

Capital Account Liberalization, the European Monetary Union and the Stability of the International Monetary System

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Capital mobility affects the pattern of trade flows between countries, determines profitability and income distribution and thus shapes the pattern of overall economic growth. Capital mobility is central in the economic concerns of EMU and constitutes a major point of reference by all students of the functioning of the international monetary system and its prospective transformations. It is ultimately a core element in understanding the sources of economic and financial instability both on a domestic and an international scale. The paper argues that, given the experience of the previous monetary regimes, it is a rather very optimistic conclusion to expect that the current design of European and international monetary institutions as well as the current restructuring policies of the Asian economies will guarantee the smooth and uninterrupted operation of the different economies systems participating in the world arena. It is argued that economic stability and growth for individual countries as well as the smooth operation of the international monetary system will be better secured if there will exist a proper coordination of domestic and international policies and institutions, which will place a great deal of emphasis on a proper regulation of capital movements on a global scale.

I. Introduction

The growth of international financial transactions and international capital flows is one of the most far-reaching economic developments in the late twentieth century and one that is likely to extend into the twenty-first century. Net flows to developing countries tripled, from roughly \$44 billion a year in 1984-89 to more than \$204 billion in 1996, before declining in the wake of the Asian crisis. Gross flows to developing countries have grown even more dramatically, rising by 1200 percent between 1984-88 and 1989-94. During those periods, an increasing number of countries have removed restrictions on capital account transactions in an effort to take advantage of the alleged opportunities afforded by this remarkable rise in international financial flows.

More generally, international capital mobility and its implications for trade flows, income distribution and growth has become a main point of reference by all theoretical considerations of the factors determining international development and economic convergence among regions. The issue of capital movements and their regulation was central in the efforts to explain the behavior of the European Monetary System (EMS)

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Table 1 Net Capital Flows to Developing Countries, Countries in Transition and Newly Industrialized Economies¹ (Billions of US dollars)

	1984-89 ²	1990-96 ²	1994	1995	1996	1997
Total						
Net Private Capital Flows ³	15.2	148.1	160.5	192.0	240.8	173.7
Net Direct Investment	12.9	63.1	84.3	96.0	114.9	138.2
Net Portfolio Investment	4.7	54.1	87.8	23.5	49.7	42.9
Other Net Investment	-2.5	30.9	-11.7	72.5	76.2	-7.3
Net Official Flows	23.9	15.3	-2.5	34.9	-9.7	27.3
Change in Reserves ⁴	-13.8	-81.2	-77.2	-120.5	-115.9	-54.7
Developing Countries						
Net Private Capital Flows ³	18.2	131.2	136.6	156.1	207.9	154.7
Net Direct Investment	12.1	56.8	75.4	84.3	105.0	119.4
Net Portfolio Investment	4.2	49.3	85.0	20.6	42.9	40.6
Other Net Investment	1.9	25.1	-23.8	51.2	60.0	-5.3
Net Official Flows	25.8	15.6	9.1	27.4	-3.4	15.8
Change in Reserves ⁴	5.8	-55.7	-42.4	-65.6	-103.4	-55.2
Countries in Transition						
Net Private Capital Flows ³	-1.0	12.8	18.4	29.8	21.3	34.5
Net Direct Investment	-0.2	6.3	5.4	13.2	13.1	18.2
Net Portfolio Investment	-	2.0	4.1	2.9	2.2	7.3
Other Net Investment	-0.8	4.6	8.9	13.6	5.9	9.0
Net Official Flows	0.2	0.5	-11.0	8.4	-5.5	0.8
Change in Reserves ⁴	-3.6	-7.8	-8.5	-35.9	0.4	-6.2
Newly Industrialized Econ.						
Net Private Capital Flows ³	-2.0	4.1	5.5	6.1	11.7	-15.4
Net Direct Investment	1.0	0.1	3.5	-1.5	-3.2	0.6
Net Portfolio Investment	0.5	2.8	-1.2	0.0	4.6	-5.0
Other Net Investment	-3.6	1.2	3.2	7.6	10.3	-11.1
Net Official Flows	-2.0	-0.8	-0.6	-0.9	-0.8	10.7
Change in Reserves ⁴	-16.0	-17.7	-26.3	-19.0	-12.9	6.7

Source: *IMF, Annual Report 1998*.

¹ Net capital flows comprise net direct investment, net portfolio investment and other long- and short-term net investment flows, including official and private borrowing.

² Annual percentages.

³ Because of data limitations 'Other net investment' may include some official flows.

⁴ A minus sign indicates an increase.

in September 1992 and the contagion effects of the recent world financial crises originating in South-east Asian countries in 1997 and in Russia in 1998. In the present days, capital movements and their regulation is a central factor in the concerns regarding the future of the European Monetary Union (EMU) within the international financial system, given the introduction of the *Euro* since January 1999.

However, the explanations offered by conventional economic theory and the subsequent directions taken by theory-informed policy-makers do not seem to have been associated with efficient outcomes. It must always be recalled that economics is

meant to provide answers to real problems. Of course, some economics consists of proving theorems derived from extremely abstract models, which seem to have no contact with reality at all. Equally, some economics consist of exercises, which are designed solely to advance theoretical or econometric technique. But, fundamentally, all this work is supposed to be geared to the dual task of building a better understanding of economic phenomena, and thereby determining how economic goals can be better achieved. Economics is ultimately about the design of efficient economic policies.

If 'usefulness' and 'efficiency' are the objectives of the discipline, then the relative success of economics at any one time might reasonably be judged by how nearly real economic goals are being met. This means that the economists and their ideas must bear some responsibility for the evident failure of economic policy in so many parts of the world and in so many different occasions. Economics is failing today to provide answers to real problems not because some economists' ideas are not informing economy policy. Rather, it is failing because economics today is built upon theoretical foundations, which exclude the very substance of economic policy, namely the economic institutions through which economic life is actually lived. This is not to suggest that economic thinking should be confined to pragmatic institutionalism. On the contrary, what is needed is a body of pure economic theory which in its very core is logically consistent and historically concrete, not, as it is the case today, an economic theory which either ignores institutions or treats them as imperfections in an otherwise perfectly functioning system.

We shall illustrate some of these inconsistencies between conventional economic theory and observed reality by reference to the views held by numerous prominent economists with respect to the understanding of the three events mentioned above. These events constitute important elements in the evolution of the international financial system and therefore their understanding has considerable implications for national economies too.

It is evident that during the 1992 crisis, the EMS proved unable to activate exchange rate realignment - the built-in mechanism for such occasions. The failure of the EMS to avoid the crisis was surprising at that time to many economists, heads of central banks and financial managers (see *Financial Times*, 26th May 1993, and various issues ever since). In addition, the failure of the existing international monetary system and its institutions to prevent the occurrence of the recent financial crises and contain their contagion effects has been the subject of considerable debate around the globe (the number of references on the issue in the local and international, daily and periodical, press is very large).

But what has been the response of theoretical economists to these developments? Ironically, in about the same period with the 1992 ERM crisis, the National Bureau of Economic Research published a volume, edited by Bordo and Eichengreen (1993), in which a few economists (the widely-accepted authorities on the topic) have gathered to offer an evaluation of the past and present of the international monetary reforms. They do so by re-examining the Bretton Woods system in the light of the repeatedly emphasized 'success' of the EMS. Their view is presented, for the most part, as a justification of the optimality of suspension of gold convertibility and the end of the pegged-rate

system designed by the Bretton Woods in 1944, in favor of floating exchange rates and unconditionally free capital mobility. Their theoretical approach lies admittedly on the expectations-augmented Phillips curves, output-inflation trade-offs (Lucas (1973)) as well as on the credibility and time-consistency issues (Kydland and Prescott (1977), Barro and Gordon (1983)).

The serious setback in the process of convergence that was at the time so firmly believed to culminate, by a smooth transition, in a European Economic and Monetary Union (EMU), does not seem to have been anticipated by the different analysts contained in the aforementioned volume. The lack of any awareness of the EMS's flaws and intrinsic instability is perhaps the most striking aspect of this approach. Indeed, these scholars were clear-minded supporters of full international capital account liberalization; the theoretical underpinnings of their views on international monetary 'regimes' led them to regard any loss of policy autonomy on the part of national governments with the utmost favor.

Five years later, and just a few months before the 1997 Asian crisis (17-18 March, 1997), the International Monetary Fund (IMF) sponsored a conference, held in Washington DC, on the international implications of EMU. The proceedings of the conference were published in a volume, edited by Masson, Krueger and Turtelboom (1997), under the title: 'EMU and the International Monetary System'. As with the Bordo and Eichengreen volume, some economists (perhaps the modern authorities on the topic) gathered again to evaluate the broader systemic implications of the EMU on the world financial and foreign exchange markets, by considering the effects of EMU on the activities of a broad range of market participants as well as the private and official institutions.

In their analysis of the Euro-dollar relation, several authors in the Masson *et al.* volume anticipated considerable volatility, which was however expected to remain under control by appropriate variations, to be decided by the newly empowered European Central Bank (ECB), in interest rates and exchange rates. Moreover, as numerous authors in the volume maintained, the introduction of the Euro, associated with a simpler and more unified regulatory framework characterized by the abolition of cross-country restrictions on portfolio investment, was expected to speed up the consolidation of the European financial markets. It is moreover contended that extensive securitization, the growth of stock market liquidity and the adopted policies of credit expansion and development of derivative products, that were expected to result from the introduction of the Euro, would stimulate cross-border merger and acquisition activity, thus raising the need for further regulatory reform. However, the main elements of the proposed reforms were confined to the mutual recognition and harmonization of different standards and did not involve the consideration of any cross-border regulation on capital movements and their implication for the stability and development of financial markets. On grounds similar to those of the Bordo and Eichengreen volume, even though in a different context, any loss of policy autonomy with respect to the functioning and evolution of money and capital markets on the part of national European governments was regarded with favor (even though in a more cautious way, this time). After all, monetary policy autonomy was already been minimized by effective enforcement of the Maastricht criteria.

Finally, the World Bank and the Brookings Institution (WBBI hereafter) very recently jointly sponsored a large conference on the likely causes and consequences of the recent South-east Asian financial crisis (Palisades, NY, 25-27 March, 1999). The conference represented an attempt to bring together academic economists, investment bankers and regulators from around the world in order to provide an assessment of the crisis from different points of view.

The conference organizers clearly stated at the outset that they adopted a microeconomic, Asian-specific, approach to the understanding of the crisis. This is the same approach taken by the now US Treasury Secretary professor L. Summers (The Financial Times, 20 Febr., 1998) and the Managing Director of the IMF, Mr. Camdessus (IMF Survey, 09 Febr. 1998). In the contributions of both theoretical economists and policy makers, the roots of the crisis are to be found in the Asian model *itself* and not in any mismanagement of the Asian economies. The stance taken is very important and intriguing, given that until recently the Asian model of development proved exceptionally efficient, representing the most successful example of rapid development in history.

It is worth mentioning the main findings of the conference, which are briefly the following: western institutional investors, in their efforts to seek higher returns, overinvested in south-east Asian equities. However, chasing too few remaining profitable opportunities led them to realize considerably lower returns (Harvey and Roper (1999), Pomerleano and Zhang (1999)). At the same time, domestic corporations increased their leverage to levels that exposed the entire region to substantial foreign exchange risk (Cooper (1999), Adler (1999)). Even though the participation of foreign institutional investors in the south-east Asian equity markets was formidable, their role in engineering the crisis proved unclear and rather controversial (Barth and Zhang (1999), Harvey and Roper (1999)). However, the destabilizing role of foreign institutional investors proved much more important when each country's pegged exchange-rate system was being abandoned in order to restore exchange rate credibility. More specifically, the destabilizing role of institutional investors was due to their contribution to the enormous increase in equity prices (Wilcox (1999)) and their preference for 'glamour stocks' rather than 'value stocks' (Pormeleano and Zhang (1999)). The inefficiencies in the corporate governance systems exacerbated the intensity of the crisis (Scott (1999)) in a region where the process of efficient debt restructuring had already been too slow (Cooper (1999)). The large current account deficits did not proved to exert a decisive influence in all cases, without however their essential role being denied. The main problem was held to be the sudden change in the willingness of foreign institutional investors to continue financing them (Cooper (1999), Edwards (1999)).

Notwithstanding the importance of these findings, they all eventually led directly or indirectly to the conclusion that the prevention of a future crisis in the region and more generally, would require greater levels of transparency (however, a necessary but not sufficient factor according to the contributors), the development of more efficient financial and regulatory structures, improvements in the corporate governance systems mainly directed towards the opening up of the domestic financial and credit organizations

to foreign ownership and control and finally the establishment of a strong presumption against the adoption of any form of capital movements regulation.

It is the purpose of this paper to reconsider the effectiveness from a theoretical point of view of these events. All attempts at explanation rested on the analysis of a number of factors while at the same time ignoring the special role of extensive liberalization policies, which were largely taken as a non-debatable issue. The paper will examine these events as well as their implications for stability and long-run growth of the European and world economies, by paying special attention to the important role of these policies, characterized by generalized deregulation and abolition of capital movement regulation. In order to have a basis for comparison, the distinctive features of the Bretton Woods system, particularly with respect to the role of regulation of capital mobility, are first presented and then contrasted with those of the new European and the prevailing international monetary system. Then some questions are raised on the effectiveness of the international system of transactions and payments and the likelihood of international financial crises. We are intended to show that the root causes of these problems in the operation of the international financial system in all three cases considered lie in the inadequate theoretical understanding of it, the neglect of institutions and therefore the design of inappropriate policy.

A main point of the paper's argument is that, at the face of a commitment to stable foreign exchange markets, monetary and fiscal policies of a country participating in a union will be effective only if there is some room for control over domestic interest rates and, therefore, capital mobility. In other words, appropriately designed capital movements regulation and rather gradual liberalization both on a national and a global scale are conducive to some degree of national autonomy in policy making and thus to the securing of sound long-term growth and employment policies, among other things. In addition, these actions, given the absence of any world financial authority with sufficient powers to act as a disciplinary force in a deregulated global economy, will contribute to the reduction of foreign exchange risk and thus to the effective containment of currency crises and their contagious consequences.

II. The Bretton Woods System and the Implications of its Collapse for International Stability

The main features of the Bretton Woods system may be usefully grouped around two distinct central themes. There is, on the one hand, what can be called the core of the system, that is the combination of the fixed exchange rates, capital movements regulation and domestic policy autonomy that distinguished the experience of the major capitalist economies during the Bretton Woods years. On the other hand, there is the question of the economic hegemony of the United States.

Major contrasts between current economic thinking and the way of reasoning that was prevalent in the Bretton Woods era essentially concern the first theme - the one on which the influence of Keynes's ideas was paramount. As to the second theme, there was really no body of economic ideas behind the firm establishment of the economic

hegemony of the United States, so that there have been no significant changes in economic thinking over the years. From a Keynesian perspective, this hegemony increasingly became, over the years, the necessary counterpart of an international growth process, which previously was essentially based on an 'unconstrained' growth of domestic markets. However, as it is clear in the first two aforementioned volumes, in both the Bretton Woods era and the present times, economists did recognize the difficulty of developing adequate mechanisms that successfully link the supply of international reserves to the stock of gold and revalue gold in terms of the dollar without creating speculative runs on the reserve currency. More generally, these economists did favor, on the grounds of greater capacity to endure, an international monetary system that is not based on the dominant position of one country's currency.

The primacy given in the Bretton Woods settlement to national macroeconomic autonomy is fully recognized. It is also widely acknowledged that capital movements regulation were the elements that permitted that autonomy, by reconciling it with a system of fixed, but adjustable, exchange rates. Capital movements regulation and policy autonomy, however, have been invariably interpreted in all three conferences as a most important source of trouble to the system. Let us first look at capital movements regulation and policy autonomy in the light of the policy design of the Bretton Woods system.

It was held that governments must not subordinate expansionary domestic policies and social welfare to external factors and international arrangements. At the same time, the continuous pursuit by each country of high levels of employment was seen as conducive to overall growth of output and trade. To the primacy thus given to the national macroeconomic autonomy, there corresponded the widespread belief that control of capital movements must be a permanent feature of the post-war system - a prerequisite for the commitment to the promotion and maintenance of high levels of employment and real income and the development of productive resources of all members as primary objectives of economic policy (UN Monetary and Financial Conference (1944)). The commitment was the expression, at the international level, of the same commitment to maximum employment as the principal objective of economic policy, which led to the 1944 British "White Paper on Employment Policy" and the 1946 American "Employment Act".

In fact, in the twenty-five years before the breakdown of the peg-system in 1973, each country was left free to be its own judge, and to act as it deemed best in its own interests, in the fields of control over capital movements. In particular, movements of capital could be used, with the approval of the International Monetary Fund (IMF), to avoid deflating domestic economies excessively as a way to correct external payment deficits; and to avoid impairing the powers to control domestic interest rates as a way to maintain exchange rates within the margins specified by the IMF: exchange rate stability could be defended and its benefits reaped, without losing control over domestic interest rates.

The idea that movements of capital should not be left unrestricted was put forward by Keynes (1942, p.147) during the long preparatory works and negotiations for the IMF agreement. The IMF Agreement (article VI) expressed the commitment to promote

and maintain high levels of employment, the belief that the flow of capital funds may be a major cause of imbalances and instability so that the country cannot cope to control interest rates at home, if movements of monetary capital out of the country are unrestricted. This gave every member country the right to control all capital movements and almost requiring member countries using the resources of the IMF to exercise the control over the outflow of capital. What in the pre-war system 'used to be a heresy,' in the field of international economics 'is now endorsed as orthodox' (Keynes (1942, p.17)).

By the end of 1950s, it was still endorsed as orthodox, within the OEEC, that capital movements were not necessarily in a desirable direction, so that the burden of proof in respect to their liberalization was on those who wished to liberalize (Horsefield (1969, p.504)). Also, within the six countries making up the European Economic Community in 1957, each member state was authorized to take protection measures, if necessary, to ensure the equilibrium of its overall balance of payments and to maintain confidence in its currency, while ensuring a high level of employment and the stability of the level of prices (Treaty of Rome 1957, art. 104, 108 and 109). The necessity not to loose all control over the domestic interest rate was clearly implied in the Treaty of Rome, where it was stated that each member state was given the sovereign right to take action on its own against movements of capital leading to disturbances in the operation of the capital market (Treaty of Rome, art. 73(2)).

At the beginning of the 1960s, we manifest a change in economic policy objectives. A gradual movement started to develop toward freeing international movements of capital from controls, based on the view that greater freedom would have brought about a greater integration among markets and hence it would be beneficial (Horsefield (1969, p.540), de Vries (1985, 99ff)). The governments of the leading countries, the USA and the UK very soon reinforced controls. Restrictions on capital movements were among the main policy measures they took to correct their payments imbalances without compromising domestic employment levels. Thus, in the USA the new Democratic Administration of 1963 imposed a tax on purchases of foreign stocks and bonds - The Interest Equalization Tax - which was followed in 1965 by other measures aiming at the discouraging of capital exports by banks and their affiliated institutions (IMF (1975)). At the same time, as restrictions on capital movements resulted in widening differentials between Eurodollar rates and US Treasury Bill rates, the rate of unemployment was reduced progressively from 6.7 per cent in 1961 to 3.5 per cent in 1969, the lowest rate in post-world war II period, whilst the average for the 1961-70 period is 4.7 in the US and 2.2 in EU15 (Table 2).

Also, in the UK increasingly stringent exchange controls regulations were imposed in the 1960s, starting with a shift in 1964 from Conservative to Labor governments. A few years later, the strict connection between capital movements regulation and employment policy was slackened by the abandonment of the commitment to high employment and the change in the objectives of economic policy: the abolition of capital movements regulation was one of the first significant measures of Thatcher's conservative government in 1979.

**Table 2 Movements of Basic Macroeconomic Variables
in Selected Countries, 1960-67**

		1961-70	1971-80	1981-90	1995	1996	1997
USA	Interest rate	4.8	7.3	10.2	6.6	6.4	6.3
	Unempl. rate	4.7	6.4	7.1	5.4	4.9	4.6
	Inflation rate	3.1	7.4	4.7	2.3	2.0	2.0
	Growth rate	3.8	2.8	2.6	2.8	3.8	2.5
	Current balance ³	0.6	0.2	-1.9	-1.7	-1.9	-2.0
Japan	Interest rate	5.1	8.1	6.6	3.3	3.0	2.2
	Unempl. rate	1.2	1.8	2.5	3.4	3.4	3.5
	Inflation rate	5.4	7.8	1.9	-0.4	0.7	0.5
	Growth rate	10.5	4.5	4.0	3.9	1.0	0.4
	Current balance ³	0.2	0.6	2.3	1.5	2.2	2.8
United Kingdom	Interest rate	7.0	12.5	10.9	8.2	7.8	7.0
	Unempl. rate	1.7	3.8	9.8	8.2	7.1	6.5
	Inflation rate ¹	4.2	13.9	6.2	3.0	2.6	2.3
	Growth rate ²	2.9	2.0	2.6	2.3	3.5	1.9
	Current balance ³	-0.1	-0.6	-1.4	-1.5	-0.9	-2.2
Germany	Interest rate	6.8	8.0	7.6	6.8	6.2	5.7
	Unempl. rate	0.7	2.2	6.0	8.8	9.7	9.8
	Inflation rate ¹	3.8	5.2	2.8	1.0	0.6	1.2
	Growth rate ²	4.4	2.7	2.2	1.4	2.2	2.6
	Current balance ³	0.7	0.7	2.6	-1.2	-0.6	0.1
France	Interest rate	6.5	10.3	11.4	7.5	6.3	5.6
	Unempl. rate	1.8	4.1	9.2	12.4	12.5	11.9
	Inflation rate ¹	4.4	9.8	6.3	1.1	0.9	1.5
	Growth rate ²	5.6	3.3	2.4	1.5	2.4	3.0
	Current balance ³	0.2	0.3	-0.5	1.6	2.9	2.9
Italy	Interest rate	6.7	11.6	15.0	11.9	9.2	6.7
	Unempl. rate	4.8	6.1	8.8	12.0	12.1	12.0
	Inflation rate ¹	4.5	15.0	10.6	5.1	2.6	2.2
	Growth rate ²	5.7	3.6	2.2	0.9	1.5	2.4
	Current balance ³	1.7	-0.2	-1.0	3.4	3.1	3.3
Netherlands	Interest rate	5.6	8.7	8.3	6.9	6.2	5.6
	Unempl. rate	0.9	4.4	8.5	6.3	5.3	4.4
	Inflation rate ¹	5.2	7.6	2.0	1.3	2.0	2.2
	Growth rate ²	5.1	3.0	2.2	3.3	3.3	3.7
	Current balance ³	0.0	1.4	3.2	5.8	5.8	5.6

Source: *European Economy*, No. 65, 1998.

¹ Price deflator GDP at market prices.

² Gross Domestic Product at 1990 market prices (annual percentage change).

³ Balance on current transactions with the rest of the world (Percentage of Gross Domestic Product at market prices).

The overwhelming majority given to reducing inflation since the late 1970s has brought about unemployment rates in the major capitalist economies entirely out of the Bretton Woods experience, and such that would not have been considered politically acceptable in the 1950s and 1960s. Current macroeconomic thinking has hardly contributed anything valuable to the explanation of the objectives of general economic policy. Keynesian-Kaleckian type interpretations seem decidedly more relevant to the explanation of that change than state-of-the-art interpretations in terms of the alleged evolution of central bank independence (Fратиanni and von Hagen (1992)).

The basic motivations of the introduction of capital movements regulation as a permanent feature of the Bretton Woods adjustable peg system of fixed parities are ultimately linked to the quest for national independence in matters of money, credit and interest. The reasons for countries not wanting to sacrifice monetary autonomy were the following: First, the desire to curb exchange speculation when a currency's devaluation looked likely, due to the presence of a fundamental disequilibrium. Second, the desire to minimize the cost of government debt service, at the presence of large government debt issues. Conditions had before to be ensured under which monetization of part of the debt and the financing of the rest at relatively low rates could be maintained over time as distinguishing features of public finance. Third, the desire to minimize foreign government debt financing, that is to keep the country's foreign indebtedness and the burden of interest payments abroad within narrow limits. To the extent that capital movements regulation yielded the opportunity to maintain lower interest rates that otherwise would have been required, then also the level of foreign government debt financing and overall external indebtedness would have tended to be less than would otherwise had been the case in the absence of controls. Fourth, the desire to defend the exchange rate without impairing activity levels. Within expansionary domestic policies, monetization and relatively low interest rates would have been clearly incompatible with exchange rate stability, in the absence of capital control.

Consideration of these motivations suggests that monetary and fiscal policy require a unified approach if the government's objectives are to be achieved at all. National autonomy in monetary policy essentially means the ability of monetary authorities to establish the levels of domestic interest rates. Control of domestic interest rates in turn, owing to its fiscal and distributive repercussions as well as its impact on the balance of payments, the external position of the country and the exchange rate, is a most crucial component of the government's general economic policy.

A very different picture of capital movements regulation and their effects during the Bretton Woods era emerged from the influential views contained in Bordo and Eichengreen (1993). It was pointed out that, owing to the restrictions of the international movements of capital, the pegged rates of the Bretton Woods system were not conducive to international financial integration, so that there was nothing particularly admirable about financial market performance under the Bretton Woods system, which eventually degenerated into a system plagued with controls, which undermined government credibility and thereby promoted instability in international financial markets. The benefits of exchange rate stability could not be fully reaped because international financial transactions were

not free to proliferate and smoothly finance current account imbalances.

The picture one finds in the contributions contained in Bordo and Eichengreen is one in which free international movements of capital on the whole accommodate developments in the real economy rather than constrain them, that imperfect capital mobility made countries' reserve constraints tighter than what would have been in today's world. The picture, on the one hand, underrates the possibility of perverse movements of lending by deficit to surplus countries; on the other, it ignores the negative repercussions of a rising external indebtedness on a deficit country's creditworthiness and a smooth financing of its current account deficits.¹ Even though it is acknowledged that capital movements regulation in the Bretton Woods era reconciled exchange rate stability with national monetary autonomy no permanent output and employment effects are attributed to this policy autonomy and the primacy given under the Bretton Woods system to national macroeconomic goals. Thus, aggregate demand management policies are taken to have only temporary effects on output and employment and permanent effects only on the level of prices. Over the long period, therefore, policy autonomy - that is the absence of 'convergence' in economic policies - is seen as having merely resulted from the persistent international inflation differentials, which are in turn referred to as the very measure of the national policy autonomy.

We are reminded that the recent literature on the time inconsistency of optimal government policy has demonstrated that, in almost all intertemporal policy situations, the public would benefit if the government were bound by a commitment preventing it from changing planned future policy. Accordingly, the Bretton Woods system is regarded as having been flawed by the absence of rules that forced government to pursue policy convergence, thereby binding policy actions over time. Naturally, capital movements regulation, as the chief means for keeping the management of the domestic economy in line with internal conditions and needs, are reviewed as the chief source of the lack of convergence and imperfect government credibility; as major governments were unwilling or unable to maintain key systematic commitments, the system invariably failed.

The explanation of the behavior of the real variables in the Bretton Woods era offered by those economists is not very conclusive. It is, indeed, pointed out that the Bretton Woods years were characterized by fast growth averaging 4.2 per cent per annum in the G7 group. However, apart from the conviction that capital movements regulation and national macroeconomic autonomy were the culprits of the system and cannot possibly explain the good performance of the real economy under Bretton Woods, no further explanation is offered.

1. One author of the Bordo and Eichengreen volume had a different position. Thus, Krugman, commenting on Marston observes that it is 'somewhat puzzling in retrospect' why capital movements regulation were so frequently imposed on the Bretton Woods era: 'After all', he writes, 'the major nations had the option of stabilizing their currencies by changing domestic interest rates', thus failing to see the relevance of retaining control of domestic interest rates for national policy purposes. However, Krugman is reluctant to fully accept the effectiveness of free capital movements: 'The capital controls of the Bretton Woods era may not have made a great deal of sense - but then the free capital flows of our time do not make much sense either'.

It is pointed out that the good performance of the Bretton Woods system is due to the favorable supply conditions - that is exceptional stability in the economic environment. Thus, the absence of significant shocks, rather than the adopted economic plans and overall macroeconomic demand management policies, was the very reason for the good overall macroeconomic performance of the Bretton Woods era. Even though the role of monetary and fiscal policies is acknowledged, it is nevertheless argued that those policies succeeded in manipulating output and employment because policies with inflationary consequences were not expected to persist and hence their short-run stimulative effects were not neutralized by higher wages and costs. But it is difficult to argue that expansionary monetary and fiscal policies were not expected to persist since those policies reflected the commitment by those countries to promote and maintain high levels of employment.

It is, in general, suggested that ultimately for a smooth operation of a system of stable exchange rates is not continual convergence *per se* that matters but a commitment to exchange rate stability with sufficient credibility to reassure agents and policies will be consistent with stable exchange rates in the long term. Thus, before the exchange rate crisis of 1992, the stabilizing role of free capital mobility, seen as the outcome of a credible commitment to the exchange rate stability, was frequently referred to in the literature on the EMS as a distinguishing feature of that regime - indeed, the very source - in the face of persistent inflation differentials.

III. The Present State of the International Financial Environment and the Efficiency of National Macroeconomic Policies

The importance of the new post-Bretton Woods system of international relations is clearly manifest in the growth performance of developed and underdeveloped countries. The persistence of the slow growth of demand into the last two decades seems to have been predominantly caused by the change in the structure of international finance and the consequent impact on the structure of domestic macroeconomic policies. The slowdown has from time to time been attributed to a number of other factors, including the growing profit-squeeze at the end of the 1960s, the exhaustion of easy opportunities for technological 'catching-up' with the United States, and, of course, the impact on the growth of demand of the rise in raw material prices, particularly oil prices. But none of these seems to have an explanatory power comparable with that provided by changes in the international financial relationships (Glyn, Hughes, Lipietz and Singh (1990)).

The explanation of these phenomena must be sought not only in the collapse of the Bretton Woods fixed exchange-rate system in the early 1970s and the establishment of an era of floating rates, but also in the decisive replacement of regulated financial markets of the 1960s by the deregulated global markets of the 1980s and 1990s (Eatwell and Taylor (1998)). Several economists have analyzed over the years the fact that the post-Bretton Woods trading and payments system dealt with the international trade imbalances mainly by deflation and growing unemployment in weaker countries - a deflationary impulse that has proved contagious. Less attention has been paid to the

fact that this deflationary pressure is reinforced by the deregulation of global markets and the huge growth of short-term financial flows.

Perhaps, the most important consequence of the collapse of the Bretton-Woods system has been that financial markets are today dominated by short-term financial flows that seek to profit from changes in asset prices - in other words, from speculation. The growth in the scale of speculation, relative to other transactions, has been particularly marked in the foreign exchange markets in the past twenty years. Daily speculative flows now regularly exceed the combined foreign exchange reserves of all G7 governments. The explosive growth of short-term speculative flows originated in a combination of the carrot of profit and the stick of financial risk.

To an important extent, speculation is an inevitable outcome of the abandonment of the fixed exchange rates. Under the Bretton Woods system there was little profit to be had in speculation, since currencies move in very tight bands, apart, that is, from the very occasional change in parity. Indeed, the Bretton Woods system provided quite remarkable stability. For example, the core currencies of the EMS, locked together in the 1980s in the ERM, enjoyed *greater* stability in relation to one another during the Bretton Woods era than they have been able to achieve since. Indeed, the Bretton Woods system was so stable that those currencies that were long-term members of the narrow-band ERM² had experienced even less variation in their relative parities from 1961 to 1969 than has typically been the case since within the ERM (Table 3).

Table 3 Instability of the Exchange Rates of the Members of the Narrow-Band ERM

	Nominal effective exchange rate relative to member countries ^a	Percentage change in Nominal effective exchange rate relative to 19 industrial countries ^b
1961-1969	0.9	-0.3
1970-1972	2.2	1.3
1973	4.9	2.7
1974	4.0	-1.8
1975	4.0	1.4
1976-1978	4.4	-3.3
1979-1980	1.8	4.1
1981-1985	2.8	-7.7
1986-1990	1.9	4.8
1991-1995	2.3	-3.3
1996-1998	2.3	-2.6

Source: *European Economy*, No. 58, 1994, p.166; No. 65, 1998, pp.326-7.

^a Unweighted average of the absolute annual percentage change of the currencies originally participating in the narrow-band of the ERM.

^b Average of the absolute annual percentage change of the twelve EU member currencies.

2. Belgium, Denmark, France, Germany, Ireland, Luxemburg and the Netherlands.

However, under the Bretton Woods system, unlike the ERM, national monetary and fiscal policies were shielded behind an elaborate structure of capital movements regulations and a variety of trade restrictions and subsidies. In the face of Bretton Woods stability, it was not worthwhile maintaining the large-scale currency dealing facilities with which we are familiar today - even if the contemporary regulatory structures had not placed significant barriers in the path of short-term financial flows.

However, once the Bretton Woods system had collapsed in 1973, then opportunities for profit proliferated, regulatory structures that inhibit flows of capital were challenged as 'inefficient' and 'against the national interest' and the infrastructure of speculation was constructed. The incentive to deregulate international financial flows, which was created by the abandonment of fixed rates, was decisively reinforced by the need to hedge against the costs that fluctuating exchange rates imposed on the private sector. With that system's collapse, foreign exchange risk was privatized (Eatwell (1996)). This privatization of risks imposed substantial strains on the domestic and international financial system. The need to absorb and cover foreign exchange risk demanded the creation of new financial instruments (e.g., derivative products), which in turn required the removal of many of the regulatory barriers that limited the possibilities of laying off risk, and a restructuring of financial institutions.

Combined with other, domestic, pressures for the removal of financial controls, the collapse of the Bretton Woods system was a significant factor driving the worldwide deregulation of financial systems. Exchange controls were abolished. Domestic restrictions on cross-market access for financial institutions were scrapped. Quantitative controls on the growth of credit were eliminated, and monetary policy was now conducted predominantly through management of short-term interest rates. A global market in risk-hedging monetary instruments was created.

Today the sheer scale of speculative financial flows can easily overwhelm any government's foreign reserves. The ease of moving money from one currency to another, together with the ease of borrowing for speculative purposes means that enormous sums can be shifted across the exchanges - especially for short periods of time. Prior to the September 1992 run on Sterling, the British government boasted of a \$15 billion support facility it had negotiated in Deutsche marks, to be used to defend the parity of the pound. Yet, when the speculative storm broke, the sum would be matched by the sales of sterling by just one prominent player in the foreign exchange markets.

The overwhelming scale of such potential flows means that governments must today, as never before, keep a careful eye on the need to maintain 'market credibility'. Credibility has become the keystone of policy making in the 1990s. A credible government is a government that pursues a policy that is 'market friendly'; that is a policy that is in accordance with what the markets believe to be 'sound'. Particularly favored are measures designed to meet a 'prudent' predetermined monetary target, such as maintaining a given exchange rate parity, or a given growth rate of the money supply. Governments that fail to pursue sound and prudent policies are forced to pay a premium on the interest costs of financing their programs. Severe loss of credibility will lead to financial crisis. The determination of what is credible, and how governments lose credibility,

MERTZANIS: CAPITAL ACCOUNT LIBERALIZATION

is a product of the way that speculative markets actually work.

In his *General Theory of Employment, Interest and Money*, John Maynard Keynes likened the operations of a speculative market to a beauty contest. He had in mind a competition that was then popular in the British newspapers, in which readers were asked to rank pictures of young women in the order that they believed they would be ranked by a 'celebrity panel'. In the same way, the key to playing the markets is not what the individual investor considers to be the virtues or otherwise of any particular policy, but what he or she believes everyone else in the market will think.

Since the markets are driven by average opinion about what average opinion will be, an enormous premium is placed on any information or signals that might provide a guide to the swings in average opinion and as to how average opinion will react to changing events. These signals have to be simple and clear-cut. Sophisticated interpretations of economic data would not provide a clear lead. So the money markets and foreign exchange markets become dominated by simple slogans - larger fiscal deficits lead to higher interest rates, an increased in money supply results in higher inflation, public expenditure is bad whilst private expenditure is good - even though those slogans are persistently refuted by empirical research. To these simplistic rules of the game is added a demand for governments to publish their own financial targets, to show that their policy is couched within a firm financial framework. The main purpose on insisting on this government 'transparency' and a commitment to financial targeting is to aid average opinion in guessing how average opinion will expect the government to respond to changing economic circumstances, and how average opinion will react when government fails to meet its goals.

The demands for credibility have imposed broadly deflationary macroeconomic strategies on the G7. In the 1960s, the managed international financial framework permitted expansionary, full employment policies that were contagious both domestically, encouraging private investment, and internationally, underwriting the growth of world trade. In the 1980s, the deregulated financial framework has encouraged policies that elevate financial stability above employment. This has raised real interest rates, which have in turn reduced domestic investment and slowed the growth of world trade.

Financial markets volatility was shown to have a severe impact on the ability of companies to invest with confidence and, indeed, on their ability to survive (Michie and Smith (1996)). The globalization of financial markets has meant that whereas international disequilibria may, in the past, have been manifest in exchange rate movements, today they have an impact on interest rates in domestic money markets. The instability of local interest rates means that international financial pressures are felt by small and medium firms operating in the home market, and not only by large companies operating internationally. These new pressures on small firms have major implications for any drive to create new jobs.

Instability has a further negative effect on policy. It severely reduces the scope of the fiscal co-operation that the G7 countries so desperately need to engineer a concerted attack on unemployment. With exchange rates fluctuating, the distribution of the gains of such a concerted strategy is highly uncertain. But if the 'pay-off' is unknown, it

is difficult for governments to commit themselves to cooperative strategy, particularly when this strategy carries the risk of loss of credibility.

IV. Capital Account Liberalization, the Introduction of the *Euro* and the New International Monetary System

The new EMS and the introduction of the *Euro* is by now a fact and seems to have adopted all the 'desired' features suggested by the post-Bretton-Woods wisdom: full European central bank independence committed to price stability but *not* to maintaining employment levels (as is the case with the *Federal Reserve System* in the US), full international mobility of capital, commitment and sticking to rules, convergence and exchange rate stability. As discretionary policies were disfavored, so did capital movements regulation, leaving no space for monetary independence. Indeed, the Bretton Woods system is widely viewed as an inferior system compared to the new EMS since the latter is based on international arrangements that bind national policy actions overtime. The new EMS is a promising regime because it essentially encompasses the requirements for a well designed fixed exchange rate system. These requirements include that the countries follow similar domestic economic goals (such as downward convergence of inflation rates), that the rules are transparent and that the European Central Bank will enforce them. The success of the EMS in creating an area of exchange rate stability in Europe is, moreover, taken to be the convergence of attitudes toward the reduction of inflation rather than employment.

It is surprising to see that these views, put forward by the authors in the Bordo and Eichengreen volume, are later reversed by the same authors. Indeed, in a later paper, Eichengreen and Wyploz (1993) discovered (of course *post factum*) that the established structure of the new EMS was insupportable and the exchange rate crisis all but inevitable. The reason offered was that interest rates would have had to be maintained at high levels to stabilize the exchange rates and that high interest rates had an adverse impact on economic activity, the government budget, the housing market and the stability of the financial system if they are maintained for extensive periods. Thus, they went on arguing, if the authorities wish to defend an exchange rate, barriers to capital mobility have a comparative advantage because, by creating a wedge between foreign and domestic interest rates, they limit the domestic dislocations followed by policies of defense. Thus, for regaining and retaining a reasonable amount of control over domestic interest rates, at the presence of exchange rate differentials, it is suggested that full capital mobility must be given up.

Here we are back to Keynes's ideas and the spirit of the Bretton Woods. A reality-induced 180 degrees turnaround was made with no signs of embarrassment or acknowledgement. It is reasonable to expect that growing unemployment and its social impact will eventually free us from the NAIRU concept of the economy and much of the theoretical work developed around it the last twenty years.

But the establishment of the new EMS has far more serious implications for world growth and the international monetary system. The establishment of the *Euro* as a major

MERTZANIS: CAPITAL ACCOUNT LIBERALIZATION

international currency will create a multi-polar international financial system and eventually a decline in the international role of the dollar. This might have been expected to emerge from the collapse of the Bretton Woods system. But if anything the opposite occurred. Following the collapse of the Bretton Woods system, there has been a significant expansion in the use of the dollar as a unit of account and a major-expansion of dollar-banking. The reason for this expanded role lies in the return to an established international monetary standard.

Under the Bretton Woods fixed exchange rate system, there was a very high elasticity of substitution between the major currencies. Manufactured goods were invoiced in the currency of their country of origin and raw materials in the currency of their major markets (Llwellyn (1974), Llwellyn and Pesaran (1976)). And international banking was based on a variety of major currency assets. With the demise of the Bretton Woods system and the replacement of the fixed exchange rate regime with fluctuating rates, the elasticity of substitution between major currencies fell significantly. The private sector was now forced to take over the foreign exchange risk previously absorbed by the public sector. Transaction costs in international trade rose sharply. The response was the establishment of the dollar as the international money, fulfilling the role of both a trading unit of account and, more importantly, a vehicle currency for international banking. The rapid growth of dollar-banking was, of course, facilitated by the rapid expansion of offshore dollar deposits, notably in the Eurodollar market, fueled by large United States current account deficits.

It is inevitable that the *Euro* will eventually become the largest world-trading currency for industrial goods. Indeed, insofar as the share of the United States in international trade declines, and the development of the *Euro* reduces transaction costs with the EU countries and between EU countries and third parties, then the share of the Euro, both in trade and finance, is bound to rise yet further. The dynamic already manifests itself in the volume of foreign portfolio investment inflows in the EU core countries (Tables 4 and 5).

Table 4 Net Flows by Institutional Investors (billion Euros)

	United States			Largest 4 <i>Euro</i> countries		
	1996	1997	1998	1996	1997	1998
Bond funds	-0.2	25.1	66.0	35.6	53.9	117.7
Equity funds	119.9	201.2	141.3	-2.2	36.8	57.4
Mixed funds	10.9	14.6	9.5	-0.5	21.0	37.9
Ex. Money market funds	202.6	240.9	216.8	32.9	111.7	213.0
Money market	79.1	90.3	209.4	6.9	1.6	51.1
Grand Total	281.7	331.2	426.2	39.8	113.3	264.1

Source: OECD, *Financial Market Trends*, Vol. 72, Feb. 1999.

Table 5 European Market Growth of New High Yield Issues (billion USD)

	Dollar-denominated		Euro-denominated	
	Amount	Δ %	Amount	Δ %
1996	4.3		0.1	
1997	6.1	41.9%	0.9	800.0%
1998	12.0	96.7%	5.3	488.9%
1999:8	5.6	-53.3%	6.2	17.0%

Source: *The Financial Times*, 29 Sept. 1999.

Whether dollar-banking will as a consequence decline is less clear. Provided that the single currency European market will become the dominant market for the sale of some commodities and a dominant source of imports for commodity-exporting countries, there will be some switching into *Euro* denominated trade with attendant effects on banking. The introduction of the *Euro* is already associated with an increase in intra-EU trade, whilst EU trade has tended to show its overall balance of payments to be near equilibrium. That this was so in the 1960s, and even the 1970s, when national current account balances were seldom very large as a proportion of national product, is unsurprising. But it is more notable as a characteristic of the 1980s and the 1990s, when very large national imbalances appeared and, indeed, persisted (Table 6). Thus even though individual countries have non-zero balances in their extra-EU trade, the EU as a whole does not.

Table 6 EU Balance on Current Transactions with the Rest of the World, 1961-1998
(Percentage of GDP, at market prices)

Years	EU-15	United States	Japan
1961-1970	0.3	0.6	0.2
1971-1980	-0.1	0.2	0.6
1981-1990	0.0	-1.9	2.3
1991-1995	-0.5	-1.2	2.7
1996-1998	1.1	-1.9	2.2

Source: *European Economy*, No. 65, 1998, pp.304-5.

But the experience of the persistent international role of pound sterling before the Bretton Woods system and of the dollar after the Bretton Woods agreements suggests that any change of this sort will be subject to considerable inertia. The growth of international banking in *Euro* will also be inhibited by the lack of any net capital flows from the EU. Without the flow of the *Euro* assets into the world's money markets, net foreign holdings of *Euro* will rise only with EU reciprocal holdings of foreign currency. The growth of liquidity that has accompanied the rise of dollar-banking will be difficult to replicate.

The amalgamation of the EU currencies into the *Euro* will rather confirm the division, suggested by many, of the world trading system into three major zones, built

around the dollar, the yen and the *Euro* (replacing the deutsche mark). If free capital movements between the three currency blocks are allowed to persist, there will arise a serious need to establish an exchange rate credibility on a much greater scale than was necessary under the EMS, for credibility will have now to be reproduced on a tripartite international scale. The consequent upward bias in real interest rates will not probably be avoided, given the lack of a clear symmetry, that is leadership, in the tripartite system. Under these circumstances the tripartite character of the new international monetary regime will not produce stability and may, indeed, precipitate further instability, which all attempts at coordination of both the new EMS and the international trading agreements will do very little to alleviate. The new international system will require cautious management with the objective not only to reduce short-term instability, but also of ensuring that international monetary exposure is consistent with the relative economic strength of the issuing economy. A set of proper policies, carefully designed to control the international movements of capital and the volatility of exchange rates, are in need if we are to avoid the experience of prospective instability.

The instability attributed to non-hegemonic international financial structures and the lack of appropriate international stabilization mechanisms derive from a disjuncture between the real economic strength of a country within the international monetary system and its ability to support the widespread international use of its currency. The operation of the international monetary system thus far has been based on a persistent United States current account deficit, as opposed to a persistent capital account deficit, which is likely to prove very fragile. Moreover, the Plaza and Louvre agreements were attempts to develop some collective responsibility for the stability of the international financial relations. But despite all the rhetoric on policy coordination the real achievements have been limited at best. The high real interest rates and the unprecedented cross-border movements of funds that have characterized the 1980s and 1990s testify to that limitation.

In the tripartite world created by the EMU, the coordination of international monetary policy and the internationalization of the function of the lender of last resort will be the keys to the maintenance of economic stability and growth. However, the role of the required institutions within this international effort does not seem to have been taken into account in the design of the EMU. Moreover, the current institutional structure of the EMU assigns responsibility for the conduct of domestic monetary policy to the independent European Central Bank, while exchange rate policy is to be determined by the Council of Economics and Finance Ministers. If there is to be any attempt to play an active role in international coordination, this division of responsibility is nonsensical. It will not be possible to separate domestic monetary policy from external monetary policy. Finally, the fiscal segmentation of the EU will mean that international coordination will require the managing of the three international monetary policies with seven fiscal policies of the G7 group.

Some of these views are shared by certain authors, but do not generally reflect the central thesis of the Masson *et al* volume. Thus, even though it is contended that the international attractiveness of the *Euro* will be determined by Europe's overall macroeconomic policy, the latter is thought to depend mainly on the success of the

European Central Bank in maintaining political independence and, therefore, achieving low inflation. Given the anti-inflationary mandate of the ECB, it is contended that the strength of the *Euro* will depend on the extent of structural reforms, the efficiency of the network of externalities that will result from the reduction in transaction costs caused by the realization of economies of scale, the extent of European country participation in the EMS and their coordination, or, finally, the relative efficiency of European financial markets.

Moreover, it is argued that following the introduction of the Euro, the inducement for international policy co-ordination will be less a result of the concentration of powers in the ECB and the divergence of fiscal practices among member-states and more a result of the rise in the general level of global uncertainty (Masson and Turtelboom), the occurrence of financial crises and the effective harmonization of institutional frameworks governing multilateral agreements.

However important these arguments may be, they never deal explicitly with the questions of free capital movements between the three currency blocks and fiscal coordination in the EU states, nor do they consider extensively the issue of maintaining market credibility, particularly exchange-rate credibility, on a global scale. In addition, the question of world leadership required, in the absence of a widely agreed coordination framework, to secure global stability and the need for careful international management is only casually treated. Finally, there is no mention at all, given the commitment to world deregulated markets, of the need for a central financial authority with sufficient powers to regulate capital movements on a world scale.

Yet, about two years later than the publication of the Masson *et al* volume, amidst the already manifest contagious impact of the 1997 Asian crisis and just before the wake of the 1998 Russian crisis, the same IMF supported a new study, which underscored the possibility of high risk accompanying the liberalization of the capital account within a globally unregulated environment (Eichengreen and Mussa (1998), comprising contributions by Dell'Arricia, Detradiache, Ferretti and Rweedie). These views were also echoed in the IMF's 1998 Annual Report, where for the first time in the IMF's history there was an official reference to the risks involved in the adoption of full and unconditional capital account liberalization policies in emerging markets. However, no novel policy suggestions were accordingly made. This lack of novelty, seems to have led the task force, sponsored by the Council on Foreign Relations in the US, which includes figures such as Paul Volcker (former Federal Reserve Chairman), Carla Hills (former US trade representative) and George Soros (fund manager), to make, among other suggestions, strong endorsement of Chilean-style taxes aimed at the discouragement of short-term capital movements (The Financial Times, 18-19 Sept., 1999)

V. Capital Account Liberalization and the Asian Financial Crisis

Ever since the 1992 ERM crisis, the role of the capital account liberalization for the understanding of financial stability and the eruption of financial crises is a widely acknowledged and remains a strongly debated fact. However, the precise links between

overall macroeconomic management, economic performance, capital movements and systemic stability are not usually agreed upon. The most recent example is that of the explanation of the causes of the recent south-east Asian crisis. The general aura from the WBBI conference referred to in the introductory section attests to this. The problems are widely seen in the structure and behavior of the Asian development model *itself* and not (at least not principally) in the quality of macroeconomic policies followed by the south-east Asian states in the years preceding the crisis, most notably the uncritical and rapid deregulation of the capital account and the liberalization of their economies without the necessary oversight.

In the early 1990s, the World Bank (1991) claimed that the south-east Asian countries were successful because they followed a 'market-friendly' strategy for development and integrated their economies closely with the rest of the world. State intervention was acknowledged, but was deemed neither necessary nor sufficient for the region's success. The IMF too suggested that important characteristics in the Asian model are dysfunctional. Especially were singled out (a) the close relationship between business and government, which was regarded as creating 'crony' capitalism and inefficiencies in resource allocation, and (b) the various distortions to competitive markets. Thus, the view that the Asian crisis was essentially 'home-grown' came to dominate higher level government circles and international financial institutions, including, in addition to Summers (1998) and Camdessus (1998), the widely influential but more cautious view of Greenspan (International Herald Tribune, 13 Febr. 1998).

However, this is not the only view on the causes of the crisis. A more sophisticated version of 'external factors' originating in the analysis of the Mexican 1994 crisis held that financial crises may clearly occur even when a country's fundamentals are totally sound. It may arise because of changes in investors sentiment or perceptions that may be triggered-off entirely by external events such as changes in interest rates or equity prices in advanced markets, or some other factor. Such crises of confidence can be self-fulfilling prophesies (Calvo and Mendoza (1996), Sachs, Tornell and Velasco (1996), Cole and Kehoe (1996), Krugman (1998)).

At the same time, a growing body of literature attributes the cause of the crisis to the liberalization of the global financial markets, and particularly to the deregulation of the capital account, which many Asian countries have undertaken in the preceding period (Akuyz (1997), Amsden (1994), Amsden and Euh (1997), Amsden and Singh (1994), Chang (1998), Singh (1998), Singh and Weisse (1998)). These authors suggest that full and accelerated deregulation and liberalization was the main cause of the crisis rather than any structural factors connected with the Asian development model of state-guided investment and state direction of the financial system. It is argued that had those policies been continued, the crisis would not have occurred at the first place. The crisis occurred directly as a result of the deregulation of the capital account and liberalization policies when the governments relinquished controls over the financial sector as well as corporate investment activities. This led to misallocation (towards, e.g., the property sector) of investment as well as of over-investment.

In general, a complete account of the factors contributing to the emergence of

a crisis include the following: (a) the role of fundamentals; (b) the proximate cause of the crisis (e.g., the capital supply shock in the Asian crisis); (c) the role of structural factors (transparency, corporate governance, bureaucracy, etc.); and (d) the role of macroeconomic policies (e.g., financial liberalization).

The analytical conclusions from the close examination by the lastly mentioned authors of the role of the above factors are basically the following:

First, the currently widely held view that the root cause of the present financial crisis lies in the *dirigiste* model of Asian capitalism pursued by these countries is seriously mistaken. The analysis suggests that the fundamental reason for the crisis is to be found not in too much but in too little government control over the financial liberalization process which these countries implemented in the recent period. All the crisis countries had strong fundamentals in the sense of a proven record of being to sustain fast economic growth (Table 7). In view of their export orientation, they also had the ability to service their debts in the long-term. In addition, the external supply shock hypothesis is not valid since aggregate financial figures for these countries indicate that their net external capital inflows increased substantially between 1994-96 (Table 8).

Table 7 Macroeconomic Indicators for Asian Crisis Economies
(percent of GDP unless otherwise indicated)

Countries	1975-82 (average)	1983-89 (average)	1990-86 (average)	1995	1996	1997f
Malaysia						
Real GDP growth	7.1	5.4	8.8	9.5	8.6	7.0
Inflation(a)	5.3	2.0	3.5	3.4	3.5	3.7
Domestic Saving	21.6	29.4	32.1	33.5	36.7	37.0
Fixed capital formation	29.4	28.5	38.3	43.0	42.2	42.7
Current account	-2.0	-0.7	-6.0	-10.0	-4.9	-5.8
Fiscal balance	-6.3	-4.0	0.0	3.8	4.2	1.6
External debt service	3.8	9.0	6.0	6.6	5.4	8.4
Indonesia						
Real GDP growth	6.2	5.5	8.0	8.2	8.0	5.0
Inflation(a)	15.0	8.1	8.6	9.4	7.9	8.3
Domestic Saving	19.3	23.2	28.9	29.0	28.8	27.3
Fixed capital formation	19.8	24.3	27.4	28.4	28.1	26.5
Current account	-2.6	-3.5	-2.6	-3.3	-3.3	-2.9
Fiscal balance	-2.6	-1.3	0.3(c)	0.8	1.4	2.0
External debt service	3.5	6.8	8.6	8.5	9.0	10.5

MERTZANIS: CAPITAL ACCOUNT LIBERALIZATION

Table 7 (Continued)

Countries	1975-82 (average)	1983-89 (average)	1990-86 (average)	1995	1996	1997f
Thailand						
Real GDP growth	7.0	8.1	8.6	8.7	6.4	0.6
Inflation(a)	9.0	3.1	5.1	5.8	5.9	6.0
Domestic Saving	19.6	25.4	34.2	34.3	33.1	31.8
Fixed capital formation	23.6	27.7	40.4	41.8	40.8	35.8
Current account	-5.6	-3.2	-6.9	-8.0	-7.9	-3.9
Fiscal balance	-5.8	-3.0	2.8	2.6	1.6	-0.4
External debt service	3.8	5.8	4.5	5.0	5.4	7.1
Korea						
Real GDP growth	7.0	9.6	7.7	8.9	7.1	6.0
Inflation(a)	17.6	3.8	6.4	4.5	4.9	4.3
Domestic Saving	25.7	32.7	35.0	35.1	33.3	32.9
Fixed capital formation	29.4	29.4	36.7	36.6	36.8	36.6
Current account	-4.6	2.5	-1.9	-2.0	-4.9	-2.9
Fiscal balance	-2.7	-0.3	-1.0	0.0	0.0	0.0
External debt service	NA	1.4(d)	2.2(e)	NA	NA	NA

Source: IMF, 1997. *World Economic Outlook: Interim Assessment*, December; World Bank.

(a) average annual percent change of consumer price index.

(b) gross international reserves in months of import cover

(c) 1990 and 1994 data unavailable.

(d) 1980-90, (e) 1996 figure, (f) IMF estimate.

Table 8 Capital Flows to Asian Crisis Economies (a)
(percent of GDP)

Countries	1983-98(b)	1989-95(b)	1994	1995	1996	1997
Malaysia						
Net private capital flows	3.1	8.8	1.5	8.8	9.6	4.7
Net direct investment	2.3	6.5	5.7	4.8	5.1	5.3
Net portfolio investment	NA	NA	NA	NA	NA	NA
Other net investment	0.8	2.3	-4.2	4.1	4.5	-0.6
Net official flows	0.3	0.0	0.2	-0.1	-0.1	-0.1
Change in reserves(e)	-1.8	-4.7	4.3	2.0	-2.5	3.6
Indonesia						
Net private capital flows	1.5	4.2	3.9	6.2	6.3	1.6
Net direct investment	0.4	1.3	1.4	2.3	2.8	2.0
Net portfolio investment	0.1	0.4	0.6	0.7	0.8	-0.4
Other net investment	1.0	2.6	1.9	3.1	2.7	0.1
Net official flows	2.4	0.8	0.1	-0.2	-0.7	1.0
Change in reserves(e)	0.0	-1.4	0.4	-0.7	2.3	1.8

Table 8 (Continued)

Countries	1983-98(b)	1989-95(b)	1994	1995	1996	1997
Thailand						
Net private capital flows	3.1	10.2	8.6	12.7	9.3	-10.9
Net direct investment	0.8	1.5	0.7	0.7	0.9	1.3
Net portfolio investment	0.7	1.3	0.9	1.9	0.6	0.4
Other net investment	1.5	7.4	7.0	10.0	7.7	-12.6
Net official flows	0.7	0.0	0.1	0.7	0.7	4.9
Change in reserves(e)	-1.4	-4.1	-3.0	-4.4	-1.2	9.7
Korea						
Net private capital flows	-1.1	2.1	3.1	3.9	4.9	2.8
Net direct investment	0.2	-0.1	-0.3	-0.4	-0.4	-0.2
Net portfolio investment	0.3	1.4	1.8	1.9	2.3	-0.3
Other net investment	-1.6	0.8	1.7	2.5	3.0	3.4
Net official flows	0.0	-0.3	-0.1	-0.1	-0.1	-0.1
Change in reserves(e)	-0.9	-0.8	-1.4	-1.5	0.3	-1.1

Source: IMF, 1997. *World Economic Outlook: Interim Assessment*, December; World Bank.

(a) Net capital flows comprise net direct investment, net portfolio investment, and other long- and short term net investment flows, including official and private borrowing.

(b) Annual averages

(c) IMF estimates

(d) Because of data limitations, other net investment may include some official flows.

(e) A minus sign indicates an increases.

Secondly, given the different circumstances of the Asian countries, the IMF staff appears to have misdiagnosed the causes of the crisis. They have therefore proposed inappropriate remedies (for example, further liberalization, large fiscal austerity, a steep rise in real interest rates) which are likely to deepen the crisis. Moreover, market confidence, which was of critical importance in the evolution of the crisis, is unlikely to have been helped by the IMF's emphasis on the ostensible fundamental structural weaknesses of these countries and the recommendations that they should implement far-reaching reforms in their economic and social systems. All these factors contributed to turning what was essentially a liquidity problem into one of solvency.

Thirdly, the governments of the affected countries made serious errors by not controlling the financial liberalization process. Although it is true that the IMF as well as the US government have been urging capital account liberalization for these countries, it is also the case that the growing domestic constituency also supported such liberalization. Thus, for example, prior to the crisis, Thailand and Malaysia were vying one another as well as with Hong Kong and Singapore to assume the role of regional financial center. This necessarily entailed considerable financial liberalization and was accompanied by excessively high gearing ratios (e.g., ratios of debt to the equity capital of the shareholders) (Table 9). The euphoria accompanying the large inflows of capital in the 1980s and 1990s, the benefits of becoming a regional financial center were readily seen. However, the governments seemed oblivious to the potential financial costs.

Table 9 Gearing Ratios: Total Liabilities Divided by Shareholders Equity
(Top listed manufacturing corporations)

Gearing	South Korea	Malaysia	Thailand	India	Mexico
Whole Period	<i>1980-94</i>	<i>1983-94</i>	<i>1987-94</i>	<i>1980-92</i>	<i>1984-94</i>
Mean	5.22	1.03	1.23	3.24	0.60
SD	4.98	1.96	0.98	10.90	1.61
Minimum	0.42	0.03	0.00	0.61	-1.94
First quartile	2.53	0.32	0.60	1.50	0.16
Median	4.30	0.64	1.00	2.28	0.32
Third Quartile	6.39	1.11	1.52	3.16	0.61
Maximum	61.97	29.12	6.78	259.41	24.49
Range	61.55	29.10	6.78	259.10	26.43
Early Period					
Mean	6.90	1.04	1.27	3.44	0.95
SD	5.84	2.14	1.00	14.46	2.04
Minimum	1.47	0.03	0.03	0.31	0.04
First quartile	4.30	0.31	0.62	1.47	0.32
Median	5.48	0.62	1.03	2.37	0.52
Third Quartile	7.81	1.12	1.62	3.13	0.84
Maximum	61.97	29.12	6.78	259.41	24.49
Range	60.51	29.10	6.76	259.10	24.45
Late Period					
Mean	3.38	1.02	1.18	3.06	0.13
SD	2.87	1.74	0.95	6.03	0.35
Minimum	0.42	0.06	0.00	0.50	-1.94
First quartile	1.81	0.33	0.59	1.53	0.03
Median	2.62	0.68	0.97	2.21	0.16
Third Quartile	3.96	1.09	1.41	3.19	0.27
Maximum	27.56	22.42	6.56	83.38	1.53
Range	27.14	22.36	6.55	82.88	3.47

Source: Singh (1998).

Finally, in addition to the pursuit of financial liberalization without a proper institutional controls, the governments of some of the crisis countries might also have made some macroeconomic mistakes, such as for example not adjusting the exchange rate, relying on short-term capital to finance large current account deficits. Nevertheless, although these governments policy errors may have initiated the crisis, this was compounded by other factors: the lack of co-ordination between banks and the desire of each bank not to renew its short-term loans following the crisis of confidence; the herd behavior of international investors which was partly responsible for the contagion throughout the region; and, as mentioned above, the inappropriate policy response by the IMF to the confidence crisis. Thus, a liquidity problem has been transformed into a far more

serious solvency problem.

Again, it is manifested that reality does not conform to conventional economic thinking. The emergence of the Asian crisis is due not to the quality of the Asian model itself, as the contributors in the WBBI conference advocate, but to the loss of credibility and subsequently to the diminution of domestic political support. The loss of credibility is in turn the result of overall macroeconomic mismanagement coupled with weakened supervision of the liberalization process. The resumption of credibility will obviously require the development of an institutional approach that comprises the achievement of political unity in the crisis-hit countries, the cooperation between government and business, labor and civil society institutions in a national program to resolve the economic situation. This would inevitably mean that the burden of adjustment would need to be equitably shared by all sections in the society. Thus, the traditional Asian model of capitalism, essentially based on corporatism, becomes all the more essential if the present acute crisis is to be overcome.

VI. Conclusions

International capital mobility affects the pattern of trade flows between countries, determines profitability and income distribution and thus shapes the pattern of overall economic growth. Thus, the understanding of international capital mobility as a major factor determining international financial stability, development and economic convergence among regions has become a sine qua non condition by economic researchers. The issue of capital mobility is even more central in the economic concerns of the EU in view of the prospective EMU and given the fairly recent experience of the 1992 crisis of the EMS. Finally, it constitutes a major point of reference by all students of the functioning of the international monetary system and its prospective transformations. It is ultimate a core element in understanding the sources of economic and financial instability both on a domestic and an international scale. The main thesis of the paper has been that, given the experience of the previous monetary regimes, it is a rather very optimistic, not to mention unrealistic, conclusion to expect that the current design of European and international monetary institutions will guarantee the smooth and uninterrupted operation of the different economies participating in the world arena. This conclusion rests on the prevailing belief by current practitioners and policy makers that free movements of capital must remain essentially and unconditionally unregulated in favor of floating exchange rates. Indeed, sufficient variations in the values of the different currencies are believed to correct existing external imbalances and thus gear the economies toward a path of growth within a smoothly functioning international monetary system. It is the paper's thesis that on the basis of past experience and sound economic theory, these conclusions seem unwarranted. Instead, it is argued that economic stability and growth for each country will be achieved, as well as the smooth operation of the international monetary system will be secured only if there will exist a proper coordination of domestic and international policies and institutions which do place, among other things, a great deal of emphasis on a proper regulation of capital movements on a global scale. Given

MERTZANIS: CAPITAL ACCOUNT LIBERALIZATION

the prevailing commitment to global economic deregulation, perhaps the establishment of a special financial authority with sufficient powers to regulate movements

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