Recent Instability in Financial Markets and the Implications for Developing Countries

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I. *A New Kind of Financial Crisis for the New Millennium?*

It is now accepted that globalisation has brought about increased economic dependence in the international economy. Part of this increased interdependence has been the result of the adoption by a number of countries of development policies based on opening their economies to direct participation in the global trading system and integrating their domestic financial systems into the international financial system.

An equally important part has been the increasing tendencies for the geographical diversification of different stages of production by transnational corporations. While companies that operated integrated production and sales facilities in a number of different national locations were initially identified as multinational or transnational, today hey increasingly operate from single national headquarters operating management and research activity that coordinates stages of the production and assembly of output in owned or outsourced geographically dispersed facilities.

It has been suggested that this increased interdependence has produced a change in the nature of international crises. Instead of external crises caused by unsustainable imbalances in the trade in goods and non-factor services account, crises are now characterised by rapid reversals in shirt-term capital flows on portfolio account. Balances of payments crises on current account have been replaced by capital account crises and the external constraint caused by excessive domestic absorption has been replaced by the foreign investment constraint caused by the inability to attract sufficient for capital to meet domestic savings gaps. No less an authority than the Chairman of the Board of Governors of the US Federal Reserve Bank, Alan Greenspan has declared the 1994 Mexican crisis heralded this shift and was identified as the first of the new breed of crises that would be typical of the new Millennium. The rapid succession of the Asian Financial Crises of 1997, the global credit crunch set off by the Russian crisis in the summer of 1998, the Brazilian exchange rate collapse of 1999, the collapse of the US stock market in 2000, and the Argentine crisis of 2001 indeed suggested that something fundamental had changed in the international financial system.

II. *Origins of Recent International Financial Instability*

However this was not a change that occurred sometime in the early 1990s, it was inherent in a structural design fault in the design of the post-war international financial and trading system. The

post-war financial system was developed on the idea that private capital flows had been the basic cause of the 1920s breakdown of international economic stability. The new system was thus to give such private flows an extremely limited role and be subject to active government policy control. In the words of US Treasury Secretary Morganthau capital flows should be: "instrumentalities of sovereign governments, and not of private financial interests" and the US government considered government direction of financial markets as necessary to the success of New Deal policies.[1]

The British government believed that it would be necessary to create an institution to replace the private market determination of capital flows and manage exchange rates. As Paul Einzig noted, the most innovative part of the British proposal drafted by Keynes was the possibility that private foreign exchange market trading could be replaced by an international clearing arrangement.[2] In the end, the US argued in favour of creating a stabilisation fund to manage private currency markets, but limited to commercial transactions, with another agency, the IBRD to manage capital flows through its participation in private capital markets. Thus the presumption that the post war system was one in which capital flows would be minimal or non-existent in fact turned out to be one in which capital flows remained an integral part, but the international institutions created to manage them did not have either the mandate or the resources to manage them as "instrumentalities of sovereign governments".

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[1]See Richard N. Gardner, *Sterling-Dollar Diplomacy in Current Perspective*, OUP, 1956, p. 76 of the new expanded edition, Mc-Graw Hill, 1969.

[2]"The principles embodied in the Keynes Plan indicate beyond doubt the system of the future, the adoption of which is a mere question of time. It is inconceivable that mankind should put up very much longer with the irrational system of uncontrolled transfers. International exchange clearing between Central Banks enjoying a monopoly of exchange dealing in their respective countries is the rational system and it is bound to come." *Currency After the War: The British and American Plans*, London: Nicholson& Watson, 1944, p. x.

This lack of resources and mandate became especially obvious in the late 1960s and early 1970s as the US ran ever larger external imbalances without any international mechanism to coordinate national economic policies in a way that would require symmetric policy action on surpluses and deficits, and in the international petroleum crisis in which governments actively encouraged private financial institutions to carry out the recycling of the growing petroleum producing countries surpluses through private lending when it was clearly impossible for the OPEC countries to increase their domestic absorption sufficiently. Thus, the creation of the Euro market and the rapidly increased lending to developing countries that were still employing policies based on development from within created the conditions which eventually caused those policies to be abandoned. Since these policies were based on the development of domestic industry, the increased short-term Euro dollar lending was largely employed in support of domestic industrialisation programmes (when it did not go for military or political purposes) that were only indirectly linked to increased export capacity and thus created little prospect for repayment. In the words of Walter Wriston, head of City Bank in this period, the lending was based on the idea that sovereign government did not go bankrupt – he was not referring to any lack of an international bankruptcy code, but on the presumption that government borrowers would always be able to refinance their outstanding indebtedness, either from private sources, or from multinational financial institutions. And this probably would have been the case had it not been for the rapid reversal in US interest rates and the value of the US dollar that took place after Paul Volcker's appointment as Chairman of the Board of Governors of the Federal Reserve and his decision to adopt an anti-inflation policy based on strict control of the money supply that resulted in sharply increased real interest rates that were more or less instantly reflected in the borrowing rates, and thus the debt service commitments, of the Latin American borrowers. Although the conditions that produced the 1982 Mexican debt default were systemic to a policy of financing import substitution policies with large external financial flows, it was initially considered to be an isolated event limited to Mexico's domestic development policy. However, difficulties soon spread to Argentina and then Brazil and the rest of the region not so much as a result of their inability to pay as the result – pace Walt Wriston– of the inability to roll over lending as US banks sharply reduced their regional exposure.

III. *The Shift in Development Policy*

Default brought in its wake large currency depreciations that reinforced the pressure on

domestic price levels and as output fell created conditions of hyperinflation in some countries as they sought to emerge from the rapidly accumulating debt burdens. Since debt repayment required earning sufficient foreign exchange, a policy that emphasised building up domestic production capacity and domestic consumption was clearly inappropriate. The result was the emergence of support for a "new policy response" which came in the form of what John Williamson would call the "Washington Consensus".

The new policies that were introduced were thus based on "structural adjustment" to restore balance in internal accounts in order to stop inflation and create external surpluses that would meet outstanding debt service commitments. The policies were more successful in the meeting the latter objective than the former, as Latin America accumulated failed price stabilisation plans and a succession of exotically named currencies that failed to halt the wave of inflation. For example, Brazil implemented nine stabilisation plans, fifteen wage policies, nineteen adjustment to the exchange rate regime and twenty fiscal adjustment programmes during the 1980s (Miranda, 1996). The net result, however, was to bring to an end the epoch of extremely rapid growth, as well as financial flows to the region, producing a period of stagflation and hyperinflation.

An important step towards successful price stabilisation policies in the region occurred when the Brady Plan shifted the focus of the resolution of the debt problem from creating large current account surpluses to policies that would allow Latin American countries to access the international capital markets in order to refinance their outstanding debt by shifting it to the private sector institutional lenders in the developed countries. Just as in the previous experiences of liberalisation policies in Latin America, the Washington Consensus was designed and implemented in order to create conditions to bolster the confidence of international lenders and allow countries to access international financial markets. Although Williamson has recently frequently reiterated that his approach did not rely on deregulation and liberalisation of domestic capital markets, it is clear that the Brady approach brought private capital flows not only back to the center of the international system, but were crucial to the end of the 1980s debt crisis. Thus countries were encouraged to introduce changes in their domestic economies that would make them more attractive as destinations for international portfolio and direct investment flows.

The primary objective remained the introduction of domestic stabilisation policies to eliminate inflation and to reduce demand sufficiently to generate external surpluses. The preferred

avenue was via the stabilisation of exchange rates and rapid return to full convertibility of currencies at a designated rate or range. Thus Mexico and Brazil introduced regimes with tight fluctuations bands and Argentina rigidly fixed the peso to the US dollar through the Convertibility Law. While all experienced initial periods of real exchange rate appreciations, both Mexico and Brazil experienced periods in which their exchange rates appreciated in nominal terms as well against the US dollar. Again, while Williamson has objected that his original version had exhorted stabilisation of a competitive real exchange rate, it is clear that none of these policies would have succeeded in producing disinflation had they not been based on a fixed nominal exchange rate anchor. These fixed exchange rate regimes were supported by policies to cut government expenditures and introduce primary government budget surpluses along with tight controls over expansion of the domestic money supply. To reinforce the price stabilisation policy, domestic markets were opened to create competition from foreign imports on domestic producers in order to encourage them to increase their competitiveness and also to make exporting a more attractive alternative.

Thus private capital flows, dominated by the interests private capital markets had thus returned to dominance of the international system – the crises that were produced were thus not something linked to a new system of international finance in the new Millennium, they were simply a return to the past history of financial crises caused by sharp reversal of flows such as had characterised Latin America in the 19th century.

IV. *New Financial Crisis but Old Policy?*

What was new, however, was the existence of the Bretton Woods multilateral financial institutions that had been created and developed policies on the presumption and in a period of limited international capital flows. Why is this important? First, consider the basic theory used by these institutions to analyse the post-war system. The extension of Keynes' income-expenditure theory to an open economy involved adding the impact of trade in goods and non-factor services to the creation of income by adjustment of the simple expression for the sources of aggregate demand to produce the simple relation Y = C+I+G+NX where Y is gross domestic product, and NX represented the balance on goods and non-factor services trade with NX determined by exports given by the real exchange rate and imports by the level of domestic expenditures. There was no formal role for capital flows in this model, and the impact of borrowing to finance an external deficit

on the payments balance itself was seldom recognised, even in the famous Fleming-Mundell version of the model in which appropriate levels of the domestic interest rate could attract foreign financial flows to fund a current account deficit and allow the government to finance its deficit spending to preserve full employment with a fixed exchange rate. Here, even though foreign capital inflows are explicitly acknowledged, the model is supposed to be sufficiently "short term" so that there is no recognition of the impact of the accumulation of debt over time and the increasing share of debt service in both government current expenditures or the factor services flows in the current account balance.

Thus, even in the presence of capital inflows, the theory did not reflect the impact on the fiscal and external accounts and thus on the structure of the economy itself. The approach used as the basis for balance of payments stabilisation policy in the Fund was based on Polak's extension of Keynes' theory to include policy to be introduced by the central bank in support of policy of the Treasury. It starts from the definition of the balance of payments, B, as the result of the difference between domestic income and domestic absorption: NX = Y - (C+I+G) or in Polak's terms B=y-A. In a fixed exchange rate system a negative value for B caused by an increase in A due to an increase in G not balanced by an increase in taxation must be financed by purchases of domestic currency with foreign exchange reserves so -B = -ΔR, where R represent the Bank's holding of foreign exchange reserves. If R changes then either its holdings of government debt, D must rise or High Powered Money – base money, H must decline. If the bank does not finance the increased expenditure by buying government debt, which is often represented as a decision not to "sterilise" the impact of the foreign balance on the economy through purchases of government debt then ΔD = 0 and

$-B = -\Delta H = -\Delta Ms < \Delta Md.$

If it is assumed that the demand for money is of the quantity theory form then Md = f(y) and there will thus be an excess demand for money. Equilibrium in the money market will then be subject to households ability to restore their desired real money balances. They can only do this by reducing their expenditures which will cause domestic expenditures to fall and A wi decrease until B = 0. Thus the adjustment in absorption will be given by

$\Delta A = f(Ms - Md)$ and in the external balance by

$\Delta B = f(\Delta y - \Delta A)$ and combining gives

$\Delta B = f[\Delta y - (Ms - Md)]$

With full adjustment the decline in private expenditure should just equal the increased government expenditure, representing full crowding out and no change in the overall level of income.

These relations were formalised by Polak in an attempt to frame an adjustment policy that would be introduced by countries seeking balance of payments adjustment lending from the IMF. The simple relation traced out says that if a country is facing an external imbalance and is drawing down its reserve tranche at the Fund to support the exchange rate, adjustment will require that $B > 0$. This can be achieved by ensuring that $Ms < Md$ which means that the central bank must produce $-\Delta H$. Since the central bank cannot affect R directly, this means that the only variable it can use is to reduce its financing of government expenditure and selling government debt $\Delta D < 0$ reducing prices and increasing the price of government debt. Cutting back on government spending or reducing the central bank financing of government expenditure through increasing interest rates will thus bring about a fall in A and a rise in R, bringing an improvement in the balance of payments and stabilisation of the exchange rate.

For present purposes it is not important whether or not the level of income is affected or not, the basic point is that in Polak's extension of traditional Keynesian theory endorsed by the IMF the via maestra for restoring external balance is through changes in expenditure. While interest rates do appear in the Polak version or in the more sophisticated Fleming-Mundell version of Keynes simple income-expenditure approach, the reduction in domestic expenditure is supported by an increase in interest rates. They ignore the impact of sustained capital flows on stocks of external debt and thus on debt service. But it is only in the absence of external borrowing to finance balance of payments disequilibrium that the current account may be represented by the balance on commercial goods and services trade. However, in the presence of external financing, the current account will include factor services, among them the servicing for foreign debt. The same is true of the government's budget.

V. *The Implications of Failing to Recognise the Impact of Capital Flows: Debt Service*

Is this important? Let us take an extreme example and suppose there is no trade in either goods or services and there is no labour mobility, but there are extensive capital flows. Then the current account of the balance of payments would be completely determined by the factor services balance – the earnings of foreign investments. In the case of a negative current account balance

calculated to include the factor earnings balance, the structural adjustment models referred to above would still record an external deficit -B, and the IMF would recommend a stabilisation policy to reduce A by reducing government expenditure and the money supply, which would be reinforced by an increase in the rate of interest. However, under these assumptions decreased domestic expenditure would have little or no impact on the size of the external imbalance. If the foreign borrowing generating the outflows on factor service account is of very short term and in foreign currency, the payments balance might actually deteriorate for interest payments would rise. If the country is meeting conditionality targets based on fiscal or external deficits this would require further domestic adjustment and further declines in the level of domestic expenditure and income. The very simple point is that the factor services balance reflecting the value of the debt service on foreign borrowing is not influenced by changes in domestic expenditure, but may be directly and rapidly influenced by changes in interest rates.

The basic difference in financial crises is thus due to the structural impact caused by the resumption of private capital markets determining international capital flows and the impact on fiscal and external balances caused by the impact of large debt stocks on factor service payments and on governments' current expenditures on debt service. For example, as a result of the resumption of external debt accumulation that was inherent in the success of the Brady Plan, a structural shift in the composition of government expenditures on current account occurred with declining expenditures on goods and labour services to bring about the required reductions in G often more than offset by increased interest service on outstanding debt due to the increased indebtedness and the higher real interest rates. This negative impact on the government finances is reinforced by the negative carry on the increased reserves due to the difference between the domestic interest rate paid on the bonds issued to sterilise the capital inflows, and the developed country short-term rate earned on the deposit of the reserves in NY.

A similar shift occurred in the composition of the current account from goods and services to factor services representing increasing debt service. These shifts in the structure of internal and external account balances brought about an important change in the way these economies responded to traditional policy measures. By cutting government expenditures traditional balance of payments adjustment policies aimed to create a fiscal surplus that would be translated into a balance of payments surplus as incomes declined and imports fell while excess productive capacity was

directed to increasing exports. But, when fiscal expenditures and external claims are dominated by interest payments, these traditional IMF adjustment policies designed to influence income levels have little impact on the net balances. If they create increased international risk perceptions due to the falling growth and profit rates, they may cause risk premia to rise, and the result may be that increased interest costs more than offset any improvement in spending, leading to a deterioration in the accounts.

The first signs that these traditional structural adjustment polices, while efficient in fighting inflation could not produce any sustained return to capital accumulation and growth that had characterised the early period of domestic capacity building through development from within were evident in Tequila crisis. At the same time, debt burdens similar to those of the earlier crisis had returned, although the type of debt was different, and current accounts continued to deteriorate and provide a constraint on growth. The underlying logic of the Washington Consensus, that import substitution growth strategies could be replaced by eliminating inflation distortions and restoring the profitability of investment so that resources were more efficiently allocated, and by foreign direct investment creating a competitive export platform to eliminate the external constraint, proved to be mistaken.

VI. *Summary of the Structural Impact of the Return of Private Financial Flows*

Four areas can be identified in which the structural adjustment policies recommended by the IMF to bring about financial stability have in fact operated to do the opposite in an international economy dominated by private markets determination of international financial flows. The first is the overvaluation of the exchange rate; the second is the high level of real interest rates, the third is the composition of the fiscal accounts, and the fourth the composition of the external accounts.

Success in fighting inflation on the basis of a stable nominal exchange rate anchor produces real exchange rate appreciation and reduces the incentive to sell goods abroad. In Latin America, real exchange rate appreciations resulted not only from stickiness in the prices of non-traded goods and wages, but also from nominal appreciations where the currency was left free within fluctuation bands (e.g. in Mexico and Brazil). Combined with the opening of domestic markets to foreign trade, this makes it more difficult for domestic industry to respond to the new price and productivity structure imposed by international markets. While overvaluation of the exchange rate is beneficial in reducing the price level of imported goods, it also allows foreign importers to gain competitive

advantage relative to domestic producers if the latter cannot adjust local cost and production structures rapidly. As a result, while the use of an exchange rate anchor can provide useful support in the initial stages of a price stabilisation policy it may eventually undermine the restructuring of the productive sector if real appreciation is allowed to persist.

In Latin America, as in most other emerging markets using exchange-rate based stabilization programs, currency appreciations have been eventually corrected through reversal of capital flows. Often, there is an overshooting of the currency in the opposite direction. While this restores the competitiveness of the domestic industry, it is associated with a disruption of economic activity and particularly in the import and credit systems which delay export response to currency changes. More importantly, such gyrations in the real exchange restrict the ability of industry to take a long view and impair investment in machinery and equipment needed to restructure the industry and improve productivity and competitiveness. Indeed, one of the significant features of the East Asian NIEs during their rapid pace of industrialization was highly stable real exchange rates, until they were destabilized around mid-1990s by unsustainable capital flows, resulting in a deep financial and economic crisis.

The tight monetary policies considered an integral part of the macroeconomic discipline necessary to bring inflation under control generally produce high nominal interest rates that, in conditions of rapidly falling inflation rates, translate into extremely high real interest rates. The high nominal and real rates are also used as the means to attract foreign capital necessary to refinance outstanding debt and to provide finance for investment and the modernisation of domestic industry. As a consequence, however, domestic industry faces excessively high interest rates to finance restructuring, while banks which, during hyperinflation, had ceased to provide adequate credit to the private sector, find it more attractive to increase holdings of high-yielding government securities, often financed by borrowing externally at lower interest rates, or offer credit to consumers, taking advantage of the deregulation of financial markets. Business firms, facing a lack of domestic credit and extremely high domestic interest rates, are also attracted to borrowing abroad at much lower rates of interest, taking on increased foreign exchange exposure that is usually not hedged because of the confidence in exchange rate stability created by the sharp reduction in inflation and the large foreign capital inflows. The result is that domestic banks concentrate on financing government deficits and provide virtually no lending to private business, while the latter finances production and

investment either from own funds or by borrowing abroad, with consequent increases in financial fragility

One of the basic reasons for implementing anti-inflation policies linked to exchange rate stability is the belief that these policies would bring about declines in interest rates and financing costs, thus providing support for investment. This is because high interest rates are believed to be caused by a large inflation premium and the high risks of currency depreciation. On this view, lower inflation and greater exchange rate stability policy should bring a reduction in nominal interest rates and boost domestic investment without any negative impact on external capital inflows. Indeed in Argentina as a result of the elimination of inflation by pegging the peso to the dollar under the Convertibility Law it was expected that domestic interest rates would converge towards those prevailing in the United States. However, the need to attract international capital and induce residents to maintain local currency deposits, as well as relatively high credit risks of Latin American financial institutions, offset much of the benefits of lower inflation and exchange rate stability. Further, the deregulation of financial markets increased the costs of financial transactions in domestic credit markets disproportionately for small and intermediate businesses who did not benefit from the preferential access accorded to large businesses in international capital markets. The differential in interest rates and disparate financial costs contributed to the consolidation and concentration of private national economic groups in many countries in the region. The persistence of large interest rate differentials also generated inflows based on interest rate arbitrage similar to those that had been prevalent in Asia in the runup to the financial crisis of 1997.

In the period immediately after implementation of Brady Plans when the stabilisation policies were introduced most countries had relatively low external indebtedness as the result of positive commercial account balances generated during the debt crisis, cut-back of international bank lending, and debt reduction. However, after the success of stabilisation policies in fighting inflation, the rising demand and growth caused external balances to turn negative, and debt once again started to increase along with the policies to attract increased capital inflows. As a result, a shift occurred in the composition of the current account as the share of factor services increased relative to goods and services trade. This shift was further enhanced by that fact that with increasing global financial integration an increasing share of domestic government debt was held either directly or indirectly by non-residents who thus received higher domestic interest rates. In addition, the sharp

increase in the FDI and portfolio flows increased non-resident claims on current account in the form of profit and dividend remittances to foreign investors. Thus, factor services became an increasingly important component of the current account balance for countries engaged in successful disinflation by relying on capital inflows.

Similarly, the resumption of external debt accumulation in the 1990s that was inherent in the success of the Brady Plan as well as the stabilization programs, and the failure of interest rates to fall increased the interest component of current government expenditures as governments had to refinance and issue new debt at higher interest rates. Indeed, the restrictive fiscal policy often only served to depress domestic activity and tax yields, thus increasing the size of the deficits to be financed, while it did little to reduce government borrowing costs that were set by international financial markets and by international risk premia. This negative impact on the government finances was reinforced by the negative carry on the increased reserves due to the difference between the domestic interest rate paid on the bonds issued to sterilize the capital inflows, and the short-term interest rates earned on the deposit of the reserves in New York.[3] Further, the fact that real interest rates remained high, while domestic growth rates, after initially increasing, eventually stagnated, made it very difficult if not impossible to reduce the debt burden irrespective of the restrictiveness of the government's financial policy and despite large primary surpluses.

The new policy orientation based on the Washington Consensus, particularly in countries applying exchange-rate-based stabilization programs under free capital mobility, has resulted in fundamental changes in the way that the economies responded to payments or fiscal imbalances as well as in the scope and effect of macroeconomic policies. However, the expectation that the new policy regime would provide almost automatic adjustment to payments or fiscal imbalances without much sacrifice from growth proved to be unfounded.

For example, in Argentina policy makers ignored the rapid increase in the external deficit in the course of stabilisation on grounds that thanks to the Convertibility Law which made it impossible for the central bank to exercise policy autonomy, an autonomous adjustment mechanism similar to that presumed to have existed under the gold standard would operate. An external deficit would result in the erosion of foreign exchange reserves and thus a decline in the domestic money supply.

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[3] See *UNCTAD, Trade and Development Report 1999*, p. 124)

These, in turn, would cause domestic wages and prices to fall, thereby restoring external competitiveness despite the fixed nominal exchange rate, increasing exports and reducing imports until external balance was achieved. However, this automatic adjustment process can be severe in terms of output and employment if wages and the prices of non-tradeables are sticky downwards. In such cases considerable deflation would be needed to achieve an adjustment in the real exchange rate and external balances. This was indeed the case in Argentina when unemployment rates reaching 20 per cent in the aftermath of the Mexican crisis of 1994-1995 were not sufficient to restore external balances.

Furthermore, such a process of adjustment could be disrupted by excessive capital flows. When private capital inflows exceed the level needed to offset the current account deficit, as was initially the case in most countries in the region using exchange-rate based stabilization programs, external deficits fail to reduce growth of money supply and to bring about an orderly adjustment in the real exchange rate even when wages are fully flexible. Conversely, when mounting deficits eventually result in a sharp reversal of private capital flows, reserves would decline much more than the amount of the current account deficit, leading to a deflationary overkill. In other words, while a currency board regime "ties the hands" of central bankers by removing their control over money creation and thus the risk of political influence in favour of inflation, with open capital markets it simply places monetary policy in the hands of international investors whose only objective is to maximize the return on their international investments.

There was an equivalent argument for the automatic adjustment of the fiscal balance since the central bank cannot monetize government debt unless it also acquires foreign exchange. Thus, when fiscal receipts fail to cover public expenditures, the government must either increase taxation or reduce expenditures or to raise borrowing from the private sector. Any of these responses should have the same general effect of reducing domestic demand and exercising downward pressure on wages and prices, causing imports to fall, exports to rise and external demand to expand sufficiently to offset the fall in internal demand. However, this adjustment mechanism can also become inoperative because of capital inflows. Indeed, this was the case in Argentina: for the first half of the decade revenues from the sale of state-owned property, and in the second half the creation of a captive domestic market for government debt through a reform of the pension system and banking laws meant that the government did not face a binding constraint on its ability to borrow- a process

which delayed adjustment and eventually resulted in an unsustainable debt burden .

This means that financial markets cannot be relied to bring about orderly adjustment in fiscal and current account imbalances. As long as private lenders are willing to finance deficits, the automatic adjustment mechanisms may not function as expected. Private capital flows tend to offset and postpone market-based adjustment to external and internal imbalances; when such flows are suddenly reversed as a result of mounting imbalances, the adjustment occurs in the form of a deep and costly financial crisis.

The change in the composition of the budget and external accounts resulting from the build-up of external and internal debt also affect the way economies respond to traditional macroeconomic policy measures for payments adjustment. By cutting government expenditures Keynesian policies aim to create a fiscal surplus that is reflected in an improvement in the balance of payments as declining domestic demand reduce imports and the resulting excess productive capacity is directed to exports. But, when fiscal expenditures are increasingly dominated by interest payments on outstanding debt, and current payments abroad have an increasing factor services component in the form of interest payments, dividends and profit remittances, the impact of fiscal retrenchment on budget and current-account balances will be greatly reduced. Alternatively, the amount of deflation needed to attain any given improvement in the budget and external accounts will be higher, the greater the share of factor service payments in the budget and the external account. The basic difficulty is that while government expenditure policy may influence imports and exports of goods and services, the debt service component of fiscal expenditures and the factor service component of external expenditure are determined by other factors such as international interest rates, the maturity structure of the debt and repatriation patterns over which governments have little direct control. For instance, if restrictive demand policies increase the international risk premia because investors view falling growth as increasing the likelihood of an exchange rate adjustment or of a reversal of stabilisation policy, the resulting increase in interest costs may more than offset the impact of any improvement in domestic absorption on the current account.

VII. *Are FDI Flows the Answer to Private Financial Flow Instability?*

In response to the failure of these new development policies to create financial stability by creating the exports necessary to meet debt service payments, increasing attention has been paid to changing the nature of capital flows to increase foreign direct investment which is supposed to

increase stability by providing the technology capable of generating large increases in value added from exports. However, the majority of foreign direct investment has been in the service sector, which has little impact on exports. In some cases, such as Brazil and Argentina, transnational companies have had a negative impact on the commercial and current account balance, as well as increasing foreign currency indebtedness. In Brazil, a sample of large foreign companies shows a marked shift away from net exports of high technology goods in 1989 before the introduction of the Real plan with a sharp increase in imported technology goods by 1997.[4] This would not have created a problem if the increased imports had been linked to an increase in exports by these companies, but in fact the eighty-five foreign companies in the sample move from an overall export surplus in 1989 to an overall deficit in 1997, increasing their imports at more than double the rate of increase of exports (23 percent versus 8.8 per cent).[5] The study thus concludes that in Brazil the process of globalisation has been asymmetric, and primarily with the inclusion of Brazil in the integrated global market of transnational companies as far as imports are concerned, but not for exports. [6] While national firms have increased exports in high technology goods, the net surplus on primary commodities trade is still twice that in technology goods. Similar results have been reported for Argentina where an analysis of the external accounts of the 1000 largest firms for the year 1997,

[4] The data represent a sample of 185 large firms, 80 with national ownership and 85 with foreign ownership, operating in Brazil from 1989 to 2000. See, Instituto de Estudios para Desenvolvimento Industrial (IEDI), Grandes Empresas Industriais Nacionais e Estrangeiras: Participação no Comércio Exterior Brasileiro, November 2002.

[5] The study also notes that national and foreign owned firms reacted differently to the exchange rate adjustment that occurred in 1999 with domestic firms sharply increasing the share of exports in their total sales from 12 per cent to 20 per cent, and the share of high technology goods, while foreign firms decreased exports, basically because their exports were to regional markets where demand was in sharp decline, and increased their exports to NAFTA and the EU. The improvement in their net balance was due to an even sharper fall off in imports.

[6] The problem is not a new one. Brazilian President Getulio Vargas complained in a speech at the end of 1951 that Brazil had been experiencing negative net liquid financial outflows almost continuously from 1939: see Aristoteles Moura, *Capitais estrangeiros no Brasil*, Editura Brasiliense, Sao Paulo, 1959, pp. 26-7. According to CEPAL, *Análisis y proyecciones del desarrollo económico, El desarrollo económico de la Argentina*, México, 1959, pág. 29, Argentina also experienced net outflows in the period 1900-1944 of some $46 billion.

one in which the economy was still experiencing high growth rates, concludes that the deficits on their external operations caused the Argentine commercial deficit to double.[7]

[7] "Of the total commercial deficit of $US 2.216 billion for 1997 transnational firms operating outside the natural resources and extractive sectors accumulated a deficit of nearly $US5 billion, while national firms in the same sectors registered a surplus of nearly $US 1 billion (estimates from a panel study of the 1000 largest firms). ... In sum, for 1997, which is representative of the expansionary phases of the economy in the 1990s, the operations of foreign firms doubled the total commercial deficit of the country as a whole." Matías Kulfas, Fernando Porta, Adrián Ramos, *Inversión extranjera y empresas transnacionales en la economía argentina*, Oficina de la CEPAL en Buenos Aires, Serie estudios y perspectivas No. 10, Buenos Aires, setiembre de 2002, p. 88. D. Chudnovsky and A. López ("Estrategias de las empresas transnacionales en la Argentina de los años 1990," *Revista de la CEPAL*, No. 76, abril 2002, p.161) also note that foreign firms have an import coefficient that is roughly twice that of domestic firms, where there is no statistical difference between their export coefficients.

Not only have foreign firms had a detrimental impact on external accounts, and thus on the increase in debt required to finance deficits, their financial policies have caused external indebtedness to increase because foreign firms have financed a large proportion of their investment by borrowing from parent companies or from engaging in foreign currency borrowing. In Brazil statistics on total indebtedness show that the expansion of foreign firms operating in Brazil has been predominantly by means of increased indebtedness rather than increased equity. In 2000, for every $1.00 of equity, firms with foreign participation held $1.98 of debt, of which $0.82 was external debt and $1.16 was internal debt; for each $1.00 of foreign direct investment firms with foreign participation held $2.49 of debt of which $1.03 was external debt and $1.46 was internal debt. [8] The same pattern can be discerned in Argentina where "A significant part of the foreign direct investments by foreign interests in Argentina were financed by borrowing abroad, basically by means of the sale of negotiable paper and other financial instruments in international capital markets. Between 1992 and 1998 the non-financial private sector borrowed more than $ 35 billion, corresponding to nearly three quarters of the borrowing by foreign investors."[9] A study undertaken by the U.S. Tariff Commission in the 1970s covering 70 percent of U.S. manufacturing investments abroad concluded that multinational corporations "in dealings with their parent company, exert a large and growing negative or adverse influence on host country balance of payments."[10]

[8] IEDI, *O Investimento Estrangeiro na Economia Brasileira e o Investimento de Empresas Brasileiras no Exterior*, Sao Paulo, Fevereiro, 2003, p. 22.

[9] IEDI, 2003, , p. 19.

[10] Quoted in Karin Lissakers *(Banks, Borrowers, and the Establishment*, New York, Basic Books, 1991) p. 58.

Mexico and a number of central American countries have followed a slightly different path with foreign direct investment being invested in enterprises specialising in the assembly of semi-finished goods for re-export.[11] As a result, FDI in the manufacturing sector rose nearly 50 percent of the total in 1981-1993 to over 60 percent in 1994-2000, mainly due to increased investment in maquiladora activities as gross fixed investment in maquiladoras grew at an average of around 30 percent a year. This sector is the only one to have experienced persistently high growth in the period since the new policy reforms were introduced. However, the basis of this industry in the processing of imports means that it has an extremely small impact on net exports and produces value added only to the extent of the extremely low wage unskilled labour required for assembly. Although Mexico has been extremely successful in increasing its share of world manufacturing exports, it has not been able to increase its share of global value added from manufacturing[12]. This suggests that FDI provides employment, but does little to further the transfer of technology or to change the production structure of the economy.

VIII. *Can Development be Based on External Financial Flows Without Producing Financial Crisis?*

[11] The first free trade zones in Mexico along the border with the United States date from the 1930s. The current maquiladora program was initiated in the Border Industrialisation program created in 1965 to provide employment for Mexican workers returning to the country as a result of the end in 1964 of the "bracero" program instituted to supplement the United States labour force during the war, which allowed legal employment of Mexican workers in the United States. Their growth was stimulated by the signing of the NAFTA treaty.

[12] **See, UNCTAD, *Trade and Development Report*, 2002, Part II, chapter III.**

As noted above, John Williamson has repeated stressed that his original specification of the Washington Consensus did not contain a recommendation on private capital market liberalisation. Nonetheless, it is clear that the new development strategies from Brady on have been based on the idea that the optimal development strategy is based on creating an appropriate environment for attracting foreign investment in both the real and the financial sectors and that this will be sufficient both to offset the domestic savings gap and the technology gap. The previous section suggests that even foreign direct investment may not offset the technology gap through transfer of technology to domestic producers. However, there is an even more important difficulty. The idea that foreign capital can provide the financing for the import of external capital goods and other strategic imports required to build a competitive export structure is constrained by an important limitation that is also linked to the fact that external borrowing creates a capital inflow, but also produces rising factor service payments that produce a deterioration on current account. Thus, an increasing proportion of capital inflows may go to debt servicing. In the limit, a country may find itself in a position of having to borrow abroad just to meet its debt service. In this case, foreign borrowing provides little contribution to domestic investment or competitiveness and amounts to little more than what Minsky called Ponzi financing.[13] The limiting condition is quite easy to see. The rate of interest on the foreign borrowing has to be lower than the rate of increase of foreign borrowing otherwise debt servicing outflows will become an increasing share of the current account deficit and a surplus on goods and non-factor services trade will be required to offset it. But this would undermine the role of foreign borrowing in allowing developing countries to net import investment goods.[14] There are

[13] See, Kregel, "Can We Create A Stable International Financial Environment that Insures Net Resource Transfers to Developing Countries?", forthcoming, JPKE.

[14] The applicable formula comes from Domar ("The Effect of Foreign Investment on the Balance of Payments", *American Economic Review*, December, pp. 805-26, 1950), which was part of the post-war debate on dollar scarcity. It is interesting that it deals with the possibility that the rate of growth of US foreign investment outflows would be too low to sustain full employment through export led growth since an interest rate greater than the growth rate of outflows would cause inflows on interest and amortisation to exceed outflows. The problems that might face developing countries on the receiving end in the form of negative net resource transfers was not yet of concern to economists. Vargas, cited above, saw the problem from the side of the recipient country and drew attention to the potential pressure that foreign direct investment profit remittances placed on the stability of the balance of payments. In actual fact,

virtually no countries in which this condition is met, which suggests that it would be inappropriate to base a development strategy on foreign capital flows, and that any attempt to do so would be self-defeating.

The conclusion is that financial crises in the recent have past been the result of the acceptance of the return of private market flows to dominance in the international financial system and the increasing emphasis on foreign capital as the basis for economic development finance which together with policies to produce sound economic policies on the basis of traditional adjustment policies of reducing government expenditure and high real interest rates produce structural changes in fiscal and external accounts which produce conditions in which external capital flows are incapable to supporting a viable economic development policy. Thus, the recent collapse of US financial markets, which provided the basis for most of the financing of FDI flows to developing countries can be looked upon as a positive factor, first because it produced a sharp reduction in such flows, second because it produce a sharp reduction in international interest rates, and third because it reduced the pressures for instituting an multinational investment agreement which would sharply reduced the ability of developing countries to control the size and costs of their capital inflows.

US investments in Latin America were averaging ratios of earnings to equity investment of around 20 per cent in the early 1950s. Thus, despite the countercurrent of rising US direct investment in the region, Latin America continued the experience of negative net financial flows through the 1950s.