Escola de Economia de São Paulo

Recovering the Traditional Model of Financing Economic Development:

Savings Gaps, External Finance and Debt Crises

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Alternative Approaches to Explaining Economic Activity

- Economics of Scarcity
  - Supply Constrained Economies
  - Limited by Available Resources
- Economics of Poverty in the Midst of Plenty
  - Demand Constrained Economies
  - Limited by Ability to fully utilise resources

Economics of Scarcity

- Economics of Choice
  - Limited Resources-Unlimited Wants
  - Maximisation of utility subject to externally given income constraint
- Robbins Definition of Economics
  - “Economics is the science which studies human behavior as a relationship between given ends and scarce means which have alternative uses”
  - Austrian theory of costs
    - alternative uses-opportunity costs
    - knowledge of alternative uses?
      - entrepreneurs have to discovery them
        - » innovation drives economic change
      - entrepreneurs have to compete for the resources
    - Schumpeter: The Banks Intermediate this process
      - Innovation interrupts Walrasian equilibrium
      - Catching up economies imitate before they innovate

Economics of Poverty:

in the Midst of Plenty

- Economics of Effective Demand
  - Economy is Demand Constrained
- RF Kahn: Always ask: are you at Y_{full}?
- Domar: Raising investment to reach full employment will create more productive capacity and supply
  - Economy faces endemic excess supply
  - Growth requires continual increase in demand
- Harrod: warranted growth rate

Keynes and Effective Demand

- Royal Committee on Finance and Industry -- Macmillan Committee
- Keynes contests Treasury View:
  - Private demand is exogenous, efficient
  - Public Investment competes with private
  - Public Investment is wasteful
    - if it were profitable private sector would do it
- Keynes: Bank rate sets hurdle rate
  - Does any private invest earn bank rate?
  - Bank rate insures gold from flowing out

Demand determines Scarcity

- Scarcity (in a monetary economy) imposed by
  - Bank rate in fixed exchange rate
  - Liquidity Preference in floating rate
- Investors prefer to hold financial assets
  - Demand for money does not increase output or employment
- Poverty in the Midst of Plentiful (resources)
- Reaction to First World War stock market fall
  - No change in real productivity of capital but collapse in equity value of capital

Trade and the External Constraints

- James Meade: Gains from Trade
  - Drafted UK proposal Commercial Union
  - For Havana Conference on Trade and Employment -- 3rd Pillar of Bretton Woods
- Gains from Trade depend on full utilisation of resources: On PP curve
  - Inside Production Possibility Curve: free goods even if costs are higher than competitors!

Traditional Approach is Demand Constrained Approach

- Domestic demand required for domestic industrialisation
  - Declining terms of trade
- Mobilsation of Domestic Resources
- Sufficient demand growth and income level is required to prevent deindustrialisation
  - required to support transition from manufacturing to the services sector
  - UNCTAD: Trade and Development Report 2003

Post-War was a struggle between the two Approaches

- Demand Management; Fine Tuning
- Stagflation
- Monetarist counter-revolution
  - Keynes: demand for money approach implies full employment
- Rational Expectations
  - failure is statistically predictable
- Market Fundamentalism Equilibrium
- Washington Consensus: Demise of Development Economics
- Financial Instability

Pioneers of Development

- Rosenstein Rodan: Big Bang
- Ragnar Nurkse: Balanced Growth
- Gunnar Myrdal: Cumulative Causation, unbalance growth
- Raul Prebisch: Center Periphery- Decline in Terms of Trade
- Hans Singer: Decline in Terms of Trade
- Celso Furtado: External impluse, Center-Periphery
- Francois Perroux: Asymmetry, Economic Space, Growth Poles
- Albert Hirschman: Unbalanced Growth
- Nicholas Kaldor: Sectoral Balance, Cumulative Causation
- Marcelo Diamand: Bottlenecks, dual x-rates
- Lauchlin Currie: Plan of Four Strategies, focus on urban housing and export diversification
- Henry Wallich: Derived Development
- Michael Kalecki: medium balanced path

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
      - Income, not capital

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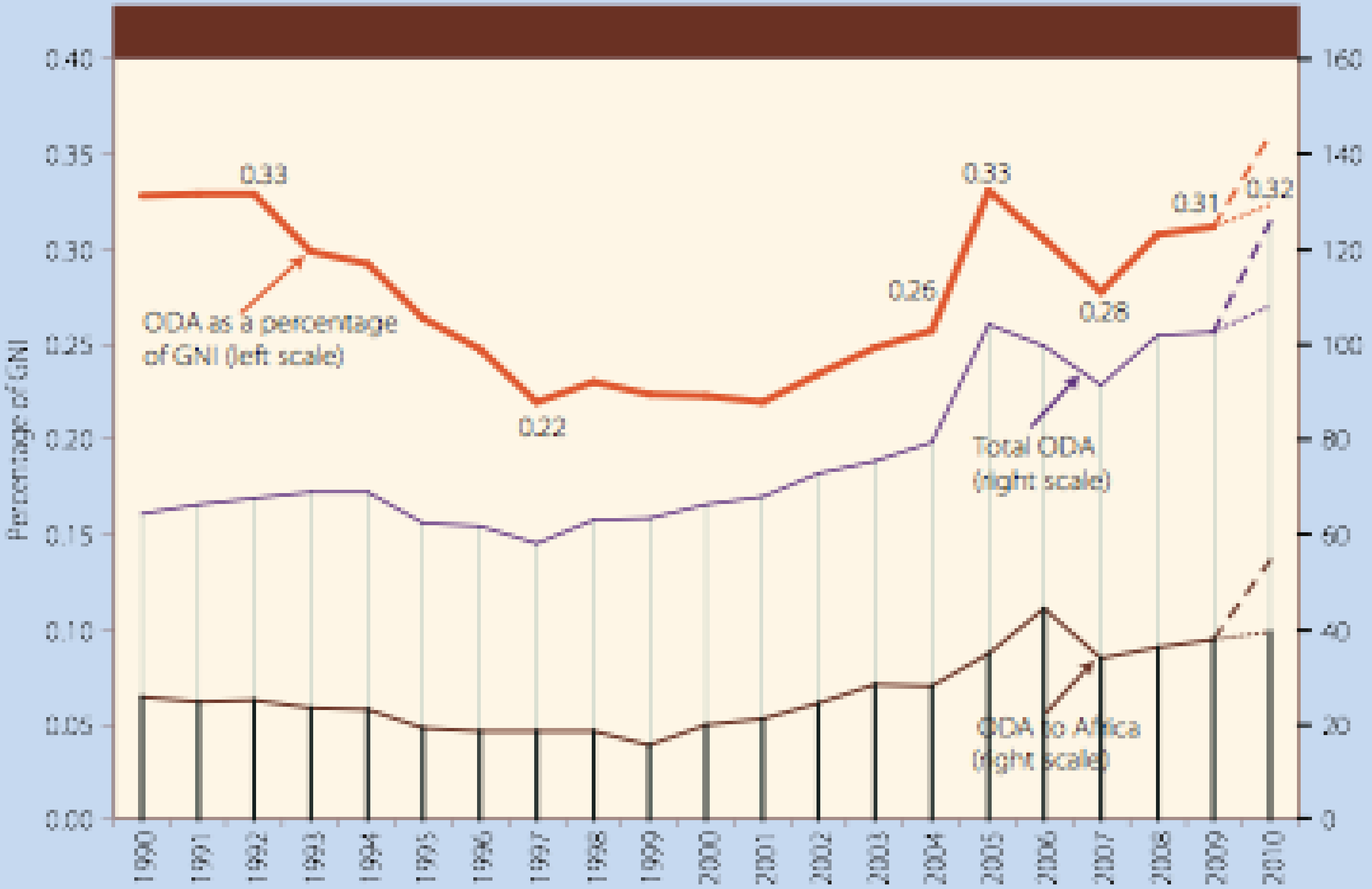
Figure III.2
Net ODA of DAC members, 1990-2009, and DAC secretariat simulations to 2010



7 United Nations, *MDG Gap Task Force Report 2010: The Global Partnership for Development at a Critical Juncture* (United Nations publication, Sales No. E.10.I.12).

Official development assistance in 2009 and 2010 in relation to commitments and targets

	Billions of 2004 dollars	Billions of 2009 dollars	Percentage of GNI
Total ODA			
Commitment for 2010	125.8	145.7	..
Delivery in 2009	103.3	119.6	..
Gap in 2009	22.5	26.1	..
Projected shortfall in 2010[a]	17.7	19.7	..
Overall United Nations target	..	272.2	0.7
Delivery in 2009	..	119.6	0.31
Gap in 2009	..	152.7	0.39
ODA to Africa			
Commitment for 2010	53.1	61.5	..
Delivery in 2009[b]	37.9	43.9	..
Gap in 2009[b]	15.2	17.6	..
Projected shortfall in 2010[b]	14.1	16.3	..
ODA to least developed countries			
Target	..	58.9-78.5	0.15-0.20
Delivery in 2008	..	36.0	0.09
Gap in 2008	..	22.9-42.5	0.06-0.11

Source: *United Nations, MDG Gap Task Force Report 2010: The Global Partnership for Development at a Critical Juncture*

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.

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Implicit Assumptions and Conclusions

- Assumptions (diminishing returns)
  - Capital Scarcity in Developing Countries so rate of return in higher
  - Capital Surplus in Developed Countries so rate of return in 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

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Cambridge Capital Theory Debates: There is No Theoretical Support for Assumption on Capital Flows

- 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

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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."

Table III.1

Net transfer of financial resources to developing economies and economies in transition, 1998-2010

Billions of dollars	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010[a]
Developing economies	**-41.0**	**-128.0**	**-194.0**	**-164.4**	**-210.2**	**-302.7**	**-379.5**	**-597.2**	**-807.8**	**-881.1**	**-876.4**	**-545.1**	**-557.0**
Africa	2.9	1.6	-31.7	-16.4	-4.2	-16.1	-34.5	-76.4	-108.3	-100.9	-99.1	2.9	-35.3
Sub-Saharan Africa (excluding Nigeria and South Africa)	11.5	7.9	2.3	6.4	4.4	5.3	3.5	-0.6	-10.5	-9.1	-4.8	27.3	14.6
East and South Asia	-129.8	-139.8	-122.8	-120.8	-149.2	-175.6	-183.4	-265.7	-385.7	-529.8	-481.3	-427.5	-352.9
Western Asia	34.5	2.7	-35.3	-29.7	-23.2	-46.7	-76.3	-143.7	-175.6	-144.0	-222.5	-48.4	-112.7
Latin America and the Caribbean	41.5	7.4	-4.2	2.5	-33.6	-64.3	-85.4	-111.4	-138.0	-106.4	-73.5	-72.1	-56.1
Economies in transition	**0.7**	**-25.1**	**-51.6**	**-32.9**	**-28.0**	**-38.0**	**-62.5**	**-96.0**	**-117.1**	**-95.9**	**-149.1**	**-81.1**	**-133.0**
Memorandum items:													
Heavily indebted poor countries (HIPCs)	8.8	9.5	7.9	8.3	8.9	8.8	10.7	13.4	11.2	19.0	31.0	29.6	31.0
Least developed countries[b]	12.5	10.2	5.0	8.2	5.9	7.5	5.0	1.3	-7.9	-5.2	-4.5	26.3	16.8

Source: UN/DESA, based on IMF, *World Economic Outlook Database*, October 2010; and IMF, Balance of Payments Statistics.

a Partly estimated.

b Cape Verde graduated in December 2007 and is not included in the calculations.

Table III.2

Net financial flows[a] to developing countries and economies in transition, 1997-2011

	Average annual flow						
	1997-2000	*2001-2006*	*2007*	*2008*	*2009*	*2010[b]*	*2011[c]*
Developing countries							
Net private capital flows	92.3	103.5	383.7	110.0	385.7	659.2	602.8
Net direct investment	146.4	161.9	311.8	341.6	193.3	247.5	270.9
Net portfolio investment[d]	31.1	-59.4	7.7	-135.5	77.7	93.4	79.9
Other net investment[e]	-85.3	1.0	64.1	-96.0	114.7	318.2	252.1
Net official flows	-0.4	-69.1	-140.7	-113.5	-26.8	-249.4	-217.7
Total net flows	91.9	34.4	243.0	-3.5	358.9	409.7	385.1
Change in reserves[f]	-76.7	-373.1	-1059.4	-787.8	-687.5	-654.2	-561.6
Africa							
Net private capital flows	7.8	13.3	31.5	26.0	38.8	53.8	57.4
Net direct investment	8.5	22.5	41.9	52.5	42.3	39.9	50.3
Net portfolio investment[d]	2.3	3.7	8.4	-31.1	-3.4	14.4	12.9
Other net investment[e]	-3.0	-12.8	-18.8	4.6	-0.1	-0.5	-5.7
Net official flows	0.9	-10.3	-6.7	-1.2	8.9	12.9	15.4
Total net flows	8.7	3.0	24.8	24.9	47.7	66.7	72.8
Change in reserves[f]	-8.0	-34.8	-86.9	-75.3	1.5	-25.3	-26.6
East and South Asia							
Net private capital flows	4.7	65.7	137.6	-23.6	267.2	426.4	377.7
Net direct investment	62.8	72.8	133.6	138.9	57.3	67.8	63.7
Net portfolio investment[d]	20.9	-34.9	2.2	-88.8	27.9	48.0	40.0
Other net investment[e]	-79.0	27.8	1.8	-73.7	182.0	310.6	273.9
Net official flows	-0.4	-16.3	-43.4	-17.5	-16.5	-259.9	-185.2
Total net flows	4.2	49.5	94.2	-41.1	250.7	166.5	192.5
Change in reserves[f]	-59.7	-269.2	-674.5	-529.0	-644.1	-497.1	-460.7
Western Asia							
Net private capital flows	15.9	-2.7	109.1	50.1	56.0	47.3	34.5
Net direct investment	6.6	18.2	49.5	57.8	31.2	61.8	60.8
Net portfolio investment[d]	-4.8	-20.7	-39.2	2.2	22.1	-17.0	-13.0
Other net investment[e]	14.1	-0.3	98.9	-9.8	2.7	2.5	-13.3
Net official flows	-7.7	-32.7	-84.8	-96.1	-64.1	-28.9	-54.3
Total net flows	8.2	-35.4	24.3	-46.0	-8.1	18.5	-19.9
Change in reserves[f]	-6.6	-46.4	-164.8	-133.2	6.4	-56.8	-45.8
Latin America and the Caribbean							
Net private capital flows	63.9	27.2	105.4	57.4	23.7	131.6	133.2
Net direct investment	68.5	48.4	86.8	92.4	62.6	78.1	96.0
Net portfolio investment[d]	12.7	-7.5	36.4	-17.9	31.1	48.0	40.0
Other net investment[e]	-17.3	-13.7	-17.8	-17.1	-69.9	5.6	-2.8
Net official flows	6.8	-9.7	-5.7	1.3	44.9	26.4	6.4

Modern Experience of Net Transfers of Reso

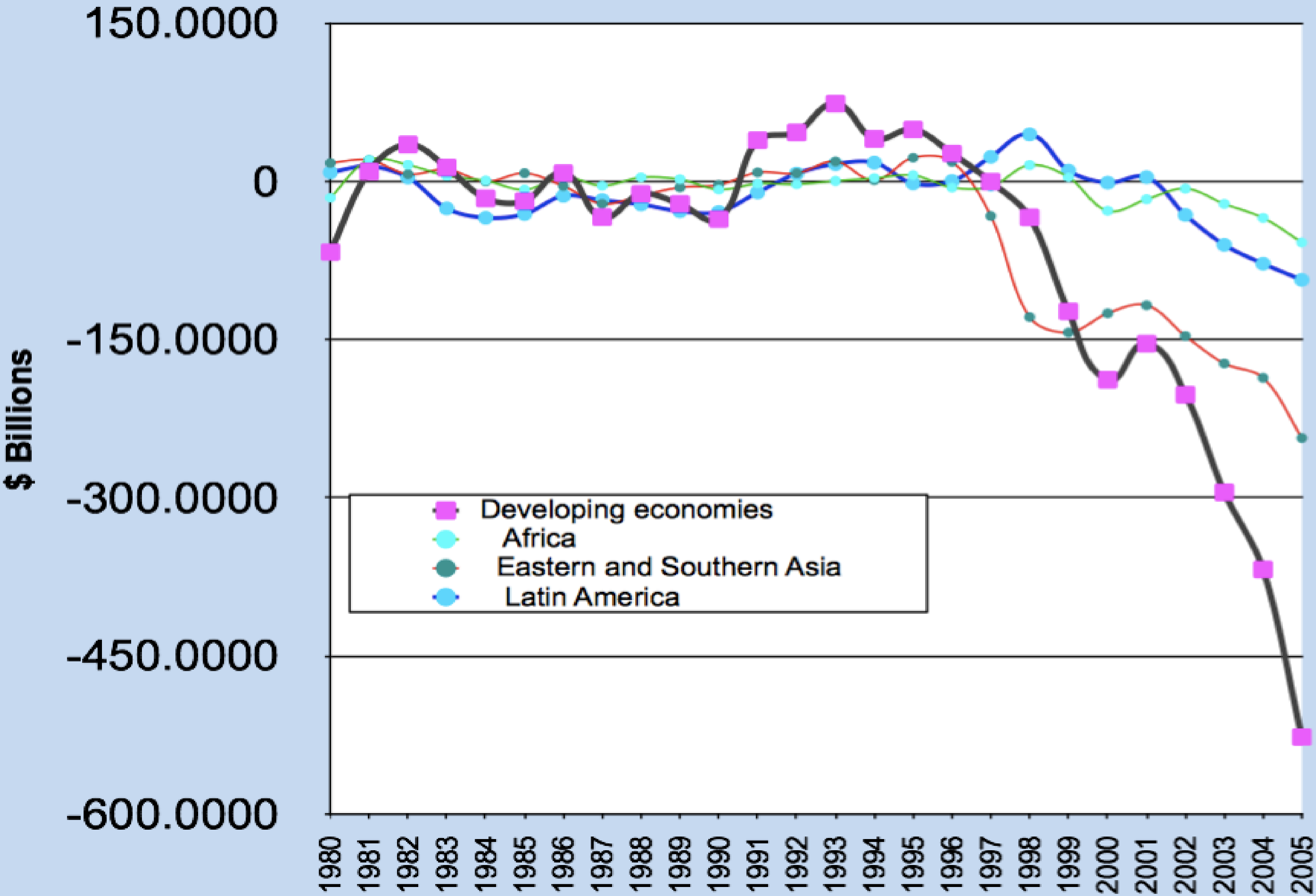


Figure III.1a
Net financial transfers to economies in transition and developing countries, 1998-2010

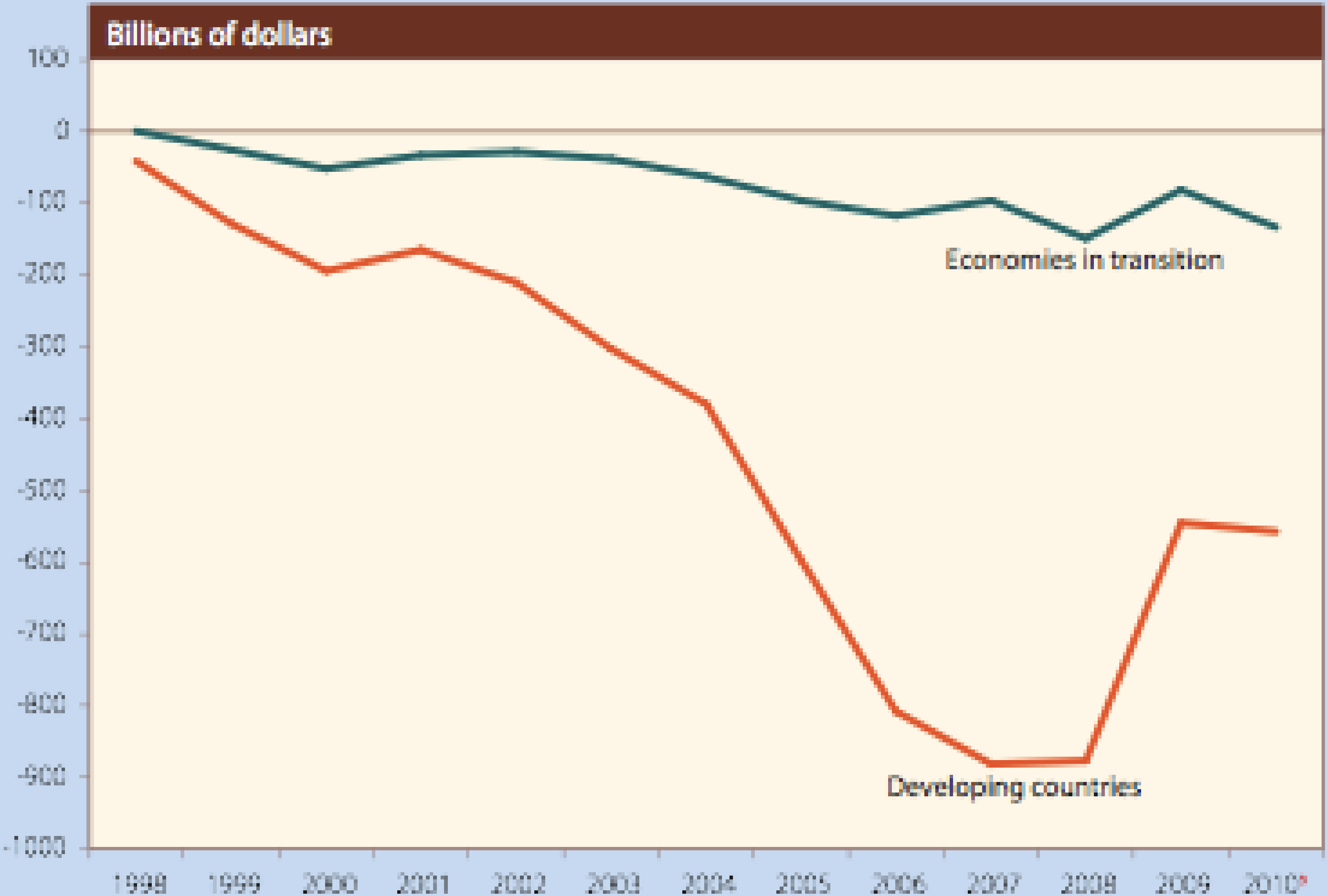
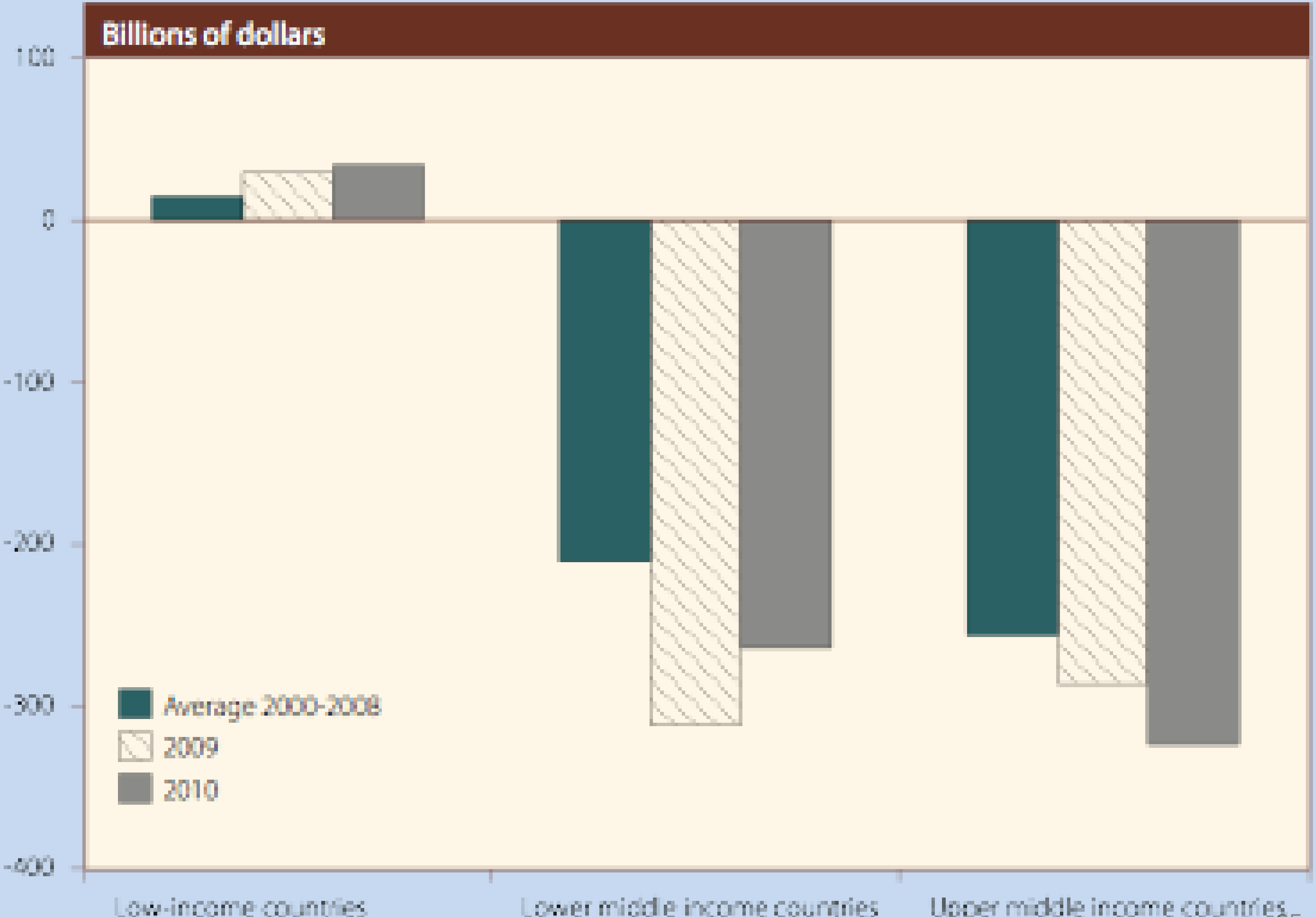


Figure III.1b
Net financial transfers, by income categories, 2000-2010



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- cf Nurkse
  - Global Financial Markets may thus may be acting efficiently by creating negative net resource flows
  - A Rediscovery of the position of the “Development Pioneers”
    - Demand determines profitability and growth
    - Cumulative causation
    - Increasing Returns to Manufacturing

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.

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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

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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 emploment 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
  - Privatise 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

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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 indefintely
- **Externally Financed Policy Space WAS An ILLUSION**

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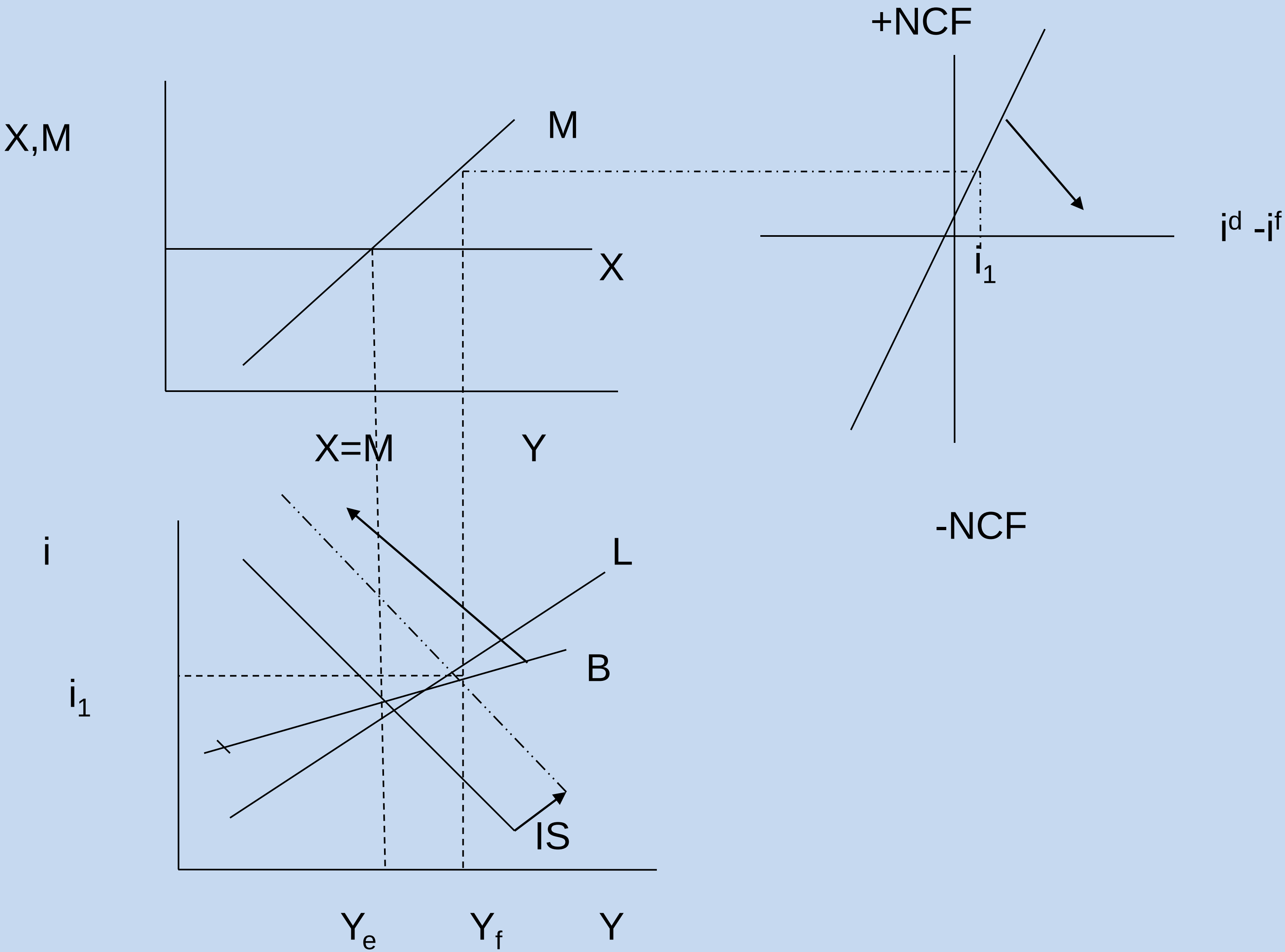

+NCF
X,M
M
$i^d - i^f$
X
i_1
X=M
Y
-NCF
i
L
B
i_1
IS
Y_e
Y_f
Y

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

No Fifth Development Decade: Millennium Declaration

- Reduced emphasis on resource transfers
- A “directed” aid strategy
- To meet “time-bound”, “measurable” Social Development Goals
- But, these Goals are really symptoms of underdevelopment
- Eliminating them still requires external resources:
  - $100 billion per year to 2015
- **What happens after 2015?**
  - UN has only now started to confront this issue

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2002 Financing for Development: Global Development Partnership

- Shift in Emphasis to **Domestic Resource Mobilisation**
  - Developing countries responsible for their own development
  - Primary source of development finance is Mobilising Domestic Resources
  - Developed countries pledge to provide additional resources required to support sound national development strategies

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2005 Summit Outcome Emphasised Domestic Mobilisation

Employment

47. We strongly support fair globalization and resolve to make the goals of full and productive employment and decent work for all, including for women and young people, a central objective of our relevant national and international policies as well as our national development strategies, including poverty reduction strategies, as part of our efforts to achieve the Millennium Development Goals.

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Employment joins MDGs

- High-level segment of the 2006 substantive session of the Economic and Social Council Ministerial Declaration reinforced the 2005 World Summit position
- Make full and productive employment and decent work for all, including for women and young people, a central objective of relevant national and international policies and national development strategies and to be part of efforts to achieve the internationally agreed development goals, including the Millennium Development Goals.

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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

Return to Traditional Approach of Development Pioneers

- **What are the available domestic resources?**
  - **Most developing countries have abundant natural resources**
  - **But all have unemployed, underemployed or underqualified domestic labour**
  - **Increasing employment presents the greatest unexploited potential for mobilising domestic resources**
- **Employment increases Income and thus Savings**
  - **Nurkse: "All Capital is Made at Home"**
  - **Built by Disguised Unemployed Labour**
  - **Requires policy to ensure income is saved and used to increase capital**

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

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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

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How does national wealth increase?

- Smith:
  - ➢ Growth of population employed
  - ➢ Growth of productivity
- Prebisch-Myrdal-Singer
  - ➢ Trend decline in terms of trade in primary commodities
  - ➢ Diversify production to include industry
- Knowledge Economy
  - ➢ You cannot buy productivity by buying capital goods
  - ➢ Technical knowledge is no longer embodies
- You have to produce your own technology
  - You cannot invest in it by buying shares in foreign companies
  - Financial terms of trade – real exchange rate appreciation

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."

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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

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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

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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**

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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

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