International Finance in the New World Order

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Take-off into Development and Emerging Capital Markets: Stages of Financial Development and Equity Financing

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Take-off into Development Financial Markets

Economic development is neither a linear nor an automatic process. Nor can a particular path of achievement be considered an ideal to be followed by others. However, the persistence of underdevelopment in many nations has called for the closer analysis of successful past and recent experience to draw some important lessons and enhance development policies. Model building is also necessary to search for faster, more efficient, and smoother paths into economic development.

This search for development alternatives has led to important contributions in institutional, historical, theoretical, and comparative analysis, which have not been free from controversy. Nevertheless, one important common factor among them has been the identification of 'essential factors' or characteristics which lead to important break-troughs from traditional levels of economic activity and welfare. It is a critical point at which nations take-off into development. In terms of policy-making this calls for an identification of all those factors that in past and current experience have led to the attainment of those characteristics, to induce them in other countries by promoting institutional changes and applying innovative policies so that their development process can be accelerated.

The relationship between savings and investment has been one of the most recurrent in model building. As an extension, historical and institutional studies have pinpointed the importance of financial markets and institutions on economic development. Finally, cross-sectional comparative studies have helped to identify differences in financial policies and in financial systems and their role in economic development, it is therefore possible to identify the characteristics that a financial system must have to be, if not the leading factor, one of the most relevant variables that induce a take-off into development. An identification of the stages of financial development is a contribution along these lines. To have a comprehensive picture of this phenomenon, it is necessary to examine financial development considering financial structure, development financing through foreign sources, and capital markets development; this picture must be completed with; an analysis of the relevance of batik financing vs capital markets financing*, financial integration, local and to the international markets, and patterns of nation building. Thés is precisely the concern of this chapter. Stages of financial development are presented following this comprehensive perspective. ''They are presented in a simplified manner, stressing the relationship between financing and development, to avoid rigidities of a pre-conceived path for development, in reality, due to the complexity of socioeconomic change, developing countries today simultaneously show characteristics identified with different states of financial development. Levels of financial and economic development are also very heterogeneous among nations. Thus, the theoretical framework presented here is intended to support in each country the formulation of the policies needed to promote changes in its financial structure in its search for alternative paths of development in the competitive, globalized economy which has emerged at the end of the millennium and that will determine world economic growth for the future.

Stages of Financial Development

Developing countries are generally characterized by low savings formation and weak financial markets and institutions. For this reason they must resort to external funds to promote greater and faster economic growth. Developed countries, on the other hand, export capital, making real and financial investments in other countries to take advantage of investment opportunities. Between these two types of capital mobilization processes there is a long process of financial market and institutional development, a well differentiated use of debt and equity to promote economic activity, and a clear pattern of inward and outward economic and financial integration.

Financial Deepening and Development

Financial markets and institutions allow the mobilization of savings from surplus units to deficit spending, investing units. This is made through the creation of financial claims. The more refined, bigger and innovative such a system of markets, institutions and financial assets is, the higher and more efficient savings mobilization and investment allocation will be. The financial sector becomes a superstructure which supports the infrastructure of national wealth— output and the physical assets of the economy.

The importance of the financial sector of an economy and its degree of development can therefore be measured by the level of financial claims in an economy—assets and liabilities outstanding in relation to total national wealth, or to domestic production, gross domestic product (GDP)—which is commonly referred to as financial deepening. The greater financial deepening is, the higher the level of financial development, and the greater the importance of the financial sector on economic activity. Higher financial deepening should also lead to qualitative changes. Six stages of financial development can be distinguished, corresponding to specific overall economic development attributes.[1]

1. *Prefinancial.* Here, financial markets, institutions and claims are lacking. Barter predominates for the exchange of goods and services, although rudimentary forms of currency begin to be used Production and investments, which are subsistence oriented, are usually communal; some output is saved to reproduce the agricultural cycles and some resources are devoted for the creation and maintenance of embryonic capital goods: rudimentary tools. Measures of financial deepening are therefore non-existent.

2. *Financial embryogenesis.* In a second stage of financial development, real markets appear and money, a financial claim, is used for transactions as a general equivalent. Agricultural production prevails, subsisting farming coexist along with large land tenure holdings. Technological innovation is imitated. Smart surpluses are derived from labor intensive exploitation of land. Trade with other societies is negligible. Surpluses are channeled for 'stand-still' investment and luxury consumption. Money is treasured and credit appears routed through informal markets and incipient forms of formal financial intermediation. Output per capita remains low and relativity constant over time. Financial depending remains very low.

3. *Transitional monetary.* At this stage monetary financial (banking) intermediaries and asset appear.[2] Money create credits induce greater economic activity. Agricultural production still prevails. Production is mainly directed for local consumption, but trade with other societies begins to take place. Family business devoted to commercial activities

and arte rafts also appear. Their liquidity needs are supported with credits from monetary intermediaries. Informal credit markets coexist with formal markets. Output per capita increases slowly. Financial deepening ratios remain below one, but increase over time, revealing the growing importance of financial markets and institutions on economic development.

4. Transitional non-monetary. Non-monetary financial intermediaries appear but remain limited in scoped Commercial banking nears maturity[4] and other forms of financial intermediation multiply. Capital markets also appear but channel insignificant amounts of savings to investments. In general, a full spectrum of financial institutions exists, but their activities are bounded by imperfections in the real and financial markets. Output per capita grows, unevenly, at moderate rates. Corporations appear, concentrating their activities in commerce, art crafts and embryonic industrial activities. Productivity and economies of scale are low, but factory production grows in importance leading to industrialization of traditional goods.[1] Corporations are family owned and controlled. Investments are financed largely with retained earnings and depreciation, but commercial banking credits grow in importance. Use of these credits for investments expand economic activity but induce instabilities in the financial system and high sensitiveness of corporations to changes in the business cycles. Governments begin to regulate financial intermediation activities. Financial deepening ratios are above one, but below two.

5. *Take-off financing.* Persistence of surplus generating conditions leads to accelerated development and rapid technological change, industrialization expands to more advanced manufacturing patterns/ Productivity increases rapidly and economies of scale begin to be significant. Increases in these variables in one or more sectors might be very notable, converting them into leading sectors of the economy. There is an increased need for investments and savings; adequate support for these needs leads lo rapid quantitative and qualitative changes. The economy takes-o IF into development, leaving behind traditional schemes of production and low standards of living. Financial institutions become the vasomotors of these processes. The consolidation of long-term debt and equity markets allow a more efficient mobilization of savings and investments. Thus, the financial system is characterized by an increased importance of non-monetary financial intermediaries and 'emerging' capital markets.

Financial deepening coefficients become significant, Hearing two. The growth of financial claims is proportionally higher than growth in output. Here a change in the patterns of financing from short-term bank credits to long-term financing through claims created at capital markets also takes place. Take-off occurs when corporations assert technological innovation and finance their investment opportunities through the capital markets. Corporate financing patterns change from banking sources to capital markets sources. Equity financing increases in importance. In addition, risk aversion also leads owners to yield control of their firms and hold a diversified portfolio of real and financial assets. The public corporation-becomes the preferred form of ownership, and specialized, professional managers control the corporation on behalf of its shareholders.

If a lack of correspondence in the development of real and financial markets (or other obstacles) appears, due to the persistence of traditional patterns of growth m the real or financial sectors, the development process breaks up and take-off into development does not take place or is interrupted. Indeed, a painful heuristic process of leaps and dives will generally take place.

6. *Mature financial intermediation.* In the mature economy financial markets and financial institutions are fully developed and innovative. Financial claims are the standard vehicle to link savings and investments. Manufacturing expands to major consumer and high technology goods. Productivity and economies of scale are high. In the long run, services become the most important economic activity. Growth rates are moderate but considerably higher than population increases. Product per capita and the standard of living are high. High consumption standards and rapid technological changes maintain a high demand for goods and services creating ample investment opportunities. Public corporations are the prevailing form of ownership; wide groups of the population hold financial claims issued by the corporations to sustain their growth. Financial deepening ratios are above two.

7. *Decaying financial intermediation.* A relative fall in technological innovation and competitiveness create gaps in saving and investment.[8] Society produce and consume beyond its capacity filling up gaps with foreign source and fiscal deficits. Domestic financial market and institution are unable to reverse those tendencies. Speculative bubbles further weaken financial market and institutions. Persistence of these conditions leads to low rates of growth and stagnation. The nation falls behind, and the standard of living of its population falls. Financial deepening ratios decline in the long run.

Financing Stages of a Nation and its Corporations

The development of financial markets and institutions opens up the alternative of mobilizing funds internationally to support investments and further economic growth. This alternative is directly related to the Level of financial development and financial integration of a nation with world markets. Eight stages can be differentiated in this process, from closed to open financial development financing.[9] They begin at the financial embryogenesis stage of financial development,

1. *Secluded credit.* The generation and mobilization of savings for investments is local and informal, carried out usuriously and mainly by individuals. Solidarity credits within the extended family circle and between individuals are also common. Lending activities are rather secretive due to the social stigma associated with it.

2. *Domestic funding.* In a traditional monetary society, economic activity is funded exclusively through domestic financial markets and banking institutions. Informal credits subsist. Growth is limited to local savings generation. However, international financial banking and insurance activities appear and ultimately consolidate to support trade among nations, which is carried out by family businesses.

3. *Undeveloped international borrower.* During a transitional non-monetary stage of financial development, income levels are low and Local savings are insufficient to promote the levels of investment needed to achieve full employment and overcome low welfare standards. The state resorts to foreign borrowing to enhance national infrastructure and to channel preferential credits to corporations. Public foreign debt is also issued to support wars associated with independence or the consolidation of sovereignty and the nation state. However, the country borrows beyond its capacity to pay. Economic growth is present but unstable. Foreign borrowing increases over time in relation to domestic output, sometimes beyond manageable levels. In addition, unemployment, balance of payments deficit and social problems in health, education, housing, etc, persist. As a result, the country frequently falls into severe disequilibrium and payments problems. Adjustments set back some gains achieved in periods of economic boom.

3. *Take-off international borrower.* Long-term growth and international borrowing can be reconciled, in the long run, growth generates sufficient surpluses to pay off external borrowing. Profound economic changes, correct for take-off financing, go along with an increased internationalization of the economy. Particularly, outward oriented production—exports—and foreign investments become the engine for economic growth. Important niches arc opened up in the production and trade of some goods. Public external borrowing continue to be important, but corporations internationalize their funding to bolster their local an

international investment opportunities. Foreign debt remains high in relation to national output.

Severe payments problems can take place, and harsh adjustment policies may be needed if sustainable levels of foreign debt and expected patterns of payment cash flow are not properly identified and reconciled with expected growth patterns. Proper identification of existing alternatives enhances (he role of international development financing.

5. *Immature lender.* The development process is still at a critical point, but at late take-off financing and early mature financial intermediation local savings and surpluses from exports exceed the capacity to absorb capital. Thus, exporting of capital begins with deposits in foreign banks and some portfolio investments in public and private securities from more advanced countries. Domestic corporations expand their international activities and direct foreign investments also begin to take place, particularly in neighboring countries. Some corporations fully internationalize their operations and promote national technological development. External borrowing decreases as a proportion of domestic output.

6. Mature lender. Underdevelopment is overcome. Local savings and surpluses from exports and services continue to be higher than local needs. Foreign debt decreases substantially in relation to domestic output. Large corporations and monopolies internationalize their production. Hence, foreign investments are the primary method of channeling funds abroad. Local financial institutions also internationalize their operations to support investments and operations of multinational firms. Through their operations in their own domestic markets and at international markets, ° financial institutions also lend to governments and corporations from other countries. Business cycles lead to periods of boom and sharp contractions in foreign lending. Indeed, sovereign lending could destabilize international financial institutions due to overexposure to credits from immature borrowers and take-off borrowers during downturns in the economic cycle.

7. Mature lender/borrower. Economic development and standards of living remain high. Internationalization of the economy and sophistication in consumption tasted lead to sharp increases in important and investment from foreign firms in local market. Deficit in trade appear but are generally balanced with revenues generated by foreign direct investments made by local firms. The maturity of local markets also attracts large portfolio investments from foreign investors, but these are subject to international competitiveness in interest rates. In general, bidirectional movements in capital flows tend to long-term equilibrium. The strength of the economy allows it to support external shocks, as well as greater borrowing than lending at certain periods; in the long run the external sector is balanced and economic development sustained.

8. Decaying lender/borrower. Income remains high, but the propensity to save is too low to support, investments needed to sustain prevailing standards of living. Technological innovation lingers, and soon imports surpass exports. Public deficits and external borrowing are used to maintain the production and import levels required but create further disequilibrium. All these problems could be tainted by- other factors such as wars and excessive military spending. Thus, public and private borrowing from local and international sources increase sharply. International borrowing increases and surpasses flows generated by direct, investments abroad. The economy becomes more vulnerable to economic cycles and external shocks. Crises recur leading the country to decreased welfare levels.

Capital Markets Development Stages

It is capital markets and their institutions which make a take-off into development possible. Investments, long-term in nature, are supported with long-term financial claims. They allow corporations to fund their operations beyond their resources and short-term operations financing.[10] Corporations can concentrate in furthering their specialization in production and technological innovation activities, leaving behind 'survival' financing and indulging in strategic planning to take advantage of their investment opportunities and optimize their operations. Six stages of capital market development can be identified.[11]

1.Germinal Long term financial claims are latecomers into the financial system of a nation. They appear during the transitional non-monetary stage of financial development, after banking institutions have arisen during the previous traditional monetary stage of financial development. During this germinal stage, money markets and capital markets begin their conformation, but remain unimportant. Capital markets and their institutions, as well as other non-monetary financial intermediaries remain rather small. In a first stage they are rather embryonic. They resemble a club of investors who consolidate their alliances and seek additional capital mobilized lo their firms from traditional landholders and merchants. There is not properly a class of capitalist entrepreneurs, but a small traditional élite that takes advantage of investment opportunities in commercial and traditional industrial activities. Firms are family owned and controlled. Thus, the supply of securities to the capital markets is very limited and demand for them is reduced to small groups of élite investors who also seek opportunities outside the primary sector or other traditional activities. Capital market activity is stagnant.

2. Imperfect debt securities market. During the early phases of take-off into development capital markets grow slowly but are mainly geared to debt instruments. Long-term public offerings finance special development projects. Corporate offerings are rather short-term in nature. The supply of equity instruments continues to be very limited. This time, however, investors also beLong to a rising capitalist class. Institutional investments in these markets are limited to banking institutions. Capital markets are very thin and imperfect. Commercial banks are responsible for the bulk of savings and credit generated in an economy Indeed, corporations and banks establish strong associations between themselves in capital and management. Large industrial firms remain family owned and controlled and become the nucleus of conglomerates investing In multiple products. These 'groups[1] remain highly leveraged, acquiring preferential credits from developing banks[52] and their own banking institutions.[13] Capital markets form part of this circuit through the association of banking institutions and investment banking intermediaries,

3. Money markets progression. Through time, the activity of the capital markets increases and becomes more sophisticated. However, before equity offerings consolidate, money markets emerge which are well differentiated from capital markets and, in addition to becoming an important source for take-off financing, they also become the link to equities financing. Treasury bilks and other government securities become important sources for public financing. Trade in these securities predominates in the exchange markets. Later, short-term government bills become the main mechanism to control money supply and credits. These developments contribute to furthering the development of long-term securities and above all to establish the basis for efficient valuation in the financial markets. Treasury bills become the guideline—the risk-free asset—from which risk premiums on other public and private offerings are required by investors; equilibrium conditions between risk and returns are thus settled. Investments from rising middle classes take hoLd of money and capital markets. Only minority positions are held by these investors, and protection of their position is Hot fully unfolded. Takeoff into development is in process, but can suffer setbacks due to crises and inadequately designed and managed economic policies, particularly financial repression and excessive government intervention.

4*. Take - off of emerging equities market.* Take-off growth creates ample investment opportunities, but internal resources and group financing are insufficient to sustain corporate growth. Further, competition in local and international markets requires rapid technological changes.[14] Financing moves from short bank financing to capital markets financing. High leverage levels, a trait of 'group's' financing, are overcome by issuing equity. Stock trading increases sharply and stock markets 'emerge' as the most significant source of take-off financing. Hence, owner—managers tend to relinquish control of the corporation. The corporation becomes fully public. Increases in income and better distribution of wealth and income boost the participation of middle class investors in the stock markets. Institutional investing also propitiates the dispersion of ownership, but corporate ownership continues somewhat concentrated. However, minority holdings are fairly well protected and professionals manage the corporation. In general, stock markets show an explosive growth and imperfections tend to decrease. Rapid growth of the economy makes stock markets highly sensitive to key economic factors, which determine their systematic risk. Local capital markets become increasingly integrated with international financial markets and mobilize significant amounts of foreign resources for their corporations by offering high risk premiums relative to international risk-free assets.

5. *Perfect markets.* Along with maturity of the economy, and maturity in financial intermediation, stock markets also reach maturity. Market imperfections disappear as information asymmetries arc minimal and the supplv and demand for risk-bearing securities is ample and competitive. The preferred form of corporate ownership is the public corporation. Ownership and control are therefore separated. Companies finance their investment opportunities mainly with bonds and equity financing. Securitization is innovative, and pricing of financial assets is a function of the risk—return trade-off inherent in the expected corporate cash flows. The value of the firm and its decisions are ultimately established by the market. A wide dispersion of ownership and market participation from the middle classes makes securities pricing and corporate decisions socially oriented. Institutional investments made on behalf of individual investors— pension funds, mutual funds—mobilize increasing amounts of savings to investments, Mature markets, however, arc not exempt from speculative bubbles and periods of high volatility caused by domestic or international downturns in business cycles.

6. *Decaying capital markets.* Decay in the economy is also followed by decay in financial markets. The loss of international competitiveness of an economy and its accompanying symptoms leads to processes of financial disintermediation. In these processes, securities markets become more speculative and volatile. High concentration in corporate ownership returns. Systematic risk also tends to increase, relative to other markets, so that high risk averse investors seek other markets. The limits for erosion are set. by the capacity of the economy to rccuperate its technological initiative and correct its structural problems.

Banking vs Capital Market Financing

An advanced stage of financial and economic development is also possible without strong capital markets. Instead, a strong banking system can become - the main mechanism of linking savings and investments. In this case, complex networks between banking institutions and business firms are established to substitute the place capital markets. Indeed, this is the historical experience of most European countries and Japan. In these countries, strong links within financial institutions and between financial institutions and business firms has led to the rise of important industrial and commercial groups, highly competitive at the international level, and which in turn have furthered economic development in their own nations. On the opposite side, economic development in the United States has been closely tied to the development of its capital markets. The rise and success of large U.S. conglomerates and multinational corporations, and to a great extent the US.'s economic hegemony during most of this century is closely related to the evolution of its capital markets.

Thus, two patterns of financial and economic development apparently compete in today's capitalist world. These have been identified as the American model and the Rhenish model. Further, it has been argued that the European-Japanese experience is more efficient and socially just. The U.S. model is assumed to be less efficient and less socially just because of its 'excessive weight' on the market, on short-term performance, and in individual achievement. Managers are over concerned with short-term trends and investors[5] and consumers' behavior. This over concern is particularly present in relation to corporate financing and performance. Immoderate attention to trends in the capital markets ultimately hinders long- term planning and leads to weakening fights for control between managers and owners (proxy fights, leveraged buy-outs, etc.). Finally, an excessive emphasis on individual achievement leads to weak social solidarity. Poverty and many social problems are seen as an individual problem of under achieve me fit; for that reason those problems are treated inadequately. On the contrary, the financial-industrial networks which characterize the Rhenish model promote stable financing and planning, which enhance technological development, productivity, and competitiveness. Similarly, greater social solidarity, leads tQ greater social justice through sophisticated social security mechanisms.[15]

Thus, which is the more efficient model is a question that needs to be solved to promote sound policymaking, particularly with reference to the changes that the developing nations need to promote in their financial systems. However, five important facts confirm the need to promote the development of capital markets as a necessary condition to induce take-off. First, the importance of capital markets on economic development has been widely recognized; many theoretical and empirical studies support their relevance to enhance economic development.[16] Second, although the European—Japanese patterns of financial—industrial links will continue to prevail for some time, the growth and internationalization of the capital markets in those countries clearly point out their importance. Capital markets now play an important complementary role to bank financing for European and Japanese corporations- Their role will most likely increase throughout the years and could parallel in importance the role that capital markets played in the United States. Third, financial and economic globalization, coupled with financial and technological innovation are leading to some important changes in financial markets and institutions. An important change "that has taken place is the rise of 'universal banking[1]. Specialized banking will continue to coexist with this new form of offering financial services: In either case, both institutions need a broad and efficient financial system to promote a more efficient savings-investment process. Capital markets and institutions are essential for the provision of a diversified set of claims that meets the needs of investors and businesses in terms of returns or costs, liquidity, risk coverture, and maturity. Fourth, in most developing countries large family business, 'industrial groups' have traditionally maintained close relationships with banking institutions, similar to those maintained by European and Japanese firms with financial institutions. These linkages, however, take place in the context of inward-oriented models of development and excessive regulation and intervention of the state in the economy. Current Liberalization policies aim at breaking away from those restricted patterns of growth. To respond to the challenges of a competitive globalized economy and to take advantage of its opportunities, developing countries need to build viable corporations. Publicly-owned corporations arc the most adequate alternative. Private corporations can play, initially, an important role in the modernization and outward-oriented activities from the developing countries. But their potential will remain limited if growth is limited to their resources and traditional banking financing. Owner-managers will eventually have to consider external equity financing and eventually relinquish control to be able to take advantage of market opportunities, and in addition be able to diversify their holdings and minimize risk. This crucial step cannot be taken in the absence of well-developed capital inarkecs. Finally, large movements of corporate and sovereign financing currently take place through strong links between the local capital markets and the international capital markets. That is, countries without or with narrow and inefficient capital markets have and will have limited opportunities to channel international savings for investments in infrastructure and corporate activity. Their development will be limited.

In sum, both bank financing and capital markets financing are important for economic development. The specific weight that each institution should have in each country depends both on past patterns of growth, as well as on the policies that are used to promote economic growth. The development path to be chosen by each developing nation depends on domestic economic and political facts and their links with the international economy. At any rate, a sovereign choice should be made considering that capital markets can play an important role in the mobilization of local and international savings to support economic activity: In addition, the choice of economic policies should always take as a point of reference the sustainability of economic growth.[1]-

Nation Building and Financial Development

The process of financial development assumes greater complexity, once the nature of nation building is considered. One aspect must be emphasized: The relationship between the rise of capitalism and the rise of the nation-state. If these two processes go hand in hand, as was the case of the European countries and the United States, financial development begins early and goes along with and supports economic development. Differentiation among countries largely' depends on how early or how late capitalistic development begins, and in endowments and the capacity for innovation of each country.

Countries for which capitalism came as an exogenous shock and nation building is shaped by colonialism show retarded economic and financial development. Real markets and financial institutions take a big leap in relation to pre-colonial conditions, often characterized by pre financial or protofinancial development. However, real markets and financial institutions develop to extract benefits for the colonial power. With the advent of independence begins a late and painful process of nation building. The development of real and financial markets is further complicated by backward socioeconomic conditions and profound disadvantages in relation to mature capitalist countries. A vicious circle of Underdevelopment ensues for many nations. Endowments, the growth of sizable local markets, and outward-oriented production help some nations to overcome underdevelopment. Take-off financial development proceeds in leaps and dives. Innovations are often applied learning from past experiences and copying advances in developed markets. Moreover, international financial cooperation takes place and induces the creation of local and international institutions geared to fill the gaps in financial development. Paramount among these institutions are development banks. They become the government agents for international borrowing and help in overcoming incipient capital markets development. Take-off is affirmed when real and financial markets are unfettered from restrictions imposed by inward-oriented development models and excessive regulation and intervention in the economy. Then equity markets emerge and lead take-off financing. This is precisely the process which now characterizes some developing countries.

Reality now offers another complication to financial development. Some developed countries lag in real and financial -markets development. Their experiment with state-led socialism for decades fell apart. Now they are in a transitional stage in which they must create their markets and institutions. At the financial level, the establishment of banking institutions will probably be the smoother, based on previously existing institutions. Money and capital markets, on the other hand, are starting from scratch. Thus, their financial development will assume very peculiar characteristics, different from the experiences of the developed market economies, and certainly different from those from the less developed economies.[18]

Financial Integration and Financial Development

To be successful, the growth of financial markets and financial institutions must be accompanied by financial integration. Segmentation at the national level lead to sharp differences in regional and sectoral development. As a result, lagging sectors deter economic development Moreover, overgrown but segmented financial markets induce a drain on savings from less developed national areas to foster investments in the developed areas. This process assumes specific characteristics for each nation according to its political and economic development levels.

At the international level, segmentation from world financial markets limits the mobilization of international resources for domestic uses. However, this process is also conditioned by the evolution of international financial markets and their financial integration *perse.* During times of high international liquidity, financial markets increase their integration, and credits are relatively easy to acquire, even by governments and firms from developing nations and firms from these countries. Downturns in the economic cycles segment markets and international lending becomes restrictive.

Two other factors affecting international financial integration are the quantity of international trade and the quantity and quality of the internationalization of production. Increases and positive innovations in these variables further international financial integration, National financial development is affected by the schemes of financial integration induced by the degree of openness of an economy to trade and investments.

Finally, another factor affecting international financial integration is -the level of financial development among nations. Integration tends to proceed among the most financially developed nations. This leads to the presence of a core of developed financial markets interacting very actively between themselves, and a series of peripheral less well-developed financial markets which exchange -mainly with one core market based on the intensity of trade and investments relationships. It is worth noting that under current circumstances, the globalization of world financial markets is primarily taking place among developed capital markets, and secondarily among emerging capital markets and developed capital markets. In these latter cases, the mobilization of international resources is moving away from lending to governments to lending to corporations through innovative forms of securitization of equity and debt. Hopefully, developing countries integrating to world financial markets in this fashion are in a final phase of take-off development financing.

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Notes

1. Identification of these stages of financial development is based on the empirical works dealing with money and capital and financial structure and financial deepening. A select bibliography includes: Gurley and Shaw (1957, 1960), Gurley (1968); Shaw (1973); Goldsmith (1969, 1972); Bennet (1965); Ben .Amor (1974); Burns (1967); Powers (1971); McKinnon (1973); Ortiz (1977, 1980); Drake (1980); TowscncI (1983); Kindleberger (1984); Patrick (1984); Jung (1986); Kitchen (1986); Rogers (1989); Fry (1990); Dow (1993); Givannini (1993).
2. The principal function of financial intermediaries is to buy primary securities issued by ultiinaLe borrowers and to issue indirect debt for the portfolios of ultimate lenders. Primary securities are the liabilities and equities of spending units (households, business, government). Surplus units, generally households, generate savings which are then lent to deficit spending, investing, units (business and government) through financial intermediaries. Monetary intermediaries are those in which part of their liabilities are a portion of the medium of exchange. That is, they buy primary securities and create money, and administer the payments mechanism.
3. Savings banks, credit unions, insurance companies, savings and loans institutions, mutual funds, pension funds, etc. These institutions purchase primary securities from spending units and issue non-monetary claims on themselves. Increases in income decrease liquidity needs from surplus units. They search for alternatives for savings and risk coverage. New types of financial institutions appear, filling those needs by supplying non-monetary claims. An important proportion of these claims are long term in nature (for instance life insurance) which promotes long- term lending to investing units. In turn, long-term financing allows investing units to enhance their investment decisions, free from refinancing problems, and economic growth increases and is sustained. At this stage of development, however, these institutions are in a germinal stage, and long-term corporate financing is limited. For that reason, investments and economic growth are heavily influenced by refinancing problems and the evolution of the financial monetary sector. Central banking, if it exists, heavily influences the investment and economic growth processes with its policies.
4. Commercial banking undergoes a complex development process. These issues have been dealt with successfully by other authors; for this reason, this chapter focuses on financial development emphasizing other aspects. Nevertheless, it is worth noting that according to Jung (1986), at their early stages of development banking institutions are primarily providers of safe custody for currency holdings of savers, whereas in later stages they are primarily creators of credit. Based on that proposition and their own works, Chick (1983, 1988) and Chick and Dow (1988) hypothesize that banking evolves through six different stages. St. Hill (1992) explores the relevance of these stages of banking development on economic development, particularly for the case of dual economies.
5. Traditional goods (and other traditional development characteristics) should be understood in the context of a specific historical period. That is, in today's world some developing countries show some characteristics which resemble this stage of financial development. Their industrial sectors, however may be producing goods which by no means could be considered traditional in the nineteenth century.

   They are, however, traditional in comparison to the new types of high-tech goods that are produced by the most industrialized countries today. Similarly, a country in which high-tech goods are only assembled (it lacks its own technology) should be considered traditional in the context of the theoretfeaf frame work built in this chapter. Thus, a country with a traditional production system as clarified here, arid a financial sector which is still characterized by the p r e do nn nance of monetary intermediaries, in terms of development financing, should implement policies that enhance its non-monetary financial system to attain the conditions for take-off into development. A process which should be characterised among other things by a high degree of autonomous technological development, which by no means presupposes autarky.

6. In a historical perspective: this refers to the appearance of the central bank and other regulator)' institutions. Some institutional regulatory agencies may be scill needed in some developing countries today, but that is an exception. On the contrary, in the-context of current world economic trends developing countries need to 'modernize* their existing financial institutions, and revise their regulation Jaws and mechanisms, to eliminate over-regulation, to liberalize their financial system and make it more competitive. Furthcf, liberalization is essential to promote financial integration with other markets, which in the case of the developing countries means the acquisition of funds fof development at the developed international markets.
7. From a historical perspective this implies a change_ironi traditional goods to light manufactured goods. In the context of this work this changc must be understood like a qualitative shift from traditional manufacturing patterns, to more advanced patterns of manufacturing, taking into account the clarification previously made, i.e. the historical context.
8. Decay is a possibility that policy-makers should consider. For that reason, this chapter includes it in the stages of financial development, presented in this and the following sections.
9. Stages presented here differ but present some affinities with an earlier conceptualization of stages of external debt financing (see Gvowzet, 1972). The stages here have benefitted from ulterior historical and empirical studies on the external debt problem, particularly for the Latin American case (see ELcherigreeri and Lindert, 1989; Sachs and Collins, 1989, 1990; Marichal, 1989; Green, 981, 1988; OTUZ, 1987, 1988a, h, 1989, etc.).
10. Higher stages of economic development could be supported bv banking institutions, which has been the experience of some countries. The stages presented here recognize the importance of capital markets to economic development not only taking into consideration^successful experiences from some countries, but also considering current trends in financial globalisation and capital transfers to governments and firms from developed countries via links with emerging and international capital markets- The controversy between hanking vs capital markets financing is treated later to shed some light on policy options for financial development.
11. Kumar and Tsetketos (1992) identify five stages of financial-sector development, corresponding to Rostow's stages of financial development. Their capital markets are part of the drive to maturity and maturity. The stages presented here differ in conception. Capital markets play a significant role in take-off financing. Additionally, the stages put forth here attempt to integrate the experiences of both developed and emerging capital markets. Some relevant studies on emerging capital markets include Aspe (L981), Cheng (1980), Dawson (1990), de Tarso Madeiras (1981), Errunza (1979), Khambata and Khambata (1939), Kitchen (19S3, 1986), Ramos (1988), R. Marshall (1991), Fischer *et at* (1992, 1993), Ortiz (1992), etc.
12. Financing by development banks was, of course, not available tor the large family corporations from today's developed countries whose financial system experienced an earlier development, It is an alternative that arose basically In the twentieth century, intended to promote a supply-leading financial sector in the
13. developing countries. Essentially, develop merit banks have aimed at financing some priority sectors. To sonic extent, the industrial sector development banks filled the lack of capital markets in the developing countries. These banks have played an important role in corporate financing and in strengthening the development processes. However, their proliferation, excessive intervention in the credit processes, and their inefficiencies, also thwarted the development of capital markets in the developing nations. Liberalization of the real and financial markets has led to a reconsideration of the rote of development banks. Most developing countries are cutting down the excessive number of* development banking institutions operating in their economies, and those who are left are devoted to specific development promotion tasks and use more refined credit analysis criteria, hi these contexts, development banks can be conceived as part of a transitional phase in the development of capital markets.
14. For analyses and a theoretical framework on 'groups' and corporate financing for today's developing countries see Fischer el ai. (1992. 1993).
15. It is worth noting that investment opportunities and foreign financing alternatives wilf be limited if the economy is closed. Further, protectionism would distort the allocation of resources, and corporate 'groups' wili tend to subsist in oligopolistic markets. Thus,

protectionism can thwart take-off development. Exceptionally, large countries could take-off into development based on their own markets.

16. In a solid argumentative study, .Albert (1993) identifies these two models and affirms that the European-Japanese experience is more efficient and socially just. The Rhenish model is particularly identified with Germany, Switzerland, Belgium, The Netherlands, Luxembourg—northern Europe in general—and, with some variants, Japan. Other European countries seem to be adopting chat model, like in the case of France, or should adopt it because oi its superiority over the American model, and to make more plausible European economic integration and growth The American model is considered unique, although loosely could include the U.K. and other Anglo-Saxon countries such as Australia and New Zealand, Reflecting on current world economic changes, Albert also recommends the Rhenish model for both the developing nations and the ex-socialist nations now in transition to market economies.
17. For key references on this issue see Ortiz (1993).
18. For instance, Foreign debt should be acquired within sustainable levels; bank and group financing should not be promoted if market imperfections can lead to monopoly power and other corporate inefficiencies; bank financing should be preferred to capita! markets financing if viable corporations cannot be developed through capitalization in the local and international capital markets, etc.
19. On this issue see Kemrae and Rudka (1992) and Givannini (1993).