

assessments of the market's influence on tastes. The unreality of the assumption that a person consists of "warring selves" may not matter to a follower of Friedman's famous methodological claim that "assumptions don't matter," but it is particularly odd that one as interested as Schelling in capturing the "lived experience" has also been a promoter of this way of modeling internal conflict.

The third and final notable shortcoming has to do with an omission. Schelling's essays, both those appearing in this book and those appearing elsewhere, carry with them much relevance for controversies over how societies should be organized. Schelling has served as an advisor on the political front throughout his career, but when it comes to raising questions about the spread of market forces he has nothing to say. This is especially hard to understand in his essays on "Commitment as Self Command" (the title he gives to the essays on self-control). The examples of conflicts within the self that he chooses to focus on are dramatic but unrelated to what sort of economic system prevails. The currently sober self having to pre-commit to make impotent the future drunk who aspires to drive, and the pregnant woman who takes measures to disempower her future self who might refuse a natural birth procedure are powerful examples. But I would like to have seen more attention given to the conflicted overeater and the conflicted undersaver, who are becoming more familiar as market forces spread.

These criticisms must not be taken to suggest that this is a book to be avoided. Thomas Schelling manages to enlighten while holding the reader's attention at the same time, a greatly needed gift in our profession. *Strategies of Commitment* was a pleasure to read, a particularly nice perk for a reviewer.

Reference

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The Next Great Globalization: How Disadvantaged Nations Can Harness Their Financial Systems to Get Rich. By Frederick S. Mishkin. Princeton University Press, Princeton and Oxford, 2006. 310pp., \$27.95. ISBN: 0-691-12154-0.

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As the author of a leading Money and Banking textbook and a Federal Reserve Governor, Frederick Mishkin needs no introduction. This work displays the same clarity of modeling and composition that made his textbook a bestseller. It is a plea for open financial flows; its central message is clear — globalize or languish.

Mishkin fears that disadvantaged nations will experience a backlash against globalization and will suffer as a result. His book seeks to prevent such a catastrophe; however, it may not achieve its goal because the solution is political, not economic. Mishkin himself learned, as an advisor to Ecuador, that many



policymakers recognize the need for good policy prescriptions but are afraid to adopt them.

Mishkin defines “economic globalization” as the “opening up of economies to flows of goods, services, capital, and business from other nations that integrate their market with those abroad” [p. 1]; *financial* globalization is “the opening of a country’s financial system to capital flows and financial firms from other countries” [p. ix]. Finally, Mishkin uses *disadvantaged nations* as an umbrella term covering developing and emerging market countries. He aims the book at the last group of countries because they already have good financial systems.

Mishkin begins by emphasizing that globalization in the early 1900s included large capital flows; those countries that globalized grew, while those that did not stagnated. Financial globalization lowers the cost of capital, improves its allocation, and promotes the development of property rights and institutions, such as the financial system. Nations can develop only if funds flow to their most productive users. Financial institutions promote capital allocation by overcoming the problems of adverse selection and moral hazard, which means that prudential regulation and supervision are needed for a well-functioning financial system.

In Chapter 3, Mishkin acknowledges that development problems are political and that politicians are poor agents of the voters. In countries without a free press, the public finds it hard to monitor politicians. Globalization can help by weakening political elites and strengthening those who support institutional development. Mishkin believes that foreign direct investment introduces best practices into financial markets and that the free flow of capital is necessary to lower interest rates.

Chapter 4 argues that financial crises, which are associated with capital account liberalization, are not a necessary consequence of this liberalization. Instead, they follow from the mismanagement of liberalization or from fiscal imbalances. Chapters 5 and 6 look at two cases: the 1994–95 Tequila Crisis in Mexico and the 1997–98 crisis in Korea. Mexico emerged from the crisis with a healthier and mostly foreign-owned banking system. However, despite NAFTA, the economy is languishing because it rests on an inefficient legal system that impedes development of the financial system. Korea recovered more successfully because the 1997 election brought in a new party, which decreased the power of *chaebol* vested interests, instituted broad financial reform, and improved corporate governance.

Chapter 7 describes the 2001–02 collapse of Argentina’s currency board, which was instituted in 1991 to tie the hands of the central bank and curb hyperinflation. The board set the peso to equal one dollar, a rate that many believed overvalued the peso and set the stage for its collapse. Despite excellent bank regulation and supervision, the currency board could not support the peg. A fiscal imbalance, compounded by external shocks (depreciation of the Brazilian real in 1999 and the appreciation of the US dollar in 2000), led to an unsustainable government and external debt.

Chapter 8 suggests that the best way to liberalize domestic financial markets is to free up markets for trade in goods and services. Mishkin thus implicitly recognizes sequencing — free trade comes first and promotes competition and efficiency (including reducing corruption), which can then spread to the financial sector. Chapter 9 shows how to prevent financial crises. Here, Mishkin emphasizes prudential bank regulation and supervision, such as limiting currency mismatch and ensuring adequate banks capital; allowing entry of foreign banks to bring in capital and competition; prudential capital controls; and stabilizing the macro-economy to prevent fiscal imbalances.

In Chapter 10, Mishkin states that because disadvantaged countries have no easy way out of financial crises, they must follow the hard way and improve their financial systems. Following the Asian crisis, several prominent economists argued that the IMF should have pushed for expansionary policies. Mishkin counters that such policies would have been a mistake because of two major differences in the corporate debt structure of advanced and disadvantaged countries. Corporate debt in advanced countries is long term and denominated in domestic currency; corporate debt in disadvantaged countries is short term and denominated in foreign currency. Expansionary monetary policy causes inflation and currency depreciation. These have an expansionary effect in advanced countries, but exactly the opposite effect in disadvantaged countries. Currency depreciation increases the value of foreign-denominated debt, and expected inflation cannot lower the value of the long-term debt the countries do not have. In disadvantaged countries, expansionary monetary policy lowers corporate wealth and creates bankruptcies and recessions.

Chapter 11 assigns a pivotal role to the IMF as the only institution that can act as a lender of last resort in disadvantaged countries. The IMF provides foreign exchange, which can “be used to stabilize the value of the domestic currency” [p. 177] on the foreign exchange market and help alleviate a financial crisis without causing depreciation and inflation. IMF lending can also help prevent a contagion spreading to other countries. Mishkin stresses that, to be effective, the IMF must act quickly and selectively as lender of last resort. To minimize the moral hazard associated with financial assistance, it must intervene only in real crises, and it must make reform of the financial system (especially the closing of insolvent financial institutions) a precondition for help. Unfortunately, speed and financial-reform conditionality are almost mutually exclusive, which is one reason the IMF is so ineffective, but Mishkin does not address this dilemma between fast aid without conditions and slow aid with conditions.

In Chapter 12, Mishkin comes down on the side of trade in the aid-or-trade debate. He argues that advanced countries have a responsibility to open their markets, enabling poorer countries to grow through exports, the only proven method of development, which includes financial development. More exports also help by increasing the inflow of foreign currency, which cushions the country in a financial crisis.

This book addresses an important global problem, the low state of development experienced by much of the world’s population, and it makes a valuable contribution to the development literature by focusing on domestic institutions. Moreover, while most economic discussion about institutions is highly abstract, Mishkin focuses on financial institutions. Nonetheless, I see three weaknesses in the book — two unresolved issues and an unclear audience level.

First, there is the issue of sequencing. On the one hand, financial crises tend to occur if financial liberalization takes place too soon. In addition, as Mishkin admits in Chapter 9, many of his recommendations for strengthening the financial system must occur, for political reasons, after the opening to foreign capital. On the other hand, waiting to open financial markets leads to slower economic growth. Disadvantaged countries thus face a dilemma. They can choose financial liberalization and risk potential financial crises, or they can remain relatively closed and grow slowly. Neither option is catastrophic. Ten years after the South Asian financial crisis, the region is thriving. And closed economies do not have to grow slowly — although they typically do. The Asian Tigers relied on domestic savings during the early part of their stunning growth. Another way out of this dilemma is to



separate the movement of capital and the movement of firms [p. 2]. While the latter is relatively non-controversial, Mishkin admits that free capital flows are hugely controversial. Thus, he should have focused more on the movement of firms because it is politically more acceptable and eventually leads to the movement of capital.

A second weakness involves the issue of financial crises and contagion. The book presents no argument or evidence for free capital flows to satisfy the major critics. It is built on first-generation models of speculative attacks, which assume that there is a unique equilibrium in the foreign exchange market, reachable through healthy macroeconomic policies. But the critics of free capital flows use newer models with multiple equilibria, some of which are self-fulfilling, showing that emerging countries are vulnerable to contagion.

Third, Mishkin suspects that some readers are not familiar with key terms, and so he defines some (e.g., GDP) in footnotes, but ignores others (e.g., the balance of payments). I would recommend that Mishkin include another chapter about the balance of payments that parallels his treatment of financial markets in Chapter 2. The book would also profit from a more extensive index and a glossary.

Overall, however, this stimulating book was a pleasure to read. I look forward to using it in my development class.

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The Bourgeois Virtues: Ethics for an Age of Commerce. By Deirdre McCloskey. University of Chicago Press, Chicago and London, 2006. 616pp., \$21.45. ISBN: 0-226-55663-8.

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The Bourgeois Virtues is the first book of a four-volume set intending to resurrect the themes of *A Theory of Moral Sentiments* and *The Wealth of Nations*. “Forgetting Smith in a commercial society,” McCloskey [p. 507] argues, “has orphaned the virtues. It is the ethical tragedy of the modern West.” And “the way forward is to go back to the blessed Adam Smith, or at any rate to his project” [p. 514]. As planned, “Volume 1 has most of the philosophy and theology, volume 2 most of the economic and social history, volume 3 most of the intellectual history, and volume 4 most of the economics” [p. 36].

The audience for this grand work is the “clerisy.” From the left, “the members of the clerisy believe that capitalism and profit are evil,” and from the right “they believe that capitalism and profit are good for business but have nothing to do with ethics.” Those in the middle are “bobos in paradise” agreeing “with the harder folk to the left or right about the laughably nonethical character of capitalism” [pp. 5–6]. Since Marx, McCloskey [p. 148] suggests, the clerisy has failed to articulate a transcendent moral tradition that illuminates our lives. She intends to remedy this error.

The book begins with a 50-page overview of the larger work. Capitalism has enriched humanity, making democracy and higher culture possible. Capitalism has also made us more virtuous. Trade nurtures love, for example, by spreading trust,