Effect of washington consensus upon emerging market

Finance, Market

Washington Consensus implemented by emerging markets refers to economic policies created by John Williamson (Hooper, 2002; Rodrik, 2006). It is based on financial liberalization theory of McKinnon and Shaw, which emphasis on freeing financial markets from government intervention. Financial liberalization theory assumed perfect financial markets with perfect information, perfect competition and depends on institution-free analysis (Demetriades, 1999). These assumptions are irrelevant in the sense that market, as a whole is imperfect.

Despite these deficiencies, emerging countries agree to implement Washington Consensus requested by International Monetary Policy (IMF) and World Bank as part of their loan contracts. According to Washington Consensus, emerging economies facing similar problems with developed markets should be treated with the same tools. Washington Consensus aims to encourage privatization with high level of economic openness. There are many criticisms regarding the policies content of Washington Consensus.

Some critics argue that the policies are not being devised in a sequentially correct manner and did not consider emerging markets' development stage (Hooper, 2002). There are several impacts of the implementation of Washington Consensus upon the emerging capital markets namely worsen economic growth and increase stock market's volatility. Implementation of the Washington Consensus through financial liberalization has affected economic growth of emerging capital markets. Financial liberalization is developed in the objective of improving economic growth by encouraging saving, investment and capital productivity.

Before financial liberalization is introduced, many developing countries encounter financial repression, which is the process where government intervenes in the economy (Demetriades, 1999). In 1960s and 1970s, government intervention was needed to control pegged exchange rates under Bretton-Wood regime. Government controlled the markets by allocating high reserve requirement, interest rates ceiling, and controlling capital, credit as well as exchange rate. These interventions led to disequilibrium in interest rate, for example, interest rates were below equilibrium level (Hooper, 2002).

In order to curb the problem, financial liberalization is introduced, for instance, by setting higher interest rates. High interest rates were aimed to encourage savings, which will attract investment through borrowing and thus improved economic growth. Unfortunately, financial liberalization did not result in greater savings instead high interest rate can destroy reformation in real sector (Hooper, 2002). In addition, financial liberalization exacerbates economic growth in the sense that ratio of reserves to foreign denominated short-term indebtedness had declined substantially (Stiglitz, 2000).

Washington Consensus suggests emerging capital markets to deregulate their economies in order to achieve economic growth. However, lack of comprehensive regulation has led to Asian Financial Crisis in 1997. Moreover, dampen economic growth during Asian Financial Crisis came from maturity and currency mismatch. For example, long-term investment in local currency financed short-term liabilities in dollars. Besides, Washington Consensus did

not emphasis on capital flow structure in liberalizing capital flows. Many emerging capital markets destabilized due to high level of capital flows.

In Latin America (1980), economic crisis was a result of cash flow structuring problem with the increase in portfolio equity to replace portfolio debt. Asian Financial Crisis 1997 has been deteriorated due to regular flows ofmoneybetween financial markets. This term hot money will flow from countries with low return to countries with the highest interest rates as banks attempt to get highest return as possible. These flows can affect balance of payments if exchange rates in the total is high (Hooper, 2002).

Thus, Washington Consensus worsens economic growth of emerging capital markets. Volatility of stock markets is also affected by the implementation of Washington Consensus. Financial liberalization lead emerging capital markets to more volatility. This is because financial liberalization encourages deregulation, and liquidity, which are the components enhancing volatility. It also goes for taxation as lower taxes lead to volatility. Since liberalize markets usually have lower market concentration, volatility will also increase (Hooper, 1998).

Moreover, increasing portfolio equity flows increasing volatility of stock markets (Hooper, 2002). These situations reduce the attractiveness of investing in emerging stock markets (Stiglitz, 2000). Besides, stock markets' volatility will be exasperated when there is no sufficient accounting disclosure since investors are not able to make informed judgment about the

firm. However, financial liberalization did not improve accounting disclosure and structure of governance (Hooper, 2002).

There is negative relationship between quality of accounting system and volatility of stock market. Poor accounting system lead to higher market volatility. Moreover, Washington Consensus policy of deregulation has also intensified volatility of stock market (Hooper, 1998; Hooper, 1998). In addition, financial liberalization increased volatility of stock markets with changes in outside country. Since, emerging markets seemed risky, investors are discouraged to invest in the markets. Thus, results in large capital outflows (Stiqlitz, 2000).

However, in the long run, volatility of emerging stock markets is improving as they liberalize. International investors find investing in emerging markets are profitable since their risk-return of overall portfolio improved. Investing in emerging stock market lead to diversification of risk, as there is low correlation with other markets (Hooper, 1998). Despite that, implementation of Washington Consensus in emerging capital markets lead to volatile stock market especially in the short-term cycle.

There are several ways for IMF and World Bank to conduct policy in developing countries. One of the ways is IMF and World Bank have to make sure that Washington Consensus policies are implemented in correct sequencing manner (Hooper, 2002). For example, financial sector should be reformed after regulatory and bank supervision are restructured and after real sector has been reformed. IMF and World Bank should also encourage

developing countries to review and comprehend their regulation system since deregulation can harm economic growth (Hopper, 2002).

Furthermore, fortifying securities and accounting regulation help reduce volatility (Hooper, 1998) by implementing framework and policies like fiscal policy, which represent the countries stock markets' volatility. Besides, IMF and World Bank should bequest emerging countries to be more transparent in accounting disclosure and adopt good governance structure. For example, companies with poor governance are required to pay high return to investors. To reduce the premium, corporation should lessen information asymmetry by increasing accounting disclosure.

Thus, cost of equity is lowered since investors are more aware about the firms' cash flow. Moreover, accounting disclosure overcomes capital flows problem while clear securities framework helps lower volatility. Accounting disclosure should improve so that firms are abled to be monitored and controlled by government (Hooper, 2002). In addition, higher interest rates in emerging capital markets leads to adverse selection and moral hazard problem. Adverse selection normally occurs when interest rates are high as borrowers invest in extremely risky investment without lenders' knowledge.

While moral hazard arises when borrowers invest in projects they had not agreed to. This can lead to increase in cost of borrowing for other borrowers. Thus, encouraging accounting disclosure helps to reduce adverse selection and moral hazard. For example, Thailand and South-East Asian faced moral hazard due to deficient accounting disclosure and comprehensive regulation

(Hooper, 2002). Besides, transparent information helps heal economic growth through effective resource allocation (Stiglitz, 2000).

IMF and World Bank should also emphasis on binding constraints on economic growth by finding ways to correct the constraints. It is important for an economy to use the appropriate tools in reducing the constraints. For instance, reforming financial intermediaries will not improve investment with poor property rights. Thus, binding constraints have to be evaluated (Stiglitz, 1998). In conclusion, implementing Washington Consensus in emerging capital markets is not efficient. It deteriorated economic growth of many developing countries; for instance, East Asian and Latin America were in bad financial crisis.

Moreover, the liberalization process also affects stock market of emerging countries by exacerbating stock markets' volatility. Thus, International Monetary Fund and World Bank have to play their role by setting up efficient policies in order to curb problems arise from the implementation of Washington Consensus as well as improving the economy of emerging countries. REFERENCE LISTS * Demetriades, P 1999, ' Financial liberalization: the experience of developing countries', Eastern Economic Journal, vol. 25, no. 4, pp. 441-457. Hooper, V 1998, ' Volatility and openness of emerging stock markets: some empirical evidence', Emerging Capital Markets: Financial and Investment Issues, pp. 35-45. * Hooper, V 2002, ' The Washington Consensus and Emerging Economies', pp. 1-14. * Rodrik, D 2006, ' Goodbye Washington Consensus, hello Washington Confusion', pp. 1-28. * Stiglitz, J 1998, ' More instruments and broadergoals: moving toward

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