



International Dimensions of Financial Fragility

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FIH as an Analytical Tool

- Minsky applied it to business investment decisions and to financial institutions
 - Identify cash in/out flows
 - Analyse Balance Sheets
 - Identify Cushions of Safety
- Can FIH be applied to Countries?
 - Imports and exports generate cash commitments and receipts
 - International Borrowing and Lending generate cash commitments and debt stocks
 - Cushions of Safety: Reserves, Export potential
- Shocks to System
 - Changes in exchange rates ,capital flows, interest rates, interest differentials

Circular Flow Problems

- $Y = C + I$ (centrality of Private Sector Balances)
- $Y = C + I + [G-T]$ (implies Govt has constraint)
- $Y = C + I + [G-T] + [X-M]$ (BW fixed rate)
 - I, G, T Exogenous
- Bretton Woods: No Capital Flows
- Post Smithsonian: Capital Flows so
- $B = [X-M] - [\text{Net Capital Flows}]$
- Impact on Size of International Imbalances

FIH and Financial Crisis

- Southern Cone Crisis
- Latin American Debt Crisis
- Tequila Crisis
- Asian Crisis: Capital Account vs Current Account Crisis
 - Post Washington Consensus Crises –
 - Trade and Development Report 1997
- Argentine Crisis
- Brazilian Crisis

Minsky Analysis of Financial Fragility

- Under BW: countries were encouraged to have hedge financial profiles
 - Small external payments positions
 - Reserves as margin of safety against fluctuations in net exports .
- When reserve cushion insufficient IMF lending
- IMF program to restore hedge position
- carried asymmetric deflationary bias
 - all countries could not have hedge financing profiles
 - unless there was an external source of liquid reserves via a lender of last resort.

Minsky Analysis of Financial Fragility

- After BW: countries could avoid limits on external imbalances
 - Borrow reserves from Private Markets
 - Avoid IMF programmes
 - Confusion between Gross Reserves and Net Unborrowed Reserves
 - Procyclical FDI Flows
 - Real Exchange Rate Volatility
- Hedge to Speculative to Ponzi
 - Borrowing to Meet Interest on Accumulating Foreign Debt
- Capital Reversals – Reserves Disappear – Capital Account Crisis
- Short-term Expansionary/Inflationary Bias
- But Long-Term decline
- Increased Volatility in Real and Financial Variables
- The Financial Crisis replaces IMF in restoring hedge Financing profile

How to replace IMF and Financial Crises

- Policies to Induce Hedging Profile
- Limit External Borrowing
 - Control of International Capital Flows
 - Control of Private Financial Institutions
- Balance external earnings and external claims
 - Use Private Markets and Financial Engineering
 - VAR on Brady Bonds
 - Argentine GNP Warrants
 - Use Forex Options
 - Make foreign obligations correlate with ability to pay
- But this means balanced current accounts

Return to the Approach of the Pioneers

How to Lift the Development Constraints?

- Savings generated internally by increasing incomes through full employment Financing is assured by limiting reliance on external financial resources – Monetary Sovereignty
- Policy to Build Domestic Industry
- Policy to Earn Necessary Imports through export promotion
- Policy to reduce leakages into imported consumption goods and use of capital to produce domestic luxury goods

Mainstream Approach to Financing for Development

- **Constraints on Developing Countries:**
 - **Deficient Domestic Savings**
 - **Scarcity of Domestic Resources**
 - **Deficient Capacity to Produce Capital Goods**
- **How to Overcome constraints:**
 - **Increase Domestic Savings**
 - **External Financing for Development**
 - **Bilateral Grants and Concessional lending – ODA**
 - **Multilateral Institutions – IBRD – IDA - IFC**
 - **Private direct investment flows –FDI**
 - **Emigrant Remittances**

Theoretical Support for External Financing

“The basic argument for international investment of capital is that under normal conditions it results in the movement of capital from countries in which its marginal value productivity is low to countries in which its marginal value productivity is high and that it thus tends toward an equalization of marginal value productivity of capital throughout the world and consequently toward a maximum contribution of the world’s capital resources to world production and income.”

Jacob Viner, “International Finance in the postwar World,” *Journal of Political Economy*, 55, April, 1947, p. 98.



Implicit Assumptions and Conclusions

- Assumptions (diminishing returns)
 - Capital Scarcity in Developing Countries so rate of return is higher
 - Capital Surplus in Developed Countries so rate of return is lower
- Conclusions
 - Global investors raise their returns by investing in Developing Countries
 - Developing Countries develop more rapidly by Borrowing Capital from Developed Countries
 - Global rate of Growth and Wealth Formation Maximised

Cambridge Capital Theory Debates: There is No Theoretical Support

- Impossible to establish an inverse relation between capital scarcity and rate of return
- Not even possible to measure capital scarcity

Assumptions Cannot Be Supported by the Stylised Facts

- No empirical evidence that foreign capital inflows increase domestic investment and growth
- Relative returns will depend on stable exchange rates

Historical Evidence

- Negative net transfers have been the rule
 - Capital Flows from Developing to Developed Countries
 - Alliance for Progress (AfP) --1960s,
 - Latin America's "lost decade" of the 1980s,
 - Mexican, Asian financial crises of the 1990s
 - Excess Reserve accumulations of the 2000s
- Private Flows dominate Official Assistance
 - Private flows not subject to development needs, but to determined by investors incentives

What Led to AFP?

Brazilian President Getulio Vargas
(in a New Year's Eve speech at the end of 1951)
complained that Brazil had been experiencing
negative net financial flows continuously from
1939 (with 1947 the exception).

Financial Transfers under Alliance for Progress

Former Chilean finance minister Gabriel Valdes to President Nixon, June 12, 1969

“It is generally believed that our continent receives real financial aid. The data show the opposite. We can affirm that Latin America is making a contribution to financing the development of the United States and of other industrialized countries. Private investment has meant and does mean for Latin America that the sums taken out of our continent are several times higher than those that are invested. ... In one word, we know that Latin America gives more than it receives.”

Modern Experience of Net Transfers of Resources

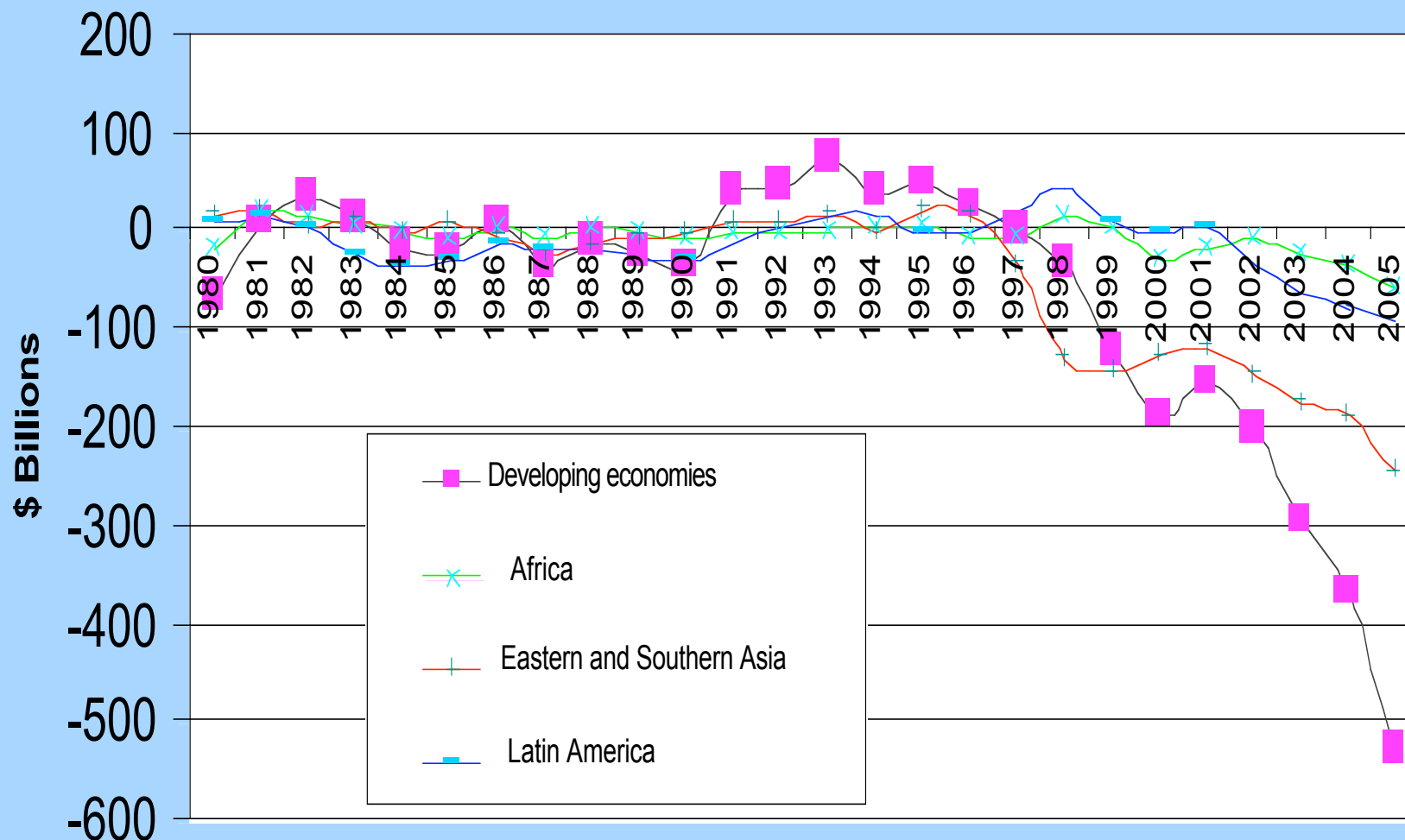


Table 1
Net transfer of financial resources to developing economies and economies in transition, 1996-2007

(Billions of United States dollars)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006 ^a
Developing countries	23.8	-1.1	-33.7	-118.4	-185.8	-154.7	-204.4	-298.9	-351.2	-533.3	-661.6
Africa	-5.9	-5.3	15.5	2.2	-31.6	-17.2	-7.1	-22.2	-35.8	-66.3	-78.9
Sub-Saharan (excluding Nigeria and South Africa)	5.0	7.7	12.0	8.9	2.8	6.9	5.2	6.3	3.9	2.0	-1.0
Eastern and Southern Asia	18.9	-31.5	-128.1	-137.6	-120.2	-116.9	-145.4	-171.0	-161.6	-231.5	-322.0
Western Asia	10.6	12.6	34.8	7.7	-31.5	-23.9	-19.5	-44.1	-71.4	-129.3	-131.6
Latin America	0.3	23.2	44.1	9.3	-2.5	3.2	-32.4	-61.5	-82.3	-106.1	-129.1
Economies in transition	-11.7	-2.9	-6.7	-32.1	-58.0	-40.3	-38.8	-50.6	-78.0	-111.6	-133.0
Memorandum item: Heavily indebted poor countries	7.2	7.9	9.2	10.6	8.5	9.1	11.5	10.9	11.5	14.5	12.8
Least developed countries	10.5	9.2	12.5	10.8	5.7	8.8	7.2	8.9	5.2	3.7	1.7

Source: United Nations Department of Economic and Social Affairs, based on International Monetary Fund (IMF), *World Economic Outlook Database* (April 2007), and IMF, *Balance of Payments Statistics*.

^a Estimates.

Modern revisionists

- Real Growth Theory
 - Increasing returns to investment in
 - Human capital
 - Market institutions
 - Investment in Developed countries may thus have higher returns than investment in Developing countries
 - Global Financial Markets may thus may be acting efficiently by creating negative net resource flows
- A Rediscovery of the position of Development Pioneers
 - Nicholas Kaldor
 - Ragnar Nurkse
 - Gunnar Myrdal
 - Hans Singer
 - Celso Furtado

Modern Equivalent: Build Financial Institutions

“The case for capital account liberalization is a case for capital seeking the highest productivity investments. We have seen in recent months in Asia -- as at many points in the past in other countries -- the danger of opening up the capital account when incentives are distorted and domestic regulation and supervision is inadequate. ... The right response to these experiences is much less to slow the pace of capital account liberalization than to accelerate the pace of creating an environment in which capital will flow to its highest return use. And one of the best ways to accelerate the process of developing such a system is to open up to foreign financial service providers, and all the competition, capital and expertise which they bring with them.”

Summers, Lawrence (1998) US Government Press Release, 2286, March 9, 1998: “Deputy Secretary Summers Remarks Before The International Monetary Fund.”



What do Foreign Financial Institutions Contribute?

- Foreign Banks were the first to exit Argentina in 2000
- Before the Corralito was imposed
- Before the Suspension of debt service
- Did not act to create stable domestic environment
- In Brazil foreign banks are less efficient than domestic banks
- Foreign acquisitions of Latin American banks have been of the best domestic performers

See Mario Tonveronachi, "The Role of Foreign Banks in Emerging Countries – The Case of Argentina, 1993-2000, *investigación económica*, vol LXV, No. 255, enero-marzo, 2006 and Jon and Fatima Williams 'Does ownership explain bank mergers and acquisitions? The case of domestic banks and foreign banks in Brazil', Oxford Centre for Brazilian Studies and Luiz Fernando Rodrigues de Paula, *The Recent Wave of European Banks in Brazil*", Oxford: Centre for Brazilian Studies.

Nonetheless Policy Application has accepted the Mainstream Approach

- **First United Nations Development Decade-1961**
 - *Kennedy -- Alliance for Progress*
 - *Objective: 5 per cent GDP Growth*
 - *Instrument: One per cent of developed country GDP to be transferred to developing countries*
 - *Assumption: 0.3 per cent private flows, 0.7 per cent ODA*
- **Growth Rate Target Achieved**
- **Official Aid Target Not Achieved**

External Finance caused loss of Policy Autonomy in the 1960s and produced 1980s Debt Crisis

Conflict between internal and external equilibrium

- **If external account in equilibrium at less than full employment**
 - *Expanding demand by active fiscal policy produces an external deficit*
- **If external account in deficit at full employment**
 - *Restricting demand with restrictive fiscal policy raised unemployment rate*

Fleming-Mundell: Externally Financed Policy Space

- External capital flows in open capital markets provided policy space
- Policy “Assignment” Problem
 - Use monetary policy to attract capital inflows to finance the full employment current account deficit
 - Use fiscal policy to keep aggregate demand at full employment level

External Finance was used to provide Policy Space after the Latin American debt crisis

- **Brady Plan to Emerge from the Debt Crisis – restore access to international borrowing**
- **By means of policies to eliminate inflation and support growth**
 - Exchange rate anchor
 - Deregulate and develop domestic capital markets
 - Liberalise external capital inflows
 - Privatisise state-owned assets
 - Liberalise interest rates
 - Tight monetary policy
 - Restrictive Fiscal policy

External Finance thus “created” Policy Space

- Policy Space Successes
 - Rapid fall in rate of inflation
 - Rise in domestic consumption
 - Recovery in domestic growth rates
 - Increased per capita real incomes

But Had Unintended Consequences:

- Renewed inflows increased external debt
- Produced increasing commercial deficit
- Brought overvaluation of exchange rate
- Sustained international interest differential
- Encouraged foreign currency borrowing in financial and non-financial sector balance sheets – currency mismatching
- Rising debt service increased external and domestic fiscal deficits
- Reversal of capital flows produced financial sector and exchange rate crisis
- ***Crisis and LOSS OF POLICY SPACE***

And a New Policy Dilemma

Inflation would not have been reduced without

- Exchange rate anchor
- Capital inflows to prevent external deficit from creating an exchange rate crisis
- Capital inflows financed increased domestic consumption not investment
- Growth and low inflation become hostage to international investors

Loss of Policy Control

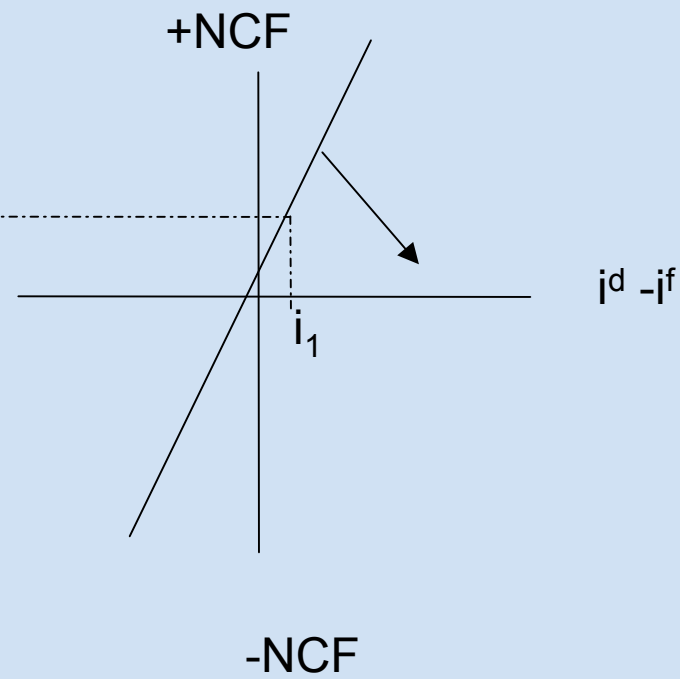
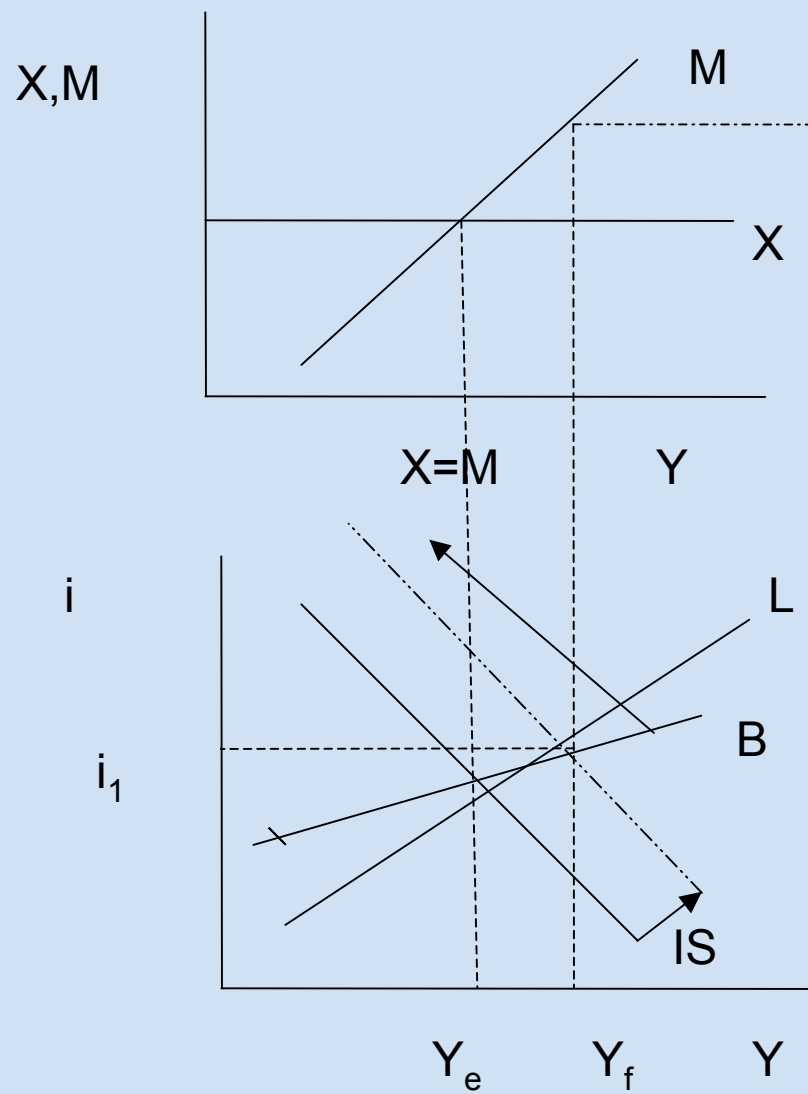
- Monetary Policy determined by portfolio decisions foreign investors
- Interest rates set to avoid loss of sufficient capital inflows
- Nominal fiscal balance out of control as interest rates on government debt rise
- Overvaluation of real exchange rate
- External balance driven by debt service

Comment on the Margin

- Williamson argues that this result could have been avoided if:
 - Financial Liberalisation had been appropriately sequenced
 - Real exchange rate had been managed at a stable value
- **This argument does not hold since:**
 - The policy would not have succeeded without the external capital inflows
 - The Consensus stabilisation policy required a nominal Exchange Rate Anchor

How did this Happen?

- Fleming-Mundell
 - Ignores impact of capital inflows on debt stock
 - No analysis of impact of high interest rates on debt service
 - No analysis of impact of rising debt service on current account balance
 - No analysis of rising debt stock on risk premium on external borrowing
 - Assumes capital flows can be maintained indefinitely
- ***Externally Financed Policy Space WAS An ILLUSION***



Can the Fleming-Mundell Dilemma be Resolved?

- This is the same question we ask about the current US deficit
- The same question was asked after the Second World War – but in reverse
 - Is a permanent US trade surplus possible
 - i.e. will the dollar shortage be permanent
- The Answer was given by Evsey Domar

The Domar Condition

- A net export surplus can be maintained only if the stock of foreign lending increases at a rate equal or greater than the interest rate charged on the foreign lending
- For a deficit, foreign borrowing must increase at a rate equal or greater than the rate of interest paid on the lending
- If interest rate rises with increasing stocks of foreign loans, then the rate of borrowing must also increase

Domar and Ponzi

- The Domar condition is the same as the condition for a **successful Ponzi Finance scheme**
- Such schemes are inherently unstable
- Thus, Keynes's recommendation to use capital controls
- But long-term stability will require a balanced structure of production that creates exports sufficient to meet debt service
- Industrial policy is also necessary for policy space

But Externally Financed Growth Undermines Domestic Mobilisation and Employment Creation

- **Private flows and Official Aid create debt service obligations**
- **Foreign currency needed for debt service**
- **Foreign currency generated by external surplus**
 - That is by a negative net resource transfer

BWI Structural Adjustment Programmes to meet debt service obligations

- Reduce level of activity to free resources to meet debt service**
- External surplus is produced via fiscal surplus**
- Fiscal surplus created by cutting investment in education, health, social expenditures, government wages**
- Fiscal surplus reduces domestic absorption and domestic resource utilisation**
- Creates unemployment and lost potential output**
- Absence of Social Safety Net creates economics and social marginalisation – informal labour markets**

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This Approach Builds on Keynes's *Treatise on Money*

- “It is, therefore, a serious question whether it is right to adopt an international standard, which will allow an extreme mobility and sensitiveness of foreign lending, while the remaining elements of the economic complex remain exceedingly rigid.
- If it were as easy to put wages up and down as it is to put bank rate up and down, well and good. But this is not the actual situation.
- A change in international financial conditions or in the wind and weather of speculative sentiment may alter the volume of foreign lending, if nothing is done to counteract it, by tens of millions in a few weeks.”

Keynes's *Treatise on Money*

- In The *Treatise on Money* Volume II – the *Applied Theory of Money* Keynes makes a detailed analysis of financial globalisation
- Open International Financial Markets implied:
 - Uniform rates of interest in all countries
 - Loss of “national policy autonomy” to offset volatility of domestic investment in support of full employment

Globalisation Reduces *National Policy Autonomy*

- Chapter 36 of the *Treatise* is called “**National Policy Autonomy**”
- He notes the conflict between free international investment flows and policy to offset the impact on the economy of the cyclical behaviour of domestic investment decisions.
- Today the United Nations talks about national “**policy space**” for developing countries

Keynes had already warned about the *false illusion* of externally borrowed National Policy Space

- A single international monetary standard requires the Central Bank to relinquish control over domestic interest rates
- This implies a uniform rate of interest across countries.
- Any attempt to use interest rates to offset domestic fluctuations in investment would then create interest rate differentials and international capital flows that would eventually undermine the country's commitment to the international standard.
- To resolve this policy conflict Keynes suggests the ***control of net capital flows*** -- the foreign capital balance.

Long-term Capital Flow Controls

- Keynes recommends formal controls over long term capital flows.
- He notes that most countries have always had registration requirements for capital issues in their own markets and that these could be expanded internationally.
- He also suggests a tax on purchase of foreign securities not listed in the UK market of 10 per cent.

Short-term Capital Flow Controls

- To influence short-term flows
 - he recommends a dual rate structure that differentiates between financial flows and trade finance, given preference to the later.
 - He also recommends a more flexible exchange rate structure through variation in the rates at which the Central Bank's bid and offer rates within the gold points
 - He also recommends the active use of intervention in the forward market, a suggestion that was first made in the *Tract*, to set short-term interest rates on short term capital transactions.
- **Keynes concludes that Central Banks should use bank rate, the forward rate and flexibility in its bid and offer rates to influence short-term flows.**

The Ideal International Financial System

- However, he notes that an ideal system would have **flexible exchange rates**
- From the time of the *Tract on Monetary Reform* Keynes argued that a flexible exchange rate system was preferable to a fixed rate system as long as there was a **forward foreign exchange market** in which traders could cover their exchange risks.
- This is basically the same position that was incorporated in the proposal for the Clearing Union and the position that he took to the Bretton Woods Negotiations in 1944.

Implications of Keynes's Analysis for “National Policy Space”

- The most important point of Keynes's analysis of these issues for current conditions is his implicit acceptance of the position that dominated pre-war thinking on these issues –
External capital flows determine domestic conditions and trade flows, rather than the other way around

Again Keynes in the *Treatise*

- The belief in an extreme mobility of international lending and a policy of unmitigated laissez-faire towards foreign loans ... has been based, ... on too simple a view of the causal relations between foreign lending and foreign investment.
- Because ... *net* foreign lending and *net* foreign investment must always exactly balance, it is been assumed that no serious problem presents itself.
- Since lending and investment must be equal, an increase of lending must cause an increase of investment ... and a decrease of lending must cause a decrease of investment; ...
- Indeed, the argument sometimes goes further, and -- instead of being limited to *net* foreign lending -- even maintains that the making of an individual foreign loan has in itself the effect of increasing our exports.
- **All this, however, neglects the painful, and perhaps violent, reactions of the mechanism which has to be brought into play in order to force *net* foreign lending and *net* foreign investment into equality.**

More Keynes

- I do not know why this should not be considered obvious.
- If English investors, not liking the outlook at home, fearing labor disputes or nervous about a change of government, begin to buy more American securities than before, why should it be supposed that this will be naturally balanced by increased British exports? For, of course, it will not. It will, in the first instance, set up a serious instability of the domestic credit system -- the ultimate working out of which it is difficult or impossible to predict.
- Or, if American investors take a fancy to British ordinary shares, is this going, in any direct way, to decrease British exports?

Will Flexible Rates Produce Policy Space?

- Many countries introduced flexibility after crises
- Many use inflation targeting and primary fiscal surplus targets
- But – despite capital account surpluses:
 - Debt stocks remain high
 - Nominal deficits remain high
 - Interest rate differentials remain high
 - Growth rates remain low
- **Management of capital flows still required**

Conclusion

National Policy Space (Priority for mobilisation of domestic financial resources) Requires:

- Prudential management of capital flows:
 - To prevent overvaluation of Flexible Exchange rate
 - To allow management of interest rate independently of conditions in international capital markets
 - Maintaining Control over domestic financial markets
- Management of composition of trade flows
 - To Provide Sectoral Industrial Policy
- This requires:
 - Management over borrowing in Foreign Currency
 - Government Borrowing only in Domestic Currency
 - Monetary Sovereignty