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FINANCIAL GLOBALIZATION AND QUALITY OF INSTITUTIONS

The financial crisis begun in the US substandard mortgages market in 2007, spilled over the world economy. A lot of countries with good macroeconomical indicators and not directly connected with the American mortgage market in the course of the crisis suffered much more than developed countries closer to the epicenter of the crisis.

The crisis was preceded by a period of very successful growth in the world economy: average annual growth rates of GDP increased up to 4.2 % in 2000-2007 (GDP growth rates made 3% in average for the last 20 years). This acceleration was driven, first of all, by developing countries and emerging markets¹ in which growth rates went up to 6.4% (3.2% in 1990s). Consequently, their share in the world GDP went up from 36% in 1990s to 44% before the crisis².

Many economists attribute these achievements to the globalization process speeded up in 1990s. One of the manifestations of this tendency was rapid development of the world trade amid considerable reduction of tariff and non-tariff limitations in movement of goods. Thus, from mid 1980s to mid 2000s average import tariffs dropped twice as much. While the volume of international trade constituted 37% of the world GDP in 1980s, the figure has been above 60% in recent years. Quality changes in forms of international division of labour are not less important: the volume of final or raw materials is often replaced by the alignment of the value added chain where integration takes place inside the production process, i.e. countries do not exchange production, but cooperate during the manufacturing process.

¹ This group includes countries actively implementing economic reforms and integrating into the world economy. First-rate emerging market countries are China, India, Russia, Brasil and Mexico.

² Share is determined on the basis of GDP indicator, calculated by purchasing power parity.

Another significant direction in the general globalization process is financial integration within the scope of which limitations on inflow of foreign capital to a country and outflow of capital were either reduced or abolished. In addition, a number of countries opened their financial markets for activities of foreign banks and financial companies. Consequently, transboundary financial flows grew rapidly and borders among national financial markets were removed. The latter gradually changed in closely connected segments of the global market functioning by approximately the same rules.

In recent years, Azerbaijan has taken a series of strong measures on integration. The country was open to foreign investors as far back as early 1990s, when foreign banks accessed the native market and limitations on operations with capital were removed in 2008.

Note that, globalization, emerging as an economic phenomenon, becomes politically and socially more important. It presents new requirements for joint activities of national governments, interrelations of state and private sectors and mobility of labour force. The key objective for all countries in the globalizing world is to effectively combine measures by coordination of the economic policy with foreign partners and endeavours directed at competitive advantage in the world arena.

The crisis revealed a reverse side of integration of economies and financial systems of different countries: problems emerging in independent markets rapidly spilled over the world. Strengthening financial ties turned into the transmission channels of crisis “contagion” among countries, but economies particularly thriving in foreign investment attractions were threatened by a sudden turn of world capital flows. This drew economists’ attention to the question actively discussed after the Asian crisis of 1997-1998s again: whether rewards of integration outweigh inherent risks and losses.

Note that, experts, almost unanimously assess liberalization of foreign trade positively – there is a sufficient amount of evidences on positive effect of economy’s trade openness³. Meanwhile, the effect of liberalization of financial markets is estimated ambiguously. Yet, when developing the Bretton-Budd system, Jhon M. Keins cast doubts on profitability of high capital mobility. At

³ Sachs J., Warner A. Economic Reform and the Process of Global Integration // Brookings Papers on Economic Activity. 1995. No 1; Wacziarg R., Welch K. Trade Liberalization and Growth: New Evidences // NBER Working Paper No 10152. 2003.

present, particularly S.Fisher⁴ and L. Summers⁵ support the financial liberalization. So, Fisher suggested to include gradual liberalization of world capital flows to IMF tasks. Along with the above economists, some others (J.Stiglitz⁶, P.Krugman, D.Rodrik⁷) approach to their profitability sceptically. For instance, Rodrick believes that such liberalization considerably elevates crisis risks in emerging countries, but Krugman suggests that countries in the crisis should actively control capital flows. J. Williamson, who formulated basic principles of the Washington consensus noted that he did not include liberalization of financial markets into the standard set of market reforms due to lack of unanimous thought to that effect⁸.

Being guided by the experience of last decades, we can conclude that on the backdrop of globalization, international financial stability remains as an important social benefit going further beyond national goals and interests. Therefore, it is necessary to work out general understanding of advantages and disadvantages of integration through our combined efforts. The policy of liberalization of financial markets should be evaluated through comprehensive analysis of possible effects and factors on which its final results depend.

Basic trends in financial globalization process

In the period of development of international financial integration, national financial markets are unlocked for foreign participants, while local banks and companies gain the right to invest abroad. That means removal of barriers for crosscountry capital flows and financial services in the form of capital control and tax measures. Another significant measure on integration is to apply equal rights to foreign financial institutions and foreign capital and local banks and investors.

Financial globalisation is interpreted via objective economic factors (via achievements of earlier liberalization of international trade and rapid growth of

⁴ Fischer S. Capital Account Liberalization and the Role of the IMF: Speech at the IMF annual meeting. Sept. 19, 1997.

⁵ Summers L. International Financial Crisis: Causes, Prevention, and Cures // American Economic Review. 2000. Vol. 90, No 2.

⁶ Stiglitz J. Globalization and Its Discontents. N.Y., L.: W.W. Norton, 2002 (russian trans.

⁷ Rodrik D., Subramanian A. Why Did Financial Globalization Disappoint? // IMF Staff Paper. 2009. Vol. 56, No 1.

⁸ Williamson J. Did the Washington Consensus Fail?: Outline of speech at the Center for Strategic and International Studies. Washington, DC, 2002.

transnational companies) on the one hand and via technical ones (via progress in information - communications technologies) on the other hand. Active integration policy pursued by many countries is obviously of great importance as well. The key economic powers existed on the basis of financial openness before recently have been joined by emerging markets, who, one by one, removed restrictions on operations with capital and allowed foreign banks and companies to their own markets.

Financial liberalization required dramatic changes in the entire economic policy. Particularly, it triggered rejection to maintain fixed exchange rates, stimulated improvement of prudential regulation and supervision, and stipulated the necessity to harmonize national standards and legal norms through their coordination or adoption of revised standards, shared by all.

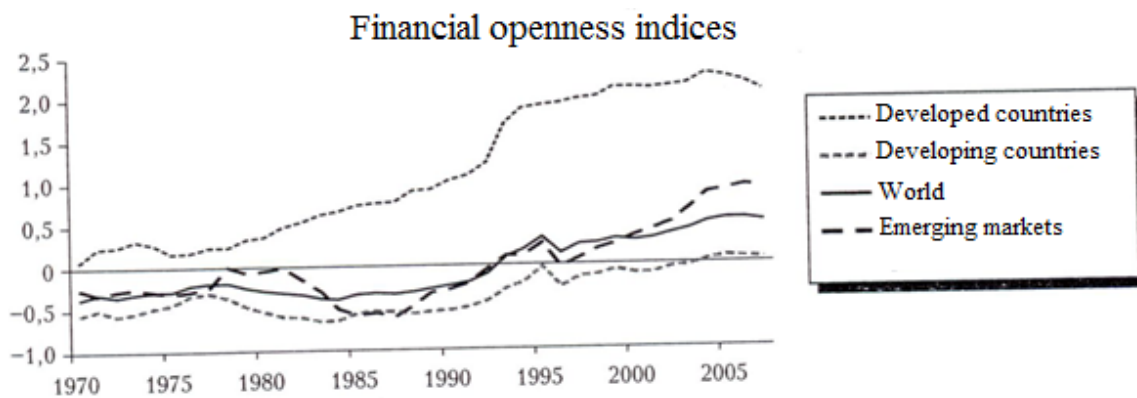
Oil-producing countries have a number of specifics in integration techniques. Fluctuations in the scale of current account balance is particularly significant for those countries upon swings in world prices for hydrocarbon resources. Another feature of those countries is that the major part of oil revenues, as a rule, is under government control. Launch of oil funds, where a substantial part of revenues is accumulated (at least in the period of prosperous conjuncture), is a more widespread tendency. A standard approach is investment of oil fund reserves in foreign assets, which means that surplus/deficit of current account balance is partially compensated through outflow/inflow of capital by public channels due to changes in official forex reserves, and direction of capital inflows can cyclically vary. At the onset of development of deposits oil-producing countries are exposed to massive inflows of foreign direct investments. Such a pattern was observed in Azerbaijan, Kazakhstan, and some other countries.

We can use the financial openness indices created by Chinn M. and Ito H⁹ to quantitatively describe the integration process, which reflect existing crosscountry operations with capital. Values of the index are ranged from -2.5 (minimum financial openness) up to 2.5 (complete openness). As shown in Chart 1, during the period of liberalization, (from mid-1980s to mid-2000s) average world index of openness increased considerably: from -0.4 to +0.5. Liberalization in developed countries began in 1980s and actually completed in mid-1990s.

⁹ Chinn M., Ito H. A New Measure of Financial Openness // Journal of Comparative Policy Analysis: Research and Practice. 2008. Vol. 10, No 3.

Emerging markets started active financial liberalization early in 1990s and terminated the process only until on the onset of the current crisis. Finally, openness of developing countries in the given period increased as well, however, this process was limited basically by the first half of 1990s. In whole, developed countries went farthest in financial liberalization, while developing countries advanced least of all, thereby deepening differences between countries to that effect.

Oil-producing countries are close to the average world level with respect to financial liberalization (chart 2). Interestingly, openness of those countries fluctuates together with oil prices: It increases with hikes and decreases with slides in oil prices. The reason is probably in the aspiration of authorities to simplify capital outflows in the period of price boom in order to compensate for growth of export revenues. However, cyclicality of capital flows is often the reverse side: growth in the stage of price hikes and outflow with price falls. In recent years, such a cycle has been observed in many oil-producing countries.



Source: according to: Chinn M., Ito H. Financial Openness Measure. www.ssc.wisc.edu/mchinn/kaopen_2007.xls.

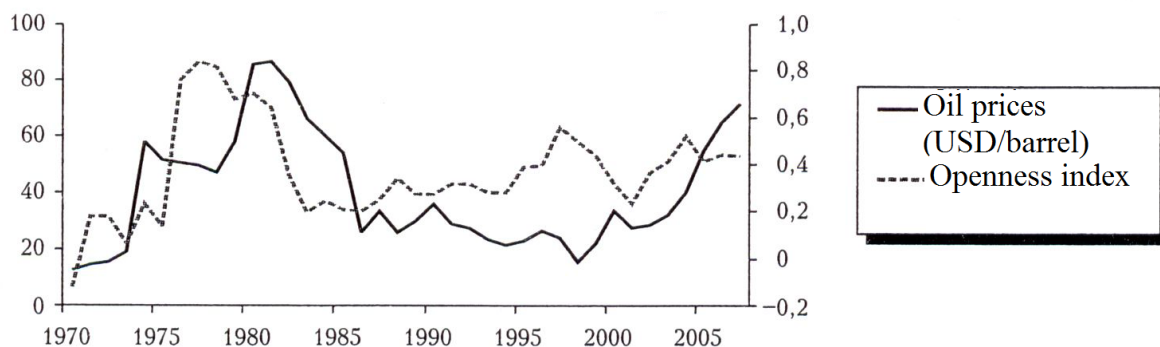
Chart 1

Measures taken to liberalize capital movement and markets seriously transformed the international financial system:

- investment activity frames expanded, and capital became internationally more mobile;

- relations amongst market participants, markets and financial systems strengthened;
- effectiveness of international markets increased;
- adaptation of financial flows and asset prices to changes in economic conditions accelerated;
- financial instruments and trade strategies became more complex;

Openness index of oil-producing countries and oil prices



Source: chart 1.

Chart 2

These tendencies substantially complicated the process of safeguarding financial stability. Firstly, national central banks were obliged to monitor the entire world economy, to timely reveal potential sources of shocks, which under modern conditions spread rapidly through the chain of interrelated financial markets. Secondly, dynamics of value of key assets (shares, property) became more crucial when evaluating potential threats of price stability.

The results of financial integration reflect total size of current account deficit. Indeed, deficit is financed due to foreign capital flows (given the fact that changes in gold reserves also correspond to specific variety of capital movement). Total current account deficit (on deficit-holder countries) in USD increased ten times as much until 2008 compared to the indicators of early-1980s. The deficit to GDP ratio (weighted average of GDP) in the said

period roughly doubled: from predominant 2 – 2.5 % in 1980s-1990s to 4.4 – 5 % in recent years (see Fig 3).

Interestingly, if to consider current account deficit on country groups, the picture will be unexpected (See Chart 4). Starting with end-1990s average size of current account balance on developed countries was negative (pre-crisis – 1.3.... – 1.4% of GDP), while it was positive on emerging markets (about 3.5% of GDP).

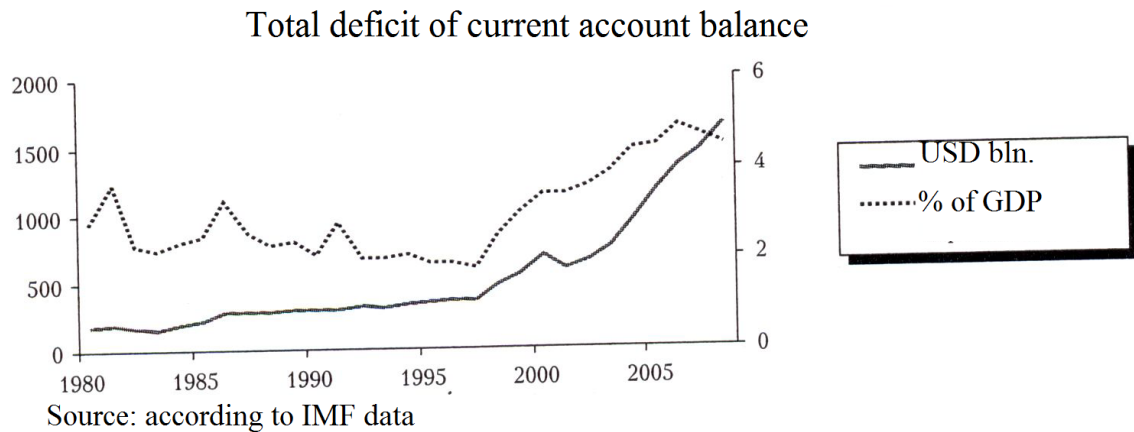


Chart 3

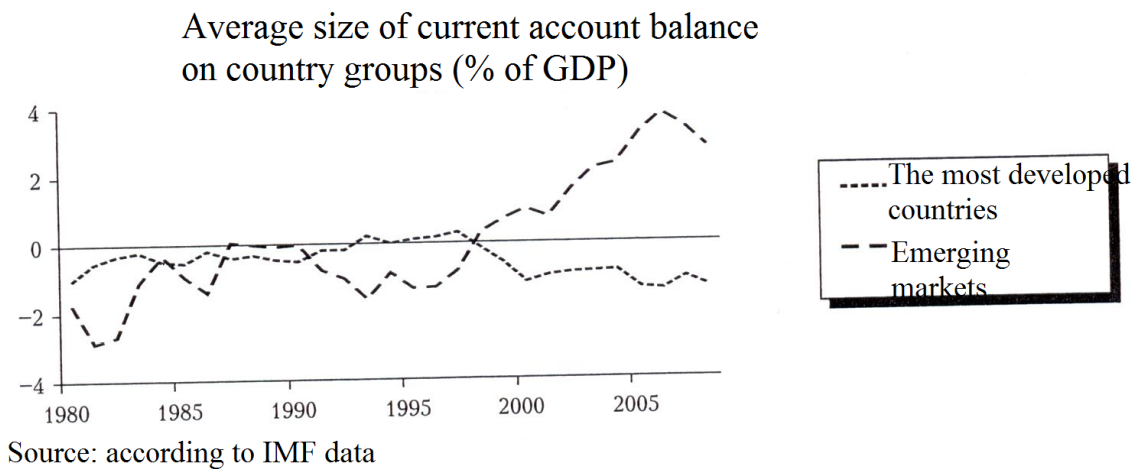


Chart 4

Another important indicator characterizing consequences of the globalization is the scale of gross capital flows amongst countries. As expected, this indicator rose much (practically twice) more rapidly than the size of net flows characterized by current account balance. The data in Charts 1 and 2 allow to make an unexpected conclusion: *Rapid climb in capital outflows from developed countries and emerging markets has turned out to be the basic result of active financial liberalization of recent years.*

Consequently, capital inflow to those countries in 1999 changed into net outflow in 2007. Growth rates of capital inflow and outflow for this group of countries considerably outweighed that of developed ones.

Net capital outflow from developed countries was connected with accumulation of their forex reserves (basically at the expense of the policy of China and leading oil-producing countries). On other kinds of capital, the indicators of net inflow to developed countries and emerging markets slightly improved. At the same time, the share of foreign direct investments in the structure of capital inflow to developed countries decreased significantly (from 84 down to 37%). Thus, growth in the scale of capital flows paralleled with shifts in their structure.

The above data verify the presence of the Lucas Paradox. R. Lucas, exemplifying investments in the USA and India, showed that the direction of world capital flows does not correspond to predictions of neoclassical models¹⁰. Given much smaller size of capital per employee in developing countries, ultimate output of capital in those countries must be much higher and consequently, at its free movement it should entirely target developing countries. The data in Table 2 display that net capital flows from developing countries to developed ones. Lucas found this contradiction as one of the major problems of economic growth. This paradox is explained below.

¹⁰ Lucas R. Why Doesn't Capital Flow from Rich to Poor Countries? // American Economic Review. 1990. Vol. 80, No 2.

Table 1

Capital flows (USD bln.)

	1999	2007	Growth(times)	1999	2007	Growth(times)
	Capital inflow			Capital outflow		
All types of capital						
The most developed countries	1701	7201	4,2	1560	6559	4,2
Developing countries and emerging markets	202	1666	8,3	158	2285	14,5
Total	1903	8867	4,7	1717	8844	5,1
Foreign direct investments						
The most developed countries	632	1132	1,8	816	1461	1,8
Developing countries and emerging markets	170	611	3,6	18	199	11,3
Total	802	1743	2,2	833	1659	2,0
Portfolio investments						
The most developed countries	892	2534	2,8	668	1343	2,0
Developing countries and emerging markets	34	358	10,5	23	337	14,5
Total	926	2892	3,1	692	1680	2,4
Other investments*						
The most developed countries	178	3535	19,9	-12	3707	-308,9
Developing countries and emerging markets	-2	698	-349,0	79	522	6,6
Total	175	4233	24,1	67	4229	63,2

* Include loans, deposits and other types of investments

Source: according to: Global Financial Stability Report / IMF, Oct. 2009

Table 2

Net capital inflow (USD bln.)

	1999	2007	Growth(times)	1999	2007	Growth(times)
	All types of capital			FDI		
The most developed countries	142	642	4,5	-184	-329	1,8
Developing countries and emerging markets	44	-619	-14,1	153	412	2,7
	Portfolio			Others		
The most developed countries	223	1191	5,3	190	-172	-0,9
Developing countries and emerging markets	11	21	1,9	-81	176	-2,2

Source: table 1.

Effects of financial globalization

According to a standard approach, financial openness generates a great deal of benefits. From the investors' standpoint, access to foreign financial markets enables to increase return on capital and diversify risks. In terms of capital recipients, foreign investments broaden opportunities to finance investment projects and consequently, extend the accumulation norm, raise the capital/labour ratio and accelerate economic growth. Moreover, existing foreign capital markets facilitate macroeconomic stability and allow to smooth consumption capacity at the expense of borrowing in unfavourable periods (slump in production or worsening of foreign conjuncture) and repayment of debts in favourable periods. Such a countercyclical policy is completely substantiated, if shocks are of temporary.

Another aspect of financial integration - emergence of foreign banks and investment companies in domestic markets is likely to have serious positive consequences as well. As a result of high competitiveness, intermediary activities become more effective: its cost drops and resource allocation is optimized. International practice shows that entry of foreign banks to domestic markets facilitates businesses' access to loans.

Within these presentations, developing countries should be top beneficiaries of globalization: they have, as known, a relatively low level of savings and capital flows are followed by dropped interest rates. Substantial volatility of macroeconomical indicators is typical for developing countries, accordingly, they need stabilizing instruments more than the developed ones.

However, financial integration bears a great deal of risks. First of all, existing capital flows may lead to serious macroeconomic challenges, including excess monetary expansion (under sterilization problems), overheating of the economy, inflation pressure, real strengthening of a national currency and worsening of current account balance. A fixed exchange rate under these conditions may eventually undermine stability and result in a currency crisis.

One of the most important consequences of liberalization of capital movement is related to trilemma: inability to simultaneously control exchange and interest rates in the environment of openness. This means that either authorities should maintain a more flexible exchange rate, or they will face restrictions when implementing an independent monetary policy. As J. Aizenman, M.Chinn and

H. Ito showed, various country groups solved the problem in different ways¹¹. The most developed countries, on the background of existing liberalization, eased their monetary independence having considerably raised exchange rate stability (basically owing to creation of the euro zone) from early 1990s. Emerging markets followed the principle of exchange rate stability until the end of 1980s, thereafter starting to conduct the compromise policy of managed flexibility based upon the intermediate state of all elements of trilemma: openness of account operations with capital, control over the exchange rate and monetary independence. Accumulation of substantial forex reserves is one of the crucial elements of such a policy.

The analysis by the World Bank showed that short-term capital flows are of procyclic: its inflow increases in the period of high economic growth, while it decreases in the period of slowdown¹². Such cyclicity can be hazardous, if it is related to external factors, not to changes in domestic demand, e.g. (with respect to an oil-producing country) decline in oil-prices. Thus, countries are much likely to be exposed to the impact of external conditions as a result of integration. Particularly, drastic swing of capital inflow to outflow (as observed during the current crisis) may generate a liquidity crisis in the country – investments recipient. These problems can even arise in countries with good macroeconomic indicators, since turn of capital in such situations is stipulated by the situation in donor- countries. The risk of unexpected cessation of capital inflow or beginning of capital outflow from developing countries has caused a special concern recently, because many of them to a considerable degree rely on borrowings from foreign banks or portfolio investments of foreign investors.

One more source of risks is related to the fact that financial integration heightens quality requirements of public institutions. An accountable macroeconomical policy and a sound financial system are particularly important in such a case. Note that, access to world capital markets not supported by a tough budget discipline quite often leads to excess borrowings and high budget and current account deficit with low effective public expenditures. Owing to huge volume of a short-term debt, nominated in a foreign currency, countries are vulnerable to external shocks or changes in investors' mood. Experience of many highly financially integrated countries, that suffered from such an accumulated foreign

¹¹ Aizenman J., Chinn M., Ito H. Assessing the Emerging Global Financial Architecture: Measuring the Trilemma's Configuration over Time // NBER Working Paper No 14533. 2008.

¹² The Benefits and Risks of Short-term Borrowing // The World Bank // Global Development Finance. 2000. Vol. 1. Ch. 4.

debt, points out amplification of risks of a low budget discipline amid open account of capital movement. Its prompt openness also exposes a country to serious risks, if its supervisory and regulatory bodies are not effective enough. On the backdrop of the poorly-regulated banking system and presence of other violation cases in domestic financial markets, foreign capital inflow can intensify the ineffectiveness existing in such an economy. For example, if domestic financial institutions direct a substantial amount of investments to the firms with poor financial indicators and excess risks, then financial integration will lead to growth of these flows.

Since the economic theory does not clearly determine balance of profit and losses of financial openness, it is reasonable to turn to empiric studies. It is necessary to consider not only existing relationship between liberalization and economic growth, but also basic mechanisms of such relationship (if any). IMF experts introduce a more detailed review of empiric studies on the present subject¹³. The main summary of the review is as follows:

1. According to the results of 25 studies, which analysed the relationship between financial liberalization and economic growth, there are no solid confirmations of its availability for developing countries and emerging markets. Some studies reveal such interrelation, though it nearly always proved to be volatile with respect to specification of a model (e.g., it vanishes when adding standard factors that explain economic growth).
2. There is a relation between liberalization and investments, but weak and unsteady. Moreover, its strength gradually decreases¹⁴.
3. Correlation of consumption volatility and revenues increased for emerging markets (most actively conducting liberalization recently), but remained unchanged for developing and developed countries (where liberalization of the economy remained nearly unchanged in the given period)¹⁵. It contradicts to the prerequisites on stabilizing impact of financial integration.

The last conclusion can be explained thus: high labour productivity and production rate in 1980s – early-1990s in the given country group led to a

¹³ Kose A., Prasad E., Rogoff K., Wei S. Financial Globalization: A Reappraisal // IMF Working Paper No WP/06/189. 2006.

¹⁴ Mody A., Murshid A.P. Growing up with Capital Flows // Journal of International Economics. 2005. Vol. 65, No1.

¹⁵ Kose A., Prasad E., Terrones M. Financial Integration and Macroeconomic Volatility // IMF Staff Paper No 03/50. 2003.

consumption boom, financed by foreign investors. Intensification of the boom in many countries resulted from liberalization of the domestic financial system and simultaneously with the openness of the economy for international financial flows. Under the influence of negative shocks, these countries missed an opportunity to quickly access to international capital markets. Thus, access to them has a cyclical element, that generates higher volatility of output and excess volatility of consumption (concerning revenue volatility).

Jh. Isenmann, jointly with his colleagues¹⁶ showed that an estimated portion of (in consideration for savings in certain years, borrowing in others) investment financing at the expense of own funds remained stable (at the level of 90%) for developing countries and emerging markets over the period of 1990s in spite of the active liberalization. Moreover, the authors determined that countries with a much higher level of self-financing grew faster than others. Indian researchers¹⁷ came to an analogous conclusion that there is a positive correlation between the size of current account balance and growth rates in developing countries and emerging markets. It means that apparent net capital outflow from the given country group do not hurt their development.

We can draw a conclusion that the analysis of actual growth indicators of countries implementing an active financial liberalization policy does not demonstrate its positive effect (neither related to high growth, nor to low volatility). Standard hypotheses on mechanisms of such an effect (particularly the deficit of own financial resources in developing countries) cannot be confirmed. Absence of expected positive results may partially be explained by the facts that potential negative consequences of liberalization mentioned above may heighten positive effects, and also that their potential mechanisms function under certain conditions.

Financial liberalization and institutional environment

Since standard conceptions on the effect of financial liberalization are not confirmed, it is necessary to substantially modify an approach to its evaluation. Its prerequisites are considered to be as follows:

¹⁶ Aizenman J., Pinto B., Radziwill A. Sources for Financing Domestic Capital – Is Foreign Saving a Viable Option for Developing Countries? // NBER Working Paper No 10624. 2004.

¹⁷ Prasad E., Rajan R., Subramanian A. Foreign Capital and Economic Growth // NBER Working Paper No 13619. 2007.

1. *It should be acknowledged that the positive effect is not guaranteed, it manifests itself under certain conditions only.* This is explained with the fact that an unprepared country cannot fully enjoy potential benefits of liberalization or growth of those countries accelerates temporarily, however, a crisis becomes inevitable crossing out achievements.
2. *Interrelation between the economic policy and capital movement is of a double-sided nature:* not only decisions of governments and central banks have an influence on capital flows, but the latter also affect parameters of the policy and economic environment. For instance, since liberalization posts advanced requirements towards the quality of macroeconomic policy, it compels authorities to pursue a more accountable and disciplined policy.
3. *Consequences of various capital inflows should be analysed.* In terms of financing of investment projects, diverse forms of investment cause analogous effect. However, in terms of side effects of capital movement, difference may turn out to be quite essential. In this case the factors determining the structure of capital flows should be explored.

Other effects of liberalization were formulated in a number of studies as well. Thus, A. Kose, jointly with coauthors revealed some indirect benefits of the financial system openness, which may positively influence the total factor production improving resource allocation¹⁸. Such benefits include: development of the domestic financial sector; improvement of institutional environment; improvement of government regulation; optimization of macroeconomic policy, etc.

High financial transparency and corporate governance standards in companies, interested in attracting investments from foreign markets are concrete patterns of such an external effect of openness. Low cost of capital stimulates them, and effects are felt both before and after investment attraction. It is crucial to align financial accounting and corporate governance standards to international requirements in order to access international markets. Upon receiving investments a company or bank is monitored by a domestic creditor or should admit a foreign proprietor to corporate control. Indirect benefits may be related to activities of authorities: e.g., if, to attract foreign investments, they adjust the legislation on functioning of financial

¹⁸ Kose A., Prasad E., Rogoff K., Wei S. Op. Cit.

markets, provisions of investment activity, taxation, etc. to the best international standards.

Series of researches support a similar approach. Thus, listing of a company in an exchange of a country with a high quality judicial system and administrative apparatus, as well as stricter requirements for disclosure of information leads to improvement of corporate governance in that company¹⁹. Increasing capitalization stimulates the process: the fact of quotation of company's shares in American Stock Exchange raises their cost.

It can be assumed that initial conditions determining the effect of financial liberalization are stipulated by the quality of institutional environment. M. Klein revealed a significant positive impact of liberalization on economic growth of countries with relatively high quality of institutions²⁰. In consideration of a close relation between institutional environment and per capita income level, countries with revenues above medium-scale are likely to benefit from liberalization.

In another research, authors revealed its significantly positive influence both on capital accumulation and economic growth using subtler quantity measures of financial openness²¹. However, the main reason for acceleration of the economy was not high investments, but growing total factor production which the authors associate with indirect positive influence of liberalization on quality of institutions and financial development. The research displays that financial openness promotes improvement of situation in these spheres, but the degree of influence of openness upon economic growth considerably depends on initial quality of institutions and growth of the financial system. Thus, in countries where the quality of institutional environment is above medium, influence of liberalization on growth of investments is six times more than in countries with weak institutions. It is significant to note that the unveiled effect is of permanent character (it is explained by the growth of the factor production), though the neoclassical model forecasts only temporary positive impact of liberalization on production growth.

¹⁹ Doige C., Karolyi A., Stulz R. Why Are Foreign Firms Listed in the U.S. Worth More? // Journal of Financial Economics. 2004. Vol. 71, No 2.

²⁰ Klein M. Capital Account Liberalization, Institutional Quality and Economic Growth: Theory and Evidence // NBER Working Paper No 11112. 2005.

²¹ Bekaert G., Harvey C., Lindblat C. Financial Openness and Productivity // NBER Working Paper No 14483. 2009.

The next step in understanding the effect of financial liberalization is in revealing its threshold nature. The influence of liberalization upon economic growth may be positive or negative depending on initial quality of institutional environment²². Countries with developed financial system and effective banking supervision system, protected property rights and implementing a responsible macroeconomic policy benefit from integration. Under these circumstances positive effect overbalances risks of globalization, otherwise common consequences may prove to be both positive and negative. A much higher degree of liberalization in advanced economies may prove this conclusion.

The origin of relations between institutional environment and the results of liberalization may be partially induced by the factors depending on the direction of capital movement. L. Alfaro, jointly with his colleagues, demonstrated that in 1970- 2000, distribution of capital amongst countries was, to a considerable extent, determined by quality of their institutional environment – protectability of property, degree of corruption, qualification of administrative apparatus and law observance²³. Ascertained dependence was strong enough: when quality of institutions made an upward shift from the level of Peru to that of Australia, other circumstances being equal, investments jumped four times as much.

Given the above, the Lucas paradox is institutionally explained: relatively smaller investment inflows in developing countries compared to forecasts of standard theoretical models is stipulated by poor quality of their institutions. According to conclusions of Alfaro and his coauthors, in the given period institutional factors were the main reason for predominance of capital flows in developed countries. Risks and additional transactional expenses associated with institutional weakness actually decreased effective profitability of investments in developing countries. Thus, in consideration of these amendments, marginal profitability of investing to developed and developing countries proves to be roughly equal.

FDIs are particularly vulnerable to the quality of institutional environment. They constitute a more desirable form of capital flow. First, FDIs are accompanied with technology transfers and management experience. Second, such investments are less mobile, therefore in this case the risk of sudden

²² Kose A., Prasad E., Taylor A. Thresholds in the Process of International Financial Integration // NBER Working Paper No 14916. 2009; Ju J., Wei S. Domestic Institutions and the Bypass Effect of Financial Globalization // NBER Working Paper No 13184. 2007.

²³ Alfaro L., Kalemli-Ozcan S., Volosovych V. Why Doesn't Capital Flow from Rich to Poor Countries? // NBER Working Paper No 11901. 2005.

interruption of capital inflow, which frequently provokes severe crisis. is smaller. Researches demonstrate that FDI inflow is virtually completely transforms to accumulation of Tier I Capital, then such a connection becomes substantially weaker as for other kinds of capital²⁴.

Not only forms of FDIs, but also the sectors they are channelled are very crucial. Investments to processing industry have a stronger impact on the economy, since they generate great demand for production of other sectors, and also “pull” institutional environment up to a higher level. In general, portfolio investments can also be evaluated positively, although their much higher (compared to FDI) volatility elevates the risk of sudden interruption of capital flows. In this regard, beneficial nature of considerable long-term financial inflows for the economy gives rise to doubt: in some phases of development this can facilitate its growth, however, generally negative consequences of increasing external debt overbalances benefits.

To avoid severe crises standard views on the effect of financial liberalization need to be reconsidered. Its consequences are mainly related to improvement of institutional environment and show up not so much in growth of accumulation as in total factor productivity owing to additional investment resources. Thus, financial liberalization requires intense initial preparation: development of a financial system and improvement of the quality of institutional environment. One of the elements of such a preparation may be to increase trade openness of the economy, since adaptation to foreign shocks occurs mainly at the expense of current operations in that case. Otherwise consequences might turn out to be rather negative: financial liberalization, not stimulating growth, raises exposure of the economy to external shocks and crisis probability. But in the event the economy is quite well prepared for financial liberalization, the relevant policy may facilitate institutional development of the country, and strengthening of the financial system and production growth.

²⁴ Borensztein E., De Gregorio J., Lee J. How Does Foreign Direct Investment Affect Growth? // Journal of International Economics. 1998. Vol. 45, No 1; Bosworth B., Collins S. Capital Flows to Developing Economies: Implications for Saving and Investment // Brookings Papers on Economic Activity. 1999. Vol. 30, No 1.