

FagsF 26

Bernhard Emunds

**The Integration of Developing Countries
into International Financial Markets –
Remarks from the Perspective
of a Christian Economic Ethics**

Paper presented at the Fourth International Symposium
on Catholic Social Thought and Management Education
(July 11-14, 2000, Universidad Iberoamericana, Puebla, Mexico)

Frankfurt am Main, Juli 2000

Contents

1	Preliminary remarks on a Christian ethics of international economic relations	4
1.1	The perspective of Christian ethics	4
1.2	Global redistribution – a nonsolution for the misery in the »Third World«	5
1.3	The co-responsibility of the North for the development of the South	5
1.4	What kind of development?	5
2	Why can debt be a problem for development?	7
2.1	Development needs expansion of debt	7
2.2	Portfolio investments in emerging markets – a wealth-creating nonsolution of the development problem	7
2.3	The causes of large net external debt	8
2.4	Problems caused by net external debt	10
3	Goals for shaping financial integration	12
3.1	Limitation of capital inflows	12
3.2	Reduction of the vulnerability of the domestic financial system to financial and monetary crisis	13
3.3	Strengthening of the domestic banking system	13
3.4	Maintaining some flexibility in national economic policy	14
3.5	Further development of a country's particular economic style	15
4	Possible measures for shaping the financial integration	16
4.1	Regulation of external financial relations	16
4.2	Monetary cooperation between the South and the North	17
	Literature	20

The Integration of Developing Countries into International Financial Markets – Remarks from the Perspective of a Christian Economic Ethics*

In this paper I would first like to indicate the ethical perspective from which the financial integration of developing countries will be evaluated. The second part of this presentation will consist of a brief economic analysis of the problems developing countries have with external debt. This will lead us - third - to an outline of the goals for reshaping the integration of »Third World« countries into international financial markets. And I will conclude - fourth - with some remarks on possible measures to improve this integration.

1 Preliminary remarks on a Christian ethics of international economic relations

1.1 *The perspective of Christian ethics*

The perspective of Christian social ethics is marked by the »option for the poor«. In the Bible, God is at the side of the poor, sees their misery and encourages them to an exodus out of the house of slavery (Lohfink, 1995). For those Christians who are not poor the option requires them »to evaluate social and economic activity from the viewpoint of the poor and powerless« (EJA 87) and to give the highest priority to »meeting the basic needs of the poor« (EJA 90). In the Bible, the poor were not passive recipients of charity but played an active role. They left Egypt, marched through the desert and founded a new society. Thus the nonpoor Christians in a rich society have to avoid paternalism. Their task is to help to order »social institutions ... in a way that guarantees all persons the ability to participate actively in the economic, political, and cultural life of society« (EJA 78).

Similarly, a Christian ethics of international economic relations begins with the challenge posed by the overwhelming misery of the majority of the people in developing countries. Because ethical reflection does not mean simply giving advice as an unconcerned bystander, ethicists from industrialized countries should only participate in a »moral-practical discourse« over development issues in the South if they acknowledge that the North is in several ways co-responsible for the situation of the South.

* This text is based on some of the findings of a research project conducted at the Nell-Breuning-Institut of the Hochschule St. Georgen and financed by the Volkswagen-Stiftung: http://www.st-georgen.uni-frankfurt.de/nbi/nbi_pro_finanz.htm

1.2 *Global redistribution – a nonsolution for the misery in the »Third World«*

Some people argue that the misery in the »Third World« could and should be abolished merely by a global redistribution of funds. They contend that people in the industrialized countries have a responsibility to help the poor in developing countries by renouncing a part of their consumption and placing the huge amounts saved at the disposal of the developing countries. Certainly, the industrialized countries should use a greater part of their gross domestic product for development assistance that truly supports the development processes in the countries of the »Third World«. But the misery in these countries cannot simply be abolished by a huge redistribution of funds from the North to the South. Historical experience shows that hunger and poverty in a country can only be reduced if the people in this country themselves shape and bring about their country's development. So the North should realize its co-responsibility not by granting enormous sums of money but by furthering the development processes in the South.

1.3 *The co-responsibility of the North for the development of the South*

From the industrial countries' co-responsibility for the situation in developing countries follows an obligation both to grant development assistance and — more importantly — to meet two extensive and demanding challenges. First, the North needs to transform its economy to an ecologically sustainable system. Because the industrialized countries need to leave environmental space — both in terms of natural resources and absorbing capacity — not only for their own future generations but also for the growth of the South they have a responsibility to start a transition toward sustainability (Sachs/Loske/Linz 1998). This responsibility is reinforced by the fact that the economies of the »First World« continue to be the most influential models for the »Third World«. The second challenge follows from two realities (cf. Pogge 1998): Markets and other institutions at the global level influence the paths of change developing countries take. And global structures are primarily determined by the G7 and other industrial countries. Thus a Christian ethics of international economic relations needs to address how global institutions can be changed so that they will promote development in the »Third World«.

1.4 *What kind of development?*

In Catholic social teaching, the desired social change (both in developing and industrialized countries) is described as a comprehensive process: »the fully-rounded development of the whole man and of all men« (PP 42). »Peoples or nations

too have a right to their own full development, which, while including (...) the economic and social aspects, should also include individual cultural identity and openness to the transcendent.« (SRS 32). This kind of comprehensive development process is seen as an increasing fulfillment of »human rights — personal and social, economic and political, including the rights of nations and of peoples« (SRS 33).

The economic aspect of the desired development process in the South can be identified as sustainable growth of per capita income and balanced distribution of income and wealth. More specifically a developing country should – according to John Rawls´ maximin rule – chose the development path that will offer »the greatest benefit for the least advantaged«. It is true that Rawls´ concept of »justice as fairness« has been interpreted as a concept tied to its particular context of the United States, i.e. reflecting the convictions of a profoundly democratic people with at least a minimum of basic institutions of social security. Nevertheless his maximin rule is particularly appropriate for developing countries, where alleviating the abject misery of the majority of the population should take precedence over all further claims for improving the standard of living for those who are better off. At least for these countries the maximin rule offers a conclusive synthesis of wealth creation and distribution – the two goals forming the motto of this symposium.

Some economists like to analyze ideal markets and emphasize their advantages over other institutions (mainly regulations and activities of the state). But market relations are imbedded in social institutions and cultural traditions. On the one hand cultural attitudes affect all economic activities. Without internalized rules of conduct most economic activity would be very risky and their transaction costs prohibitively high. On the other hand changes in the economy are also a very dynamic force for change of an entire society, including gradually changing world views and values and norms of people. If considered from this angle, each society has its own economic style (»Wirtschaftsstil«; cf. e.g. Schefold 1995), which means a specific shape of its economic institutions or specific rules of its domestic economic activities. This economic style is connected with other institutions of the society and with the values held by the people.

In a changing society the cultural identity of a people, including its economic style, is in a continuing process of transformation. In some cases the living conditions of the poor in the »Third World« can only improve if cultural attitudes and the corresponding economic style change¹. However, this does not mean that developing countries ought to adopt the cultural values and economic style of the North/the West or, even less so, the shape of economic institutions prevalent in one

¹ An interesting example, the establishment of a microcredit institution in Nicaragua, is analyzed by Bastiaensen 2000.

particular northern country. »Not even the need for development can be used as an excuse for imposing on others one's own way of life or religious belief« (SRS 32). It is part of the right to development that a country must have an opportunity for authentic development of its own economic style. That means an institutional transformation that allows most members of the society to see their economic activities reflect their own – also changing – perception of good life.

2 Why can debt be a problem for development?

2.1 *Development needs expansion of debt*

Jubilee 2000, the international movement that advocates for the cancellation of the debt of developing countries, demands of politicians and bankers in industrial countries: »Break the Chains of Debt!«. The German campaign for example advertises with the motto: »Development requires forgiveness of debt (Entwicklung braucht Entschuldung)!«. Looking at the financial relations within a developing country the opposite seems to be true: »Development requires expansion of debt!«. The reason is that achieving higher levels of income is closely associated with production processes involving more expensive capital goods, most of which are financed not only by profits but also by credits. Thus economic growth requires that the circulation of credit – efficiently allocated to promising investment projects – expands too². Or, alluding to the title of the symposium: Because each title of debt is not only a liability (for the borrower) but also an asset (for the creditors), »wealth creation« and growth of indebtedness for the most part are two sides of the same coin.

2.2 *Portfolio investments in emerging markets – a wealth-creating nonsolution of the development problem*

Economists like to circumvent distributional conflicts by recommending measures that should result in a Pareto-superior economic situation: Some participants will be better off than they were before, while nobody ends up worse off. Such positive-sum gains – in a certain sense strategies of »wealth creation« – are very attractive recommendations, but they don't always work. One influential idea of a global positive-sum gain was a driving force behind the high growth of private financial flows – mainly in the form of portfolio investments (in contrast to non-tradable

² The positive influence the development of a workable financial system has on the growth of the economy has emerged as a very important field of economic research (cf. the overview of this literature by Levine 1997).

bank loans and foreign direct investments)³ – into East Asian and Latin American countries in the first half of the 1990s. In this view, the low savings rates of many developing countries were attributed to the extremely low income of the majority of the people in these countries (»financing gap«)⁴. Because financial flows from industrial countries would seem to reduce or completely fill this gap they should allow higher investment and accordingly faster growth of developing countries. At the same time savers in industrial countries could – according to this view – benefit from higher returns if their financial intermediaries invested in companies in developing countries.

This optimistic view was deeply shaken by the Asian Crisis (1997/98). Because in the years before the crisis institutional investors had massively bought money markets instruments, bonds and stocks – financial assets that can be sold immediately on secondary markets – problems in the financial system of Thailand were able to trigger an immense outflow of capital from Thailand and therefore a monetary crisis of the Baht. Also the short-term character of portfolio investments made it easier for the virus of crisis to leap over first to other East Asian countries and in the following months to some Latin American markets and to Russia (contagion). Obviously the immense portfolio investments in emerging markets that had been welcomed as a global Pareto-improvement now proved to have greatly increased the vulnerability of the debtor countries to financial and monetary crises. That is why the majority of economists today are more skeptical about portfolio investments and support the idea that measures to reduce the purchase of treasury bills, commercial papers, wholesale deposits, bonds and stocks by foreigners can be beneficial for developing countries (cf. 4.1). But perhaps the problem indicated by the Asian Crisis is not exclusively one of the short-term character of foreign investments, but a more profound problem associated with every large net external debt⁵ of developing countries.

2.3 The causes of large net external debt

³ A portfolio investment means the buying of money market instruments, bonds or stocks (without attaining decisive influence on the management of a business) in a foreign country.

⁴ Because of the possibility of commercial banks to create money the Keynesian position that saving (which includes retained earnings of companies) is determined by investment and not by voluntarily postponing consumption is more convincing to me. That is the reason why I think that the »financing gap« view is inherently flawed. Cf. for example Riese 1986; Studart 1993.

⁵ Net external debt = liabilities of domestic economic units owed to foreigners - domestic claims on payments by foreigners.

Since the Latin American debt crisis many attribute the high external debt of developing countries to extravagance, bad planning and embezzlement of governments or elites in the "Third World". Surely this view highlights important obstacles to development in some countries. But because the debt discussed here is external, an analysis of causes has to take into consideration the role played by international economic relations. According to the ethical perspective of co-responsibility, the following analysis is focused on these aspects.

If a country's current account balance is in deficit, the country is constrained to net capital imports. If the difference between the goods and services imported and those exported is not financed by grants the country's net external debt grows. The unbearable external debt of the poorest countries – many of them located in sub-Saharan Africa – is largely caused by such current account deficits (and by the interest on debt previously borrowed). Because their creditors are mainly national governments and international financial institutions (such as the IMF and the World Bank) and not financial intermediaries, businesses or households, the special debt situation of these countries is not further considered here⁶. But the high net external debt of some Latin American middle income countries – partially owed to financial intermediaries, businesses and households in industrial countries – is to some extent also caused by persistent current account deficits, which are of course the reverse of current account surpluses of other countries especially of the European Union and of Japan. So one should note here that a large part of the net external debt is caused by international trade asymmetries: by the success of export-oriented countries, by import obstacles in industrial countries, by falling prices of raw materials, and by the failure of indebted countries to diversify the range of their exports.

At least since the early 1990s, however, the opposite causal direction became more important for Latin America: High capital imports caused current account deficits (Turner 1995). The inflow of enormous funds – released by the search of international investors for higher interest rates – allowed some Latin American countries to finance a great expansion of aggregate demand, which increased imports. At the same time the expansion, which was partially financed by external debt, raised domestic prices and nominal wages. This inflation eroded the competitiveness of the Latin American businesses on international markets. With imports increased and exports slowed, the current account balance had to turn negative. The role of autonomous capital imports (capital imports not induced by trade) was even more pronounced in the case of the growing indebtedness of pre-

⁶ I agree with the Jubilee 2000 proposition that an extensive debt relief for these countries is needed. Because benefits from investments in education, health or infrastructure are a long time coming, future development assistance should be given in grants, not credits.

crisis East Asian countries. Because they liberalized cross-border financial transactions, these countries of the »Asian miracle« became favorites of international investors (cf. Dieter 1999). But in this case the affection was not beneficial to the recipient. As we already know these portfolio investments increased the vulnerability of the East Asian countries to monetary crises. In addition they contributed to the East Asian boom of real estate and stock markets, which set the stage for the financial crisis of 1997.

2.4 Problems caused by net external debt

Countries with great net external debt run a much greater risk that foreign exchange markets become a source of instability seriously impairing their development, if their money is not one of the few international currencies (especially U.S. \$, EURO, Yen). A currency is called international currency if (almost) all large-scale international investors wish to hold assets denominated in it. Especially assets denominated in U.S. \$ make up a sizable share of the portfolios of international investors. In the end the profit that assets of different currencies are expected to yield is measured and compared in terms of U.S. \$. Thus U.S. citizens can borrow extensively and without difficulty in their own currency. By contrast, economic units of a developing country have to borrow in foreign currency. If they succeed in borrowing in their own currency they have to pay a higher interest rate compensating the creditors for the risk of devaluation.

Most problems associated with the high net external debt of developing countries derive from the fact that for a currency not appreciated by international investors this external debt causes an expectation of devaluation. First, high net capital imports, unless they are balanced by a corresponding current account deficit, cause a real overvaluation. In the case of fixed exchange rates the risk that prices of goods produced in the country rise on international markets is transmitted by high domestic inflation (higher than in other countries). In the case of floating exchange rates it is the rise of the exchange rate itself which causes the real overvaluation. But what is overvalued today is expected to come down in the future. Second, high net external debt of a developing country causes the expectation of a future high supply of its currency: The coming interest payments and repayments of debt (or the withdrawal by the creditors) will involve an exchange of the domestic currency of the debtor into currencies accepted by the creditors. If this increased supply of the debtors' currency will not be met by an equally higher demand by private

economic units there will be a tendency of devaluation⁷. In the case of flexible exchange rates the debtors' currency will devalue in the moment of higher supply. In the case of pegged exchange rates the central bank of the debtors' country can maintain the exchange rate in principle as long as their international reserves are not used up. But in the long run it alone will not be able to neutralize the private capital outflow. That is why private economic units often begin to speculate on the devaluation of the currency. If the central bank of the debtors' country is not assisted by a central bank of an international currency, this speculation will probably skyrocket and become a speculative attack that forces a monetary crisis.

One fundamental problem of devaluation is that the debt burden of all the country's economic units with foreign debt is increased in relation to their income, which is earned in domestic currency. Thus a massive devaluation can trigger mass bankruptcies of banks and businesses, which depress the economy.

Another basic problem is that the anticipation of a probable devaluation weakens the country's commercial banks. In an industrial country with an internationally accepted currency, the central bank is able to stabilize the commercial banks. The main part of their business can be described as maturity transformation: to lend on relatively long terms and to »finance« that with short-term liabilities. The latter are the deposits for which the banks pay lower interest rates than they earn on their loans. The business of maturity transformation is possible as long as all depositors feel assured that, if need be, they will be able to convert their deposits into legal tender, i.e. »cash«. Because this convertibility is guaranteed by the central bank – which could if necessary issue legal tender (of its own currency) without limits (»lender of last resort«) – no mass withdrawals and bank runs will occur.

But in the case of developing countries under suspicion to devalue, investors don't feel hedged against a crisis by guarantees to convert their bank deposits into the legal tender of the country's currency. They demand international currencies, which can be placed at their disposal by the developing country's central bank only in the limits of its international reserves. Because the domestic central bank of a developing country cannot exclude the possibility of a bank run (accompanied by a monetary crisis), commercial banks in developing countries are much less stabilized by their central bank than their counterparts in industrial countries.

Because they are less stabilized, sound commercial banks in developing countries strongly restrict the expansion of their loan business, which is crucial for long-lasting

⁷ Here the contrast with U.S. debt is also instructive. Because it is expected that (almost) all international investors will continue to want to hold assets denominated in U.S. \$ no structural oversupply – and accordingly no long-term tendency of devaluation – is anticipated for the U.S. \$.

growth processes: By expanding credit, commercial banks provide businesses with additional funds for expanding and modernizing their production processes. Because sound commercial banks do not lend to just anybody but search out businesses with promising investment projects and monitor their use of the money lent, the expansion of their loans finances real growth and not only inflation.

3 Goals for shaping financial integration

The just analysed negative consequences of net external debt for developing countries could lead one to conclude that developing countries should as much as possible resist integration into international financial markets. Such a position of financial isolationism, however, is unrealistic. First, the overwhelming majority of economists today believes that participation in trade and an openness to foreign direct investments not only generally promote growth, but also improve the living standard for the poor. Trade and foreign direct investments, however, always involve crossborder financial transactions. Second, the problem for a developing country is not its foreign debt in and of itself, but a high net external debt, i.e. liabilities owed by domestic economic units to foreigners, which are far greater than the domestic claims on payments by foreigners. Third, a balanced current account may be an important goal of development – it follows not only from the already analyzed negative consequences of net external debt for developing countries, but also from the loss of aggregate demand to abroad associated with a substantial current account deficit. But because the road to a balanced current account is far, in the foreseeable future many developing countries will continue to have to live with current account deficits that make its net external debt grow. And because a substantial increase in governmental development aid at this point does not appear very likely, developing countries don't seem to have much of a choice but to integrate into the private international financial markets. The main question is whether this integration will be shaped consciously and which goals should be pursued in doing so.

3.1 *Limitation of capital inflows*

As detailed above (2.3), it is not only true that current account deficits lead to net capital imports but, vice versa, high autonomous net capital imports can also lead to current account deficits. Considering these correlations, the negative consequences of a high net debtor status and of persistent current account deficits suggest the following policy goal: Developing countries with a current account deficit should try to limit capital inflows to the extent they need to finance their current account

deficits. Additional capital imports should be reduced so they won't lead to a further accumulation of debt, which is not necessary for financing a trade deficit, and to an additional worsening of the current account balance.

3.2 Reduction of the vulnerability of the domestic financial system to financial and monetary crisis

The key role that the rapid massive outflows of stocks and bonds played in triggering and expanding the Asian Crisis indicates the importance of not only limiting but also actively shaping net capital imports. Thus today most economists would applaud efforts by developing countries to reduce their susceptibility to financial and monetary crises by reducing their share of portfolio investments in favor of more direct investments and longer-term bank loans.

3.3 Strengthening of the domestic banking system

Considering the importance of a strong domestic banking sector for sustainable economic growth (cf. 2.4), the question arises whether commercial banks are more strengthened or weakened by fostering stock and bond markets. This question – which can probably only be answered for the particular economic situation in each country – is important here because substantial portfolio investments can only flow into countries that have sufficiently developed stock and bond markets. Thus a far-reaching external financial liberalization always requires a high internal financial liberalization, particularly a promotion of stock and bond markets.

As far as the relationship between the growth of stock and bonds markets and the strengthening of the banking sector is concerned, it must be noted that on the one hand stock and bond markets are in competition with the long-term loans supplied by banks. When companies have greater and more attractive opportunities to get financing by issuing stocks and bonds, the profit margins in the credit business of commercial banks decline – and with it their capacity to invest in expanding their business (Hellmann/Murdock/Stiglitz 1997, 179). On the other hand, an expansion of the stock and bond markets can also sometimes expand the credit-business opportunities for commercial banks. Such a complementarity occurs when businesses first use commercial banks to finance short-term their investment projects and then issue stocks or bonds and use the receipts to repay the bank loans (»funding«). In this case, stock and bond markets partially relieve commercial banks from the task of maturity transformation. This expands the capacity of commercial banks to lend further credits because their risk to become illiquid is

positively correlated with the extent of their maturity transformation (cf. Studart 1993). But there may be an other way to reduce the extend of maturity transformation by banks necessary for a certain volume of total credit: The depositors of commercial banks can do it by reducing the part of deposits they withdraw and by changing the relation between short-term and long-term deposits in favor of long-term. Of course this requires that the saver have a high degree of trust in the long-term solvency and liquidity of the commercial banks – a condition that in developing countries is not easily met (cf. 2.4).

For the financial aspect of rural development it is crucial that domestic banks are able to achieve high profit margins that allow them to expand their rural branches. Of course, the expansion of domestic banks into rural areas alone provides no guarantee that micro-enterprises with promising investment projects actually obtain credit. That is why the establishment and expansion of micro-credit institutes should be promoted as well.

3.4 *Maintaining some flexibility in national economic policy*

A combination of free capital flow and fixed exchange rates does not allow small countries to pursue an independent monetary policy («impossible trinity»). Lets assume that a country announced fixed exchange rates and that there is no expectation of a devaluation or revaluation of its currency at all. In other words not only the actual exchange rate of the currency (e.g. to the U.S. \$) but also the expected exchange rate for one year hence seems to be sure. If the country has liberalized its capital account it is compelled to set the riskfree interest rate for one-year bonds at the level of the corresponding interest rate of the global market. Otherwise a higher domestic interest rate would result in massive capital inflows, while a lower rate would lead to massive capital outflows.

Similarly, high capital mobility limits the available options for a government's financial policy. If the government of a developing country to a considerable extent debt-finances its budget, investors on the international financial markets will invariably interpret this as a sign of fiscal laxity. That's why developing countries that attempt to counter a recession with an expansive fiscal policy run the risk of prompting or accelerating a strong outflow of international capital (cf. Eichengreen 1999b, 210-212). In a country in which monetary policy can no longer be used anticyclically and in which fiscal policy has to be consistently restrictive at all times, the amplitudes of business cycles are greater and financial crises more likely. That reduces the average growth and increases in particular the insecurity of low-income or short-term workers and of the unemployed (cf. ILO 1998). The integration of

developing countries into the international financial markets should be shaped in a way that maintains some economic-political flexibility for their governments.

3.5 Further development of a country's particular economic style

To illustrate the importance of this goal, it may be helpful to take a look at the particular style of the German economy. To this day in Germany the task of corporate control has been fulfilled by insiders of the corporation: representatives of the »house banks« – often combining the role of most important lenders and major shareholders – by managers of related businesses and by representatives of the employees. All these parties have accumulated an enormous capital of private knowledge about the corporation and, because they have much at stake, are interested in its success in the long run. This system of corporate control and the resulting long-term-profit orientation are part of the German (or continental-European) economic style. Other characteristics are the search for a fair balance of interest between employees and employers, highly motivated employees with secure jobs and high company-specific know-how and products that may not be at the cutting edge of technological innovations but that provide solid solutions to complex problems by means of mature technologies (cf. e.g. Albert 1993; Schmidt 1999). However, the German system of corporate control has been eroding because of the increasing integration of Germany into international stock markets. Like in Anglo-American financial systems (cf. e.g. Allen/Gale 1995), these markets – by the threat of hostile takeovers (»market for corporate control«) – discipline managers in the interest of shareholders. If in the end the German system of corporate control is replaced by the Anglo-American system, which is above all oriented to the short-term interests of »outsiders«, the German economic style of long-term profit orientation and balance of interests will be in peril.

Perhaps this little digression can indicate how much greater the cultural problems are that developing countries face in integrating their financial markets into the international financial system. These problems are obvious in the case of countries with a mainly Islamic population that keep to the prohibition of interest. But they are also present in the case of more »liberal« financial systems in East Asia that are not less bank-dominated than the Japanese or the German. In the course of a hasty financial liberalization, regulations that limited loans to buyers of shares or real estate were abolished. As a result, the interrelationship between credit-expanding banks and companies buying capital goods was impacted and a boom on markets for shares and real estate – which was one of the causes of the later financial crisis – was triggered (cf. Stiglitz 1998a). Another typical characteristic of the East Asian economic style was the close connection between the government and the commercial banks. The government used the banks to provide financial funds to

industries with high strategic importance for development and in return guaranteed the banks' survival. When in the course of financial liberalization the traditional limits to external debt were released, many commercial banks assumed that they would not have to take the risk of becoming insolvent by a devaluation of their currency and extensively refinanced themselves on the lower interest rate level of foreign money markets.

But in all cases – not only when the risk of a financial crisis is increased – attention should be paid to the compatibility of a national financial system transformed by a new or deeper integration into international financial markets with the economic style of the country and with the people's convictions of good life. A transformation of a national financial system will frequently cause or accelerate changes in a country's traditional economic style; but it should not imperil this economic style.

4 Possible measures for shaping the financial integration

The widespread opinion that developing countries should reduce the risks inherent in the integration into international financial markets primarily by means of a good internal economic policy addresses key elements. In our context this means, among other things, a fiscal and monetary policy oriented to sustainable growth, a limit on the external debt of the government and an effective regulation and supervision of financial institutions (cf. e.g. Eichengreen 1999b, 219). But it were economies that had until then been praised as »miracles« that fell victim to the Asian crisis. This shows that all developing countries need some protection against the instabilities of the international financial system. Those developing countries that do not shape their integration into international financial markets will be exposed to the vagaries and whims of international investors.

»Even with the best economic management, small open economies remain vulnerable. They are like small rowboats on a wild and open sea. Although we may not be able to predict it, the chances of eventually being broadsided by a large wave are significant no matter how well the boat is steered. Though to be sure, bad steering probably increases the chances of disaster, and a leaky boat makes it inevitable, even on a relatively calm day.« (Stiglitz 1998b)

4.1 Regulation of external financial relations

Since the Asian crisis, support has grown among economists for some kind of capital controls, especially for measures that would slow the inflow of foreign short-

term capital. Above all the Chilean non-remunerated deposit requirement is praised. This capital control stipulates that all debt foreign capital inflows must be accompanied for one year by a deposit without interest (cf. Eichengreen 1999a, 49-55). Because the loss of interest income from this regulation declines with the duration of the investment, the government of a recipient country can, with this tool, try to reduce the share of short-term external debt in favor of long-term debt (cf. 3.2). At the same time it can also be flexible in determining the percentage of the invested money that has to be deposited without interest. Because this will raise or lower the costs associated with the capital control, the country possesses a tool with which it can try to limit the capital inflow to the extent necessary for financing its current account deficit (cf. 3.1).

With moderate regulations a developing country can also try to shoe up externally a policy that stabilizes its domestic commercial banks (cf. 3.3). This is needed because an erosion of the profit margin in banking is inevitable if portfolio investments flow into the country to an extent that financing by issuing new shares, bonds or commercial papers becomes very attractive. Limits of entry and operation for foreign financial institutions can often also be helpful in securing the profits of domestic banks in order to safeguard their capacity to invest in the expansion of their business. To be clear, it is the enforcement of exactly these kinds of regulations for which the Meltzer Commission recommends to punish a country by cutting it off from further IMF lending (IFIAC 2000).

The limitation of capital inflows and of foreign financial institutions can also help a developing country with a bank-dominated financial system to preserve and continuously adapt its own authentic economic style (cf. 3.5). With such measures the special aspects of a domestic financial system that have a positive influence on the development process of the country can be protected against the global trend of a standardization of financial systems toward the Anglo-American model.

Of course, the task of regulating the external financial relations of economic units in developing countries is the responsibility of the governments of developing countries. But the above comment on the Meltzer Commission indicates that here too industrial countries have a co-responsibility. Without the support of the Northern-dominated international financial institutions – especially the IMF and the World Bank – most developing countries will not be able to implement such capital controls over the opposition of big international investors.

4.2 *Monetary cooperation between the South and the North*

Compared with the just-mentioned modest capital-control regulations, a developing country that wants to maintain fixed exchange rates and an autonomous monetary policy would have to implement much tighter restrictions on capital flows. A country with credible fixed exchange rates could fix the short-term interest rate for a longer time above (or below) the interest rate level of international money markets only if it strangled nearly completely any capital in- or outflows. Because the costs of such a financial isolation would be too high, many economists recommend that developing countries simply give up on setting any exchange rate targets and let their currencies float unimpeded. But this recommendation overlooks an important risk of floating exchange rates: If the currency of a developing country devalues, it quickly leads to an expectation that the currency will continue to devalue further. If this happens, a floating currency risks getting pulled into a maelstrom of devaluation with all the disastrous consequences outlined above (cf. 2.4).

For developing countries, the chances for growth seem greater if another recommendation would be adopted (Bofinger 1998; 2000). On the one hand, Mr. Bofinger's blueprint for reshaping international monetary relations envisions that the central bank of a developing country has the ability to fix the short-term interest rate according to the internal demands of the national economy. On the other hand, the central bank is urged to choose an exchange rate target that is compatible with this interest rate. Thus a central bank could, for example, try to slow down a boom by setting short-term rates higher than the interest rate level of international money markets. But such a policy would have to be complemented with an officially targeted devaluation of the country's currency to an extent that would - for international investors - exactly compensate the difference in interest income (cf. theory of interest parity)⁸. With such a consistent interest and exchange rate policy, the central bank of a developing country could prevent massive inflows of foreign capital attracted by exceptional high interest rates.

Because the central bank of the developing country would not by itself be able to prevent a currency crisis and a massive outflow of capital, the other part of Mr. Bofinger's proposal addresses the role of central banks in leading industrial countries. In the case of an imminent currency crisis, investors want to hold an international currency. That is why in these cases the central bank of a developing country is dependent on the support of central banks that can issue without limit legal tender of an international currency. Only with this support can the exchange rate target of a developing country credibly be protected downward. If central banks in leading industrial countries would announce their cooperation with the central

⁸ In the long run, the development of the exchange rate of a developing country must also be compatible with the difference in inflation vis à vis industrial countries with international currencies (cf. theory of purchasing power parity).

bank of a developing country along the lines of this plan, and if such an announcement were seen as credible by international investors, the country would no longer be vulnerable to a currency crisis (cf. 3.2). In addition, such a cooperation would strengthen the domestic banking system of a participating developing country (cf. 3.3) because it would make possible an effective »Lender of Last Resort« protection: The central bank of the developing country would guarantee that in the case of a crisis all deposits of solvent commercial banks can be converted into domestic legal tender; the participating central banks with international currencies would guarantee a rate at which this money, in case of a crisis, could be exchanged into an international currency.

This far-reaching proposal demands a high degree of cooperation from the central banks of industrial nations that issue international currencies. If at all, such a cooperation would only seem acceptable to industrial countries if their co-guarantee of the exchange rate target would be tied to the developing country pursuing a sound economic policy. In our context this means above all an interest and exchange rate policy that would be consistent – in the sense indicated above – and an effective regulation and supervision of financial institutions. Industrial countries might be persuaded to be more accepting of this proposition if they realize that a credible cooperation would lead to a constellation in which the need for interventions by leading central banks would be greatly reduced. Last but not least one could point out that industrial countries would also benefit from the resulting stabilization of the entire international financial system.

Nevertheless, for the time being, the realization of Mr. Bofinger´s proposal remains highly unlikely because it would involve a loss of monetary sovereignty on the part of participating industrial countries – and this concession would have to be made primarily not for their own interests but »only« for the development chances of countries in the South. Thus the main point of this blueprint for reshaping the international monetary relations is not that it would be a realistic proposal but as a model of an alternative international monetary order. Such a model can help to highlight the need for changing the structures of international financial markets that are impeding the chances for development in the »Third World«.

Perhaps a Christian economic ethics that emphasizes the co-responsibility of the North for the development chances of the South can help to reduce the resistance in the North against such cooperative solutions, which are demanding not only for governments and elites in developing countries but also for the governments of industrial countries.

Literature

EJA: U.S. Catholic Bishops: Economic Justice for All. Pastoral Letter on Catholic Social Teaching and the U.S. Economy, Washington D.C. 1986,
<http://www.osjspm.org/cst/eja.htm>.

SRS: John Paul II.: Sollicitudo Rei Socialis. On Social Concern, Rome 1987,
<http://www.osjspm.org/cst/srs.htm>.

PP: Paul VI.: Populorum Progressio. On the development of people, Rome 1967,
<http://www.osjspm.org/cst/pp.htm>.

Albert, Michel:

(1993) Capitalism vs. Capitalism. How America's obsession with individual achievement and short-term profit has led to the brink of collapse.

Allen, Franklin/Gale, Douglas:

(1995) A welfare comparison of intermediaries and financial markets in Germany and the USA, in: European Economic Review 39, 179-209.

Bastiaensen, Johan:

(2000) How to remove sand out of the wheels of local financial markets. Financial institution building in rural Nicaragua, in: Van Liedekerke, Luc/Van Gerwen, Jef/Cassimon, Danny (ed.): Explorations in Financial Ethics (Ethical Perspectives Monograph Series 1), Leuven/Belgium: Peeters, 205-241.

Bofinger, Peter

(1998) The Euro and the »New Bretton Woods«,
<http://www.wifak.uni-wuerzburg.de/wilan/wifak/vwl/vwl1/downloads/nbw.pdf>

(2000) Währungspolitik in »emerging market economies«, in: Hengsbach, Friedhelm/Emunds, Bernhard (eds.): Finanzströme in Entwicklungsländer - in welcher Form zu wessen Vorteil? Impulse einer Fachkonferenz (Frankfurter Arbeitspapiere zur gesellschaftsethischen und sozialwissenschaftlichen Forschung 24), Frankfurt am Main.

Dieter, Heribert:

(1998) Die Asienkrise. Ursachen, Konsequenzen und die Rolle des Internationalen Währungsfonds, Marburg: Metropolis.

Eichengreen, Barry:

(1999a) Toward a new international financial architecture. A practical post-Asia agenda, Washington DC: Institute for International Economics.

(1999b) The global gamble on financial liberalization. Reflections on capital mobility, national autonomy, and social justice, in: Ethics & International Affairs 13, 205-226.

Hellmann, Thomas/Murdock, Kevin/Stiglitz, Joseph:

(1997) Financial restraint. Toward a new paradigm, in: Aoki, Masahiko/Kim, Hyung-Ki/Okuno-Fujiwara, Masahiro (eds.): The role of government in East Asian development. Comparative institutional analysis, Oxford: Clarendon, 163-207.

International Financial Institution Advisory Commission (IFIAC)

(2000) Report, <http://phantom-x.gsia.cmu.edu/IFIAC/USMRPTDV.html>.

ILO:

(1998) The social impact of the Asian financial crisis. Technical report for discussion at the high-level tripartite meeting on social responses to the financial crisis in East and South-East Asian countries,

<http://www.ilo.org/public/english/60empfor/cdart/bagkok/index.htm>.

Levine, Ross:

(1997) Financial development and economic growth. Views and agenda, in: Journal of Economic Literature 35, 688-726.

Lohfink, Norbert F.:

(1995) Option for the poor. The basic principle of liberation theology in the light of the Bible (Berkeley lecture series 1), 2. ed., N. Richland Hills :BIBAL Press, 1995.

Pogge, Thomas W.:

(2000) The international significance of human rights, in: The Journal of Ethics, 45-69.

Riese, Hajo:

(1986) Entwicklungsstrategie und ökonomische Theorie. Anmerkungen zu einem vernachlässigten Thema, in: Entwicklungsländer und Weltmarkt (Jahrbuch Ökonomie und Gesellschaft 4), Frankfurt/Main: Campus, 157-196.

Sachs, Wolfgang/Loske, Reinhard/Linz, Manfred:

(1998) Greening the North. A Post-Industrial Blueprint for Ecology and Equity, New York: St. Martin´s.

Schefold, Bertram:

(1995) Theoretical approaches to a comparison of economic systems from a historical perspective, in: Koslowski, Peter (ed.): The Theory of Ethical Economy in the Historical School (Studies in Economic Ethics and Philosophy), Berlin: Springer 1995, p. 221-247.

Schmidt, Reinhard H.:

(1999) Differences between financial systems in European countries. Consequences for EMU (Johann Wolfgang Goethe Universität Frankfurt am Main, Fachbereich Wirtschaftswissenschaften, Working Paper Series: Finance & Accounting No. 35), Frankfurt/Main, <http://www.wiwi.uni-frankfurt.de/~rschmidt/wp/wp35.pdf>.

Stiglitz, Joseph:

(1998a) Sound finance and sustainable development in Asia. Keynote adress to the Asia Development Forum (March 12, 1998),

<http://www.worldbank.org/html/extdr/extme/jssp031298.htm>.

(1998b) The role of the financial system in development. Presentation at the Fourth Annual Bank Conference on Development in Latin America and the Caribban (June 29, 1998), <http://www.worldbank.org/html/extdr/extme/jssp062998.htm>.

Studart, Rogério:

(1993) Financial repression and economic development. Towards a post-Keynesian alternative, in: Review of Political Economy 5, 277-298.

Turner, Philip:

(1995) Capital flows in Latin America. A new phase (BIS Economic Papers 44), Basle.