

**INITIAL DYNAMICS OF FINANCIAL MARKETS IN THE TRANSITION ECONOMIES  
IN THE 1990s AND NEW CRITIQUE OF THE BIG BANG POLICY:  
HETERODOX APPROACH**

**I. Introduction: Orthodox and Heterodox  
Economics about Financial Markets in the  
Advanced Market Economies**

Orthodox economics — mainly, neoclassical approach — believes that development of financial markets in the market economy is always beneficial for the real sector. The main idea is that financial markets provide efficient intermediation of savings between ultimate lenders and borrowers and therefore help both to reach optimal allocation of resources and to increase economic growth. Such markets provide links between savers, who — according to their rate of time preference — refrain partially from current consumption, and investors, who want to invest due to high marginal productivity of capital and need external financial resources for it. Furthermore, neoclassical economics assumes that “financial markets provide correct signals about the underlying fundamentals (the real economic variables) as proposed by the efficient markets hypothesis” (Binswanger, 1999a, p. 1; see also Raines and Leathers, 2000). In short, any possibilities of negative influence of financial markets on real sector are irrevocably excluded.

Heterodox (Post Keynesian and Institutional) economics, contrary, proves that, owing to various causes, the expansion of financial markets can do the harm for the real sector. Such conclusions are the effect of the fact that Heterodox economic analysis takes account of variability of preferences, planning horizons, and, especially, degree of rationality in the behavior of economic agents. In particular, Post Keynesian and Institutional approaches reject the idea of unboundedly rational behavior in the financial markets (as well as in the other markets) due to the importance of different informational problems such as uncertainty of the future, extensiveness and complexity of information, and also asymmetric information (Ees and Garretsen, 1993; Lavoie, 1994; Davidson, 1996; Hodgson, 1997; Dequech, 2000a). Such informational problems preclude optimizing rationality. Sometimes suppliers and demanders in the financial markets behave according to the principle of bounded rationality (see about this principle in Simon, 1959; Dequech, 2000c). But often the actions of participants of financial markets are governed by such factors as animal spirits and “folk psychology” (Veblen,

1904, ch. 6; Keynes, 1936, ch. 12; Raines and Leathers, 1996; Dequech, 2000a). Such behavior is non-rational, irrational or “arational” (Dequech, 2000a) and often leads to various speculative bubbles and fads (Raines and Leathers, 2000). It is speculative activity that often rules the roost in the financial markets, rather than “tranquil” transactions providing mentioned efficient intermediation of saving for financing growth of the real economy.

These behavioral assumptions have led to the following Heterodox arguments in favor view that expansion of financial markets can have adverse influence on real sector (see generalization in Binswanger, 1999a, p. 9-11).

*The “crowding out hypothesis”.* Financial assets can crowd out real productive assets in the form of fixed capital. More exactly, this capital can be crowded out by “financial hoarding”. “The term refers to all the financial funds used for trading financial assets between households, firms and financial institutions without involving any real economic activity” (Binswanger, 1999b). This idea has been traced to Keynes’s (1930) distinction between the industrial and the financial spheres of circulation. The main point is that under fundamental uncertainty and other informational problems financial hoarding can be more preferable for investors than purchases of real assets bearing returns only in long-term unknowable future.

*The “financial dominance hypothesis”.* “Important economic variables, such as interest rates and exchange rates are increasingly determined by speculative financial activities, which do not reflect the “real conditions of the economy”. Therefore, the financial sector increasingly also “dominates” the real sector as financial activities set the standard (e.g. the opportunity costs of real investments) for activities of the real sector” (Binswanger, 1999a, p. 10). It seems to me that this hypothesis is the least important among other ones.

*The “casino hypothesis”.* This hypothesis is based on the idea that prices of stock do not reflect accurate information about expected real returns determined by real economic activity and depend upon financial speculations. Then “financial markets develop their own speculative growth dynamics, which may be guided by arational behavior as, in the words of Keynes, «intelligence is devoted to anticipate

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what average opinion expects the average opinion to be». This development is supposed to harm the real economy, as it is in danger to become the by-product of a casino“ (Binswanger, 1999a, p. 10; see also Keynes, 1936, ch. 12). This argument concerns only stocks and shares. The point is that unique role of stocks and shares is a consequence of fundamental uncertainty regarding real expected returns “underlying” prices of these financial assets. “The reason seems to be the high degree of information asymmetry among the players (e.g. insiders and noise traders) on the stock market and the uncertainty about the underlying fundamentals which creates an ideal environment for the emergence of bubbles“ (Binswanger, 1999b).

*The “short-termism hypothesis”*. Here the main idea is that “financial markets attract short-horizon speculative traders as these markets allow for sequential trading“ (Binswanger, 1999a, p.10). Therefore prices become very volatile and allow to make big profits within very short periods of time. If managers take seriously account of financial markets evaluations then their way of thinking becomes also has been infected by “short-termism”. “If financial markets undervalue long-term investments also managers will undervalue them as their activities are judged by the performance of a company”’s financial assets, which may harm the long run perspectives of companies“ (Binswanger, 1999a, p.10).

In principle, it can be proved that financial markets (more exactly, stock markets) can generate managers’ short-termism also without speculations. In such case short-termist behavior of managers “is a consequence of the interaction between the principal-agent problem and the characteristics of the financial system and, in particular, of the existence of a market for corporate control” (Dickerson et al., 1995, p. 362; this paper has written in a little more orthodox spirit).

*The “financial instability hypothesis”*. This is the most famous argument — put forward by Minsky (1977, 1985, 1986) — which concerns, however, only debt financial assets. The idea is that economic expansion is provided by fixed capital investment, and the latter is financed by debt. “During economic booms, as full employment is approached, debt commitments start to outstrip the income flows necessary to service them“ (Binswanger, 1999a, p. 10). Agents become financially fragile. “Financial fragility in itself is not a constraint to growth, but it may disrupt the process of expansion” (Stuart, 1995, p. 52). The point is that it creates prerequisites for deep economic crisis in the form of debt-deflation (Minsky, 1986). The conception of “financial instability hypothesis” has generated a lot of attempts of its formal modeling (Semmler, 1989; Fazzari and Papadimitrou, 1992; Dymski and Pollin, 1994), although up to now it is not clearly how to overcome chronic tendency of market “capitalist” economies to financial fragility. Minsky himself suggested a somewhat

utopian idea “that a simplification of financial structures is a way of achieving greater stability” (1985, p. 53); he approved also use of less capital-intensive techniques and orientation toward more “consumptive” (i. e. less “investment”) economy. Such reforms can hardly be consistent with technical progress.

The aforementioned arguments do not imply that financial markets expansion occurs always at cost of the real sector (Binswanger, 1999a, p. 11). Heterodox economists do not reject any positive influences of financial development on economic growth. But nevertheless, often these influences can be more than offset by negative impact.

We suppose that both methodology and conclusions of heterodox economics can be especially topical for the transition economies of some East European countries and republics of the former USSR. The point is that the fundamental features of the transition — intensified by the big bang policy — affect behavioral patterns of both agents making portfolio choice and ones who emit securities. These patterns, in turn, lead to the adverse effects of the expansion of financial markets in such economies, and such effects may be even more negative than similar ones which occur in the advanced market economies.

The present paper devotes to the analysis of both these patterns and their influence on the dynamics of financial markets in the 1990s, which are here conflated with securities markets (so I do not consider banking system and non-banking financial institutions which are characterized by peculiar properties). This one is both theoretical investigation and direct generalization of bitter experience of initial phases of financial markets expansion in some unsuccessful transition economies such as Albania, Russia and so on.

And first of all, using Post Keynesian and Institutional approaches, I will stress the important patterns of portfolio choice in the transition economies.

## **II. Demand in the Financial Markets in the Transition Economies**

### *The “investor myopia”*

In the different economies different economic agents have different time horizon of planning. Some agents evaluate consequences of their decisions only over short-time horizon, other ones can take account of long future. The former can be called “investor myopia”. The concept of investor myopia should not be confused with aforementioned and allied phenomenon of “short-termism”, as Juniper (2000) has pointed out; the latter concept can be defined as an excessive discounting of future returns (this phenomenon will be considered in the next subsection).

The duration of planning horizon, and, hence, both presence and degree of investor myopia, depends upon various factors. The matter concerns, for example, individual psychology, occupation, national way of life etc.

The very important factor is an institutional

environment. The stable and steady institutional system provides orderliness, coherence (Herr and Westphal, 1991) and coordination of various economic activities of various agents. For each agent reactions of other agents become more predictable. In short, institutions reduce degree of uncertainty (Dequech, 2000b; Sapir, 1999; Davidson, 1972, 1996; Carvalho, 1992). Furthermore, without institutions no time-consuming economic activity can be possible because of extreme degree of uncertainty precluding any orderliness and coherence.

Needless to say, stable institutional environment helps attempts to evaluate long future performance. Other things being equal, the more institutions are stable, the longer agents' planning horizons are. "Unequal other things" are first of all "quality" of institutions. Some institutions — like forward contract system — strongly contribute to "long-term orderliness", other ones — like tax evasion when it is not occasional phenomena but behavioral norm — even can prevent account of long-term consequences of decision-making. It can be very important. But nevertheless the matter of institutional stability remains relevant for duration of agents' planning horizons.

The point is that the transition economies can be treated by definition as the economies with changing and unstable institutional environment. I imply both formal and informal institutions. On the one hand, the State abolishes a lot of old formal institutions inherent to planned economic system and tries to create new formal ones constituting market economy. On the other hand, private agents are forced gradually to transform informal institutions in the forms of behavioral norms, traditions, routines, habits etc. It means that transition economies are characterized by fundamental shifts in its institutional system (Sapir, 1999).

At that, very often such economies are systems exhibiting so-called "institutional hiatus", for example, when "the old command system had collapsed before the new coordinating mechanisms of the market economy could be put in its place and generate effective responses" (Kozul-Wright and Rayment, 1997, p. 643; see also Kornai, 1993). The "institutional hiatus" in the transition economies is inevitable effect of the big bang policy (Tsang, 1996, Rozmainsky, 1997, 2000), because such policy by its nature has directed to quickest destruction of planned system institutions.

The instability of institutional environment — particularly, if such instability "incarnates" in the form of institutional hiatus — prevents formation of long-term planning horizons. Frequent changes in an institutional environment sharply increase degree of unpredictability of agents' actions and reactions and overall economic conditions as a whole. To a considerable extent, economic activity is liable to reduce to the "fishing in troubled waters" which often is nothing but diverse forms of shadow economy (Rozmainsky, 1997).

It is clearly, that economic agents in such

circumstances usually take account of only short future periods: the evaluation of long-term benefits and costs seems foolish practice. Therefore transition economies — particularly, if transition is realized through the big bang policy — are systems where agents are characterized by investor myopia. It means that in emerging transition economies agents make specific portfolio decisions: they will choose assets and/or transactions bearing return over short period of time. Assets which promise high return in the distant future but do not bear any gains over short time intervals are almost completely non-attractive. It is one of the most important patterns of portfolio choices in the transition economies.

*Poverty of portfolio-decisions-makers  
and their short-termism*

As is well known, almost all countries with transition economies are poor ones. This statement is especially relevant to the members of the former USSR and some countries of Eastern Europe like Romania, Bulgaria and Albania. Therefore the majority of economic agents in the transition economies suffer from low standards of living. Often they do not consume even many staple goods. Broadly speaking, it means that such agents will prefer current consumption instead of future one. Hence, participants of transition economies as a rule are characterized by very high rate of time preferences. They discount "outcomes" belonging distant future by astronomically high rates. Present goods and returns bear them very considerable utility.

Needless to say, in such case agents invent various ways to improve these standards during the quickest periods of time. One of ways to make it is saving which further is invested in assets and/or transactions promising very high gain over short time interval. In such case the dividing line between consumption/saving decisions and portfolio ones disappears: changes in financial wealth and its structure become linked with consumption considerations. This "non-standard" circumstance is direct effect of emergence of financial markets in the countries with low standards of living, i. e. low level of consumption.

So objectives of participants of financial markets in the transition economies fundamentally deviate from objectives of financial investors in the developed countries. In the latter case, of course, consumption can depend on wealth measured by stock prices index. But this link has rather psychological nature (Keynes, 1936). In the former case, however, returns on investments in financial assets will directly spend on consumption goods in order to improve standards of living. The discussed (and up to now unexplored) pattern of portfolio choice can be treated as a serious distortion in the preferences system of financial markets participants in the transition economies. It is such system that generates described short-termism which by its nature fundamentally differs from short-termism observed in the developed countries (Juniper, 2000; Dickerson et al., 1995; Singh, 1995, p. 93-95).

The first two described patterns had led to a selection (in the emerging financial markets of the transition economies) of extremely risky securities which promised very high gain.

*The lack of skills*

As I have mentioned above, the transition economy is usually the economic system which moves from the planned economy to the market one. But the planned economy is the economy without financial markets. Therefore economic agents have no necessary skills for rational allocation of its savings, i. e. for rational portfolio decision-making. What such skills are?

Firstly, portfolio-choice-makers should be able to comprehend financial health of securities issuers. Such agents should both possess minimum relevant information about them, for example, about recent balance sheets and income statements, and be able to understand and evaluate it. It is necessary condition for rational behavior in the sphere of portfolio choice. Otherwise they can be easily cheated by fraudulent, unscrupulous, dishonest or simply “fallen in hard times” issuers. In such case their choice will not be rational and do the harm to them in some future period. It should be noted that described things are beyond asymmetric information problems, although nevertheless the latter is also relevant to it.

Secondly, portfolio-choice-makers should be able to estimate future movements of macroeconomic conditions and understand links between them and situation on the financial markets. For example, if such agents see that in the near future slump is inevitable they should realize that expectations of high dividends or high capital gain cannot be fulfilled. Usually such information is absent because of a presence of fundamental uncertainty (Dequech, 2000b).

Thirdly, portfolio-choice-makers should be able to estimate future dynamics of financial market itself, particularly when their planning horizon is short. For example, they should understand that domination of bearish tendencies in the market is unfavorable for large purchases of financial assets. This and previous kinds of skills are also important for (at least, unboundedly) rational decision-making in the described sphere.

Broadly speaking, portfolio-choice-makers in the developed countries hardly possess these skills (at least, completely). But such lack had been filled there by special institutions. First of all, I mean institution of financial brokers. These agents help to “ordinary” investors to make portfolio choice and get fee by using of own special skills and knowledge. Due to brokers many “ordinary” people have been insured from fatal errors and mistakes. Another special institution which can fill lack of knowledge is institution of investment advisers. Such advisers guide “ordinary” investors and help them not to make serious mistakes.

However, both brokers and advisers institutions had appeared much more lately than financial markets. Just

as the State regulation of financial transactions, such institutions are the reflection of maturity of securities markets. The history of developed countries contains numerous cases of non-rational speculations (for example, Tulipmania in Holland).

Participants of financial markets in the transitions economies are in danger of knowing bitter experience of developed countries. Inability to make rational financial decisions makes them victim of insolvent and fraudulent companies. The described pattern of portfolio choice — the lack of skills for rational financial behavior — is an example of “information overload” (Lah and Sušjan, 1999) and, using more narrow definition, complexity (of information), which was mentioned above. The latter is a situation when “... there is a gap between the complexity of the decision environment and the analytical and computational capacity of the agent” (Hodgson, 1997, p. 665; see also p. 669-671; Simon 1959; Dequech 2000c). Complexity is one of the bounds to unboundedly rational behavior (see details in Hodgson, 1997; Dequech, 2000c). The second main bound is also aforementioned (fundamental) uncertainty of the future which was also relevant for considered issue, although this “bound” matters always in sphere of private real investment and financial decisions (see Carvalho, 1992).

*The lack of rationality as the norm of behavior*

Moreover, in the transition economies agents as a rule may not make fully rational choice at all. The point is that the rational behavior implies “calculatedness” (Leibenstein, 1976, p. 72-82), i. e. detailed personal account of current and future benefits and costs which are concerned with the decision-making. Only politically, socially and psychologically independent people with deliberate objectives, personal responsibility and care for own material welfare will make rational decision in their economic life. That is why rationality is not universal feature of human behavior; it should be treated as the behavioral norm can be formed by religious, cultural and social factors. The most famous illustration of last sentence is Weber (1965) conception of the Protestant ethic influence on rise of capitalism. Western capitalistic society itself compels people to be rational, as it implicitly follows from the famous work of Leibenstein (1976, ch. 5). As Kregel (1995, p. 168) pointed out, “an economy based on exchange for private gain in the form of learned behavior, a particular form of human culture which cannot be expected to resurface unaided which more than 75 years in the Soviet Union, and over 40 in most of Eastern Europe have been spent trying to form ‘New Socialist Man’”.

In other words, the planned economy is the system which very strongly affects behavioral norms and features of its participants. The planned economy implies both political and social dependency of people and low level of personal responsibility. Many social-and-economic relations have been based on the State paternalism (Kornai, 1980). In the planned economies people usually had shifted

the burden of individual decision-making responsibility to somebody's shoulders. As a rule, this "somebody" is the State or an enterprise of the State. The level of wage, consumption bundle and other important objects of economic choice had been determined by the State in exchange for guaranteeing of staple economic goods and social maintenance. People had been insured against starvation, homelessness, bankruptcy, misery, unemployment. Their personal efforts could not both make them bankrupt or unemployed and allow them to enrich. Needless to say, planned economy had led to very high degree of psychological personal dependence of people and their very low propensity to innovate in any spheres of economic life. Non-rational behavior of participants of the planned economy is a natural consequence of fundamental properties of such system (although, on the other hand, rise of this system itself can be treated as an effect of religious, cultural and social factors preventing rationality)

To overcome behavioral norms is time-consuming process (Sapir, 1999, p. 4). Therefore in the beginning of transition agents did behave not yet fully in the rational manner, because they had no appropriate habit! It is clearly that last statement is relevant also for portfolio decision-making.

The last two described patterns led to the very high degree of consensus of opinion in the financial markets and to the phenomenon which was called by J. M. Keynes (1936) "conventional judgement" (see also Raines and Leathers, 2000; detailed analysis of different definitions of "conventions" is contained in Dequech, 1999) and by Parenteau (1999) "herding". Each agent tries to follow the behavior of others and refuses from individual independent weighing of benefits and costs of own choice. The issue of extreme "consensus of opinion" in the financial markets of many transition economies will be explored in details below.

Furthermore, these two patterns had been cause of high degree of suggestibility of transitional financial investors. High suggestibility, other things being equal, increases effectiveness of advertisement which was used by many issuers in many transition economies in order to manipulate demanders for securities.

### **III. Supply in the financial markets in the transition economies**

Above I have described basic features of the demand-side of emerging financial markets in the transition economies and its distinctions from analogous markets in the developed economies. The supply-side of such markets — determined by behavioral patterns of issuers — in the transition is also specific. First and foremost this specificity consisted in the tendency of domination (in the described market) of supply of very risky and very often junk assets. The following factors have been important.

The first factor is the above-mentioned investor myopia.

A lot of companies which issued its securities had been characterized by short planning horizon owing to analyzed causes. These companies tried to make money as quickly as possible. One of means for it was rapid achievement of enormous sales of securities for getting money and speculating in wildcat securities and other assets.

The second one is very deep macroeconomic slump together with destruction of those formal institutions of the planned economy which provided enterprises free or cheap finance. The very main such institutions are, firstly, access to credits of the State (with zero or negligible interest) and, secondly, the State system of centralized wholesale distribution of inputs and outputs which provided uninterrupted "relations between firms as suppliers of raw materials and intermediate goods and between firms as producers of final goods and retailers as the sellers of goods to the public" (Kregel, 1995, p. 173). The demolition of both institutions had generated extreme problems with liquidity in the production sectors of many transition economies (Kornai, 1993). Financial markets might be almost only quick means of getting liquidity.

The third one is concerned with informal part of institutional environment of the transition economies. I imply here mainly destruction of moral norms. This destruction took place gradually at later stages of planned economies development and accelerated sharply in the beginning of transition. The criminal sector had become expand very quickly (Rozmainsky 1997; Lah and Sušjan, 1999, p. 592-593). Fraudulent actions in many transition economies became to treat as morally acceptable. Broadly speaking, such mentality cannot be transformed within short time period (Kornai, 1995, ch. 8).

These factors had led to the domination of insolvent and fraudulent issuers, on the one hand, and preponderance of supply of junk and wildcat securities and other financial assets, on the other hand. The mechanism of quick receipt of liquidity has been very simple. Issuers promised fantastic interest and dividend incomes (aggressive advertisement played often enormous role). Initially such incomes should have been provided, but by very insecure method in the form of new emission of bonds, stocks, shares and etc. It is famous Ponzi finance, which here is not consequence of long economic expansion accompanied increasing financial fragility (which was described above). It is an effect of just analyzed behavioral patterns of financial assets issuers.

### **IV. Heterodox Economics of Initial Financial Markets Dynamics in the Transition Economies**

According to the efficiency market view, analyzed patterns of issuers' behavior should have not been cause of transformation of financial markets into the markets for junk and wildcat securities. But it is understood that limits to such transformation could be "installed" only if demanders for financial assets would be unboundedly rational. Then junk bonds and similar assets would be displaced. The above description of basic behavioral

patterns of financial investors proves the opposite perspective. Demanders in the financial markets behave as bounded-rational agents in general in the advanced market economies and as non-rational agents in particular in transitional economies.

Broadly speaking, high dividend/interest incomes are always more preferable than low ones. Even if financial investors are not non-rational but simply over-optimistic, issuers promising higher incomes crowd out more “conservative” ones (Boyd and Blatt, 1988, p. 59). Moreover, when demanders face with complexity (of information), have no habit of detailed account of all relevant data and want to get a lot of money as quickly as possible, such “crowding out” is beyond doubt!

In the beginning of 1990s described events had been reality of above-mentioned unsuccessful countries. By means of very aggressive advertisement, insolvent and fraudulent issuers persuaded potential financial investors to buy their bonds, papers, stocks etc. The given promises had been fantastic. And their promises had kept! How? By means of Ponzi finance! As the “intermediate” result, both sides of financial market had been satisfied. Suppliers got quickly required money. Some demanders got the same; yes, at the expense of other demanders, but owing to analyzed behavioral patterns full comprehension of it had been absent. Needless to say, financial turnover grew very rapidly and expectations became more optimistic; there was a typical speculative bubble.

It is important that another “crowding out” took place: financial speculations crowded out physical investment! Negligible “inducement to invest” (in fixed capital) was generated not only by deep transformational recession but also by fantastic gains from such speculations. It is an above-mentioned “crowding out” argument in favor of pessimistic view on role of financial markets in the economy (Binswanger, 1999a).

Above I wrote about “herding” and “consensus of opinion”. It is very important for deep understanding of financial crises in the transition economies in the early 1990s. The point is that complexity and uncertainty have led to inability to behave unboundedly rationally; and absence of norms and habits of rationality in the behavioral principles can exclude even bounded rationality.

In turn, both inability and unwillingness to behave rationally — to collect, process and evaluate all relevant information — is the very main cause of up to now unexplored “propensity to herd”. “Herding is the tendency for agents to follow their competitors” (Parenteau, 1999, p. 52). Personal “propensity to herd” — the concept invented in the present paper — measures (indirectly, of course) intensity of such tendency for each concrete agent. Aggregation of personal “propensities to herd” gives collective “propensity to herd”. The more the latter “indicator”, the more consensus of opinion is high.

The degree of consensus of opinion, in turn, does

the influence on instability potential of considered markets (Keynes, 1936, ch. 12; Pollin, 1999, p. 44-45). When expectations are similar, expanded turnover grows more than impetuously. That was just early dynamics of emerging financial markets in many transition economies. Naturally, that initial phase of dynamics cannot continue endlessly in this fashion. Ponzi-finance is short-lived.

Broadly speaking, the moment of approach of financial markets dynamics turning point depends upon two factors: financial investors’ wealth and changes in their confidence (Boyd and Blatt, 1988). Exhaustion of financial resources and sharp decrease in the degree of confidence lead to fall in demand for securities, and then price index very quickly goes down. But this general scheme is not complete for considered case. Probably, more important factor is exit (from market) of enriched issuers together with their broken promises. For demanders for financial assets it is a something like a “cold turkey”. They loose confidence and almost unanimously — this unanimity is “provided” by very high degrees of “propensity to herd” and “consensus of opinion” — try to get rid of securities. But the group of demanders as a whole cannot make it (Boyd and Blatt, 1988). The collapse of financial market takes place. That was just end of initial phase of financial market dynamics in many transition economies.

But adverse consequences of described behavioral patterns and events up to here have not finished. As a result, human trust to financial market had become extremely low. People lose desire to buy securities of majority of private companies and became to prefer either foreign currency or financial assets supplied by the government (i. e. deposits of the State banks and government bonds). I christen it “*dynamic paradox of transitional portfolio choice*”. This paradox consists in voluntary narrowing of range of financial assets in the course of spontaneous expansion of financial market in the transition economies, although, according to “common sense”, spontaneous financial expansion would be characterized by widening of demanded assets range.

The loss of trust and confidence, in turn, had two allied consequences. Firstly, fruits of evolution of financial markets have been destroyed, because almost all securities had disappears from these markets. At that, new securities could be actively tradable only when trust and confidence would take place. Therefore, secondly, financial markets could not play the role of financing new fixed capital investment and, hence, economic growth and technical progress. The lack of finance had been one of the most important causes of low level of physical investment in many transition economies in the 1990s (Kornai, 1993). That is why in some countries such as Russia financial markets in the second half of the 1990s developed first and foremost owing to emissions of government papers.

So specific behavioral patterns of transitional suppliers and demanders in the financial markets have

done harm to the real sector. In the “short run” financial assets have crowded out real productive assets. Thus the expansion of financial markets has been additional reason for economic slump and technological degradation. In the “long run” the mentioned behavioral patterns have generated speculative bubbles which burst and led to... self-destruction of financial markets!

This self-destruction was fruit of growth of seeds contained in spontaneous emergence and expansion of these markets. The unregulated dynamics of financial markets in the specific conditions of the transition — determining behavioral patterns of both financial investors and securities issuers — had led inevitably to such crash, as if financial development had not appeared at all. It raises relevant normative questions.

#### **V. The Implications for Policy and Conclusions**

The main practical conclusions are the following. The expansion of financial markets in the transition economies must be always controlled and governed by the State. First of all, the State should both create serious institutional barriers to entry of insolvent and fraudulent companies into the financial markets and to exit of such companies from these markets. Paradoxically, “fierce” competition in the financial markets in the beginning of the transition is harmful for economic welfare. This paradox is explained by various informational problems described above. The State should provide very imperfectly financial market structures in the transition economies by “throwing away” insolvent and fraudulent suppliers of financial assets. The right to issue stocks, shares, bonds and other financial assets must not be universal and should be given only to companies satisfying certain financial and legal requirements (as it takes place in the developed countries). Furthermore, the State should prevent free exit (from markets) potential bankrupts and financial swindlers. The State must legally both punish such swindlers and protect ordinary financial investors. Very often this protection should be provided in the framework of standard enforcement of contracts by the State because all debt securities, for examples, bonds, are debt contracts. The State should also protect demanders for financial assets from aggressive advertisement. The last kind of protection is effective means of correction of portfolio choices in the conditions of complexity and uncertainty. Without analyzed legal and financial constraints development of financial markets cannot be “genuine” from the perspective of financing huge fixed capital investment and rapid growth. Possibly, one of such constraints could be high securities transaction excise tax which was a practice of some developed countries (Pollin, 1999).

Secondly, the State should help people to learn basic skills of portfolio choice. As I mentioned above, the planned economy is an economy without financial markets, and “socialist people” have no any “financial skills”. Therefore, “transitional people” also have no these

skills, at least, in the beginning of the transition. The State should take the responsibility of “financial enlightenment” of ordinary representatives of civilians. Such enlightenment could be provided through the government mass media. These reasonings also regard to elementary “legal skills” such as knowledge of rights of stockholder.

Naturally, relevant skills can be acquired without any government policies through the process of “learning-by-doing”. It is a way of the majority of transition economies. But such way seems ineffective, because it is concerned with great financial losses of ordinary financial investors and, especially, with continuation of human aversion of securities of private issues. When distrust takes place, financial markets cannot provide “finance” (Keynes, 1937) for the productive sector, and investment process can stop together with economic growth.

The State can help also ordinary people by means of development of brokers and investment advisers institutions. The presented analysis shows the importance of these institutions for financial markets stability.

All this reasoning implies critique of the big bang policy from the perspective of securities markets dynamics. As is well known, the essence of this policy is quickest destruction of institutions of the planned system and simultaneous realization of all reforms providing rise of the market system. It is the big bang that main cause of both sharpening of the informational problems (Rozmainsky, 2000) — complexity and uncertainty — and heavy macroeconomic slump, including liquidity crisis. As the above analysis has showed these factors together with some elements of the “socialist past” had formed specific behavioral patterns of suppliers and demanders in these markets which allowed expansion of financial markets to deep transformational recession and to increase social cost in the form of big losses of many ordinary portfolio-decision-makers.

More concretely, such patterns — to a considerable extent created by the big bang — generates the threat of the domination of financial papers of insolvent, illiquid and fraudulent issuers in the financial markets. And then, the majority of participants of financial markets can loose money invested in the assets of such “bad” companies. It leads to human distrust to the financial markets. People begin to escape from investing into the financial assets of private firms and to hold wealth in the form of cash money and/or foreign exchange. The “dynamic paradox of transitional portfolio choice” takes place. As a result, the financial system has become degraded; and its development has been stopped. The economy as a whole loses capability for financing investment and growth. Such dynamics took place in some transition economies, for example, in the Albanian and Russian economies in the 1990s.

Financial market should emerge only when law framework for a market economy, in general, and laws regulated financial transactions, in particular, have been created. There must be strict enforcement of obligations,

fast legal procedures and also consistent and non-contradictory legislation. Such features had been absent in many transition economies (Lah and Sušjan, 1999, p. 592).

In general, spontaneous expansion of financial markets in the course of transition is harmful for the real sector. Such expansion harms real economy through some combinations of (described in the Heterodox economics) “crowding-out”, “casino”, “short-termism” effects and also specific “fraudulent” form of “financial instability” effect. These markets should emerge only when some important institutions of market economy have been already created. Moreover, financial markets should be variously regulated by the State through financial and legal controls. Otherwise such markets cannot fulfill their main (from the Heterodox point of view) function of financing physical investment and economic growth. These are the lessons from the 1990s.

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**Rozmainsky Ivan V. Initial Dynamics of Financial Markets in the Transition Economies in the 1990s and New Critique of the Big Bang Policy: Heterodox Approach**

Heterodox — Post Keynesian and Institutionalist — economics proves that expansion of financial sector can be harmful for the real sector. Such conclusion is an effect of account of variability of preferences, planning horizons and degree of rationality in the behavior of economic agents. We suppose that both methodology

and conclusions of Heterodox Economics can be especially topical for many transition economies. The point is that fundamental features of the transitional economies affect the patterns of choice of agents in the financial markets. These patterns, in turn, lead to the adverse effects of the expansion of financial markets in such economies.

*Key words:* Financial Markets; Transitional Economies; Economics of Transition; Rationality; Heterodox Economics.

**Розмаїнський І. В. Початкова динаміка фінансових ринків в перехідних економіках 1990-х і нова критика політики великого вибуху: Неортодоксальний Підхід**

Неортодоксальна — посткейнсіанська та інституціональна, — економіка доводить, що розширення фінансового сектора може бути шкідливим для реального сектора. Такий висновок: ефект урахування мінливості переваг, горизонтів планування та ступеня раціональності в поведінці економічних агентів. Ми припускаємо, що і методологія, і висновки неортодоксальної економіки можуть бути особливо актуальні для багатьох перехідних економік. Річ у тім, що фундаментальні особливості перехідних економік впливають на схеми вибору агентів на фінансових ринках. Ці зразки, у свою чергу, приводять до несприятливих ефектів розширення фінансових ринків в таких економіках.

*Ключові слова:* Фінансові Ринки; Перехідні Економіки; Економіка Переходу; Раціональність; Неортодоксальна Економіка.

**Розмаинский И. В. Начальная динамика финансовых рынков в переходных экономиках 1990-х и новая критика политики большого взрыва: Неортодоксальный Подход**

Неортодоксальная — посткейнсианская и институциональная, — экономика доказывает, что расширение финансового сектора может быть вредно для реального сектора. Такое заключение — эффект учета изменчивости предпочтений, горизонтов планирования и степени рациональности в поведении экономических агентов. Мы предполагаем, что как методология, так и выводы неортодоксальной экономики могут быть особенно актуальны для многих переходных экономик. Дело в том, что фундаментальные особенности переходных экономик воздействуют на схемы выбора агентов на финансовых рынках. Эти образцы, в свою очередь, приводят к благоприятным эффектам расширения финансовых рынков в таких экономиках.

*Ключевые слова:* Финансовые Рынки; Переходные Экономики; Экономика Перехода; Рациональность; Неортодоксальная Экономика.

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