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International Financial Flows

By Sarah Anderson, Institute for Policy Studies

After a decade of rapid growth, the international financial system is now plagued with extreme volatility and crisis. International financial flows have exploded during the 1990s as countries, particularly in the developing world, have bowed to the conventional wisdom that they should remove barriers to these flows. As a result, three major trends have emerged:

1. Dominance of private capital: As recently as 1990, financial flows into developing countries from public institutions (e.g., the World Bank) were larger than those from private sources (e.g., Citicorp); today private capital dwarfs the value of public lending. In 1994 and 1995, roughly three-quarters of the resource flows into the developing world were from the private sector; by 1996, private flows were over 85 percent of the total.
2. Short-term portfolio flows: Foreign direct investment remains the largest source of private financial flows, but short-term portfolio flows have grown at the fastest pace. Between 1990 and 1996, the movement of portfolio equity flows into the South surged from $3.2 billion to $45.7 billion as a number of debtor countries followed U.S., World Bank, and IMF advice (often in order to satisfy loan requirements) to open their stock markets to foreign investors and deregulate their financial markets. Even some countries not under IMF or World Bank programs bowed to pressure from inside and outside to liberalize their financial systems or be left behind in a dynamic global economy.
3. Highly concentrated investment: Despite the surge in private flows, the entire developing world is not awash in foreign capital. In fact, three-fourths of private investment goes to just 10 countries, often called the "emerging markets" because of their profitable trade and investment opportunities and prospects for economic growth. Meanwhile, the rest of the developing world has experienced not only reduced aid flows but also the inability to attract private capital in the form of loans for investment.

Key Points

- International finance has exploded during the 1990s as countries, particularly in the developing world, have bowed to the conventional wisdom that they should remove barriers to these flows.
- The flood of capital into countries like Mexico, while fueling economic growth for a period of time, has done little to improve the lives of the majority of people.
- The roots of the crisis may lay in the financial liberalization that encouraged a flood of short-term private flows into Thailand, the Philippines, and elsewhere in the early 1990s.

Supporters of a deregulated global economy have heralded the capital influx as the developing world's ticket to prosperity and a sign of sound economic management in the recipient countries. Critics have argued that the flood of capital into countries like Mexico, while fueling economic growth for a period of time, has done little to improve the lives of the majority of people. Moreover, they have argued that the flood of unregulated capital inflows has made countries vulnerable to economic instability caused by rapid capital flight.

With the advent of the Asian financial crisis in mid-1997, the debate over financial flows has finally reached the front pages of newspapers. Between July 1997 and January 1998, currencies and/or stock markets plunged by at least one-third in seven nations. The fact that three of these were the highly touted "newly industrializing economies" (NICs) of South Korea, Singapore, and Hong Kong, and four were would-be NICs (Thailand, Indonesia, Malaysia, and the Philippines) has greatly shaken confidence in the global economy.

Walden Bello, of the Bangkok-based group Focus on the Global South, has made a convincing case that the roots of the crisis lay in the financial liberalization that encouraged a flood of short-term private flows into Thailand, the Philippines, and elsewhere in the early 1990s. The flows generated high growth rates, yet most funds were not channeled into productive long-term uses; instead much of the short-term capital artificially inflated both real estate and stock markets. In some countries, the problems were exacerbated by imprudent lending practices by the banking sector. When investors began to lose confidence in these markets, economic instability was made much worse by draconian austerity measures imposed by the International Monetary Fund (IMF) and the speculative activities of currency traders.

Coming at a time when the international financial system was still recovering from the aftershocks of the 1994 Mexican peso crash, the Asian crisis prompted even stalwart supporters of economic globalization to engage in a debate over the need for what Treasury Secretary Robert Rubin calls the "new architecture" of the international financial system.

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The U.S. Treasury Department, both in its bilateral dealings with other countries and in its dominant position in the IMF, has been a central backer of liberalized financial flows. Likewise, the U.S. Trade Representative has promoted investment liberalization through the North American Free Trade Agreement (NAFTA) and in talks around the Free Trade Area of the Americas. In both North and South, three key concerns related to private capital flows have been raised:

1. Enhanced mobility gives corporations more power over workers and communities: The explosion of foreign direct investment into the developing world (and into the developed countries as well) affects workers in the United States and the rest of the North directly as factories shift from North to South. In addition, the enhanced corporate ability to shift capital overseas further weakens labor's position in bargaining over wages and working conditions. A Cornell University study of organizing drives at several hundred U.S. plants found that in more than 60% of cases, employers attempted to defeat the union by threatening to move the plant to a lower-wage area.

   At the same time, foreign investment has done little to improve the living standards of workers in the recipient countries. In Mexico, for example, a flood of foreign direct investment has helped to raise productivity levels, yet the repression of worker rights (along with the collapsed value of the peso since the end of 1994) has prevented workers from sharing the rewards. During the first years of NAFTA, from 1993-1996, productivity increased 12.6% while real wages dropped 21.9%.

2. Global financial casino: The huge increase in short-term private flows from mutual funds, pension funds, and insurance companies leaves the leading developing nations extremely vulnerable to rapid capital flight. In the emerging markets of Asia, for example, capital was flowing in at the rate of about $100 billion a year in 1996; by the second half of 1997 it was flowing out at about the same rate. The leaders of some Asian nations blame the outflow of capital largely on the predatory practices of currency speculators, whose influence on the international financial system has boomed as the result of the liberalization of private financial flows. Indeed, foreign currency transactions now approach $1.5 trillion a day, and speculators have made even the strongest currencies vulnerable to destabilization.

   In the previously strong economies of Hong Kong and South Korea, unemployment has doubled and tripled, respectively since mid-1997. Indonesia's GDP is expected to drop about 20% in 1998. Similar effects were felt in Mexico, where capital flight in late 1994 led to a crisis that destroyed two million jobs and drove one-third of Mexican businesses into bankruptcy.

   From a U.S. perspective, the currency collapses that have accompanied the capital flight out of Asia have resulted in stock market volatility at home that is certain to depress consumer spending. At the same time, the United States is experiencing a growing trade deficit with Asia and Mexico. Forecasters are predicting an increase of about $100 billion in the U.S. trade deficit in 1998. If this proves true, the Economic Policy Institute claims that as many as a million U.S. jobs could be lost.

3. The MAI and IMF Reform: Two major efforts are underway to further liberalize financial flows and hence exacerbate the problems caused by capital mobility. One is the proposed Multilateral Agreement on Investment (MAI). Just as GATT (and now the World Trade Organization) has liberalized flows of goods and services over the past 40 years, the MAI would remove most remaining restrictions on the flows of investment. The MAI is being negotiated within the 29 industrial nations that are members of the Organization for Economic Cooperation and Development. While talks appear to be stalled at the moment, analysts claim that MAI promoters are not only still counting on obtaining an agreement within the OECD but also plan eventually to expand the pact globally. A similar effort is taking place within the IMF, where a proposed amendment to the IMF's Articles of Agreement would give it increased authority to require debtor countries to liberalize capital flows.

Key Problems

- The enhanced corporate ability to shift capital overseas weakens labor's bargaining position in both the North and the South.
- The huge increase in short-term private flows from mutual funds, pension funds, and insurance companies leaves the leading developing nations extremely vulnerable to rapid capital flight.
- In the midst of the worst global economic crisis since the 1930s, the U.S. has opposed measures to put restraints on capital flows.

The U.S. government has been on the wrong side of these issues. It backs enhancing IMF powers and has continued to press MAI negotiations forward. In the midst of the worst global economic crisis since the 1930s, it has opposed measures to put restraints on capital flows.

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The spreading financial crisis has made ever more clear the need for a new international financial system that encourages long-term productive investment in a climate that promotes worker rights and sustainable development. The U.S. could be a major catalyst of those changes through its leadership in the G-7, the World Bank, the IMF, and the WTO. The U.S. should promote international negotiations to create alternatives for the future of the international financial system, based on the following goals:

1. Measures to ensure that long-term capital flows reinforce worker rights and environmental standards: The U.S. government should support the strategy that has been advocated by labor unions and environmental groups to place strong mechanisms to enforce internationally recognized worker rights at the core of international agreements on financial flows. These mechanisms would give workers and communities more power to press for their fair share of investment benefits. In the event of a conflict, these rights should take precedence over investors' rights.

   Howard Wachtel of American University has proposed another idea that merits further analysis. Wachtel calls for a tax on foreign direct investment designed to encourage corporations to invest in countries with strong labor rights records. The level of the tax would vary depending on the rating the country received from the International Labor Office about its adherence to core labor standards. According to Wachtel, such a tax "says companies can invest wherever they wish, but they pay a higher tax if they choose to invest in those countries with the worst labor standards."

Key Recommendations

- The U.S. should support efforts to place strong mechanisms to enforce internationally recognized worker rights at the core of international agreements on financial flows.
- The U.S. should refuse to sign any international agreement that does not allow governments to impose controls on international capital.
- The U.S. government should analyze possible mechanisms to penalize reckless lending, perhaps by forcing banks to take on at least part of the burden for funding bailouts.

2. International measures to address short-term flows and currency speculation: In the late 1970s, Nobel-prize winning economist James Tobin of Yale University offered a proposal to reduce short-term movements of capital by placing a small tax on foreign exchange transactions. The U.S. government should promote international talks aimed at putting the Tobin tax concept into practice. In addition, the U.S. should support the development of a democratic process for determining how proceeds of the tax could be best administered to fund environmental clean-up or other social goals.

3. Local, state, and national measures to address short-term flows and currency speculation: The Mexican and Asian crises each spread panic to a number of other countries with equally open and deregulated markets, the so-called "tequila effect." However, countries with some form of capital controls have weathered the storm far better. Chile, for example, remained relatively unaffected by the Mexican crisis. At that time, Chile required local firms that borrowed from foreign sources to keep 30 percent of that loan on deposit at the central bank (without interest) for a year, thus encouraging firms to borrow only for long-term purposes. Between 1992 and 1994, these controls contributed to a decline in international arbitrage funds from 3.5 percent of GDP to nearly zero. (Arbitrage is speculative investment made to profit off minor swings in currency exchange rates or other factors.) The Chilean government recently lifted the deposit requirement, but still requires foreign investments to stay in the country for a year. Given the success of such controls, the U.S. should discontinue efforts to pressure countries to eliminate such protections and instead refuse to sign any international agreement that does not allow governments to impose controls on international capital.

4. Measures to root capital locally: As conventional wisdom begins to shift away from the free flow of capital across borders as the great panacea, there is a small but growing movement to root capital locally. Dozens of U.S. communities are pursuing strategies to regain control over their economies by investing in locally owned businesses like credit unions, cooperatives, community land trusts, municipally owned utilities, small worker-owned firms, community development corporations, and local shareholder-owned firms. A few areas are also experimenting with alternative community currencies. In the developing world, there is also a growing resistance to the problem of leakage of local savings that occurs when banks lend capital to borrowers outside the community. Most communities the world over do not need new capital; they simply need to retain local resources. The U.S. government should not endorse any international agreements that do not protect the rights of communities to pursue strategies aimed at rooting capital locally.

5. Measures to discourage future crises: As long as banks and other financial actors know that the IMF will bail out countries in crisis, there is likely to be little restraint in new lending across borders. The financial press has picked up this problem and noted that investor behavior contains an element of "moral hazard" which, in the words of *The Economist* "causes people to take excessive risks in expectation that a central bank or the IMF will bail them out if things go wrong." The U.S. government should analyze possible mechanisms to penalize reckless lending, perhaps by forcing banks to take on at least part of the burden for funding bailouts. For example, George Soros has proposed an International Credit Insurance Corporation that would charge a small fee on all international bank loans and use the proceeds to fund any rescues.

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Sources for More Information

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World Wide Web

OECD's International Financial Architecture
http://www.oecd.org/subject/fin_architecture/

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