

*Development and
Financial Reform in
Emerging Economies*

*Edited by Kobil Ruziev
and Nicholas Perdikis*



DEVELOPMENT AND FINANCIAL REFORM
IN EMERGING ECONOMIES

SCEME STUDIES IN ECONOMIC METHODOLOGY

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EDITED BY

Kobil Ruziev and Nicholas Perdikis

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FOREWORD

It is an honour for me to be asked to write the foreword to *Development and Financial Reform in Emerging Economies*, which the editors, Dr Kobil Ruziev and Professor Nicholas Perdikis, have dedicated to the memory of Dipak Ghosh. Dipak was a close friend whom I knew for more than three decades. Like his many other friends and colleagues, I admired him immensely for his scholarship, his passionate belief that economics could be a powerful instrument for improving the life of the poor all over the world, his deep concern for the welfare of his students, and, above all, his compassionate and gentle personality. He was always eager to explore new ideas and ready to share his ideas with anybody who might be interested. Only a few weeks before his death, he wrote to me to ask me whether I would like to join him as a coauthor of a paper that he was planning to write on the implications, for welfare economics, of having individual preferences which might change with a change in the distribution of property rights.

This volume spans some of the major research interests of Dipak. The chapters in [Part I](#) explore a number of important issues in development economics. A highly interesting feature of many of these chapters (see, for instance, [Chapters 1, 2, 3 and 6](#)) is that they delve into the history of economic thought and highlight insights from the contributions of thinkers such as Smith, Hume, Keynes and Kalecki. The chapters in the [second part](#) of the volume study financial markets in many different parts of the world, including Kazakhstan, Uzbekistan, China, India, Bangladesh and Africa. A valuable addition to the literature on economic development and financial reforms in developing and transition economies, *Development and Financial Reform in Emerging Economies* is a fitting tribute to the memory of Dipak.

PRASANTA K. PATTANAIK

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INTRODUCTION

Kobil Ruziev and Nicholas Perdikis

Economic crises, be they large like the 1929 Great Depression or the Global Financial Crisis (GFC) of 2008, or small, are costly in terms of lost economic opportunities. They are also painful as they lead to unemployment and increase personal and social tensions, damaging the lives of millions of ordinary people. Ironically, major crises provide an impetus to challenge orthodox thinking which can lead to new ideas with radically different policy conclusions. The Great Depression, for example, inspired John Maynard Keynes to write *The General Theory* (1936). In this pioneering work, Keynes rigorously explained, in terms of fundamental uncertainty, monetary production and investor psychology, why market-based monetary economies were inherently unstable and proposed measures to tame excessive fluctuations in aggregate demand.

Success, however, often breeds complacency. This is a common trait in academic disciplines and is no less true of economics. The economic success in advanced economies during the post-World War II period and the subsequent ‘triumph’ of Keynesianism in the 1950s and 1960s led to the detachment of economic theorizing from reality. Economists started treating restrictive formal models, and the results of simulations based on them, as if they represented reality. Unfortunately, the economic problems of the late 1970s and the early 1980s, which could not be explained by the traditional Keynesianism, did very little to change this trend. With the collapse of Keynesianism, the detachment from reality actually widened with the rise and subsequent dominance of the neo-classical orthodoxy during the so-called Great Moderation, which preceded the GFC. Orthodox theories not only failed to predict the scale and the magnitude of the GFC, but, with their insistence (or preaching) of the inherent stability of market-based economies, can also be blamed for indirectly contributing to it.

Although the GFC has been interpreted as the second biggest crisis since the Great Depression in terms of its depth, probably it is the biggest ever in terms of its breadth as it affected almost all countries in the world in one way or another.

The hope and expectation is that, similar to the Great Depression, the GFC will motivate economists to challenge the established orthodoxy in economics and help bridge the gap between economics and the real world. Although the status quo is proving a lot more difficult to change than expected, the dissatisfaction with the neoclassical orthodoxy is gradually gaining momentum.

In this sense, this volume of collective essays aims to contribute to this process; specifically so in the context of development economics in general and the financial sector reforms in emerging economies in particular. Modern development strategy, led by international financial institutions in charge of policy advice to emerging economies, is built heavily around uncompromising orthodox economic ideas that are succinctly summarized by the words 'Washington Consensus', the term coined by Williamson. By putting its dogmatic faith in sheer market efficiency, this approach gives only marginal importance to the role and vitality of institutions in the economic process, and ignores largely the complex and time-consuming nature of institutional capacity building. It does not fully engage with the ideas of alternative schools of thought on the operation and functioning of modern economies despite the repeated failures of its policy recommendations in emerging economies since the 1960s.

By revisiting the contributions of past influential economists, and evaluating unintended consequences of reforms in some of the transition and developing economies, this volume aims to reassert the importance of historic experiences in generating a more realistic and dynamic world view about the way modern economies function and hence the way development strategy should be formalized. Recognition of the constantly changing nature of the economic relations and the associated evolution of institutions, including money, banking and finance, in the economic process is of paramount importance in this regard. Improving our general understanding of the potential sources of economic growth and the essential inputs required to develop the productive capacity of economies should also help us to design and shape better economic policies. One of the key and critical conclusions to emerge from this volume is that improvements in our understanding of the interdependence between the changing nature of economic relations and the development of ideas which form the basis of policy prescription can lead not only to the adoption of better and more relevant policies, but also to more accurate anticipation and analysis of their likely impact. The book is aimed at a broad audience, including academics, postgraduate students, policymakers and professional practitioners.

This essay collection would not have come into existence if it were not for the respect and admiration the contributors had for the work of Dipak Ghosh who died when the idea of this book was being conceived. He was a passionate fellow academic who worked tirelessly in areas of our academic interests. He was an inspirational colleague, a compassionate and reliable friend, and a very kind gen-

tleman; a rare combination of qualities to possess in modern academia. During his productive career spanning more than twenty years at the University of Stirling, Dipak inspired many people. He published his work in various economics journals including *Manchester School*, *Scottish Journal of Political Economy*, *Journal of Post Keynesian Economics*, *Journal of Economic Methodology*, *Progress in Development Studies*, *Problems of Economic Transition*, *Studies in Economics and Finance*, *Savings and Development*, *Development Southern Africa*, *Economic and Political Weekly*, *Journal of Business Finance and Accounting*, *Journal of Small Business Management*, *Economic Notes*, *Australian Economic Papers*, *Indian Economic Journal*, *Central Asian Survey*, *Economies et Societes*, *Acta Oeconomica* and *the Bulletin of Economic Research*. He was an active member of various scholarly associations and research centres including the Post Keynesian Study Group (PKSG), Stirling Centre for Economic Methodology (SCEME), the Bangladesh Economic Association, Development Studies Association, International Institution for South Asian Studies, Royal Economic Society, Scottish Economic Association, Scottish Local Government Academic Network, and South Asian Social Research Forum. The volume presents a selection of methodological and critical essays discussing pertinent issues in development economics and financial sector reforms in emerging economies, areas of research Dipak Ghosh felt passionately about and contributed extensively to in his lifetime. It is to his memory that this book is dedicated.

The critical essays collected here are organized under two broad themes: economic development; and financial sector reforms in transition and developing economies. [Part I](#) discusses the relationship between economic development and the development of ideas and experiences. It attempts to show how appreciation of this process can contribute to a better understanding of the working of modern economies, advanced and developing, and as a result the prescription of relevant policies. Included in this part are contributions by Sheila Dow and Alexander Dow, Roy Grieve, Dipak Ghosh, David Vazquez-Guzman and Jan Toporowski. Regarding Dipak Ghosh's two contributing chapters, the drafts of these chapters existed at various stages of development and these were completed by Victoria Chick and Kobil Ruziev. [Part II](#) covers financial sector reforms in selected emerging economies, and also includes a discussion of the importance of the role of money and finance, and that of financial regulation, in market-based emerging economies. Contributions include those of Kobil Ruziev and Sheila Dow, Daniela Gabor, Jens Holscher and Khurshid Djalilov, Alexandr Akimov, Chaoyan Wang and Malay Dey, Jahangir Chowdhury and Radha Upadhyaya.

Finally, we would like to thank all our authors for their excellent contributions and also for being patient with our demands during the editorial process, some of which, we admit, were raised out of pure ignorance. We enjoyed reading the individual chapters immensely and remain hopeful that this will be shared by our readers.

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I ECONOMIC DEVELOPMENT IN THE SCOTTISH ENLIGHTENMENT: IDEAS AS CAUSE AND EFFECT

Alexander Dow and Sheila Dow

Man, it was postulated, not only *made himself* and his institutions: he and his institutions in an important sense *were themselves made* by the circumstances in which from time to time and from place to place he happened to find himself.

Ronald L. Meek, 1976¹

Dipak Ghosh was a friend and colleague to both of us, and an intellectual companion over many years. He was a true scholar, motivated by the scope for economic ideas to promote economic and social development. Given this long-held concern with development issues, as well as his fondness for Scotland, we offer the following analysis of a peculiarly Scottish contribution to ideas on development in the hope that he would approve.

In characterizing the European Enlightenment, Ronald Meek, as quoted above, identifies as ‘perhaps the most important’ idea, that of adding ‘a new dimension to the problem of man and society’: the significance of context. In this chapter we apply this insight to an analysis of the particular characteristics of Enlightenment thought as it developed in Scotland, and specifically to the theory of economic development. In particular we argue that both the existence of cultural mix in Scotland, and the nature of Gaelic thought as part of that mix, influenced Scottish Enlightenment thought.

While Scottish Enlightenment thought developed as part of a wider intellectual movement in Europe in the eighteenth century, it had distinctive features. It was arguably on account of these distinctive features that innovative ideas emerged within a range of disciplines. A notable contribution which arose from this distinctive intellectual environment was the seminal contribution to thinking about economic growth and development in the form of Adam Smith’s *Inquiry*

into the Nature and Causes of the Wealth of Nations. Other Enlightenment figures, notably Sir James Steuart, David Hume, James Anderson and Adam Ferguson, contributed to the debate on issues of growth and economic development.

The contribution of Scottish Enlightenment figures to the later development of economics was substantial, and is thus the subject of a vast literature, with a range of interpretations. Here we focus on the particular ideas with respect to economic growth and development which refer to ideas themselves. One of Smith's key contributions was to develop and apply the principle of the division of labour, which he elucidated as one of the key engines of growth. The concept was in fact first introduced in the context of division of labour in the generation of ideas, and only later extended to the mode of production. On this foundation was built the theory of trade-led growth in an expanded market, and hence a vent-for-surplus theory of economic development. Indeed this marked the idea of economic development itself as an object of study. But possible feedbacks of the division of labour in the form of diminishing moral sensitivities, and the consequence of this for economic development were also discussed in the period. There was considerable concern that economic growth and moral virtue would be incompatible. Another key idea was that economic development itself is a precondition for ideas conducive to economic development: consumption aspirations on the one hand and innovations to improve productivity in order to meet these aspirations on the other. To what extent, then, was the Scottish Enlightenment itself, as a set of ideas, the product of prior economic development?

The aim here, therefore, is to explore the interdependencies between the particular economic experience of Scotland and the ideas for economic development which arose in the eighteenth century, focusing particularly on the role of ideas themselves in economic development. There has been disagreement in the literature on the Scottish Enlightenment as to the relative influences of civic humanism and natural law (between particularity and generality). Here we will find a circularity between the general forces which influenced the Scottish Enlightenment thinkers and the particularities of their circumstances. Indeed we will suggest that an absence of dualism, such as between particularity and generality, was a central feature of Scottish thought. In the process we address an issue being given increasing attention in the literature: how far were these ideas for economic development a veiled analysis of 'improvements' in the Highlands and Islands? We extend the discussion by addressing the further question, as to how far the distinguishing characteristics of the Scottish Enlightenment were themselves a product of the particular cultural backdrop.

We start by considering some of the distinctive characteristics of Scottish Enlightenment thought, where theories of economic development arose out of moral philosophy. In the following section we focus on the particular ideas as to economic development which relate to the importance of ideas as a mechanism

for productivity growth. We then provide some background to these ideas in the form of the socio-economic conditions leading up to the Scottish Enlightenment, paying particular attention to the Highland–Lowland distinction. This focus is in line with a renewed attention in intellectual history on the Highlands in relation to the rest of eighteenth-century Scotland.² In the process, we address the debate as to how far economic development was instrumental in facilitating the Enlightenment itself. Finally, we consider the extent to which the form the ideas of the Scottish Enlightenment took, on economic development as well as on knowledge more generally, were influenced by the cultural composition of Scotland at that time. We are therefore considering ideas, not as something independent of material reality, nor as fully determined by material reality. Rather we consider the important mutual influences between ideas and reality, mediated by moral philosophy (and thus culture).

The themes that run through the discussion are first the interplay between ideas and context, so that we consider how the Scottish experience (including its cultural diversity) served to spawn the particular set of ideas of the Scottish Enlightenment, which included ideas about the interplay between development and ideas; and second, the interplay between particularity and generality – between general trends in ideas and economic reality on the one hand and the particularity of the Scottish reality and of the ideas of the Scottish Enlightenment – which included ideas about generality and specificity.

The Distinctive Characteristics of the Scottish Enlightenment

The eighteenth-century Enlightenment was a general European intellectual movement which took the form of a challenge to the authority of the Church in matters of science (or knowledge more generally), and established alternative foundations for knowledge, most particularly in reason and evidence. Just as in other emerging fields of enquiry, this approach to knowledge was applied to the functioning of the economy. The origins of this intellectual movement are complex, and the currents of thought within Europe spread from one country to another.

However, this movement took a range of forms, such that the Scottish Enlightenment differed in several important respects from the Enlightenment elsewhere, most notably in France.³ This occurred in spite of the strong influence from Continental thought through a variety of channels, not least from direct, extended, contacts in France on the part of Hume, Steuart and Smith. Indeed it could be argued that it was Hume's (ultimately unsuccessful) attempts to grapple with French Enlightenment rationalism that encouraged him to develop an alternative approach to knowledge. Under the influence of Descartes, the French Enlightenment prioritized reason as the foundation for knowledge. Hume eventually concluded that reason could not provide the proof of existence which was necessary for science applied to the real world; this was the pinnacle of his scepticism.⁴

Hume therefore turned to his project of developing a science of human nature to provide the alternative basis for knowledge in conventional belief, based on generations of experience. In contrast to Descartes's pure reason, conventional belief was not the outcome of demonstrable truth. Brian Loasby refers to this as 'Hume's Impossibility Theorem: "It is impossible ... that any arguments from experience can prove this resemblance of the past to the future; since all these arguments are formulated on the supposition of that resemblance"'.⁵ Experience itself was subject to the problem of induction. In Hume's hands, this problem was not simply a matter of unobserved instances, but the more profound problem that reality is too complex, and underlying causal mechanisms too deeply hidden, for any knowledge of them to be held with certainty.⁶

Using the Newtonian 'experimental' method, knowledge could be built using systematic study of experience (detailed historical study) combined with reason.⁷ Where reason was combined with imagination to identify patterns and fill in evidential gaps, the outcome was conjectural history. But prior to experience and reason were conventional belief, the imagination required to conceive of cause in the first place, and then to engage in abstract reasoning, and, as Smith explained in the *History of Astronomy*, the sentiment to motivate the search for knowledge.⁸ Then, as Smith explained in his *Lectures on Rhetoric and Belles Lettres*, this knowledge had to be communicated in such a way as to persuade different audiences, appealing to their prior knowledge and to the imagination.⁹ This was far removed from French rationalism, which consisted of applying classical logic to axioms held to be true, as well as from the empiricism without abstract theory more characteristic of the English Enlightenment.

This approach to knowledge was both influenced and reinforced by the system of higher education.¹⁰ Students entered higher education in their mid-teens, and were provided a structured approach to knowledge built on early teaching of moral philosophy. This philosophy emphasized the absence of a single rationalist truth, but rather took a historical approach to explain the different possible ways of building knowledge. This carried forward into other subjects, which were also taught historically, exposing students to the idea that knowledge can be built in different ways best suited to problems at hand. It is this approach, arguably, which underpinned the inventiveness of the period.

In his *Lectures on Jurisprudence* (1762–3), Smith developed the idea of the division of labour in terms of knowledge: 'Genius is more the effect of the division of labour than the latter is of it. The difference between a porter and a philosopher in the first four or five years of their life is, properly speaking, none at all'.¹¹ While anyone was capable of becoming a philosopher, this activity was facilitated by education. Further, it appealed more to the sentiments of some than to others, who then went on to specialize in pursuing particular lines of enquiry with a higher input of reason. The difference between philosophers

and others then became an issue for rhetoric: how to persuade different types of audience, with different experience, different familiar knowledge, and different inclinations to apply reason, to accept particular ideas.

The key characteristics which Scottish Enlightenment thinkers brought to economic questions followed from this overall approach to knowledge. First, knowledge was provisional since it could not be demonstrated to be true. In particular, principles could be teased out of detailed study of societies in different times and places, but these might require adaptation in the light of new circumstances and when applied to new cases. Second, the focus on society ensured that economic questions were approached from the standpoint of moral philosophy; and indeed for Francis Hutcheson and Smith their economic ideas developed as applications for moral philosophy teaching. The focus on society also meant that economic questions were also integrated with social, psychological and political questions. It was only later that these lines of enquiry emerged as separate disciplines.

Finally, the methodological approach differed not only from the French deductivism characteristic of the Cartesian approach, but also from English empiricism based on a different understanding of Newton.¹² Knowledge was derived from experience, but with the aid of imagination and reason it could be systematized and communicated for more general, albeit provisional, application. Hume and Smith were thus able to develop a theory of human nature which drew out what they identified as common features of humanity, while demonstrating how these features were manifest in different ways in different societies. Smith argued in the *History of Astronomy* (appeared 1795) that aesthetically-pleasing systems drawn from first principles, and connecting with what is already understood, would be most persuasive to audiences. Yet persuasion was distinct from the process of theory formulation itself. However, the provisional nature of theory emerging from the Scottish Enlightenment arguably became communicated in a more deterministic manner than was intended, because that was aesthetically appealing. We shall consider this possibility in terms of the theory of economic development.

Theories of Economic Development

The first idea on which we focus is the idea of economic development itself, which arguably was the first contribution from the Scottish Enlightenment thinkers. (Indeed, it could be argued that the notion of an economy as such only emerged during the Enlightenment, as something distinct relative to the polity.)¹³ Before Smith, indeed with origins dating back to ancient times, there had been discussion of change in the means of subsistence and associated modes of organization by means of stages of development.¹⁴ But the eighteenth century saw a much greater focus on understanding economic history in terms of advance from one

stage of development (one mode of economic organization) to another: the hunting and gathering, pastoral and agricultural stages, leading to the final stage of commercialization. Indeed this discussion emerged within a new discourse, on economic development.¹⁵ In the French stadial approach, notably Turgot, the emphasis was on agriculture.¹⁶ But Smith changed the focus from agriculture to one of growth in prosperity once the fourth stage, commercialization, had been reached. He introduced the idea, drawing on natural law philosophy, that such growth might be the normal condition for commercial societies.

There were differences of opinion as to whether such growth was indeed sustainable, and Smith himself considered a range of moderating factors. A key feature of this discourse followed from Scottish Enlightenment thought, that it emerged out of moral philosophy. Economic development was not discussed in isolation, but in conjunction with an emphasis on moral sensibilities as a practical question of norms and conventions. Thus Hume and Smith both aimed to encourage debate as to the best way to secure both virtue and prosperity, their mentor Hutcheson having expressed concerns that commercial society was incompatible with virtue.¹⁷ There was debate as to whether prosperity would support, or even promote, moral sensibilities, or whether it would erode them.¹⁸ It was therefore seen as necessary that appropriate social institutions be developed in parallel to economic development. This debate resurfaced much later as the Adam Smith Problem,¹⁹ referring to the apparent incompatibility of Smith's moral philosophy and his economics.²⁰ The sustainability of the commercial economic process is now primarily discussed in the economic literature in terms of how far market forces can be relied on to generate socially optimal outcomes. Would the unintended consequences of self-interested behaviour produce a good outcome for society, without reference to moral values? But in the eighteenth century the focus was at least as much on production and whether the emergent specialized mode of production in commercial society was independent of social institutions and moral concerns.

The key principle applied to thinking on economic development, referring to production, was the principle of the division of labour. This principle was present in others' thinking before Smith.²¹ But it was Smith who developed the principle, drawing on a wide range of evidence from different societies in order to establish how generally it could be applied. The division of labour allowed division of tasks and thus specialization and productivity growth. The surplus thus generated could then be used for investment in order to specialize productive functions further, yielding ever more surpluses. This process was facilitated by commercialization, which extended markets, and Smith focused on the market process. If markets could be extended overseas, then exports would provide even more latitude for division of labour. Economies then could reap the benefits of economies of scale at a macro level and experience growth in prosperity at an