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The Developmental Agenda in the Age of Neoliberal Globalization

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Introduction

"Is this the end of economic developmental state?" was the opening title of a modeling exercise by Adelman and Yeldan in the *Global Trade Policy Analysis* meetings of Odense, June 1999.[1] Referring to the recent Asian crisis as a point of reference, the authors utilized a smooth-functioning neoclassical model with fully flexible commodity and financial markets to show how the neoliberal global agenda severely restricts the autonomy of the developing countries to pursue strategic policies to attain development targets. Accordingly, with the recent attempts towards full liberalization of the capital account under pressures from the US and the IMF (the so-called Washington consensus), governments lost their autonomy in designing a strategic mix of the exchange rate and interest rate instruments for promotion of industrialization targets. Thus, in Grabel's words

> "these changes, coupled with the ensuing investor euphoria, led to a general speculative appreciation of asset prices, extremely high real interest rates, and an overall shift in aggregate economic activity toward financial trading and away from industrial activities" (Grabel 1995: 128).

The assessment that the process of neoliberal globalization is associated with successive financial crises has further been a recurrent theme in much of the literature on international finance and open economy macroeconomics. Notwithstanding the original proposition of a (Tobin's) tax on short term capital flows, the detrimental effects of unregulated flows of financial capital have been the topic of active debate in Stiglitz (2000), Rodrik (1997), Calvo, Leiderman and Reinhart (1996), Grabel (1996), Diaz-Alejandro (1985), and Velasco (1987); and also constituted one of the main themes in all of the last five annual *Trade and Development Report*s of UNCTAD.

In this paper, I attempt to address to the ideas provided in this literature and try to deduce implications for a renewed development policy. After a brief conceptual introduction on the distinguishing characteristics of the recent wave of globalization in the next section, I discuss the development concept as distinct from that of growth in the context of late 20th century financial

[1] The revised text then appeared in *World Development* (2000) 28(6): 1087-1100, under the title "The Minimal Conditions for A Financial Crisis: A Multi Regional Intertemporal CGE Model of the Asian Crisis".

liberalization and market orthodoxy in section 2. In section 3, I highlight the main mechanisms of how unfettered workings of the global financial transactions restrict the autonomy of the states to pursue indigenous development objectives and deprive them from the classic tools of austerity. Finally in section 4, I sketch some concluding comments.

Neoliberal Globalization and the Concept of Development

Neoliberal globalization is the dominant mode of thinking in the macroeconomic policy agenda at the current juncture. Broadly defined, globalization is meant to be the process of the complete integration of the constituent parts of the world economy with each other and with international markets. The dual process of the liberalization of trade and capital movements constitute globalization in its narrowest economic sense. On a broader perception, this economic duality necessitated "… a programme for destroying collective structures which may impede the pure market logic" (Bourdieu, 1998). In order to sanctify the power of the markets in the name of economic efficiency, this "infernal machine" requires the elimination of administrative or political barriers which limit the owners of capital in their quest for maximization of individual profit, which, in turn has been upheld as the supreme indicator of rationality (*ibid*).

World capitalism has experienced two broad waves of globalization within the last 200 years. The first one roughly dates 1870 through 1914, and was sparked by the rapid advances following the 18th century technological revolution. Following the cessation during the war years and the post-World War II regulatory international exchange regime of the so-called Bretton Woods system, the second wave has been initiated roughly in the 1970s to extend to-date.

The most important phenomenon of the first wave of globalization in the 19th century was the rapid acceleration of the rate of growth. Thus, the world economies were almost at the subsistence level of economic activity by the turn of the 1800s. Average rates of economic growth accelerated rapidly to 2 percent during the 19th century and rose above 3 percent over the 20th century course of development. During this process the rate of growth experienced by the leader of world capitalism is observed to have accelerated at each new round. While the rate of growth experienced by Netherlands, the then leader of world capitalism between 1580 and 1840, was only 0.2 percent; the upcoming leader, England, enjoyed a rate of growth of 1.2 percent during its reign 1820 through 1890. The rate of growth of the current leader, USA, averaged 2.2 percent over 1890 to 1990.[2]

We know that the other side of this underlying process of economic growth was a concomitant phase of *de*-industrialization of the regions which we refer today as the "third world". For example, India, which was the leader of the world textile manufacturing until the 18th century, has been converted into a peripheral economy which imports 70 percent of its textile

[2] For further discussion and specifics see, Parente and Prescott, 1993.

consumption in exchange for raw cotton by the 19th century.[3] Thus, the first wave of 19th century globalization was invigorated over a relatively equal distribution of income in a world producing at roughly subsistence level of consumption. Yet, the initial conditions of world income distribution inherited by the second wave of globalization in the late 20th century rested upon a deeply unequal structure.

Consequently one of the major distinguishing characteristics of the 20th century globalization regards the uneven distribution of world income upon which the consequent process of liberalization and deregulation are initiated. This second globalization wave is observed to deepen the existing/created unevenness of world income strata even further. As documented by the *1998 Trade and Development Report* of UNCTAD, the world *gini* coefficient of income distribution was 0.66 in 1965; increased to 0.68 in 1980; and to 0.74 in 1990. The average of the lowest percentile of world income was 74$ in 1965, in comparison to the average of the highest percentile which was 2,281$. This gave a ratio of 1-to-31. By 1990, the figures for the comparable percentiles were calculated to be 283$ for the lowest, and 17,056$ for the highest group. This meant a ratio of 1-to-60.

Concomitant to the intensified deterioration of the distribution of income strata, the 20th century globalization also witnessed a drastic change in the structure of the liquidity generation mechanism across the globe. While the liquidity mechanism of the 19th century was based mostly on the gold standard, the 20th century monetary systems mostly utilized *fiat* currencies. The fact that most of the major currencies of the world markets were based on nominal fiat values, which were effectively off-the gold standard after 1973 meant a system where "countries give up the exchange rate as an instrument of monetary policy up-front and must accept whatever exchange rate the global system generates" (Adelman and Yeldan, 2000b: 102). Set across a system of freely mobile international capital flows, flexible exchange rates amplify the swings in the financial markets by allowing speculation on foreign exchange markets that are excessively large; excessively liquid; excessively volatile; imperfectly informed; and subject to herd psychology.

Thus, it is this feature of the 20th century financial capital centers invited Adelman and Yeldan (2000b) to assert that "the process of economic development is at risk because the nature of global institutions for short term capital flows is robbing developing countries of their autonomy" (p. 96). To be able to better evaluate this assertion, we need to capture the essence of the concept of development more closely.

Economic Development Defined Proper

First, let's highlight the distinguishing characteristics of the process of *economic development* proper from *growth*. Succinctly put, the term "economic growth describes the process by which an economy dominated by agricultural activities carried on with low levels of capital per laborer is transformed into one in which industry and other non-farm activities produce the bulk of society's output using high levels of capital per worker"

[3] See, e.g., Collins and Williamson, 1999; Landes, 1969.

(Putterman, 2001: 142). As an extended outcome of this process, the proportion of output produced for consumption directly by the producer declines while the share of consumption produced by others increase. This phenomenon reflects the nature of commercialization embedded within the modern economic growth itself.

Economic development, on the other hand, refers to that process of growth "that translates into wide spread improvements in well-being" (*ibid*: 143). Following this vision, Adelman and Yeldan (2000b) note the following five determinants of economic development, as distinct from mere economic growth:

1. self-sustaining growth;
2. structural change in patterns of production and consumption;
3. technological upgrading;
4. social, political, and institutional modernization;
5. widespread improvement in the human conditions.

Accordingly, prior to World War II, today's developing countries experienced only cycles in economic growth, but not economic development. These cycles were in turn very much under the discretion of the cycles in the industrial countries through their input demands of primary food and raw materials from the developing world.

After the end of World War II, several new elements coincided to enliven economic development as a real possibility: (1) through a succession of movements for independence, most developing countries attained political autonomy; (2) this, in turn, coincided with a favourable international environment which granted a fairly strong economic autonomy in managing their industrialization targets.

Yet, it is precisely this economic and, by extension, political autonomy that is under severe attack by the current stage of neoliberal global agenda, putting the underlying policies of economic development at risk. The new wave of globalization, with the unfettered workings of highly liquid and volatile flows of financial capital, restricts the autonomy of the developing countries to pursue strategic policies to attain indigenous industrialization targets. To understand why this is the case, we must look at the underpinnings of the current exchange rate and open capital account regimes, and explain how the free international movement of short term financial capital undermines the ability of countries to induce economic development targets, depriving them of even the basic instruments of stabilization and austerity.

The Holy Trinity

To be able to take better account of the disruptive mechanisms of this structural fragility, we have to note the famous *tri-lemma* underlying an open economy that the international economists are fond of. In an open economy, the monetary authority can independently choose only one of the three following instruments: the nominal exchange rate, the interest rate, and the stock of money, leaving the determination of the other two to the interplay of the market forces. In fact, the interest rate and the exchange rate lose their independent autonomy all together, and turn into a single variable whose value is characterized by their relative magnitudes vis-à-vis each other. In

this setting, raising the net differential of the interest rate and the rate of depreciation of the exchange rate above the world market levels triggers a large foreign capital inflow, setting the structural foundations of a culminating financial crisis: the increased flow of foreign capital leads to an appreciation of the exchange rate, causing a deterioration of international competitiveness. Exports stagnate while import demand escalates. As this process continues, current deficit widens and foreign speculators lose confidence in the domestic currency. This might itself signal the confinement of the domestic asset markets to a vicious trap: in order to overcome the rising country risk and gain International creditworthiness, the central bank is compelled to rise the interest rates even further and start hoarding international reserves. In fact to market the economy as an attractive site for the international speculators, governments will necessarily be compelled to maintain interest rates at levels higher than they otherwise would prefer. This will set of a vicious circle of uncontrolled inflows of foreign capital, appreciation of the exchange rate, deterioration of the current account balance, erosion of the confidence… all of which necessitate even higher rates of interest calling for the re-commencement of the cycle. Elements of this vicious cycle are further studied in Kaminsky and Reinhart (1999), Diao, Li, and Yeldan (2000), Dornbusch, Goldfajn and Valdés (1995), Velasco (1987), Diaz-Alejandro (1985), and more recently referred to as the *Neftci-Frenkel cycle* in Taylor (1998) (following Neftci (1998) and Frenkel (1998)).

The initial bonanza of debt-financed public (*e.g.* Turkey) or private (*e.g.* Mexico, Korea) spending escalate rapidly, and severe the fragility of the shallow financial markets in the home country. Eventually the bubble bursts and a series of severe and onerous macro adjustments are enacted through very high real interest rates, sizeable devaluations, and a severe entrenchment of aggregate demand, while the short term "hot money" flows have already rushed out of the country leaving it broke and deprived of the traditional tools of adjustment and austerity. Conversely, setting the net differential of the interest and the exchange rates bellow the world market levels set the stage for capital outflow, directly triggering the crisis.

In short, countries that are dependent upon capital inflows need to adopt or maintain contractionary monetary policies in order to secure investor confidence and international creditworthiness. Thus, the governments of the emerging markets who seek to attract and maintain inflows of foreign capital are severely constrained in the *ex ante* sense to adopt a set of restrictive monetary and fiscal policies (Grabel, 1996). In this environment portfolio investors become the ultimate arbiters of national macroeconomic policy (Cizre-Sakallioglu and Yeldan, 2000; Frieden, 1991).

As an example of the magnitude of adjustments involved through the workings of the Neftci-Frenkel cycle outlined above, I refer to data from Turkish post-capital account liberalization episode. In Table 1, I portray the elements of this process. The net return on "hot money" is reported in column 1. This return is calculated as the rate of difference between the highest (nominal) interest offered in the domestic economy and the rate of (nominal) depreciation of the TL. It yields the net return to a foreign portfolio investment, which switches into TL, captures the interest income offered in the domestic economy and switches back to the foreign currency at the end-of-period exchange rate. The difference between interest earned

and the loss due to currency depreciation is the net earnings appropriated by the investor.

Table 1. Speculative Short-Term capital (Hot Money) Flows and Financial Indicators, Turkey (Millions US$)

		Banking Sector Foreign Credits					
	Return on Hot Money[a]	(1) Inflows	(2) Outflows	(3) BOP Errors and Omissions[b]	Net Short Term Capital Flows[b]	Reserves at CB	Current Account Balance[b]
1988	-0.073			515	-2,281	2,307	1596
1989	0.236			971	-584	4,831	961
1990	0.293			-468	3,000	5,972	-2625
1991	-0.038	43,186	42,523	948	-3,020	4,918	250
1992	0.154	64,767	62,363	-1,190	1,396	6,116	-974
1993	0.045	122,053	118,271	-2,222	3,054	6,213	-6433
1994	-0.315	75,439	82,040	1,769	-5,127	7,112	2631
1995	0.197	76,427	75,626	2,354	3,713	12,391	-2339
1996	0.329	8,824	8,055	-1,781	5,945	16,273	-2437
1997	0.278	19,110	18,386	-2,755	1,761	18,698	-2638
1998	0.254	19,288	19,225	-1,985	2,601	19,721	1984
1999	0.298	122,673	120,603	1,899	759	23,177	-1364
2000	0.073	209,432	204,691	-2,677	4,035	18,820	-9,500

Sources: Central Bank Balance of Payments Statistics; SPO Main Economic Indicators.

a. [(1+R)/(1+E)-1]; R: The highest rate of return offered in the domestic market; E: TL Rate of Depreciation.
b. Inclusive of luggage trade after 1996.

The inflows show high sensitivity to whether or not the domestic rate of return is positive. Except for 1990 values, the net flows are observed to be of the expected sign. Net flows fluctuated widely, especially between 1993 and 1995, and caused drastic business cycles with 1994 being the worst economic crisis of the post-War Republic history. It has to be noted, however, that one has to be aware of the *gross* magnitudes of such flows rather than *net* amounts. For that is where the de-stabilizing consequences of speculative short term capital movements prevail. The gross in- and outflows of banks' foreign credit acquisitions and repayments for the post-1991 period are given in columns 2 and 3. We witness that the gross inflows grew rapidly from $50 billions in 1991 to reach $120 billions in 1995. After a brief deceleration during 1996 and 1998, they again reached to 108.6 billions in 1999, and $209 billions in 2000. This magnitude is almost the full size of the overall Turkish GNP! Clearly, the domestic financial system is under a severe pressure of the international speculative centers and is no longer in a position to generate an independent monetary and foreign exchange policy. Furthermore, those centers constituted the major reason for the short-termism and volatility of the real business cycles, led to increased fragility of the financial and the external position of the domestic economy, and resulted in worsening the distribution of income.

In order to accommodate to this process, the Central Bank is pushed into a passive role of foreign reserve administration and is forced to hold significant foreign exchange. Indeed, one of the most direct consequences of the hot money inflows was the massive build up of international reserves of the Central Bank. This build up is clearly visible from data displayed in Table 1. Thus, rather than financing productive investments in the real sector, short-term capital inflows lead to a rapid build up of the reserves of the monetary authority. This reflects a serious contrast to the orthodox expectations, prognosticating a complementarity between financial liberalization and the expansion of investment funds in the domestic economy. In this setting, the only proper role that is remained for the monetary authority becomes that of monetary sterilization so that the surge in the value of money supply is checked by restricting the *domestic* component, with a consequent rise in the domestic interest rates, and a re-commencement of the cycle.

Concluding Comments

Integration of the developing national economies into the evolving world financial system has been achieved by a series of policies aimed at liberalizing their financial sectors. The motive behind liberalization was to restore growth and stability by raising saving and improving economic efficiency. A major consequence, however, has been the exposure of these economies to speculative short term capital movements (hot money) which have increased financial instability and resulted in a series of financial crises in the developing countries along with divergence of domestic savings away from fixed capital investments towards speculative financial instruments with often erratic and volatile yields. As a result, the indigenous economies with weak financial structures and shallow markets suffered from increased volatility of output growth, short-sightedness of entrepreneurial decisions, and the overall marginalization of labor markets.

In this paper I have argued that the new wave of globalization led by open capital markets and unfettered financial flows constrain the developmental states in pursuing strategic industrialization and development targets. Yet, history provides overwhelming evidence that successful long term economic development entails a state-led process of systematically transforming dynamic interactions between institutional change, technological progress, and structural change in the profile of production, distribution, and consumption. Nevertheless, the pace of industrialization and modernization that the developing countries can achieve are severely constrained under the post-Bretton Woods era of financial liberalization orthodoxy. Such efforts are restricted to a balanced budget, entrenched fiscal expenditures, and a relatively contractionary monetary policy with an ex ante commitment to high real interest rates. All of this signify reduced political autonomy in the developing world in exchange for market access to industrialized North, and itself is a bad bargain as far as development is concerned (Rodrik, 2001).

The detrimental consequences of the free movement of short term capital flows are not limited to the erosion of the developmental objective. They are further held responsible for depriving the governments from the classic tools of austerity and setting the stage for full-fledged financial crises. As open capital markets replaced closed short term capital markets and regulated

flows of foreign investment, governments became unable to employ their traditional policy instruments (interest rates, rate of monetary expansion, and exchange rates) unilaterally: Raising interest rates above world markets triggers a large inflow of foreign capital, setting the stage for a financial crisis; fixing them below world markets, triggers a large foreign capital outflow, generating the crisis. Similarly, setting exchange rates above equilibrium levels leads to a current account deficit; fixing them below equilibrium stimulates capital flight and investment abroad, producing the crisis. Finally, running a budget deficit to stimulating growth or providing social programs more generous than the international norm causes capital outflows. Flexible exchange rates amplify the effects of these international capital flows, by allowing speculation on foreign exchange markets that are excessively large; excessively liquid; excessively volatile; imperfectly informed; and subject to herd psychology.

In the words of the UNCTAD's 1998 *Trade and Development Report*, "the ascendancy of finance over industry together with the globalization of finance have become underlying sources of instability and unpredictability in the world economy. (…) In particular, financial deregulation and capital account liberalization appear to be the best predictor of crises in developing countries" (pp. v and 55). Almost all recent episodes of financial-cum-currency instability disclose that the observed sharp swings in capital flows are mostly a reflection of large divergences in domestic financial conditions relative to those of the rest of the world. Reversals of capital flows are often associated with deterioration of the macroeconomic fundamentals in the recipient country. However, "such deterioration often results from the effects of capital inflows themselves as well as from external developments, rather than from shifts in domestic macroeconomic policies" (*ibid*, p. 56).

From a policy point of view, the very starkness of the picture of the diminished possibilities for attaining developmental targets painted throughout this paper implies that many of the remedies suggested for achieving sustained growth and avoiding future financial crises will do no such thing. These include: financial sector reform; better information; the creation of a new international institution to supervise international financial transactions and operate as a lender of last resort; cleaning up corruption in lending; getting government out of the targeting business; and improving the governance of the corporate sector. Notwithstanding the importance of these structural reforms, the single most important source in our analysis for a crisis to develop was short term financial markets open to international financial flows which are navigated by the herd behaviour induced by the speculative and short sighted portfolio investors. In this vein, our readings of the recent history of failed developmental objectives and financial crises suggest that the primary basic remedy for attaining sustained development lies in regulating short-term international flows, and highlight once again the now classic dictum due to Keynes, "*above all, let finance be primarily national".*

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