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Introduction: The Rising Hegemony of Global Finance and the Demise of Development

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Financial Liberalization

Introduction: The Rising Hegemony of Global Finance and the Demise of Development

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The decades of the 1980s and 1990s witnessed the completion of liberalization attempts in much of the developing world. Quantitative restrictions on imports were eliminated; tariffs were significantly reduced; exchange regimes and financial markets were deregulated; and, above all, external liberalization of the capital accounts was completed. Concurrently, integration of financial markets increased dramatically, and net capital flows to developing countries surged. Particularly in Latin America and Asia, annual inflows averaged more than US$ 150 billion in the first half of the 1990s — or about 2% of the aggregate gross domestic product of the developing economies.

Initially it was conventional to attribute the observed surge in capital inflows to domestic policies, such as "sound fundamentals" in the recipient countries. Eventually, however, it became clear that the phenomenon was global, affecting virtually all countries despite their diverse characteristics. This suggested that the pattern reflected an ongoing trend towards integration of world capital markets and globalization of investments worldwide, rather than being an interim phase to be explained by the adoption of "correct" macroeconomic policies. Accumulated data further revealed a major shift in the composition of capital flows in favour of portfolio investments (inclusive of bonds, equities, and other short term financial assets), while official flows fell dramatically.

The rise of foreign capital inflows was initially a welcome development. The foreign exchange constraints, which seemed constricting during the 1970s and 1980s, were suddenly relaxed, with positive effects on consumption and investment. Theory suggests that inflows of capital would complement national savings, and that financial liberalization would improve the allocation of scarce funds both internationally and inter-temporally. In a world of freely mobile capital, investable funds would flow from high-saving to low-saving countries. This process would tend to equalize interest rates across the global financial markets — North and South — and would enable individual countries to escape the size constraints on their domestic asset markets.

This benign view of the mobility of international capital has been challenged by the crisis episodes of the last two decades. Both numerous empirical case studies and the policy lessons of the

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Mexican, East Asian, and more recently the Turkish and the Argentine experiences, revealed that the expected beneficial effects of capital inflows have been overshadowed by the adverse impacts of excessive stock market volatility and the persistence of exchange rate risk. Furthermore, in a world of volatile exchange rates, the traditional dictum regarding the global equalization of interest rates failed to take place.

Empirical studies on the macroeconomic effects of capital flows in the aftermath of capital account deregulation did, in fact, highlight a number of stylized facts[1] which could not have been foreseen by the theoretical abstractions of inter-temporal optimizing.[2,3] First, it was observed that a disproportionate portion of the rise in capital inflows was trapped as foreign exchange reserve accumulation in the recipient countries. From 1990 to 1994, the share of foreign inflows channelled to accumulation of reserves was 59% for Asia and 35% for Latin America. Secondly, the surge in capital inflows was associated with widening current account deficits in the aftermath of external liberalization. This widening was the end result not only of increased investment demand, but to a larger extent was due to a significant fall in national savings. Consequently, there was a rise in private consumption spending driven mostly by rising imports of durable goods. Thirdly, with the rapid growth in the monetary aggregates in the recipient countries in both nominal and real terms, the surge in capital inflows was accompanied by sharp increases in stock and real estate prices. Finally, even though the real exchange rate movements have displayed a mixed pattern across a wide variety of countries, those countries that had ongoing disinflation programs experienced a substantial real exchange rate appreciation. In fact, such appreciation has been referred to as a "well-established empirical regularity" of exchange rate-based disinflation attempts (Rodrik and Velasco 2000).

In addition to all the above, it became clear that countries that were dependent upon capital inflows ought to adopt or maintain contractionary monetary policies in order to secure investor confidence and international creditworthiness. Thus, the governments of the emerging markets that seek to attract and maintain inflows of foreign capital are severely constrained in the *ex ante* sense to adopt a set of restrictive monetary and fiscal policies (Grabel 1995). Such efforts are restricted to a balanced budget, entrenched fiscal expenditures, and a relatively contractionary policy with an *ex ante* commitment to high real interest rates. All of this signifies reduced political autonomy in the developing world in exchange for market access to the industrialized North, which is a bad bargain as far as development is concerned (Rodrik 2000).

The next four papers will discuss different aspects of these issues. First, Chandrasekhar investigates the changing role of financial intermediation and traces the effects of the rise of finance to dominance over the global economy. Chandrasekhar argues that the financial liberalization episodes of the 1990s have put the global economy into a deflationary spiral — except for the United States, which, by exploiting its advantage as supplier of the world's reserve currency, has escaped the resulting deflation. Chandrasekhar further describes how unfettered financial dereg-

1. The term "stylized facts" originates in the influential work of Nicholas Kaldor on growth economics during the late 1950s, in which he laid out his work from a set of "stylized facts." This refers to a set of observations that are generally accepted to be true, to the point that they do not require further documentation and/or theoretical proofs.

2. Inter-temporal optimization is the essence of neo-classical dynamic macroeconomics. The neo-classical (orthodox) theory works with a representative, rational household whose sole purpose is to maximize its utility over a lifetime span (inter-temporally).

3. The following list of stylized facts is compiled from a survey by Calvo, Leiderman and Reinhart (1996). For further discussion of the empirics of the celebrated surge in capital inflows see, for example, Agenor and Montiel (1999); Prasad et al. (2003); and Rodrik and Velasco (2000).

ulation has led to the demise of growth-oriented, state-led development strategies such as those pursued by countries like Japan.

Next, Epstein and Power analyze the class structure behind this financial revolution, and present data on the share of national income appropriated by the rentier classes in a number of Organization for Economic Cooperation and Development (OECD) countries. Epstein and Power report that they could not find any evidence of a negative correlation between rentier shares and non-financial corporate income, and that rentier shares did decline in those economies that experienced financial crises. The authors read this data as suggesting that financial liberalization has been associated with the increased power of an international rentier class, whose interests are aligned with those of non-financial corporations in the rich developed countries.

In the third paper, Biçer and Yeldan investigate the determinants of short-term financial capital flows in Turkey, a country that was hit by a major financial crisis in 2000-2001 while in the process of an International Monetary Fund (IMF)-led stabilization programme. Using time-series econometrics, Biçer and Yeldan provide evidence that over the 1990s financial capital inflows into Turkey had a significant negative correlation with industrial production and trade openness, and that fixed private investments displayed an inconclusive relationship with foreign financial flows. Biçer and Yeldan's results further suggest that private investment in Turkey has a significant negative relationship with real wages. The authors read this evidence to suggest that under the volatile and uncertain conditions of speculative-led investment patterns, the downward flexibility of real wages ought to be regarded as a concomitant factor of the liberalization episodes in the often fragile and shallow financial markets of countries such as Turkey.

Finally, Alper and Onis bring the above arguments together in their critical assessment of the role of international organizations, in particular the IMF, in the crisis-ridden emerging markets of the late 1990s. Using the lessons of the Turkish crisis of 2000-2001 in particular, Alper and Onis argue that the kinds of reforms promoted by the Fund are incomplete insofar as they focus only on the regulatory role of the state, neglecting issues relating to income distribution and long-term growth.

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