Contact: Mark Primoff
845-758-7749
primoff@bard.edu

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NEW INSTITUTIONS NEEDED TO BOOST FOREIGN INVESTMENT IN DEVELOPING NATIONS, NEW LEVY INSTITUTE REPORT SAYS

ANNANDALE-ON-HUDSON, N.Y. — While much has been done to globalize international capital markets over the past 30 years, making it easier for banks and investors to lend money in foreign markets, a new report from the Levy Economics Institute of Bard College argues that significant economic barriers remain that prevent developing countries from gaining access to foreign capital. In a public policy brief, *Is Financial Globalization Truly Global? New Institutions for an Inclusive Capital Market*, Levy Institute Professor of Economics Philip Arestis and Santonu Basu, senior lecturer at South Bank Business School, London South Bank University, suggest that policymakers create appropriate institutions—a new international central bank and an international currency—to encourage, and reduce the risks of, investment in emerging economies.

"The perception of falling barriers to foreign lending partially masks a reality in which many nations cannot obtain needed capital, even for potentially profitable investments. Banks and other lenders are reluctant to lend dollars for projects that do not earn profits in easily convertible and internationally traded currencies," write Arestis and Basu, stressing that even those countries that raise vast amounts of capital on international markets are vulnerable to panic sales of their liabilities. "The result of liberating capital from constraints is not always the fair or efficient allocation of funds."

The authors cite two fundamental problems with the global financial system. The first is that, in a world where most currencies are not as highly regarded as the euro, dollar, and yen, most countries find it difficult to convince international lenders of their ability to repay in an acceptable currency. "Even if a project is profitable in terms of the home currency, the possibility remains that the currency will depreciate, or completely lose convertibility, so that the value of the project's revenues in terms of dollars, yen, or euros will be lower than the value of the required loan payments," write Arestis and Basu. "Firms must meet what is in essence a higher credit standard for international loans than for domestic ones."

The second problem, Arestis and Basu contend, is that relying on foreign capital can make an economy vulnerable to destabilizing forces originating elsewhere in the world, such as in the Asian financial crisis in 1998. "Fears of fears of the collapse of one currency can spread to other nearby markets, leading investors to withdraw from several economies at the same time. Thus, what would otherwise be a minor, local crisis can take on continental proportions, and the affected countries might have been better off not borrowing on international markets in the first place," the authors write.

As a remedy to these limitations in global finance, the authors recommend that an international central bank with an international currency be established. The bank would operate similar to the Federal Reserve by issuing reserves as needed and addressing imbalances between member banks. "Just as U.S. banks accept each other's checks, knowing that the Fed will make good on them, businesses around the world will feel more comfortable accepting payments in foreign currency," Arestis and Basu say, noting the bank could also prevent weaknesses from arising in the first place by monitoring international flows of cash. "Countries might be spared the ordeal of currency and banking crises, and they would enjoy a steadier flow of capital. The tilted playing field of international capital markets would be leveled somewhat."

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Public Policy Brief No. 75, *Is Financial Globalization Truly Global? New Institutions for an Inclusive Capital Market*

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