FINANCIAL GLOBALISATION AND CRISIS, INSTITUTIONAL TRANSFORMATION AND EQUITY

Centre for Business Research, University of Cambridge,
Working paper No. 405

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June 2010

This working paper forms part of the CBR Research Programme on Corporate Governance

Abstract

This paper comprises the long introduction to the symposium of five papers on financial globalisation published in the *Cambridge Journal of Economics*, volume 34, no 2. The paper discusses the impact of financial globalisation in a variety of spheres and shows how the five papers link together to provide a coherent view of the current economic and financial crisis. In this paper we also examine the globalisation of finance more broadly both in historical terms as well as in relation to the current widespread failure in the financial markets. We take up the policy question of how the interests of the poor in particular, and developing countries in general, could be safeguarded from the vagaries of financial globalisation, questioning how much choice communities and countries have and what can the international community do to extend these choices?

Keywords: Financial globalisation, crisis, institutional transformation and equity

JEL Codes: G15, G18, G20, G21

1. Introduction

The most profound transformation of policy strategies in recent decades has been the widespread movement toward financial and other forms of liberalization. This, along with the repeal of the US 1933 Glass-Steagall Act in 1999, which created the 'parallel' subprime mortgage market, engineered the August 2007 financial crisis. A crisis that was also promoted by the monetary policy pursued by most central banks around the globe with the single objective of price stability to be pursued by manipulating the rate of interest. A good deal of the literature has focused on issues surrounding the crises that have frequently ensued and the extent to which the efficiency of intermediation has been improved. Little analytical work has been on the issue of the relationship between financial development, institutional transformation and its effect on equity. The papers included in this special issue, analyze a variety of salient issues. And yet there is a common theme underlying the papers included in this special issue. This is that they explore at length financial globalisation and its impact in distinct areas. The first paper discusses the effects of financial globalisation, which are analysed with respect to global value chains and to subprime mortgages, applying the Miskyan approach. A second contribution examines the impact of foreign ownership of banks (itself an aspect of financial globalisation) on developing countries. The third paper examines financialisation developments from the point of view of the USA offshoring. A fourth paper examines the effects of financial globalisation, in the form of free capital flows, on poverty in developing countries. The fifth paper challenges the orthodox views on the effect of law on financial development and how the latter affects developing countries.

This is a rather lengthy and focused introduction to show how the five papers are linked together to provide a coherent whole. It addresses the main focus of the special issue, which is Financial Globalisation and Crisis with its emphasis on Institutional Transformation and Equity. We examine in this introduction the issue of financial globalisation not only in relation to the specific papers but also within a wider perspective linking it to the current turmoil in financial markets. We take up the policy question of how the interest of the poor in particular, and developing countries in general, could be safeguarded from the vagaries of financial globalisation. How much choice do communities and countries have and what can the international community do to enhance these choices.

2. Financial globalisation and the studies in the CJE issue

Gary Dymski's contribution entitled, 'Why the Subprime Crisis is Different: A Minskyian Approach', uses Hyman Minsky's financial instability hypothesis to explore the question of why the 2007-2008 subprime crisis has been so deep and persistent, and why it has triggered forces that have undermined the entire trajectory of global economic growth (Dymski, 2010). Dymski poses a challenge: if so many contemporary observers have acknowledged the current crisis as a 'Minsky crisis', why then is it that this crisis has been so resistant to precisely the sort of 'lender-of-last-resort'/'big government' policy interventions that Minsky suggested should suffice to prevent worsened outcomes for economies gripped by financial instability? Resolving this conundrum requires appreciating that there were some assumptions about the economic role of banks, which have been subsequently eroded by institutional changes. In effect, Minsky built up his ideas on the basis of the 1960s and 1970s experience; but after 1980, the role of banking and financial dynamics in the economy was transformed.

Dymski identifies several key implicit assumptions in Minsky's model, and he argues that it is the successive undermining of these assumptions by historical developments that explains the unprecedented scale of the current financial crisis. The first involves racial/ethnic discrimination in the credit market. In putting his model together, Minsky paid no attention to the problem of racial exclusion in credit markets. For one thing, he focused on commercial and industrial loans; further, when he was writing, exclusion for minority applicants and areas prior to the 1990s took the form of higher rates of loan denial. This changed in the 1990s, when racial exclusion was embodied in various forms of predatory loans, most notably, subprime loans. Dymski shows that subprime loans, that is, mortgage loans made at high interest rates, with large fees and penalty clauses, were pioneered in minority areas. What made these loans feasible was the development of securitization for higher-risk loans, which permitted banks to move these loans off their balance-sheets. This meant that the focus of banks' revenue-generation shifted from lending margin to fee-based income.

Second, Minsky did not trace out the implications of the USA being a global liquidity sink. From the 1980s onward, the USA has consistently run current-account deficits, and thus had capital-account surpluses. These surpluses have flooded the USA asset markets with funds seeking investment outlets. This has altered the USA's financial dynamics, by keeping interest rates lower than they otherwise would be; and this, in turn, permitted subprime loans to be used systematically to finance home purchases when the gap between borrowers' income and housing prices spiralled out of control. A third extension of

Minsky's ideas involves identifying, and then generalizing, another unacknowledged assumption: that is, that banks (the lenders) are more highly leveraged than households or firms (the borrower units); and banks have the lowest ratio of capital to assets of any economic sector or subsector. This assumption is invisible, because Minsky, in defining robust, hedge, and Ponzi units, focused solely on whether expected cash-flows are positive or negative. Loan commitments become unsustainable because they generate negative cash-flows. But while Minsky pays no attention to sectoral leverage or solvency, Dymski argues that these dimensions have become crucial in the current crisis.

When Minsky formulated his ideas, banks' sectoral balance sheets were more leveraged than those of either the household or firm sectors. Thus, the banking sector was more exposed to the risks of asset losses and income downturns than non-bank sectors. Central bank interventions focused on the banking sector on the assumption that they could restore financial stability before other sectors' balance sheets were systematically thrown into disarray. But in the past several years, structured investment vehicles (SIVs), even more leveraged than banks, became an important provider of credit for mortgage (and other forms of) finance. In this situation, central-bank interventions, aimed as they are at stabilizing banks' cash flows and balance sheets, have not succeeded in stabilizing the economy. Injections of liquidity, and eventually equity, into the banking system could not prevent the spread of insolvencies and failures among household and non-financial business units. So contrary to Minsky's model, lender-of-last-resort interventions could not forestall the meltdown.

Howard Stein in his contribution, entitled 'Financial Liberalisation, Institutional Transformation and Credit Allocation in Developing Countries: The World Bank and the Internationalisation of Banking', continues with the recent financial crisis and the role of the World Bank in it (Stein, 2010). Stein argues that in the wake of two decades of financial crises following exercises of orthodox financial reform, the World Bank in their reports focused not on critically analysing problems with the strategy itself but instead on a series of extraneous explanations. These included the incorrect order of financial liberalisation, incomplete liberalisation including too much state ownership of banks, inadequate liberalisation in other markets, state cronyism, inadequate prudential regulations, poor corporate governance and too much industrial policy. While there were some minor modifications in the liberalisation strategies (such as paying closer attention to the order of liberalisation) financial crises continued after the mid-1990s in the wake of liberalisation frequently sponsored by the Bank. Beginning in 1999, the continued disappointing results led the Bank to innovate once again by promoting the selling off the banking sector to foreign owners, which they believe would help improve 'sector efficiency and stability'. The World Bank argue that the existence of foreign

banks is likely to have the effect of pushing local banks into Small and Medium Enterprise (SME) markets, where they have a greater comparative advantage. The question of access to credit for the private sector, particularly the locally owned small and medium size enterprises, is central to the issue of employment generation and poverty reduction in developing countries where the bulk of new jobs are typically created by these companies.

After documenting the very rapid rise of foreign banking in the past 10 years or so in all regions, the paper traces the development of the World Bank's agenda on foreign ownership by reviewing World Bank documents published in the 1980s and 1990s. In the 1980s the key was privatization, which did not differentiate foreign and domestic private banks, which began to change after 1997. The lack of evidence particularly to counter the downside risks to lending to small enterprises clearly bothered the Bank. Four Bank economists set out to disprove this and in fact to illustrate the opposite in four Latin American countries (Clarke et al., 2005). However, and as discussed in the paper, they do not use data on lending to small businesses in every country but on loan size (for Argentina and Peru) and debt size (for Chile), which they use as a proxy for small businesses. But this is a problematic approach since large businesses might have either low debt levels or low loan levels relative to assets, which would make them highly attractive to make loans. Only in Columbia do they actually use data on lending to small businesses based on the size of the enterprise. Not surprisingly the overall portion is extremely tiny compared to the others, which is what is expected to be the case. The initial evidence provided illustrates that in four countries (Peru, Columbia, Argentina and Chile) foreign ownership is overwhelmingly associated with slower growth and lower share of lending to small businesses. This is a result we would expect but not consistent with the agenda. They, therefore, take it a step further to explore domestic vs. foreign bank lending by size category and discover that the larger foreign banks have a higher portion and greater growth of lending than small banks to 'smaller businesses' (see, also, Detragiache et al., 2006).

The paper also presents data from Zambia, Uganda and other SSA countries, which had rapid selling off of their banks to foreign ownership. The evidence is quite disturbing and includes poor financial development, rising costs of financial intermediation, declining lending to the private sector and increasing capital flight as foreign banks invest more of their assets abroad. This is a disturbing trend particularly in the wake of large-scale financial instability, which could expose foreign banks at risk. In addition, the paper discusses the tendency, particularly in Hungary and other Eastern and Central Europe, for foreign banks to lend in foreign currency. In the wake of rapid devaluations, this is greatly increasing the risk of financial instability of local companies that have taken foreign loans, which could lead to default, further financial crisis and

grave consequences to the domestic economies.

William Milberg and Deborah Winkler in 'Financialization and the Dynamics of Off-shoring in the USA', turn their attention to corporate strategy in the USA (Milberg and Winkler, 2010). They begin with the observation that, beginning in the 1980s and gaining strength in the 1990s, corporate strategy in the USA shifted, focusing more on the maximization of shareholder value and less on long-term growth. Lazonick and O'Sullivan (2000) refer to this as the shift from 'retain and reinvest' to 'downsize and distribute'. The transformation involved a reduction in investment out of retained earnings and an increase in the purchase of financial assets, and, most recently, a massive purchase by corporations of their own shares (share buybacks) aimed at raising stock prices. This 'financialization of the non-financial corporate sector' in the USA has been well documented by Epstein (2005) and others, and some recent studies have connected financialization directly to reduced capital investment, including Stockhammer (2004) and Orhangazi (2008). In this paper, Milberg and Winkler focus on the corresponding real-side aspects of this corporate strategy shift, and in particular on its international dimension. The authors note that the emphasis on maximizing shareholder value and aligning management interests with those of shareholders emerged around the same time that management experts advised corporations to reduce the scope of corporate activity to focus on 'core competence', and to outsource other operations. Milberg and Winkler find that the expansion of global production networks has served a dual purpose in the evolving corporate strategy. First, cost reductions from the globalization of production have by raising profits through a 'mark-up effect', and second, by reducing the need for domestic reinvestment of those profits, off-shoring has freed up earnings for the purchase of financial assets and the pursuit of higher shareholder returns.

Over the past 20 years USA corporate profits rose and the profit share of national income reached a 40-year high. At the same time, USA corporations faced price competition in product markets and thus slow-rising product prices at home. To maintain cost mark-ups and profits, firms shifted their corporate strategy to control of costs, in part by expanding their global production networks. Such off-shoring accounts for up to 27% of goods input purchases in some USA industries, 50% or more of USA imports, and provides reported cost savings of 20-60%. Imports are linked to higher cost mark-ups and firm profits and the gains from such non-competitive imports – the result of off-shoring – are increasingly associated with the reinvestment of these higher profits.

Milberg and Winkler conclude that financialization and globalization have reinforced each other for USA non-financial corporations and, despite the corporate sector's contribution to national savings over the past decade, the

offshoring-financialization linkage reduces the capacity of non-financial corporations to act as a driver of the recovery from the economic crisis that emerged in 2008. Having narrowed increasingly to core competence beginning in the early 1990s as part of the financialization process, USA non-financial corporations today are ill equipped to reverse course and focus on innovation and growth through reinvestment of profits. Milberg and Winkler survey the top 30 firms in terms of share repurchases and dividend payments and conclude that firms with extensive global supply chains undertook massive share buybacks in the 2000s. IT hardware and software manufacturers (Cisco, Microsoft, Hewlett Packard, Dell and Intel), retailers (Wal-Mart and Home Depot), and consumer non-durables firms (Procter & Gamble) that rely heavily on sophisticated global value chain arrangements, were among those returning the highest levels of dividends and share buybacks.

The situation has important implications for the analysis of international trade and finance. Research on international trade has emphasized the effects of trade liberalization on the relative wages of high-skill and low-skill workers. In their paper, Milberg and Winkler emphasize the importance of trade for markups, the profit share and, in turn, investment and financialization. These are better understood as the 'dynamic' aspects of offshoring, a term borrowed from the literature on classical trade models that emphasize the relation between imports and the profit rate, with its implications for capital accumulation and economic growth; and in terms of this paper financialization should be added as well.

Philip Arestis and Asena Caner in their paper entitled 'Capital Account Liberalization and Poverty: How Close is the Link?' begin with the observation that the number of poor people in the world is shocking (Arestis and Caner, 2010). According to the latest statistics, there are still more than 1 billion poor people in the world, despite the recent decent increase in average living standards. There are also dramatic differences in poverty among developing countries. Even more worrying is the recent statement by the IMF (2008) that the current financial crisis threatens severely poverty in low-income countries in particular. The paper by Arestis and Caner focuses on the financial aspects of poverty alleviation in developing countries and asks whether capital account liberalization can actually lead to lower poverty in developing countries. This study contributes to the literature by examining both theoretically and empirically the relationship between capital account liberalization and poverty for the first time. They focus on developing countries and exclude developed countries from their sample for two reasons. First, the nature and the extent of poverty in developing countries requires more urgent attention; and second, the dynamics of poverty reduction are different in these countries than in developed countries. This is important, especially when cross-country heterogeneity is a major concern.

Theory provides conflicting predictions regarding the relationship between capital account liberalization and poverty alleviation. On the one hand, by diminishing information and transaction costs and therefore allowing more entrepreneurs to obtain external finance, capital account liberalization improves the allocation of capital, thereby exerting a positive impact on the poor. To the extent that financial systems function better following capital account liberalization, financial services become available to a larger proportion of the population and to the poor. On the other hand, capital account liberalization and improvements in the financial system primarily benefit the rich and those who are politically connected. Especially at the early stages of capital account liberalization, financial services, and credit in particular, are available to the wealthy and connected. A greater degree of capital account liberalization, then, may only succeed in channelling more capital to the few, but certainly not to the poor. Therefore, the overall effect is ambiguous.

Arestis and Caner use dynamic panel econometric methods and data for developing countries to test whether capital account liberalization influences poverty. They demonstrate that capital account liberalization does little to alleviate poverty. By contrast, it is the design of high quality institutions, and to a much lesser extent economic growth, that affect poverty alleviation. All regression results suggest that capital account liberalization is not associated with a significant decrease in the poverty rate or an increase in the income share of the poor. In fact, liberalization of the capital account increases poverty according to some estimates. Another finding is that there is no threshold effect of liberalization. Furthermore, in their econometric analysis they control for the possibility of endogeneity of the capital account liberalization variable as well as for the other explanatory variables.

These findings are in fact not surprising when we think about the living conditions of the poor in developing countries. These people are mostly unskilled self-employed people, working on their extremely small-sized farms, or as artisans or small-scale entrepreneurs in shops or homes. The main constraints they face are marketing, credit, insurance and infrastructure. Such needs often require competent domestic policy-making and cannot be expected to be fulfilled by foreign investors. Moreover, if the needs of these people are not met, capital account liberalization may increase their vulnerability by leaving them open to intense competition from the outside world. The financial crisis of August 2007 and the subsequent spread of it in the rest of the economy and the world, does not augur well at all for the poor, especially so in the developing world. The conclusions of this contribution become even more relevant and timely. They also support the IMF (2008) view referred to above,

which is even more worrying in the context of this conclusion.

Prabirjit Sarkar and Ajit Singh in their contribution entitled **'**Law, Finance and Development. Further Analyses of Longitudinal Data', study the relationship between law, finance and development (Sarkar and Singh, 2010). In the controversial 'legal origin' hypothesis it is claimed that legal differences between countries can be categorized, quantified and analysed. The proponents of the hypothesis have come up with evidence showing that countries belonging to the 'common-law family' (UK and other countries) have higher protection for shareholders and greater rights for creditors than do countries belonging to the 'civil law' legal family [France and other countries]. The legal systems not only differ with respect to protection for shareholders, but also with respect to labour, contract enforcement and self-dealing rules, among other attributes.

It is argued that common law works better than civil law and is more conducive to economic development for the following reason. Judges interpret the law in common law countries whereas in civil law countries Judges are bound by long explicit laws and codes, leaving them with little discretion. This evolution of the difference between the two systems (common law and civil law system) has occurred over the last 300 years and has continued to affect development of laws to the present day. The policy implications of this 'legal origin' hypothesis are far reaching. Essentially their argument is that the Anglo-Saxon model based on English common law is most conducive to the protection of shareholders; more broadly, to safeguarding property rights, and freedom of contracts. As a consequence, common law country firms have greater access to outside finance, are less subject to government control and have faster corporate growth. These characteristics in turn generate faster growth of national income.

On that basis it is suggested that the Anglo-Saxon model of corporate law represents the end of history as there is wide consensus that main corporate goal should be shareholders' wealth maximization subject to constraints of liquid stock markets. The 'legal origin' hypothesis is very much disputed by the modern scholars of corporate law. For example, under current French practice judges interpret the law whereas English judges on the other hand have less scope than before in view of the detailed descriptions contained in modern English law, such as the company law. The French judges are also able to have discretions by appealing to the Roman law concept of 'good faith'. In this perspective an interdisciplinary research project on law, finance and development has been going on at the Centre for Business Research (CBR), University of Cambridge. The project involves both economists and lawyers. It has prepared new longitudinal data on legal protection of shareholders as well as on creditors' rights and labour rights over a 36 year period, 1970-2005 for four OECD countries (UK, France, Germany and the USA) and India. Sarkar

and Singh are mainly concerned in their contribution with the question of protection for shareholders in four OECD countries and its impact on stock market development.

The analysis and empirical results provided by the authors, lead to two rather different kinds of conclusions. The first is the narrow technical finding that the 'legal' origin hypothesis concerning shareholder protection and stock market development is not sustained by the analysis of the longitudinal data employed in the Sarkar and Singh paper. The second conclusion, which follows from the paper's analysis, concerns policy. The results of the studies carried out by the proponents of the 'legal origin' hypothesis have been used by organisations such as the World Bank to suggest that developing countries should reform their laws to adopt the common law, and to follow the Anglo-Saxon model to foster economic development. The norm of shareholder wealth maximisation subject to the constraints of liquid stock markets has been propagated as a universal standard. The empirical findings of the Sarkar and Singh paper cast serious doubt on the validity of the basic theses of the Anglo Saxon legal and developmental model. This evidence is more compatible with the 'varieties of capitalism thesis', which suggest that each country has its own form of capitalism and its own legal and regulatory institutions, and that there is no single development model which can cover all their needs. The overall conclusion of the Sarkar and Singh paper is, then, that the findings of the 'legal origin' hypothesis in its original strong form are not sustainable with respect to the issues of law, financial globalisation and growth.

3. Linking the CJE papers to the theme of financialisation

The CJE special issue provides a number of insights into its main theme. The rights of shareholders, racial and ethnic minorities access to finance for mortgages and their relationship to changes underlying the subprime mortgage crisis; the expansion of foreign ownership of banking on small and medium size enterprises access to finance; the impact of financialization among lead firms in global value chains on the income of suppliers in developing countries; the consequences of capital account liberalization on poverty and the question of the relationship between law, finance and development from a number of angles. The special issue has attempted to evaluate these relationships. The approach in all papers is heavily informed by an institutional approach to understanding the relationship between finance and equity. As such it provides a coherent approach to our understanding of financial globalisation, institutional transformation and equity.

It would be constructive to make a few comments on how each paper addresses each of the issues that have been highlighted in this introduction. We may begin

with the financial globalization and crisis aspect. Dymski's analysis on Minsky and the USA massive current account deficit that flooded the asset markets, thereby allowing the creation of the subprime mortgage market, huge leveraging and internationalization of loan bundles, and the associated derivatives, has created a huge crisis on the non-banking side as well as on the banking side. Stein makes the argument that foreign ownership of the banking sector has contributed to the globalization of finance; *e*vidence on this can be adduced from foreign banks, even in poor developing countries, are exporting capital to diversify assets abroad. This produces the potential for serious crises. The Milberg and Winkler paper provides an interesting link between the globalization of production and the financialization of profits. It exposes companies to terrible crisis in view of loss of internal funds to declining stock market prices and the extent to which companies are investing in other forms of global assets. This provides weak ability to recover in the face of crisis due to an erosion of internal capacities from outsourcing, and being subjected to the whims of bankruptcies elsewhere. In the Arestis and Caner contribution, capital account liberalization greatly increases volatility and crisis, thereby exposing domestic economies to the whims of capital flows and the financial meltdown we are now witnessing. In the Sarkar and Singh paper, the adoption of the Anglo-American model strengthens the role of the stock market. This can contribute to financial instability by causing rapid outflows from stock markets during economic downturns thereby precipitating financial crises. This can of course worsen equity because capital outflows are likely to hurt employment and are also likely to cause a decline in the standard of living due to the impact of potential devaluation.

Turning to the institutional transformation dimension, the multifaceted and rich interpretation of institutional transformation is all highly relevant to our understanding of the changing nature of international finance. Dymsky shows how the changing nature of institutional arrangements, creates the securitization of subprime loans and the resulting institutionalization of new non-bank financial leveraging. Stein is concerned with the changing nature of banking organizations and how they fit into the institutionalization of global strategies of accumulation. Milberg and Winkler show how institutional changes in production and new habits of thought can deal with the utilization of profits and the non-productive behaviour that is associated with it. Arestis and Caner examine the institutionalization of new capital account arrangements and their false rationalization as a poverty reducer. And finally Sarkar and Singh on transforming laws, which are an important part of institutions in developing countries, by pressing a singular vision the World Bank, which is imposing a new global institutional standard that is quite dangerous.

In terms of equity, Dymsky deals with new forms of exploitation of poor using subprime markets likely to be the first in line for foreclosure. Stein looks at the erosion of lending to small and medium size enterprises domestically in view of the foreign ownership of domestic banks' export of capital from poor to rich countries by transnational banks. This is undertaken through practices such as hard currency lending, which can lead to problems in enterprises in developing countries with serious consequences to employment. Milberg and Winkler point towards the loss of employment and pressure on wages from new practices of outsourcing. Also, stock purchases mean less money for improvements in productivity with implications for wages. Arestis and Caner focus on poverty with implications for equity. And finally Sarkar and Singh deal with the consequences for economic growth and crisis for equity in an Anglo-American system of laws.

4. Financial globalization: controversy over theory and evidence[1]

The above analysis has indicated how the individual contributions included in this special issue relate to various aspects of financial globalization. In this and the following sections we explore other important dimensions of financial globalization, paying particular attention to its theoretical underpinnings and also how it has contributed to the current world financial turmoil.

In general terms, the issue of financial globalization generates acute controversy in relation to theory and empirical evidence as well as policy. However, recently there has been some blurring of the ideological divide. For example, Jagdish Bhagwati (2000), an orthodox icon of free trade, regards financial globalization as a conspiracy between Wall Street and the US Treasury providing the financial leaders of the Street and the Treasury greater leverage over economic policy making in developing countries. However, Bhagwati's (op. cit.) serious point is that trade liberalization is a rather different kettle of fish than liberalization of finance (see further below).

This perspective has been seriously challenged by Stanley Fischer (1997), a former Deputy Managing Director of the IMF and by the former Treasury Secretary, Larry Summers (2000). Fischer suggests that, at a theoretical level, financial globalization in the form of capital account liberalization would lead to global economic efficiency, allocation of world savings to those who are able to use them most productively, and would thereby increase social welfare. Citizens of countries with free capital movements would be able to diversify their portfolios and thereby increase their risk-adjusted rates of return. It would enable corporations in these countries to raise capital in international markets at a lower cost. It is suggested, moreover, that such liberalisation leads to further development of a country's financial system which in turn is thought to enhance

productivity in the real economy by facilitating transactions and by better allocation of resources. Some argue that free capital movements will help increase world welfare through another channel, namely transferring resources from ageing populations and lower rates of return in advanced countries to younger populations and higher rates of return in newly industrialising economies. Such resource transfers will be Pareto optimal as both rich and poor countries would gain (Fischer, 1997).

Summers (2000) succinctly sums up the core point of the orthodox perspective as follows: '… the abstract argument for a competitive financial system parallels the argument for competitive markets in general … Just as trade in goods across jurisdictions has benefits, so too will intertemporal trade and trade that shares risks across jurisdictions have benefits' (page 3).

The theoretical case against the view that unfettered capital movements are essential for maximising the gains from trade and world economic welfare has been made by a number of economists from different schools of thought. First within the neoclassical tradition itself, Stiglitz (2000) argues that the concept of free movements of capital is fundamentally different from that of free trade in goods. Capital flows are subject to asymmetric information, agency problems, adverse selection, and moral hazard, and incomplete capital markets. Although such problems may occur also in trade in goods and services, they are intrinsic to financial flows and are far more important. Thus, it is suggested that liberalisation in the trade for widgets is rather different than the free movement of financial products between countries. Therefore, it is far from obvious that the welfare propositions of the theory of international trade carry over to the case of free movement of finance.

Further, Keynesian critics of the orthodoxy emphasise that financial markets are particularly prone to co-ordination failures and often generate multiple equilibria, some good, some bad. In the absence of appropriate coordination by the government or international authorities, an economy may languish in a low level equilibrium, producing sub-optimal output and employment levels.[2]

The post-Keynesian economists (see for example Davidson, 2001), take a more radical stance. They put forward analyses and evidence in favour of Keynesian thesis that flexible exchange rates and free international capital mobility are incompatible with global full employment and rapid economic growth in an era of multilateral free trade'. These economists also challenge the orthodox presumption that transparency and availability of more information would make the financial markets less prone to crisis. They point out that the crises are fundamentally due to the fact that the future is uncertain and people have different perceptions about it.

To sum up, the orthodox theory that financial liberalisation leads to global economic efficiency based on the analogy with free trade is flawed on several counts. Within the neoclassical tradition itself, it is the intrinsic nature of financial contracts which differentiates a market for the latter from that of ordinary goods in international trade. The Keynesian and the post-Keynesian emphasis is on inherent uncertainty about the future, on speculation and the macro-economic co-ordination failures at both the national and international levels to which financial markets are particularly prone.

Empirical findings contradict orthodox theory that suggests that financial liberalization and new financial instruments should lead to consumption smoothing rather than crises, which has been the observed outcome of many episodes of financial liberalization in developing countries in recent decades. There have been several huge financial and economic crises in emerging markets since the 1990s: Mexico (1994): Indonesia, Korea and Thailand (1997); Brazil and Russia (1998); Argentina and Turkey (2000); Brazil (2002). These crises have usually followed capital account liberalization.[3] . The reasons for the observed disjuncture between theory and reality in the context of financial liberalization are now well understood. The more important reasons include a) the inherent volatility of capital flows due to irrational exuberance or unwarranted pessimism on the part of investors; b) increased competition among banks following liberalization, leading to risk-taking and bank failures; c) the changes in the global financial system and the short-termism of the leading international actors (see Singh, 2001, for further analysis).

Until recently, empirical studies on the effects of capital account liberalization on economic growth generally produced conflicting results. However, Prasad et al (2003), an IMF econometric study, concluded that capital account liberalization may or may not promote growth but it certainly increases the volatility of consumption, which undoubtedly has a negative effect on welfare. These results although at variance with the IMF policy stance, were very much in line with those of many independent economists. The Fund economists do not easily give up. Thus, the IMF's 2006 econometric study, Kose et al. (2006), claimed that the methodology used in this and their 2003 research was incapable of detecting all the positive effects of capital account liberalization on welfare. Further, the 2006 study suggested that there was indeed a beneficial impact on some indicators of welfare, including corporate governance, and also indirectly on economic discipline. These conclusions have, however, been carefully considered and rejected by Ocampo et al. (2008).

5. Financial globalization and the current economic turmoil

After the Asian crisis of the late 1990s, many developing countries in Asia and elsewhere are once again faced with the prospect of another devastating crisis. The meltdown of the financial system in many advanced countries is affecting the real economies in both developed and developing countries. It will be appreciated that the real world economy has been performing strongly during the last five years. Apart from China and India, which have displayed stellar performances, many other developing countries have also grown relatively fast, notably in Africa. However, the world economy has also been subject to serious financial imbalances. These imbalances include the ever increasing US current account deficit which rose from three per cent of GDP in 1999 to over five per cent from 2004 onwards. One imbalance, which may be regarded as pathological is the fact that among the G7 countries real GDP has been growing faster in countries with current account deficits (for example the US) and slower in those with current account surpluses (Germany, for example). In other words, financial markets were penalizing virtue and rewarding profligacy. Yet another pathological symptom was the fact that funds have been flowing from poor to rich countries (China to the US, for example), contrary to the expectations of conventional economic theory.

In the wake of the Asian crisis, most developing countries did not strengthen capital account controls so as to further regulate international financial flows. Instead, they began to implement a strategy of building up large foreign exchange reserves to avert future financial crises. In view of the strong performance of the Chinese and Indian real economies, the international financial institutions (IFIs) expected that not only would these countries be able to protect themselves from financial turmoil originating in advanced countries but also to continue to remain sources of fast growth of demand for the world's economies.

However, as Krugman (2008) notes the script changed abruptly:

> 'What happened? Alongside the growth of the shadow banking system, there was another transformation in the character of the financial system over the past fifteen years - namely, the rise of financial globalization with investors in each country holding large stakes in other countries … this change was supposed to reduce risk: because US investors had much of their wealth abroad, they were less exposed to a slump in America, and because foreign investors held much of their wealth in the US, they were less exposed to a slump overseas. But a large part of the increase in

> financial globalization actually came from the investments of highly leveraged financial institutions which were making various sorts of risky cross-border bets. And when things went wrong in the US these cross-border investments acted as what economists call a "transmission mechanism", allowing a crisis that started with the US housing market to drive fresh rounds of crises overseas,' (p. 4).[4]

To prevent the global crisis becoming worse, it is necessary for nation states to act in concert and to avoid the mistakes of the 1930s (beggar thy neighbour policies, competitive devaluations etc). This time round the leaders of the world economy have already met and agreed to countercyclical fiscal action in developed and developing countries. They have agreed to protect the global financial system from a melt-down. For the first time, developing countries such as China, India, Indonesia and Malaysia are taking countercyclical measures to ward off recession. UBS (a major Swiss bank) has estimated that the combined effect of emerging and developed economies' fiscal stimuli will see a fiscal boost of 1.5 per cent of world GDP in 2009 (Economist, Economic Focus, A Stimulating Question. December 13, 2008). It remains to be seen whether this stimulus and associated policy measures will be enough to restore confidence in the financial system and avert a deep global recession, mass unemployment, and worsening of poverty levels.[5]

Many analysts expect an end to the fall in the US housing market in 2010, which will provide a major boost to confidence and hopefully new lending. In that case there is a reasonable chance that world economic growth may not decline by more than 1 or 2 per cent. Notably if that were to happen it would be the first actual decline of world GDP in any year in the period since the Second World War. By past historical standards, such a slow-down can be considered small. As Llewlyn (2008) notes, in the 1920s, the peak to trough fall in GDP in the major economies averaged 12 per cent, ranging from around 30 per cent in the US and Canada and somewhat under 10 per cent in Japan, Italy and Britain. If world GDP in the present crisis were to fall by only 1 or 2 per cent before recovering, this should justifiably be regarded as a triumph not only for policy-makers but also for the economic analyses which constitute the foundation for the measures adopted.

6. Concluding remarks

The *Financial Times* (2 January 2009) recently argued that, although financial markets are bad, they are nevertheless a necessary evil. It suggests that the world economy works best when international financial markets function under appropriate regulation. Widespread research suggests that free international

flows of financial capital do not always serve the needs of developing countries. This conclusion was also reached by the League of Nations economists on the basis of their analysis of European economies during the 1920s and 1930s (see, for example, Nurkse (1944), Felix (2003) and Eichengreen (2001). This was the reason why, when the IMF Articles of Agreement were negotiated at Bretton Woods, they contained strong provisions to prevent capital account liberalization. However, during the last two decades, under the idealogical hegemony of neoliberalism and Washington Consensus, the IFIs have done their best to subvert the spirit of these agreements. Indeed, in 1997, IMF officials presented a formal proposal to change the relevant Articles of the Agreement so as to make the promotion of 'orderly' capital account liberalization one of the important duties of the IMF. In the event, however, this proposal was quietly shelved in view of the Asian economic crisis. Nevertheless, this has not deterred the IFIs from encouraging or condoning capital account liberalization.

It is usually forgotten that, following the foreign exchange shock of the late 1920s, several developing countries prospered during the depression by virtue of their efforts to restructure their economies and industrialize by adopting protectionist measures. Madison (1985) noted that those developing countries that followed orthodox economic policies, as for example India and Cuba, did not fare so well as the Latin American countries in the 1930s. Other evidence suggests that both well-calibrated protection and capital controls can be useful for promoting economic development.[6]

To conclude, cooperation between developed and developing countries on international financial matters is required to develop new institutional arrangements to counteract the effects of financial globalization. Signs of this are already emerging, as for example, the recent summit of 20 developed and developing countries. To be relevant to the 21st century, the IMF needs to put development first and to have new institutional arrangements giving developing countries a full role regarding all policy issues and related decisions commensurate with their numbers and their rising GDP.

Notes

[1] This section is based on Singh (2003). The material presented here updates that paper and supersedes it.

[2] For the earlier literature on these issues, see Banerjee (1992),Bikhchamdani (1992) and Calvo and Mendoza (2000). On a slightly different tack, Minsky (1982) made an important contribution to the Keynesian theory of endogeneity of financial fragility in capitalist economies even during periods of boom, see Kregel (2007).

[3] There is a large literature on the subject; Kaminsky and Reinhart (1999) are the classic reference. See further Ramaswami (2003) and Ocampo et al. (2008) for a fuller discussion.

[4] In this article Krugman (2008) goes on to explains the role of hedge funds and carry trade in aggravating the crisis of financial globalization.

[5] Some economists do not favour fiscal expansion as a means of stemming the crisis on the grounds that the recapitalization of banks should be sufficient (see, for example, Greenspan, 2008).

[6] See, for example, various contributions in Ocampo et al (2008). See also Ocampo and Taylor (2000).

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