs. Although the banking sectors in both Mexico and Germany tend to be highly concentrated, their degrees of competitiveness differ significantly. Secondly, bankers' expected returns may be affected as much by their relationship to state policymakers as by their relationship to industrial customers. Because financial policymaking involves a clear strategic element, one cannot simply examine the interests of bankers and state policymakers in a vacuum. In fact, how bankers weigh various alternatives depends on their expectations, not only of what the state will attempt to do, but of what the state is capable of doing. Therefore, policymaking credibility on the part of the state, and general expectations about the future health of the economy, weigh heavily in the decision making processes of bankers. Finally, because state policymakers in Germany and Mexico possess a certain degree of policymaking autonomy, state preferences should be included separately from bankers' preferences when analyzing the financial policymaking process.

Here aspects of the state's role as guardian of the value of the currency and other traditional state functions are relevant as well as the state's expectations of private market reaction to announced policy changes.

Through the application of an extended-form game-theoretic model, this chapter attempts to incorporate simultaneously the decisions of bankers and state policymakers, as well as varying expectations about the future. State credibility is modeled according to its ability to control inflation and its temporal commitment to stated financial policies. The degree of policymaking credibility, in turn, affects how private elites weigh alternative economic strategies (e.g., whether to invest at home or invest abroad), or alternative policy preferences (e.g., competitiveness-conscious, stability-oriented monetary policies or monetary policies which tolerate extreme overvaluation).

Financial Market Competitiveness

In order to determine the extent to which the policy preferences of bankers diverge from those of industrialists, it is necessary to examine the relationship between these two sets of actors more closely. A comparison of the German and Mexican cases suggests that the degree of economic competitiveness among banks directly affects the extent to which they see their own economic welfare as connected with the long-term health of the real economy. To the degree that bankers enjoy privileged access to international credit, bankers are able to earn high profits, or the equivalent of monopoly rents, by exploiting short-term investment opportunities, often in the form of currency speculation. The argument that a highly centralized, less competitive banking sector promotes an interest among banks toward riskier, short-term investments is based on the following. First, when very few large banks dominate the financial sector, the health and profitability of those banks must be foremost in the minds of state policymakers. When the banks get into trouble, they can expect the state to bail them out. This was certainly the case with the peso crisis of 1994 and arguably, the 1982 nationalization can be seen as a bailout of private banks as well. This factor constitutes a moral hazard problem, where a small number of very large banks encourages excessive risk-taking because the banks know that the government will have to bail them out, unburdening them of the full downside risk of their investment decisions. The second part of the argument is that the monopoly power exercised by large banks in a non-competitive financial sector translates into privileged access to the political process and to external credit markets. Through this privileged access, banks can help maintain and take advantage of differentials between domestic interest rates and foreign interest rates, or at times even dual exchange rates. That is, there is a degree of ar-

bitrage that can be enjoyed through short-term speculation. The same cannot be said for longer-term fixed capital investment. Within a more competitive banking sector, bank profitability will be more closely tied to long-term industrial growth.

Economic competitiveness may depend, in part, on the degree of industrial and financial market concentration, and the extent of ownership ties between industrial and financial capital. However, concentration alone does not necessarily imply lack of competition, a point underscored in this comparison of two relatively concentrated bank-led financial systems. In order to assess the similarities and differences in Mexican and German financial sector competitiveness and concentration, this section will examine: (1) the context of financial sector development; (2) the extent to which banks exercise managerial control over their industrial counterparts; (3) numerical indicators of market concentration; (4) evidence of competitiveness within the banking industry; and (5) the effects on industrial performance and financial policymaking of weak financial sector competition.

A preliminary comparison of the Mexican and German cases reveals fundamentally similar development contexts as both exhibit the characteristics of bank-led finance which flourished in the context of late development. According to Gerschenkron, the role of banks in an economy depends on the degree of backwardness at the time of attempted development. Gerschenkron linked late development with a more central banking sector role in the capital formation and development process. English development, having come first, required relatively little bank involvement in the capital accumulation process. Faced with no other industrial competition during its development process, England could accumulate capital and invest at a moderate rate. Absent the need to catch up to the competition, entrepreneurial and merchant capital sufficed as a vehicle of industrialization. Germany, on the other hand, having developed later than England, required speedier development. The sense of urgency associated with German development required relatively large concentrations of capital. Although sufficient capital could not be found among entrepreneurs, banks filled the gap, making German "industrial investment banking . . . [a] specific instrument of industrialization . . . "[5]

One important difference between Germany and Mexico is the way in which bank dominance developed. Germany's industrial banks, faced with market incentives to fill a gap left by the chronic lack of capital, emerged largely without state encouragement. Germany had a long established history of strong regional private banking before the emergence of industrial mega-banks, which are today associated with the stock ownership of many important German manufacturing firms. Hamburg had developed a deposit bank in the seventeenth century, and as early as

the sixteenth century, Southern Germany had achieved an advanced state of financial sophistication, promoting silver mining, trade, and lending to princes.[6] Mexico, in contrast, developed much later than Germany, and state-leadership was a central component of the Mexican development experience. As a consequence, the Mexican private banking sector emerged as a conscious creation of the Mexican state to promote financial deepening. The state's strategy for attaining this goal involved enhancing private bank profitability and encouraging financial sector concentration. Government officials believed that only a concentrated banking sector could eventually compete effectively on an international level. As a result, the underlying nature of the Mexican private banking sector was never as competitive as the German banking sector. Nor was it until very recently opened up to foreign competition, which explains why it has remained less competitive.

A related difference between the two cases is the emergence of bank domination in relation to the industrial sector. German industrial conglomerate banks emerged as a vehicle for promoting German industry, whereas the Mexican banking sector, in the eyes of the Mexican state, took on primary importance as a growth sector to be promoted for its own sake. Of course, industrial development remained a long-term goal. Nevertheless, the path to such development necessitated a vibrant financial sector. Thus, after 1940, the Mexican state focused on promoting private financial system profitability and growth. Hamilton describes the extensive efforts of the Mexican government to promote private capital accumulation and expand a capital market.[7] Clearly, the end goal, at least for state officials, was to promote industrial growth. Still, there was a real sense of pride and urgency associated with having a thriving domestic financial sector. This factor serves as a starting point for understanding why bank-leadership in Germany has been characterized by bank officials taking a long-run view of investment in the industrial sector, and in general supporting pro-industry policies, whereas Mexican financiers have taken a shorter-run, pro-liquid assets approach to financial policy.

These historical precedents have profoundly affected the underlying degree of competitiveness in the relationship between banks and industry in Germany and the lack thereof in Mexico. One aspect of the relative competitiveness of German banks has been the historical persistence of excess supply conditions in the market for loans. This is not meant to imply that the market for loans was not clearing due to government intervention. Rather it simply describes a situation in which banks would have been happy to lend at prevailing rates but there were few takers despite the degree of concentration among, and massive size of, individual industrial banks within the German banking system. There is even evidence suggesting that excess credit supply conditions had existed for

some time preceding the German industrial takeoff.[8] That is, even preceding the historical period when, according to Gerschenkron, German banks were substituting there own capital for individual entrepreneurial capital, German banks had been more eager to make loans than industrialists or potential industrialists had been to accept them.

The lack of demand for capital in Germany just prior to industrialization was based on several factors. First, Germans had a low propensity to invest due mainly to the fact that there was no stimulation for massive investment that at the time involved a huge risk factor. In short, risk did not just deter the lenders or the availability of capital, as is commonly thought, it also influenced the entrepreneurs or the potential demand for capital.[9] The second factor that limited the demand for capital in pre-industrial Germany was a strong cultural bias against going into debt. During the pre-industrial era, it was considered unusual and even immoral to be in debt. Banks simply could not go out and create business. Thus, the demand for external finance from potential investors, as well as for self-financing, was much more limited than is generally acknowledged by the 'shortage of capital' argument. Third, it has been suggested that merchants of the period tended to have a high proclivity for liquidity, making them less likely to demand credit for fixed investment purposes.[10] One clear sign of the lack of credit demand is that many banks refused to accept deposits because they could find no use for these resources, and many enterprises that came into being with considerable resources failed because they could not achieve sustained profits—which they would surely have done had there really been a shortage of investment funds.[11]

Mexico's persistently tight credit market contrasts sharply with the German situation. There has been an element of control at play in the Mexican market for credit which can be illustrated through a brief comparison with Japanese state-led finance. Johnson has explored the ways by which a developmental state cultivates state-led finance to achieve a coherent growth-oriented industrial policy. At the heart of Johnson's analysis is the idea of making finance a limited resource. If the state can ration industrial finance, then finance becomes a tool by which to influence the direction of private investment decisions and industrial growth.[12] According to Johnson, Japan offers a panoply of market-conforming methods of state intervention, including the creation of governmental financial institutions, whose influence is as much indicative as it is monetary.[13] After the war, Japan experienced a severe capital shortage due to draconian measures used to control inflation. During this period, a two-tiered structure of government guaranteed 'city bank' over-loaning and newly created government-owned banks of last resort were developed. The Japanese Development Bank came to possess tremendous in-

dicative powers over the whole economy based on their power to make or refuse policy loans.[14] Although it was born of the capital shortage, the system of bank over-loans became attractive to the Japanese state, and especially to the Ministry of International Trade and Industry (MITI), as a means of maintaining control over the direction of industrial development.

The behavior of the Mexican state suggests a similar, though less organized, approach to achieving and maintaining state-led finance in the 1940 to 1960 time period. The Mexican state, like the Japanese state, deliberately attempted to maintain conditions of capital shortage to enhance its allocative powers with respect to industrial financing. Moreover, the prevailing conditions of capital shortage in Mexico served to enhance the monopoly power of emerging conglomerate banks over their industrial counterparts.[15]

Universal banks, combining a variety of investment and commercial functions under one roof, including ownership of investments in other bank and non-bank firms, have dominated both the German financial system, since industrialization, and the Mexican financial system beginning in the early 1970s.[16] The three largest German banks—Deutsche Bank, Dresdner Bank, and Commerz Bank—own 32.52 percent of the stock in the largest German company, Siemens; 61.66 percent of the stock in the second largest company, Daimler-Benz; 54.5 percent of the fourth largest, and 51.68 percent of the fifth largest.[17] Nevertheless, the German banking system appears to be much more competitive than its Mexican counterpart. The number of banks alone underscores the competitive differences between the two systems. In Germany, there are currently more than 5,500 independent banks, while in Mexico the total number of private banks has decreased to less than 100.[18] Not only did the Mexican banking system start out more concentrated than the German banking system, the process of concentration has continued in Mexico to a much greater extent than it has in Germany. Besides the reduction in the number of Mexican private banking institutions, resources have become concentrated among fewer institutions. In 1950, 42 banks controlled 75 percent of financial sector resources. In 1970, 18 banks controlled 75 percent of the resources. By 1979 only six banks controlled 75 percent of financial sector resources.[19]

This acceleration in the concentration of bank resources in Mexico can be credited in part to the 1970 and 1974 reforms of The General Credit Law that allowed for the formation of multi-banks (or universal banks) and financial groups. The key element in the growth of multi-banks, and the financial market concentration that went with it, was the ability of banks to form ownership ties with industrial firms. The result—concentration of power in the hands of a few financiers—further enhanced bank

hegemony in Mexico. Also, whereas conglomerate economic groups (usually family-owned) had always been a part of Mexico's economic structure, in the late 1950s banks and financial institutions became more important as a means of integrating economic groups, the process by which financial–industrial ownership ties multiplied, increasing the level of concentration in both sectors. In short, concentration within the financial sector predated financial dominance, but financial dominance managed to change the character and pervasiveness of that concentration, a process which further empowered finance capital. The German Big Banks are organized very similarly to Mexican multi-banks, but they do not seem to exercise the type of domination over industrial sector firms that Mexican banks do.

In spite of its reputation for being highly concentrated, the German banking sector nevertheless exhibits strong competitive tendencies. Although banks do tend to have close relationships with industrial firms, those firms can choose to associate with any of a large number of competing banks. The German market for bank services is still a buyer's rather than a seller's market. Thus, while there is concentration in the financial sector that might indicate the exercise of monopolistic market power, there is also competition that seems to benefit the customer and which does not seem to have done much harm to the economy as a whole.[20]

A bank-led financial structure in Mexico, under decreasing state regulatory intervention, contrary to expectations did not make a positive contribution to industrial growth, and in some cases even negatively affected the financial intermediation process and the economy. In Mexico, financial–industrial conglomerates or *grupos* are commonly cited as a source of economic inefficiency because they stifle competition. Tello notes that "bank credit practices promoted bank interests and the interests of finance capital, while negatively affecting the financial system, intermediation, and economic production."[21] According to White, "[f]inance capital was more interested in accumulating capital through rentierist practices than investing in productive operations that were more risky and less lucrative."[22] Moreover, because Mexico's industrial take-off came during state-led finance, the private financial sector can neither take credit for spurring industrialization in the 1940s and 1950s, nor can it divorce itself from the poor economic performance of 1980s.

German industrialization, in contrast, was closely associated with big banks. German banks acted as investors and lenders of capital during the three main stages of industrialization. During the first stage, a close connection between credit banks and industrial enterprises helped promote the growth of large-scale enterprises, which helped to overcome the competitive disadvantages of Germany's late development. The second stage of industrialization saw the emergence of German *grossbanken* (big

banks) which had developed out of joint-stock banks. Until World War I only eight *grossbanken* existed. By the third stage of industrialization in 1913, the three biggest German enterprises were banks, and 17 of the 25 biggest enterprises were banks. Several early scholars of German industrialization, notably Sombart and Hilferding, noted a strong relationship between German industrialization and German banks.[23] Other recent scholarship has demonstrated the importance of German banks in facilitating industrialization by showing that the provision of funds by banks grew faster than the indicator for overall economic growth (Net National Product) during German industrialization, suggesting a certain degree of credit-driven growth.[24]

The distribution of credit and equality of access for small and medium sized businesses represents another way to measure the benefits or drawbacks inherent in a bank-led financial sector for the rest of the economy. Although German banks do own substantial portions of large manufacturing firms and have historically favored financing large firms over small ones, there have been a number of significant changes in the patterns of German bank financing over the last twenty years. The commercial banks, and big banks in particular, have successfully attracted small-scale savings deposits. They have also offered more long-term lending than they used to, partly via their subsidiaries, and not only to the traditional industrial clients. The percentage of loans from the three main types of banks in Germany that went to small manufacturing businesses was 40.4 percent in 1970. The percentage from commercial banks alone in 1970 was 48 percent.[25]

This contrasts sharply with the process of accelerating concentration among financial–industrial groups in Mexico, which coincided with financial liberalization beginning in the early 1980s.[26] Grupo Banamex and Grupo Bancomer are good examples of the wedding of financial and industrial capital. Each *grupo* is organized around a massive financial institution. In the case of Grupo Banamex, the financial institution was formed by the combining of three large banks in 1977: Banco Nacional de Mexico, Financiera Banamex, and Hipotecaria Banamex. The governing board of Grupo Banamex is composed of business elites from diverse industrial and financial entities, associated with the bank through stock ownership or the provision of credit. Mexican *grupos* consolidated oligopoly power after financial deregulation by controlling access to the international capital market. Financial–industrial conglomerates, through their control over domestic banks and their overseas contracts, managed to get dollar credits at below prevailing market interest rates to re-lend at extremely high interest rates denominated in pesos.[27] This process favored those with access to international money and drove out smaller competitors. Moreover, conglomerate banks exercised market power by

keeping interest rates low on liabilities, while charging high rates on loans to nongroup members. This increased the profit margin for all conglomerate banks that stayed in business and tended to increase the cost of financing to small businesses without group affiliation. In short, the Mexican economy experienced bank-holding company behavior of a type that led to a regressive redistribution of income. With interest rate ceilings lifted, *grupos* had an incentive to solicit funds aggressively from the general public and allocate them to their related nonfinancial companies in the form of loans at subsidized interest rates. Therefore, on the asset side, there was enormous concentration of credit in a few companies, while on the liability side the distribution of deposits reflected a cross section of the personal income distribution of the economy. These phenomena led to the exclusion of nongroup members, which were typically medium and small-sized companies as well as the middle and lower classes, from access to credit facilities, and have produced large transfers from lower to high income groups.[28] Indeed, the net effect of financial–industrial conglomerate activities in Mexico was to increase the cost of financial transactions in the domestic credit markets. These increased costs were borne disproportionally by small and intermediate businesses because large business enjoyed preferential access to the international capital markets. The differential in interest rates and disparate financial costs undoubtedly contributed to the consolidation and concentration of private national economic groups.[29]

Mexican financial–industrial conglomerates earned huge profits through speculative activity in international capital and currency markets, underscoring the shift in investment focus from long-term to short-term activities, from which they derived a substantial proportion of their total profits in the 1980s.[30] Because different types of banks were owned by the same firms, it made little difference whether a bank was officially classified as a commercial or as an investment bank; all these institutions tended to use a short-term rather than a long-term framework. German bank liabilities, on the other hand, span the whole range from short-term to medium-term to long-term. This has allowed German banks to provide long-term finance to the government as well as to the private sector, without giving rise to excessive monetary expansion.[31]

The defining difference, then, between the Mexican and the German cases is that with Germany's more competitive banking sector, bank profitability is more closely tied to long-term industrial growth. Table 2.1 summarizes the competitive characteristics of finance in each country discussed thus far. A less competitive banking sector in Mexico promotes an interest among banks toward riskier, short-term investments, because the small number of banks encourages excessive risk-taking since banks have not borne the full downside risk of their investment decisions, due

TABLE 2.1 Explaining Financial Sector Competitiveness and Its Consequences

Financial Sector Characteristics	**Germany**	**Mexico**
Degree of Concentration	high	high
Industrial Wedding	extensive	extensive
Relative Competitiveness	high	low
Explanatory Variables		
Financial Sector Development	autonomous	state-sponsored
Capital Shortages	no	chronic
Relationship with Industrial Enterprises	interdependent	financial dominance
Consequences		
Bank Investment Strategies	long-term	short-term, speculative

to an implicit government bailout. Also, the monopoly power exercised by a very few banks in Mexico translates into privileged access to the political process and to external credit markets. Because of this privileged access, Mexican banks could earn greater profits by taking advantage of short-term investments made possible through the exercise of political and economic monopoly power, than they could through longer-term investments in industry. Thus, in Mexico a certain kind of incentive incompatibility arose between bankers' and industrialists' interests. In Germany, on the other hand, banks not only face economic competition from other banks, but also political competition from other societal groups, such as labor unions and industrial organizations. For this reason, bank stock ownership has resulted in industrialists and bankers taking a shorter-term investment outlook in Mexico than in Germany. Another reason is that most German manufacturing firms can choose among a number of banks as a source of credit, so that if the banks do not serve the interests of industrial firms, they can be effectively punished by the market. But in Mexico, Mexican bankers and industrialists tend to be the same people. Family ownership of several banks and manufacturing firms is not uncommon in Mexico, perhaps because of reluctance within the family-run *grupos* to take companies public for fear of losing family control over assets.[32] In a sense the answer to the proposed question about why industrialists act more like bankers in Mexico is straightforward: Mexican industrialists *are* bankers to a great extent.

In Germany, on the other hand, all major industrial firms are publicly traded. The German counterpart to the Mexican *grupo* is the voting block

formed by bank shareholdings in German companies. The data are certainly impressive in terms of the potential power that German banks wield over industrial enterprises. By U.S. standards, German banks do exercise a significant degree of control over German companies. Evidence to that effect has provided an empirical basis for labeling the German financial system bank-led. Roe highlights the stock-based control of German banks over German industry and contrasts this situation that of the United States, which until the very recent repeal of Glass-Steagal legally imposed the separation of banks from commerce. The percentage of public company stock owned by German banks has in fact increased from 6 percent in 1960 to 10 percent in 1990.[33] These numbers certainly imply a high degree of bank influence over industry when compared with the United States. Also, in terms of stock percentage, the potential for German bank influence has certainly increased.

But, the relevant comparison here is not the U.S. financial system or any other advanced industrial country's financial system, but the Mexican bank-led financial system. And compared with the Mexican bank-led financial system, the German system has resulted in far less dominance of financial interests over industrial interests. For example, German law limits the percentage of company stock any one bank can hold as one means of keeping bankers' control over industry in check. And while there is great potential for German banks to impose their will on industrial enterprises in which they hold a controlling interest, German banks do not tend to dominate industrial investment decision making. Although they are clearly positioned to influence management, there is little evidence that they commonly do so.[34]

One reason that banks do not typically encroach upon industrial firms' managerial decision-making autonomy is that German manufacturing firms are well-organized and well-represented politically. Furthermore, German business interest groups are politically viable and independent from state sponsorship. This contrasts sharply with the lack of independent political organization in Mexico. German business makes its presence felt through three major institutions. With a membership of about 80 percent to 90 percent of all firms, organized in a complex system of more than five hundred branch and regional associations, the Federation of German Industry (BDI) is the central vehicle for representing the general policy objectives of business. The collective bargaining strategy of business is defined and carried out by the Federation of German Employers' Association (BDA). More than 80 percent of all West German employers belong to one or several of the more than eight hundred branch or regional associations. Finally, the Diet of German Industry and Commerce (DIHT) represents the interests of small business and the crafts, especially on a regional basis.[35]

At a glance, it does appear as if German banks' voting rights with respect to stock ownership give them a tremendous amount of decision-making power within the firm. However, in nearly 90 percent of all cases, voting rights amounted to less than 5 percent of equity, and in only 4.3 percent of cases did rights exceed 25 percent. This dispersion means that the power of individual banks is much less than would appear from the high proportion of voting rights controlled by the banking system as a whole.[36] In short, the relationship between banks and industry in Germany exhibits a relatively high degree of competition compared with Mexico, where the banking sector is much more concentrated and tends to dominate the industrial sector.

Policymaking Credibility

Thus far this chapter has argued that market structure and degree of economic competitiveness within the financial sector account for much of the difference between the Mexican and German economies despite their shared bank-led financial structures. In addition to economic competitiveness, the degree of policymaking credibility on the part of the state also helps explain some of the differences between the Mexican and the German cases. Policymaking credibility will be analyzed by focusing on two primary relationships: that between bankers and the state, and that between the state and society.

During the post-war period, financial policymakers in Germany consistently gave a high priority to controlling inflation. More importantly, the consistency of anti-inflationary policy has given the German central bank credibility in the eyes of market actors. This credibility has, in turn, allowed state officials to pursue policies without fear of encouraging private financial sector behavior that would prove harmful to the economy as a whole.

The degree of sensitivity to threats to the value of money, and the degree to which monetary authorities have run policy in accordance with those fears, makes sense only in the context of Germany's dramatic experience with hyperinflation in the inter-war period.[37] As a consequence, Germany's monetary stability after World War II could not have contrasted more sharply with the instability of monetary policy during the Weimar Republic. The German central bank has defended its stable price stance in public often, and a refusal to compromise on inflation has become a part of the Bundesbank ethos. German central bankers have been unwilling to stimulate the economy at the expense of risking inflation. According to Helmut Schlesinger, a Bundesbank official, "even single digit inflation destroys the currency's value over the medium term and gradually destroys the economy as a whole." In 1986, while Germany

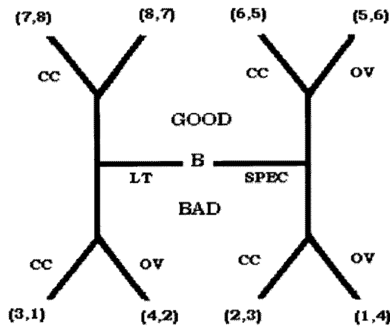
was experiencing zero inflation, Schlesinger continued to warn against inflationary pressure.[38] It is important to keep in mind that the anti-inflationary bias of central bankers in German is shared by the German population, even though few alive today actually experienced the hyperinflation. Clearly, the shared societal memory of severe inflation has simplified the task in political terms of keeping inflation low. Furthermore, the fact that market actors understand the basis of central bankers' concern over inflation gives monetary officials a certain degree of credibility that would not otherwise exist.

In contrast, when Mexican monetary officials have announced plans to reduce or keep inflation down, the response of market actors has typically been skepticism. Policy credibility in terms of inflation control seems to be a more difficult and complicated issue for the Mexican state than it has been for the German state. Inflation control in the form of austerity measures involves real sacrifices for the Mexican people, especially for the masses, while the fear of hyper-inflation does not provide a counterbalance to such costs.[39] Also, devaluation has historically been seen as a political liability by Mexican presidents, making them less than willing to devalue even during times of obvious overvaluation of the peso. Yet most business leaders and especially bankers come to expect devaluation eventually even though policymakers continue to insist on their commitment to fend off devaluation. This process tends to weaken the Mexican government's policy credibility in general.[40]

Game-Theoretic Analysis

This chapter has underscored key differences in German and Mexican financial markets with respect to the vigor of competition and the level of policymaking credibility enjoyed by monetary officials. What remains is to explain how these differences inform the dynamics of financial policymaking in each case. This analysis demonstrates how competition and policymaking credibility inform the strategic interaction between state policymakers and private bankers in each country. Since policymakers choose strategies contingent on expected market behavior, and market actors make investment decisions contingent on expected government policies, this chapter employs a game framework in order to capture the dynamics of these relationships in Mexico and Germany.

This extended form game is an attempt to model the strategic interaction between the state and bankers over financial policy with uncertainty built in over whether a good or bad state of nature will prevail. This model is meant to be descriptive and heuristic rather than general. The payoffs are assumed, so that the outcomes that derive from them are conditional on the sizes of the payoffs. The probability of being in either



Legend: LT is long-term investment; SPEC is speculative investment, including capital flight; GOOD indicates a good state of nature prevails; BAD indicates a bad state of nature prevails; CC represents competitiveness-conscious exchange rate policy; OV represents exchange rate policy that tolerates extreme overvaluation; B indicates bankers' choice between LT and SPEC.

FIGURE 2.1 Extended-Form Game Tree: The Strategic Dynamics Between Bankers and Monetary Officials

state of nature can be interpreted as an expectation on the part of the players regarding macroeconomic performance, which may include expectations about the effectiveness of government policy and the likelihood of good or bad exogenous shocks. I assume that all players hold similar beliefs concerning the probabilities assigned to the states of nature. Furthermore, I assume that the banks and the state move simultaneously and that neither knows which state of nature has resulted before making their decision. All the possible outcomes including the payoffs for the state and the bankers are represented by the eight branches of the game tree.

Payoff Structure

The state's preferences among the 8 possible outcomes were deduced in the following manner and assigned a 1 through 8 rank ordering, where 8 represents the highest utility measure and 1 represents the lowest.[41] The state prefers all outcomes under the good state of nature to all outcomes under the bad state of nature. Consequently, the four possible outcomes on the upper branches of the game tree must be assigned 5 through 8 in terms of payoffs for the state. Furthermore the state prefers that the bankers engage in long-term investment rather than short-term speculative investment (e.g. capital flight or currency speculation) regardless of the type of financial policy pursued, competitive-conscious or tending to-

ward overvaluation. This means that the highest payoff for the state comes under the good state of nature with the bankers engaging in long-term investment. There are two possible outcomes that satisfy these criteria: one where the state plays competitiveness-conscious and one where the state plays overvaluation. There is a tradeoff here for the state. On the one hand, the state can better fend off inflation with a strong exchange rate. On the other hand, a competitiveness-conscious financial policy is more likely to encourage long-term investment in export industries, which presumably the state also values. But if we assume that bankers have already decided to invest long-term regardless of state policy because they hold positive expectations about the future, then the only relevant question for determining the rank order of state preferences is relative cost in terms of political liability incurred by the state of each policy path. For example, at the end of 1993 Mexican President Salinas, similar to many presidents before him, did not see devaluation as a viable political option because of the likely inflationary effects and the sense that an inflationary spiral would make him and his party look weak in the midst of a presidential election. In addition, Salinas might have believed that devaluation would spook portfolio investors, whose inflows generated the large capital account surplus needed to counterbalance the trade deficit. As long as portfolio capital flowed in, the government could avoid devaluation and its potential inflationary consequences. In the short run, protecting the value of the peso appeared to be a more satisfactory political strategy. Certainly, the sudden increase in the government budget deficit during this period, which coincided with the electoral campaign, indicates that Salinas was willing to risk longer-term economic instability for the sake of short-term political gains.[42] Ironically, maintaining an artificially high currency will sometimes best serve the state's short-term political interests, even if it does not serve the long-term economic interests of the nation. This has certainly been the case in Mexico. By this reasoning, under 'GOOD/LT/OV' the state receives 8 and under 'GOOD/LT/CC' the state receives 7.

Now consider the good state of nature where the bankers have chosen to invest short-term. The state will prefer competitiveness-conscious policy, especially since, under the good state of nature, it would be confident in its ability to bring about long-term investment. Thus, the state's payoff is 6 for 'GOOD/SPEC/OV' and 5 for 'GOOD/SPEC/CC.' Next consider the bad state of nature where bankers invest long term, which we know the state finds preferable to the bad state of nature where the bankers speculate in foreign currency in order to hedge against devaluation of their own currency.[43] By the same reasoning, the state prefers 'BAD/LT/OV' in which case it receives 4 to 'BAD/LT/CC' in which case it receives 3. Lastly, consider the bad state of nature where bankers invest short-

term. By the reasoning used above the state prefers 'BAD/SPEC/CC' to 'BAD/SPEC/OV' and receives 2 and 1 respectively.

The bankers' preference, like the state's, is for the good state of nature over the bad state of nature regardless of policy or investment strategy. Likewise, locking into a long-term investment strategy when the good state of nature prevails is likely to be more profitable than any short-term, speculative investment strategy that does not take full advantage of the good state of nature within the domestic economy. Although debatable, it seems that bankers would prefer a well-implemented competitiveness-conscious financial policy to a policy of extreme overvaluation under the good state of nature, a scenario under which banks bare the risk of being locked into long-term industrial investments should the policy be abandoned, inducing a currency free fall. So bankers prefer 'GOOD/LT/CC' to 'GOOD/LT/OV' and receive 8 and 7 respectively. However, when bankers invest short-term, their preferences approximate those of pure liquid capital holders. We assume that liquid capital holders tend to prefer policies that favor maintaining high currency value especially in the absence of effective inflation-control policies because their investments are denominated in terms of pesos and thus profitability depends upon currency value. Moreover, bankers (the largest constituency of liquid capital holders) at least in Mexico tend to be burdened with large foreign debt exposures, making them even more likely to prefer a strong currency. Therefore, bankers receive 6 under 'GOOD/SPEC/OV' and 5 under 'GOOD/SPEC/CC.' Assuming the bad state of nature prevails, bankers prefer short-term speculation to long-term investment regardless of the financial policy path. Liquid-capital holders prefer not to be locked into long-term investments in a stagnant economy. Under the bad state of nature, where bankers have invested short-term, they would prefer that policymakers intervene in capital markets to uphold the value of the currency, by using foreign reserves to buy pesos on the open market for example, rather than allow currency devaluation to take place in order to promote longer-term export growth. This follows because of the assumption that bankers are already engaged in a short-term investment strategy that involves hedging against a fall in the value of the home currency, capital flight, and foreign debt exposure, rather than a strategy of investing in the longer-term health of export industries. So bankers receive 4 for 'BAD/SPEC/OV' and 3 for 'BAD/SPEC/CC.' Lastly, under the bad state of nature when bankers have invested long-term, the worst thing that could happen would be for the state to allow a currency free fall. One way to think of this is that currency devaluation is acceptable to banks only if the trade-off involves increased profits from a thriving industrial customer base. If the economy is stagnant and the currency deflates, bankers lose on two counts. This applies especially to heavily in-

debted countries whose debts are denominated in the foreign currency. Bankers prefer 'BAD/LT/OV', and receive 2, to 'BAD/LT/CC', and receive 1.

Expected Payoffs

Based on these payoffs and the structure of the game, the expected payoff to the state of implementing competitiveness-conscious monetary policies, given the bankers invest only short-term, is:

$$E^S(CC \mid SPEC) = 6\,\pi_g + 2\,\pi_b$$

Whereas the expected payoff to the state of exchange rate overvaluation, given the bankers speculate, is:

$$E^S(OV \mid SPEC) = 5\,\pi_g + \pi_b$$

$$E^S(CC \mid SPEC) - E^S(OV \mid SPEC) = (\,6_g + 2\,\pi_b\,) - (\,5\,\pi_g + \pi_b\,) = \pi_g + \pi_b = 1$$

Since $E^S(CC \mid SPEC) - E^S(OV \mid SPEC)$ is always positive, $E^S(CC \mid SPEC)$ must be greater than $E^S(OV \mid SPEC)$. In other words, if bankers choose to speculate, then the state always prefers to engage in competitiveness-conscious monetary policy. One possible interpretation of this outcome is that the state has little to lose once capital flight is already out of control by trying to restore export competitiveness.

On the other hand, if we assume that bankers take a longer-term outlook and have a close relationship with industrial producers, then the state always prefers to overvalue according to the model. The state's expected payoff from overvaluation, given the bankers play long-term, is:

$$E^S(OV \mid LT) = 8\,\pi_g + 4\,\pi_b$$

While the state's expected payoff from competitiveness-conscious policy, given the bankers invest long-term, is:

$$E^S(CC \mid LT) = 7\,\pi_g + 3\,\pi_b\text{ ; and,}$$

$$E^S(OV \mid LT) - E^S(CC \mid LT) = (\,8\,\pi_g + 4\,\pi_b\,) - (\,7\,\pi_g + 3\,\pi_b\,) = \pi_g + \pi_b = 1$$

Since $E^S(CC \mid LT) - E^S(OV \mid LT)$ is always positive, $E^S(OV \mid LT)$ must be greater than $E^S(CC \mid LT)$. Here a similar logic holds, there are certain political benefits that the state enjoys by choosing to maintain an overvalued exchange rate which will outweigh the economic benefits of a com-

petitive exchange rate assuming that bankers will support the export industry anyway.

The model also allows us to examine the incentives facing bankers as they decide between different investment strategies. The bankers' expected payoff from investing long-term, given the state is tolerating, indeed encouraging, overvaluation, is:

$$E^B(LT \mid OV) = 7\,\pi_g + 2\,\pi_b$$

While the bankers' expected payoff from speculating, given that the state tolerating overvaluation, is:

$$E^B(SPEC \mid OV) = 6\,\pi_g + 4\,\pi_b$$

$$E^B(LT \mid OV) - E^B(SPEC \mid OV) = (\,7\,\pi_g + 2\,\pi_b\,) - (\,6\,\pi_g + 4\,\pi_b\,) = \pi_g - 2\,\pi_b$$

If $\pi_g - 2\,\pi_b > 0$, then $E^B(LT) > E^B(SPEC)$, and bankers prefer to invest long-term. In short, if the probability of the good state is greater than O, and the state tolerates currency overvaluation, then the bankers will invest long-term. If, on the other hand, $\pi_g - 2\,\pi_b < 0$, then $E^B(LT) < E^B(SPEC)$, and bankers will prefer to speculate. That is, if the probability of the good state is less than 2/3 and the state allows overvaluation, then bankers will speculate.

These results make intuitive sense, since one would expect long-term investment in an economy with optimistic expectations and short-term speculative investment where expectations were pessimistic. In addition, these results suggest that tolerating overvaluation, in and of itself, does not necessarily lead to a sub-optimal outcome. Instead, it appears that a state which enjoys a great deal of policymaking credibility, say the probability of the good state of nature is greater than 2/3, also enjoys quite a bit of policymaking leeway. If the future looks bright, both types of financial policy will be consistent with long-term industrial investment.

Given that the state engages in competitiveness-conscious external monetary policy, then the expected payoff to bankers of investing long-term is:

$$E^B(LT \mid CC) = 8\,\pi_g + 1\,\pi_b$$

The expected payoff to the bankers of investing short-term, given that the state has engaged in competitiveness-conscious policy, is:

$$E^B(SPEC \mid CC) = 5\,\pi_g + 3\,\pi_b$$

$$E^B(LT \mid CC) - E^B(SPEC \mid CC) = (8\,\pi_g + 1\,\pi_b) - (5\,\pi_g + 3\,\pi_b) = 3\,\pi_g - 2\,\pi_b$$

If $3\,\pi_g - 2\,\pi_b > 0$, then $E^B(LT \mid CC) > E^B(SPEC \mid CC)$, and bankers prefer to invest long-term. In short, if the probability of the good state is greater than 2/5 and the state engages in competitiveness-conscious policy, then the bankers will invest long-term. If $3\,\pi_g - 2\,\pi_b < 0$ then $E^B(LT \mid CC) < E^B(SPEC \mid CC)$ and bankers will prefer to speculate. That is, if the probability of the good state is less than 2/5 and the state policy is competitiveness-conscious, then bankers will speculate. Again, these results make sense since one would expect long-term investment in an economy with optimistic expectations and short-term investment where expectations were pessimistic, regardless of the character of financial policy. In fact, this analysis does suggest that long-term investment will be forthcoming if bankers are very confident, but under conditions of moderate confidence capital flight or other forms of speculation may ensue. In other words, the greater than 2/5 criterion for credibility does not give the state as much leeway as the greater than O situation.

Implications

The general implications of the model are fairly intuitive. The predictive or explanatory value of this game lies in the equilibrium analysis. There are two conditions under which this game yields an unambiguous solution. For $0 < \pi_g < 2/5$, the Nash equilibrium is 'SPEC/CC.' Also, for $2/3 < \pi_g$ the Nash equilibrium is 'LT/OV.' For each player these strategies represents the best response given the other player's move. As one would expect, the game predicts long-term investment where expectations are very optimistic and short-term investment where expectations are more pessimistic. For $2/5 < \pi_g < O$ there is no Nash equilibrium in pure strategies. There does exist a mixing strategy where bankers speculate a certain percentage of the time, and invest long-term otherwise, which satisfies the Nash equilibrium criteria but it adds little to the analysis.

The model predicts in theory the outcomes that would have prevailed in Mexico and Germany given the incentive structures facing key decision makers. For the most part, the events that have unfolded in Mexico and German are consistent with the equilibrium analysis presented here. However, even where the model fails to accurately predict certain outcomes, the logic of mutual incentive mechanisms that forms the basis of the model helps to explain the inconsistency.

For the Mexican case, assume $\pi_g < 2/5$ for the bank-led period of the 1980s because this period coincided with dismal economic performance and the height of the debt crisis. This being the case, the model suggests

that banks will speculate, and the state will engage in competitiveness-conscious financial policy. This certainly captures the behavior of the bankers. It does not, however, capture the behavior of the Mexican state, which tolerated extreme overvaluation of the peso throughout the 1980s and early 1990s, a fact that precipitated the Peso Crisis of 1994. In fact, many now sight flawed exchange-rate policy as virtually the only misdirected element of Mexican economic policymaking throughout this period.

The question is why policymakers followed this course despite the fact that it entailed the risk of inducing severe economy-wide hardship. One possible answer is that Mexican policymakers faced increasing pressure to uphold the peso's value from an increasingly powerful domestic financial sector, whose share of financial assets had risen steadily since the early 1980s.[44] This also seems to have been the case in Thailand more recently. The state's nationalization of the banks and imposition of capital controls in 1982 represent the state's initial response to short-term investment and capital flight under a bad state of nature. However, bank-leadership eventually gave bankers significant influence over the determination of financial policy. Based on the game tree, if bankers could choose the state's move once bankers had invested short-term in the bad state of nature, they would choose 'OV', opting to receive 4 rather than 3. The game suggests that state policymakers would have been better off engaging in competitiveness-conscious external monetary policy from the beginning of the debt crisis. What the game fails to capture is that Mexican bankers who owed millions in dollar-denominated loans stood to lose vast amounts as a result of devaluation. The bankruptcy of any one of Mexico's large financial institutions might have induced financial chaos, a chance the state could not afford to take. Under these circumstances, the short-term behavior of the Mexican state, while not optimal, is understandable.

In contrast to Mexico, German bank-leadership has been accompanied by a great deal of optimism. Furthermore, confidence in the German state's policymaking effectiveness has grown out of the central bank's staunch anti-inflation policy. In short, investors know what to expect. The German economy has consistently fallen somewhere in the $\pi_g > 2/3$ range. Hence, one would expect bankers to invest long-term and the state to tolerate some overvaluation. While the former is certainly corroborated by the analysis, the latter is not. The Bundesbank has been willing to accept an appreciation only as a last resort, and only after going to great lengths to reconcile internal and external balance in order to avoid making a choice in the first place.[45] This fact is especially noteworthy given the Bundesbank's aversion to inflation, because highly valued currencies tend to fend off inflation much more effectively than weak

currencies.[46] However, despite the emphasis of German external monetary policy, there has been a movement toward a strong Mark since the 1970s due to the role of the mark as anchor currency for the evolving EMU.[47] This, together with the German societal aversions to inflation, discussed earlier, allowed German monetary officials to pursue their interests at relatively low trade-off costs. In short, the political benefits that entered into the state's preferences for a strong currency weighed less heavily in the German case due to a set of special circumstances that allowed policymakers to enjoy the political benefits of internal stability without compromising their commitment to external stability and export-led growth.

Conclusion

This chapter has examined why the German bank-led financial system structure has resulted in a set of financial policies that has tended to favor the export industry and long-term growth, while the Mexican bank-led financial system structure has resulted in a set of more changeable, unstable monetary policies and extreme overvaluation of the peso, which favors liquid capital holders. One explanation is that bankers in Germany do not dominate the German financial market to the degree that Mexican bankers do. German banks are big, but they are also very competitive.[48] The second explanation is that the German state has enjoyed policymaking credibility and the Mexican state has not. This is reflected in bankers' expectations about the future (state of nature), which in turn determines how bankers' react to state policies. In fact, the renewed credibility of the Mexican state during the Salinas Presidency surely accounts for some of the economic success in the early 1990s, but it has been more than offset since the peso crisis of 1994.

One lesson that emerges from this analysis is that in promoting the growth and deepening of a financial system, the state must remain keenly aware of the consequences of a highly oligopolized financial system in order to avoid creating an inefficient politically and economically dominant sector. Exposing both manufacturers and banks to international competition early on, as was the case for the German financial and export-manufacturing sectors, may not only promote economic efficiency but also political stability. It is noteworthy that the process of financial development in Germany required little or no conscious state policy, in part a reflection of Germany's status as a relatively early developer. In contrast, the Mexican government continued to protect banks from foreign competition, and from foreign debt exposure by artificially overvaluing its currency well into the 1990s.[49] Now in the wake of the Mexican peso crisis and the Asian financial crisis, it has become clear to

academics as well as policymakers that politically entrenched, oligolopized, over-indebted private banking systems represent the biggest obstacle to sustained growth in newly industrializing countries.

Notes

1. Henning [1994].
2. Gerschenkron [1962]; Zysman [1983].
3. Zysman [1983]
4. *Nacional Financiera* [1988]; *Banco de Mexico* [1985–1992].
5. Gerschenkron [1962], 14.
6. Kindleberger [1984], 117.
7. Hamilton [1982], 209,215.
8. Lee [1991], 117.
9. Borchardt [1991], 21.
10. Borchardt [1991], 21.
11. Borchardt [1991], 27.
12. Johnson [1982], 317.
13. Johnson [1982], 318.
14. Johnson [1982], 200.
15. White [1992]; Maxfield [1990]
16. Economists Advisory Group Ltd. [1981], 43.
17. Roe [1993],1937.
18. Quijano [1981]; Economists Advisory Group Ltd. [1981], 43.
19. White [1992], 86.
20. Economists Advisory Group Ltd. [1981], 75.
21. Tello [1984], 105.
22. White [1992], 100.
23. Lee [1991], 116.
24. Lee [1991], 117.
25. Economists Advisory Group Ltd. [1981], 239.
26. White [1992], 86.
27. McKinnon [1988], 400.
28. Galbis [1986], 133.
29. White [1992], 75.
30. White [1992], 113.
31. Economists Advisory Group Ltd. [1981], 373.
32. Camp [1989].
33. Roe [1993], 1960.
34. Economists Advisory Group Ltd. [1981], 229.
35. Economists Advisory Group Ltd. [1981], 10.
36. Economists Advisory Group Ltd. [1981], 212.
37. Borchardt [1991], 132.
38. Kennedy [1991], 7.
39. Teichman [1988], 40. Especially as a result of the 1994 peso crisis, government policymakers have lost credibility and now have much less leeway with re-

spect to convincing portfolio investors of the sustainability of an overvalued exchange rate.

40. Manson and Agenor [1996].

41. It should be mentioned that these payoffs are meant to reflect only relative preferences. The cardinal values of the payoffs are not meaningful. However, this should not present a problem because my conclusions depend only on ordinal value.

42. Edwards [1996], 176.

43. Note that the decision to speculate in this case is actually a conservative risk minimization strategy.

44. Anglade and Fortin eds. [1985], 223; Ladman [1986], 37.

45. Henning [1994], 178.

46. Henning [1994], 178.

47. Henning [1994], 179.

48. Edwards and Fischer [1994], 221–223.

49. Kessler [1998], 36.

3

Policy Choice or State Autonomy?

Financial Liberalization In Mexico and South Korea

This book has, thus far, analyzed the political process which generated financial liberalization in Mexico, based on the premise that the consequences of financial liberalization are integrally tied to, and cannot be understood apart from scrutinizing, the process by which such policies come about. Financial liberalization policies in Mexico came about both because it became too costly for the weakened Mexican state to maintain financial heterodoxy, and because newly empowered agents (private financiers) stood to benefit from financial liberalization. But financial liberalization has proven more successful in other contexts. The purpose of this chapter is to determine under which conditions financial liberalization is more or less likely to be successful by comparing an apparently successful case, South Korean (hereafter referred to as Korea), with a less successful one, namely Mexico. This chapter's comparison of Korean and Mexican financial liberalization in the 1980s underscores the benefits of gradual financial liberalization with the government in control over financial liberalization with the government ceding control to private financiers more quickly. This is especially the case where financial–industrial conglomerates dominate the domestic market, as Mexican *grupos* and Korean *chaebol* do. Although the Korean economy has more recently experienced the consequences of financial sector oligopolization and inefficiency, it did manage to put off these consequences for the better part of a decade. While the Mexican economy was devastated throughout the 1980s, the Korean economy grew rapidly with little or no increase in levels of inequality. One factor that differentiated these economies was state capacity and autonomy, which enabled the Koreans to control the *chaebol* in a way that the Mexican state could not with respect to the *grupos*.

At first glance, the Korean case seems to imply a lack of generalizability to the findings presented for Mexico. Chapter 1 argued that the structural shift in the financial system from a state-led to a bank-led system caused the policymaking shift from heterodox to orthodox financial policies. That chapter also proposed that state-led finance provided a basis for Mexico's extraordinary economic performance in the miracle years (1940–1960), while the economic downturn and financial crisis in the post–1980 period was a predictable result of the shift toward bank-led finance and financial liberalization. Viewed within a larger comparative framework, these arguments are problematic for several reasons. First, the argument for Mexico's adoption of financial liberalization was based solely on domestic variables: the decline of state autonomy in the financial sphere, and the simultaneous rise of bankers' hegemony. This implies that financial liberalization simply represents the outcome of a political struggle between self-interested bankers and state officials who presumably represent a version of the 'national interest.' This approach fails to address the worldwide trend toward financial liberalization during the 1980s, when virtually all Asian countries adopted some version of financial liberalization, as did Chile, Argentina, Indonesia, Turkey, and Israel.[1] The second problem is that the characterization of financial liberalization in Mexico presupposed to a certain degree the ill-effects of financial liberalization on the economy. In other words, the context of bank-leadership doomed the financial policy to fail from the outset. While this domestic structures approach explains the Mexican case, it fails to explain the mixed record of financial liberalization policies among other NICs, particularly Asian NICs such as Korea.

However, these apparent inconsistencies are actually consistent with the basic hypothesis offered in chapter one, that state autonomy is a necessary element for any policy, whether orthodox or heterodox, to be successful. Yet this is not a state interventionism versus the evils of the free market type of argument. The declining ability of the Mexican state to direct finance, together with the increasing power of societal actors (financiers) in relation to the state, as well as in relation to other societal actors (industrialists), first made heterodox financial policies untenable and later made financial orthodoxy untenable as well. And, in contrast, we shall see that the Korean state at the inception of the liberalization process possessed considerably more autonomy than did the Mexican state. This argument rests more on the particular structural characteristics of the state and the market, than on some notion that either is better suited in the abstract to make economic decisions. With respect to political structure, the state should have the capacity to pursue a policy path that approximates the "national interest" rather than one that attempts to satisfy narrower sectoral interests, thus falling prey to rent-seeking and

cronyism. With respect to market structure, the financial market should be relatively competitive so that market actors face incentives to invest that are compatible with overall economic growth and long-term stability. Both in Mexico and in Korea, financial market structures have not satisfied this criterion, making it difficult to claim that any move away from state intervention toward free market policies will automatically increase efficiency. By the same token, the claim that Korean interventionism with respect to financial policy has benefited the Korean economy rests on the fact that state policy was formulated so that it did overlap with the "national interest" and remained relatively insulated from monopolistic market influence, rather than on the assumption that states know better than markets.[2]

Yet if Mexico liberalized because it had to out of policymaking weakness, the Korean state, with its policymaking autonomy, seemingly had the ability to choose. Why then did it choose financial reform? In fact, why have most newly industrialized countries engaged in some degree of financial liberalization? One might be tempted to attribute the liberalization trend to pressure from international financial organizations and powerful developed countries. The challenge of this chapter is to explain why the worldwide trend toward financial liberalization does not necessarily negate the argument that Mexico engaged in financial liberalization because of declining state autonomy, and not only because of international pressure.

There is little question but that Korea faced tremendous international pressure to liberalize domestic financial markets, as did Mexico. In 1979, no doubt partially in response to such pressure, Korea initiated financial de-regulation.[3] Indeed, Korea is only one of a number of NICs in which the state had previously exercised considerable control over the allocation of credit in order to achieve political and economic goals. It is extraordinary how many of these states embarked upon a program of financial liberalization during the 1980s, especially given the advantages enjoyed by countries with state-led financial systems in earlier periods. For example, Mexico entered the ranks of the NICs with the help of state-led finance, as did Korea, Taiwan and Brazil. Japan and France also enjoyed tremendous growth coincident with the height of state-led finance. Loriaux and Woo-Cummings note two puzzling things about the financial liberalization trend among developing countries. First, they question the timing of this trend. Liberalization of financial markets began in earnest during the 1980s, following a period during which many of these countries had relied on state-directed finance as a key component of industrial policy to achieve impressive growth rates.[4] It was, in part, through its mediation of enormous amounts of capital that the Korean state had achieved its autonomy and its capacity to shape the market,

firms, and society at large.[5] Secondly, these reforms occurred in countries such as Mexico, and to some extent Korea, at a time of growing unemployment and, in the case of Mexico, economic crisis. In short, reforms were adopted when there was, at least politically, "a greater justification for state intervention than ever."[6]

An examination of Korea will demonstrate that financial liberalization was, in fact, a choice variable and not simply a response to declining state autonomy or international pressure. At the beginning of the liberalization process, policy loans (loans that the government ordered banks to extend) still accounted for more than half of domestic credit.[7] Because of this, banks held the government responsible for loans they had been ordered to make.[8] Hence, the risk of bad loans was borne not by banks but by the government, and ultimately by society. This explains, in part, the great enthusiasm for financial liberalization among government technocrats, who saw it as a way to reduce the burden of socializing risk where the state played the role of creditor.[9] Also, according to Korean policymakers, financial liberalization began in 1980 not because state-led industrial policy had been a success, and not because it had been a failure, but because its mission was largely complete.[10] They suggested that the economy had developed substantially, becoming more complex in the process. Within this more complex economy, the costs of massive intervention simply began to outweigh the benefits.[11]

In sharp contrast with Korea, Mexican financial liberalization has taken place within a context of declining state autonomy. Throughout the 1980s experience with liberalization, Mexican state managers were caught between external shocks, the demands of the international banking community, and rising political unrest, further eroding state autonomy.[12] Liberalization policies so severely undermined the PRI's alliance with the official labor movement that many observers began talking about a crisis of Mexican corporatism.[13] Since 1983, Mexico's growing commitment to economic liberalization and austerity programs has led to the almost total political exclusion of the more leftist wing of the party, which in 1988 organized an electoral opposition to the PRI.[14] Additionally, the PRI faced serious opposition from the political right in the form of the PAN, a party representing business interests in the political sphere. The PAN has mounted a two-pronged attack on the PRI government, linking criticism of government economic policy to calls for greater democratization. The PAN complained that state enterprises were not being sold off rapidly enough, and that austerity had been abandoned, evident in the government's failure to hold down state expenditures.[15] A clear sign of withering PRI political dominance was the 1983 electoral defeats when the opposition PAN party won seventeen municipalities in five states, including two state capitals.[16]

The erosion of state autonomy throughout the 1980s resulted in an increasing inability of the state to contain class conflict on a broader level, not just within the party context.[17] By 1983 there were signs that the labor and peasant sectors could no longer be so easily controlled by the PRI state apparatus. In June of 1983 alone there were more than 3,000 strikes, more than had occurred in the entire previous administration. In that same month, Fidel Velazquez, the leader of the official labor organization, the *Confederacion Trabajadores de Mexico* (Confederation of Mexican Workers), called for a general strike. Eventually, Valazquez backed down and the strike did not occur, but the threat was nevertheless a sign that the PRI was under attack from a sector which had traditionally supported it. In the rural sector, peasant organizations protested growing government repression and the government's policy bias toward big capitalist agriculture. Land invasions by peasant groups accelerated as well.[18] As the administration accelerated economic liberalization in 1987–1988, its ability to contain mounting political unrest continued to decline.

The Mexican government's legitimacy among the popular sectors declined in part because its revolutionary and nationalist credentials were damaged by the belief that government expenditure cutbacks and economic liberalization had worsened the plight of the poor majority. Liberalization, in addition to imposing hardships on the Mexican popular sector, also made the Mexican state look weak vis-à-vis the international financial community because liberalization was adopted as part of a joint IMF-U.S. rescue plan. The perception was that the Mexican state had been forced to engage in financial liberalization, which undermined government legitimacy, a key component of state autonomy and effectiveness. The Korean state, in contrast, managed to escape that perception and its repercussions.[19]

If Korea still possessed a relatively autonomous and effective state at the inception of financial liberalization, as compared with Mexico, how then can the loss of state autonomy explain the phenomenon of financial liberalization more generally? It would certainly be easier to privilege international pressure in the explanation of Mexico's and Korea's contemporaneous adoptions of financial liberalization policies. But this approach fails to capture the reality or the complexity of either case.[20] Rather, this paradox can be explained, at least in part, by the fact that the rhetoric coming out of the Korean state exaggerated the degree to which Korea liberalized its financial market. This exaggeration appears to have been a response to international pressure. In the actual implementation of policies, on the other hand, Korea found a way around following international prescriptions that policymakers did not considered to be in the country's best interest. This is not to minimize the extent of international

pressure on the Mexican state to liberalize, especially considering Mexico's proximity to the United States. But it makes more sense to think of Mexico's policy as a combination of external and internal imperatives, with the internal imperatives being a necessary condition. Moreover, the international pressure for financial liberalization has existed longer than Mexico's adoption of financial liberalization.

The Korean case also calls into question the deleterious effects of financial liberalization witnessed in the Mexican case, because the Korean economy fared relatively well through the initial stages of financial liberalization. Korea managed to pursue dual policy goals of growth-promotion and financial market stability throughout the financial liberalization process, which began in the early 1980s. From 1982–1992, Korean real GNP grew at a rate of 9.9 percent a year.[21] It was not until just prior to the Asian financial crisis of 1997 that the economy began to show signs of distress. The crisis and how it relates to the larger process of financial liberalization will be discussed at greater length in chapter five. In contrast, Mexico barely managed to maintain positive growth at a rate of 0.5 percent a year in the decade following the introduction of financial liberalization.[22] Korea's impressive growth performance was accompanied by a 10.8 percent real export growth, a 31.8 percent savings ratio, and an investment ratio of 32.1 percent.[23] Korea also managed to control inflation more effectively than Mexico. Whereas Korean inflation averaged 5 percent in the 1980s, down from 19.8 percent in the 1970s, Mexican inflation averaged 68.9 percent in the 1980s, up from 19.3 percent in the previous decade.[24] In short, Korea did not experience a trade-off between liberalization and economic growth during the 1980s in the way that Mexico did. Of course, eventually these policies did encourage the emergence of very large conglomerates in Korea, whose strength subsequently reduced both the government's leadership potential and the economic advantages derived from that leadership.[25]

Nevertheless, Korea achieved a substantial degree of financial market stability and deepening after 1980, whereas Mexico experienced a major banking crisis. Korea's financial deepening is evidenced by the rising ratio of M3 to GDP, which rose faster than the ratio of M2 to GDP, and by the increase in real deposit and savings rates during this same period.[26] One factor responsible for this deepening was that, in contrast to Mexico where financial repression and an infrequently adjusted exchange rate encouraged high levels of capital flight, Korean capital controls were extremely successful in preventing capital flight.[27] In fact, Korea (at least until 1997) did not experience any of the major instabilities associated with Mexican financial liberalization such as bankruptcy of financial intermediaries, undesirable shifts in bank portfolios, a large jump in real interest rates, or destabilizing capital flows.

If financial liberalization was successful in Korea, why not in Mexico? What is particularly striking about the Korean case is that it liberalized in such a way as to maintain state policymaking control.[28] The state's ability to maintain such control is due to several factors: (1) the gradual, partial, and, at times, illiberal nature of liberalization; (2) the state's explicit goal of tempering the power of big business; (3) the role of the state in the pre-reform period; (4) the state's privileging of the real economy over finance, including the sequencing of trade liberalization before financial liberalization and the explicit goal of introducing competition into the financial sector. All of these factors enabled the Korean state to liberalize within the confines of state autonomy, rather than bank leadership. As a result, Korean financial liberalization in the 1980s was remarkably successful in achieving economic policy goals.

Korean Financial Liberalization, or Not?

How can it be that the same policy—financial liberalization—has led to such disparate results in Mexico and Korea? One important reason is the very cautious, slow, and still ongoing nature of Korean liberalization.[29] In a sense, Mexico and Korea did not really pursue the same policies at all. The stated goals of Korean financial liberalization were to internationalize the financial sector, privatize banking, deregulate interest rates, and develop capital markets. All of these supposedly formed inseparable aspects of financial liberalization.[30] Yet Korea has in reality implemented only some of these financial reforms, and where it has liberalized, its approach has been gradual and halting and not necessarily along liberal lines. Even after the supposed shift toward more comprehensive financial liberalization in the mid–1980s, Korean economic goals were being achieved through government institutions rather than by exclusive reliance on the price mechanism. But if the state retained control over financial prices, in what sense was finance liberalized in Korea? As of the end of the 1980s, it really was not. However, state policymakers went to great lengths in order to make it look as if it were. They accomplished this by significantly reducing inflation and setting high real deposit rates that more closely approximated the market price, a *de facto* financial liberalization of sorts.[31]

The rhetoric of liberalization diverges so dramatically from actual policy because up until recently, virtually all bureaucrats in the Korean Ministry of Finance had been educated inside of Korea. Such bureaucrats consulted and possibly respected the importance of western economists' free market theories, but did not necessarily implement them.[32] Korean education borrowed both from process-oriented neoclassical economic philosophies and more goal-oriented approaches, reflecting the influ-

ences of Western economics and Japanese-style industrial policy. This explains, in part, the gap between what Korea's financial system is said to be and what it actually is.

Furthermore, Korean policymakers did not necessarily view financial liberalization versus state-led finance as a choice between economic efficiency and political viability. Korean policymakers had good reason to believe that financial policy which was embedded in industrial policy could continue to be economically efficient and actually consistent with a slowly diminishing role for state-led finance over time. Neoclassical economists have argued that as an economy grows more complex, industrial policy becomes more inefficient, so the price mechanism should be allowed to operate more freely.[33] On the other hand, Korea's financial reforms suggest that industrial policy can become easier to manage as an economy grows more complex, insofar as the number of new industries that must be promoted becomes smaller in relation to the stock of already existing industries, which can be left alone. The embeddedness of Korean finance in industrial policy has generally meant that the goal of freer markets has not been pursued as an end in itself. Financial reforms have operated in conjunction with a larger set of goals related to economic growth, international competitiveness, social welfare, and political stability.

There is also a societal-based reason for the apparent contradiction between word and deed in Korea's financial policy. Interest groups, both inside and outside Korea, have influenced the extent and nature of financial reform. Korea's big business groups, the *chaebol*, wanted the financial markets to be liberalized so that they could gain greater control over capital and investment. As was the case in Mexico, they found an ally in their desire for liberalization in the international financial community. At the same time, the *chaebol* wanted the financial system to remain protected insofar as it provided them with cheap credit. Industrial interests were not nearly so influential in Mexico. This conflict permeated all aspects of Korean financial policy, and partly accounted for the halting, half-way nature of reform.[34]

Despite the fact that Korean policymakers officially deregulated interest rates, they continued to control interest rate movements and the flow of capital. For example, in December 1988 the Korean Ministry of Finance gave up the authority to set interest rate ceilings and to allocate subsidized credit to specific borrowers. This event appears to have removed the most important policy tools of the state-led financial system. In practice, however, monetary authorities continued to cap interest rates—both in commercial banks and nonbank financial institutions—by relying on an informal type of regulation known as "window guidance." Under this system, a high official in the Ministry of Finance might call the president

of a bank in order to "advise" him on both deposit and loan rates.[35] Even though most commercial banks were privatized in the early 1980s, the Korean Ministry of Finance had several means at its disposal to make "window guidance" binding so as to continue its influence over banking decisions. One reason was that the government remained the biggest shareholder in many banks. But even where it was not, the state maintained effective control.[36] The government continued to exert influence over the officially denationalized banks in terms of personnel policies, appointment of senior managers, and range of services.[37] For example, in February 1991 the government appointed new presidents for five of the commercial banks, reminding top bank managers that they serve at government sufferance.[38] In Korea commercial banks have long been considered the handmaiden for the government and its industrial policies. This metaphor held for more than a decade after denationalization of the banks.

Another means by which the state maintained control over the credit market after liberalization was through special banks, which were created in order to provide longer term credit to meet the demands for funds from key industries which commercial banks alone could not adequately supply. The government directly supervised the operations of these banks, which made up 20 percent of the Korean financial market.[39] But even in the case of non-bank financial institutions, which had always been privately owned, the Ministry of Finance set limits on the amount of funds they could invest in various financial instruments, and regulated their size by deciding whether they could increase paid-in capital. Monetary officials also relied on the threat that they could order the superintendent of banks to investigate a financial institution for "irregularities." And finally, the Ministry of Finance governed the Bank of Korea, and therefore controlled the ability of non-bank financial institutions to refinance (through the Bank of Korea).[40]

Nor did Korea truly liberalize interest rates in 1988, when it was assumed to have done so. The evidence lies in the large gap between the secondary short-term government bond market rate (18.9 percent) and the loan interest rate of commercial banks (12.5 percent) in May 1989. Although non-bank financial institutions grew rapidly in the early 1980s, the Ministry of Finance continued to exercise control over the financial activities of private non-bank financial institutions even though these institutions were never state-owned, and are controlled by powerful individuals with money of their own. In practice, the Ministry of Finance acted to prevent non-bank financial institutions from setting their own interest rates, or acting in ways that might upset confidence in the financial system. Not only was repression of commercial bank interest rates maintained by the government to support financially troubled compa-

nies, but companies not in financial distress were forced to borrow from non-bank financial institutions.[41]

A comparison of government manipulation of reserve requirements before and after financial liberalization suggest little reduction in the use of this policy tool for the purposes of allocating credit. Recall from chapter one that the Mexican state had abandoned marginal reserve requirements for the purpose of allocating credit by 1980 (See Figures 1.4–1.6). In the late 1970s, Korea lowered reserve requirements from the 20–27 percent range to the 10–20 percent range and again to 5.5 percent in 1981, suggesting a definite liberalization trend. But then in 1989, they raised the requirement to 10 percent and introduced marginal reserve requirements for the first time, reversing the trend.[42] In the 1940s and 1950s, marginal reserve requirements had constituted a major interventionist policy tool for Mexican officials. The Koreans adopted this tool for the first time a decade after supposed financial liberalization.

The Korean state also did not allow banks and other financial institutions free reign to decide who to lend to, because officials believed that in the absence of government direction small- and medium-size enterprises would not get their fair share of credit.[43] The government set minimum quotas on the amount of credit that financial institutions allocated to such firms. The Korean state continued to practice a mix of heterodoxy and orthodoxy because of the fundamental belief that the abuses of big business could only be controlled by the discipline of government regulation. This view led to a complex development path in Korea that deviated significantly from the philosophy of "getting the prices right."[44] Through a mix of window guidance, administrative capacity, and interest rate manipulation, the Ministry of Finance retained control over the credit allocation process. Thus despite liberalization in the 1980s, the Korean government continued to provide subsidized credit to special customers up until the 1993 financial reforms, a clear sign that Korean state autonomy had not eroded to anywhere near the extent that the Mexican state's autonomy had. This is not to say that state policies did not serve to profit and empower the *chaebol* in the long-run. In fact, the close government–bank–*chaebol* ties would eventually become a major catalyst for the 1997 financial crisis, as the *chaebol* increasingly used these networks to accumulate huge sums of corporate debt. The principle here is not unlike regulatory "capture theory."

The flow of international capital would be the area where one might expect to find the most extensive liberalization, at least if one assumes that liberalization in Korea stemmed from international pressure. Foreign pressure to liberalize international financial flows have certainly affected Korean officials as well as Mexican officials. Yet despite foreign pressures, Korea placed liberalization of international financial flows last on

its agenda. It is significant that Korea failed to bow to foreign pressure in a policy arena where the pressure was greatest. The policy process for regulation of external capital flows followed a similar halting pattern to that of regulating domestic finance. Under conditions of current account surplus and excess liquidity, Korean officials relaxed controls on capital outflows. Yet even as this was taking place, they strengthened controls on capital inflows. In the late 1980s, the government prohibited firms from borrowing abroad and tightly controlled other foreign capital inflows, e.g., short run speculative funds. When the current account surplus turned out to be only half of what it was expected to be and the trade account returned to deficit in November 1989, controls on capital export were re-instituted. Thus, the liberalization of Korea's international financial transactions mirrors the halting, halfway spirit of its domestic financial liberalization; the freedom to export and import capital depended largely on the current account balance. According to one expert on Korean liberalization, there is a lesson to be learned from the Korean experience, namely that objectives have been achieved through institution building and not an exclusive reliance on market forces. He admits, however, that the Korean model cannot be easily replicated. Other countries would need to build effective institutions adapted to their own social, political, and economic environment in order to mirror Korean success. In the Korean experience, new institutions have been as likely to repress market forces as they have been to liberate market forces.[45] This has been especially true with respect to big business.

Keeping Big Business in Check

Controlling the excesses of big business was an explicit goal of the liberalization process in Korea. The state embarked upon liberalization in 1980 not with the idea of letting market forces reign freely, but rather with the idea of building new institutions between the state and big business that would serve to ensure economic control over big business irregularities and to prevent its dominance in the market. Korean officials saw liberalization as redefining the rules in order to continue meeting prudential objectives and prevent the exercise of cartel-like private market power.[46] Part of the long-term liberalization plan was to restrict big business's privileged access to policy loans and their oligopolized production in the market.[47] The reform-oriented officials firmly believed that economic liberalization would not be successful without preventing further business concentration. State control over big business served not only the state's economic goals but also its political goals. The Chun regime (1981–88) put an emphasis on the political goal of the "welfare and justice society" against the previous regime's collusive state–big business ruling

coalition, thus pinning the new regime's legitimacy on its ability to control big business.[48]

Recall that towards the end of state-led finance in Mexico, the state was facing considerable challenge from financial–industrial groups as the state continued attempts to direct finance toward long-term industrial investment. In contrast, the Korean government, at least until very recently, managed to contain the growing power of Korean *chaebol*. The representatives of big business were contacted for information as the state formulated policy, but their influence remained "negligible."[49] According to one observer, "while the characteristics of light manufacturing helped make the Korean state strong and flexible, they hobbled business and labor."[50] This has been a result of both recent government policy and historical circumstances. Japanese colonialism weakened the legitimacy of the traditional ruling class, and land reform weakened the landlord class in Korea, which allowed the state to retain considerable leverage over the capitalist class.[51] This meant that the political influence of big business has continued to be limited, especially as compared with its economic influence.[52] During Korea's industrial push, the state and the market formed a successful partnership, but by no means were they equal partners. The state, as senior partner, provided big business with leadership.[53]

After 1980, the state took measures specifically aimed at combating *chaebol* power. The Monopoly Regulation and Fair Trade Law went into effect in April 1981 as a part of the liberalization process. No such antimonopoly law accompanied Mexican liberalization. The Korean government also appointed a Fair Trade Commission to oversee the enforcement of the new law.[54] In its first seven years, the Fair Trade Commission engaged in nearly 3,000 "corrective actions." At least half of these dealt with unfair trade practices or collusion and abuse of dominant position.[55] In 1984, to control excessive concentration of credit, the Korean government set an upper limit on the total amount of credit each *chaebol* group could receive. Some groups were prohibited from establishing or acquiring additional businesses, receiving loan guarantees, purchasing stocks of other companies, or acquiring non-business related real estate.[56]

The state also promoted stock market growth as a means of diffusing the wealth of the *chaebol* through greater public ownership. This strategy met with considerable success as total capital market value grew from 6.9 percent of GNP in 1980 to 56.6 percent of GNP in 1988.[57] Since the revision of capital market laws in 1987, the outstanding capital value of stocks and bonds has increased substantially.[58] The Korean government intervened on both the supply and demand sides to deepen the stock exchange. The Ministry of Finance herded big companies into the capital market as suppliers of stocks and bonds by preventing them from bor-

rowing overseas. It also prevented business groups from evading debt-equity ceilings through cross-holding stocks in affiliated companies. Such ceilings represented a far reaching form of government intervention in the market by international standards.[59] Clearly, insofar as the domestic financial system was concerned, Korea financial liberalization fell far short of liberal. It is difficult to separate the illiberal nature of reforms from the government's ability to control monopoly capital as these first two sections have illustrated. Both phenomena, in fact, appear to derive from the same source—state capacity—which will be examined next.

Industrial Policy in the Pre-liberalization Period

While both the Korean and the Mexican economies could be characterized as state-led, only the Korean could be characterized as state-led finance within the context of a comprehensive industrial policy. In other words, the Korean state possessed certain capabilities that the Mexican state never did. First, the Korean state had a sufficient tax base; the Mexican state did not. Second, the Korean state has tended to rule through a combination of social consensus and control, whereas the Mexican state has attempted to maintain political legitimacy through corporatist politics, which involved a mix of "carrots and sticks." By their very nature, corporatist politics are expensive and encourage rent-seeking behavior, limiting state policy in a way that consensus and control does not. On the other hand, the Korean bureaucracy was designed to be immune to demands from below.[60] Certainly one reason for this difference in relative insulation is the degree of political freedom, the Korean regime was a dictatorship, whereas the Mexican state could be defined as a semi-authoritarian one-party state. Third, the Korean government kept much tighter control over industrial conglomerates even in the pre-reform period than the Mexican state was able to. Korean general trading firms had no financial clout apart from the state because the *chaebol* groups did not own banks, whereas in Mexico *grupos* formed financial–industrial conglomerates that wedded financial and industrial capital. The Korean state was able to gain tremendous leverage over the *chaebol* by mediating the flow of capital in lieu of group-affiliated banks.[61] The *chaebol* in Korea were for all practical purposes private agencies with a public purpose. From the big push for industrialization until the 1980s, the Korean state intentionally blurred the distinction between public and private, using the *chaebol* as the cornerstone of the state's industrialization strategy.[62]

Throughout the 1960s and 1970s, the Korean state achieved its autonomy and its capacity to shape the market through its mediation of enormous amounts of capital.[63] Early on, the scarcity of capital forced firms to depend heavily on credit for productive investment. In the absence of ef-

fective capital markets, the state used its control over the banking system to channel domestic and foreign savings to selected industries or firms.[64] In fact, of all the Asian NICs, the Korean government exhibited the greatest amount of control over the allocation of domestic credit.[65]

The Korean state undertook what some have termed "a governed-market approach" by fundamentally reshaping the investment structure through a publicly owned banking system.[66] The state created a stable environment for long-term investment decisions through its control of several key parameters, including foreign exchange rates, interest rates, and aggregate demand. The banks, which remained publicly owned until 1980–1983, were the government's primary policy tool, allowing them to direct credit to strategic industries on a preferential basis.[67] As noted earlier, even after denationalization the banks continued to be under close government control and were still used for industrial targeting. Armed with this strategy, Korea sustained high levels of investment in the pre-liberalization period, averaging 26.5 percent of GDP between 1965–1980.[68]

The exceptional rates of industrial growth and restructuring in Korea suggest the presence of an active state, which played a positive role in supporting the industrialization process through policies which provided incentives to industries with export potential. What stands out, however, is not the level of government intervention but the purposes of that intervention, because the Mexican state also played an interventionist role. The Korean strategy involved more than just "picking winners." Rather, it required an interactive relationship between state policymakers and market actors that yielded concerted action between them.[69]

Industrial policy in Korea was characterized by widespread social consensus, which empowered the state with a great deal of policymaking legitimacy as it began financial liberalization. Korean state intervention in the pre-reform period was "market augmenting" in the sense that it reduced uncertainties and risks related to business, generated and disseminated information about opportunities, and inspired an attitude of expansion among the people.[70] The Mexican state did not enter into financial liberalization with anywhere near this degree of consensus.

In short, Korean state intervention in the pre-liberalization stage constituted part of a larger industrial policy which enjoyed social consensus. Mexican state-led finance did not. In Korea, government financial intervention did more than just steer credit toward the industrial sector, it also underwrote production during the learning process of new and potentially high growth industries.[71] This industrial policy testified to the strength of the Korean state. The Mexican state was capable of encouraging growth through the allocation of credit under state-led finance, but it never formu-

lated a coherent industrial policy, perhaps because it lacked the social consensus to support such a policy. Thus, as state autonomy eroded, the main impetus behind to financial liberalization in Mexico came from the frustration with ineffective and wasteful intervention and the belief, on the part of some state officials, that liberalization would raise allocative efficiency. Mexico chose to liberalize finance rather than face ineffective state intervention. Unfortunately, under these conditions liberalization does not usually result in a better allocation of credits. On the contrary, the urgency of financial liberalization in Mexico suggested underlying problems which were unlikely to disappear with financial reform.

Sequencing of Priorities: The Real Economy First

The differences between Korean and Mexican state capacity afforded Korea certain policy choices that were not available to Mexico. Korea chose to put the real economy first, both in the sequencing of reform and in its general approach to regulation. Korean policymakers could sequence trade reform before financial reform only within the context of gradualism.[72] Herein lies the major difference between Korean and Mexican state capacity. The word "gradual" has come into common usage among policymakers and economic scholars of East Asia.[73] For these scholars, gradualism constitutes a choice variable. This view may in fact be accurate for states that possess a relatively high degree of autonomy. Gradualism has certainly been the mantra of China, a very insulated state.[74] But the Chinese are not alone. Korean liberalization clearly embodies the gradualist philosophy, given that financial reform was initiated in 1979 but has only recently reached "full throttle."[75] Taiwanese authorities also adopted a strategy of "planned gradualism" to liberalize interest rate control, and liberalization of deposit rates has been carried out gradually in Japan as well.[76] Arguably, all of these countries have liberalized on their own terms, especially in comparison to Mexico. In fact, gradualism has not been a choice available for the Mexican state since the mid–1970s, just as gradualism has been less of a viable option for the former Soviet Union or Poland since 1989.[77] The problem more recently in Russia is one of credibility. The Russians have in fact slowed the pace of economic reform, more for internal political reasons than anything else. But gradualism in the hands of weak government leadership sends a negative signal to potential investors, as the virtual implosion of the Russian economy underscores. Economists have structured the policy debate as a choice between "big bang" policies and "gradualism," but in reality a state that lacks the capacity to formulate policy outside of the influence of private financial actors or lacks the capacity to enforce financial regulations may

not have any choice but to liberalize and let the cards fall where they will.[78]

There are several advantages to gradualism for states that possess the ability to choose such a path. According to Haggard, market actors are more likely to cooperate with policy reforms if they are made part of the debate, a process that is more likely to happen under gradualism.[79] The Korean case demonstrates the benefits of gradualism because the gradual nature of the reform process allowed the state to sequence trade liberalization before financial liberalization, and to introduce competitive forces into the financial sector.

Korean trade reform began in 1965, as it shifted from an import substitution to an export-led trade strategy. In the process, virtually all trade barriers were removed. Financial reform came later, whereas in Mexico the government liberalized trade simultaneously with finance. In Korea, the government strongly encouraged infant industries to begin exporting very early, exposing them to international competition.[80] In doing so, it not only built a thriving export manufacturing sector which contributed significantly to economic performance, but also insured that import-substitution would not become politically entrenched and challenge state reforms. Because the *chaebol* were exposed to international competition, they maintained a relatively high level of efficiency despite their massive size.[81] Most importantly, the export sector was kept separate from private finance, in that private banks were not allowed to buy up shares in export firms. Thus when financial liberalization was initiated, it did not encourage short-sighted growth-inhibiting behavior on the part of the *chaebol*, as it did on the part of Mexican *grupos*. Recall that Korean general trading firms had no financial clout apart from the state. And the *chaebol* groups possessed no banks that could back up trading firms.[82]

Between 1965 and 1980, Korea privileged the growth of the manufacturing sector over the growth of finance. In fact, after 1972 the growth of the banking system practically stopped while the real economy continued to grow at nearly 10 percent each year.[83] In Mexico, on the other hand, state officials adopted the goal of promoting private financial sector growth throughout the state-led period. Korean financial sector growth still lags behind that of the real economy, in part because of the dominance of government banking institutions.[84] In the late 1970s, the government chose to reduce the corporate debt burden at the expense of bankers.[85] In fact, some scholars have blamed the high inflation of the 1970s on government policies aimed at lending many firms out of difficulties. While Mexico also suffered from high inflation, the costs of financial crises have consistently been borne more heavily by the real economy than by banks.[86] In Korea, rather than becoming submerged by the troubled loans of commercial banks, the financial system has continued

to grow since 1980 by isolating the problems in the banks and permitting capital markets to increase the supply of funds at market interest rates to Korean firms for productive investment.[87]

In the 1980s, government officials promoted the capital market and non-bank financial institutions as competitors to the banking sector. They buttressed nonbank financial institutions such as insurance companies, securities houses, merchant banks, and investment firms. The government also set bank deposit rates lower than the capital market return.[88] Its policy of developing the stock market together with other favorable economic conditions supported an impressive rise in price-earnings ratios. Commercial and industrial enterprises began relying less on bank credit and more on loans from nonbank financial institutions' and direct financing in the capital market. By 1985, the share of banks in total corporate financing had dropped below 25 percent.[89] As a result, the Korean financial system became more, not less, competitive during the 1980s.[90] This phenomenon stands in sharp contrast to Mexican financial liberalization which promoted concentration and centralization of finance.

The Korean government emphasized gradualism in implementing its financial reform policies so that without abandoning government intervention, it could introduce competitive conditions into the financial sector and prevent the instability and rent-seeking associated with private non-bank finance.[91] Since the early 1970s, the government has sought to destroy the curb market, much of which has consisted of informal wholesale lending (by rich individuals) to meet the needs of big corporations for working capital. In this respect, Korean financial reform has actually increased regulation. The government also encouraged foreign banks to enter the Korean financial market. The number of foreign banks doing business in Korea has risen steadily throughout the 1980s, enhancing financial sector competition.[92] While promoting competition enabled the Korean state to maintain better control over the financial sector because it mitigated the ability of large banks to challenge state authority as they had in Mexico, this alone did not insure a successful transition to financial liberalization.

Korean government officials were acutely aware that financial liberalization, in the absence of a sound regulatory system, could encourage a particularly concentrated financial system in which a small number of financial enterprises were likely to be both politically and economically powerful.[93] This would be especially true if financial capital were wedded to industrial capital as was the case in Mexico. Furthermore, the weak financial position of concentrated banks actually enhanced the political leverage of the banking sector over the government.[94] Therefore, although Korea's financial liberalization program involved turning the banking institutions over to private ownership, it also attempted to pre-

vent the banks from being taken over by the large conglomerates that were heavily dependent on the banks for both loans and guarantees of foreign credits.[95]

In order to accomplish this task, the state shifted its focus from prohibitive to preventative policy measures. Before 1980, the government prohibited a myriad of financial practices. Since 1980, the Ministry of Finance has been more likely to prevent what it sees as threats to financial market stability such as inefficiency in the provision of financial services, speculation and financial instability, and foreign control of financial markets, especially capital markets.[96] One of the most important aspects of prevention involves prudential regulation. Recognizing that as economic deregulation of financial institutions proceeds, heightened safety-and-soundness regulation is necessary, and that financial liberalization will promote the provision of high quality financial services only when it is accompanied by a sound regulatory and supervisory system, Korean officials shifted their emphasis of supervision from monitoring routine operations to monitoring procedures of credit analysis, bank portfolios, and the enforcement of ratios.[97] The Korean state's ability to prevent threats to prudential banking contrasts sharply with the Mexican experience.

Korean attempts at promoting financial sector competition underscore the idea that market competitiveness cannot be taken as given. In those developing countries where bank-leadership has failed, financial markets as well as the markets for goods and services were highly oligopolistic and uncompetitive. By contrast, in countries where industrialists were encouraged and forced to compete in export markets, a similar financial system structure made a major contribution to industrialization.[98] German industrialization is a case in point, as is the Korean case of an outward-oriented development strategy.[99] One important aspect of competitive financial markets that encourages long-term lending is the availability of alternatives to bank finance for industrial firms. Since the early 1990s, Korean firms have increasingly replaced bank loans with issues of equity. In 1991, securities accounted for 55 percent of total financing compared with 27 percent as recently as 1987.[100] Even within the credit market, the sources of finance are fairly diversified. At the end of 1989, commercial banks held 29 percent of total assets of the financial sector, specialized banks 23 percent, and nonbank financial intermediaries 48 percent.[101] The degree of competition with which Korean banks must contend mitigates the extent of bank hegemony vis-à-vis industrialists. This is important because, in the end, when the state relaxes control, the economic health of the economy will depend on the characteristics of the private market that inherits control.[102]

TABLE 3.1 The Role of the State in the Financial Liberation Process

State Characteristics	Mexico	South Korea
Financial Reform Process	rapid/crisis induced	gradual/partial
State Control over Big Business	weak	strong
State's Role During High Growth Period	interventionist	developmental
Interventionist Priorities	financial sector development	export-led industrialization
Reform Sequence	finance before trade	trade before finance

Korean State Autonomy Declines

Thus far this chapter has described two sharply contrasting financial liberalization processes which are summarized in Table 3.1. While this contrast remained sharp through the 1980s, the Korean situation began to exhibit problems very similar to Mexico beginning in the 1990s.

The Korean state has now begun to experience a relative decline in state autonomy and increasing challenges to its authority from the private sector, as evidenced by the recent increase in financial profiteering by the *chaebol*.[103] Based on the rationale that concentrating resources on entrepreneurs with proven track records, and encouraging technological and organizational economies of scale would stimulate growth, the Korean government promoted the *chaebol*.[104] It did so in several ways. First, the Korean government aggressively intervened in various industries—automobiles, semi-conductors, telecommunications, and petrochemicals—while at the same time offering preferential credit. These policies encouraged the emergence of very large conglomerates whose strength subsequently reduced both the government's leadership potential and the economic advantages derived from that leadership.[105] Secondly, government-led industrial restructuring in Korea emphasized mergers rather than industrial exit or conversion. Troubled firms were mostly taken over by large business groups, which tended to delay needed adjustments and encourage greater concentration.[106] Lastly, despite the stated interest in promoting small business, the government's credit programs focused primarily on large enterprises.[107] This bias for size set in motion a dangerous tendency toward market concentration. Increasingly, *chaebol* firms have been able to use their easy access to bank loans to either keep small firms from entering the market or to squeeze out competitors through predatory pricing.[108]

The combined sales of the top ten *chaebol* now equal more than two-thirds of Korea's GNP.[109] The Korean industrial sector also exhibits significant concentration of credit. As early as 1983, 400 large firms (representing 137 different *chaebol*) claimed 69.6 percent of total bank loans. The 50 largest firms received 26.5 percent of all bank credit.[110] The *chaebol* in Korea began as a "private agency with a public purpose," but the system that the state had carefully orchestrated during the Big Push had begun to backfire by 1990.[111] One prominent observer of the Korean economy argues that the " . . . *chaebol*, whose growth the state initiated and fostered, have now become monsters that it can no longer control."[112] Also despite government efforts to prevent such an occurrence, government relaxation of controls over entry and ownership has led to the largest business groups dominating both the ownership of commercial banks and non-bank financial institutions. As a result, credit has become concentrated with the largest thirty business groups receiving over 70 percent of total short-term credit.[113]

The recent failure of government regulation to control high levels of business concentration have significantly reduced the legitimacy of the Korean government.[114] This loss of state autonomy is especially evident in the state's relationship with labor, a constituency that has traditionally been controlled and repressed by the state. From 1984–1986, Korea experienced increasing labor disputes for higher wages and protests against state managers and businessmen who restricted wages. In 1985 alone Korea experienced nearly 225 labor disputes.[115] In 1986, the Federation of Korean Trade Unions won the right to intervene in collective bargaining at the enterprise level, an unprecedented victory. Clearly, Korean state autonomy has begun to erode, although the state still appears to be at the helm.

So, while the maintenance of state autonomy throughout the liberalization period helped Korea to sustain impressive levels of economic performance, state-leadership alone is not enough to insure long-term stability. The problems currently facing the Korean economy point to the fact that *efficient* leadership is vital, and that perhaps the quality of state leadership in Korea is deteriorating. (The issue of what constitutes efficient leadership will be taken up in the next chapter). Yet even if one were to view the current Korean crisis as a consequence of failed state intervention, this does not alter the demonstrated benefits that accrued to the Korean economy over the past fifteen years due to the Korean state's ability to liberalize financial markets gradually within the context of state autonomy. There is no question that reform is urgently needed, especially reform aimed at introducing competition into the Korean export sector. But the need for reform is not what is interesting or surprising about the Korea case. Rather, what is notable is that Korea managed to put off finan-

cial crisis for fifteen years longer than Mexico. This achievement constitutes a real economic benefit in terms of productivity gains over that period, which are not diminished by current economic conditions. Likewise, Mexico's lost decade of the 1980s represents real productivity losses that cannot be recaptured.

Conclusion

This analysis has suggested the importance of state autonomy as an element of effective policymaking, regardless of policy orientation. The declining ability of the Mexican state to direct finance, together with the increasing power of societal actors (financiers) in relation to the state, as well as in relation to other societal actors (industrialists), first made heterodox financial policies untenable and later made financial orthodoxy untenable as well. In contrast, the Korean state possessed considerably more autonomy both during the pre-liberalization period and throughout the liberalization process itself. In Korea, financial liberalization constituted a policymaking choice and not simply a response to declining state autonomy or international pressure.

Moreover, financial liberalization ended up being a propitious choice for Korea, in part because the state could liberalize in such a way as to maintain state policymaking control.[116] This ability has been demonstrated in four key areas: (1) the gradual, partial, and, at times, illiberal nature of liberalization; (2) the tempering of big business power; (3) the nature of industrial policy in the pre-reform period; and (4) the privileging of the real economy over finance, as demonstrated in the sequencing of trade liberalization before financial liberalization, and the promotion of financial sector competition. All of these factors underscore the ability of the Korean state to liberalize within the confines of state autonomy, rather than bank leadership. As a result, Korean financial "liberalization" was remarkably successful in achieving economic policy goals early on. Inflation rates averaged less than 9 percent annually throughout the 1980s, while real GNP grew at an average of more than 8 percent annually.[117]

If there is one substantive policy prescription that comes out of this analysis, it is that developing economies should liberalize financial markets in the context of state-led finance, while the state still possesses relative autonomy from the emerging private sector. The state's main responsibility during the period of state-led finance is to promote efficient industrial growth under a segmented financial market, and to ensure the eventual competitiveness of the emerging financial sector, because a centralized and concentrated financial sector can doom an economy and become nearly impossible to regulate after the fact, as the Mexican case illustrates. This lesson applies to most developing economies, even though

the vast majority do not fit into the strong state model in the first place. State-led finance is still the most common financial structure among late developers, and it is even more important to introduce competition to curb the power of financial elites in countries with "weak" states.

There is always the danger that liberalization may lead to the capture of economic power by less accountable forces than state policymakers. The analytical dichotomy between "state" and "economy" can lead us to overlook the point that the same people or groups may have feet planted firmly on both sides of the divide, in which case a shrinkage of the state and an expansion of the private sector may further remove economic power formerly in the hands of the state from some degree of accountability. It may further erode a "center"—a cohesive organizational structure—where collective interests can be articulated and followed.[118] In the financial liberalization process, Korea seems to have avoided some of the complications that result from ownership concentration of major banks.[119] Whereas the Korean state maintained a tighter degree of control than the Mexican state throughout the first decade of the liberalization process, this does not mean that the same general processes have not been taking place, as Korea is starting to experience the same kinds of problems experienced by Mexico a decade ago.

This comparison between Mexico and Korea suggests two important insights concerning the politics of finance in developing countries. First, it supports the contention that the government played a positive role in achieving Korean industrial growth.[120] But the Mexican case makes clear that it is not only the choice of interventionist as opposed to free market policies that leads to success, but rather the capacity of the state to implement effective policy of any kind. The issue of effective leadership relates directly to the analysis in the next chapter.

Second, the analysis offered here suggests a common developmental trajectory from state-led to bank-led finance based on the concentration process that eventually seems to accompany financial liberalization. Cross-national data, comparing private versus public shares of the credit market over time, indicate that as countries become richer the credit allocation function of central banks becomes less important, and private banks become more important.[121] Also, private market firms, as opposed to state enterprises increasingly become the beneficiaries of bank credit as countries become richer.[122] But the data also suggest a step in the trajectory beyond bank-led finance toward market-led finance, as capital markets and other non-bank financial institutions flourish.[123] The recent Asian stock market crises underscore not only the increasing prominence of capital markets in newly industrializing economies, but also the vulnerability of the real economy to the movement of portfolio capital. This issue will be discussed at greater length in Chapter 5.

Notes

1. Tseng and Cooker [1991], 1; Bascom [1994], 1.
2. Shafer [1994], 45.
3. Dalla and Khatkhate [1996], 2.
4. Loriaux and Woo-Cummings [1993], 12.
5. Woo [1991], 148.
6. Loriaux and Woo-Cummings [1993], 12.
7. Nam [1994], 210.
8. Nam [1994], 209.
9. Woo [1991], 190, 192.
10. Woo [1991], 182.
11. Hughes [1988], 366.
12. Teichman [1992], 94.
13. Bensusan [1994]; Bizberg [1993].
14. Teichman [1992], 100.
15. Teichman [1992], 99.
16. Teichman [1992], 93.
17. Teichman [1992], 89.
18. Teichman [1992], 93.
19. Woo [1991], 182. In fact, Woo argues that the state's 'Big Push' ended "because it was a success and not because it was a failure."
20. Woo [1991], 178.
21. Fry [1996], 140.
22. Banuri [1991], 65.
23. Fry [1996], 140.
24. Banuri [1991], 65.
25. Wade [1990], 320–321.
26. Tseng and Cooker [1991], 5; Amsden and Euh [1993], 385.
27. Dalla and Khatkhate [1996], 9; Bascom [1994], 27.
28. Dalla and Khatkhate [1996], 2.
29. Nam [1994], 184.
30. Woo [1991], 192.
31. Woo [1991], 196; Bascom [1994], 35.
32. Amsden and Euh [1993], 379.
33. McKinnon [1980]
34. Amsden and Euh [1993], 380.
35. Amsden and Euh [1993], 381.
36. Lee [1993], 21.
37. Hughes [1988], 133.
38. Hughes [1988], 349.
39. Skully and Viksnins [1987], 104.
40. Dalla and Khatkhate [1996], 12.
41. Amsden and Euh [1993], 388.
42. Tseng and Cooker [1991], 39.
43. Woo [1991], 196.
44. Amsden and Euh [1993], 390.

45. Amsden and Euh [1993], 389.
46. Hughes [1988], 341.
47. Rhee [1994], 154.
48. Rhee [1994], 193.
49. Shafer [1994], 103.
50. Shafer [1994], 125.
51. Lee [1993], 17.
52. Haggard [1990].
53. Lee [1993], 35.
54. Gray [1991], 409.
55. Gray [1991], 424.
56. Lee [1993], 37.
57. Woo [1991], 201.
58. Tseng and Cooker [1991], 35.
59. Amsden and Euh [1993], 384.
60. Shafer [1994], 129.
61. Woo [1991], 150.
62. Woo [1991], 169.
63. Woo [1991], 148.
64. Lee [1993], 21.
65. Hughes [1988], 355.
66. Wade [1990].
67. Nam [1994], 186.
68. Wade [1990], 307.
69. Bradford [1994], 22.
70. Lee [1993], 25.
71. Teichman [1992], 10.
72. Harwood and Smith [1997], 3.
73. Sachs [1996].
74. Wang [1994], 186, states that " . . . [i]ncremental change was the hallmark of its goals, definitions and content..," referring to the reform process. See also, Rana, Pradumna, and Naved Hamid [1995], 73, 110.
75. Bascom [1994], 25; Dalla and Khatkhate [1996], 18.
76. Shea [1994], 4; Mieno [1990], 48.
77. Sachs [1996].
78. Sachs [1996].
79. Harwood and Smith [1997], 5.
80. Lee [1993], 25; Westphal [1984].
81. Lee [1993], 26.
82. Woo [1991], 150.
83. Cole and Slade [1991], 333.
84. Skully [1982], 164.
85. Bascom [1994], 26.
86. Hughes [1988], 137.
87. Cole and Slade [1991], 336.
88. Bascom [1994], 26.
89. Cho and Cole [1986].

90. Bascom [1994], 27.
91. Woo [1991], 165; Bascom [1994], 30.
92. Skully and Viksnins [1987], 105. In 1981 there were thirty-seven and by 1984 there were forty-eight.
93. Caprio, Atiyas, and Hanson [1994]; Vittas [1992]; Brock [1992].
94. Harwood and Smith [1997], 27.
95. Cole and Slade [1991], 335.
96. Amsden and Euh [1993], 381.
97. Tseng and Cooker [1991], 10; White [1997], 79.
98. Akyuz [1993], 24.
99. Dalla and Khatkhate [1996], 5.
100. Dalla and Khatkhate [1996], 19.
101. Tseng and Cooker [1991], 35.
102. Amsden and Euh [1993]. For that matter, it has been argued that state-led finance has actually become easier as markets have developed precisely because increased market competition means that less companies require state-directed finance. In short, both heterodox and orthodox policy work better under competitive market structure.
103. Lee [1993], 38.
104. Amsden [1989], 113.
105. Wade [1990], 320–321.
106. Nam [1994], 205.
107. Hughes [1988], 355.
108. Woo [1991], 173.
109. Amsden [1989], 113.
110. Woo [1991], 170.
111. Woo [1991], 169.
112. Lee [1993], 37.
113. Rhee [1994], 203.
114. Rhee [1994], 207.
115. Rhee [1994], 205.
116. Dalla and Khatkhate [1996], 2.
117. Haggard, Lee, and Maxfield [1993], 50.
118. Wade [1990], 370.
119. Nam [1994], 185.
120. Amsden [1989]; Johnson [1985]; Alam [1989].
121. Harwood and Smith [1997], 19.
122. Harwood and Smith [1997], 21.
123. Harwood and Smith [1997], 5.

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4

The Efficiency of Leadership and the Leadership of Efficiency

The Politics of Finance in Turkey, South Korea, Hong Kong, and Mexico

This chapter compares transitions to liberalization in four newly industrialized countries: Turkey, Korea, Hong Kong, and Mexico. These country cases have been chosen for several reasons. First, they all undertook financial reform in the 1980s. Second, they represent a wide range of outcomes in order to help explain why the transition to financial liberalization has resulted in high growth rates and a relatively equitable distribution of income in some countries like Korea and Hong Kong, while the same transition in countries like Mexico failed to mitigate the prolonged economic decline brought on by the international debt crisis of the 1980s. As we shall see, Turkey constitutes a middle outcome. Third, these countries also represent different degrees of state autonomy and capacity in order to continue the exploration of the relationship between state autonomy and financial transition begun in the previous chapter. The questions investigated in this chapter are a natural extension of the preceding chapter, which compared Mexican and Korean liberalization. That analysis suggested that policymaking autonomy (insulation from particularistic interests) and capacity (institutional and administrative) allowed the Korean state to successfully manage the transition to financial liberalization. The Mexican state, on the other hand, had become increasingly ineffective in its interventionism. Thus, financial liberalization constituted less of a choice variable for Mexican policymakers. Moreover, Mexico's implementation of financial liberalization was less successful than Korea's because state policy in general had become ineffectual. On the face of it, the previous chapter's conclusion suggests that strong interventionist states are necessary to manage the transition to financial liberalization

successfully. However, the addition to the analysis of Hong Kong and Turkey suggests a different interpretation.

This chapter will focus on the relationship between the market and the state, and specifically, on the context of policymaking leadership. Here leadership can be defined as, at a minimum, prudential regulation of the financial system, and more extensively, as the willingness and ability to lead the financial sector through severe crises, or potential crises. While such leadership is typically considered the domain of the state, this need not necessarily be the case. Moreover, the relationship between state and market actors may, in large part, determine the relative effectiveness of such leadership. Indeed, the relationship between state and market is of central importance in the study of newly industrializing countries because in most NICs, state and market actors tend not to adopt the traditional roles delineated in capitalist or planned economy models. Abstract economic models that advocate free market policies over state intervention as the best means to achieve economic growth fail to explain the diversity of economic outcomes—growth rates, distribution of income, price stability—among these mixed economies.[1] By the same token, political economy models that identify the developmental state as the key to economic success also fail to capture the diversity of successes and failures among interventionist and market-oriented states.[2]

This chapter begins with an examination of various duopoly models that generate two main hypotheses about financial markets in newly industrialized countries. First, duopoly models suggest that clearly defined and mutually accepted leader–follower roles among state and market actors influence economic performance to a much greater degree than whether an economy is led by an interventionist state or by free market forces. Second, clear leadership roles are not a sufficient condition for economic efficiency, or political stability. The source of dominance that gives the state, or the market, the ability to provide leadership must be a result of efficiency: The leader must at least be committed to maximizing national economic welfare, especially during periods of economic crisis. That is, free market leadership which results from monopolization of the market will not necessarily be more efficient than state interventionism. By the same token, state interventionist policy characterized by rent-seeking behavior might actually be less efficient than an economy dominated by a few financial-industrial conglomerate firms. As Krueger has put it, government failures may actually outweigh market failures.[3]

The four empirical cases—Turkey, Korea, Hong Kong, and Mexico—that follow the discussion of duopoly models substantially bear out these hypotheses. In Turkey, state leadership capable of supporting positive economic performance came about as a conscious effort, and only after multiple failures. In Korea, the state played a clear leadership role, keep-

ing a powerful business sector in check, from the very onset of industrialization. Thus, Korea represents one possible formula for success, strong state leadership. Hong Kong exhibits characteristics that are also compatible with success, where free market leadership and cooperative relations between the state and financial market actors supported high-growth and political stability. In contrast with all of these cases, Mexico contended with ambiguous leadership and inefficient market influence resulting in inconsistent economic performance and political instability.

What Duopoly Models Tell Us About States and Markets

In order to compare state-market relations among newly industrialized countries, it is necessary to define a desirable outcome and to distill the key variables that maximize the likelihood of achieving such outcomes. This chapter draws some inferences from economists' studies of industrial organization, and duopoly (two-firm) models in particular. Theoretical guidelines drawn from duopoly models, and tested against contrasting empirical cases provide a way to fruitfully measure or rank desirable outcomes and the conditions that are most likely to lead to such outcomes. In other words, this chapter offers a duopoly theory-informed model of state-market interaction in the financial policymaking arena, making use of some of the economic variables and conclusions contained in these models while enriching them with the knowledge of specific country and sector contexts. These models, summarized below, highlight the problems of cooperation and competition between firms, and will be applied to the context of states and markets.

There are several important conjectural variations of duopoly models. Cournot formalized the duopoly model in 1838.[4] He was able to predict the outcome of strategic interaction between two firms by making a simplifying assumption: that firm A assumes firm B will not change its choice of quantity in response to Firm A's own choice of quantity and visa-versa. The Cournot model, however, has been widely criticized as unrealistic because it assumes ignorance on the part of the players. In other words, the model may be accurate the first time through, but when the firms notice that there actually is a strategic response to their choice of quantity, they are likely to incorporate that knowledge and anticipate the reaction accordingly. The Stackelberg model represents exactly this type of improvement to Cournot's original duopoly model. In fact, it is the Stackelberg model and subsequent variations of Stackelberg that are most applicable to state-market collaboration in newly industrialized countries. Certainly for the purpose of modeling state-market collaboration, it would be a mistake to assume ignorance on the part of either party. However, before getting into the more complex models, it is im-

portant to lay out the strategic outcome of the Cournot model as well as one more model, Bertrand, which laid the groundwork for Stackelberg. Cournot predicts an outcome that lies in-between the competitive outcome and the monopolistic outcome: higher prices and lower output than under competition, and lower prices and higher output than under monopoly.

Bertrand, in 1883, criticized Cournot, contending that it was more realistic to assume that firms believe that their rivals will hold price, rather than quantity, constant.[5] This belief follows from the idea that firms are more likely to set price rather than quantity. Under the Bertrand variant of duopoly, each firm sets its price assuming that its rival will not change its price in reaction. Bertrand assumed that each firm would be motivated to cut its price slightly below the other, until price equaled marginal cost and there was no economic profit being earned. But again this model suffers from the assumption of ignorance, or at least shortsightedness, on the part of the players because in fact each firm does react by changing price slightly until it equals marginal cost. Bertrand's conjectural variation does, however, lead to a powerful result: competitive equilibrium. In short, the outcome in terms of price and quantity under the Bertrand model is exactly the same as the outcome under perfect competition.

The Stackelberg leader–follower model (1934) assumes that each firm has complete knowledge of the relations between it and its rivals in terms of profit and behavior protocol, leader or follower.[6] Note that this means one firm must be the leader and one must be the follower, and both firms must know which role they play and also know that the other firm knows which role they play. Under these conjectures, Stackelberg actually results in a more efficient outcome than Cournot, where the price charged is lower and the amount produced is higher than under Cournot's conjectures. The payoffs to each firm, however, are not symmetric. In fact, Stackelberg leadership arises when one Cournot firm recognizes that its rival is following a short-sighted reaction function; that firm (the leader) can then increase its profits at the expense of its rival by making use of its knowledge of its rival's reaction function.

The advantage of Stackelberg over Cournot and Bertrand is that it assumes full knowledge including full anticipation of the rival's best move. The disadvantage is that the existence of an equilibrium is highly dependent on the mutual knowledge and acceptance by each firm of who is the leader and who is the follower. If there exists a naturally dominant firm for some reason, then the Stackleberg outcome is quite believable, even likely. The Forcheimer variant of Stackelberg presents the case of a dominant firm with a competitive fringe. In this case, the configuration of the market predetermines who will be the leader and who will be the fol-

lower. Assuming for the moment that this is not the case, the leader–follower role might be determined by any number of established norms such as reputation and negotiating skill, or economic variables such as firm size and profitability. What Forcheimer makes clear is that the source of dominance does affect the quality of leadership and ultimately the sustainability of the outcome. As we will see, this is true for states and markets as well.

If the leader does not enjoy a natural source of dominance that implies some sort of comparative advantage in playing a leadership role, then the stability of the outcome depends on accurate guessing on the part of the players involved. If it is the case that each firm does not accurately guess whether the other will play follower or leader, one of several outcomes will result, not all of which tend toward equilibrium. First, each firm could assume the other will lead, in which case both firms will end up following. If this happens, the solution to the game is exactly the same as Cournot, because each firm does not anticipate a reaction to its move. The Cournot equilibrium that results here, however, is not sustainable because each firm will recognize that it has something to gain from being the leader once they see that their rival has played follower. In other words, both firms will be disappointed by the outcome of the game once they witness their rival's strategy. This could induce both to play leader next round, the effect of which will be discussed shortly. Another possibility is that one chooses follower and the other chooses leader by blind luck, in which case the Stackelberg equilibrium prevails. But we can probably discount this possibility, especially since the concern here is with the generalizabilty of the model for comparative purposes. The final possibility is that both firms assume the leadership role and fully anticipate the other's reaction, but each also assumes that the other is following. In this case, each firm would assume no reaction to its own change in price, but in fact a reaction exists. The result is that firms will engage in destructive competition (price wars) until prices are driven down to zero and one or both firms go out of business.

Duopoly models provide us with a range of possible outcomes which are difficult to rank from a normative standpoint: the cooperating or colluding oligopolists lead to a monopoly equilibrium, which is clearly sub-optimal; vigorously competing oligopolists, on the other hand, lead to price wars, which is also sub-optimal. The ambiguity over the desirability of cooperation versus competition in the strategic interaction between firms is similar to the ambiguity over the desirability of cooperation versus competition in the strategic interaction between the state and business.

The preceding discussion of duopoly models provides some useful insights into the issue of determining desirable outcomes in the study of

state-market relations, which is by no means unambiguous. Is full cooperation between the state and key market actors a desirable outcome? Perhaps this outcome maximizes GNP growth, just as full cooperation between oligopolists maximizes profits. However, this might exclude other constituencies, such as labor or indigenous farmers (in the case of the oligopolists, consumers) from the policymaking arena altogether. Surely such an undemocratic outcome cannot be considered optimal. On the other hand, a total lack of cooperation between state policymakers and key market actors might result in wasted resources as policymakers attempt to control powerful conglomerates, and powerful conglomerates spend resources in order to circumvent government policies. This result is analogous to destructive competition in the world of firms. Thus, the three basic duopoly models underscore the central issues involved in determining desirable outcomes within strategic relationships, such as that between states and market actors, in that they span the range of possible outcomes from the monopoly outcome, where both firms manage to "cooperate" in order to capture full monopoly profits which they split in some way, to the destructive competition outcome where each firm undercuts the other in turn until they both go out of business.

Clearly for economists concerned about efficiency the "cooperative" outcome, because it involves monopoly profits, less production, and higher prices than a competitive outcome, is less than ideal. The other end of the spectrum is certainly not optimal from a societal point of view. Under the destructive competition scenario, consumers get lower prices for a while. However, with both producers out of business, the consumer eventually faces the possibility of greater monopolization, or at least a lack of product choice. An excellent example of the phenomenon is the airlines industry. It seems that every time there is a fare war another airline files for bankruptcy. Airlines that had been able to compete on the basis of price get driven out of business (e.g., People's Express). Clearly a certain degree of cooperation, in order to avoid the destructive competition scenario, is desirable. In short, the optimal outcome in the relationship between duopolists as well as between states and markets is somewhere in between the competitive and the cooperative modes of interaction.

Many who have employed the game-theoretic model have borrowed the rather simplistic assumption that the cooperative outcome is the best outcome because it maximizes the return for each player. Przeworski and Limongi, however, make the point that the cooperative outcome between the state and business should by no means be considered unambiguously beneficial for society as a whole. They criticize the strong-state or developmental state theory which argues that a certain degree of repression and state collaboration with big business is necessary in order to promote

a successful industrial policy. Przeworski and Limongi contend that the desirability of collaboration between state and business depends on the character of the collaboration itself.[7]

In addition to suggesting which outcomes are sub-optimal, destructive competition and full cooperation, game theory—with its emphasis on sustainability—also sheds light on how to begin ranking outcomes in the policymaking arena. A sustainable outcome in a game-theoretic model implies a certain degree of stability. A solution is sustainable when all of the players involved are satisfied with their moves and the results they achieved by virtue of the strategy they played. Most importantly, satisfaction means that none of the players involved have an incentive to change their strategy. Ultimately, such a situation leads to a stable policymaking environment because future outcomes are predictable. Predictability fosters a conducive environment for investment which in turn promotes economic growth. Thus, if one were to attempt to model the policymaking environment within a game theoretic framework, one could think of a sustainable outcome, or equilibrium, as akin to political or policymaking stability. Then the simple fact that an equilibrium exists can be adopted as one way to judge the desirability of an outcome in the state-market game.

Figure 4.1, a two-by-two Prisoners' Dilemma, is a duopoly model applied to state-market relations with respect to leader and follower roles in the financial sector. In this Prisoners' Dilemma we see clearly that when the state plays leader and bankers follow (upper right), and also when the bankers play leader and the state follows (lower left), we get sustainable outcomes, or equilibria. However, when the state and bankers vie for leadership (upper left), the outcome is not sustainable because neither player will be satisfied with their strategy given the other player's move. This suggests that the mix of a powerful state and powerful banks in Mexico is at least partially to blame for Mexico's mixed economic performance following financial liberalization. It also provides some explanation for how both free market policies in Hong Kong, and state intervention in Korea and Turkey, could be compatible with strong economic performance.

Another lesson that should be drawn from duopoly models, especially the Forcheimer variant of Stackleberg, is that the mere presence of a dominant firm does not necessarily improve market performance. Rather, it depends on the source of dominance. If the source of dominance is based on efficiency (e.g., lower costs due to economies of scale) then the existence of a dominant firm improves market performance. Conversely, if the dominant firm exhibits inefficiencies and perhaps maintains its dominance by passing off costs in the form of negative externalities, then the market does not benefit from its presence. Similarly, the economic policy

		Bankers	
		Leader	**Follower**
The State	**Leader**	**Mexico** **a,a**	**Korea** **Turkey (post-1980)** **d,b**
	Follower	**Hong Kong** **b,d**	**c,c**

where $a < b < c < d$

The predicted equilibrium in the Korean case and in the Turkish case after 1980 is that the state plays leader and the bankers play follower, yielding a (d,b) payoff structure. For Hong Kong, the likely outcome is that the state plays follower and the bankers play leader resulting in a (b,d) payoff structure. In the Mexican case, the state plays the leader strategy and the bankers do as well, yielding a payoff structure of (a,a). Note that this strategy is not an equilibrium as neither player will be satisfied with the strategy they played given the other player's strategy. On the other hand, the Turkish and the Hong Kong outcomes constitute sustainable equilibria once they occur.

FIGURE 4.1 Two-by-two Prisoners' Dilemma: Modeling the Strategic Relationship Between the State and Bankers

that results from the strategic interaction between states and markets, and the degree to which it is welfare maximizing, may depend not just on whether state or market actors get their way. The outcome also depends on the goals of each side and the degree of compatibility between them. As we will see, the Turkish state increased leadership efficiency through consensus-building, or making the interests of state and market actors more compatible. The Mexican case, however, has lacked clear leadership as the state and bankers vie for financial policymaking leadership. Yet it is unclear whether either the rise of bankers' hegemony or a resurgence of state autonomy would necessarily have resulted in a successful outcome, because neither occurrence could guarantee efficient leadership. Bankers' hegemony constitutes effective leadership in Hong Kong where bankers' interests appear to be compatible with general, or economy-wide, welfare. But as we saw in Chapter 1, this has not been the case in Mexico. By the same token, state leadership must be based on an interest in economy-wide welfare. With the political challenges facing the

PRI in Mexico, the party leadership has demonstrated a tendency to put party dominance ahead of economic welfare. If both state and market face incentives that are compatible with general economic welfare, then it does not really matter whether bankers control the policymaking agenda, as is the case in Hong Kong. However, if bankers' desires with respect to economic policy are at odds with welfare-maximizing policies, then the desirability of bankers' hegemony is in question, likewise for state leadership.

Thus the application of duopoly models to the financial policymaking arena leads to two main hypotheses, which will be examined in light of four empirical case studies. First, clearly defined and mutually accepted leader–follower roles for state and market actors enhance economic performance. Second, among duopolistic firms, the source of leadership must be a result of efficiency. With respect to the relationship between the state and market actors, the leader must at least be committed to maximizing national economic welfare, which in practice means that the leader's economic interests should be incentive compatible with a broader definition of national economic interests, especially during periods of economic crisis and policymaking transitions.

In order to contextualize the duopoly model of state-market relations for specific country cases we need to identify the leader, determine the competitiveness and efficiency of the economic sector or government sector being analyzed, and assess the mutual beliefs held about leader and follower roles. A comparative analysis should also determine whether there is policymaking stability based on state-market collaboration, what the relative payoffs are to the state and the private economic sector, and how the outcome of state-market collaboration or competition affects market performance. In order to illustrate the variety of possible outcomes, this chapter analyzes four developing country cases, each exemplifying a different possible outcome. The Turkish case represents a shift from inefficient state-leadership toward more efficient and cooperative state leadership with recent high growth and relative stability. Korea stands as a model of relatively uncontested state-leadership at least through the early 1990s. Hong Kong typifies free market leadership, cooperative relations between the state and financial market actors, high-growth and relative political stability. The Mexican case exemplifies ambiguous leadership, inefficient market influence, inconsistent economic performance and political instability.

Turkey

In 1980, the Turkish economy exhibited major signs of distress with a –1.1 rate of GNP growth and a –6.4 percent rate of manufacturing growth. In

1990, just a decade later, Turkish economic performance compared favorably with virtually any other high growth economy as GNP growth exceeded 9 percent, and the manufacturing sector grew by 10 percent.[8] Economists have pointed to this recent Turkish success and heralded the shift to export promotion as the key element of that success:

> Turkey . . . [has] commanded the attention of the international donor and business communities for [its] energetic shift to an export-led growth strategy in the 1980s. Their success demonstrates that economies structured by long periods of import substitution are nonetheless capable of adapting to the rigors of international competition.[9]

But this is too simple an explanation, for it fails to consider that this shift represents far more than just a long-term economic strategy, but a political one as well. Nor should one be satisfied with the 'strong state' argument for Turkish success, because it overestimates the capabilities of the Turkish state to directly promote industrial development and stable growth. Rather, the Turkish case is an example of relative, but by no means absolute, state autonomy which allowed the state to adopt a strategy of shared leadership when state leadership failed.[10] But in order to do so the state first had to alter the political and economic context that made cooperation unlikely.

Some scholars have suggested that a successful transition to financial market orthodoxy requires the support of the industrial sector, and not just the financial sector. Such a transition

> requires action and leadership on the part of either industrialists, who, in the long-run, stand to benefit the most from the change, and/or state authorities. . . . Only a cohesive, vocal, and highly influential national bourgeoisie is likely to carry industrialization beyond relatively safe import substitution to the risky export-oriented stage.[11]

Clearly, good leadership and state-market cooperation is necessary in the transition from inward-oriented to outward-oriented industrialization strategies. Under such leadership, financial liberalization will also be more likely to produce desired outcomes in the real economy, such as stable and balanced growth. Given the reputation of the Turkish 'strong state' combined with years of failed economic policy, high inflation, and an inability to discipline a relatively powerful concentrated financial sector, one might be tempted to place Turkey in a category similar to Mexico.[12] Certainly Turkish financial conglomerates share some of the same characteristics of Mexican banks: they have been historically powerful and able to challenge policymaking reforms, and state policymakers and

powerful financial conglomerates, at least until the 1980s, engaged in a power struggle that resulted in a void of policymaking leadership. However, while significant similarities existed, the financial liberalization process in Turkey also differed from Mexico's in important ways.

Ambiguous Leadership and Market Challenges

The primary difference between Turkey and Mexico is that the Turkish state actively promoted the export sector as a means of enhancing political leverage as well as economic performance. A strong domestic export sector promised to serve as viable competition for the financial sector which had tended toward oligopolization and had supported financial policies that had been narrowly beneficial to the financial sector and the import-competing sector, but not to the economy as a whole. Leadership is crucial, but ineffective leadership may come in one of several form. It can come in the form of a state that attempts to, but cannot maintain, control over financial flows in such a way as to promote a coherent industrial policy through selective credit controls. This kind of policy in the hands of a state not well insulated from rent-seeking behavior can prove disastrous. But financial liberalization may also result in economic inefficiencies if the state is rivaled by a dominant private banking sector with narrow economic interests that resists prudential regulation. This kind of behavior, on the part of a concentrated and powerful banking sector, might be tempered in one of several ways. One is by a powerful industrial sector that is not completely dependent on bank finance. The Turkish export sector meets such a criterion because of its ability to earn foreign exchange. This, in turn, gives it political clout with the state which shares with it a common goal of maintaining a favorable balance of payments, in part because this will increase the state's autonomy vis-à-vis the IMF. Another source of political competition to rival a strong banking sector is a competitive and financially significant equities market. If firms have the option of financing investment by issuing equity rather than bank credit, banks must compete more vigorously for loans. Moreover, if they loan a significant amount to a thriving export manufacturing sector, bankers' financial horizons should expand significantly from short-term speculative investment to longer-term industrial investment because expectations about the profitability of export lending will continue to rise relative to expectations about more speculative investment. Recall from Chapter 2 that positive expectations about the good state of nature prevailing significantly altered the policy preferences of banks toward longer-term fixed capital investment.

While the record is somewhat mixed overall, the Turkish state has demonstrated considerable success in its attempt to promote a dynamic

and politically viable export manufacturing sector from virtually the ground up. Turkey had a very low share of trade in GDP until the late 1980s. The share of total exports in GNP rose from 3.5 percent in 1970 to 16 percent by 1987, due in part to the fact that the private export sector had become a privileged target of discretionary measures in shaping a new political coalition.[13] With textiles leading the way, earnings in the export sector have increased dramatically.

Early attempts to restructure trade, however, met with considerable resistence. In fact, state policies throughout the 1970s ultimately failed to promote exports. The first major attempt to promote exports came in 1970 with a dramatic devaluation aimed at fueling the economy by improving the foreign trade sector. The devaluation only served to infuriate the rest of the business sector because of the preeminence within the Turkish economy of import-substituting industries which depended heavily on imported machine tools. The positive effects of the devaluation with respect to increased competitiveness for exporters were dampened considerably because of the concessions that had to be made to the politically entrenched domestic manufacturing sector. Moreover, the strategy weakened the democratic government that had promoted it and led to a military coup in March 1971.[14] The second attempt came in 1973, when the state revoked private control over foreign trade and instituted an export price control authority.[15] But this attempt must also be considered a failure in that by the end of the 1970s, Turkey was experiencing a large external account deficit and high inflation. The private business sector publicly denounced the government's economic policies, which led to yet another military coup. Thus, the Turkish economy up through the 1970s was characterized by political instability and lack of coherent economic policy leadership. The political stalemate of the 1960s and 1970s made most policymaking difficult. In this polarized environment, the state was weakened considerably both because it lacked policymaking coherence and because few wanted to serve as part of an ineffectual state apparatus.

Cooperative Leadership

A 1980 coup that put Turgut Ozal, engineer and former World Banker, in charge of economic policy under a transitional government set the stage for a new more successful strategy. In 1983 Ozal, now prime minister, began to put forward the policies that would move Turkey toward export-led growth. This strategy of export promotion was accompanied by substantial deregulation of the domestic economy, and decreasing reliance on the protective tariff regime. But the key to success was Ozal's ability to "fashion a new coalition of interests out of the wreckage of the 1970s, one

that could sustain his economic policies politically."[16] A government ban on pre-coup parties and politicians allowed a significant re-organization of the governing coalition that brought business to the center under the Motherland Party. In short, Ozal remade the political context in which the necessary economic changes could take place.

Turkey modeled its export drive on that of South Korea by encouraging the establishment of trading companies, which were owned by the major private holding companies. In 1984, companies that had succeeded in exporting 30 million U.S. dollars worth of goods could apply to the central bank for subsidized export financing, receive foreign exchange from the Export Promotion Fund, apply for special import permits, and receive up to 6 percent of the value of exported goods as tax rebates. Having taken advantage of this program, about thirty export houses had come to dominate the field, and their share of total exports had risen from 6 percent in 1980, to 46 percent or about $5.5 billion, by 1988.[17] This certainly suggests that the Turkish state had succeeded in fostering a powerful export manufacturing sector.

It is important to recognize, however, that more than an economic success, Turkish export promotion constituted a successful *political* strategy on the part of the state to create a coalition around the principle of shared leadership to promote growth. Because the old entrenched import-competing industries presented a challenge to any broad-based long-term growth strategy, the state could not form a viable partnership with them. But neither could the government afford to ignore the political weight of that sector. Instead the government chose to strengthen a potential ally in the incipient export-producing sector. The Turkish government financed the export sector to the clear advantage of the private owners, but with an eye toward creating a state-business partnership. They built this partnership in part through joint ownership. The number of companies in which the government had a minority position increased from 72 in 1962 to 306 in 1988. This proprietary relationship promoted a coincidence of interests between the state and the emerging export sector. Turkey's extra-ordinary export performance is evidence that the relationship has paid off. But the relationship has also worked to the benefit of Turkish exporters. In the 1990s, manufactured goods exporters were the primary recipients of government resources in the form of subsidies, tax breaks, and exporting licenses.[18]

The relative success of state-business cooperation appears even more striking when contrasted with the relative lack of state leadership in late 1970s. Because of political instability, the Turkish state not only lacked the capability to provide clear leadership, it also lacked the ability to respond effectively to economic crises. Ineffectual state policy leadership in response to the external shocks of the mid–1970s led to stagnant aggre-

gate growth, high inflation rates, and political instability.[19] Not only had the high degree of political instability—three military interventions in 1960, 1971, and 1980—left economic policymakers incapable of responding effectively to accelerating inflation, balance of payments crises, and declining GNP growth, these conditions together with chronic foreign exchange crises, in turn, exacerbated the already mounting political crises.[20] The performance of the Turkish economy certainly bore out these underlying political obstacles. With each new political crisis came, according to Öniş, "a pronounced loss of state autonomy. . . . The progressive fragmentation and the heavy politicization of bureaucracy constituted another striking aspect of the decline in state autonomy."[21]

By 1980, Turkish policymakers realized that the resumption of growth would require a decisive change in development strategy toward higher export orientation and more efficient import substitution. The policy package that was implemented in early 1980 signified a determined political effort to set in motion government actions and market forces to curb hyperinflation, and to initiate a more open development process.[22] The adoption of a flexible exchange rate policy was a cornerstone of the new policy package, and during the 1980s, Turkey witnessed an unprecedented export boom by international and domestic standards whereby total exports rose rapidly from $2.9 billion in 1980 to $11.7 billion by the end of 1988.[23]

Financial liberalization in Turkey, in sharp contrast to Mexico, was accompanied by an increased regulatory vigilance and a refusal to relinquish state control. The liberalization process, which can be described as halting, resembles the Korean experience more than the Mexican experience. Although Turkey embarked upon financial liberalization in the early 1980s, it did not abandon interest rate ceilings until 1988, it continued to force banks to finance the government deficit until at least 1985, and it increased regulatory vigilance during the reform process.[24] Banks were required to submit quarterly financial statements to a Bank Supervision unit that was established in 1986 as part of the central bank to carry out off-site audits.[25] Turkey did not enter the final stage of financial reform until 1988–1989, with the liberalization of capital movements and exchange rates.[26] This a full decade after the reform process had begun. This suggests that to the extent that Turkey did adopt financial liberalization in the 1980s, it did so without much loss of state autonomy, because remarkably little actually changed in the structure and depth of state economic intervention.[27]

The relative power relationship between the private financial sector and state policymakers throughout the financial liberalization process in Turkey shifted in the opposite direction as it did during the Mexican financial liberalization process. Whereas in Mexico financiers became in-

creasingly hegemonic and state autonomy declined, in Turkey public sector borrowing remained dominant all the way through 1990.[28] Therefore, despite various privatization and liberalization attempts, the role of the public sector did not wither in the post–1980 period.[29]

One way the government could maintain control over the financial liberalization process was by mitigating the moral hazard problem, and discouraging the concentration of finance. By law, the deposit insurance fund in Turkey cannot assist weak banks, and bank loans to a single customer are limited to no more than 10 percent of bank equity, which discourages concentration of risk.[30] Furthermore, the state attempted to introduce competitiveness into the investment finance market through a Capital Market Board, developed in 1983 to promote the securities market.[31]

More importantly, the weakening of financial conglomerates in Turkey stands in sharp contrast to the concentration and centralization trend during the liberalization process in Mexico. First, the Turkish banking system's response to the implementation of the financial liberalization program was generally considered to be quite accommodating.[32] Banks immediately adapted themselves to the new conditions by implementing a program of modernization.[33] Also, there was a marked decrease in concentration as measured by the share of the three largest banks in total assets, partly due to the continued dominance of Turkish state-owned banks.[34] Yet despite the decreasing concentration levels in the banking sector, banking profits were up the second half of the 1980s. Moreover, the differences in the profitability and patterns of growth of the various categories of banks indicate that small domestic commercial banks were the most dynamic elements in the banking system, again in sharp contrast with the Mexican experience.[35]

The dramatic and successful shift from import-substitution to export-led growth during the 1980s may have signaled a move toward orthodoxy in the trade regime (that is, toward greater openness), but it did not necessarily imply greater orthodoxy in the financial realm, at least in terms of a withdrawal of state intervention. In other words, the state maintained an explicit leadership role in the financial arena. The state intervened not by setting interest rate ceilings, but by mitigating the potentially adverse effects of interest rate liberalization through the promotion of a healthy corporate sector, in this case the export manufacturing sector.[36] Given the limited financial capacity of the state, when it proved difficult to create new capacity through greater allocation of investment to export industries, decision makers in Turkey opted for an intermediate strategy. They continued protecting certain politically entrenched import-substituting industries while increasing export promotion through large subsidies. Export incentives enabled the state to attain its develop-

mental targets most effectively in industries such as readywear clothing, where a strong intermediate organization acted to stabilize the incentive regime.[37] In this case, private organizational structure within an extremely competitive industry helped the state to forge a cooperative strategy based on efficiency.

Conclusion

Uncontested leadership necessary involves a cooperative relationship between state officials and key societal groups. In particular, market actors and state policymakers must agree on their respective leadership roles, refrain from rent-seeking and regulatory circumvention, and reach at least an implicit consensus over the economic policy path that is most likely to maximize economic welfare.[38] Turkey exemplifies the benefits of uncontested leadership and efficient leadership. Ironically, the Turkish 'strong state' of the 1970s and 1980s, similar to the Mexican state, did not possess the degree of autonomy or institutional capacity necessary to foster a successful industrial policy. Turkey could not be considered a developmental state capable of a Japanese- or even a Korean-style industrialization program. Indeed, attempts at state-led finance were a failure and the Turkish economy suffered from low growth, political instability, and run-away inflation early on, in part because although the Turkish state was powerful, its leadership was vigorously contested by a politically entrenched import-substituting manufacturing sector. The state's promotion of a viable export sector not only served to counteract the power of the domestic manufacturing sector, it also provided the state with a key ally with which it could cooperate based on a shared vision of Turkey's economic future. In short, a certain degree of state autonomy, used productively to promote competitive market leadership, transformed, and is still transforming, the Turkish economy from a virtual basket case into a "paragon of export-led growth."[39]

South Korea

Throughout the 1980's gradual transition to financial liberalization, the Korean economy grew rapidly with little or no increase in levels of inequality. One factor that differentiated the Korean economy from the chaotic Turkish economy, prior to 1980, was state capacity and autonomy, which enabled Korean policymakers to forge societal consensus and implement effective policies. As was discussed at length in Chapter 3, the Korean case also contrasts sharply with the Mexican case insofar as the Korean state managed to control the *chaebol,* while the Mexican state could not do the same with respect to the *grupos.*

Contested Leadership?

By most accounts, the Korean state was not significantly rivaled for policymaking leadership by the *chaebol* until the early 1990s. Since the period of early industrialization, there has been little doubt about who was at the helm. Korean state intervention in the pre-liberalization stage constituted part of a larger industrial policy which enjoyed social consensus. In Korea, government financial intervention did more than just steer credit toward the industrial sector, it also underwrote production during the learning process of new and potentially high growth industries.[40] This industrial policy testified to the strength of the Korean state.

The Korean state, even from the very beginning of the financial liberalization process, sought to reinforce its leadership position by controlling the excesses of big business. In fact, the liberalization plan restricted big business's privileged access to policy loans and their oligopolized production in the market.[41] The reform-oriented officials firmly believed that economic liberalization would not be successful without preventing further business concentration. As such, the Monopoly Regulation and Fair Trade Law went into effect in April 1981 as a part of the liberalization process. In the end, state officials were right. Korea's biggest challenge has, most recently, come from the dominance and inefficiency of financial–industrial groups. But although state autonomy has declined, the government still appears to have some capability to control the excesses of big business. Recently, under pressure from the government, Korean banks sought to force out of business 55 companies, most of which were affiliated with the countries biggest conglomerates, in order to speed up economic reform.[42]

Efficiency of Leadership

The market-conforming character of Asian style state interventionism exemplifies key aspects of a state-leadership model. The Korean state undertook what some have termed "a governed-market approach" by fundamentally reshaping the investment structure through a publicly owned banking system.[43] The state created a stable environment for long-term investment decisions through its control of several key parameters, including foreign exchange rates, interest rates, and aggregate demand. Korea sustained high levels of investment in the pre-liberalization period, averaging 26.5 percent of GDP between 1965–1980.[44] The banks were the government's primary policy tool, allowing them direct credit to strategic industries on a preferential basis.[45] Even after denationalization the banks continued to be under close government control and were still used for industrial targeting. The exceptional

rates of industrial growth and restructuring in Korea certainly suggest the presence of an active state, which played a positive role in supporting the industrialization process through policies which provided incentives to industries with export potential. But what stands out is not just the level of government intervention, but rather the purposes of that intervention. Korean state intervention in the pre-reform period was "market augmenting" in the sense that it reduced uncertainties and risks related to business, generated and disseminated information about opportunities, and inspired an attitude of expansion among the people.[46] The Korean strategy went beyond just "picking winners." It required concerted action between state policymakers and market actors.[47] In other words, it took leadership, just as concerted action between duopolists requires at least implicit leadership. In this case the leadership was much more explicit.

In addition to being market-conforming, Korean state policy contributed to economic performance by prioritizing the real economy, both in the sequencing of reform and in its general approach to regulation. Recall that Korean trade reform began in 1965, as it shifted from an import substitution to an export-led trade strategy. In the process, virtually all trade barriers were removed. The Korean government exposed infant industries to international competition very early.[48] In doing so, it not only built a thriving export manufacturing sector which contributed significantly to economic performance, but also insured that import-substitution would not become politically entrenched and challenge state reforms. Because the *chaebol* were exposed to international competition, they maintained a relatively high level of efficiency despite the degree of market concentration.[49] Most importantly, the state managed to minimize the degree of financial–industrial wedding of capital. Thus when financial liberalization was initiated, it did not encourage short-sighted growth-inhibiting behavior on the part of the *chaebol*. Also, the number of foreign banks doing business in Korea has risen steadily throughout the liberalization period, enhancing financial sector competition.[50] Korean attempts at promoting financial sector competition underscore the idea that market competitiveness cannot be taken as given. In those developing countries where bank-leadership has failed, financial markets as well as the markets for goods and services were highly oligopolistic and uncompetitive. By contrast, in countries where industrialists were encouraged and forced to compete in export markets, a similar financial system structure made a major contribution to industrialization.[51] German industrialization is a case in point, as is the Korean case of an outward-oriented development strategy.[52]

Conclusion

In sum, Korea up through the 1980s constitutes a classic case of strong state leadership in which state interventionism and reform were effectively lead by a capable and relatively autonomous state. What stands out is the purpose of state intervention and reform, to enhance economic growth through market-conforming means. In one sense, the case of Hong Kong, "a bastion of capitalist free enterprise," could not be more different from Korea. In another sense, these cases share important characteristics that ultimately determine success.

Hong Kong

Leadership in Hong Kong has similarly remained relatively constant. There is little question but that the state has not generally provided the market with leadership at least until the fall of 1998 when officials intervened in the stock market. In fact, it was not until 1985 as a consequence of several financial crises in the early 1980s, that the state became significantly involved in overhauling the system of prudential regulation. But in the absence of state leadership, the private market has shown a remarkable ability to play the leadership role by reassuring panicked depositors, and ensuring banking sector liquidity during potential banking crises, and at times, by allocating finance to a fledgling industrial sector. Under such leadership, Hong Kong sustained high levels of economic growth and low rates of inflation. During the 1970s and 1980s economic growth averaged 7.8 percent per year, and this despite a lack of natural resources.[53] The key to this success according to most free market advocates is the unfettered free market in action. Hong Kong has been perhaps the most open and least interventionist economy in the world, a "bastion of capitalist free enterprise."[54] Hong Kong has never even flirted with a mixed economy.[55] But this interpretation of Hong Kong's success is unsatisfying for several reasons. First, it makes little sense in light of the economic success experienced by the other Asian "tigers." These countries—South Korea, Taiwan, Thailand, Singapore—also grew rapidly for extended periods of time, only they did so under a state-interventionist financial market structure. Secondly, Hong Kong's economic success cannot be attributed to the economic efficiency of vigorous free-market competition. Rather, as with most of the Asian NICs, the local financial market is dominated by a few large institutions. The banking market of Hong Kong is highly concentrated, especially locally incorporated banks, with 95 percent of deposits in five banks.[56]

So while it is tempting to make the case that Hong Kong has had little in common with the other Asian NICs in terms of financial market structure, the evidence presented here suggests otherwise. What the Asian NICs have in common, in contrast with Mexico, is a degree of certainty of leadership, whether it be state leadership or bank leadership. Hong Kong finance has been dominated by large conglomerate banks since the beginning of its industrialization push. South Korea's, Taiwan's, Singapore's, and Thailand's financial markets were tightly controlled by the state from the beginning of industrial growth, and, at least in South Korea, throughout the period of financial liberalization. In each case, up until recently, the leader met with little resistance. This lack of resistance can be interpreted less as a sign of absolute power than as an indication that other market actors see the leader as credible, capable of maintaining an economic environment conducive to growth. What is special about the case of Hong Kong is not that unfettered market forces determine economic outcomes, but that in the absence of a certain kind of state leadership, private market entities have stepped up to provide the public goods necessary to maintain financial market stability.

Bank Leadership

The most striking evidence of private leadership of the financial sector has been the role played by two commercial banks in particular, the Hong Kong Bank (also known as the Hong Kong and Shanghai Banking Corporation) and its subsidiary Hang Seng Bank. Both have performed certain central banking functions which in virtually all other countries are regarded as the preserve of nonprofit-making central banks or monetary authorities.[57] In Hong Kong, private banks fulfill most of the functions typically associated with even a relatively noninterventionist state, such as the United States. The Hong Kong Bank, the Hang Seng Bank, and as of January 1993, the Bank of China, control currency issue.[58] The Hong Kong Bank has, in fact, become the de facto central bank of Hong Kong.[59] Moreover, the banking sector has had direct access to the policy-making process through its presence on the Legislative Committee as appointed "Functional Representatives." In sum, the leading private banks in Hong Kong have played extremely important leadership roles both in the banking market and in the execution of monetary policy.

Within the banking market, private banks have controlled interest rates through a cartel arrangement which limits interest rate competition. The Hong Kong Association of Banks has the statutory power to enforce an interest rate cartel on all banks.[60] The Interest Rate Agreement circumscribes price competition in the form of offering higher deposit rates on bank deposits.[61] Thus, interest rates on domestic loans and deposits are

not determined by the market but by certain large, locally incorporated banks.[62] This system operates similarly to the way in which the United States Federal Reserve controls interest rates. The Fed sets the "best rate" at the discount windows and other banks usually follow suit. In Hong Kong, the Hong Kong Bank sets the best lending rate and other commercial lenders follow.[63] The Hong Kong Bank also engages in interest rate regulation. For example, in 1981 the Hong Kong Association of Banks reached an agreement that set a ceiling on interest rates paid by licensed banks on Hong Kong dollar deposits of less than HK$500,000 and of maturity less than fifteen months. This agreement known as the Interest Rate Rules, also prohibited the payment of interest on checking accounts. Interest rate liberalization did not begin until 1994 and even then only lifted ceilings on time deposits of exactly seven days.

It is important to note, however, that the role played by these commercial banks has not been the result of an overwhelming exercise of power in relation to the state. Bank leadership in Hong Kong is not the end result of a struggle for supremacy between state and market forces, as it has been in Mexico. On the contrary, Hong Kong has a highly insulated state with an internally cohesive economic decision-making structure.[64] The ideology guiding Hong Kong's development clearly differs from other NICs, but the political capacity of the government to implement its preferences places Hong Kong squarely in the East Asian pattern. In short, the state has actively pursued nonintervention out of a position of state autonomy not from a lack of it.[65] The absence of foreign exchange or capital controls has been described by scholars as "positive noninterventionism."[66] Hong Kong's secretary of finance, Haddon-Cave, characterized Hong Kong's approach to policymaking as "limited and *clearly defined* official intervention . . . [a] policy consciously and purposefully, taking advantage of the benefits [the government] does offer.[67] Another senior government official stated that "the Hong Kong Government does not really set out to make policies. It does not make policies: but it does react to situations."[68] The state has indeed reacted, but only once it has become clear that private banks could not deal adequately with a given situation. For example, after the 1965 bank run, the government instituted the 1967 Banking Ordinance and appointed a commissioner of banking, who exercised mostly oversight functions. The 1974 Securities Ordinance came into being under similar circumstances.[69] Finally, in response to a severe 1983 currency crisis, the government re-instituted a currency board that fixed the value of Hong Kong's currency to the U.S. dollar, and required note-issuing banks to back any new note issues with the dollar equivalent. Between 1974 and 1983, the Hong Kong currency had been allowed to float, which meant that private banks essentially set the money supply and credit.

Yet the instances of government reaction under dire circumstances remain relatively rare compared with the phenomenon of self-leadership within the banking community. The Hong Kong and Shanghai Banking Corporation, founded in 1865, showed its faith in Hong Kong's future by redeeming the unbacked currency issued during the Japanese occupation, at the not insignificant cost of 7 million pounds, and pumping more money into the economy. With this act, Hong Kong Bank became the principle banker of the government, and shared the prestige of bank of issue with the Chartered Bank. Both the Hong Kong Bank and the Chartered Bank helped lead the banking community by regulating interest rates through the Exchange Banks' Association and, when necessary, bailing out smaller banks threatened with bankruptcy.[70] The rescue of smaller banks underscores the degree of nongovernmental leadership that existed and continues to exist within the Hong Kong financial market.

More recently, clear leadership on the part of commercial banks has mitigated the costs associated with financial crises. In Hong Kong, there are no government guarantees against risk or failure in the deposit market, making private bank leadership necessary.[71] In early 1965, Hong Kong experienced runs on several local banks. At the time, banks notes had to be backed by silver as the Hong Kong dollar was pegged to the pound sterling. As depositors panicked and banks tried to reassure them, the resulting demand for bank notes caused the note issues of the note-issuing banks to increase sharply, which exacerbated fears that the supply of notes in Hong Kong might not prove sufficient. During this potential banking collapse, the trouble could have spread if the Chartered Bank had not bailed out lenders. It was not until 1967 that the government stepped in with a stronger ordinance aimed at avoiding future banking crises. As a result of the 1967 crisis, the government also stopped granting licenses for new bank charters. The prohibition was not lifted until 1978, when within fifteen months, 41 new banks, including major foreign banks, entered the market bringing the total banking community to 115 licensed banks and over 100 representative offices.[72] In the period from 1978 to 1986, 77 new banks opened, bringing the total to 148.[73] The lifting of the licencing moratorium constitutes the first stage of financial liberalization within the historically under-regulated Hong Kong financial market.

In September 1982 another banking crisis began with a run on Hang Lung Bank, which was suspected of high-risk exposure. While this prolonged crisis evolved from 1982 to 1986, total collapse was avoided several times due to the quick support actions of the leading private banks. These leading banks temporarily warded off a major panic by issuing statements of reassurance. On November 19 of the same year, two more

disclosures of financial difficulties threatened to destabilize the entire financial system. This time the Hong Kong and Shanghai Banking Corporation issued a statement pledging its support for what it characterized as "soundly-based and well-managed" deposit banks. [74] This action again temporarily averted a widespread financial crisis. Yet despite these actions, by early 1983 seven deposit-taking corporations had failed. These failures, in combination with the continuous depreciation of the Hong Kong dollar, created a mounting sense of apprehension about the soundness of the banking sector. [75] On June 17, 1985, the Hong Kong and Shanghai Banking Corporation and the Bank of China jointly extended a "substantial standby secured credit facility" to Ka Wah Bank, demonstrating both the degree of leadership and cooperation between Hong Kong's largest banks.[76] Nor was the exercise of leadership limited to credit guarantees. On September 8, 1986, the Standard Chartered bank, authorized by the banking commissioner, took over the administration of Hon Nin Bank, which had experienced liquidity problems due to loan defaults.[77]

During the 1982–1986 crisis, the Hong Kong government also stepped in to provide funds for insolvent banks, and even assumed temporary control of several banks. However, the government here again intervened as a last resort, and certainly did not become a leader in the crisis by choice.[78] In fact, some observers have cited the lack of government vigilance in the monetary and regulatory environment as the underlying cause of the crisis.[79] The financial crises of 1982–1986 did, in fact, lead to regulatory overhaul. The Banking Ordinance of 1986 now required regulators to inspect banking institutions' quality of ownership and management, capital adequacy, and liquidity profile, through a combination of on-site examinations and off-site reviews. As a result of this new level of regulatory vigilance, all locally incorporated institutions had attained the 8 percent capital adequacy ratio by the end of 1989.[80]

While there is no question that the state's reactions to prolonged financial crises have played an important role in improving the soundness of the Hong Kong financial system, the fact remains that the private sector in every major crisis situation took the lead to avoid disastrous consequences. The state, on the other hand, reacted to the crises only after the fact. Private bank leadership, and a high degree of cooperation among state and market actors in the implementation of prudential regulation, transformed Hong Kong banking from a system riddled with unsound practices including lending to interconnected entities, overexposed lending, and leveraged lending for speculative purposes, into a system that experts now view as "an effective, clean system."[81]

Private banks took the lead not just to mitigate the costs of financial crises, but also to promote industrial growth. The same banks that

stepped in to assuage depositors' fears during the financial crises of the 1960s and the 1980s also played an important role in fueling the industrialization push, just as the state did in other Asian NICs. In 1946, the Hong Kong and Shanghai Banking Corporation (then known as the Hong Kong Bank) issued "duress notes," which played a pivotal role in financing the recovery of the Hong Kong economy after World War II. It also began granting loans to experienced and reputable industrialists, many of whom were refugees from Shanghai with little capital of their own. It offered lines of credit to newer firms and managerial or technical assistance as needed. Many other banks soon followed suit, again underscoring the principle of leadership involved.[82] These actions transformed Hong Kong from a mere entrepot to an industrial economy by the early fifties and won the Bank widespread goodwill and a loyal following.[83] In sum, the banking system developed in the entrepot era facilitated and promoted the development of manufacturing industries in Hong Kong.[84]

In light of these developments, Hong Kong offers an important challenge to the proposition that successful export-led industrial growth demands state intervention. The Hong Kong government had little influence over the pattern of industry and trade.[85] Nevertheless, important functions that were carried out by the state in other NICs were undertaken in Hong Kong by highly developed commercial and banking establishments. These included long-term lending and even assistance in marketing and product design.[86]

Efficiency of Leadership

The evidence points clearly to the exercise of leadership on the part of Hong Kong's major commercial banks. Moreover, that leadership role does not appear to have been challenged to any significant degree by state policymakers. These facts constitute a necessary but not sufficient condition for a successful outcome if one views the relationship between the state and the market as similar to the case of duopolistic competition. One of the lessons drawn from the investigation of traditional duopoly models was that the source of leadership matters, but the relative efficiency of the private financial system also affects the quality of leadership, just as one would expect the bureaucratic efficiency of the state to affect industrial policy. To the extent that efficiency can be associated with vigorous—but not destructive—competition, Hong Kong appears to have enjoyed efficient leadership of the financial sector.[87] Hong Kong's banking sector is characterized by oligopolistic rather than atomistic competition.[88] However, any concentration at the top appears to have been compensated for by the continuous creation of new, small firms at the bottom, due primarily to ease of entry.[89]

Competition among banks, primarily aimed at acquiring more deposits, has been very intense in Hong Kong.[90] The shear number of banks (149) and deposit taking corporations (290) attests to the intensity of competition within Hong Kong's banking industry.[91] Foreign banks have always been free to enter the banking sector, creating intense competitive pressure in the domestic banking sector.[92] One only need compare the performance of Hong Kong finance to other highly competitive financial markets in order to recognize that this competition has, for the most part, not been of the destructive variety. For example, the Hong Kong banking sector outperformed its Singapore counterparts in almost all respects, including number of short- to medium-term loans extended, and degree of liquidity.[93]

Ironically, the intensification of competition has not been incompatible with the growing domination of the market by the Hong Kong and Shanghai Banking Corporation and the Bank of China Group. Nor does this dominance seem to be associated with increasing monopolistic inefficiencies. For example, the Bank of China Group improved banking competitiveness in 1979 when it began to play a more aggressive and innovative role in the Hong Kong financial market which had been dominated by the Hong Kong and Shanghai Banking Corporation. Most importantly, due to the degree of competition for customers, banks in Hong Kong have not been able to wield influence over nonfinancial enterprises in the way that banks have been able to in countries such as Mexico, or even Japan. According to one scholar,

> no matter how influential the [Hong Kong] banks are, they are far less pervasive than in Japan, where companies are usually deeply in debt to banks, or even most other capitalist countries. . . . The vast majority of local enterprises in all fields belong to their owners, who often have more than adequate collateral for smaller loans and seem to avoid large ones. In fact, a good number have almost no dealings of this sort with the banks.[94]

As compared with larger industrial enterprises, 88 percent of small industrial establishments are financed out of the entrepreneur's own savings, making them much less dependent on banks.[95] In fact, the vitality of competition, rather than being limited to the financial sector, encompasses the entire economy. According to a 1979 census, the ratio of employers to employees (including self-employed) was one to eight, a clear indicator of the exceptional vitality within the Hong Kong market.[96]

Although the Hong Kong domestic banking market is generally concentrated and dominated by large institutions, the international banking market is more competitive. As of 1986, Hong Kong ranked fourth in the world in having the largest number of foreign incorporated banks.[97]

Thus while local banks can obtain a monopolistic profit from operating in the local currency market, they must compete furiously in the international banking market.[98] Contrary to expectations, even Hong Kong's domestic banking sector appears to be relatively efficient. Despite the market power of Hong Kong's licensed banks in the domestic market, domestic deposit rates have not been insulated from the foreign reference rate, HIBOR.[99] That is, vigorous foreign competition has spilled over into the domestic market.

The growth of commercial banks in Hong Kong has been accompanied by a noticeable trend toward concentration.[100] Although Hong Kong has exhibited a trend towards "financial conglomerates" and commercial banks still dominate the financial services industry, banks have not encroached on the traditional preserves of other nonbank financial intermediaries, or even nonfinancial firms, in a way that seems to characterize many industrialized and industrializing countries.[101] In fact, the financial sector has become the most productive sector.[102]

Competition and dominance together constitute the cornerstone of financial market leadership in Hong Kong. Total domination of a certain type might lead to monopoly profit-taking to the detriment of the economy as a whole, whereas the absence of a hegemon in the financial sector leaves the industry without leadership and open to destructive competition. Hong Kong's dominant financial institutions—the Hong Kong and Shanghai Banking Group, the Bank of China Group, and the Standard Chartered Bank—constitute a hegemonic force in that they have demonstrated both the desire and the capacity to lead. The banking industry continues to be a central component of the Hong Kong financial markets. A 324 percent growth rate of bank assets from 1975–1982 illustrates the continuing dynamism of the banking sector.[103] Hong Kong has experienced considerable financial deepening with more people now relying on banks.[104] Many officials refer to the Hong Kong and Shanghai Banking Group as the all-powerful finance branch.[105] Reinforcing bank-leadership capacity is the Hong Kong Association of Banks, which formalizes the banking cartel through which leadership and control is exercised.[106] Hong Kong's leading banks alternate chairing the Hong Kong Association of Banks, reinforcing direct control over policy.[107] The ability to lead is reinforced by the vast financial resources that flow through Hong Kong's financial sector and ultimately through its dominant banks. The output of the banking and financial sector as of 1979 was equal to one-fifth of gross domestic product.[108] The Hong Kong and Shanghai Bank Group has also been a regular member of the Banking Advisory Committee, the Exchange Fund Advisory Committee, and the Executive Council, giving the bank direct access to the policymaking process at the highest level. [109] The desire to lead is evident in that the Hong Kong Association

of Banks has voiced specific goals. One explicit goal has been to foster a degree of centralization in the Hong Kong financial market in order to maintain a consistent value of money.[110]

In addition to the evidence of uncontested bank leadership in the Hong Kong financial sector, there is also evidence suggesting that bankers acted in such a way as to maximize general economic welfare because they faced incentives that were compatible with the interests of other important market actors. Usually, it is assumed that government entities are more likely to hold interests and policy goals that are compatible with general economic welfare. For example, it is often argued that government will be the most likely provider of public goods because government is usually assumed to represent the "public" interest. In contrast, sometimes private market actors face individual incentives that are not compatible with the "public" interest, or economy-wide economic welfare maximization. The logic here is similar to the situation where an externality exists or where the strategic situation can be modeled as a prisoners' dilemma. As was suggested in Chapters 1 and 2, Mexican financiers faced investment incentives that were incompatible with broader economic welfare. But, it need not necessarily be the case that government is the only entity that can and should represent broader social and economic goals. The structural and sectoral characteristics of the market, in combination with the structural characteristics of the state, can create an institutional environment that fosters private-sector leadership, as has been the case in Hong Kong. One reason is that Hong Kong's financial sector is export-oriented, and not heavily indebted to foreign lenders. The financial sector has also been emerging as a foreign exchange earner in its own right by directly exporting services to overseas business and institutions.[111] Indeed, there is a growing lack of distinction between local and foreign banks in Hong Kong. This has made the Hong Kong banking community a supporter of the currency board arrangement that has been in place since 1983, because it completely subordinates monetary policy to a stable and predictable exchange rate, a policy that has benefitted the exporters of financial services as well as industrial exporters.[112] In fact the Hong Kong Monetary Authority, which was established in April 1993 as part of the overhaul of the prudential regulatory system, states that "[w]ith the establishment of the Link to the U.S. dollar, the primary objective of monetary policy became the maintenance of the stability of the exchange rate."[113] Thus, private banks in Hong Kong have been effective leaders because they have shared a coincidence of interests with key market actors as well as government policymakers. Such leadership is evident in the Expot Credit Insurance Corporation (ECIC), an organization that serves to facilitate Hong Kong's trade by offering insurance policies for exporters against the risk of bad debt of

overseas buyers. This organization also provides firms with guarantees to obtain bank loans. During the fiscal year 1979–1980 about HK$3.5 billion worth of goods and services were insured by the ECIC.[114]

The case of Hong Kong illustrates most clearly that certainty of leadership and good leadership weighs much more heavily in the formula for economic success than whether the financial structure is state-led or bank-led. The Hong Kong case also underscores the fact that the state must perform certain oversight functions, because when it does not, financial crises are likely. Nevertheless, under most conditions private finance in Hong Kong has been seen by the state and other market actors as a credible leader, one capable of underpinning an economic environment conducive to growth. What is special about the case of Hong Kong is not that unfettered market forces determine economic outcomes, but that in the absence of a certain kind of state leadership, private market entities have stepped up to provide the leadership necessary to maintain financial market stability.

Mexico

In contrast to Turkey, Korea, and Hong Kong, the Mexican financial policymaking arena since 1980 has been dominated by two very powerful players—the state and private bankers—with different perceptions as to who leads. Contention rather than consensus has most often characterized the policymaking process. Moreover, the degree of cooperation between the PRI-dominated state, which has successfully held on to the presidency, and the very powerful financial elite has been tenuous, shifting from periods characterized by cooperation to periods of conflict.[115] Chapter 1 demonstrated the changing nature of state power in Mexico as state autonomy eroded. Throughout the 1980s experience with liberalization, Mexican state managers were caught between external shocks, the demands of the international banking community, and rising political unrest.[116] Whereas the period of state-leadership in the 1940s and 1950s benefitted from a coincidence of interests between the state and market actors, the period of rising bankers' hegemony exhibited a widening divergence of interests between financiers and general economic welfare. The Mexican case has been exceptional both for the active political role played by market actors, and for the extent of state intervention and one-party dominance.

Uncertain Leadership

As noted in Chapter 1, the PRI faced heightened challenges from the left in the 1980s, in part because government cutbacks in expenditure and

economic liberalization had worsened the impact on the poor majority, and produced greater foreign (that is, U.S.) influence in Mexican affairs. Liberalization, in addition to imposing hardships on the Mexican popular sector (this was not the only time in Mexican economic history that burden of adjustment fell disproportionately upon the masses), also made the Mexican state look weak vis-à-vis the international financial community. The perception was that the Mexican state was forced to engage in financial liberalization. As a result, the PRI faced challenges both from within and from outside the party structure. Tello, an influential member of the Democratic Tendency, and a key policymaking figure in the 1982 bank nationalization, led the call for an end to economic restructuring and liberalization. The PRI's liberalization package also came under attack from the right-winged, PAN, who accused the state of fostering a poor business environment.[117] The PAN's political rivalry with the PRI underscores the rivalry between the state and powerful market actors, especially financiers. In many NICs, there exists an implicit bargain between the state and domestic market actors, which allows the private sector to seek profits in the economic realm, subject to state regulation. But the private business sector is not usually granted any overt, legitimate role in formal politics.[118] In Mexico, in contrast with Turkey for example, this implicit understanding has not been observed. Since the 1930s the PAN in Mexico has openly championed business interests and has challenged the PRI in elections.[119] Thus, financial–industrial elites in Mexico have not only flexed their economic muscle, they have engaged in direct competition with the state for policymaking leadership.

Although the PRI has managed to hang on to official policymaking leadership, its ability to lead has eroded significantly since the early 1980s. This process was documented at length in Chapter 1. Nevertheless, the Mexican state has remained a formidable force which has by no means left the door open to uncontested leadership by financial–industrial elites. The Mexican state has existed more or less in its current form for the better part of the century. It is a "strong" state by comparative standards. Although Mexican bankers now dominate the financial sector, it remains unclear, especially to the participants, who leads with respect to financial policy: the state or Mexican financiers?

In the period between 1940 and 1960, the Mexican financial system could be considered unambiguously state-led. However, more recently the structure of Mexico's financial system has turned from one of state domination to one in which private-banks exercise increasing control. There are differences among scholars as to when to place the decline of state autonomy vis-à-vis financial elites. Gonzalez pointed to 1973 as the date when the business elite shifted from a defensive to an offensive position toward state policy.[120] Martinez Nava conducted a systematic

study of the secular decline in the state's relative autonomy and confirmed it for the period 1982–1988. According to him, "the state, it seems, had nurtured a progeny that would devour it."[121] For Cypher, it was in 1954–1955 when the underlying relationship between the state and private sector changed to one where the private sector exercised increased power.[122] Regardless of which date marked the beginning of the decline of state autonomy, the evidence overwhelmingly suggests that by 1980 a change in financial sector structural conditions had led to a decline in the relative autonomy of the Mexican state.[123]

One aspect of this structural shift involved a change in the physical presence of the state as a player in the banking sector. While the state, in theory, still possessed an ability to control finance through regulatory means, the reduced size of the state-owned financial sector relative to the private financial sector significantly reduced the state's policymaking effectiveness. Recall that private banks' share of financial sector resources rose steadily between 1982 and 1990 and accelerated thereafter (see Chapter 1). Much of this growth in the private-sector share of bank resources was driven by intensified state efforts to re-privatize nationalized banks starting almost immediately after the nationalization. Since 1986, Mexican privatization efforts have focused on banks that had been part of the private sector even prior to the 1982 bank nationalization. These privatization efforts underscore Mexico's trend toward bank leadership of the financial sector.

One manifestation of the banking elites' challenge to state dominance in the financial sphere was their ability to circumvent government financial regulation. By transferring and allocating funds from group-owned banks to other group-affiliated firms, financial groups increasingly avoided state oversight or central bank involvement in sector-specific credit allocation. Bankers could bypass selective credit controls by transferring funds unofficially rather than by making official loans that were subject to variable reserve requirements. This strategy on the part of financial–industrial conglomerates, reduced the state's ability to control the allocation of private financial sector credit. For example, between 1958 and 1964, within-group financing totaled 74.5 billion pesos and represented 87.4 percent of the financing of private sector gross fixed investment.[124] These transfers tended to benefit the banks that formed the nucleus of the Mexican *grupos*. Furthermore, integration of private financial networks promoted the transfer of resources through interbank lending, circumventing regulations that impinged to a greater extent upon certain types of financial institutions. By shifting funds between group-affiliates, resources could be concentrated on those institutions least subject to detailed regulation. Financial–industrial groups could evade government attempts to allocate credit through selective credit controls by using available funds for expenditure not sanctioned by monetary authorities

and then borrowing money from a group member to finance other investments.[125] Circumvention was made easier by the fact that financial–industrial groups could rely on intercompany loans as a means of bypassing financial regulation because these types of loans were completely unregulated.[126] In short, private financial institutions found it worthwhile to band together for the purposes of reducing competitive pressures, increasing banking-industry profits, and reducing the impact of financial regulation.[127]

Thus, private financiers were increasingly successful in their attempts to reduce the impact of financial regulation, at least since 1982. As the state's dependence on private capital increased, private bankers found themselves in a position to augment their political power which, in turn, they utilized to augment their economic status. The state's dependence on private financing put private bankers in a position to mediate between the state and international capital. This increased the power of private financiers to manipulate the financial regulatory system and to gain influence over policies that directly affected their own power base.[128]

In the Mexican case, beginning in the late 1950s and increasingly in the decades that followed, finance capital played a hegemonic role among other domestic elites as well. Camp's interview data describes two important characteristics of the business elite in general, and private bankers in particular. As noted earlier chapters, when business leaders were asked if they had ready access to the state, most responded that government officials were willing to hear their views. Moreover, when asked who benefitted the most from state policy, businessmen ranked bankers highest among private sector groups.[129]

The central role played by the private banking elite within the business community was based, in large part, on the imperatives of industrialization. Because the expansion of industries depended on the availability of credit, bankers progressively occupied a position of leadership within the business community.[130] The state's declining ability to finance industrialization augmented the already powerful position of financiers among economic elites. Another reason for business dependence on bank finance has been the relative underdevelopment of a competitive securities market in Mexico. In keeping with Zysman's definition of a bank-led financial system, the relative insignificance of Mexico's securities market for corporate finance required firms to seek funds as loans from banks. This process of credit allocation is a necessary element of a bank-led financial system.[131]

Bankers' Source of Dominance

Financial liberalization and the rise of bankers' hegemony could signal a shift in Mexico toward Hong Kong-style leadership, in which the private

banking sector provides adequate leadership and the state accepts an explicitly noninterventionist role. Although it is unlikely the Mexican state will be willing to play such a role any time soon, it is worth asking whether they should. The answer to that question depends on whether private finance in Mexico could, in fact, be an efficient leader. The purpose of this section is to examine the source of bankers' growing dominance (i.e., whether it is based on efficiency or monopolization), and the nature of bankers' preferences (i.e., whether these preferences are compatible with economy-wide welfare maximizing policies or whether they are based on narrow financial interests).

The primary source of financial sector dominance has been increasing concentration and centralization among Mexican *grupos*. The process of concentration was spurred by the development of multibanks and financial groups, the proliferation of speculative activity, and capital flight. The key element in the growth of multibanks, and the financial market concentration that accompanied it, was the ability of banks to form ownership ties with the industrial sector. The result—concentration of power in the hands of a few financiers—further enhanced bank hegemony. This concentration process is underscored both by the shrinking number of financial institutions, and by the concentration of resources within those institutions.[132]

Within a concentrated and centralized market structure such as Mexico's, private actors face incentives to engage in short-term speculative activities, which further contributes to market inefficiencies. Liquid-asset holders (financiers), who are in a position to profit from unrestricted capital movements because they can shift their investments quickly to take advantage of favorable changes in the economic climate or to avoid losses due to unfavorable changes, have systematically exploited the opportunities for profit under financial liberalization in Mexico, usually at the expense of the rest of the economy. The combination of decreased regulatory vigilance, extreme macroeconomic instability, and governmental fears of bank failures has induced a form of moral hazard in bank behavior. When financial markets are concentrated, bank profitability tends to be highly correlated. So that for example in Mexico after financial deregulation banks faced incentives to undertake very risky lending at very high real loan rates of interest because if macroeconomic conditions turned out to be good, the loans would be paid back and the banks would make extremely high profits, while if macroeconomic conditions turned out to be bad, defaults would be highly correlated among bank borrowers causing a breakdown in the whole banking sector. If this occurred, the monetary authority could be expected to bail out the banks because government officials would fear that the bankruptcy of one institution, due to shear size, would induce economy-wide financial panic.

Although government fears of a domino effect might be well founded, they nevertheless lead to policies that further induce private sector concentration and instability, since the existence of an implicit bailout allows financial enterprises to potentially earn enormous profits while facing little or no downside risk.

Moreover, as was argued Chapter 2, Mexican banks have profited at the expense of the long-term investment needs of the country as whole. One indication of this is the percentage of Mexican banking profits obtained from speculative activity in international capital markets. Fully 49 percent of bank profits in 1982 came from exchange operations.[133] In point of fact, the proportion of private investment dedicated to productive sectors declined seriously after 1965. From 1940 to 1965 it had risen steadily from an average of 2.7 percent to 6.3 percent of GNP. By 1970–1974, the proportion of private investment dedicated to productive sectors as a percentage of GNP had fallen to 4.5 percent, and to 4.2 percent by 1975–1978.[134] Most new funds that were channeled through the domestic financial market were either transferred abroad (capital flight) or used for luxury consumption.[135] The decline can be traced not only to the government's loss of control over sector-specific allocation of funds, but also to the increasing incentives for conglomerate banks, under a bank-led financial system structure, to take advantage of short-term financial investments.[136] Moreover, as Tello notes, "bank credit practices promoted bank interests and the interests of finance capital, while negatively affecting the financial system, intermediation, and economic production."[137]

From an efficiency standpoint, it is clear that bank practices under financial deregulation did not lead to appropriate market signals in the financial system. That is, circumvention of regulation and intra-group cronyism, as opposed to potential profitability and risk, appeared to be the primary criteria used by banks in making loans. The shift in financial policy from state intervention to financial liberalization, rather than constituting a shift from state administered investment decisions to free market signaling, instead resulted in conglomerate bank discretion. That discretion tended to favor group membership and speculative activity over long-term productivity. Thus, a policymaking environment that encouraged bank exchange operations and failed to control inflation was ultimately responsible for the speculation and capital flight problems experienced by the Mexican economy in the early 1980s.[138] This departure of financial resources, in turn, severely restricted the opportunities for productive investment.[139]

It seems clear, therefore, that Mexican financial conglomerates contributed to the destabilization of the financial system and economic system in general in the 1980s and reduced the growth potential of Mexican industry. In short, because Mexican banks have been relatively noncompeti-

TABLE 4.1 Four-Case Comparison of 1980s Financial Reform

	Hong Kong	South Korea	Turkey	Mexico
Leadership Roles	clear	clear	ambiguous ⟶ clearer	ambiguous
Leader	market	state	state/market partnership	power shared between state and market
Quality of Leadership	efficient	efficient	inefficient ⟶ efficient	inefficient
Economic Performance	strong	strong	weak ⟶ strong	weak

tive and consequently relatively inefficient, they have not constituted a viable alternative to state-leadership for the purpose of implementing and enforcing prudential bank regulation, nor for the purpose of facilitating a financial system that encourages long-term investment. On the other hand, the state has been unable to build a viable policymaking consensus with the private sector, as in Turkey, in order to ensure such leadership. The very recent emergence of the export sector in Mexico as a political force as well as the introduction of international competition in the domestic banking sector could suggest that Mexico is moving in that direction, but it has a long way to go. This possibility will be explored in the next chapter.

Conclusion

The four cases examined in this chapter, as with the duopoly models introduced at the outset, underscore the complexity of the policymaking process and the state-market relationships that produce these policies. The kind of predictability that comes from unambiguous leadership appears to be a key element in a successful growth promotion strategy.

Table 4.1 summarizes the comparisons made and conclusions drawn from the four cases analyzed in this chapter. The case of Hong Kong demonstrates free market leadership, while Korea demonstrates unambiguous state leadership. Both cases demonstrate a high degree of cooperation between the state and financial market actors that fostered high-growth and relative political stability. The Turkish case represents a shift from inefficient state-leadership toward more efficient and cooperative state leadership with recent high growth and relative stability. The Mexi-

can case exemplifies ambiguous leadership, inefficient market influence, inconsistent economic performance and political instability.

The outcome of this analysis depends heavily on the structure of the financial market. In this sense, it can be considered a structuralist analysis. However, what is most interesting about the Turkish case, in comparison to the other three cases, is the dynamic nature of those structures. That is, Turkish success has rested on the ability of the state and market actors to transform weak structures into stronger, more predictable ones. Thus, this study should more appropriately be considered a dynamic structuralist analysis. Given that structural change has perhaps been the defining characteristic among newly industrializing countries, especially in Asia, since the 1997 Asian currency crisis, the potential to learn from the application of dynamic structuralism is great indeed. It is toward an investigation of this more recent structural change that I now turn.

Notes

1. See for example McKinnon [1980]; Krueger [1990]; and Balassa [1982].
2. See for example Johnson [1982]; Wade [1990]; Zysman [1983]; and Amsden [1989].
3. Krueger [1990], 9.
4. Cournot [1838].
5. Bertrand [1883].
6. Stackelberg [1934].
7. Przeworski and Limongi [1993]
8. âenses [1994], 56.
9. Waterbury [1993], 84.
10. By relative autonomy I mean to say that relative to the Mexican state since 1980, the Turkish state possesses a greater degree of insulation from societal forces in policy formation, but a lesser degree of insulation than the Korean state, for example.
11. Barkey [1990], 17.
12. Atiyas and Ersel [1994], 104–105.
13. Waterbury [1993], 206; CelFsun [1983], iii; Waterbury [1993], 85; World Development Report [1989], 190–191.
14. Barkey [1990], 155.
15. Barkey [1990], 159.
16. Waterbury [1993], 44.
17. Waterbury [1993], 220.
18. Togan and Balasubramanyam [1996], 186.
19. Celâsun [1983], 117.
20. Önis [1992], 7.
21. Önis [1992], 8.
22. Celâsun [1983], 118.
23. Cecen [1994], 50, 119..

24. Caprio, Atiyas, and Hanson [1994], 94.
25. Caprio, Atiyas, and Hanson [1994], 106.
26. Atiyas and Ersel [1994], 107–108.
27. Waterbury [1993], 75.
28. Atiyas and Ersel [1994], 110.
29. Cecen [1994], 48.
30. Atiyas and Ersel [1994], 116.
31. Atiyas and Ersel [1994], 106.
32. Atiyas and Ersel [1994], 112.
33. Atiyas and Ersel [1994], 113.
34. Atiyas and Ersel [1994], 114.
35. Atiyas and Ersel [1994], 119.
36. Atiyas and Ersel [1994], 132.
37. Biddle and Milor [1994].
38. Önis [1992], 6.
39. Cecen [1994], 46.
40. Teichman [1992], 10.
41. Rhee [1994], 154.
42. *Wall Street Journal*, June 19, 1998.
43. Wade [1990].
44. Wade [1990], 307.
45. Nam [1994], 186.
46. Lee [1993], 25.
47. Bradford [1994], 22.
48. Lee [1993], 25; Westphal [1984].
49. Lee [1993], 26.
50. Skully and Viksnins [1987], 105. In 1981 there were 37 and by 1984 there were 48.
51. Akyuz [1993], 24.
52. Dalla and Khatkhate [1996], 5.
53. Jao [1988], 23.
54. Freris, [1991], 1.
55. Chi-keung, Cushman and Gungwu [1980], 39.
56. Chi-keung, Cushman and Gungwu [1980], 19.
57. Jao [1988], 67.
58. Lethbridge and Hong [1995], 116.
59. Freris [1991], 21.
60. Wong, Scott, and Ho [1986], 8. Hong Kong Association of Banks is a statutory body which came into existence through a 1981 ordinance. It replaced Exchange Banks Association.
61. Jao [1988], 67.
62. Hong and Krause [1981], 108.
63. Freris [1991], 31.
64. Haggard [1990], 116.
65. Haggard [1990], 125.
66. Jao [1988], 17.
67. Woronoff [1980], 41.

68. Chi-keung, Cushman and Gungwu [1980], 34.
69. Woronoff [1980], 53.
70. Woronoff [1980], 178.
71. Cole, Scott and Wellons [1995], 52.
72. Woronoff [1980], 179.
73. Jao [1988], 18.
74. Jao [1988], 52.
75. Jao [1988].
76. Jao [1988], 53.
77. Lethbridge and Hong [1995], 121.
78. Jao [1988], 53.
79. Jao [1988], 55.
80. Lethbridge and Hong [1995], 122.
81. Hausmann and Rojas-Suárez [1996], 104.
82. Woronoff [1980], 178.
83. Jao [1988], 100.
84. Rabushka [1979], 17.
85. Lin, Lee, and Simons [1979], 167.
86. Haggard [1990], 115.
87. "Destructive competition" is a term taken from oligopoly theory. It refers to competition that results in price wars, such that some competitors end up going out of business and the industry as a whole becomes increasingly monopolized by a few large firms. The U.S. airline industry is often cited as an example.
88. Jao [1988], 70.
89. Woronoff [1980], 139.
90. Wong, Scott, and Ho [1986], 7.
91. Jao [1988], 67.
92. Ho [1983], 12.
93. Ho [1983], 17; Rabushka [1979], 80.
94. Woronoff [1980], 185.
95. Woronoff [1980], 176.
96. Woronoff [1980], 116.
97. Jao [1988], 7.
98. Cole, Scott and Wellons [1995], 48.
99. Cole, Scott and Wellons [1995], 32.
100. Wong, Scott, and Ho [1986], 10.
101. Jao [1988], 37.
102. Ho [1983], 33.
103. Ho [1983], 1.
104. Jao [1988], 10.
105. Rabushka [1979], 40.
106. Ho [1983], 55.
107. Jao [1988], 101.
108. Rabushka [1979], 80.
109. Jao [1988], 101.
110. Rabushka [1979], 41.
111. Hong, Wontach, Krause [1981], 106.

112. Dodsworth and Mihaljek [1997], 34.
113. Hong Kong Monetary Authority [1995], 18; Dodsworth and Mihaljek [1997], 37.
114. Ho [1983], 26.
115. Maxfield [1990].
116. Teichman [1992], 94.
117. Teichman [1992], 99.
118. Waterbury [1993], 214.
119. Waterbury [1993], 214.
120. Cypher [1990], 32.
121. Cypher [1990], 32.
122. Cypher [1990], 61–62.
123. White [1992], 100.
124. La Cascia [1969], 54.
125. Vernon [1964], 161. ". . . combinations of financial institutions and non-financial enterprises can facilitate the systematic evasion of selective credit controls."
126. Zank, Neal. et.al. [1991], 144.
127. Ross [1971], 50.
128. This point is corroborated by White [1992], and also Maxfield [1990].
129. Camp [1989], 109.
130. Philip [1988], 26.
131. Zysman [1983], 123–124.
132. White [1992], 86. For a more detailed discussion of the concentration process, see chapter one.
133. White [1992], 113.
134. Anglade and Fortin [1985], 237.
135. Anglade and Fortin [1985], 223.
136. White [1992], 100. "Finance capital was more interested in accumulating capital through rentierist practices than investing in productive operations that were more risky and less lucrative."
137. Tello [1984], 105.
138. Tello [1984], 65.
139. *Diario Oficial* [1982]. The impact of private banks on the economy certainly did not go unnoticed by Mexican officials. In the eyes of many prominent Mexican officials, Mexican Banks were to blame for the financial crisis. In the *Diario Oficial* of 1 September 1982 President Lopez Portillo elaborated on some of the official reasons for the expropriation of the banks:

   1. The banking concession to the private sector was temporary and existed only as long as the state could provide the services.
   2. Private interests, using money deposited by the general public, created monopolies rather than managing the resources in the interest of the general public.
   3. Private banks failed to make cheap and opportune credit available to most of the population.
   4. The 1982 crisis was aggravated by the government's lack of control of the credit system.

5

From Bank-led Finance to Market-led Crisis

Reflections on the Mexican Peso and the South Korean Financial Crises

This book has focused on the transition away from state-led finance toward bank-led finance in newly industrializing countries during the 1980s. Since the mid–1990s, however, an equally significant and perhaps even more widespread shift has occurred, from bank-led finance toward market-led finance, where capital markets have been increasingly responsible for determining the allocation of finance and exchange rates have been allowed to float. The transition to market-led finance has been notably similar across country cases, suggesting that this trend is embedded in a larger movement toward globalization, and increasing capital mobility.[1] Monetary authorities virtually across the board in newly industrializing countries have responded to domestic financial crises by demonstrating a commitment to economic management based on openness to, and increasing integration with, the rest of the world. Despite the crises that accompanied this process, most of these countries have attempted to adopt vigorous structural reforms aimed at strengthening the economy, and the role of market forces, rejecting internal pressures to withdraw from the system, close down their capital markets, and retreat into financial isolation.[2] In short, the financial crises that first hit Mexico in 1994, and then Asia in 1997, seem to have marked a significant shift toward market-determined finance.

Both the Mexican and Korean financial crises left policymakers with little choice but to abandon their pegged exchange rates.[3] Indeed, scholars have argued that crises facilitate reform packages.[4] While the shift to floating rates indicates a broader transition away from bank-dominated finance in both countries, the ramifications of the transitions differed dramatically,

just as they did in the earlier transitions from state-led to bank-led finance during the 1980s. The Mexican peso crisis challenged the long-standing coincidence of interests between monetary officials and Mexican bankers by permanently altering state interests and by bolstering exporters' influence. As a result, Mexico has made important strides toward reforming its ailing financial sector, and the economy as a whole has experienced an extraordinary recovery. In Korea, on the other hand, the government has been unable to reform their weak and inefficient banking sector, nor have they managed to fundamentally restructure the *chaebol*-dominated industrial sector, largely because state autonomy, and even state effectiveness, has begun to wane as the state has faced challenges on several fronts, principally from labor unions and the increasingly powerful *chaebol*.

Just as with the earlier transition to bank-led finance, while the trend itself is quite noteworthy, the challenge is to explain the differences among countries with respect to the character and consequences of these transitions. While there is little doubt that the banking sectors in both countries have been the weak links in the economic recovery process, Mexico has of late been more successful than Korea at restructuring the banking system and mitigating the dominance and relative inefficiency of large conglomerates. This situation contrasts sharply with the financial liberalization experiences of both countries in the 1980s, when the Korean state was able to control the *chaebol* and maintain rapid growth, while the Mexican state, in the midst of the debt crisis, was unable to do the same faced with increasingly inefficient and powerful financial–industrial conglomerates, *grupos*. This chapter, after a brief overview of the two crises, will argue that the recovery and long-run growth potential of these emerging economies depends largely on the degree of competitive forces at work to mitigate the effects of concentrated and centralized financial sectors. Competitive forces, interpreted broadly, include: an *effective state*, capable of implementing prudential regulation and avoiding short-sighted politically-motivated macroeconomic policy; *traditional economic competition* within the banking sector itself, capable of reducing the oligopolistic power of financial–industrial conglomerates; and, *societal forces*, such as labor and competing economic sectors (e.g., exporting industrialists), capable of challenging the political influence of financial elites. The chapter concludes by comparing economic recovery in Mexico with Korea after the crises, highlighting the political and institutional changes that define the crisis-induced shift to market-led finance, and the ramifications of those changes.

Twin Crises?

Prior to their respective crises, Mexico and Korea were experiencing solid economic growth and following a macroeconomic path that met with the

approval of most economists and foreign investors. At the end of 1993, the international financial community was heralding the Mexican economy as a phenomenal success story. International reserves stood at $24.5 billion, up 25 percent from the previous year. Privatization efforts were increasing, with over 250 state companies already having been privatized. NAFTA (North American Free Trade Agreement) reforms were being implemented, and Mexico was welcoming foreign investment in areas that had previously been restricted to Mexican ownership. Perhaps the most impressive aspect of the Mexican economy was that inflation had dropped to single digit levels from an average of 160 percent in the pre-Salinas years. This was due, in large part, to the exercise of fiscal restraint, historically no small feat in the context of the Mexican political economy. In the decade preceding the Asian Crisis of 1997, Korean annual GDP growth averaged almost 8 percent. And over the thirty years preceding the crisis, per capita income levels had increased tenfold. In 1996, before the crisis hit, Asia attracted close to $100 billion in capital flows, almost half of total capital inflows to developing countries in that year, with Korea attracting a good percentage of that.[5]

In the span of one year preceding each crisis, Mexico and Korea went from "being on the right track" in terms of macroeconomic policy mix (fiscal restraint, privatization, trade liberalization), to needing massive rescue packages. The Mexican peso crisis began on December 20, 1994, when the government devalued the peso by 15 percent in response to a run on the currency. This failed to halt the speculative outflows, and two days later, officials abandoned the new slowly downward crawling peg altogether, and allowed the peso to float. The peso fell from 3.5 to 5.5 to the dollar in the span of two days. Over the course of 1994 and 1995, real GDP actually fell, and the unemployment rate at the end of 1995 was almost 6 percent higher than it had been the previous year. In fact, it took Mexico several years to recover from the deep recession triggered by the sudden peso devaluation of late 1994. The depth and severity of the Korean financial crisis also surprised most observers. Throughout 1997 the Korean stock price index fell continuously, from an average of 833.4 to 654.5, while the Korean won depreciated 67.7 percent against the dollar. The stock market index had actually started falling in 1994 from a high of 1027, indicating that there were some earlier signs of trouble.[6] Nor did the financial crisis spare the real economy, as seven out of the nation's top thirty conglomerates had filed for court-mediated protection or court-ordered receivership by October 1997. The size of the Korean bailout was perhaps the most telling sign of the severity of the crisis, setting a record at $51 billion, a sum bigger than the Mexican rescue package in 1995.[7]

In some ways the story leading up to the collapse of the won in 1997 is very similar to that of the peso in 1994, as both economies experienced

growing trade imbalances. Mexico's rather large trade imbalance widened, although increasing capital flows compensated for the shortfall in the current account. These capital inflows came primarily in the form of rapidly expanding portfolio investment. Mexico's success in bringing inflation down in the early 1990s, and its program of privatization, trade liberalization, and other structural reforms brought increased capital inflow from Mexican and foreign investors.[8] Thus at the beginning of 1994, Mexico still enjoyed a balance of payments surplus, but had become increasingly dependent on this relatively volatile portfolio investment. Similarly, the Korean current account deficit widened in 1995–96 to over $23 billion due to a growing trade imbalance. This made Korea increasingly dependent on short-term capital inflows which went from 3 percent of GDP in 1995 to 4.8 percent in 1996. By the end of 1996, Korea's gross external liabilities totaled $158 billion, which in and of itself was not a problem. The problem was the term structure of those liabilities, 34 percent of which were short-term in 1992, climbing to 63 percent by 1996.[9]

Both countries also fell victim to events that triggered speculative attacks on their currencies. For Mexico it was a series of political events—a rebellion in Chiapas, and two high profile assassinations—that reduced the inflow of portfolio investment, making an already volatile situation increasingly untenable.[10] For Korea, it was more the contagion effect from the collapse of the Thai baht earlier in the year.

The major difference between the economic conditions that immediately preceded each crisis was that Mexican government spending patterns changed as the year-end election of 1994 approached, while the Koreans avoided deficit spending altogether.[11] As a means of mobilizing widespread support for the PRI leading up to the election, the Salinas administration abandoned tight budget policies in favor of deficit spending.

Explanations of the Mexican peso crisis have differed considerably from those of the Korean financial crisis. In Mexico the policies and events leading up to the crisis constituted an untenable policy mix, especially given the fact that the government was unwilling to increase the rate of crawl of the exchange rate. The increasing reliance on portfolio investment made the balance of payments vulnerable to reduced capital inflow. Under conditions of unusual political instability together with the run-up of the government budget deficit, the inflow of portfolio capital did in fact slow, resulting in significant downward pressure on the value of the currency. This downward pressure was not sufficiently alleviated by the pace of the downward crawling peg. The result was an increasingly overvalued peso. Hence, while exchange rate policy did not technically change over this period, the macroeconomic policy mix became increasingly incompatible.

There has been considerably more controversy over what caused the Asian financial crisis, and the Korean crisis in particular. The major debate has been between those economists who have tended to focus on market fundamentals: weak cyclical performance, low foreign exchange reserves, and financial deficiencies resulting in high shares of nonperforming loans, versus those who emphasize the role of financial panic, pointing out that macro and micro imbalances were not enough to warrant such a severe crisis and that large scale foreign capital inflows made Asian financial systems vulnerable to panic.[12] There is no doubt that elements of both explanations were present leading up to the crisis. Rather than attempt to resolve this argument, the analysis presented here will focus on the policymaking dynamics underlying these causes because regardless of which explanation one adheres to, the relationship between private market financial actors and government policymakers underlies these explanations. Whether high shares of nonperforming loans or large-scale capital inflows are to blame, one must investigate the mutual incentives facing monetary authorities, who decided to drain foreign reserves rather than devalue sooner, and financial–industrial conglomerates (*chaebol*) who took on dangerous levels of foreign debt.

Similarly, while many observers have drawn attention to the lack of sustainability of Mexico's exchange rate policy and government spending patterns leading up to the December crisis, few have attempted to explain the underlying causes of this inconsistent macroeconomic policy mix.[13] By shifting the focus away from questions of what went wrong to why an inconsistent macroeconomic policy mix prevailed, this analysis sheds light on the structural incentives that underlay macroeconomic policymaking in Mexico. This is especially important if one considers the exceptional economic training of the majority of Mexican economic policymakers, because one cannot rely on irrationality or lack of knowledge to explain policymaking mistakes, given that the last two presidents, Salinas and Zedillo, held Ivy League doctorates in economics. Nor is this level of training unusual among high level Mexican officials.

Although the 1994 peso crisis and the 1997 Korean crisis were single events in the long histories of Mexican and Korea financial politics, it will be argued that these were more than isolated incidents. Both crises underscore the dynamics of financial policymaking, as constituted through the interactions of key state and market actors. The peso crisis reflected both the election-time interests of PRI officials, and less obviously but equally as important, the economic interests of politically influential constituent groups: the heavily indebted financial sector, and official labor unions whose wage contracts were contingent upon exchange rate stability. In Korea, the liberalization of capital markets together with implicit guarantees and lax regulation led firms to take on a massive short-term

foreign debt exposure which made the economy vulnerable. As in Mexico, there were few forces mitigating the influence and behavior of conglomerate firms.

The State

Because major structural transitions, such as the shift from bank-leadership to market-determined finance, are almost always triggered by major crises, they coincide with a weak point in the government's ability to send credible policy signals and implement effective prudential oversight. Unfortunately, this is precisely the time when credible signals and regulatory vigilance are most needed. For example, as the Korean crisis unfolded, political uncertainties and doubts about the authorities' commitment and ability to implement the necessary reforms exacerbated pressures on currencies and stock markets.[14]

The poor quality of bank supervision—lax prudential rules and financial oversight—led to a sharp deterioration in the quality of banks' loan portfolios in both Mexico and Korea.[15] While most economists agree on the need for capital-account liberalization, they have also come to believe that banks should first upgrade their risk-management practices and supervisors should strengthen oversight of financial institutions.[16] The Korean case certainly bares this out since banks and finance companies that lent on overly risky projects lay at the heart of that country's financial crisis. The problem is that competition among over-guaranteed and under-regulated banks leads to distorted investment decisions. Under these conditions, international capital mobility will not necessarily maximize the economic efficiency of the banking sector.[17] One potential sticking point for Korean officials is that if banks are to be strengthened, it might be necessary to end the ban on *chaebol* ownership of them. But that would only strengthen these conglomerates that many people believe are already too powerful.[18]

Korean financial sector development put little weight on prudential regulation under the developmental state model. Not only did the state fail to institute proper auditing, accounting, credit rating, disclosure requirements, and prudential regulation, banks were also not allowed to fail. Again, this led to a classic moral hazard problem.[19] Moreover, credit rationing denied financial institutions the experience needed to develop adequate processes of independent decision-making.[20] The fact that official and private estimates of nonperforming loans have differed significantly is symptomatic of the lack of effective oversight on the part of the Korean government.[21] In the aftermath of the crisis, experts seem to agree that Korea needs to upgrade its system of financial sector supervision and regulation.[22]

The evidence suggests that the lack of effective supervision of the banking system when the government began to sell the banks to the private sector in 1991, also played a major role in the Mexican peso crisis. Of eighteen banks the government sold off, only five still operate today under control of the Mexican bankers who bought them. Foreign banks bought all or most of four more banks that are still operating. The government has taken over three others, and six went under.[23] Basically, in Mexico as well as Korea, the incentives faced by poorly supervised banks that still enjoyed implicit bailout guarantees resulted in a large foreign debt exposure that made these countries vulnerable to crises.

Policymaking credibility is especially important under pegged-exchange-rate systems, which are extremely sensitive to domestic political developments, or external shocks that affect investors' expectations. In today's fluid international financial markets, a small change in the stock demand for the capital assets of a country can cause a large, sudden change in the rate of flow of capital into or out of the country, putting sudden pressures on exchange rates to appreciate or depreciate.[24] In this environment, policymaking credibility becomes the first defense against full-scale crisis, and in the case that a crisis does unfold, policymaking credibility may be the key to a more rapid recovery. The desire to maintain credibility with world markets may have given both Mexico and the Asian NICs a powerful incentive to respond to the crises by strengthening market reforms rather than retreating. But the same desire for credibility may also have given policymakers an incentive to maintain the exchange-rate peg longer than most economists believe was prudent.

Mexico's brief economic upturn in the early 1990s that lasted until the peso crisis in December of 1994 illustrates the powerful nature of policymaking credibility with respect to investor expectations. In Chapter 2, the extended form game that modeled strategic decision-making among bankers and the state predicted higher payoffs on the basis of increased business confidence and state credibility. It appears that Mexico experienced just such a phenomenon at the beginning of the 1990s. Former President Salinas clearly had some success in restoring the confidence of Mexico's powerful business interests. Unfortunately, that confidence disappeared, with Salinas in exile having apparently embezzled millions, and the Zedillo administration facing an increasingly unstable political climate. The passage of NAFTA also generated positive expectations (shared belief that the good state of nature would prevail), which enhanced economic performance in two ways. First, Salinas being credited with the successful passage of NAFTA clearly improved his government's policymaking credibility. Also, NAFTA may have contributed to positive expectations through the promise of more vigorous competition, which led to increased foreign and domestic investment in the Mexican

capital market. Unfortunately, Mexico's economic success was short-lived as the peso crisis brought it to a temporary halt.

Mexican officials in early 1994 faced a dilemma over whether to devalue the peso or use foreign reserves to boost the peso as a way of continuing to send positive signals to foreign investors. Korean officials faced much the same dilemma in the wake of the collapse of the Thai currency. This chapter will now analyze the incentives facing policymakers just prior to the 1994 peso collapse, and the 1997 won collapse. Taking the other macroeconomic conditions—dependence on portfolio investment and election-induced deficit spending—as givens, one must question why Mexican policymakers were unwilling to devalue earlier. One explanation is that Salinas, as with many Mexican presidents before him, did not see devaluation as a viable political option, because of the likely inflationary effects and the sense that an inflationary spiral would make his party look weak in the midst of a presidential election.[25] In fact, according to one influential observer of the Mexican economy, the mild increase in exchange-rate-policy flexibility after November 1992 may have contributed to the government's loss of credibility thereafter.[26] Hence, there is some reason to believe that Salinas's fear of devaluing may have been well founded. A predictable peso exchange rate had been at the heart of Salinas's reforms, and had provided the bedrock for foreign portfolio and direct investment.[27] In addition, Salinas might have believed that devaluation would spook portfolio investors, whose investments were allowing the government to maintain a balance of payments without bearing the costs typically associated with it. Certainly the sudden increase in the government budget deficit during this period, which coincided with the electoral campaign, indicates that Salinas did not intend to suffer short-term political losses for the sake of longer-term economic stability.

One could argue that Salinas chose short-term political gain for himself and his party at the expense of long-term economic gain for his country, but this explanation fails to capture the full complexity of the situation. The more compelling question seems to be why such a policy prevailed despite its flaws? Moreover, while it is possible that Mexican policymakers would have intentionally risked the devastating costs incurred as a result of the peso crisis simply because they thought it would increase the chances of a PRI victory, this line of reasoning does not explain why the Salinas administration did not devalue shortly after the election. If government officials alone have control over policy implementation, then the only answer for why exchange rate overvaluation prevailed is political myopia, because policymakers chose to actively maintain the peso's value by depleting foreign exchange reserves, despite the risks involved in such a strategy.

The Korean situation leading up to the collapse of the won does share some important parallels. Like Mexico in the early 1990s, Korea prior to 1997, was an ideal debtor in the eyes of the international financial community because of its record of steady, low-inflation growth. Korean policymakers could draw on thirty years of unprecedented growth as a signal of credible policy. Unfortunately, because of the nature of capital markets and short-term loan structure, countries with the most positive attributes in the eyes of the international lending community are most likely fall victim to the over-lending phenomenon. Before the fall, the Asian NICs were seen as the most attractive sovereign borrowers among emerging markets because they had integrated themselves into the world economy, achieved rapid economic growth, and boasted a disciplined fiscal position.[28] Ironically, and similar to Mexico, these positive attributes ended up contributing to the depth of the crisis. This phenomenon has prompted some observers of these crises to argue for limiting or taxing short-term borrowing abroad as the Chileans have done.[29]

The Korean debt overhang thus made the won vulnerable, as the peso had been in 1994. The collapse of the baht in July of 1997 certainly did not help matters, as officials faced the very real possibility of contagion. However, there is widespread evidence that the won had become considerably overvalued even before 1997 (the real exchange rate appreciated 30 percent between 1987–97), and yet monetary officials chose to maintain the value of the won-yen peg until after the won came under attack by currency speculators.[30] Could Korean politicians have been worried that a won devaluation would damage their credibility, as had been the case in Mexico? There is some evidence that Korean politicians were increasingly facing political challenges similar to Mexican politicians. In 1997, Kim Young Sam enjoyed a legislative majority but his administration fell victim to divisions within the Party and ultimately between executive and legislature. In the 1980s, strong executive powers had allowed the Korean state to respond aggressively to potential crises.[31] But waning executive power is only part of the story. According to many expert observers of the Korean economy, the problems that must be fixed are more microeconomic than macroeconomic, and involve the private sector more than the public sector.[32]

Conglomerates

In order to better understand the underlying nature of the currency crises in Mexico and Korea and the implied failure of bank-led finance, we must look beyond the incentives facing state officials, because policy derives from the interplay between the state and powerful market actors. Monetary authorities certainly could have devalued sooner in both coun-

tries, but in order to fully understand why they did not, it is important to know who the powerful market actors were, as well as what they stood to lose from devaluation of the currency?

Chapter 1 laid the harmful effects of financial liberalization in Mexico at the doorstep of bank-led finance. Was the peso crisis in some way associated with bank-led finance as well? But Chapter 2 demonstrated that some forms of bank-led finance have actually promoted growth, as in Germany. Moreover, the Korean economy fared quite well through the initial stages of financial liberalization and emerging bank leadership. Instead, the failure of bank-led finance in Mexico, and eventually in Korea, had more to do with the concentrated and centralized character of the financial and industrial sectors than with bank leadership per se. Prior to the peso crisis, the hope had been that NAFTA, by exposing these sectors to competitive pressures, would eventually allow financial liberalization to work in Mexico. But while some aspects of the NAFTA agreement had already been implemented when the peso crisis began, little had been done with respect to foreign entry into the domestic banking sector. This suggests that we had not yet witnessed the full effect of competition on the Mexican financial sector. In fact, a recent audit described Mexican banking, in the early 1990s, as an incestuous system in which "a small business elite controls the banks as well as many of the companies that want to borrow from them."[33]

The Korean economy also showed signs of increasing concentration and lack of competition prior to the crisis. The share of GNP accounted for by the thirty largest *chaebol* rose from 13.5 percent in 1992 to 16.2 percent in 1995.[34] Moreover, during the 1994–1996 investment boom, large enterprises accounted for 45.7 percent of debt, while small and medium-sized enterprises accounted for only 17.7 percent.[35] The financial sector also showed signs of increasing concentration with the top eight nationwide banks together accounting for two-thirds of the entire commercial banking sector, and three-quarters of total commercial bank assets.[36]

The effects of increasingly powerful financial–industrial conglomerates vis-à-vis the state in Mexico and Korea can be observed in the form of overexposure to foreign debt, especially short-term debt, which also exerted pressure on exchange rate policies. In fact, both crises share a critical common factor: the maintenance of pegged exchange rate regimes for too long.[37] In Mexico, exposure to foreign debt gave bankers an incentive to resist devaluation. In Asia, government policy and international credit market conditions encouraged external borrowing, and led to excessive exposure to foreign exchange risk in both the financial and industrial sectors.[38] The same economic policies which were highly conducive to steady, low-inflation growth when capital flows to developing countries were modest, encouraged speculative excesses when large amounts

of external liquidity became available during the 1990s.[39] Arguably, this exposure, on the part of firms that were "too big to fail," gave Korean monetary officials a powerful incentive to resist devaluation as well.

The Mexican financial sector had both the means and the motive to influence exchange rate policy in order to insure that a slow crawl, rather than a fast one, would prevail. As noted earlier, since the early 1980s the percentage of financial market assets controlled by private banks had been increasing steadily, allowing them to exert a growing influence within the Mexican economy. Financial elites have often played a strategic role as political intermediaries between the government and the business community. Firms not associated with a financial–industrial group have had difficulty finding adequate sources of financing for their activities. Bankers also have exercised political influence through informal networks, involving personal connections and access to well-placed state officials. The Mexican Bank Association (ABM), an independent institution representing bankers' interests, has provided a mechanism for bankers to discuss their legislative and economic agenda with state officials. Its channels of communication have allowed members to rely on behind-the-scenes negotiation as a principle method of influence rather than protest, or direct participation in the political process. In other words, the absence of public lobbying efforts or numerous high-profile speeches espousing financial interests is not evidence of political weakness on the part of bankers. On the contrary, the close personal and professional relationships between Mexican bankers and high level officials obviates the need for a more public exercise of political voice.

In addition to its access to the policymaking process, the Mexican banking community has also had a vested interest in exchange rate policy. State officials were not alone in their short-term desire to maintain the crawling peg, and hence overvaluation. The Mexican financial community, consisting of private as well as state-owned banks, benefitted from the overvalued exchange rate, at least in the short-run, because they owed millions in dollar-denominated loans to foreign banks. Between 1988 and 1994, banks' external short-term debt had nearly tripled from $8.6 billion to $24.8 billion in U.S. dollars. Because this outstanding debt, denominated in dollars, would increase in peso terms as the peso's value fell in relation to the dollar, Mexican bankers faced a powerful incentive to pressure against rapid devaluation. Given this, it is reasonable to assume that overvaluation was probably not simply a result of election year pressures facing the governing party. This is not to diminish the argument that the Salinas administration stood to benefit politically from resisting devaluation. However, this analysis does underscore another, and perhaps more pervasive, dimension to the story. It suggests that pressure against devaluation exists even when an election is not immi-

nent, and that this pressure only increases as financial sector dominance grows.

Debt exposure made the Korean economy vulnerable to external shocks as well. Since the early 1990s, Korean dependence on foreign borrowing has grown steadily.[40] The reliance of the *chaebol* on bank borrowing—as opposed to equity or bond financing—has increased leverage ratios and has made the *chaebol* highly susceptible to bankruptcies when hit with shocks. In turn, the health of the banking sector has become greatly dependent on the viability of the *chaebol*, since such a high fraction of bank assets is in the form of lending to these enterprises.[41] Korean financial institutions were over-exposed to foreign-exchange risk and a high proportion of foreign liabilities had relatively short maturities. Thus the Korean economy, similar to Mexico's in the early 1980s, has increasingly suffered from problems associated with the extensive wedding of finance and industry.

Deregulation of the financial sector in the early 1990s together with ongoing features of the government-banking-*chaebol* relationship increased Korea's vulnerability to outside capital flows.[42] Financial deregulation created the incentive for indebtedness and short-term debt structure. The liberalization of the commercial paper market led to the rapid expansion of short-term financing. Firms and banks were allowed to borrow abroad and international investors to invest in Korean assets. Between 1994 and 1996, foreign bank lending to Korea went from $52 to $108 billion. About $60 billion of debt outstanding in 1997 was used by the *chaebol* to finance direct investments abroad. Korean banks invested in foreign assets with funds borrowed from foreign banks in the range of $23 billion.[43]

The lack of sufficient oversight was in part due to loopholes built into the reform process. While the Business Specialization Plan called for the *chaebol* to pare down to core businesses, the government offered in return exemptions from credit and equity investment controls.[44] Also, the government converted twenty-four financially weak short-term financing companies into merchant banks in two separate rounds: nine in 1994 and fifteen in 1996. These merchant banks proceeded to engage in risky foreign exchange transactions. Among the banks whose licences were revoked in 1998, five were new entrants from 1994, and ten were from 1996. This suggests that even government reforms aimed specifically at curbing the influence of powerful conglomerates instead had the effect of encouraging greater debt exposure in an already overexposed financial system.

There is fairly widespread agreement that the rollover of short-term foreign currency denominated debt eventually became the catalyst behind the currency crisis in Korea.[45] Yet the volatility of short-term maturities has political, or policy, as well as economic consequences. Just as was the case with Mexico, the more exposed to foreign debt powerful finan-

cial conglomerates are, the more incentive financial institutions have to resist devaluation. Thus in order to avoid major financial crises, the influence of powerful financial industrial conglomerates, who if allowed to will take on excessive risk portfolios, must be curbed.

Societal Pressures

One of the most effective ways to control the power of the *chaebol* in Korea and the *grupos* in Mexico is through the counterbalance of other societal pressures on economic policy. These pressures, which can come from market actors in competing sectors or from organized labor, can serve to either reinforce the policy preferences of financial–industrial conglomerates or to counterbalance them.

In Mexico, the *Pacto* represents one institutional arrangement between the government and society that formalized the government's incentive to avoid inflation. As a part of the corporatist-style government-labor pact, official labor unions agreed to a strict wage policy that would tame inflationary pressures. But as a means of protecting real wages from severe drops, wage contracts were made contingent upon exchange rate stability. In short, if the slowly downward crawling peg crawled faster than expected, wage contracts would be adjusted to reflect the decreased purchasing power of the peso, triggering inflation. Thus, because a central goal of the Mexican government was to control inflation, the institutional arrangement with labor made policymaking officials resistant to more rapid devaluation. On the other hand, some analysts have argued that the Mexican government was able to act decisively in the wake of the peso crisis because the PRI still dominated Mexican politics. One reason for this is that Mexico's unions remain considerably weaker than Korea's.[46]

Pressures from Korean unions have grown stronger with increasing democratization. This has had two main effects. Firstly, it has weakened the state in the sense that the state has been less able to fulfill a developmental agenda. Secondly, in part because Korean labor costs had been rising since the mid-1980s, the competitiveness of the export sector has been steadily declining. Despite strong export growth, indicators of Korea's international competitiveness show a deterioration in cost factors from 1993–94, with prices of major exports falling and relative unit labor costs increasing.[47] Thus, labor indirectly served to reinforce the appreciation of the real effective exchange rate in both Mexico and Korea

While the overvalued-exchange-rate policy was, in part, a result of a confluence of interests between state officials, private bankers, and to a certain extent labor, these were not the only market actors affected by exchange rate policy. Exporters in both countries should have been com-

plaining bitterly about this policy, which significantly diminished their competitiveness, as Mexico's exchange rate appreciated by nearly 40 percent in real terms between 1988–1993 and Korea's real exchange rate appreciated 30 percent between 1987–1997.[48] Yet exporters voiced surprisingly little displeasure concerning the overvaluation of the peso. In Mexico, this may have been the result of exporters not being as politically powerful or economically dominant as their financial counterparts. In Korea this certainly was not the case. A more likely explanation is that in both countries, exporters are wed to banks through ownership ties evident in the dominance of the *grupos* and the *chaebol*. In other words, exporting industrialists wear two hats: they are exporters, but they are also financiers, and as such their interests are mixed. In the short-term, the profits involved in banking, or rather the losses involved in foreign-debt exposure, dwarf those involved in exporting. In addition, industrialists in import-competing industries also favor overvaluation. So it makes sense that Mexican *grupos* and Korean *chaebol* would comprise a more powerful lobby against devaluation than for it.

But the Mexican economy is now enjoying a spectacular recovery from the financial collapse and recession which followed the peso devaluation of late 1994. Ironically, the dramatic reaction of international currency markets, following the initial devaluation (the peso eventually fell by 50 percent), has contributed to Mexico's recovery by way of an export boom. But even more than the initial peso plunge, the peso's continued weakness, and the tendency on the part of Mexican policymakers to refrain from peso-promoting intervention, has resulted in boosted export earnings. After contracting by 6.2 percent during 1995, output growth revived to 5.2 percent during 1996 and 7.4 percent in 1997. The current account deficit fell from $29.7 billion during 1994 to only $1.6 billion during 1995 as a result of exports increasing 33 percent while imports declined 13 percent.

Since the peso's plunge, representatives of the nontradable sectors in Mexico have voiced displeasure with what they perceive to be an explicit policy of undervaluation. For example, Roberto Salinas-Leon, executive director of the center for Free Enterprise Research in Mexico City, sees recent government policy as "a dangerous obsession with 'competitive' exchange rates and export-led growth . . . haunting Mexico's efforts to regain stability".[49] On the other hand, exporters have begun to promote the idea that there is excessive appreciation of the real exchange rate and thereby loss of external competitiveness.[50]

Such observations might suggest that the underlying political pressures for overvaluation have changed. The selection of Guillermo Ortiz as the new governor of *Banco de Mexico* continues a clear signal that the administration is committed to avoiding the real appreciation of the cur-

rency. Ortiz has been vocal about his belief that the peso collapse of 1994 resulted from "an excessively overvalued currency." And in point of fact, the peso has been one of the world's most stable currencies among economies with floating exchange-rate regimes in the past two years, and has survived the "dragon" and "samba" effects in Asia and Brazil nearly unscathed. For now, Mexican exchange-rate rhetoric is fraught with commitments to a competitive exchange rate. But as always, Mr. Ortiz's fervent commitment to a competitive exchange rate policy must be counterbalanced with the desire for low inflation and peso stability.[51]

One can also point to institutional changes that now guard against a repeat of 1994. The most significant change is that the exchange rate regime is now floating as opposed to a crawling peg. It now takes a greater act of policymaking will to intervene in capital markets in order to bolster the peso's value. Moreover, a common view from within Mexican policy circles is that speculative attacks on fixed exchange rate systems are the main causes of crises, as was the case in Mexico.[52] Also, because Mexican monetary authorities are now required to share financial information in a more timely manner, and because markets demand a higher threshold of certainty as a result of having been caught off guard before, there are fewer benefits to be gained from attempting to protect the value of the currency under a pegged exchange-rate regime.

While it remains to be seen if the perceived undervaluation of the peso is a longer-term phenomenon, or if Mexican officials will opt to reinstitute the crawling peg, it appears that for the time being policymakers are satisfied with the prevailing exchange rate as determined by market forces. In the immediate aftermath the peso crisis, exchange rate policy could have been a way of signaling to markets that another sudden large devaluation was unlikely. Policymakers may now prefer the floating exchange rate because they are especially wary of falling into the same exchange rate dilemma that proved so devastating to the Mexican economy under the crawling peg. And, although election cycle theories would have predicted a governing party dramatic run-up of the budget deficit prior to the 2000 presidential election, no such run-up occurred. Moreover, the peso remained relatively stable throughout the election process, further reinforcing the perceived benefits of the floating exchange rate regime.

While it may be the case that Mexican policymakers' short-term incentives and institutional constraints have changed, given the analysis of exchange rate preferences leading up to the peso crisis offered here, we must question what has changed with regard to underlying constituent pressure? Have bankers lost their traditional power base to influence policy, at least insofar as the state no longer sees its interests as compatible with the financial sectors' interests? One factor that suggests an affirma-

tive answer to this question is the growing economic strength of exporters in Mexico. Mexico ran a $7.4 billion trade surplus in 1995, as exports rose 30 percent and imports fell 10 percent. Due largely to prevailing exchange rates, the export industry continues to expand and prosper, making it possible for Mexico to earn enough foreign exchange to pay its debts. For this reason, the government has thus far supported the peso float. This, in turn, is making exporters vital new allies.

To the extent that the emerging economic strength of exporters translates into political influence, the peso crisis can be seen as a turning point in Mexico's policymaking balance. That is, newly empowered exporting interests have begun to mitigate the influence of financial-sector interests. Mexico's economic policy mix could be on its way to looking more like that of South Korea, with a clear export-oriented bias. If so, the Mexican peso crisis has permanently altered state interests, and bolstered exporters' influence, challenging the long-standing coincidence of interests between monetary officials and Mexican bankers.

Some analysts have noted that Mexico was well positioned for recovery because of its membership in the GATT and NAFTA which set the stage for significant restructuring of the economy from import-substitution to exports. Clearly the data support such a contention. Nonoil export share went up to nearly 30 percent during the mid–1990s compared with below 5 percent in mid–1980s. Yet the liberalization of Mexican trade merely brought Mexico to the same position that Korea was in a decade and a half ago. If export competitiveness were the only criteria, Korea would not have suffered such a deep and prolonged crisis.

Recovery and Reform

The answer, similar to the one offered for the 1980s, lies not in the transition itself (i.e., market liberalization), but rather within the context of the transition to market-determined finance. While there is no question that for both Mexico and Korea, the banking sector has been the weak link in the economic recovery, Mexican officials have recently implemented reforms that appear to challenge the power of the private financial sector much more significantly than their Korean counterparts. Of the eighteen Mexican banks that were privatized starting in 1991, thirteen have either been taken over by the government or sold since 1994 at a cost of more than 14 percent of GDP.[53] Mexico's hotly contested financial reform package gives full control over exchange rate policy to the Banco de Mexico, gives more autonomy and power to the National Banking and Securities Commission to supervise the banking industry, and removes all limits on foreign investment in Mexican banks.[54] The reforms have also attempted to reduce moral hazard by eliminating the bank rescue fund and creating

two separate bodies: one to protect depositors but only up to $125,000, and one to sell off the bailout assets.[55]

It appears as though Mexico's attempt to stabilize its banking system through a combination of government intervention and relaxation of barriers to foreign investment in the financial services sector has achieved a measure of success. Only three of nineteen banks that were privatized during 1991 still have the same management. Some were taken over by the government and some were sold to foreign financial institutions. Foreign-controlled banks now account for nearly one-third of bank assets.[56] In fact, the Mexican banking system seems to be showing signs of health. Banks are creating hundreds of new loans, many of them for small and medium-sized businesses that are borrowing in pesos for the first time in years. This after overall bank credit to business and government sectors had been contracting over the previous thirty months. This credit revival is an important sign that the controversial plan to restructure the banking system may have paid off. It also provides the most tangible sign to date that economic growth in Mexico is trickling down to the grass roots level. In contrast, although Korea's export-oriented firms are now more profitable as the devaluation of the won has made them more competitive than ever, many are unable to take advantage of new market opportunities because the breakdown of the banking system has severely constrained the availability of working capital.[57]

Compared with Mexico, Korea has lacked leadership from the government leading up to the crisis and in its aftermath, and the private sector has not been equipped to perform that function. For example, the government historically has been the only effective mechanism of corporate discipline because of the underdevelopment of financial markets and weak internal discipline. During the period of rapid growth the government periodically weeded out insolvent firms, but since 1980, it has not. In fact, no *chaebol* has failed since 1989.[58] The reluctance to close insolvent financial institutions certainly added to the turbulence in financial markets in the immediate aftermath of the crisis.[59] The lack of effective leadership on the part of the Korean government is both a result of historically high levels of state autonomy, and of recently diminished state autonomy. During the period of rapid growth, economic policy was conducted through personal networks between banks, their clients, and politicians, usually with the state directing the process toward an overall goal of national development. The government no longer has the ability to direct the process, but political relationships between banks, their clients, and politicians still dominate the policymaking process. The void left by previous government leadership also contributed to corporate financial distress by way of a moral hazard problem. Private firms, accustomed to signals of government-approved investment opportunities, took Korean Development

Bank lending as significant enough to constitute a signal of government policy and commitment.[60] By most accounts, the government failed to respond to signs of crisis because of the preoccupation with the upcoming election and the fragmentation within the ruling party.[61]

As the recent Mexican experience demonstrates, the need for leadership remains a constant for developing country financial sectors, especially in times of crisis. However, strong state leadership in Korea has truly begun to wane. The Korean government has not been very successful at restructuring the economy or mitigating the dominance and relative inefficiency of the *chaebol*. Some analysts are hopeful that the forces of global competition and deregulation will force the *chaebol* to reform on their own. The *Sangyong* Group, for instance, is now negotiating to sell its money-losing automobile business to the Samsung Group, so it can concentrate on areas like cement and oil where it is stronger.[62] Others insist that the only way to mitigate the *chaebol* stronghold over the Korean economy is to relax the rules against foreign participation.[63] This solution is certainly consistent with the Mexican reform package.

Conclusion

Ultimately this comparison of Korean and Mexican financial liberalization since the 1980s underscores the common and recurring underlying theme of competition. The argument presented in this chapter has suggested that the longer-term solution to achieving healthy, robust economies in Korea and Mexico, as well as other NICs, must involve the introduction of competitive forces of a political, as well as an economic nature, capable of altering the policy preferences and relative power of financial elites. Unfortunately, one of the most common features of late development has been top-heavy economic structures, in which even during periods of rapid growth the rewards are shared by a privileged few. Both Korean and Mexican economic development, as a result of conscious government policy, has been in the hands of giant, family-dominated conglomerates. This is what one popular account has referred to as "trickle-down economics with a vengeance."[64] It is simply too early to tell whether the limited success achieved by Mexico in the aftermath of the peso crisis will continue, and whether Korea, given enough time, will manage to restructure the economy successfully or mitigate the dominance and relative inefficiency of the *chaebol*. What we can observe is that Taiwan, which has avoided the deep prolonged crisis suffered by other Asian NICs, practices trickle-up economics, where small and medium-size entrepreneurial businesses dominate the economy. These businesses have an average debt-equity ratio of 1:1, whereas in Korea the typical debt-equity ratio ranges from 4:1 to 8:1.[65] In the aftermath of the crisis, it

has become clear that as the state loses its ability to lead the development process, close business-government ties can become a blueprint for corruption.[66] Clearly the combination of market oligopolization and close government-business ties tends to skew economic incentives, especially as economies transition toward market-determined prices.

Notes

1. Eichengreen [1999], 4.
2. Fischer [1999].
3. A crawling-peg exchange-rate policy is one in which the currency is periodically devalued in proportion to the difference between domestic and international inflation. Edwards [1996], 176.
4. Rodrik [1996].
5. Fischer [January 22, 1998].
6. Pyo [1999], 151.
7. $21 billion from the International Monetary Fund, $10 billion from the World Bank, and $20 billion from major industrial nations (mostly the U.S. and Japan). Pyo [1999], 152.
8. Meigs [1999].
9. Smith, H. [1998], 67.
10. Gil-Diaz and Carstens [1996], 166.
11. Calvo and Mendoza [1996], 172.
12. Corsetti, Roubini, and Pesenti [1998]; Radelet and Sachs [1998].
13. Dornbusch and Werner [1994]; Dornbusch, Goldfajn, and Valdés [1995]; Krugman [1995]; Fraser [1995].
14. Fischer [January 22, 1998].
15. Fischer [January 22, 1998]; McLeod and Garnaut [1998], 270.
16. Eichengreen [1999], 2.
17. *The Economist* [1998], 66.
18. Pollack [1997].
19. Crafts [1998], 32.
20. Wesphal [1990], 58.
21. Goldstein [1998], 13.
22. Goldstein [1998], 24.
23. Preston [1999].
24. Meigs [1999].
25. Edwards [1996], 176.
26. Edwards [1996], 179.
27. Henderson [1998], 69.
28. Goldstein [1998], 13.
29. Eichengreen [1999], 12.
30. Radelet and Sachs [1998], 26.
31. Haggard and Mo [1999], 3.
32. Summers [1998].
33. Preston [1999].

34. Pollack [1997].
35. Haggard and Mo [1999], 4.
36. Dekle and Ubide [1999], 7.
37. Fischer [January 22, 1998].
38. Fischer [January 22, 1998].
39. McLeod and Garnaut [1998], 267.
40. Haggard and Mo [1999], 4.
41. Dekle and Ubide [1999], 18.
42. Haggard and Mo [1999], 22.
43. Haggard and Mo [1999], 7.
44. Haggard and Mo [1999], 5
45. Goldstein [1998], 1; McLeod and Garnaut [1998], 16.
46. McLeod and Garnaut [1998], 278.
47. Smith [1998], 68–69.
48. Radelet and Sachs [1998], 26.
49. *Wall Street Journal*, 24 May 1996.
50. Salinas-Leon [1997].
51. Salinas-Leon [1997].
52. Gil-Diaz and Carstens [1996], 169; Calvo and Mendoza [1996], 170, 174.
53. Smith [April, 1998].
54. Previously foreign ownership was limited to 20% in the biggest Mexican banks.
55. Smith [April, 1998].
56. McLeod and Garnaut [1998], 277.
57. McLeod and Garnaut [1998], 20.
58. Haggard and Mo [1999], 10–11.
59. Fischer [January 22, 1998].
60. Haggard and Mo [1999], 9.
61. Haggard and Mo [1999], 12, 22.
62. Pollack [1997].
63. Goldstein [1998], 24.
64. Tanzer [1998], 52.
65. Tanzer [1998], 52.
66. Tanzer [1998], 52.

Conclusion

This book began with an exploration of the changes in Mexican financial politics over time. It contrasted economic performance, the structure of the financial sector, the orientation of financial policymaking, and the degree of concentration within financial markets in the 1940–1960 with the 1980–1994 period. The magnitude and breadth of the changes in these areas underscore a fundamental transformation in the politics of Mexican financial policy. The Mexican case demonstrates a causal link between financial system structure and the character of financial policymaking. The shift in financial system structure from state leadership to bank leadership supported financial liberalization after 1980. Moreover, the interventionist financial policies under state-led finance provided a basis for Mexico's extraordinary economic performance, while financial liberalization, under conditions of growing economic concentration and centralization, contributed to the economic downturn and financial crisis. Several puzzles emanated from these initial hypotheses, which in turn motivated the analyses of the chapters that followed.

The first of these puzzles—why bank-domination proved so devastating for Mexico but not for other countries with similar financial structures—was taken up in Chapter 2, with a comparison of the effects of a bank-dominated financial market structure on the politics of financial policy in Germany and Mexico. The analysis focused on two independent variables: the degree of economic competitiveness in the financial sector, and the extent of state policymaking credibility. Whereas Mexican policymakers have tended to adopt short-term oriented monetary policies which tolerated extreme currency over-valuation, German policymakers have tended to favor competitiveness-conscious, stability-oriented monetary policies. The analysis concluded that the divergence in monetary policies can be attributed to the relative lack of competition among Mexican banks as compared with German banks, and the historical lack of state policymaking credibility, based on the inability to control inflation, in Mexico as compared with Germany.

Two major implications derived from this analysis of Mexican financial liberalization: that financial liberalization can have harmful conse-

quences, and Mexico liberalized because the state increasingly lost the ability to control private finance anyway. However, as many scholars have noted, some countries have performed well economically after financial liberalization, and many countries liberalized at the same time as Mexico so that liberalization could not be simply a function of Mexico's internal politics. These inconsistencies were tackled in Chapter 3, through an examination of Korea, a country that liberalized at the same time as Mexico and performed well economically in the process. The analysis found that financial liberalization within the context of state autonomy was more likely to promote growth and financial stability than financial liberalization in the context of declining state autonomy. The declining ability of the Mexican state to direct finance—a consequence of bank leadership—first made interventionist financial policies untenable, and later made financial liberalization incompatible with growth and stability. On the other hand, Korea liberalized within the confines of state autonomy rather than bank leadership. As a result, Korean financial liberalization was more successful in achieving economic policy goals.

The analysis in Chapter 3 also suggests that comparisons of transitions from intervention to financial liberalization should focus more on issues of timing and damage control. Financial liberalization may be inevitable, but its characteristics and ramifications are not. If this is the case, then the debate over states versus markets is becoming increasingly irrelevant. The relevant question has shifted from why Korea adopted financial liberalization to why the Korean state was able to pick and choose pieces of its financial liberalization program. The answer lies in the nature of Korean state autonomy, that it remained relatively intact throughout the transition from heterodox financial policy to orthodox financial policy. Whereas Mexico experienced the structural transition from state-led to bank-led finance and then had to liberalize, Korea pursued elements of financial liberalization while the underlying structure of the financial system remained state-led.[1]

Chapter 4 then generalized from the Mexican case by looking at the transition to liberalization as a strategic interaction between market actors and state actors in four divergent cases: Turkey, South Korea, Hong Kong, and Mexico. Focusing on the issue of policymaking leadership, this chapter demonstrated that economies exhibiting clear leadership roles, whether they are state-led or bank-led, are more likely to experience successful policy outcomes than countries in which key players are vying for leadership. Mexico was been hurt by having simultaneously a powerful state and a powerful private financial sector; Korea exhibited clear state leadership of the financial sector throughout the initial phases of financial liberalization in the 1980s and early 1990s; Hong Kong benefitted from a leadership-oriented private banking sector and a state with

a hands-off philosophy; and Turkey, while it suffered in the past from conditions similar to Mexico's, later entered into a cooperative power-sharing relationship with a relatively efficient state-fostered exporting sector, which has challenged entrenched and relatively inefficient economic sectors.

From Bank-Led Finance to Market-Based Finance

Just as the Mexican peso crisis raises questions about the harmful effects of bankers' hegemony, the rash of currency crises that began with Thailand in the summer of 1997 raise an obvious question about state-led finance. Was state-led finance, as practiced by the Asian tigers, deeply flawed after all? How can we understand the collapse of most of the Asian markets within such a short period of time? Are these currency crises similar to the Mexican peso crisis of 1994? Chapter 5 argued that these currency crises, as in the Mexican case, mark a transition to a new financial market structure, from bank-led finance to market-based finance. Moreover, this transition appears to be part of a more extensive developmental trajectory from state-led to bank-led finance to market-based finance. Cross-national data, comparing private versus public shares of the credit market over time, indicate that as countries become richer the credit allocation function of central banks becomes less important, and private banks become more important.[2] Also, private market firms, as opposed to state enterprises, increasing become the beneficiaries of bank credit as countries become richer.[3]

The following story describes the typical progression from state-leadership to bank-leadership in abstract terms. A strong state desires to use its capabilities to promote growth. Finance constitutes the tool of choice in the state's efforts to promote industrial investment. Toward this end, the state engineers an elaborate state-led financial system and directs private financial flows toward industry. This strategy successfully encourages growth. However, the process of state-directed finance systematically empowers an emerging private financial and/or industrial sector. Usually, this is a self-conscious policy on the part of the state in order to build up the domestic market so as to compete internationally. Thus, analogous to the principle underlying hegemonic stability theory, this process is dynamic and, to a degree, self-regulating. The state inevitably creates its own monster.

Yet there is another step in the trajectory beyond bank-led finance, toward market-led finance, as capital markets and other nonbank financial institutions flourish.[4] We see this most clearly in Korea but also in other Asian countries, and increasingly in Mexico. The recent Asian stock market crises underscore not only the increasing prominence of capital mar-

kets in newly industrializing economies, but also the vulnerability of the real economy to the movement of portfolio capital. The clearest indication of the transition from bank-led to market-led finance is the abandonment of various forms of currency pegs in favor of floating exchange rates in virtually all of these economies. The Mexican peso crisis, therefore, illustrates not only the relationship between bank-led finance and currency crises, but also the role of major currency crises in bringing about the transition from bank-leadership to market-based finance. Again the ramifications of this transition vary across countries depending upon the relative competitiveness within the financial sector and between the financial sector and other competing state and market actors.

Policy Prescriptions

This book has attempted to bridge the gap between theory and practice by generating several broad policy prescriptions. First, developing economies should attempt where possible to liberalize financial markets in the context of state-led finance, while the state still possesses relative autonomy from the emerging private sector. The state's main responsibility during the period of state-led finance should be to promote efficient industrial growth under a segmented financial market, and to ensure the eventual competitiveness of the emerging financial sector. As we have seen, a centralized and concentrated financial sector can doom an economy and become nearly impossible to regulate after the fact, as the Mexican case illustrates. This lesson applies to most developing economies, even though the vast majority do not fit into the strong state model in the first place. State-led finance is still the most common financial structure among late developers, and it is even more important to introduce competition to curb the power of financial elites in countries with "weak" states.

Second, while state autonomy goes a long way toward distinguishing among countries which fit the international trend toward financial liberalization, the state-centered approach is not by itself a sufficient explanation. Although the Korean, Taiwanese and Japanese states all possess relatively greater autonomy from societal forces than the Mexican state, they, as with the Mexican state, have experienced erosion of state autonomy over time. This trend underscores the main theme of this book: Internal domestic relations between states and markets change over time in response to financial structure, which in turn also changes over time in response to state and market interaction. This dialectic or interplay ultimately determines the general character of financial policy.

Third, this study warns against drawing overly general lessons concerning financial liberalization from individual case studies because the

political context in which a policy is pursued can be as important as the actual policy orientation chosen. Hence, there is considerable danger in heralding the success of open market policies based on the experiences of countries which, for political reasons, have managed to mitigate destructive rent-seeking and speculative behavior, such as Hong Kong. If such free-market policies are implemented in economies exhibiting a lack of competition and regulatory enforcement, the results are likely to be devastating.

Finally, this book has considered two circumstances under which bank-led finance did not have such devastating effects: (1) in an advanced industrial country context where competitive banking developed without state intervention, as in Germany; and (2) in a newly industrialized country context where banks played an active leadership role in the absence of state intervention, as in Hong Kong. There is also a third way, for states that have practiced interventionist finance. State-led finance need not "create its own monster" in the form of bankers' hegemony. If the state succeeds in creating a relatively competitive industrial and financial sector, the potential for a successful transition to bank-led or market-based finance exists. A competitive market tempers the political and economic power of private market actors long enough to allow for a slower erosion of state autonomy which, in turn, makes gradualism a viable policy option. And, perhaps more important in the long-run, bank-led or market-based finance can only be as efficient as the banking or industrial sector on which it is based.

Conclusion

Ultimately, conventional ways of formulating research questions concerning financial liberalization are becoming increasingly irrelevant. Asking whether or not a particular country will or should choose to liberalize financial markets seems pointless, in light of growing international pressure for liberalization on a political level (following the collapse of the Soviet Bloc) as well as on an economic level (based on the growing internationalization of capital). These pressures make financial liberalization an undeniable reality. A more fruitful question to ask is how countries will manage to implement liberalization: in what political context (state autonomy versus bank hegemony), and in what economic context (market structure)?

Based on what we know about the Mexican economy there are reasons for cautious optimism. Recent evidence from Mexico suggests that recovery from the 1994 peso crisis has been slow to reach middle and lower income Mexicans. The government intervention in the banking sector was expensive, requiring the conversion of bank debt into public debt which

increased public debt from 27 percent to 40 percent of GDP.[5] While Mexico's economic recovery is being held out as a model for the crisis-ridden countries of Asia because of booming exports, growing foreign investment, rising retail sales, and even the repayment of bailout loans, standards of living have remained low as consumer prices have continued to rise faster than salaries.[6] On the other hand, competitive political forces hold out hope for the future, as the process of democratization has begun to penetrate the previously elitist sphere of financial policymaking. The bank rescue plan was the most fiercely contested legislation in recent Mexican history. In the past, the President's bills were rubber stamped by the legislature, which was controlled by the PRI. In 1998, for the first time in seven decades, the PRI lost control of the lower house of congress (although it retained the senate). When the government introduced the financial reform bill (Fobaproa), which called for a fund to rescue banks, to Congress in April, it was stunned by the firestorm of protest. The PRD, Mexico's leftist party, has been the driving force in turning the highly technical bank issue into a matter of street protests.[7]

The danger, however, is to assume that liberalization will automatically bring with it democratization and increased economic efficiency. In fact, the popular view of the transitions taking place in NICs around the world is that personal networks and huge families of linked companies are giving way to a more open system in which "business is allocated not by loyalty but by price."[8] This kind of thinking leads to calls for liberalization without full consideration of the consequences. The fact is that social structures may shape economic structures more than the other way around. Under these conditions, the results of rapid financial liberalization can be disastrous, as we have witnessed not only in Mexico and Asia, but also in Brazil. In financially underdeveloped economies, free access to foreign capital, particularly short-term finance, is incompatible with financial stability. Foreign funding gives banks seeking to take on excessive risk an additional way to lever their bets. Also, there is wide-ranging evidence that volatility of real exchange rates is typically higher under floating than under fixed exchange rate regimes.[9] The question of how to involve the private sector in reform so as to prevent, or at least mitigate financial crises is critical, and not yet fully resolved. Ironically, the Mexican state's position vis-à-vis the powerful Mexican *grupos* seems to be much less precarious now than it was a decade ago due largely to increasing democratization at the grass roots level. The Korean state has not fared so well in their attempts to restructure the *chaebol*, a reversal of the situation in the 1980s.

The framework employed in this book, were it to be extended even more broadly, suggests that while strong state leadership can mitigate financial crises in the short-run, eventually state-leadership will give way

to bank- and then market-leadership. The relative competitiveness of financial markets then becomes an important determinant of economic welfare for the entire economy. The devaluation of the Brazilian real January of 1999 demonstrates once again how the shift away from bank-led finance toward market-led finance tends to be accompanied by financial crisis. The Brazilian banking sector does not appear to suffer from inefficiency and lack of competitiveness to the same extent that Asian banks have demonstrated, in part because they have had to cut costs in order to adapt to three straight years of low inflation.[10] For this reason, the Brazilian crisis may prove to be more short-lived. However, the level of short-term indebtedness is comparable, as Brazil needed to rollover more than $100 billion in debt in the late fall of 1998.

The Russian crisis August 1998, on the other hand, demonstrates a total lack of leadership, with the state unable to provide even basic market infrastructure. It comes as no surprise that without such leadership, crises will continue to plague the Russian economy. But the framework presented here may also suggest that given the pressures of financial globalization, it is unlikely that any developing economy will be able to foster an oligopolized, protected financial sector in the way that Mexico did beginning in the 1940s. Instead, the development of finance in emerging economies is likely to involve vigorous competition among foreign banks. Ultimately, this will lead to a healthier more robust economy in which the politics of finance do not become captive to powerful domestic financial interests. Certainly, an application of the framework employed in this book, which models the mutual incentives facing state and market actors paying special attention to the degree of political as well as economic competition, to emerging economies which have recently gone through or have yet to go through the transition to market-led finance would contribute significantly to our understanding not only of financial crises but of development processes more generally.

Notes

1. Dalla and Khatkhate [1996], 4.
2. Harwood and Smith [1997], 19.
3. Harwood and Smith [1997], 21.
4. Harwood and Smith [1997], 5.
5. McLeod and Garnaut [1998], 277; Salinas-Leon [1998].
6. Smith [Jan. 1998].
7. Sheridan [1998].
8. Kristof [1998].
9. Mussa [1986].
10. *The Economist* [March 27, 1999], 7.

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