

# **The Past as Future? The Contribution of Financial Globalization to the Current Crisis of Neo-Liberalism as a Development Strategy**

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During the initial quarter-century of the post-World War II era, the development strategies urged on less-developed countries by the economic think tanks and foreign aid agencies of the capitalist world were shaped by Keynesian macroeconomics and by two “lessons” from history that further enlarged the economic role assigned the state in the development process. During the second post-war quarter century, the mainstream perspective shifted to neo-liberalism, which reoriented macroeconomic policy to accord with monetarism, structural policies with competitive general equilibrium theorizing, and reinforced the reorientation with “lessons” from history that diminished the role of the state in the development process. Recently, however, we have been witnessing growing defections from neo-liberalism at the ideational level and tectonic shifts away at the political level. Optimistically, these trends will return capitalistic development strategies and their theoretical rationale, in spirit though not in detail, back to those of the initial post-war quarter century; pessimistically, not before passing again through a 1930s-type dark tunnel.

## **I. The Evolution from *Dirigiste* to Neo-liberal Development Strategies**

What Keynesian theory brought to *dirigiste* development strategizing was the inference that aggregate output and employment paths of market economies *sans* government guidance are inherently unstable. That inference was further supported by the global financial chaos of the interwar decades, which graphically demonstrated that private financial markets are inherently too unstable to be allowed full freedom of

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action.<sup>1</sup> Interest, exchange, and capital controls and subsidies—“financial repression”-- were therefore acceptable tools for stabilizing fragile developing economies and facilitating the funding of priority development projects as they struggled to catch up with the developed world.

Internationally, this “lesson” plus Keynesian theory also shaped the Bretton Woods Articles of Agreement, which established the World Bank to supply long-term project loans to both war-ravaged and to less-developed countries, and the International Monetary Fund to help implement and protect the pegged exchange rate system called for in the Articles. These required all currencies to be convertible for current account transactions, but sanctified controls of capital account transactions. The U.S. dollar was to be pegged to gold, and the other currencies to be pegged to the dollar. The IMF was to supply short-term credits to help countries defend currency convertibility, and to keep the convertible exchange rate system compatible with domestic full employment by coordinating the macroeconomic policies of deficit and surplus countries. In practice, World Bank and IMF credits were dominated by governmental foreign aid flows that were guided mainly by U.S. Cold War objectives. But both institutions rose in importance in the succeeding neo-liberal era, although with new functions that deviated from the Articles of Agreement. The Articles are still its *de jure* charter, but the IMF now “honors them more in the breach than in the observance.”

The second “lesson,” drawn from 19<sup>th</sup> century economic history, was that industrialization is the primary engine of economic development, but revving it up required more extensive state action of later industrializing countries than of early

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<sup>1</sup> To quote from Ragnar Nurkse’s canonical study of the period:

“If there is anything that inter-war experience has clearly demonstrated, it is that paper currency exchanges cannot be left to fluctuate from day to day under the influence of market supply and demand....If currencies are left free to fluctuate, speculation in the widest sense is likely to play havoc with exchange rates—speculation not only in foreign exchanges but also as a result, in commodities entering into foreign trade.” [Nurkse, 1944, pp.137-38].

industrializers to build up supportive infrastructure and to offset barriers to investment and its appropriate allocation. “Industrial policy” and “picking winners” were permissible components of strategies for industrializing the less-developed countries of the post-WW II era.

The neo-liberal approach, on the other hand, takes off from the conviction that general competitive equilibrium theorizing firmly establishes that competitive market forces can bring real world capitalist economies to optimal output and employment growth paths that maximize the welfare potential of the stocks of productive forces employed. The chief cause of the unstable output and employment levels observable in the real world are “exogenous shocks”--unpredictable events that require changing production plans, relative prices and quantities, and that may transitorily disrupt the system of interacting markets. Such disruptive events are primarily “technology shocks,” i.e., the introduction of novel products and processes, and “policy surprises,” i.e., unanticipated government interventions in the operations of the private economy. But governments can also retard longer term growth through tariffs, taxes and controls that more permanently distort private incentives and relative prices. Differences in the reliance on such market distorting policy instruments account in large part for the differences in growth rates between countries.

Development strategy should, therefore, focus on maximizing market efficiency by minimizing policy-induced distortions and surprises. Shrinking the scope of the activist state would still leave it with essential functions. Thus inflation and deflation, which distort market perceptions and incentives, require “market friendly” collective action, i.e., “sound” fiscal and monetary policies to stabilize the price level. “Soundness”

meant balancing the fiscal accounts and stabilizing the growth of the money stock.<sup>2</sup> The state would also retain an essential role in enforcing contracts, protecting life and property, advancing education, and providing other basic public goods. But overcoming the technological and capital accumulation shortfalls that had concerned the interventionist development strategies of the Bretton Woods era should be left to the market, by removing capital controls and other impediments to the free flow of foreign direct and portfolio capital.

Supporting “lessons” from history? Chief among these was that the pre-World War I gold standard demonstrated the viability as well as the virtues of free capital mobility. Free of capital controls, long-term capital had flowed massively from industrialized Europe to the United States and other “regions of recent settlement” with independent currencies, while stabilizing short term financial flows substituted for gold flows in keeping the exchange rates of the creditor countries within their “gold points.”<sup>3</sup> Other “lessons” have been reversible. The path of neo-liberalism through the developing countries soon became strewn with temporary successes that ended abruptly in systemic currency and banking crises. Heralded initially by Washington, the IMF and Wall Street as exemplars “pour encourager les autres,” the stricken exemplars after their fall were transformed into examples of misapplications of the neo-liberal strategy to be avoided in the future.

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<sup>2</sup> When the key components of Friedman-type Monetarism—the demand for money function and the money multiplier—proved unstable, the emphasis shifted to targeting the price level, with the central bank manipulating the short-term interest rate as its main targeting instrument.

<sup>3</sup>This is obviously a narrow assessment of a complicated era in which pro-cyclical unemployment, wage depression and emigration were also basic adjustment mechanisms in both the creditor and debtor countries, along with tariff increases in most of the industrialized countries; domestic financial crises were frequent phenomena; and many of the capital recipients, notably in Latin America, were unable to stay on the gold standard for long. [Eichengreen 1996, Thomas 1954, 1972, Bloomfield 1959, Felix 2002].

Neither of the alternative approaches to development was, therefore, implemented uniformly and both produced mixed results. But the events that led to the shift to neo-liberalism differed qualitatively from the current crisis of neo-liberalism that threatens a return to *dirigiste* development strategies akin to those of the Bretton Woods era. The earlier *dirigiste* approach gave way primarily because of political and ideological pressures; the neo-liberal approach is giving way, counter political and ideological pressures notwithstanding, because of its flawed economics.

*Dirigiste* development was gradually undercut by the backwash from the crisis that terminated the Bretton Woods exchange rate system in the early 1970s. That crisis was fundamentally political. There were economically feasible modifications of the Bretton Woods system that could have extended its workability, but they required collective agreements that proved politically unattainable.<sup>4</sup> However, there was no concurrent economic crisis of *dirigiste* development. Indeed, the 1960s decade climaxed a record high quarter-century of growth of both GDP and GDP per capita in all developing as well industrialized regions of the world [Maddison 2002, Table 3-1a]. The

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<sup>4</sup> Thus, the “Triffin Dilemma,” a key factor in the 1960s crisis, could have been avoided had the U.S. not rejected Keynes’ Clearing Union proposal for handling global liquidity problems and opted instead for the IMF with its more-limited and inflexible dollar-dominated credits as the global supplier of emergency liquidity. Belgian economist Robert Triffin had pointed out that this arrangement, combined with a dollar freely exchangeable for gold at a fixed price in intergovernmental transactions, rendered the Bretton Woods system dynamically unstable. That is, the growth of world trade would require an increase in global reserves to finance trade and current account imbalances. With the monetary gold stock more or less fixed, that increase would require the U.S. to run chronic balance of payments deficits. But as it did so, its rising stock of foreign liabilities would soon overtake its gold stock, which would undermine the credibility of its commitment to exchange gold for dollars on demand at the agreed price of \$35 per ounce and threaten a self-feeding run on the U.S. gold stock. Since the resources of the IMF were too meager to fill the liquidity gap, the U.S., to keep its commitment would have to pursue deflationary policies sufficient to halt the dollar drain. But that would also shrink global liquidity and threaten a return to inter-war deflation and its dire economic repercussions. Alternatively, Bretton Woods members could transform the IMF into a mechanism closer to Keynes’ Clearing Union.

A 1960s proposal to allow the IMF to supplement member country reserves with Special Drawing Rights (SDRs) was intended to do that. Applied expansively, it would have loosened the chains tying the dollar to gold, making it easier for the U.S. to devalue, and surplus countries to revalue, their exchange rates. But that might also have weakened the international power that being the sole supplier of global reserves brought the U.S. So it fought off the proposal for most of the 1960s before grudgingly agreeing to a token allocation of SDRs at the end of the decade. The mechanism has remained marginalized since.

uniquely fast growth was also unusually stable and equitable, leading Angus Maddison and others to dub the quarter-century “the Golden Age of Capitalism.”<sup>5</sup>

The transition to neo-liberalism was mainly impelled by political and ideological changes external to the developing world. In the 1970s “foreign aid fatigue,” especially in the United States with its weakened balance of payments and war-induced inflation, plus the recycling of surplus OPEC country deposits into bank loans to upper-tier developing countries, initiated a major privatizing of “North to South” financial flows. The OPEC price surge also slowed economic growth and accelerated inflation in the industrialized countries. The stagflation helped monetarism and the new classical macroeconomics dethrone Keynesianism as the ruling orthodoxy among Anglo-American economists. So also did the “magic” of the financial markets, as they rapidly exploited arbitraging opportunities, creating liquid markets for new financial instruments to hedge against the unexpected volatility of the newly floating exchange rates. The efficient market and rational expectations hypotheses (EMH and Ratem) became centerpieces of the emerging neo-liberal orthodoxy, while also providing theoretical backing to the demands for decontrol from the financial sectors of the major industrial countries.

Paradoxically, it was the first major financial failure of neo-liberalism, the early 1980s debt crisis, that was most instrumental in forcing the new orthodoxy on the developing countries, for it brought in the IMF to oversee the rescue. Sidelined during the recycling boom, the IMF was now assigned the task by the major creditor countries of coordinating a rescue effort that would keep the mainly Latin American debt crisis from exploding into a global banking crisis. The fear was that some of the major international lending banks, having become badly overleveraged in their avidity to lend, were vulnerable to massive withdrawals of inter-bank deposits, should one or more

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<sup>5</sup> The interval 1950-73 was also the only sustained period during which the interregional spread of GDP per capita narrowed rather than widened. [Maddison 2001, Table 3-1b].

overborrowed Latin American country default. Withdrawals plus the fall in the market value of the defaulted loans could force the overleveraged banks into insolvency as well as illiquidity, with dire repercussions on other banks and their business customers around the world.

In coordinating the rescue, the IMF therefore tied the bailout credits to priorities that deviated from those assigned it by its charter, the Bretton Woods Articles of Agreement. Protecting private international creditors took top priority over stabilizing the debtor economies and minimizing employment and output losses.<sup>6</sup> Large IMF, World Bank and IBRD loans to enable debtor governments to keep up debt servicing were made conditional on the creditor banks agreeing to renew maturing loans, and on debtors agreeing to raise interest rates, but not capital controls, to deter the ongoing capital flight, and to move toward primary fiscal surpluses sufficient to service the foreign bank debts. The latter had to include loans to private domestic banks and corporations that had been contracted without government guarantee. The last condition, an *ex post* socializing of private debts, augmented the requisite primary fiscal surpluses, as did also repaying the bailout credits. The rescue packages sustained debt servicing long enough to enable the overleveraged banks by the end of the decade to regain solvency and the confidence of the international financial centers.<sup>7</sup> But the cost to the Latin American debtors was the “Lost Decade,” their first extended economic depression of the post-war.

To rationalize the asymmetrical burden-sharing, the IMF and World Bank embarked on an extensive campaign to spread the neo-liberal message. Their reports

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<sup>6</sup> During the Bretton Woods era currency and debt crises were more easily localized. Since most of the international lending was intergovernmental, the Paris Club, a consortium of creditor countries, would take charge of negotiating relief packages with the debtor governments. The IMF, to the extent it became involved, typically conditioned its credits on commitments by the debtor governments to reduce domestic and external macroeconomic imbalances by policies that reduced reliance on quantity controls.

<sup>7</sup> Near the end of the decade the creditor banks felt strong enough to refuse to participate in new bailout packages. The U.S. Treasury then intervened with the Brady Plan, which imposed a mild “haircut” on the banks and collateralized their remaining loans outstanding with U.S. bonds.

blamed the debt crisis on various policy errors and omissions of the debtor governments that had misled the creditor banks to overlend; hailed the potential benefits to developing countries of opening up to foreign capital inflows; and urged the adoption of market-liberalizing reforms to “get prices right,” and “sound” macroeconomic policies to regain the confidence of foreign lenders and investors. Protecting the private foreign creditors, blaming crises on government failure, and conditioning its credits on “sound” macroeconomic policies and more market liberalizing reforms became the IMF’s standard approach to future currency and financial crises of developing countries. Thus as the frequency of such crises rose, the IMF reacted to rescue failures by expanding its market-liberalizing and privatization demands in order to hasten the removal of the policies and structural inadequacies that it decided were still blocking the way to the Holy Grail, the transformation of developing countries into smooth functioning, fast growing and globally integrated free market economies. Prior to 1975, the average number of conditions to which the IMF had tied its credits was less than four; during 1985-95 it rose to twelve [Gould 2003; Figure 1].

The IMF view of its role in sustaining financial globalization also soared. During the *tequila* crisis, Michel Camdessus, then Managing Director of the IMF, pronounced that “In today’s globalized markets, we must ensure that our ability to react approaches the instant decision making of investors if we want to have the ability to give confidence to markets and our members.”[IMF Survey, June 19, 1995].<sup>8</sup> Concurrently, the IMF and the U.S. proposed amending the Articles of Agreement by replacing embarrassing Article

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<sup>8</sup> Camdessus indicated what this entailed in a February 1995 interview on the McNeil-Lehrer News Hour. The chief objective of the \$50 billion credit package given Mexico was not to prevent default, he asserted, but to keep Mexico from using capital controls to halt the run on its dollar reserves by foreign and domestic holders cashing in their peso-denominated, exchange rate-indexed *tesebonos* for dollars. Contractually, Mexico was merely obligated to remunerate holders of these treasury notes in exchange-rate adjusted quantities of pesos. It could therefore have curbed much of the dollar drain by closing the Banco de Mexico’s dollar window to the peso recipients. But, as Camdessus pointed out, were Mexico successful in solving its currency crisis this way, it would set a bad example to other developing countries in similar financial distress, which might reverse the progress toward globalizing free capital mobility.

VI, which validated the use of capital controls by member states and authorized the IMF to suspend credits to members when used to finance capital flight, with a new article that made eliminating capital controls a condition of membership in good standing. The proposal was to be submitted to the September 1997 meeting of IMF members. But with the Asian crisis then in full contagion, the proposal was quietly shelved.

But while the push to spread neo-liberalism as a development strategy has been fundamentally political, its current crisis is rooted in economic failures. Chief among these is the accumulating evidence that the capstone of the neo-liberal strategy, liberalizing and globalizing capital markets, has not accelerated economic growth in the developing countries by more efficiently guiding their capital accumulation and technological progress. On the contrary, it has been associated with slower and more unstable growth. Moreover, the failure is likely to persist, because the neo-liberal case for capital market liberalization has also an extremely weak basis in economic theory, and growing awareness of this is undermining confidence in its policies at the IMF and other promoters of capital market liberalization. How soon such policies themselves come to be modified to allow developing countries more macro-policy autonomy will be determined more by power and ideology than by economic analysis. But the failure of the capstone of the neo-liberal strategy to deliver economically, should lead through domestic political reactions to a weakening of the heavy hand of the international capital markets over the macroeconomic policies of developing countries, which should make other dimensions of *dirigiste* development feasible again. Sections II, III and IV expand on the evidence and the theoretical critique, while concluding section V discusses policy implications for developing countries.

## II. The Pace of Development: Bretton Woods vs. the Neo-Liberal Decades.

Tables 1 and 2 document that, contrary to neo-liberal expectations, capital market decontrol and the resulting increase of market-driven international financial flows has been associated with a slow-down rather than a faster increase of national output. Table 1, which groups countries by region, shows that the falloff of GDP growth after the Bretton Woods quarter century affected all but one of the groups. Among the industrialized groups, the decline ranged from -26% for the “Western Offshoots” (Maddison’s term for the U.S. and the British Dominions) to -69% for Japan. Among developing countries, growth rates declined for all but the Asian group, with Africa falling-38% and Latin America -43% below their Bretton Woods era rates during 1973-98. The “World” decline of -39% includes the Soviet cum ex-Soviet countries. They dropped, according to Maddison’s data, from an annual growth rate of 4.84% during 1950-73, to -0.56% during 1973-98. The negativity was because of the collapse of output during their great leaps forward to capitalism in the 1990s; earlier their declining growth was still positive.

<u>Regional Groups</u>	<b>1950-73</b> <b>(a)</b>	<b>1973-98</b> <b>(b)</b>	<b>%Change:</b> <b>(b)/(a)</b>
<b>Western Europe</b>	4.81	2.11	-56.8
<b>Western Offshoots<sup>a</sup></b>	4.03	2.98	-26.1
<b>Japan</b>	9.29	2.97	-69
<b>Asia (excluding Japan)</b>	5.18	5.46	5.4
<b>Latin America</b>	5.33	3.02	-43.3
<b>Africa</b>	4.45	2.74	-38.4
<b>World<sup>b</sup></b>	4.91	3.01	-38.7

<sup>a</sup> The U.S. and British Dominions.

<sup>b</sup> Includes the Soviet and ex-Soviet Countries.

Table 2 tests whether the Table 1 comparisons hide countering trends and individual exceptions. The data covers all non-Communist countries whose 1983 GDP exceeded US\$10 billion in 1983 prices, and sorts out major oil exporters from the industrial and developing countries' sub-sets. The Table divides the post-Bretton Woods era into three decades and compares the GDP growth rate per decade of each country with its growth rate in 1960-71. The latter period marked the institutional peak of the Bretton Woods exchange rate system. The West European countries had terminated the European Payments Union, and beginning in 1959 their currencies were fully convertible for all current account transactions.<sup>9</sup> Table 2 shows that the first post-Bretton Woods decade had the largest number of exceptions; 13 of the 53 countries had annual GDP growth rates that equaled or exceeded 1960-71. But subtracting the oil exporters removes 6 fast-growing developing countries, leaving only 7 of the remaining 44 developed and developing countries with 1972-81 growth rates that matched or exceeded their 1960-71 rates. The numbers shrink with each successive decade. In 1992-2001 only 5 of the 53 countries matched or exceeded 1960-71: three developing countries--none oil exporters—and two industrial countries. As regards growth, the Bretton Woods era ended on a high note; while the neoliberal era has been heading toward low B flat.

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<sup>9</sup> We chose 1960 to begin our Bretton Woods yardstick in order to enlarge the developing country sub-set, for many of whom methodologically standardized GDP time series are available only from 1960 on.

**Table 2**  
**Comparative GDP Growth per Decade: 1960 - 2001**

	Percent with Decadal Growth below their 1960 - 1971 Average			
	Total Sample (n=53)	Excluding Oil Exporters*	Industrialized Countries**	Developing Countries***
1972 - 1981	75.5	84.1	90.9	64.5
1982 - 1991	88.7	88.6	100.0	80.6
1992 - 2001'	90.6	88.6	95.5	87.1

Sources: World Bank, World Development Indicators, various issues

IMF, International Financial Statistics, various issues

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\* Oil Exporters: Algeria, Ecuador, Egypt, Indonesia, Mexico, Nigeria, Norway, United Kingdom, Venezuela

\*\* Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Israel, Italy, Japan,

Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, United States

\*\*\* Algeria, Argentina, Bangladesh, Brazil, Chile, China, Colombia, Congo, Ecuador, Egypt, Arab Rep., Hong Kong, China, Hungary, India, Indonesia, Iran, Korea, Kuwait, Malaysia, Mexico, Morocco, Nigeria, Pakistan, Peru, Philippines, Saudi Arabia, Singapore, South Africa, Syrian, Thailand, Turkey, Venezuela

Table 3 shows, unsurprisingly, that the annual growth of gross fixed investment also declined sharply after 1971. More surprising, Table 3 shows that despite the intensified emphasis on trade liberalization in the neo-liberal era, the annual growth of merchandise exports has also declined. Maddison, using the regional groupings of Table 1 above, finds that the export growth rate in 1973-98 was substantially lower than in 1950-73, both world wide, and in all his regions except Latin America [Maddison 2001, Table 3-2a]. The rising ratio of exports to GDP in Table 3 merely reflects that the GDP growth of the industrialized countries declined more than their export growth. Maddison's data show that this was also the case world-wide and in all the developing regions except Africa, where export growth fell more than GDP growth in 1973-98 [Maddison 2001, Tables 3-1a and 3-2b].

Table 4 shows that for the industrialized countries, the post-Bretton Woods growth of labor productivity of their business sectors has also fallen off sharply.

Comparable data are too sparse to extend the comparison to a representative sample of developing countries. But Tables 5 to 9 below report financial trends from the post-Bretton Woods era that imply that the causality runs from the financial globalization of the past two decades to the adverse real economy trends indicated by Tables 1 to 4.

<b>Table 3</b>			
<b>Growth of Real Investment and Exports, 1959 - 2002</b>			
	G7	OECD	World"
	(Percent)		
Annual Growth of Gross Fixed Investment			
1959 - 1971	6.1	6.0	
1972 - 1984	2.5	2.3	
1985 - 1997	3.6	3.9	
1998 - 2002'	2.6	2.5	
Annual Export Growth'''			
1959 - 1971	7.8	8.5	8.2
1972 - 1984	6.2	6.3	4.6
1985 - 1997	6.6	6.7	6.8
1998 - 2002'	2.8	3.8	5.1
Ratio of Export Growth to GDP Growth			
1959 - 1971	1.7	1.8	
1972 - 1984	2.1	2.3	
1985 - 1997	2.5	2.5	
1998 - 2002'	0.5	1.4	

Sources: OECD Economic Outlook, various issues

IMF, International Financial Statistics, various issues

' 2002 is an estimation

" World exports are deflated by IMF's unit export prices.

''' Data for G7 and OECD are GDP weighted averages.

**Table 4**  
**Labor Productivity Growth of the Business Sector of the OECD**  
**Countries: 1960 - 2002**

	G7	Other OECD	All OECD
	(Percent)		
Annual Averages			
1960 - 1973	4.5	5.0	4.6
1973 - 1979	1.6	3.1	1.8
1979 - 1997	1.4	2.6	1.6
1998 - 2002 <sup>1</sup>	1.5	3.2	1.6

Sources: OECD Economic Outlook, various years

<sup>1</sup> 2002 is a preliminary estimation

GDP weighted averages

### III. Causal links from Financial Liberalization to Slower Growth

#### A. Increased Volatility and Misalignments of Real Exchange Rates

Table 5 data contradict a basic tenet of neo-liberalism: that a regime of floating exchange rates and free capital mobility would enable nominal exchange rate movements to stabilize real exchange rates. Movements of the nominal rates should eliminate temporary disequilibria in the pricing of goods in different currencies, with arbitraging currency speculators speeding up the adjustment, and thus helping to keep international traders and investors supplied with the correct set of real prices on which to base their decisions. Large longer-term fluctuations of real exchange rates, on the other hand, reflect misaligned real exchange rates, that are generally caused by policies that hinder nominal exchange movements and capital mobility. In the past two decades nominal exchange rate volatility indeed increased over the already volatile 1970s, and capital decontrol spread around the globe, allowing daily global foreign exchange transactions to shoot up from around \$18 billion in 1977 to \$1.5 trillion in 1998. But as Table 5 shows, annual movements of the real exchange rates, already substantial in the 1970s, rose moderately higher in most of the industrialized countries after 1980, and more substantially in most of the developing countries.

Underlying this global financial churning are problematic global trends, most beginning in the mid-1970s to early 1980s. These are a sustained rise of real long-term interest rates, a rising share of economic resources drawn into financial activities, an income distribution trend in the industrialized countries favoring rentier income at the expense of wage income, slower GDP growth, and a sustained upsurge in the rate of debt accumulation--mostly household and business debt.

**Table 5**  
**Inter-Decade Comparison of the Annual Volatility of Real Exchange Rates: 1970 - 1980 = 100**  
 (Trade Weighted Indices)

	1970 - 80			1981 - 91			1992 -2002		
	Mean	Range*	Coef Var**	Mean	Range*	Coef Var**	Mean	Range*	Coef Var**
Industrialized Countries	100	0.2148	0.0703	104.51	0.2113	0.0720	107.45	0.1892	0.0639
U.S.	100	0.2320	0.0773	108.39	0.3045	0.1070	106.91	0.2195	0.0841
Japan	100	0.2220	0.0690	105.76	0.3107	0.0999	113.56	0.2729	0.0939
Euro Countries	100	0.2093	0.0738	94.59	0.2540	0.0929	96.37	0.2259	0.0735
Other OECD	100	0.2124	0.0691	105.11	0.1819	0.0615	108.13	0.1704	0.0565
Developing Countries	100	0.4327	0.1470	98.18	0.5510	0.1988	87.60	0.3201	0.1020
Asian 10	100	0.3413	0.1173	91.22	0.3952	0.1493	76.04	0.2450	0.0826
Lat. Am. 8	100	0.3141	0.0991	93.82	0.6964	0.2411	96.66	0.3726	0.1175
Mideast/African 6	100	0.7433	0.2604	115.58	0.6168	0.2248	94.79	0.3754	0.1136

Source: Morgan Guaranty Trust Company, World Financial Markets, various issues

\* Difference between the highest and lowest values in the period, divided by the mean.

\*\* Standard deviation divided by the mean.

Euro uses a synthetic Euro spot exchange rate, for pre-Euro years

Other OECD= Australia, Canada, Denmark, New Zealand, Norway, Sweden, Switzerland, U.K.

Asian 10 = Hong Kong, India, Indonesia, Korea, Malaysia, Pakistan, Philippines, Singapore, Taiwan, Thailand

Latin America 8 = Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Venezuela

Mideast/African 6 = Kuwait, Morocco, Nigeria, Saudi Arabia, South Africa, Turkey

Ind. Countries = US, Canada, Japan, Austria, New Zealand, Euro, Denmark, Norway, Sweden, Switzerland, UK.

Developing Countries = Latin America 8, Asian 10, and Mideast/African 6

## B. Higher Real Long Term Interest Rates

Table 6 contrasts the interest rate/growth rate relationship for the G-7, pre- and post- the early 1980s, using the credit risk-free 10 year government bond rate of each G-7 to index its real long-term interest rates. Note that during the peak Bretton Woods period, 1959-71, the real 10-year interest rate of each G-7 was comfortably positive, averaging 2.6% for the group [Felix 1998, Table 7]. Yet it fell short of the GDP growth rate of each country by a substantial margin. The margin shrank in 1972-84, but remained negative in all except Germany during the inflationary OPEC-boom years, since despite the decline of GDP growth in each of the seven, their real interest rates also fell, averaging negative in three of the countries [Felix 1998; Tables 2 and 7]. The abrupt shift to positive margins during 1985-2002, on the other hand, is due primarily to sharply higher real interest rates, with further GDP growth retardation a minor contributor except in Japan.

**Table 6**  
**Real Interest Rate on 10 Year Governments Minus the Real GDP Growth Rate\***

	Canada	France	Germany	Italy	Japan**	United Kingdom	United States	G-7***
1881 - 1913								0.97
1919 - 1939								2.40
1946 - 1958								0.36
1959 - 1971	-1.98	-4.29	-2.01	-3.40	-8.56	-0.38	-1.96	-3.23
1972 - 1984	-1.65	-1.87	1.54	-4.92	-2.76	-1.58	-0.44	-1.67
1985 - 1997	3.74	3.56	0.89	2.99	0.21	1.88	1.82	2.15
1998 - 2002	2.61	3.03	1.26	3.30	1.51	1.61	1.22	2.08

Source: IMF, *International Financial Statistics*, various issues

Pre-1959 data from Bordo (1993, Table 1)

\* Nominal rates deflated by the GDP deflator after 1958 and by CPI pre-1959.

\*\* Data begin in 1965

\*\*\* Unweighted average.

Why the upsurge of real long-term interest rates? A common explanation is that lenders, reacting belatedly to the higher inflation of the OPEC period, have been incorporating a higher inflation premium in their offer prices. The trouble with this

explanation is that G-7 inflation peaked in the early 1980s and has been declining since, into deflationary territory in the case of Japan, yet real long-term rates have maintained their positive margins over GDP growth rates.

The alternative explanation uses the fact that the upsurge of real long-term rates coincides with the approximate date when capital decontrol had encompassed enough major industrial countries to allow the formation and rapid expansion of an international market in long and short-term debt instruments. This severely weakened the power of central banks to influence long-term rates; they could still anchor the short end of the yield curve, but the slope depended much more than before on market reactions to the central bank's move. Before, when the central bank lowered the short end, bond holders could only express their inflation phobia by moving down the yield curve to shorter maturities. But this was self-limiting, since it would soon depress those yields to unappealingly low levels. Decontrol opened up another escape channel--to foreign debt instruments with higher interest rates and favorable exchange rate prospects. Over the next two decades international transactions in debt instruments rose explosively.

What provided the surging demand for loanable funds needed to keep up real yields internationally by matching the explosive outflows? Not the growth of real aggregate demand or real investment; both slowed globally (See Tables 1-3). And not rising deficit financing; during 1983-2000 aggregate fiscal deficits of the OECD countries declined as a percent of GDP [Economist August 23, 2003; p.56]. Rather, the slower growing financing needs of real investment and fiscal deficits were offset by more rapidly growing demand for consumption financing (housing, consumer durables, etc.), funding of mergers and acquisitions, venture capital acquisitions, initial public offerings, and other financial underpinnings of the global equity price bubble and expanding flows during the 1990s to "emerging market" countries, both peaking at the end of the 1990s,.

Thus, by weakening the ability of central banks to influence the slope of the yield curve, capital decontrol has imposed two types of costs on the real economies of the financially liberalized economies. During the prolonged equity price and lending bubbles, high real long-term interest rates helped depress the growth of real investment.<sup>10</sup> And the aftermath of the recent collapse has been a massive debt overhang which is further depressing private investment and demand for labor, as over-indebted firms and households struggle to make payments and rebuild their balance sheets, with lenders reacting to their accumulating *carteras vencidas* by becoming more risk averse.<sup>11</sup> But the stimulating effect of lowering the short end of the yield curve is still being thwarted by bond market reactions that tilt the slope. In Table 6, real long-term interest rates of all the G-7 have continued to exceed their real GDP growth rates, despite the collapse of the bubbles, outright deflation in Japan and further diminution of inflation in the other six countries. Indeed, Table 6 suggests the current situation resembles not the pre-WWI Gold Standard era with its secularly rising prices, but the depressed interwar era with its secularly declining prices. Deflation helped make the large debt overhangs of the 1930s unserviceable, a “lesson from history” that must haunt Chairman Greenspan of the U.S. Fed, as he runs out of room to lower further his weak policy instrument, the short-run rate.

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<sup>10</sup> The high real interest rates may have also contributed to the misallocation of investment by raising the “hurdle rate” less for investing in higher risk-higher expected returns projects than for lower return-lower risk projects. This may help account for the high concentration currently of structural excess capacity in “New Economy” facilities and consumer durables plants.

<sup>11</sup> The IMF’s recent Global Financial Stability Report is concerned that lenders of the major financial centers have become too risk averse. Viz: “...as this report went to press, the main sources of risk to global financial stability seemed to be associated with a further significant and excessive cutback in risk taking in financial markets and in lending to less creditworthy borrowers, including in emerging markets, which could have potential implications for the global economy.”[IMF December, 2002; p.7]

### **C. Rising Resource Absorption in Financial Activities and Rising Rentier Shares of National Income**

From the 1950s through the 1990s the gross value added of Finance, Insurance and Real Estate activities (FIRE) rose nearly monotonically as a share of GDP, in each of the G-7 countries [Felix 1998; Figures 1-7]. The share of finance proper in the labor force of the OECD countries averaged 21% higher, and its share of total OECD investment 104% higher in 1980-93 than in 1970-79 [Edey and Hviding 1995; Table 2]. After 1975, finance was also the fastest-growing component of international trade in services, rising at 13% per annum, while investment in financial facilities was the largest component of FDI in services during the 1980s [OECD 1994].

However, the relationship between FIRE and the non-financial components of GDP appears to be non-linear. After the mid-1970s the rising trend of their FIRE shares associate with declining real growth rates of non-financial activities in each of the G-7.<sup>12</sup> The welfare implication of the non-linearity is striking. The welfare contributions of non-financial activities are direct; they produce the goods and services which supply consumption and productive capacity. The welfare contributions of FIRE activities are indirect; they facilitate and govern the allocation and distribution of non-financial goods and services currently and over time. The adverse relationship between the growth of Fire and non-Fire activities after 1975 implies that the progressive liberation of FIRE activities after the mid-1970s enabled them to draw resources from non-financial activities to the detriment of economic welfare.

As for income shares, these took a great leap upward during the two “Bubble Economy” decades. A recent study that extensively mined OECD national income and

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<sup>12</sup> I have not had time to extend these charts for this paper, but the sketchy financial and employment data suggest that FIRE share probably peaked around 2000, and has been declining since, perhaps faster than the declining growth of non-financial activities.

financial data, extracted the following findings for 13 industrialized OECD countries [Epstein and Powers 2003: Table 1]. In 10 of the 13 countries, the average rentier share of national income in 1980-2000 was higher than for 1960-1980.<sup>13</sup> The mean increase for the ten countries was 77.9% and the median increase 80.5%. The study provides data on the capital shares of the non-financial private sector of 11 of the 13 countries for the same two periods. Their average share merely rose 9.5%, and the median share 17.2%, with decreased shares in 4 of the 11 countries. Combined, however, the national capital shares of 9 of the 11 countries averaged higher in 1980-2000 than in 1960-1980, which means decreased labor shares of national income, a result consistent, the study points out, with the findings of other labor income studies.

#### **D. External Capital Flows and Net Resource Flows to Developing Countries, 1970-2002**

Table 7 presents annual debt flow data, i.e., interest-bearing loans, to the developing and the Soviet cum ex-Soviet countries from 1970 to 2002, while Table 8 adds non-debt inflows—foreign direct investment (FDI) and portfolio equity flows—and puts the combined data in a balance of payments format. The debt data combine official with private flows, with all data deflated to 2002 U.S. dollars to get a better handle on net resource flows. To save space, the annual flows are presented only in 10 year intervals, plus the latest available post-Bubble Economy year, 2002.

The combined data for all the Table 7 regions show two gross debt inflow cycles, one peaking around 1980, the second around 2000 (actually, 1998) circling a flat trend. Deduct repayments of principal, however, and the net inflows decline sharply after 1980 to around zero by 2000. Subtract rising interest payments on debt and the net resource transfers become increasingly negative from 1990 on. The last is only partly offset by

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<sup>13</sup> Rentier income is defined in the study as the net profits of firms engaged primarily in financial market activities plus net interest income received by the rest of the private economy. Capital gains were excluded from the calculations of Table 1 because of inadequate data.

equity inflows—FDI and portfolio equity inflows—which cycled upward after 1980 and peaked around 2000 before declining. As Table 8 shows, net flows on capital account have remained positive to date, but rising current account outflows—profit remittances and interest payments—have overtaken net capital account inflows, so that net overall resource transfers also became negative by the end of the 1990s.

The regional data present a more diverse picture. Latin America, East Asia and the ex-Soviet bloc—have largely determined the overall trends, receiving around 81% of the Gross Debt inflows and 91% of the net equity inflows, with Latin America *numero uno*, receiving 38% of all debt inflows and 36% of all equity inflows.<sup>14</sup> But the post-Bubble data show Latin America also to be the most vulnerable of the three major recipients. Since 2000, it has been the focus of almost all the decline of gross debt and FDI inflow to developing countries, and its outward resource transfer leads the three by a wide margin. The “Lost Decade” rides again? The debt indicators in Table 9 suggest this possibility. They show Latin America’s recent indicator values to be second only to those of the Sub-Saharan Africa region, whose need for debt relief is now axiomatic.

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<sup>14</sup> Most of the regional results were determined by flows to a handful of countries. A recent IMF study reports that flows to 22 developing countries accounted for almost all the private flows to developing countries: 7 are Latin American, 8 are East Asian, 2 are South Asian, 4 are Middle East and North Africa, and 1 is Sub-Saharan [Prasid et al. 2003; Appendix V].

**Table 7**  
**Annual External Debt Flows: 1970 - 2002 (selected years)**  
(2002 US\$ million<sup>1/</sup>)

	1970	1980	1990	2000	2002
<b>All Developing Countries.</b>					
1. Gross Debt Inflow*	49,384	269,513	186,466	267,014	247,844
2. Net Debt Inflow**	24,431	186,303	74,168	-1,059	7,193
3. Interest Payments		89,111	86,409	126,829	102,701
4. Net Transfers on Debt***		97,191	-12,241	-127,979	-95,508
<b>East Asia and Pacific</b>					
1. Gross Debt Inflow*	6,032	31,376	48,349	31,108	48,820
2. Net Debt Inflow**	3,678	23,093	24,255	-18,634	-8,282
3. Interest Payments		9,338	16,180	26,144	20,659
4. Net Transfers on Debt***		13,755	8,075	-44,778	-28,941
<b>Former Soviet Countries</b>					
1. Gross Debt Inflow*	4,120	40,164	28,226	77,319	71,183
2. Net Debt Inflow**	1,893	26,224	2,976	22,817	11,165
3. Interest Payments		10,456	15,536	24,232	23,877
4. Net Transfers on Debt***		15,769	-12,560	-1,415	-12,711
<b>Latin America and the Caribbean</b>					
1. Gross Debt Inflow*	25,041	131,482	55,317	128,140	96,159
2. Net Debt Inflow**	10,757	89,378	26,149	-1,134	3,509
3. Interest Payments		47,733	29,138	56,703	41,797
4. Net Transfers on Debt***		41,644	-2,988	-57,837	-38,288
<b>Middle East and North Africa</b>					
1. Gross Debt Inflow*	3,393	26,646	20,899	8,371	12,130
2. Net Debt Inflow**	1,820	16,901	999	-6,767	-302
3. Interest Payments		12,417	10,879	8,944	7,738
4. Net Transfers on Debt***		4,484	-9,880	-15,711	-8,040
<b>South Asia</b>					
1. Gross Debt Inflow*	6,009	14,168	17,510	13,676	9,727
2. Net Debt Inflow**	3,016	11,187	10,765	3,540	860
3. Interest Payments		2,354	7,882	6,155	4,863
4. Net Transfers on Debt***		8,832	2,883	-2,614	-4,003
<b>Sub-Saharan Africa</b>					
1. Gross Debt Inflow*	4,794	25,675	16,165	8,400	9,826
2. Net Debt Inflow**	3,271	19,520	9,022	-881	243
3. Interest Payments	0	6,812	6,794	4,651	3,768
4. Net Transfers on Debt***	0	12,709	2,228	-5,623	-3,524

Source: World Bank, *Global Development Finance* - CD-Rom 2003

US GDP deflator from IMF, *International Financial Statistics*, various issues

<sup>1/</sup> Deflated by US GDP Deflator,

\* Long term plus short term private and official debt inflow

\*\* Line 1 less repayment of principal

\*\*\* Line 2 - line 3

The current debt indicator values of Table 9, in conjunction with the findings of a recent IMF study of the debt overhang problem, also shed additional light on the impact of financial globalization on the welfare of the developing countries and on current global financial fragility. The IMF study [Patillo et al. 2002] working with 1969-98 external debt and GDP data from 93 developing countries obtained non-linear average relationships between external debt and GDP growth—Laffer-shaped curves—that are quite similar to each other under different econometric techniques and conditioning variables. The curves peak at debt/GDP and debt/export ratios well below any of the current regional values in Table 9, implying that all the regions are now on the descending half of the external debt/GDP growth curve. More ominous is the finding that the curves move into negative territory--meaning the debt level is depressing-the growth rate--when the debt/GDP ratio exceeds 35 to 40%, and the debt/export ratio exceeds 160 to 170%. Table 9 shows that the ex-Soviet countries, Latin America, and Sub-Saharan Africa—now exceed that critical debt/GDP ratio, with the last two regions also exceeding the critical debt/export ratio.

The IMF study imposes a full capacity growth condition on the econometrics, smoothing its annual data by 3-year and 10-year averaging. Its working hypothesis is that over-indebtedness lowers economic growth by depressing the level of investment and its quality, but not the level of capacity utilization. It thus avoids confronting the adverse Keynesian effects on GDP growth brought on by the volatility of capital inflows, and by the pro-cyclical fiscal-monetary policies forced on developing countries with large foreign-debt overhang debts by the “disciplining” of the capital markets and IMF bailouts.

**Table 8**  
**Balance of Payment Impact of Capital Flows of Developing Regions, 1970 - 2002**  
**(selected years)**

	(2002 US\$ million <sup>1/</sup> )				
	1970	1980	1990	2000	2002
<b>All Developing Countries.</b>					
Capital Account Inflows	32,836	196,500	110,811	192,159	159,553
Net Foreign Direct Investment	8,411	10,200	30,828	166,298	143,000
Net Portfolio Equity Flows	-8	-2	5,815	26,921	9,360
Total Non-Debt flows	8,403	10,198	36,643	193,219	152,360
Net Debt Flows	24,433	186,302	74,168	-1,059	7,193
Current Account Outflows	-11,264	-126,664	-109,193	-204,150	-168,701
Net FDI profit remittance	-2,537	-37,553	-22,784	-77,320	-66,000
Interest Payments on Debt	-8,727	-89,111	-86,409	-126,829	-102,701
Net Resource Transfers	21,572	69,836	1,618	-11,990	-9,148
<b>East Asia and Pacific</b>					
Capital Account Inflows	4,443	25,630	39,559	46,892	54,128
Net Foreign Direct Investment	767	2,546	13,226	45,595	57,000
Net Portfolio Equity Flows	-1	-8	2,078	19,931	5,410
Total Non-Debt flows	765	2,538	15,304	65,526	62,410
Net Debt Flows	3,678	23,092	24,255	-18,635	-8,282
Current Account Outflows	-616	-12,586	-22,780	-58,653	-49,659
Net FDI profit remittance	0	-3,249	-6,599	-32,509	-29,000
Interest Payments on Debt	-616	-9,338	-16,180	-26,144	-20,659
Net Resource Transfers	3,826	13,043	16,779	-11,761	4,469
<b>Former Soviet Countries</b>					
Capital Account Inflows	2,115	26,281	4,884	54,287	41,565
Net Foreign Direct Investment	221	56	1,569	30,223	29,000
Net Portfolio Equity Flows	0	0	338	1,248	1,400
Total Non-Debt flows	221	56	1,907	31,470	30,400
Net Debt Flows	1,894	26,225	2,977	22,816	11,165
Current Account Outflows	-565	-10,516	-15,815	-30,833	-29,877
Net FDI profit remittance	0	-60	-279	-6,601	-6,000
Interest Payments on Debt	-565	-10,456	-15,536	-24,232	-23,877
Net Resource Transfers	1,550	15,765	-10,932	23,454	11,689

**Table 8 – (cont)**

	1970	1980	1990	2000	2002
<b>Latin America and the Caribbean</b>					
Capital Account Inflows	15,258	101,789	39,863	76,912	46,509
Net Foreign Direct Investment	4,501	12,412	10,458	78,437	42,000
Net Portfolio Equity Flows	0	0	3,255	-392	1,000
Total Non-Debt flows	4,501	12,412	13,714	78,045	43,000
Net Debt Flows	10,757	89,377	26,150	-1,133	3,509
Current Account Outflows	-7,852	-57,997	-38,796	79,709	-60,797
Net FDI profit remittance	-2,537	-10,264	-9,658	23,005	-19,000
Interest Payments on Debt	-5,315	-47,733	-29,138	56,703	-41,797
Net Resource Transfers	7,406	43,792	1,067	-2,797	-14,288
<b>Middle East and North Africa</b>					
Capital Account Inflows	2,795	11,475	4,599	-3,962	2,728
Net Foreign Direct Investment	979	-5,427	3,594	2,555	3,000
Net Portfolio Equity Flows	-2	0	6	250	30
Total Non-Debt flows	977	-5,427	3,600	2,805	3,030
Net Debt Flows	1,819	16,901	999	-6,767	-302
Current Account Outflows	-387	-30,840	-14,376	-15,602	-12,718
Net FDI profit remittance	0	-18,422	-3,497	-6,658	-5,000
Interest Payments on Debt	-387	-12,417	-10,879	-8,944	-7,738
Net Resource Transfers	2,408	-19,365	-9,777	-19,564	-10,010
<b>South Asia</b>					
Capital Account Inflows	3,277	11,563	11,592	8,452	6,660
Net Foreign Direct Investment	260	377	693	3,198	5,000
Net Portfolio Equity Flows	1	0	135	1,713	800
Total Non-Debt flows	261	377	828	4,911	5,800
Net Debt Flows	3,016	11,186	10,765	3,541	860
Current Account Outflows	-1,108	-2,420	8,031	-7,400	-5,863
Net FDI profit remittance	0	-66	-149	-1,246	-1,000
Interest Payments on Debt	-1,108	-2,354	-7,882	6,155	-4,863
Net Resource Transfers	2,169	9,143	3,561	1,051	797
<b>Sub-Saharan Africa</b>					
Capital Account Inflows	4,949	19,762	10,314	9,580	7,963
Net Foreign Direct Investment	1,684	235	1,289	6,290	7,000
Net Portfolio Equity Flows	-5	6	3	4,171	720
Total Non-Debt flows	1,678	241	1,291	10,461	7,720
Net Debt Flows	3,271	19,521	9,022	-881	243
Current Account Outflows	-737	-12,304	-9,395	-11,953	-9,768
Net FDI profit remittance	0	-5,492	-2,601	-7,302	-6,000
Interest Payments on Debt	-737	-6,812	-6,794	-4,651	-3,768
Net Resource Transfers	4,213	7,458	918	-2,373	-1,804

Source: World Bank, *Global Development Finance* - CD-Rom 2003

US GDP deflator from IMF, *International Financial Statistics*, various issues

<sup>v</sup> Deflated by US GDP Deflator,

Table 9 shows that four of the regions—East Asia, the ex-Soviet countries, the Middle East and North Africa, and South Asia—have been trying to avoid that plight by building up their foreign exchange reserves at a fast pace. This has meant accumulating U.S. treasury bills, which currently yield a meager 1% interest, as expensive and uncertain insurance against currency attacks and U.S. protectionist threats. It is uncertain because the widening U.S. current account deficits now require foreigners to purchase a half-trillion dollars per annum of dollar assets, else the U.S. would have to close the gap through dollar depreciation, tightened U.S. monetary-fiscal policies and slower growth. The reserve buildups of developing countries and Japan are now major bulwarks against these depressing alternatives. The Chinese and Japanese buildups, which this year are financing half the U.S. current account deficit, are also defenses against increasing U.S. pressure on those countries to appreciate their exchange rates or face US. protectionism. A number of dire global financial scenarios can be constructed from the conflicting behavior.<sup>15</sup>

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<sup>15</sup> An interesting one is that were China to succumb to U.S. demands to lift capital controls and let its exchange rate be market-determined, it would cause a flight to the dollar by depositors in China's shaky banks that would depreciate the *yuan*, while destabilizing China's financial system and relative exchange rates globally [*Economist*, September 6-12.2003; pp.13-14].

**Table 9**  
**External Debt Indicators of Developing Regions** (Percent)

	1970	1980	1990	2000	2002
<b>All Developing Countries.</b>					
Total Debt over GNP	11.6	20.6	35.2	39.7	39.1
Total Debt over Exports		84.6	170.8	119.4	112.8
Debt Service over Exports		13.0	18.7	19.3	16.2
Interest paid over Exports		6.7	8.1	6.2	4.9
Short Term over Total Debt		23.3	16.3	14.2	14.5
Reserves over Total Debt	18.1	23.8	11.7	30.1	40.0
<b>East Asia and Pacific</b>					
Total Debt over GNP	30.2	16.2	35.5	31.8	28.7
Total Debt over Exports		190.0	135.2	77.2	71.2
Debt Service over Exports		26.7	17.8	11.4	10.9
Interest paid over Exports		14.2	7.2	3.9	2.9
Short Term over Total Debt		22.6	16.1	12.9	18.4
Reserves over Total Debt	21.6	23.3	26.0	55.6	77.2
<b>Former Soviet Countries</b>					
Total Debt over GNP	27.8	80.6	17.6	54.2	48.6
Total Debt over Exports		422.3	306.3	121.9	110.1
Debt Service over Exports		70.2	44.8	18.4	18.0
Interest paid over Exports		30.1	17.1	5.7	5.1
Short Term over Total Debt		22.6	18.2	16.0	13.9
Reserves over Total Debt	6.0	1.9	5.6	24.0	34.6
<b>Latin America and the Caribbean</b>					
Total Debt over GNP	20.3	35.8	44.6	40.9	48.2
Total Debt over Exports		201.6	254.5	168.4	173.6
Debt Service over Exports		36.3	24.4	38.6	29.6
Interest paid over Exports		19.3	12.2	11.8	9.2
Short Term over Total Debt		26.7	16.3	13.5	12.7
Reserves over Total Debt	13.3	15.0	9.9	19.9	20.4
<b>Middle East and North Africa</b>					
Total Debt over GNP	12.4	22.0	45.7	30.5	30.5
Total Debt over Exports		40.9	118.9	88.1	86.9
Debt Service over Exports		5.6	15.6	10.1	8.7
Interest paid over Exports		3.1	5.5	3.8	3.3
Short Term over Total Debt		25.3	24.1	23.0	23.6
Reserves over Total Debt	69.1	68.6	15.8	39.5	52.3
<b>South Asia</b>					
Total Debt over GNP	15.1	16.2	32.4	27.9	25.4
Total Debt over Exports		164.3	324.7	154.1	138.6
Debt Service over Exports		12.0	28.7	14.7	11.4
Interest paid over Exports		5.3	15.5	5.5	4.0
Short Term over Total Debt		6.5	9.6	3.6	3.4
Reserves over Total Debt	8.5	22.6	2.7	26.2	48.5
<b>Sub-Saharan Africa</b>					
Total Debt over GNP	11.4	23.5	63.1	68.8	65.0
Total Debt over Exports		65.4	208.6	175.2	164.5
Debt Service over Exports		7.2	12.8	11.2	10.7
Interest paid over Exports		3.8	6.3	3.7	3.0
Short Term over Total Debt		18.3	11.6	15.7	13.5
Reserves over Total Debt	32.3	23.5	7.4	16.4	17.8

Source: World Bank, *Global Development Finance* - CD-Rom 2003

#### **IV. The Current Theoretical and Policy Confusion at the IMF**

The IMF's rationale for its conditionality demands of developing country supplicants has been that financial liberalization, privatization, and "sound" monetary-fiscal policies opens the road to faster development by attracting more private foreign capital to supplement shortfalls in domestic savings, skills and technology. Underpinning this rationale is the belief that financial markets are efficient processors of information and allocators of capital, hence pour in to fill such shortfalls. When the funds showed a disturbing propensity to also pour out, it was facile for a time to blame that on policy surprises, lack of transparency and other information flaws of the recipient country that had misled the financial markets, and to add conditionality demands to the programs to reshape the economy and make it more appealing to the financial markets.<sup>16</sup> Such conditions have imposed heavier adjustment costs on the debtor country, but the improved appeal to foreign investment was supposed to bring it greater offsetting benefits over the longer run.

Confidence at the IMF in this general policy approach and its theoretical underpinnings is now flagging. This shows up in critical reports by IMF economists, and in the rhetoric of top level IMF bureaucrats about the need for countries to "own" their adjustment programs, denials that the IMF takes a "one size fits all" approach to policy, and similar jargon.

Thus IMF economists Ashoka Mody and Antu Murshid in a 2002 IMF Working Paper ["Growing Up with Capital Flows," IMF Working Paper WP/02/75] tested the

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<sup>16</sup> The increases were labeled "structural adjustments" as distinct from mere quantitative targets. "Whereas in the mid-1980s structural conditionality in IMF programs was rare, by the mid-1990s most programs included some structural conditions...the average number of structural conditions per program year increased from two in 1987 to more than 16 in 1997 [Bulir and Moon 2003; p.5].

relationship between capital inflows and domestic investment on 1977-98 data from 60

developing countries and report the following:

“Our results suggest that the flush of capital inflows in the 1990s was more of a ‘push’ into developing countries than a ‘pull’ based on a significant unmet demand for investment financing. As a consequence, much of the new wave of inflows was diverted into alternative uses, a part of which (specifically the accumulation of reserves) was a direct consequence of the inflows. However, a striking aspect of the 1990s experience was the large volume of capital outflows from the same countries that received significant inflows. Thus the observed marginal relationship between capital inflows and domestic investment fell, even as countries liberalized to attract new flows. The results of this paper imply either that the shortage of capital was not the problem, as in many countries of East Asia, or that the ability to absorb that capital was limited, particularly when faced with a rush of volatile flows.”

The study does find a statistically significant positive effect of FDI on domestic investment, but one that weakened in the 1990s as the percentage of FDI directed at mergers and acquisitions rose from 6% in 1995 to 30% in 1998. The degree of financial liberalization, however, had no statistically significant effect on either long-term FDI or portfolio inflows.

Similarly, Ales Bulir and Soojin Moon, in “Do IMF-Supported Programs Help Make Fiscal Adjustments more Durable?” [IMF Working Paper WP/03/38, February 2003] answer the titled question negatively. Their procedure is to compare the fiscal balance effects of 33 IMF “program countries” where the programs included structural adjustment conditions with those of 31 program countries without such conditions. The programs of both groups of countries were operative during 1993-96. The fiscal balance behavior during the same period of a third group of 48 “non-program countries” is used, along with other conditioning variables, to isolate exogenous cyclical and trend effects on the program outcomes. The tests compare the average fiscal balances and the proportions due to revenue and expenditure changes three years after program termination for each group of countries. The main findings (pp. 27-28):

“Although the overall fiscal balance improved in most countries, the impact of IMF-supported programs was not statistically significant....The statistical insignificance

of IMF-supported programs indicates that program participation does not make the fiscal adjustment softer—on average program countries adjust as much as non-program countries. In general, all fiscal variables were strongly influenced by the business cycle.”

“In programs with structural conditionality, revenue declined slightly and expenditure declined significantly. In contrast, in programs without structural conditionality, revenue remained stable and expenditure increased somewhat.”

“We find some evidence that programs with too many structural conditions have worse results than those with fewer conditions (the ‘ownership’ nexus). Second we find no quantitative evidence that structural conditionality aimed at raising revenue was successful. Third, post-program expenditure compression clearly was much stronger in countries with structural conditionality, but risk of reversal was higher too.”

The canonical IMF reassessment of the effect of financial globalization on the developing countries is a recent monograph by four senior IMF economists, including the IMF’s outgoing chief economist [Prasad et al. IMF March 17, 2003. 86 pp]. Its review of the evidence?

1. “The main conclusions are that, so far, it has proven difficult to find robust evidence in support of the proposition that financial integration helps developing countries to improve growth and to reduce macroeconomic volatility.” (p.11)
2. “There is little evidence that financial integration has helped developing countries to better stabilize fluctuations in consumption growth, notwithstanding the theoretically large benefits that could accrue to developing countries in this respect. In fact new evidence presented in this paper suggests that low to moderate levels of financial integration may have made some countries subject to even greater volatility of consumption relative to that of output. Thus while there is no evidence that financial globalization has benefited growth, there is evidence that some countries have experienced greater consumption volatility as a result.” (p.6)

Its policy suggestions, however, are minor adjustments of the IMF’s basic policy line. Greater integration with the financial markets of the North should remain the basic orientation of developing country policy, though they will also need more “robust legal and supervisory frameworks, low levels of corruption, high degree of transparency and good corporate governance” to increase the benefits from, and control the risk of, globalization.” (p.6) How to accomplish this?

“The review of the available evidence does not...provide a clear road map for countries that have started or desire to start on the path to financial integration. For

instance, there is unresolved tension between having good institutions in place before capital market liberalization and the notion that such liberalization itself can help import best practices and provide an impetus to improve domestic institutions. Furthermore, neither theory nor empirical evidence has provided clear-cut general answers to related issues such as the desirability and efficacy of selective capital controls.” (pp. 6-7)

Therefore,

“...there may be value for developing countries to experiment with different paces and strategies for pursuing financial integration....It might not be essential for a country to develop a full set of sound institutions matching the best practices in the world before embarking on financial integration....An intermediate and more practical approach could be to focus on making progress [toward]...transparency, control of corruption, rule of law, and financial supervisory capacity.” (p. 58)

In sum, the policy reassessment is rather a damp squib. It advises the IMF to ease up on its structural adjustment demands, but ignores a more pressing conundrum afflicting IMF policy. The capital flows to developing countries, and the macro policies that the IMF demands of debtor countries in order to sustain debt servicing, are both strongly pro-cyclical. Do the higher interest rates and the fiscal austerity demanded by the IMF induce a faster return of foreign capital, or do they deter the revival of foreign capital inflows by deepening and prolonging the domestic depression? The heated conviction that the latter is the case has become the main motivator of the rapid rise of popular anti-IMF fervor in the developing countries. To extend a U.S. political cliché: it's the economy, stupid, not lack of policy ownership *per se*. But reverting the IMF from its current function of protecting financial globalization to its original task under its charter, the Articles of Agreement, of facilitating full employment growth of its members, requires power shifts or ideological changes among the IMF's political overseers, the owners of its policy-making. That's beyond the powers of the IMF bureaucracy to effect, or even to discuss openly.

#### **A. Theoretical Confusion at the IMF**

IMF theorizing about financial globalization and its current problems appears now to be riding two horses in opposite policy directions. IMF policy advice to developing countries still rests on the thesis that liberated financial markets can consistently price capital assets correctly in line with future supply and demand trends of the economy (i.e., “the fundamentals”) and that the asset pricing, therefore, provides a reliable welfare improving guide to private saving and investment decisions in decentralized market economies. Call it the Efficient Market Hypothesis writ-large, or EMH+. The current policy head-scratching concerns merely how fast to liberalize and to elevate the domestic institutional environment to the level of “transparency, control of corruption, rule of law, and financial supervisory capacity” characterizing “the best practices of the world,” where presumably the EMH+ already rules. But a different perspective is seeping into recent IMF Global Financial Development Reports, working papers that explore balance sheet deterioration as a crisis precursor [e.g, Keller et al, 2002] and house efforts (unsuccessful thus far) to devise workable early crisis warning models (briefly described in Mulder, 2002). This perspective resembles Keynes on financial markets, which helped shape the approval of capital controls in the Bretton Woods Articles of Agreement (notably, Article VI) and which forms the core of the research program of the Post-Keynesian school. It is that liberated financial markets are inherently prone to endogenously generate destabilizing dynamics that will lead to crises with adverse repercussions on aggregate output and employment, and need, therefore, to be held in check with countervailing policies.

Why the infiltration of theoretical heresy? Presumably because IMF economists are recognizing that the heresies are far better grounded in real world behavior of economic agents under uncertainty than the fanciful micro-foundations anchoring the

EMH+, and provide therefore more useful theoretical insights for analyzing the crises that are plaguing financial globalization. A brief comparison may explain why.

The EMH+ takes off from the assumption that capital markets are in almost all essentials like all other markets in the neoclassical paradigm. They are populated by equally well-informed maximizing agents who exchange at market-clearing prices that accurately reflect this information and the maximizing choices of each agent given her available resources. To be sure capital markets involve the exchange of claims today on the expected returns from assets that only start paying off tomorrow and the days after. But while it is too much of a stretch to assume that today's information about tomorrow is complete, it is OK to assume that the capital market agents know today the stochastic probability distributions of the future cash flows from capital assets and collectively price the present value of these assets accordingly.

Armed with the EMH+, anti-Keynesian economists embarked in the 1960s on an ambitious research program to refute Keynesian theorizing in all its varied forms. Rational Expectations (dubbed Ratex for short) showed that market agents equipped with accurate knowledge of future probabilities would render impotent counter-cyclical macro policies to smooth saving and investment volatility. The Real Business Cycle school embarked on demonstrating that the business cycle was not generated endogenously by market dynamics, but by exogenous shocks, primarily from new technologies, that temporarily destabilize the economy as they move productive forces in real time to higher equilibrium output paths. As it became evident in the 1970s that exchange rates had become quite volatile, and that cross currency trading in assets rather than in commodities had become the dominant determinant of exchange rate movements, the EMH+ was used to develop "news models" of exchange rate determination. These were intended to show that the volatility merely reflected the speed with which traders in the

liberated exchange markets are able to move the exchange rate to its new equilibrium value each time new information about fundamentals required it.

Methodologically, however, the research program has, in Lakatosian terms, been “degenerate.”<sup>17</sup> It tries to protect its core belief in the optimality of real world markets by illegitimately shrinking the explanatory scope of the “protective belt” of other auxiliary propositions developed with the same intent. In making technical change exogenous, the Real Business Cycle School simply discards as inconvenient rather than disproved the earlier post-war literature on factor market-guided technical change that inhabits the same protective belt surrounding the core paradigm. The “representative agent” simplification, which has been the hallmark of asset market modeling grounded in the EMH+, conveniently avoids the complications of asymmetric information, but can’t explain why market agents holding identically optimal portfolios at each moment, would have any motive for trading with each other—a serious defect of models intended to explain asset trading dynamics. The analytic modeling has thus produced professional in-jokes rather than insights, while the econometric versions have performed very poorly as out-of-sample predictors..

Completing the critique is the falsity of the claim that the EMH+ is a logical corollary of the mathematical proofs that competitive multi-market economies can produce vectors of simultaneously market clearing prices and quantities. Except for the Arrow-Debreu model, these proofs merely establish alternative sufficiency conditions for the existence of local equilibriums. That is, markets reach equilibrium and bounce back to it if subjected to limited disturbances, but beyond these limits equilibrium breaks down. This is a structuralist, not a laissez-faire, conclusion, expressed in higher math.

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<sup>17</sup> The reference is to Imre Lakatos’s modification of Thomas Kuhn’s paradigm-shift approach to scientific epistemology. [Lakatos and Musgrave 1970].

Moreover, the proofs have nothing to say about equilibrium in financial markets, since they do not assign a role to money as a store of value.

The Arrow-Debreu proof establishes necessary and sufficient conditions for the existence of general competitive equilibrium that does address inter-temporal exchange, but with conditions that are unattainable in a real world capitalist economy. The A-D proof requires a complete set of futures markets to exist, or to form as needed, that allow investors to insure their inter-temporal positions against all possible adverse contingencies. That eliminates uncertainty, but also transforms the capitalist entrepreneur, the bearer of uninsurable risk, into an accountant able to convert his risky positions into sure bets. And since an appropriate timing of payments and receipts eliminates the need to hold assets for their liquidity, wealth maximizing agents would not hold money, a zero earning asset.<sup>18</sup> Nor would fully insured entrepreneurs need to protect their wealth by overseeing production. Hence as self-interested consumers valuing leisure over work, they would head for the golf course instead of the office. In short, realization of the complete futures markets condition is blocked by an insoluble moral hazard barrier. The Arrow-Debreu model is thus a *reductio ad absurdum* disproof that a laissez-faire economy can move along a stable growth path, and that investor uncertainty can be contained in reliable probability distributions, as the EMH+ assumes [Cf. Arrow and Hahn 1991; Chapter 14].

The inference of the A-D disproof is also that there is no sound theoretical basis for the IMF's contention that combining gradual liberalization with institutional reforms that bring "transparency, control of corruption, rule of law and financial supervisory capacity" to the levels characterizing the "best practices of the world," will allow developing countries to absorb foreign capital flows beneficially. It takes two to tango,

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<sup>18</sup> Yet "in a world with a past as well as a future and in which contracts are made in terms of money, no equilibrium may exist." [Arrow and Hahn 1991; p.361].

and full liberalizing—capital decontrol and all—gives maximum scope to the financial markets of each partner to misstep. Putting the onus on the developing countries to do all the adjusting is biased policy when the financial markets of the developed economies are responsible for much of the stumbling.

The alternative post-Keynesian perspective focuses primarily on financial instability in capitalist economies with mature financial sectors. The micro-foundations driving its dynamic analysis are twofold. Individual position-taking in a competitive capitalist economy is clouded by radical uncertainty about future cash flows, and market competition forces rational agents to include changing market “sentiment” as well as changing “news” about fundamentals in their calculations. More specifically, in a continually changing capitalist economy probability distributions of future cash flows that convert uncertainty into reliable risk assessments do not exist. And fear of losing market share deters firms and banks from sticking with cautious liability strategies, if their competitors are gaining from more risky debt leveraging.

The late Hyman Minsky, a leading post-Keynesian, combined these microfoundations with elements from Keynes, Kalecki, Marx, Schumpeter, and the pre-WW II Chicago School, to advance two general propositions in his increasingly influential Financial Instability Hypothesis (FIH). The first proposition, that the well-developed financial markets of modern capitalist economies are inherently crisis-prone, may now be reaching sympathetic ears among IMF analysts. The second proposition, that crisis minimizing requires preemptive monetary policy surprises, and “big government” rather than rolling back the state, is still forbidden territory, given the ideological predilection of the current owners of IMF policy; hence the wishy-washy reaffirmations of that general policy line with which IMF analysts conclude their critical reports.

The first proposition asserts that a state of financial tranquility—the ubiquity in the economy of banks and firms with strong balance sheets and cautious liability management—produces the seeds of its destruction by lowering assessments of credit risk. Banks and related financial institutions begin exploiting more intensely the interest arbitraging opportunities offered by the upward-sloping yield curve. They expand their privileged access to low cost liquidity in order to lend more long-term, and resort to financial innovations to evade regulatory constraints on their liability leveraging and maturity mismatching. Concurrently, non-financial firms take advantage of the increased availability of long term credit to increase debt financing of new and existing products and production processes. Loan pushing interacting with debt leveraging generates a surge of investment and output, encouraging the capital markets to hike up asset values. These collateralize higher levels of debt and add an augmented risk of hostile takeover to the fear of loss of market share to impel cautious firms to join the debt leveraging. The ballooning of debt commitments renders the financial system increasingly vulnerable to the risk that interruptions in the flow of funds between debtors and creditors will spiral into a systemic payments crisis with adverse repercussions on output and employment. Various endogenous shocks can set off the interrupted payments spiral: capacity overbuilding in the production sector; credit crunches, i.e., abrupt hardening of refinancing terms; the collapse of asset price bubbles, etc. The timing of the shock, whether it hits the financial system when the bulk of individual balance sheets are still robust or when they have become fragile, determines whether the financial system will self-adjust or spiral into a crisis. And in an extreme case, such as the 1929-33 Great Depression, spiraling asset and debt deflation, combined with severe downward wage-price spiraling and rapidly declining aggregate demand, can push the entire economy into a near death spiral.

Minsky's policy propositions derive from this range of possible crisis outcomes. "Thwarting Mechanisms," preemptive "policy surprises" by the monetary authorities, are intended to curb overly optimistic risk/return expectations before they get fully embodied in dangerous debt and asset bubbles. But thwarting mechanisms lose effectiveness as market agents learn to innovate around the new constraints, so they require periodic revision or replacement. From the FIH perspective, neither government policies nor market processes of capitalist economies can produce stable equilibrium growth paths. What interventionist policies can do is dampen the volatility of market processes by timely interventions [Ferri and Minsky 1992]. The thwarting mechanism concept takes to a higher level the aphorism, popular among conservative central bankers of the post-war Golden Age, that their job is to remove the punchbowl when the party really gets going. It is thus subject to the riposte then and now from anti-policy-surprise economists that this assumes government bureaucrats have more accurate information about future returns than market agents. But the riposte misses the essential point. At issue is not difference in knowledge but difference in objective function. Market agents are constrained to pursue individual goals—greater profit and wealth. Central bankers and other economic bureaucrats are supposed to pursue collective goals, such as more stable economic growth.

Similarly, the contrast between the Great Depression and the moderateness thus far of post-WW II business cycles in the industrialized countries motivated Minsky's proposition that "Big Government" is an important bulwark against a reprise of a Great Depression-scale disaster. "Big Government" means the central government's expenditures are a large enough share of GDP and its revenue structure sufficiently progressive to produce automatic stabilizers large enough to dampen significantly the cyclical fluctuations of aggregate demand. The Great Depression culminated an era of

“small government” with regressive tax structures. Automatic stabilizers were then lacking to even partly offset the impact on aggregate demand of the pro-cyclical fiscal efforts by which governments sought initially to avert the financial spiraling. On the other hand, war financing, and the post-WW II ideological shifts that produced the welfare state, progressive taxation and the acceptance of active counter-cyclical policies, also produced strong automatic stabilizers, while easing the need to precisely time the active policies.

Minsky developed the FIH in a closed economy context, but it can easily and fruitfully be extended to open economies and globalized finance. Required, as Arestis and Glickman show, is adding exchange rate risk to Minsky’s focus on credit risk. [Arestis and Glickman 1999]. Exchange rate risk alters Minsky’s tri-partite typology of financing units. Hedge financing units, firms that borrow with the expectation that their future cash flows will be able to fully pay off principal as well as interest without cutting into working capital, are the backbone of the financial tranquility phase in Minsky’s version of the FIH. But if the same debt is borrowed in a different currency from their revenue they become *de facto* speculative units, since they risk having to roll over rather than pay off principal, should the exchange rate depreciate. Speculative units, firms that debt leverage to where they expect to fully service the interest on the debt but to have to roll over the principal, drive the expansionary phase of the FIH in its closed economy version. In that version, An upsurge of rollover interest costs or diminution of cash flow can convert them into Ponzi units, requiring expanding debt to meet the interest service as well as to and roll over the principal on existing debt; i.e., they become technically insolvent. Their numbers are increased by endogenous shocks as the FIH reaches its crisis phase. In the open economy FIH, speculative units that borrow in a different currency from their revenue are dubbed “super speculative” by Arestis and Glickman,

since exchange rate depreciation as well as credit tightening can transform them into Ponzi units. Moreover, governments who borrow in currencies other than the one they can print and collect taxes are also “super-speculative” units. In all, its dynamics are likely to move the FIH to a crisis phase faster in open than closed economies.

## **V. Inferences of the FIH for Development Policy and for Stabilizing Financial Globalization**

The FIH reverses the causal implications of the frequently cited correlation between financial deepening and economic development. Broadening and deepening the economy’s productive capacity pulls financial deepening along, rather than the reverse. That is, the dynamics of the FIH include Tobin’s Q relation, in which the physical investment rate gets pulled up as the booming equity markets bid up the capital value of existing firms above their replacement cost. But in open economies, the degree to which the equity boom will generate a boom in domestic intermediate and capital goods industries, and a strong multiplier impact on domestic aggregate demand, depends on the size, depth, and technological sophistication of the existing industrial structure. Industrialized economies equipped with such structures now have financial sectors that have deepened by servicing the long-term financing needs of their deepening industrial structures, and are able to fund in domestic currency most of the boom in goods production. By contrast, in developing economies with liberalized and privatized financial institutions but shallow industrial structures, the equity boom mainly generates a surging demand for capital and intermediate goods imports, and for the foreign exchange to fund the purchases. Domestic banks typically supply most of the foreign exchange to the final purchasers by borrowing abroad to onlend at home, profiting from the interest spread. The result is a weaker multiplier impact on domestic aggregate demand, and a

strong association of financial liberalization with frequent “twin” currency and banking crises that severely depress output and employment and deter financial deepening [Kaminsky and Reinhart 1996].

Thus, the FIH and the evidence to date refute the neo-liberal claim that building up the financial sector through financial liberalization is the most effective financial strategy for promoting the long-term economic growth of developing countries. Rather, using financial policy to reduce the vulnerability of economic growth to external blockages by facilitating the broadening and deepening of the productive structure should take precedence over financial liberalization. Of current neo-liberal modifications of earlier enthusiasm for financial liberalization, such as liberalizing in step with building up human capital, learning from past mistakes, and liberalizing the production sector,<sup>19</sup> the first two requirements change little. The buildup of human capital and learning from past mistakes could as well improve the use of the financial instruments, such as capital controls, official development banks, and financial subsidies and restrictions, that industrial strategies rely on to help channel resources to priority areas.

However, the advice to keep liberalizing the financial sector in step with further liberalizing of the production sector, does indeed differ from reinstating industrial strategies and their financial controls as a response to the poor performance and rising discontent with neo-liberalism as a development strategy. To be sure, since few if any developing countries have as yet fully liberalized, defenders can blame the poor performance of neo-liberalism on incomplete implementation rather than basic analytic flaws. But as the IMF reports cited above admit, the IMF hasn't a clue as to whether this means speeding up or slowing down the liberalization process, which empties both the defense and the gradualism advice of substance.

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<sup>19</sup> See the advice to Latin America of IMF Deputy Managing Director Eduardo Aninat at Chilean and Peruvian seminars, IMF Financial Survey March 3, 2003.

What remains is the belief that the globalized financial markets will also learn from past misbehavior, and become as time goes on more stable suppliers of international finance, thus creating a progressively safer global environment to facilitate the efforts of developing countries to liberalize further. The FIH shares the first part of this belief, but not the second. Financial innovation and risk reassessment are ongoing processes, but they need not bring financial stability closer, according to the FIH. Rather they are essential components of the financial dynamics that, unless checked by countervailing policies, will continue to move capitalist financial systems recurrently from robustness to fragility. To illustrate:

In reaction to the 1980s Latin American debt crisis, the Basel Committee of central bankers from the major industrial countries reached an accord in 1988, now dubbed Basel 1, intended to reduce risky loan pushing by banks. Basel 1 divided bank lending into rising credit-risk classes, and set higher compulsory equity capital to loan ratios for the riskier loan classes. But as the central banks began implementing the requirements on banks under their jurisdiction, the banks began gaming the new restrictions.

The gaming has taken four major forms, two merely involving altered lending strategies and two requiring financial innovating. The altered lending strategies sharply increased inter-bank loans and short-term lending to developing countries, each of which were in lower risk classes than were long-term loans, as shares of total assets on the bank's balance sheet. Much of the explosion of inter-bank lending was applied to covered interest rate arbitraging, but part of it financed the expansion of open speculation on exchange rate movements and interest rate spreads by bank clients and by the banks themselves. The fast growth of short-term lending to developing countries went mostly to local banks for domestic onlending. In East Asian countries it financed the

overleveraging of industrial investment and the real estate bubbles that led to the 1997 financial crises. Not surprisingly, IMF analysts, still bemused then by the EFH+, gave a green light to these trends in their pre-crisis reports, and when the crises broke, the IMF conditioned the bailout credits on sharp increases of domestic interest rates to re-attract the fleeing foreign bank lenders. The interest increases instead produced waves of domestic bankruptcies that overwhelmed the local banks with bad loans, setting off massive credit crunches that intensified the decline of output and employment. That also intensified rioting in the streets, forcing the IMF to countermand its austerity orders and acquiesce instead to expansionary monetary-fiscal measures to turn things around. Today, the IMF warns developing countries against loading up heavily with short-term foreign debt, and approves the deposit requirements that Chile has used to control hot money inflows. But controls on capital outflows are still off its formulary.

The two major bank innovations, securitization and customized derivative mongering, were intended to profit from off-balance sheet lending activities that were exempt from equity capital requirements. Securitization meant booking long-term loans that could be quickly converted and resold as bonds collateralized by the stream of interest payments and/or other cash flow commitments of the original loans, with the banks setting the initial bond price to yield them a moderate one-time profit. Derivative mongering meant devising and selling “over the counter” (OTC) customized interest, commodity and exchange rate derivatives for a fee to corporations and hedge funds seeking cheaper ways to hedge against various perceived risks from their operations. To generate high returns on equity, both innovations require large volume and rapid turnover of bank funds. Hence the large international banks that dominated the innovations had by the late 1990s pushed the value of the global stock of securitized bonds to multi-trillion

dollars, while the notional value of the global stock of OTC derivatives reached a staggering \$99.7 trillion in June 2001 [BIS 2001; p. 23].

The ballooning of global financial transactions relative to the growth of production and trade of non-financial products also increased the volume and variety of financial risks. Basel 1 had concerned itself merely with credit risk. But the wholesale conversion of long-term bank loans into securitized bonds, which enabled the initiating banks to pass on the credit risk to the bond holders, also inflicted market risk on the holders--the risk that falling bond prices due to an increase in interest rates or in default risk might substantially depreciate the value of their assets.<sup>20</sup> The huge volume of OTC derivative transactions and of inter-bank lending augment settlement risk--the risk to participating banks that their transaction counterparties might renege on payment commitments. The systemic repercussions of settlement risk are further augmented because OTC derivative mongering and inter-bank lending are concentrated globally in a few dozen very large banks who typically engage in very sizeable transactions.

In reaction to the gaming of Basel 1 and the accumulation of financial risks with systemic repercussions, the Basel Committee decided in the mid-1990s to devise an updated risk control accord, dubbed Basel 2. The effort has focused on supplementing pre-defined risk classes, with market risk assessments by bond rating agencies such as Moody and Standard and Poor, and in-house risk control systems of the large banks. Reaching agreement on details, has, however, been a prolonged process. Basel 2 is now supposed to be finalized this year (2003), and to go into full operation in 2007. Can it stabilize the globalized financial markets? An insightful analysis by two Deutsche Bank

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<sup>20</sup> This is being brought home big time by the recent collapse of the IT and telecommunication bubbles, which has wiped out an estimated \$3 trillion of bond market values, much of it securitized bonds. The main holders affected have been U.S. and European pension funds and insurance companies, leaving many of them underfunded relative to their expected payout commitments. Higher insurance rates and risk of breaks in payouts are part of the asset and debt deflation process currently depressing private profits and investment in the U.S. and the EU.

economists [Folkerts-Landau and Garber 1998] concludes with a resounding no. The effect of adding the additional risk control methods might well be to increase global volatility and contagion. To quote the authors:

“A downgrade of a country’s credit rating leads to an immediate sell-off of its bonds and an inability to approach the market for more funding. Risk control systems require that margin calls in foreign exchange be made on domestic counterparties whose derivative positions...take losses from market price movements. A volatility event in one country automatically will generate an upward re-estimate of credit and market risk in a correlated country, triggering automatic margin calls and tightening of credit lines....These are not the responses of panicked green-screen traders arbitrarily driving economies from a good to a bad equilibrium. Rather they work with relentless predictability and under the seal of approval of supervisors in the main financial centers. ‘Contagion’ is the other side of the coin of risk control in the industrial countries.”

A case for reintroducing capital controls? Not for the authors. To quote again from their analysis:

“Modern risk control methods pushed heavily by the BIS and national regulatory authorities are liquidity hungry. They trigger heavy demands for cash, collateral, and capital on a systemic level when asset prices move significantly. Such methods have now created a clear tension between the thrust of prudential regulation of industrial country supervisors and the lender of last resort responsibility of G-7 authorities.”

“Credit and currency control events are poison for such systems of risk management. These break the netting and hedging vision under which most traders and risk managers work. If funds cannot be moved across borders easily or if a piece of a portfolio defaults, then risk control methods fall apart. Positions must be regarded from a gross not a net basis, with considerably higher capital costs than may be justified by the risk-return tradeoff of a given security.”

In sum, the analysis depicts the international financial markets as implacably unstable, but beyond public control. Can anything be done? In 1999 Congressional testimony, Folkerts-Landau, former high-level IMF apparatchik and now Managing Director and Global Head of Research of the Deutsche Bank, gave his harsh policy advice.<sup>21</sup> Do not try to change the behavior of the international financial markets, but strengthen instead the power of the IMF to force developing countries to accept the disciplining of the financial markets.

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<sup>21</sup> Hearings on the Architecture of International Finance of the U.S. House of Representatives Committee on Banking and Financial Services, May 20, 1999.

“More concretely, after improving its surveillance capability the Fund will need to go public with its findings and let the markets do the rest. It will need to pressure countries publicly for policy changes, including international sanctions, aid curtailment, the imposition of additional capital requirements on bank lending to countries identified as following destabilizing policies, and ultimately declaring countries ineligible for access to the Fund’s lending facilities—it is astonishing that this has never happened.”

The analysis passes over the likelihood that banks will adapt their risk controls to changes in the global regulatory environment. And Folkerts-Landau’s testimony merely demonstrated his own lousy surveillance capability, when he illustrated his case by lauding Argentina as one of the few developing countries with “the necessary economic policy discipline” for sustaining “access to large inflows of foreign capital.”

However, the basic message of his analysis, that strengthening prudential supervision of the financial center banks will not stabilize financial globalization is valid, even if his policy conclusion is neither adequate nor moral. It is inadequate because the vast bulk of global financial transacting is between the industrial countries. Forcing developing countries to absorb the instability of their small share of global transacting touches merely the fringes of the global instability problem. It is immoral because it imposes the entire adjustment burden of that unstable share on the weaker and poorer partner. The current worries that a replay of the Great Depression could be in the offing emphasize discordant fiscal, monetary, and exchange rate policies among the U.S., the E.U. and Japan, as well as the ease with which the liberated and excessively liquid global financial markets react to thwart efforts at policy adjustment. Both features have a late 1920s aura. The renewed interest in capital control mechanisms thus arises from recognition that they are a prerequisite for effecting improved policy coordination between the Big Three as well as for allowing developing countries to pursue counter-cyclical stabilization and industrial development strategies.

The IMF in its current lending has been backing away from the policy direction advocated by Folkerts-Landau. The terms of the new rollover of its Argentine loans,

which largely acquiesce to the Argentine government's demand that it be allowed to finance economic recovery before renewing its dollar debt payments, has upset the international financial markets, not least because it may presage a general weakening of the IMF's role of debt payment enforcer. Yet capital controls, even "market-friendly" ones like the Tobin tax, not only remain off the IMF's policy agenda, but remain too hot a topic for honest public appraisal by its analysts. The latter is evidenced by a recent piece by Kenneth Rogoff, the IMF's outgoing Economic Counsellor and Director of Research. ("Rethinking Capital Controls," Finance & Development, December, 2002). In a single paragraph, Rogoff, who surely knows better, dismisses the Tobin tax concept by falsely accusing Tobin of having been motivated by the belief that "all short-term flows are bad," and by falsely claiming that the tax "would discriminate indiscriminately against all short-term flows," including trade credits, "the life blood of all trade." The latter assertion is precisely the opposite of the objective of the tax and of its practical effect, since its proposed small globally uniform tax on all exchange transactions would impose a smaller relative tax burden on transactions involving longer round trips, like trade credits, than on the short-term round tripping characteristic of arbitrage and speculative exchange transactions.<sup>22</sup>

This suggests a two-pronged approach to render alternative development strategies to neo-liberalism more feasible. Give capital controls a prominent place in the development programming, as a pre-requisite for implementing counter-cyclical macroeconomic policies as well as counter-free market industrialization programs. But concurrently, urge developing country governments to demand that serious consideration

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<sup>22</sup> Earlier published IMF critiques of the Tobin tax were misguided, but not deceitful. The gist of those critiques was that if the international financial system was always in full equilibrium, the Tobin tax would necessarily be introducing a welfare-reducing "distortion." If one believed in the EMH+, as apparently many IMF economists did back then, the analysis was at least intellectually honest, if worthless. Rogoff's dismissal, on the other hand, merely reflects an arrogant disregard of the voluminous published literature on the tax and its feasibility.

be given to proposals for thwarting measures by the major industrial country blocs to stabilize financial globalization and for macro-policy coordination to stabilize global aggregate demand. Were that to strengthen the political clout of such proposals sufficiently to allow collective rationality to triumph over the current ideological and narrow self-interest barriers blocking adoption, it would be short-cut return to the humane global vision of the early Bretton Woods era. Were it to fall short, the first prong would still leave developing countries better equipped to ride out a reprise of the stormy 1930s that led to Bretton Woods.

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