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REVISITING THE WASHINGTON CONSENSUS DEBATE TODAY: A Theoretical Appraisal of International Institutions Prescriptions to Emerging Economies

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During the 1990's, emerging economies largely engaged in financial liberalization process, following the prescriptions (or commandments) of international institutions, namely the International Monetary Fund and the World Bank. Yet, at the end of the nineties, instead of experiencing the promised economic growth, the more financially integrated emerging economies were hit by major financial crises of severe economic impact. We examine, in this paper, the way international institutions reacted to the apparent failure of their economic models and predictions. We synthetize the main arguments of the theoretical debate that followed the 1990's emerging economies crises, and the way international institutions incorporated it, in the form of the so-called "Augmented Washington Consensus" (AWC). We observe that the standard economic views endorsed by the IMF did recognize that liberalizations policies and crises were related in emerging economies. They however failed to admit that financial liberalization may be among the causes of the instability, blaming instead the process of implementation (too rapid or disordered) of liberalization and/or some pre-existing macroeconomic insufficiencies, such as lacking fiscal discipline or inadequate legal and regulatory framework. We argue, in this paper, that although the IMF proved able to adjust its views in the face of undisputable facts, this adjustments remain insufficient and the dominant economic views regarding

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financial liberalization keep a dogmatic character. Regarding policy recommendation changes, they mainly focus on institutional development objectives, added in the AWC. This is obviously a highly desirable target. However, we argue that the standard approaches of institutions endorsed by international institutions, which primarily address asymmetries of information effects, globally miss the point. Institutions of financial systems need to be incorporated to the analysis first – and not added afterword. They require to be assessed in the historical context and stage of development of each economy. In this perspective, Minsky's approach of financial instability and institutional mechanisms constitutes in our view a promising theoretical alternative. Today, international institutions are once more providing both help and policy "recommendations" to emerging economies, often pushing governments to adopt policies denied by their population. Revisiting the debate around the Washington consensus and financial liberalization proves an unclosed subject.

Key words: Augmented Washington Consensus, Financial liberalization, Institutional development, Financial crisis, Emerging economies, Minsky

Introduction

At the end of the 1990's, a series of financial crises have hit financially integrated emerging economies. Those crises are well known today and have been largely documented. They presented several empirical regularities that still call for further thinking. The first relates to the characteristics of these crises: they were systemic liquidity crises with sudden stop of capital flows. The second is that the countries affected had all engaged financial liberalization process or intensified this process in the years preceding the crisis (Prasad, Rogoff et al. 2003). This process includes two main components: an increase in the volume of international capital inflows (de facto financial integration), with an increasing portion of short term and portfolio capital flows, and the implementation of financial liberalization policies (de jure financial integration). From these observations arises the following question: why would financial liberalization favor the emergence of systemic financial crises in emerging economies?

The current context also justifies in our view to revisit this question. Financial liberalization as it was implemented in the emerging economies in the 1990's was a process pushed or imposed by international institutions. The role of those institutions today is once more debated. The International Monetary Fund, but also the European Union, are in position to impose their economic paradigm to the countries they help, often in opposition with the populations of these countries. The recent elections in Greece illustrates such a situation. It is thus legitimate to re-question the efficiency and relevance of these international institutions' economic paradigm, in particular regarding financial liberalization, as well as their ability to question their own failures.

In this paper, we discuss the effects of financial liberalization process on crises occurrence in emerging economies at the end of the 1990's, by exposing the debate that took place among "standard" economists. The debate lead to the expansion of the initial Washington consensus (the so-called Augmented Washington Consensus – AWC-) and focused on asymmetries of information. We discuss the limits of these approaches and solutions and propose alternative theoretical perspectives in the light of Minsky.

In the first section, we justify theoretically and empirically the link we make between financial liberalization and financial crises in financially integrated emerging economies[1]. We relate this to the debate that prevailed about the Washington Consensus (WC). In the second section, we discuss the main theoretical arguments of this debate. We finally present a series of limits we see to the standard approach.

From Financial Liberalization in Emerging Economies to Financial Crises

The analysis of the potential causality between financial liberalization and crisis in emerging economies can hardly be isolated from the debate, sometimes virulent, that emerged at the beginning of the 2000's about the Washington Con-

1 This corresponds to 22 countries at the end of the 1990's with a high level of *de jur*e and *de facto* financial integration (Prasad et al. 2003).

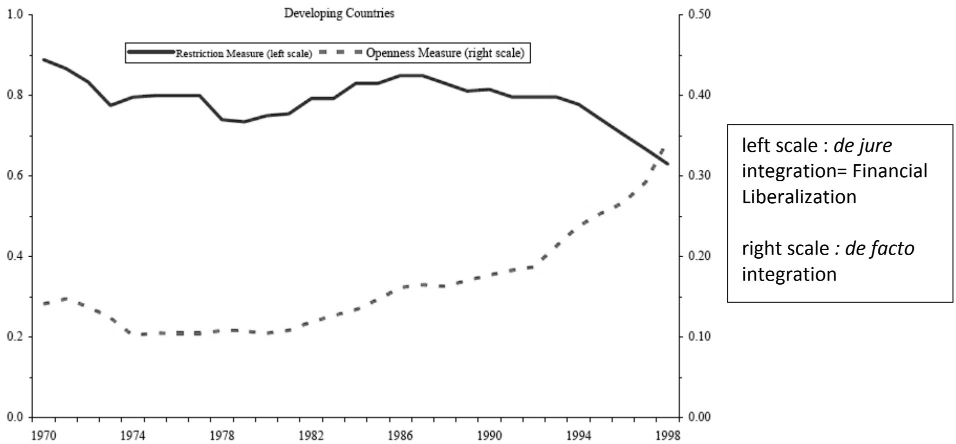
sensus (WC). The terms ”Washington's consensus“ and ”financial liberalization“ refer to (Williamson 1990) and (Williamson and Mahar 1998) respectively.

The proposals they included as well as the related policies recommended (or imposed) by the international institutions (IMF, World Bank) to emerging economies, have been strongly criticized after 2000, in particular by J. Stiglitz and D. Rodrik (Stiglitz 2000, Williamson 2000, Rodrik 2004, Williamson 2004, Rodrik 2008, Rodrik 2008). These critics encompass broader aspects than our question. At first, they dispute the ability of the 10 “rules” of the consensus (Williamson 1990, Williamson and Mahar 1998) to favor growth in emerging economies. Complementarily, they criticize the dogmatic character of international financial institutions (IFI's) and their neoliberal views, which would systematically endorse the objective to reduce the role of states and to cut in social public expenses (education in particular). (Williamson 2004) has answered these attacks, arguing that they were, for a large part, based on a misunderstanding of his initial proposal, without however totally closing the debate. Today, this debate is still of blatant actuality, and one may wonder what has changed since then in the IFI's views of what should be ”good“ economic policies.

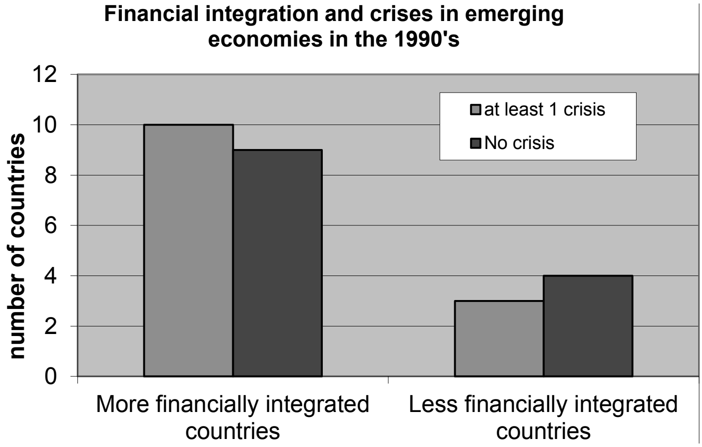
Revisiting this debate is of interest for our question for two reasons. First, because out of the 10 ”propositions“ of the WC, the 4th, dedicated to financial liberalization, was the more disputed. We may note that in the initial version (Williamson 1990) limited this 4th proposition to ”interest rate liberalization“. This was (rightly) interpreted as a recommendation to set up financial liberalization policies. In a later contribution, Williamson detailed his idea (Williamson and Mahar 1998) and confirmed this interpretation. He indicated that this fourth proposal should be redefined and understood in terms of financial liberalization, of which interest rate liberalization is only one of the six dimensions. Secondly, it is precisely because financial liberalization would favor crises that it would fail to promote growth in emerging economies (Caprio 1998). From this, a series of arguments arise, that focus on liberalization and financial instability inter-relations.

Financial liberalization, crisis, growth: main arguments of the debate Standard economic theory predicts that financial liberalization should favor growth. It enables countries with insufficient domestic saving to attract complementary external financing for domestic investment. Risk management is expected to improve, thanks to increased portfolio diversification possibilities. Business cycle is expected to be reduced: agents (household, firms) may smooth their consumption thanks to increased access to debt. Eventually, access to international investment for domestic agents should contribute to improve risk adjusted return, in turn encouraging saving, investment and growth.

Observations in emerging economies crises at the end of the 1990's however contradict such predictions. First, the series of crises that hit emerging economies at the end of the nineties coincides with the achievement of a decade of implementation of financial liberalization policies in those countries (cf. Graph 1 hereafter). These policies were prescribed by international institutions (the International Monetary Fund and the World Bank principally), as part of the set of measured they actually "imposed" in the so-called Washington Consensus. When examining the link between liberalization degree and crisis occurrence, we find that the more emerging economies were engaged in financial integration, the more they were prone to a crisis (cf. Graph 2 hereafter). Second, these crises were of major economic impact, counter-acting the expected positive effect of financial integration on growth (cf. Table 1 hereafter). Besides, those crises episodes presented the common features (cf. Table 1) of being systematic liquidity crises (combining financial market, banking and currency crises) with sudden stop of capital flows. This suggests a link with the international financial integration process those countries were involved in.



Graph 1 - International financial Integration in Emerging economies
Source : Prasad et al (2003)



Graph 2

Sources: (Jeanne 2003, Kose, Prasad et al. 2003; Ben Gamra 2004), author's calculations

Table 1

	start of the crisis	**Sudden Stop of Capital**	**Financial market Krach**	**Banking Crisis**	**Currency crisis**	**Sovereign Crisis**	**economic impact ***
Argentina	*2001*	**YES**	**YES**	**YES**	**YES**	**YES**	-11%
Colombia	*1998*	**YES**	**YES**	**YES**	NO	NO	-4%
South Korea	*1997*	**YES**	**YES**	**YES**	**YES**	NO	-7%
Ecuador	*1998*	**YES**	*na*	**YES**	**YES**	**YES**	-6%
Indonesia	*1997*	**YES**	**YES**	**YES**	**YES**	**YES**	-13%
Malaisia	*1997*	**YES**	**YES**	**YES**	**YES**	NO	-7%
Philippines	*1997*	**YES**	**YES**	**YES**	**YES**	NO	-1%
Russia	*1998*	**YES**	**YES**	**YES**	**YES**	**YES**	-6%
Thaïland	*1997*	**YES**	**YES**	**YES**	**YES**	NO	-11%
Turkey	*2000*	**YES**	**YES**	**YES**	**YES**	NO	-6%
Uruguay	*2002*	**YES**	*na*	**YES**	**YES**	**YES**	-11%

Sources: (Boyer, Dehove et al. 2004; Laeven and Valencia 2008; Durdu, Mendoza et al. 2009), author's compilation

While initially disputed, these observations forced economists, including the "defenders" of financial liberalization, to re-assess their predictions.

Their first insight in the topic is that the allocation of international capital flows to investment may not be optimal in the wake of liberalization. A series of empirical works have showed that contrarily to trade liberalization (Sachs, Warner et al. 1995; Vamvakidis 1999; Wacziarg 2001), a surge in capital inflows does not favor domestic investment. To the opposite, it would trigger inefficient allocation of resources (Rodrik 1998, Stiglitz 2000, Bresser-Pereira 2008) and thus be detrimental to growth. This idea however remains highly disputed, even in empirical works which fail to provide a univocal perspective (Williamson and Mahar 1998; Bekaert, Harvey et al. 2001; Caprio and Honohan 2001; Rajan and Zingales 2003).

The majority of authors eventually recognized that the financial liberalization process increased the probability of occurrence of a crisis, which in turn affected growth. However, defenders of liberalization argued that these effects were of limited impact. They would prevail mainly in the short run (O'Donnell 2001; Kose, Prasad et al. 2003; Prasad, Rogoff et al. 2003). While financial liberalization is correlated to a reduction of growth in the short run, it would still be positively correlated to growth in the long term (Loayza and Ranciere 2006). According to (Ranciere, Tornell et al. 2010) and (Tornell, Westermann et al. 2004), a combination of growth and crisis would even favor long term growth, which seems at least counter-intuitive. In short, negative impacts of liberalization are limited in time. In the long run, positive effects prevail. Although our objective is not to discuss directly growth and liberalization, retracing this theoretical debate enables us to highlight a prevailing consensus that financial liberalization policies favor crises, even among the ”pro“ financial liberalization economists:

> ”financial liberalization can yield a real social benefit in terms of an improved allocation of investment, but also that it can be dangerous” (Williamson 2004, 6).
>
> “in a significant number of cases, financial liberalization [...] appears to have been associated with costly financial crises. [...] Financial liberalization more generally, is essentially inevitable for all countries wishing to take advantage of the substantial benefits of broad participation in the open world economic system [...]. Financial liberalization also has its dangers.” (Eichengreen, Mussa et al. 1998, 1).

Behind this consensus however, a debate remains regarding the explanatory mechanisms which lead to such results, as well as regarding economic policy prescriptions to avoid them.

The Dominant Theoretical Arguments: Asymmetries of Information

A series of work were conducted since the end of the 1990's to explore this robust though undesirable positive correlation between financial liberalization and financial instability in emerging economies.

The dominant view was synthetized in an IMF economic report (Eichengreen, Mussa et al. 1998). Financial liberalization in itself is not seen as the cause of financial instability. However, by revealing pre-existing (but hidden) market imperfections, liberalization may favor instability. Imperfections consist in asymmetries of information, which are responsible for adverse selection, moral hazard and herd behavior. They result in excessive risk taking within domestic financial systems, accounting for a higher exposure to financial reversals.

It may be noted that asymmetries of information are a standard characteristics of financial markets. It is thus in no way a characteristics of neither emerging economies nor financial liberalization. The argument referred to here-above is the following: emerging economies were, before they implemented financial liberalization, financially repressed; financial liberalization did unveil the pre-existing asymmetries of information, the effects of which were hidden by financial repression.

The effect of asymmetries of information on financial markets are common knowledge. Initially developed by (Akerlof 1970) and (Stiglitz and Weiss 1981), asymmetries prevail within financial systems where some agents are better informed (regarding the risk of the project especially) than others (in particular borrowers and lenders). It results in situations of adverse selections. Lenders being unable to correctly assess the risk of projects, rate projects according to an average risk. Low risk projects are excluded from financing, while low quality projects (more risky / less profitable) are financed. Adverse selection contributes to the inefficient allocation of funds to investment as well as to financial risk taking.

Asymmetries of information also trigger moral hazard, the presence of explicit or implicit guarantees favoring risk taking on financial markets. Eventually, herd behavior is reinforced by the presence of asymmetries of information, less informed agents following those they think better informed. Herd behavior may thus be rational, but it results in an amplification of financial cycles, feeding both financial bubbles and krach.

Asymmetries of information effects, adverse selection, moral hazard and herd behavior thus result in increased – and pro-cyclical- risk taking within financial systems. This is not specific to emerging economies, although the implementation of financial liberalization policies in previously financially repressed markets is expected to unveil and trigger such undesirable effects. When credit is controlled and/or domestic financial markets are not open, when credit allocation to investment is centrally controlled, adverse selection would for instance be neutralized, since investment projects are not assessed in terms of risk or return by independent banks or investors. In this example, the way finance is allocated to investment may be criticized, but asymmetries of information are not at the origin of excessive risk taking.

Financial liberalization will all the more reveal asymmetries of information effects as financial systems are little developed. Countering asymmetries of information negative impacts require to develop an ”adapted“ institutional system: an efficient prudential system, accounting & auditing standards and transparent financial information. Such institutions were largely inexistent or insufficiently developed in emerging economies in the 1990's. This is in part due to the fact that under financially repressed markets, effects of asymmetries of information are limited.

According to this approach, financial liberalization cannot be charged for increased instability. The institutional disorder of emerging economies financial systems being to be blamed – and adjusted, as argued by Williamson:

> ”Where I failed was in not emphasizing the need to accompany financial liberalization by the creation of appropriate supervisory institutions.” (Williamson 2004, 6).

The IMF answer: Sequencing, macro-economic pre-conditions and institutional development

In addition to the general argument regarding the role of asymmetries of information and the need for better institutions, standard economic analysis also questioned the implementation process of liberalization in those countries.

According to (Williamson 2004),

> ”the objective of liberalization indeed makes sense, but [...] it needs to be qualified in two important ways. One is in delaying capital account liberalization until many other reforms have been successfully completed.” (6).

This idea is rooted in the initial approach of financial liberalization, prescribed as gradual (McKinnon 1993): capital account liberalization should come last, after internal financial liberalization, development of domestic financial markets and of institutions.

A series of analysis have enforced this standard economic view and the need for ”sequencing“. Pre-conditions to the financial liberalization process were identified: (i) a preliminary macroeconomic stabilization and (ii) the development of the prudential system. The preliminary macroeconomic stabilization mainly consists in fiscal discipline: public deficit (and debt) should be limited, in order to leave possible margin of intervention to governments in case of a crisis and to reinforce the country's monetary credibility. Prudential control aims at improving the supervision of financial agents and institutions, to avoid excessive risk taking and systemic risk and to counter moral hazard.

The above arguments are based on empirical appraisals. (Williamson and Mahar 1998) studied 34 developed and emerging countries and showed that countries which faced crises had not respected requested pre-conditions : implementation of financial liberalization in times of macroeconomic instability or high inflation (Argentina, Brazil, Mexico, Peru, Turkey, Uruguay, Venezuela); capital account liberalization before adequate trade liberalization (Colombia, Indonesia, Malaisia, Mexico, Turkey); absence of appropriated prudential system for almost all emerging economies. (Schneider 2001) has similar results. The inappropriate pre-conditions to the policy reforms would thus be to blame – not financial liberalization.

Sequencing the Implementation of Financial Liberalization

Besides, an appropriate sequencing of implementation of financial liberalization should be the following : domestic financial liberalization (interest rate liberalization, bank restructuring, financial markets development) precede capital account liberalization, which itself should start with foreign direct investment (FDI), than long term capital flows and eventually short term capital flows.

If the diversity of level of development, of institutional and legal framework and practices, cannot lead to a ”unique recipe“, some principles however should guide the sequencing of the reform (Eichengreen, Mussa et al. 1998). FDI should be first liberalized because they are accompanied by technological transfers that exceed the “fear for foreign control”. Internal deregulation of the domestic banking system may trigger vulnerabilities of domestic entities, due to increased competition in particular. But benefits should prevail, thanks to increased efficiency, if liberalization is appropriately preceded by a restructuring of the sector. Because they are highly volatile, short term flows should be liberalized last.

(Stiglitz 2000) has similar views, adding that short term flows are not only particularly instable but are also not financing investment. Capital account liberalization of short term flows enable capital flights, prevent governments to pursue some ”legitimate“ economic stability objectives via contra-cyclical macroeconomic policies. Stiglitz denies the disciplinary benefit of short term flows liberalization on fiscal deficits. While for the IMF, short term flows liberalization should simply be delayed till all pre-conditions prevail, for Stiglitz, such flows should be controlled. This leads Williamson (2004) to argue that he agrees with Stiglitz and that their divergence is only “semantic”. In our view however, their opposition is more significant that it may seem, in that it lays in the analysis in itself, although the recommendations may look similar.

The IMF empirical findings support such argument (Echeverria, Darbar et al. 1997). More recent works however provided less convincing results. (Ben Gamra and Plihon 2008) studied 22 emerging countries from 1970 to 2002 and tested the role of sequencing on the occurrence of crises. They find non-significant results regarding internal liberalization first / external liberalization second, but significant impact of internal liberalization second / external liberalization first.

The standard economic approach we exposed in this section has thus provided a coherent analytical framework to address the initially unexpected – but undeniable- result that financial liberalization, instead of promoting economic development, exacerbates financial instability in emerging economies. Explanation would lay in the effects of asymmetries of information, hidden or ineffective while financial systems are repressed, but unveiled by liberalization, and inadequately addressed by emerging economies because of inappropriate sequencing of the policy implementation or inappropriate macro-economic pre-conditions.

The debate which led to this apparent univocal analysis was strong. The theoretical analysis still includes diverging voices, regarding budgetary austerity preconditions for instance, as illustrated by the Stiglitz-Williamson argument. Eventually, while case studies tend to support such analyses, more systematic empirical tests seem to provide less convincing results. Alternative perspectives need, in our view, to be explored, which would encompass the institutional dimension of financial system dynamics. While the mainstream economic approach has incorporated institutional development within the analysis, this approach remains, in our view, inappropriate, as will be further argued hereafter.

Insufficient Institutional Development

To achieve a successful implementation of financial liberalization policy, some pre-conditions, as mentioned above, would be required. Among those, the development of an appropriate institutional framework has received significant emphasize.

Institutions refer, in this approach, to financial supervision and regulation, and is attributed the function to counter asymmetries of information effects and to improve financial information. The supervision primarily aims at banking activities, as prescribed at the international level (Basel II agreements in particular). Appropriate institutional development also relates to international accounting & auditing rules and standards regarding financial information disclosure and diffusion, property rights enforcement and corruption.

The necessity to supervise banking activity and risk taking would be increased by the implementation of financial liberalization. Because they are more exposed to both internal and external competition, banks margin tend to decrease; banks are more exposed to bad loans or losses from bad operations. Besides, banks have access to activities previously repressed, enabling them to develop risky activities. Capital account and foreign exchange liberalization also enable foreign currency denominated borrowings, which may be at a lower cost but which include additional risk and the possibility of spill-over effects from the forex to the credit markets. Exploiting in incautious or fraudulent manners newly open possibilities becomes easier (Eichengreen, Mussa et al. 1998). This would be all the more pregnant as investors' rights (property rights) are insufficiently enforced or that corruption prevails.

Besides, newly financially liberalized economies have access to complex financial instruments, such as derivatives, which are particularly complex. Without appropriate supervision and accurate accounting standards, trading such instruments may increase the lack of balance sheet transparency, thus reinforcing asymmetries of information (id.).

A weak prudential supervision may also reinforce moral hazard in presence of implicit or explicit public guarantees. (Krugman 1999) expands (Akerlof, Romer et al. 1993) developments to the cases of the Asian crises. Banks benefitting from public guarantees on domestic and international deposit would develop moral hazard and the resulting fraudulent practices and/or excessive lending and risk taking. Bailout public guarantees reinforce the moral hazard in newly liberalized economies, all the more as bank supervision is insufficient. These bailout plans, implicit or explicit, act as investment subventions, favoring the financing of risky projects that moral hazard encourages. The losses associated to the excessive risk taking would lead, in fine, governments to cancel these implicit guarantees, precipitating banking crises (McKinnon and Pill 1996; Corsetti, Pesenti et al. 1999).

Excessive risk taking may favor bubbles on assets prices, in a self-sustaining process (Sarno and Taylor 1999) where the credit boom finances risky projects, triggers assets price increase and in turn improves artificially financial intermediates' balance sheet. The burst of the bubble is inevitable and may conduct to a financial crisis.

Unregulated moral hazard would also contribute to the development of currency mismatch. Banks have incentives to borrow in foreign currency and at short term, to benefit from interest rate lower than those prevailing on the domestic curency. The risk relates to the fact that these funds finance domestic projects generating financial revenues denominated in domestic currency. The risk is however neglected or accepted, because banks rely on the implicit public guarantee they expect to benefit from in case of difficulty. This constitutes a risk of spill-over effect in case of currency crisis (Tornell and Westermann 2002; Tornell and Westermann 2003).

Those perspectives conducted to the establishment of a ”new“ Washington consensus, or Augmented Washington consensus (Rodrik 2001). The initial 10 proposals of the original Washington consensus were the following: Fiscal discipline, Reorientation of public expenditures, Tax reform, Financial liberalization, Unified and competitive exchange rates, Trade liberalization, Openness to DFI, Privatization, Deregulation, Secure property rights. Only the last recommendation did deal with institutional aspects as discussed above. To this, the ”Augmented Washington consensus“ adds: Legal/political reform, Regulatory institutions, Corruption, Labor market flexibility, WTO agreements, Financial codes and standards, “Prudent” capital-account opening, Non-intermediate exchange rate regimes, Social safety nets, Poverty reduction. These additional recommendations focus on institutional dimensions, regarding legal aspects, regulatory aspects, financial information standards and corruption.

Critics to the standard approach of institutional development & financial liberalization, theoretical alternatives proposal

The internal coherence of the above ”standard“ analyses may not be disputed. Their explanatory power, regarding facts and observations, may however be questioned.

Limits and Critics to the Standard Approach

A series of empirical tests tried to capture the significance of institutional development, as described above, in crises explanatory factors. (Falcetti and Tudela 2006) find significant correlations, but they assimilate institutional development to an unexplained factor.

(Gelos and Wei 2002) find significant correlation between lack of information transparency and herd behavior. (Mehrez and Kaufmann 2000) find that information transparency is significantly correlated to crises when it is associated with financial liberalization. Transparency and corruption are also very significant explanatory factors of crises in (Ben Gamra and Plihon 2008).

(Demirgüç-Kunt and Detragiache 1998) show that property rights, law enforcement and corruption level constitute significant explanatory factors of crises occurrence, if combined with financial liberalization. (Eichengreen and Arteta 2002) also observe significant correlation between law enforcement and crisis risk in emerging economies, but the value of the correlation is slightly different from zero.

(Ben Gamra and Plihon 2007) show that prudential regulation and supervision are highly significant variables in their analysis of crisis and financial liberalization.

The role of implicit public guarantee and moral hazard in crises occurrence can hardly be established empirically. (Radelet and Sachs 1998) show that the majority of the loans established in Asian countries which faced a crisis in the 1990's did not have such guarantees. More than half of international bank loans and almost the totality of portfolio flows and FDI towards non-financial firms neither had public guarantee. In short, about the $3/5^{th}$ of capital flows to Asia before the crises were not eligible to such guarantees. More systematic empirical survey are similarly non-convincing. While (Demirgüç-Kunt and Detragiache 1998) establish a positive correlation between implicit public guarantees and crisis probability, (Eichengreen and Arteta 2002) find that the correlation is non-significant statistically.

These results suggest that institutional development, when assessed globally, tend to appear as a significant factors in the link between financial liberalization and crises for emerging economies. The definition and ways of intervention of the IMF ”adequate“ institutional framework is however less convincing in empirical tests, with statistical results sometimes contradictory, statistically non-significant or of very weak effect. Besides, these empirical tests are in many cases based on surveys and declarations of international investors, thus encompassing potential declarative biases and pro-cyclical perceptions of the quality of the institutional framework.

It may be argued that assessing the efficiency of institutions is rather an impossible task, because it cannot be a universal approach. Different institutional arrangements may have different impacts depending on the cultural, historical or political context of a given country.

In addition, considering separately some ingredients of the legal or regulatory framework of a country to assess an institutional framework is inappropriate. Understanding the role of the institutions of a financial systems requires, to the opposite, to develop a global approach, which is specific to the context of the country and to its historical development.

Eventually, the standard approach mainly limits institutional mechanisms to the function of asymmetries of information reduction. While we would not dispute the fact that asymmetries of information effects are relevant and active on financial markets, we would argue that they are insufficient explanations to our question. Herd behavior and procyclical risk taking also find their origin in behavioral dimensions (not only in asymmetries of information). This sole argument would plead for very different types of prescriptions than the Augmented Washington consensus, in particular because in this perspective, improving information is in no way a sufficient solution.

Contrary to the standard approach discussed in this paper, an appropriate understanding of the link between financial liberalization and financial instability would require, in our view, to adopt an alternative theoretical, where institutions are first and not added to the analysis, where historical time and context is taken into account, and which would admit ”imperfections“ of financial systems are not ”imperfections“ nor ”biases“ to an ideal system, but are the very characteristics of liberalized financial systems.

Theoretical Alternative: Minsky's Hif and Institutional Approach

Minsky's approach of financial instability constitutes in our view an appropriate theoretical alternative. While the predictions of his Financial Instability Hypothesis are common knowledge (Minsky 1986; Minsky 1992), the role he attributed to institutions is less documented. Minsky argued that financial system are inherently instable. During the upward phase of the cycle, risk taking increases, in the form of both financial risk taking (indebtness, short term financing of long term investment projects) and degradation of the quality of investment. This process cannot last indefinitely. When the first defaults appear, fragile economic entities are pushed to bankruptcy. An auto-cumulated debt deflation crises follows. In the case of emerging economies recently liberalized, financial risk increase also takes the form of currency and maturity mismatch, that trigger similar hedge-speculative-ponzi mechanisms as initially described by Minsky (Arestis and Glickman 2002).

Those mechanisms explain how financial fragility develops with the business cycle and how the cycle reversal is itself endogenous (Nasica 1997). Understanding why financial fragility develops however requires to revisit Minsky's analysis of institutional mechanisms.

In a series of late papers, partly unpublished except as working papers (Minsky 1992; Minsky 1996; Minsky and Whalen 1996; Whalen 1999; Whalen 2001), Minsky develops an original perspective. Institutions definition are anchored – or borrowed- to American institutionalism, to J.R. Commons in particular (Sinapi 2012). Institutions include habits, routines, rules and regulations, as well as authorities defining and enforcing rules. The role of institution is to act as ”circuit breakers“.

> ”To contain the most evident evils that market systems can inflict, capitalist economies have developed sets of institutions and authorities, which can be characterized as the equivalent of circuit breakers. These institutions in effect stop the economic processes that breed the incoherence, and restart the economy.” (DelliGatti, Gallegati et al. 1994, 5)

Two types of institutional mechanisms interfere in the financial fragility development process.

> ”The financial instability hypothesis is a model of a capitalist economy which does not rely upon exogenous shocks to generate business cycles of varying severity. The hypothesis holds that business cycles of history are compounded out of (i) the internal dynamics of capitalist economies, and (ii) the system of interventions and regulations that are designed to keep the economy operating within reasonable bounds.” (Minsky 1992, 8)

First, cautious usages within the financial agents relax with success. Risk taking is thus under-estimated of increases, because of the ”euphoria“ of the boom.

> “Successful operation of the economy, defined as an interval in which no serious financial crisis and no serious depression occur, is taken to imply that the current institutional structure is less crisis and depression prone than the structure of earlier times.” (Minsky 1991, 17)

Consequently risk taking is trivialized, the quality of investments declines (selection of increasingly risky projects) and speculative and Ponzi financing develops. The combination of incentive to take risk and relaxation of prudential usage in good times is an inherent (endogenous) institutional mechanisms, involving ”informal“ institutions of the financial system, which is behind financial fragilization for Minsky, and which he denotes as (i) the “internal dynamics of capitalist economies”. “Informal” institutional forms (institutions and usages) trigger a dynamic within the system or a “spontaneous” dynamic.

The second dynamic sustaining the financial fragilization process arises from the action of the system of interventions and regulations, that is, from the formal institutions: regulations, supervision capacities, and regulatory organizations. If the system is effective, it acts as a “circuit breaker,” that is, it counters the first mechanism (the internal dynamics of capitalist economies) which promotes risk taking: these institutions are a stabilizing force. But under the effect of innovation and development of capitalism, Minsky argues that the structure becomes inoperative.

In particular, Minsky anchors his proposals in a long term analysis of capitalism development (Whalen 1999). This long term dynamic is also of institutional nature. Through time, the form of capitalism evolves and with it the need for formal institutions. No standard nor universal institutional framework can thus be recommended. But the adjustment of institutions to the new conditions is necessary. This is all the more true as innovations and development of new forms of capitalism lead former institutional arrangements to be inoperative.

Implementation of financial liberalization constituted, for emerging economies in the nineties, a significant mutation of their form of capitalism. As a result, their former institutional arrangements, understood as the set of regulations, supervisions and authorities which counter the natural dynamic of capitalism towards financial fragility, became inappropriate. Financial fragility developed, taking standard Minskian form of credit boom, maturity and currency mismatch, till the reversal of the cycle triggered systemic financial crises, of major economic impact.

This approach, to the contrary of the standard view, does not predict universal solutions as regards to what should be ”the“ appropriate institutional framework. It neither emphasizes the role of information as the key issue to be addressed. It rather predicts that authorities of each emerging economies may choose – or not choose- to implement financial liberalization, but should also have in mind that such form of financial capitalism are inherently prone to instability and that supervision, state regulation and authority, in the form of ”Big Bank“ (banking prudential supervision, lender of last resort, monetary policy) and ”Big Government“ (public spending and deficits to restart the economy after a krach) are required to counter it.

Conclusion

In times where the role of international financial institutions is once again determinant for many emerging economies facing the consequences of the 2007-8 financial crisis, it is of interest to revisit the economic dogma in which international institutions anchor their ”recommendations“, or conditions to their support. Similar argument would stand for South European countries, among which Greece, whose population keep on denouncing the conditions imposed by the so-called ”Troika“ (the European Commission, The European Central bank and the IMF).

In this paper, we questioned the efficiency and relevance of these international institutions' economic paradigm, in particular regarding financial liberalization, as well as their ability to question their own failures.

Observations proving a link between financial liberalization process and crises in emerging economies forced the emergence of a theoretical debate, some-what sharp. The dominant economic views embraced by these institutions have adjusted in accordance. They recognized that financial liberalization may have favored crises, without however considering financial liberalization as a potential cause of such crises. The Augmented Washington consensus completed the initial Washington consensus version, by adding prescriptions in terms of institutional development and sequencing of the financial liberalization implementation. While such elements can hardly be criticized - fighting corruption, improving prudential regulation, standardizing financial statements – we feel they miss the point.

The approach of institutions adopted in the standard approach is purely instrumental and the universal prescriptions for institutional development are disconnected from the cultural, historical context of countries. The causes of instability are seen as resulting from market imperfections, asymmetries of information especially. We argued in this paper that, to the opposite, instability does not result from biases or imperfections.

What is seen as imperfections are in our views characteristics inherent in financial systems. Financially liberalized economies are prone to instability, endogenously generated through both cyclical institutional mechanisms and long term – historical - institutional development. To counter crisis does not mean to abandon financial liberalization, nor financial capitalism, but to regulate it, taking into consideration each country's specific institutional context. This requires political will and adequate economic views leading economic authorities within emerging countries. Following Minsky,

> "we should [be] looking ahead – toward a new era of institution building. Economic systems are not natural systems. It is possible not only to reduce present-day economic insecurity without sacrificing economic progress but also to frame and establish the institutional prerequisites for a successful 21st Century capitalism." (Minsky and Whalen 1996)

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Rezime:
Revizija debate o Vašingtonskom konsenzusu: Teorijska ocena recepata međunarodnih institucija za brzorastuće ekonomije

Devedesetih godina prošlog veka brzorastuće ekonomije su se uglavnom bavile procesom finansijske liberalizacije, sledeći recepte (ili zapovesti) međunarodnih institucija, konkretno Međunarodnog monetarnog fonda i Svetske banke. Ipak, krajem devedesetih godina prošlog veka, umesto da se desi obećani ekonomski rast, sada značajno finansijski integrisanije brzorastuće ekonomije pogođene su velikom finansijskom krizom. U ovom radu se proučava način na koji su međunarodne institucije reagovale na očigledan neuspeh njihovih ekonomskih modela i predviđanja. Sintetišu se glavni argumenti teorijske rasprave koja je sledila nakon finansijske krize koja je pogodila brzorastuće ekonomije devedesetih godina prošlog veka i objašnjava se način na koji su ove argumente međunarodne institucije inkorporirale u tzv. „Proširenom Vašingtonskom konsenzusu". Primećujemo da su standardni ekonomski pogledi koji su prihvaćeni od strane MMF-a prepoznali da je proces finansijske liberalizacije usko povezan sa finansijskom krizom u slučaju brzorastućih ekonomija. Međutim, nije priznato da finansijska liberalizacija može biti među uzrocima nestabilnosti, i umesto toga okrivljuju se proces implementacije liberalizacije (prebrz ili haotičan) i/ili neki već postojeći makroekonomski nedostaci, kao što su nedostatak fiskalne discipline ili neadekvatan pravni i regulatorni okvir. Ovde se pokazuje da, iako je MMF pokazao da može da prilagodi svoje stavove nespornim činjenicama, ova prilagođavanja su nedovoljna što ima za posledicu da dominantan ekonomski pogled u vezi finansijske liberalizacije zadržava dogmatski karakter. Što se tiče preporuke o promeni politike, ona se nadograđuje na Prošireni Vašingtonski konsenzus i uglavnom se fokusira na institucionalni razvoj. Ovo su, očigledno, veoma poželjni ciljevi. Međutim, mišljenja smo da standardni pristupi institucijama, koje su međunarodne institucije preporučile, a koje se prvenstveno fokusiraju na asimetrično informisanje, su na globalnom nivou promašile poentu. Institucije finansijskih sistema treba na početku da budu uključene u analizu, a ne posle. One zahtevaju ocenu u istorijskom kontekstu zavisno od faze razvoja svake privrede pojedinačno. U tom smislu, Minskijev pristup finansijskoj nestabilnosti i institucionalnim mehanizmima-predstavlja obećavajuću teorijsku alternativu. Danas, međunarodne institucije

još jednom obezbeđuju pomoć i političke „preporuke" za brzorastuće ekonomije, uz uslov da vlade usvoje ove preporuke koje su istovremeno osporavane od strane stanovništva. Ponovna debata oko Vašingtonskog konsenzusa i finansijske liberalizacije pokazala je da ova tema još uvek nije zatvorena.

Ključne reči: Prošireni Vašingtonski konsenzus, finansijska liberalizacija, institucionalni razvoj, finansijska kriza, brzorastuće ekonomije, Minski

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