

How the full opening of the capital account to highly liquid financial markets led Latin America to two and a half cycles of 'mania, panic and crash'

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### Abstract

Latin America has recently experienced three cycles of capital inflows, the first two ending in major financial crises. The first took place between 1973 and the 1982 'debt-crisis'. The second took place between the 1989 'Brady bonds' agreement (and the beginning of the economic reforms and financial liberalisation that followed) and the Argentinian 2001/2002 crisis, and ended up with four major crises (as well as the 1997 one in East Asia) — Mexico (1994), Brazil (1999), and two in Argentina (1995 and 2001/2). Finally, the third inflow-cycle began in 2003 as soon as international financial markets felt reassured by the surprisingly neo-liberal orientation of President Lula's government; this cycle intensified in 2004 with the beginning of a (purely speculative) commodity price-boom, and actually strengthened after a brief interlude following the 2008 global financial crash — and at the time of writing (mid-2011) this cycle is still unfolding, although already showing considerable signs of distress. The main aim of this paper is to analyse the financial crises resulting from this second cycle (both in LA and in East Asia) from the perspective of Keynesian/ Minskyian/ Kindlebergian financial economics. I will attempt to show that no matter how diversely these newly financially liberalised Developing Countries tried to deal with the absorption problem created by the subsequent surges of inflow (and they did follow different routes), they invariably ended up in a major crisis. As a result (and despite the insistence of mainstream analysis), these financial crises took place mostly due to factors that were intrinsic (or inherent) to the workings of over-liquid and under-regulated financial markets — and as such, they were both fully *deserved* and fairly *predictable*. Furthermore, these crises point not just to major market failures, but to a *systemic market failure*: evidence suggests that these crises were the spontaneous outcome of actions by utility-maximising agents, freely operating in friendly ('light-touch') regulated, over-liquid financial markets. That is, these crises are clear examples that financial markets can be driven by buyers who take little notice of underlying values — i.e., by investors who have incentives to interpret information in a biased fashion *in a systematic way*. Thus, 'fat tails' also occurred because under these circumstances there is a high likelihood of self-made disastrous events. In other words, markets are not always right — indeed, in the case of financial markets they can be seriously wrong *as a whole*. Also, as the recent collapse of 'MF Global' indicates, the capacity of 'utility-maximising' agents operating in (excessively) 'friendly-regulated' and over-liquid financial market to learn from previous mistakes seems rather limited.

**Key words:** Causes of financial crisis, Latin America, East Asia, Financial liberalisation, Neo-liberal economic reforms, Systemic market failure, Keynes, Minsky, and Kindleberger

**JEL classifications:** D7, D81, F21, F32, F4, G15, G28, G38, H12, L51, N2, O16, O43

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"The problem is that [...] the theories embedded in general equilibrium dynamics [...] don't let us think about [issues such as ...] financial crises and their real consequences in Asian and Latin America [...]."

**Robert Lucas**

"Swollen' financial markets tend to produce socially useless products and innovations."

**Chair, Financial Service Authority**

"I can [understand and] calculate the motions of the heavenly bodies, but not the madness of [the South Sea Bubble] people."

**Isaac Newton**

"Globalization opened up opportunities to find new people to exploit their ignorance. And we found them."

**Joseph Stiglitz**

"When you combine ignorance and leverage, you get some pretty interesting results."

**Warren Buffett**

"[...] and, above all, let finance be primarily national."

**John Maynard Keynes**

## 1.- Introduction

Latin America (LA) has experienced three cycles of capital inflows since the mid-1970s, the first two ending in major financial crises. The first cycle took place between the oil price increase that followed the 1973 'Yom Kippur' war and the 1982 debt-crisis, with Chile (the only country in the region that had already fully opened up its capital account) being the most affected — with a 20% drop in its real GDP between the third quarters of 1981 and 1983.<sup>2</sup> The second cycle took place between the 1989 'Brady bonds' agreement (and the beginning of the economic reforms and financial liberalisation that followed) and the Argentinian 2001/2002 crisis, and ended up with four major crises (as well as the 1997 one in East Asia) — one in Mexico (1994), one in Brazil (1999), and two in Argentina (1995, the 'Tequila-crisis', and 2001/2). Finally, the third inflow-cycle began in 2003 as soon as international financial markets felt reassured by the surprisingly neo-liberal orientation of President Lula da Silva's government. This cycle intensified in 2004 with the beginning of a (speculation-led) commodity price-boom, and actually strengthened after a brief interlude following the 2008 global financial crash — and at the time of writing (mid-2011) this cycle is still unfolding, but it is already showing considerable signs of distress.<sup>3</sup>

The main aim of this paper is to analyse the dynamics of the second cycle — from the 1989 'Brady-bonds agreement' to the Argentinian 2001/2002 crisis (and 9/11). Two common characteristics of the financial crises resulting from this second cycle — in both LA and East Asia (EA)— are that the countries involved had recently opened up their capital accounts, and that they had done so at a time of high liquidity in international

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<sup>2</sup> For this first cycle, see Díaz-Alejandro (1984); Ffrench-Davis (2010); Marcel and Palma (1988); and Palma (1998).

<sup>3</sup> Some authors have argued that the third cycle finished in 2008, and a fourth cycle began after the downturn in 2009; however, I disagree because for LA the so-called fourth cycle is nothing but the resumption of the third after a brief pause in 2008 — led by the same type of inflows, and by the same commodity-price boom (see Figures 2 and 3 below). For how these three financial cycles relate to the long-term 'technology-cycle', see Pérez (2002).

financial markets, and slow growth in most OECD economies. That is, at a time when ever more liquid, volatile and progressively un-regulated international financial markets were anxiously seeking new high-yield investment opportunities — hopefully also uncorrelated with their existing portfolio!

This paper will attempt to show that no matter how diversely these newly financially liberalised Developing Countries (DCs) in both LA and EA tried to deal with the absorption problem created by the subsequent inflow-surges (and they did follow different routes), they invariably ended up in a major financial crisis. I shall identify three different ways in which these DCs tried to deal with massive surges of inflow, and conclude that each of them led to a financial crisis via a different path. These are best illustrated by (i) the Mexican 1988-1994 experience — henceforth 'route 1' (the "try to keep public finances in balance, and let markets resolve the resulting private imbalances by themselves" route), with Chile and Argentina (at least until its 'Tequila crisis' of 1994/5) following the same route;<sup>4</sup> (ii) the Brazilian 1994-1999 one — 'route 2', characterised by a country that tried to avoid becoming 'another route-1-Mexico' via an aggressive sterilisation and tough monetary policy; and (iii) the Korean 1988-1997 one — 'route 3' (where most inflows were used to finance private investment, in a scenario of falling corporate profitability), which also included Malaysia and Thailand.

This paper further attempts to show that all three 'routes' led to financial crises in ways that have little to do with the financial processes described in the most popular mainstream models of financial crises — in particular 'second-' and 'third-generation' ones — especially with their supposed *unpredictable* and *undeserved* nature.<sup>5</sup> That is, the key proposition of this paper is that the common feature of all three routes to financial crises during the second cycle is that the resulting crises were both (fairly) predictable and (certainly) deserved. Basically, they were the outcome of economies opting to integrate fully (and indiscriminately) into international capital markets via an open capital account, and then being unable to absorb the subsequent surge of inflows (no matter how hard they tried to deal with them). The experiences of China, India and Taiwan during the same period (as well as those of Chile and Colombia in the 1990s, when they implemented 'price-based' capital controls) show that a more *selective* path of participation in international capital markets is a far more effective way of avoiding the pro-cyclical dynamics of unrestricted capital flows — or the huge costs of sterilisation (Ocampo and Palma, 2008). They also help avoid the massive costs in the alternate phase of the cycle, associated with stampedes by intrinsically restless (and often under-informed) fund-managers — so prone to oscillating between manias and panics.

## 2.- International financial markets and the three main stylised facts of capital flows into middle-income DCs since the liberalisation of their capital accounts

### 2.1. Opening up to an world of financial 'virtual realities'

Following Kindleberger, my main contention is that the most likely source of a financial

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<sup>4</sup> Although Chile's 1982-crisis belongs to the first cycle, as Chile opened-up of its capital account two decades before the rest of the region, its 1982 crisis resembles a 'route-1' crisis (for a full account of the process of economic reform in Chile, see Ffrench-Davis, 2010). In terms of Argentina, this country was the only one that, when first in trouble (1995), managed to continue with the same policies for several years thanks to generous IMF help and some skilful — but eventually self-defeating — 'financial engineering'. Therefore, events between its two crises (1995 and 2001) are unique, and do not really fit into any of the 'routes'. However, for reasons of space I cannot discuss in detail the intricacies of these events (1995-2001). For analyses, see Chudnovsky (2002); and O'Connell (2002).

<sup>5</sup> For a brief description of 'first-', 'second-' and 'third-generation' models, see Appendix 1; see also Krugman (2001).

crisis is a sudden surge of liquidity. The financial crises studied here are no exception. So, the starting point of the analysis has to be the “when, how and why” there was this increase in liquidity — and how its ‘clearing process’ led to increased ‘leverages’, asset-price bubbles, and the opening-up of new and more risky ‘liquidity-outlets’. The ‘rediscovery’ of DCs is an example of the latter, and the sub-prime mortgage-market is another creation of a new ‘outlet’ to unload excess liquidity. In fact, in the US financial markets not only issued nearly half a trillion dollars in sub-prime mortgages, but, according to the WSJ, in 2007 alone the number of new credit-card solicitations mailed to sub-prime borrowers reached more than 1.3 million (<http://finance.yahoo.com/news/bringing-expired-debt-back-to-life.html>). In other words, financial markets became so liquid that almost any financial asset could be sold with ease — no matter how toxic it may be. This ‘liquidity-clearing process’, in turn, leads to increased (Minskyian) financial fragilities. In fact, one way of looking at how liquid international financial markets had become during the second and third inflow-cycles is that between 1980 and 2007 (i.e., between the beginning of financial de-regulation with Thatcher and Reagan, and the year before the current global financial crisis), the four components of the *stock* of global financial assets (equity, public and private bonds and bank assets) jumped *9-fold* in real terms (to US\$241 trillion). As a result, as a multiple of world output the stock of financial assets jumped from 1.1 to 4.4 (see Palma, 2009a).

In turn, the outstanding amounts of over-the-counter derivative contracts increased from 2.4 to 11 times the size of global output. And the gross market value of these ‘financial weapons of mass destruction’ grew eight times faster than world output. In fact, just those involving commodities increased 59-fold during the same decade (BIS, 2011; excludes gold). This frantic speculation is certainly more important than China or India in explaining the post-2003 boom in commodity prices. Also, in terms of emerging markets, total assets for single-manager hedge funds whose primary investment focus were DCs grew 4.5-fold in only the three years before 2008 — with emerging market equity managers becoming the best niche group in the hedge fund industry (returning on average 37%; HFR, 2007).

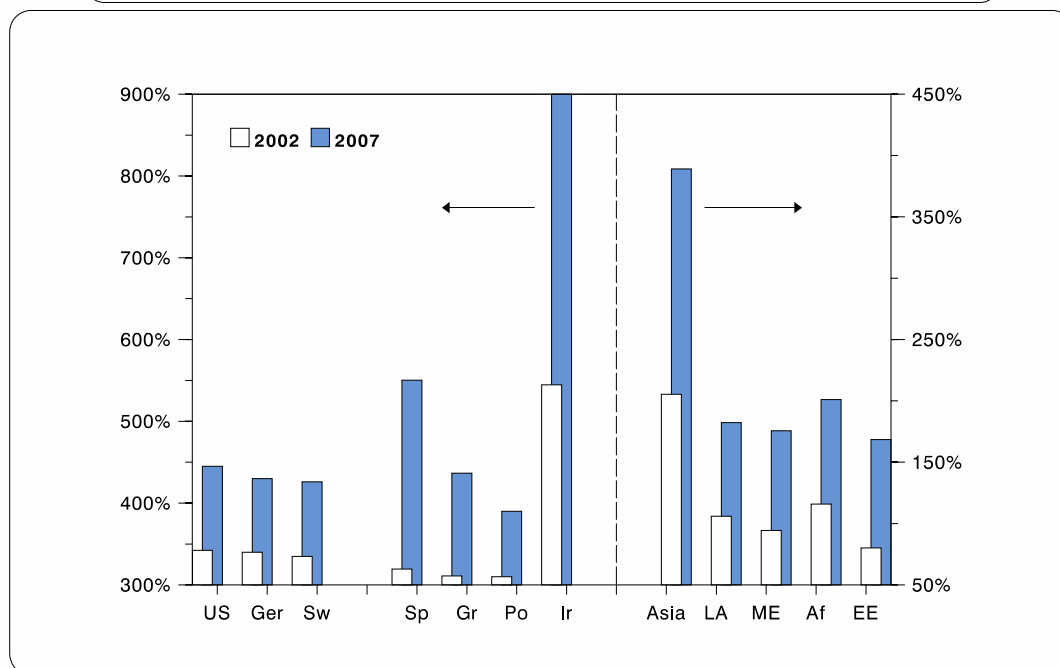
In terms of players in the ‘shadow financial market’, the total number of hedge funds and funds of funds grew from 610 to nearly 10 thousand between 1990 and 2007, with total assets at that time of nearly US\$2 trillion (and total market ‘positions’ of US\$5.3 trillion). In fact, even after the LTCM debacle in 1998 the number of hedge funds (and LTCM’s business model) continued to expand as if nothing had ever happened — or, rather, as if life could continue ever more enjoyably as there was now the guarantee that the Fed would always be available at the other end of a 911 call. And an indication of their shadiness is that of these funds 53% were registered in the Caribbean, 25% in Delaware, and only 1.3% in New York.

Two of the main problems emerging from these post-1980 increasingly liquid and un-regulated international financial markets were the increased *volatility* and the *correlation* of returns on financial assets. In fact, now shockwaves are transmitted — and amplified — to such an extent that a simple way of looking at the onset of the 2007/8 financial crisis would be to say that (long-delayed) concerns over US\$500 billion of ‘sub-prime’ mortgage lending led to the wiping off of more than US\$40 trillion in global asset markets. In fact, it used to be that when the US sneezed, the rest of the world caught a cold; now it is enough for Greece to sneeze, for the rest of the world to catch pneumonia. And these are the international financial markets to which LA and EA — and countries of Eastern Europe and of the European periphery — chose to open their capital accounts fully. The irony is that this was done, supposedly, in search of diminishing uncertainty and counter-cyclical finance! As Summers once famously said, for DCs to open capital accounts without capital controls has proved to be like building a nuclear plant without safety valves

Figure 1 shows the massive ‘financial deepening’ that took place in the above economies just in the five years between 9/11 and the 2007/8 global financial crises.

FIGURE 1

"Financial deepening": ratio of financial assets to GDP, 2002-2007



• **Ger**=Germany; **Sw**=Sweden; **Sp**=Spain; **Gr**=Greece; **Po**=Portugal; **Ir**=Ireland; **LA**=Latin America; **ME**=Middle East; **Af**=Africa; **EE**=Eastern Europe.

• **Source:** IMF (2011a). As mentioned above, the four components of the stock of financial assets are the capitalisation of stock markets, public and private bonds, and bank assets. The source does not report data for Iceland.<sup>6</sup>

Basically, in only five years the above countries increased the value of their stock of financial assets by an amount larger than a whole GDP: Ireland by 3.6 GDPs; Spain 2.3; Asia 1.8; and Greece (of all countries) by 1.3. That this happened in countries with dynamic growth, such as China or India, could plausibly have some justification in the eyes of financial liberalisers (as 'irrational exuberance'). Also in Ireland something was actually happening in the real economy. But that it took place in Portugal (0.9% growth p.a. for GDP, and 15% for financial assets), Greece (4.3% and 24%), or Spain (3.5% and 27%) can only be labelled as surreal — i.e., the outcome of 'self-regulation' in financial markets becoming freedom to run amok, and 'market discipline' becoming a joke. Something similar happened in LA (4.8% and 27%), Africa (5.7% and 30%), or Eastern Europe (5.6% and 45%).

These asymmetries between the real and the financial economy are *precisely* what FDR tried to avoid with the 'New-Deal'-type financial regulation, and Keynes with Bretton-Woods. Also, they are not exactly what the 'efficient-market hypothesis' (especially 'strong-form version' theorists) had in mind when they asserted that in liberalised financial markets "prices at all times fully reflect all available information — public and private" (Fama, 1976). In essence, according to this theory there cannot be an *endogenous* gap between prices in financial market and fundamentals — let alone a bubble. That is, asset prices deserve a pedestal, and stock options are therefore the most efficient reward for good performance. Well, not exactly what has happened in the

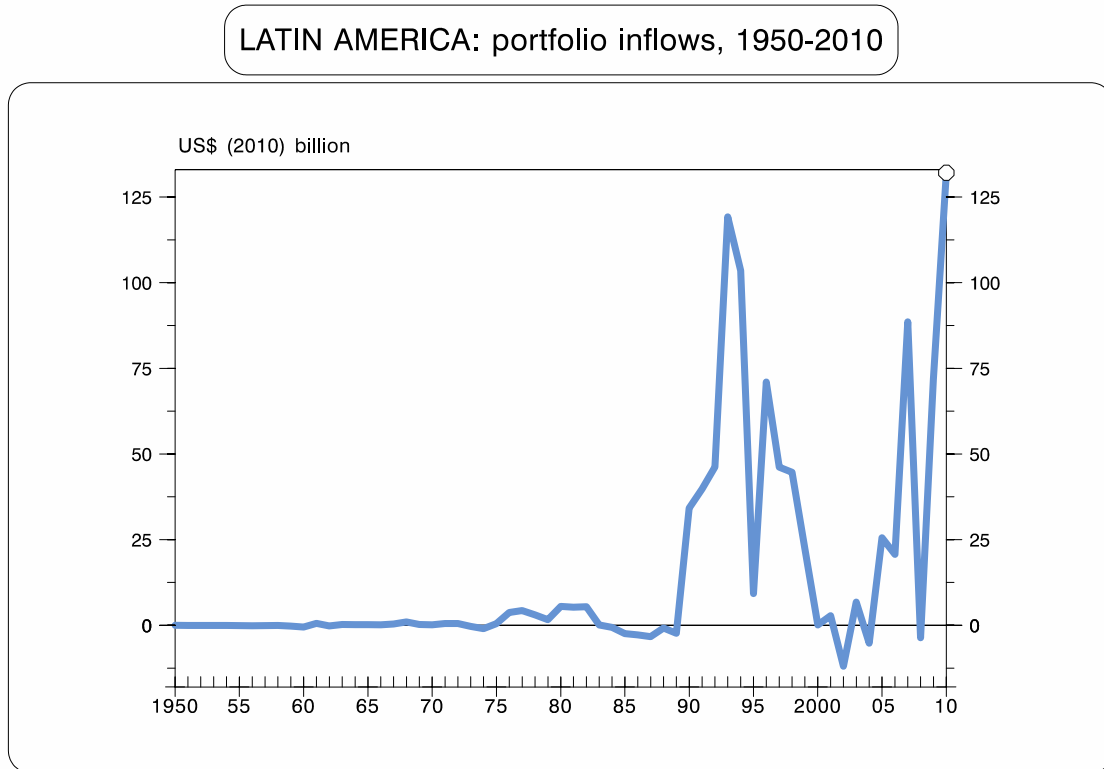
<sup>6</sup> According to a senior IMF official, what one has to understand is that "Iceland is no longer a country — it is a hedge fund" (quoted in Lewis, 2009). On Iceland, see Wade and Sigurgeirsdottir (2010).

increasingly over-liquid and under-regulated post-1980 financial markets!

## 2.2.- The first stylised fact of post-1990 inflows into (newly financially-liberalised) DCs: a massive surge of highly volatile capital flows

Figure 2 shows the first and crucial stylised fact of post-1990 inflows into these middle-income DCs: the sudden surge, the high volumes, and the huge instability of these inflows.

FIGURE 2



• **Source:** ECLAC (2011; total portfolio inflows).

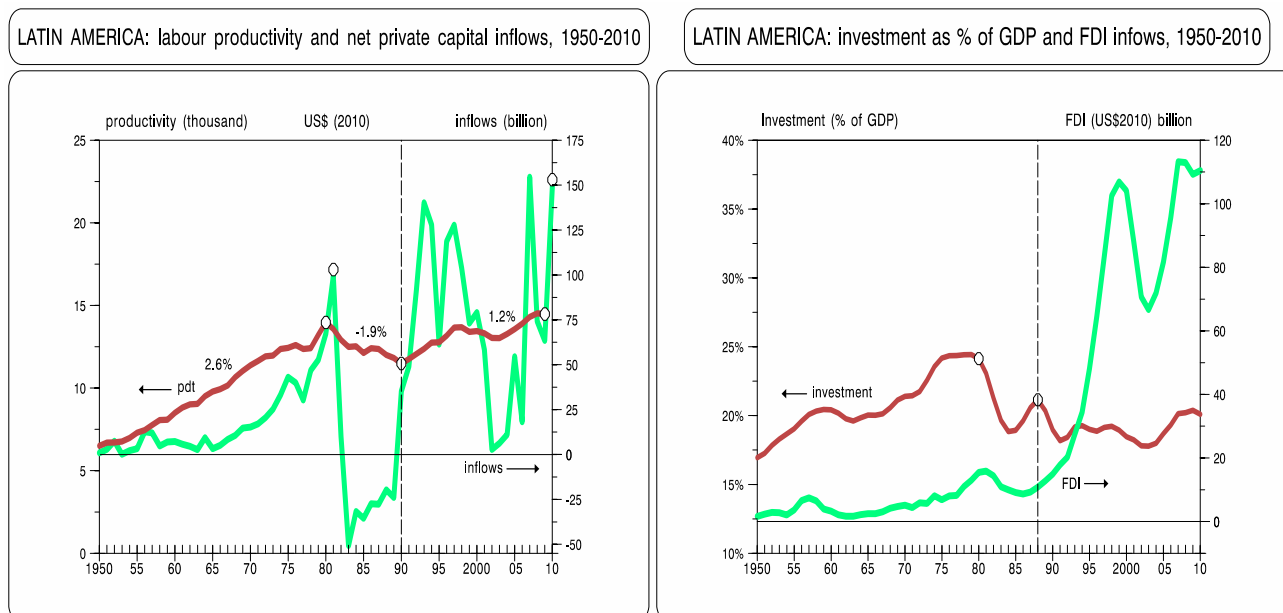
According to mainstream economic theory (and the Washington Consensus discourse), full integration into international capital markets should be highly beneficial to DCs with 'sound fundamentals' for a number of reasons, but especially because it should pool risk, and provide countercyclical access to finance. Well, there's little evidence of that. In fact, since 1990 almost all Latin American countries have had (what in the narrow sense of the Washington Consensus is understood as) 'sound fundamentals', and remarkably easy access to international finance. However, the outcome of this has been rather different from the prediction of mainstream economists and neo-liberal politicians (of all political persuasions). As Figure 2 indicates, this has been one of damaging surges of inflows, *pro-cyclical* finance, and hugely increased financial fragility — and augmented *uncertainty*. In particular, as will become clear below, the key characteristic of 'route-1' countries in LA was the *intensity* of the pro-cyclical nature of the surge in inflows when these were dealt with following the credo of the 'efficient-capital-market' theory, and the first law of Welfare Economics — i.e., (i) try to keep public finances in balance; and (ii) leave markets to resolve the resulting private imbalances by themselves.

Looking at LA's overall scenario since 1990 (in both 'route-1' and 'route-2' countries), if I was asked to put forward the argument for capital controls — as the only effective mechanism for dealing with the problem of the volatility of inflows *at source* — Figure 2 would be my 'Exhibit A'.

### 2.3.- The second stylised fact: at least in LA, the tsunami of inflows has had little or no positive impact on the real economy

Figure 3 indicates the second stylised fact of the surge in (volatile) inflows: given what has happened in LA since financial liberalisation, it would be rather difficult to argue that the opening up of the capital account c.1990 has had an unambiguous positive impact on the real economy — this is true even for FDI!

FIGURE 3



- **pdt**=labour productivity. The percentages in the left-hand Panel are average rates of productivity growth for respective periods (1950-1980, 1980-1990, and 1990-2010). In the right-hand panel, investment and FDI are 3-year moving averages.
- **Sources:** productivity, WB (2011; for output), and GGDC (2011; for employment); investment, ECLAC (2011; current prices); net private inflows, ECLAC (2011; for 1950-70), and IMF (2011b; for 1970-2010); and FDI, ECLAC (2011).

As the left-hand panel of Figure 3 indicates, before 1980, when inflows averaged less than US\$ 20 billion per year (in 2010-US\$), productivity growth reached 2.6% p.a. (3.8% for Brazil). But when they increased by more than three times (1990-2010), productivity growth only reached half the pre-1980 rate (1.2% p.a.; 1.3% for Brazil). Of course the disappointing post-1990 performance in 'liberalised' LA has many roots (see Palma, 2011a), but there is little doubt that the negative effects of the massive surge of (volatile) inflows is part of that narrative. For example, huge inflows led to a chronic deficiency of effective demand for non-commodity tradable activities, especially manufacturing; this was the outcome of the 'deadly triad' of over-valued exchange rates (that switched aggregate demand towards foreign markets); high interest rates (due to 'tough' monetary policies to deal with these inflows); and remarkably low levels of public investment by 'sterilised' governments (of about 3% of GDP; these were necessary to balance public finances in a context of low taxation, as part of the 'sound fundamentals' shop-window part of the open capital account story).<sup>7</sup> Added to this, there was a hugely increased uncertainty (especially due to the volatile nature of inflows) affecting especially

<sup>7</sup> While in OECD countries personal income tax collection reaches on average 9% of GDP, in LA it amasses less than 1% — with income tax evasion fluctuating around 50%, equivalent on average to 4.5% of GDP (ECLAC, 2010). From this perspective, there is little doubt that LA confirms Schumpeter's hypothesis that: "[t]he fiscal history of a people is above all an essential part of its general history" (1918).



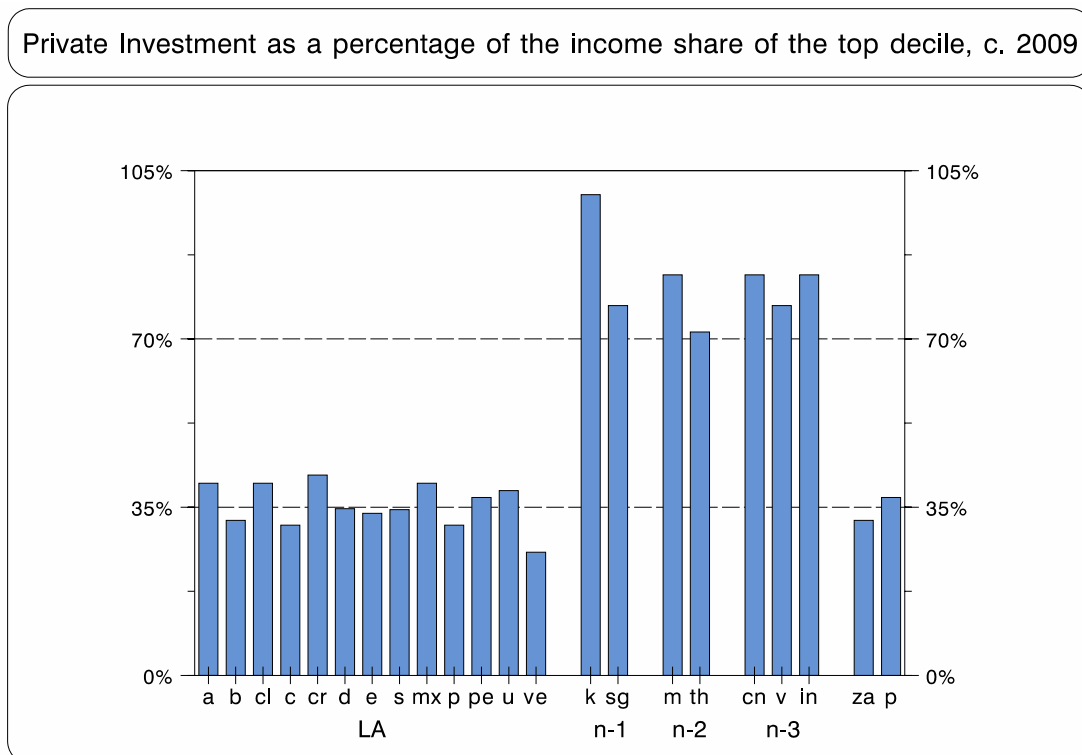
private investment.

One aspect of inflows that is truly remarkable is shown in the right-hand panel of Figure 3: a significant surge of inflows of FDI after the 'Brady-bonds' agreement and the beginning of economic reform — reaching an average of US\$ 75 billion a year between 1988 and 2010 (in 2010-US\$; ECLAC, 2011) — has been associated with a remarkably poor rate of investment (as a share of GDP). In fact, despite the growth-acceleration in many countries after the post-2003 commodity-price boom and the new surge in inflows, as well as the rapid recovery after the 2008 crisis, by 2010 the average investment-share of the region was still in its (already disappointing) starting point — with Brazil and Venezuela, although for different reasons, lagging behind. In other words, as Figure 3 clearly indicates, in LA inflows of FDI equivalent to *US\$1.8 trillions* (1988-2010; 2010-US\$) has been associated with a rate of accumulation that is poor even from the perspective of its inadequate historical record — on average 19% of GDP (ECLAC, 2011; see also Palma, 2011a).<sup>8</sup>

So, again, not much support here for the mainstream proposition that DCs are full of investment opportunities, just waiting for the availability of finance (which, supposedly, can only come from rich countries and not from the high proportion of the national income appropriated by their élites). And significant support for the Keynesian proposition that the mere availability of finance does not lead to higher levels of investment.

In fact, perhaps the most striking political-economy difference between LA and Asia is found in their contrasting relationships between income distribution and investment (Figure 4).

FIGURE 4



• **n-3** = third-tier NICs (China, India and Vietnam), and **a** = Argentina; **b** = Brazil; **cl** = Chile; **c** = Colombia; **cr** = Costa Rica; **d** = Dominican Republic; **e** = Ecuador; **s** = El Salvador; **mx** = Mexico;

<sup>8</sup> Part of this phenomenon is the fairly unimpressive rôle of mostly rentier Spanish multinationals, only able to operate in (protected) non-tradable activities (including domestic finance and utilities). To paraphrase Oscar Wilde, for LA to have been conquered by Spain once may be regarded as a misfortune; twice looks like carelessness.

**p** = Paraguay; **pe** = Peru; **u** = Uruguay; **ve** = Venezuela; **k** = Korea; **sg** = Singapore; **m** = Malaysia; **th** = Thailand; **cn** = China; **v** = Vietnam; **in** = India; **za** = South Africa; and **P** = Philippines.

• **Sources:** for income distribution, WDI (2010); for private investment IMF (2010).

While in LA private investment (which usually hovers around 15% of GDP) accounts for only one-third of the income-share of the top decile (about 45% of national income), in most of Asia this ratio jumps to more than twice that level — with Korea's even above 1. In other words, while LA's top deciles appropriates *twice* as much as those of Korea and Taiwan, LA's share of private investment in GDP reaches *half* the East Asian levels. From my own perspective, this is *the* most crucial characteristic of the (sub-prime) nature of LA's capitalism: what I like to call the "two-times-half-style capitalism" — i.e., how to create an institutional environment in which one can get twice as much, with half the effort.<sup>9</sup> And FDI, instead of making a positive impact on that asymmetry, has been happy to adjust.<sup>10</sup>

Oddly enough, in South Africa (in this respect, LA's honorary middle-income country in Africa), and in The Philippines (the honorary one in Asia) similar low ratios as those of LA indicate that their capitalist élites have the same Latin preference for having their cake and eating it...

So the usual argument that one of the main reasons why LA needs capital inflows is because its many investment opportunities are constrained by finance is rather hollow. It is not that in LA lacks investment opportunities (e.g., those associated with forward and backward linkages of commodity production); the issue that still needs a more elaborate answer is why is it that neither domestic nor foreign capital shows much interest in taking advantage of them? And, again, post-reform LA has shown little support for the mainstream argument that says that all that is required for the happy union between these investment opportunities and foreign finance are 'prices right' and 'institutions right'. The experience of EA shows that effective trade and industrial policies, pro-growth macros, and so on are probably more relevant.

Keith Griffin once wrote that foreign aid may well end up simply *substituting* domestic savings (Griffin, 1970); well, post-reform LA seems to indicate that in DCs FDI also could have a strong substituting effect on national private investment — except, of course, in Asia! It is fairly obvious that LA's capitalist élite has a preference for both sumptuous consumption, and for accumulation via mobile assets (financial ones and capital flight) rather than via 'fixed' capital formation.<sup>11</sup> And neo-liberal reforms — despite all the efforts towards defining and enforcing property rights, and all the other 'market-friendly' policies aimed at incentivising investment — have had little impact on that (in spite of all the resources and foreign exchange provided by inflows, and the particularly favourable terms of trade). Not much evidence here of the supposed revitalising effects of 'financial-deepening' promised by McKinnon and Shaw.

In essence, economic reform has been unable to reproduce even the relatively low investment rates of the state-led industrialisation period; instead, it seems to have unleashed more powerfully the predatory and rentier instincts of the region's capitalist élites (the former especially during the privatisation period).<sup>12</sup> In many Asian countries, meanwhile, reforms, especially financial liberalisation, may have brought complex challenges to the macro, and the inevitable financial fragilities (as well as increased inequalities, labour insecurity and so on), but at least the rate of accumulation increased significantly *after* their implementation. In LA, meanwhile, the cloud did not even have that silver lining (Figure 5).

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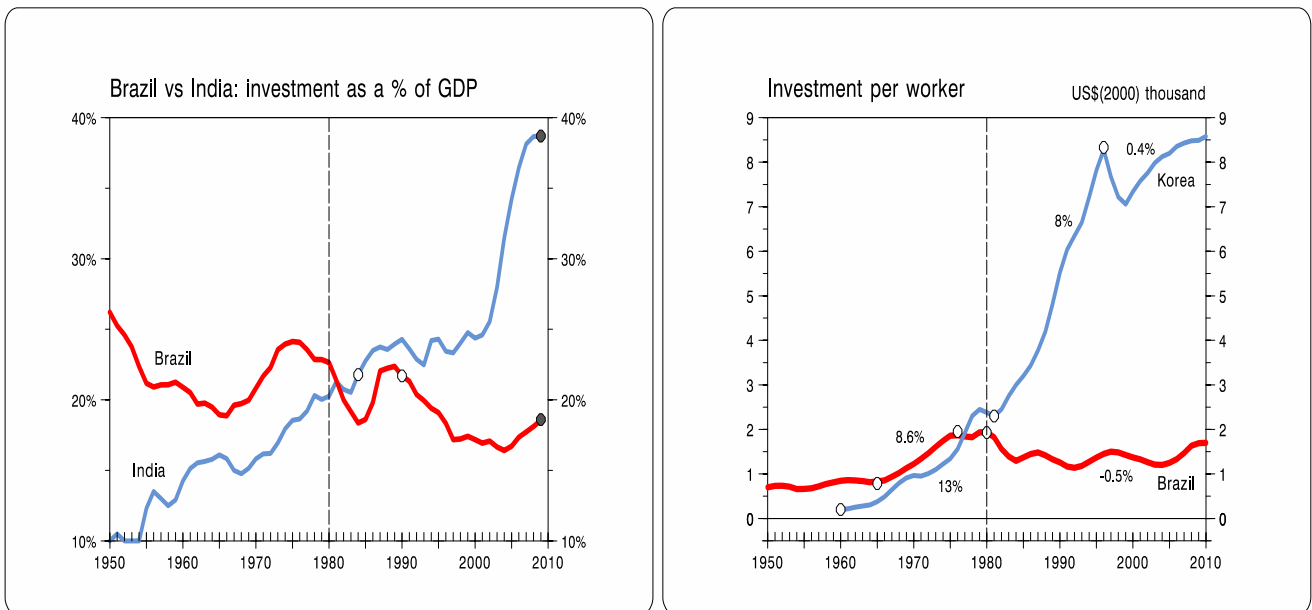
<sup>9</sup> TFP aficionados, however, may well argue that there is a positive twist in this.

<sup>10</sup> For example, as discussed below, the share of LA in Banco Santander's worldwide profits is twice that of its assets, while in its European operations it is exactly the other way round.

<sup>11</sup> At least easy access to mobile assets helps oligarchies to become democratic (Boix, 2003).

<sup>12</sup> See, for example, Mönckeberg (2001); Wolf (2007); and Winter (2007).

FIGURE 5  
Investment patterns in Latin America and Asia, 1950-2010



- In the left-hand panel, white circles indicate the beginning of economic reform (for India, 1980; for Brazil, 1990 — Collor's 'New Brazil' Plan). In the right-hand panel, percentages shown in the graph are growth rates in the respective periods (for Brazil, 1965-1976 and 1980-2010; and for Korea, 1960-80, 1981-97 and 1997-2008). 3-year moving averages.

- **Sources:** for investment, WDI (2010); for investment in LA before 1960, CEPAL (2010); in India (<http://mospi.gov.in/>). For employment, GGDC (2009).

The contrast between Brazil and India is particularly telling (left-hand panel) — both countries started their economic reforms with a 22% investment rate in GDP; however, by 2010 one (India) had brought this rate up to 37%, while the other (Brazil) had brought it down to 19% (WB, 2011; IPEA, 2011).

The contrast between LA and Asia is even starker when the comparison is drawn with investment *per worker* (right-hand panel). In Brazil, for example, by 2010 (and despite the post-2004 acceleration of growth) investment *per worker* (in real terms) was still well *below its 1980 level*. Most LA follows a pattern similar to Brazil. An extreme example is post-NAFTA-Mexico: despite the highest level of FDI per worker in the world, by 2010 its investment per worker had also not recovered its 1981 level. By then, and despite 1997, Korea had a level 3.6 times higher, and Malaysia and Thailand 2.2. In turn, China's 2010 level was 12 times higher; India's 4.5; and Vietnam had more than trebled this statistic since 1994 (the first year that data are available; see Palma, 2011a). Perhaps from this perspective the contrasting productivity growth performance of LA and many in Asia since 1990 — and especially the inability of LA to *sustain* productivity growth — may not be so difficult to explain after all.

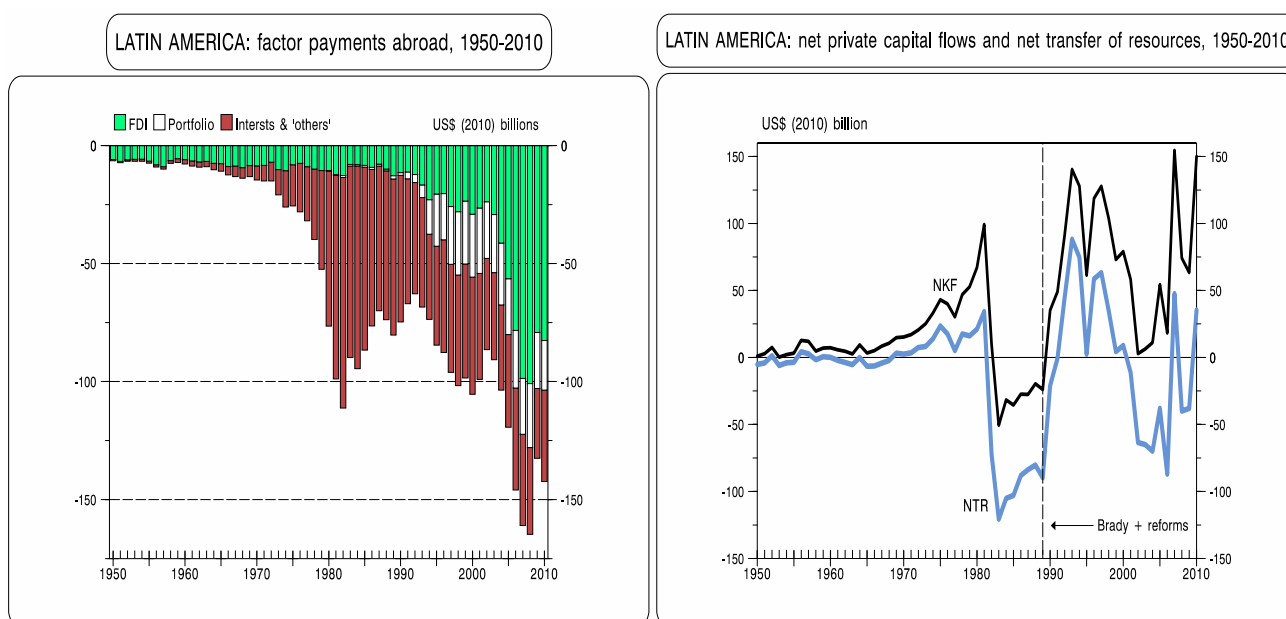
Furthermore, in the very few cases in LA where investment actually increased after reforms, as in Chile, it is not obvious why it took so long for it to happen (ten years), let alone why it ran out of steam so easily afterwards (Ffrench-Davis, 2010; Palma, 2011a and b). Moreover, what also remains unclear is why despite the huge share of national income appropriated by the top earners, and despite well-defined and enforced property-rights, 'pro-market' reforms — and a *tsunami of FDI* — every time private investment in LA manages to rise much above 15% of GDP its capitalist élite starts experiencing feelings of vertigo.

## 2.4.- The third stylised fact: the growing costs of capital inflows in terms of factor payment abroad

As is evident from Figure 6 the fortunes of LA's factor payments abroad (interest payment, profit repatriation, etc.) took a rather remarkable turn after the appointment of Paul Volker (with his flamboyant monetarism) to the Fed in 1979, and the election of Reagan a year later — as most of LA's debt was saddled with flexible interest rates, its interest payments on foreign debt alone jumped (in 2010-US\$) from US\$29 billion in 1978 to US\$95 billion in 1982 (or nearly half the region's exports). Unsurprisingly, LA ended up with a debt crisis.

Overall factor payments abroad (debits) then fell from US\$108 billion in 1982 to US\$61 billion in 1992, to then jump again (mostly due to increased profit repatriation by FDI) to US\$122 billion in 2010 (having reached US\$135 billions in 2007 — see Figure 6).

FIGURE 6



- **NFK**=net private capital inflows; and **NTR**=net transfer of resources (NKF – net factor payments). In left-hand panel, payments are debits.
- **Source:** ECLAC (2011).

As a result, in post-Brady-bonds/economic-reform LA a *US\$1.5 trillion* of net inflows (1989-2010) got wiped-out in terms of 'net transfer of resources' due to a net factor payment abroad of US\$1.6 trillion (US\$2.3 trillion in terms of debits). The figures for the 2000s were net inflows of US\$672 billion, and negative net transfers of US\$321 billions — due to net factor payments of almost US\$1 trillion (US\$1.4 trillion in debits). In fact, if 'net' transfer of resources also excludes increases in reserves (as some have argued that it should), the net transfer of resources reaches a *negative* figure of US\$810 billions just in the 2000s. Large inflows, even when they have a strong FDI component, are certainly not a free lunch.

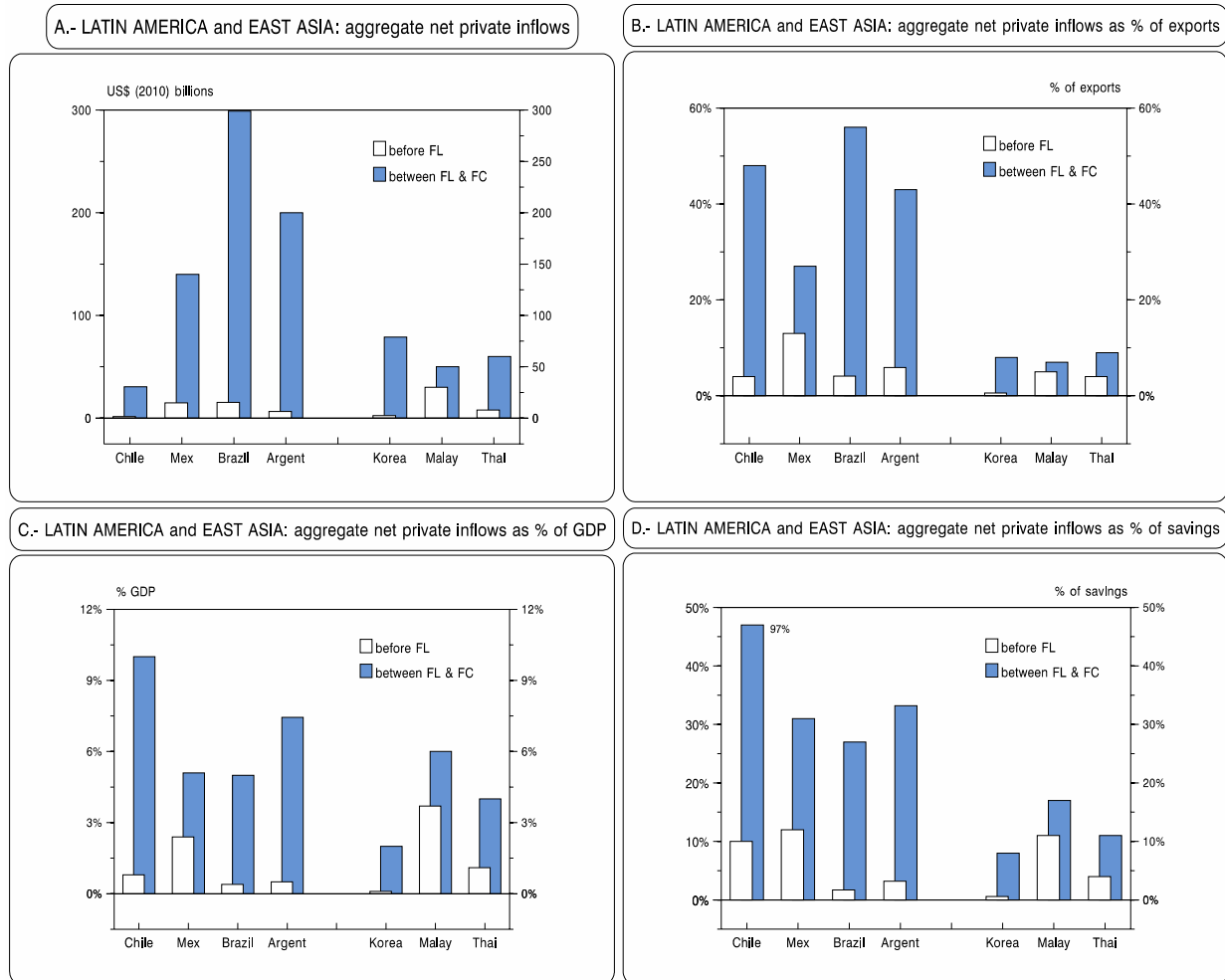
In Chile, for example, towards the end of the 2010s profit repatriation by copper-FDI alone was equivalent to two-thirds of all public expenditure, and twice the overall level of public expenditure in education, health and housing combined. Furthermore, they were equivalent to about 1.6 times Bolivia's GDP, and twice Paraguay's GDP. In fact, Chile is one of the few countries in the world with no royalty on mineral extraction — as the tax it euphemistically calls 'royalty' is a specific tax, not a 'royalty'; i.e., the actual mineral extracted pays no royalty. Furthermore, as this was not enough, the

Concertación government that created this meagre tax gave FDI an additional 'magical-realist' concession: foreign corporations can include this specific tax as a cost of production! With such 'light-touch' fiscal attitude, no wonder LA's 'new' left is so welcome at Davos...

### 3.- The 'three routes' to financial crisis

Figure 7 shows the crucial issue at stake, common to all these crisis-countries, but especially to LA: the remarkable surge in inflows on the heels of financial liberalisation.

FIGURE 7



• **FL**=financial liberalisation; **FC**=financial crisis; **Mex**=Mexico; **Argent**=Argentina; **Malay**=Malaysia; and **Thai**=Thailand.

• The period '**between**' covers the years between financial liberalisation and financial crisis. The period '**before**' covers the same number of years before financial liberalisation.

• **Source**: World Bank (2011).

In LA, the turnaround following the opening-up of the capital account is remarkable: (in 2010-US\$) the difference between the two periods amounts to US\$277 billion in Brazil, US\$194 billion in Argentina, and US\$125 billion in Mexico; in fact, the turnaround in Brazil or in Argentina was larger than in the three East Asian economies together (US\$153 billion). These surges are even more impressive in relative terms to exports and savings (particularly in Chile). In fact, some of these countries even began to be important players in the newly developed derivatives markets (IMF, 2011a).

Foreign capital swamped these countries due to several 'push' and 'pull' factors. The main 'push' factor consisted of excess liquidity in international financial markets — from this perspective, DCs continued to play their historical rôle of 'financial market of last resort' (Palma, 1998). As mentioned above, this rôle (emergency 'liquidity-outlet') is not that different from the one played by the 'sub-prime' mortgages during the financial cycle that followed 9/11. Other 'push' factors included business cycle conditions, changes in interest rates, the rise of institutional investors (such as mutual funds, pension funds, hedge funds) always in need of new profitable assets (hopefully also with low-correlation in returns with their existing portfolio), and demographic forces in industrial countries. There was, however, a crucial difference between LA and EA in terms of the 'pull factors'. In EA there was an urgent need for foreign-finance to sustain corporate investment in the face of falling profitability; in LA, instead, the key 'pull factor' was rather the combination of radical economic reforms (in particular wholesale privatisations, and the speed and intensity of trade liberalisation) and the opening up of the capital account in a context of undervalued asset markets (and when many domestic corporations were eager to join the stock market just to attract foreign buyers), high interest rate spreads, and expectations of exchange rate appreciation. In particular, optimism regarding the success of economic reforms was in excess-supply, partly as a result of the massive 'spin' put on them by those to be found circling around the 'Washington Consensus'.

That is, there was a major difference regarding 'pull' factors, as in LA a significant proportion of inflows had practically to 'invent' a need for themselves (i.e., it was a supply in search of a demand — as it takes two to tango). The key characteristic of LA's 'pull' factors is that they fed into themselves: inflows were attracted by newly created domestic 'magnetisms'; these inflows generated pro-cyclical dynamics, which attracted more inflows. Finally, a crucial 'pull' factor in all routes was the 'moral hazard' created by the near-certainty in international financial markets (particularly after 1994-Mexico) that, as in every good old Western, the cavalry, in the form of a vast international rescue operation, could be counted on to arrive in the nick of time, should the 'natives' threaten to default or close their capital account.

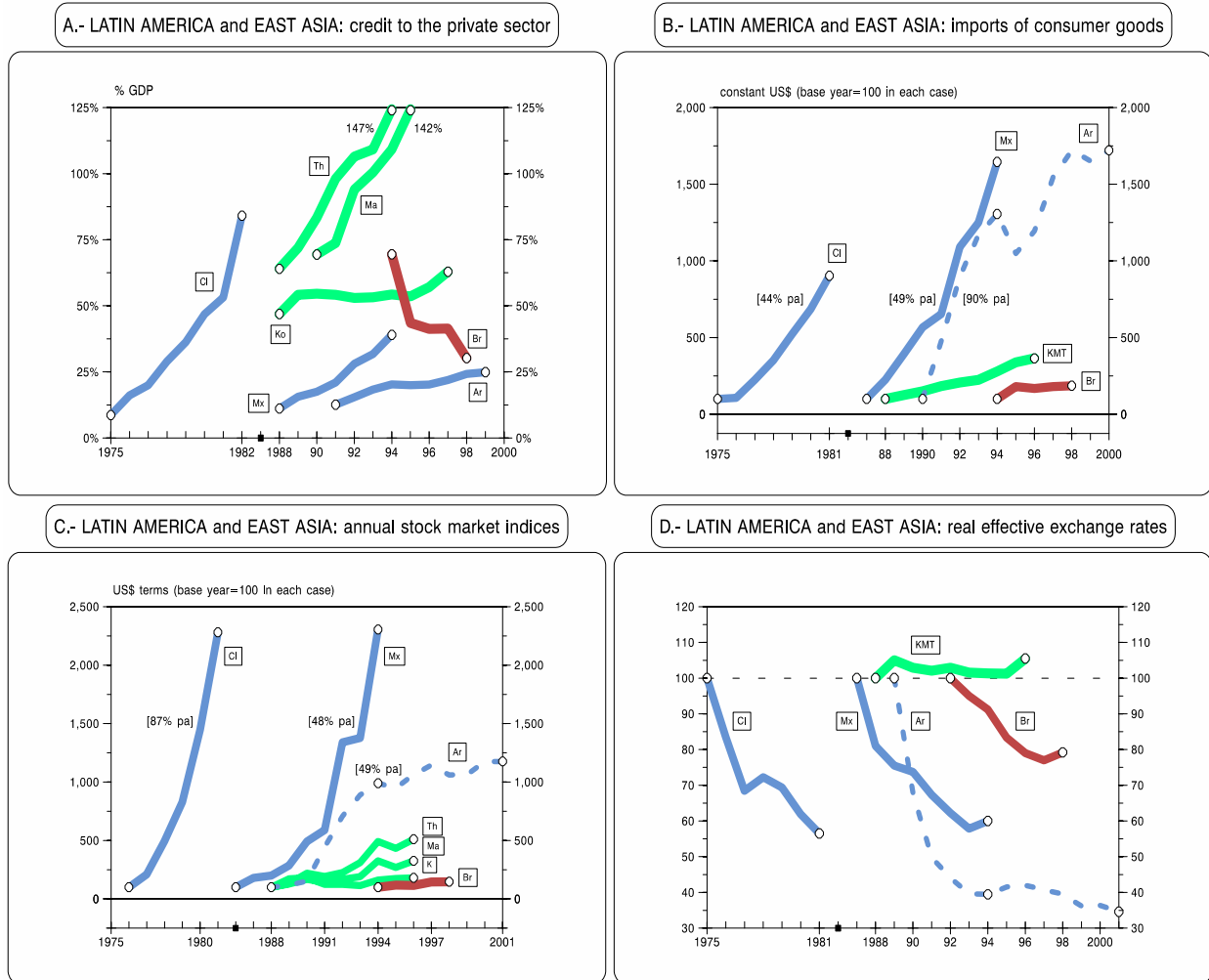
One way of testing which was the *causa causans* of the surge in inflows ('exogenous push' in LA vs. 'endogenous pull' in EA), is by looking at the time-sequence between changes in the current and in the capital accounts. The question here is, what is the driving force behind the balance of payments cycle? Does the current account 'lead' the capital account ('endogenous 'pull'), or is it the other way round ('exogenous push')? This issue can be tested with the help of the Granger 'time-precedence' or 'predictability' test (often misleadingly called the Granger-'causality' test). The results of this test show a major difference between LA and EA in this 'chicken-and-egg'-type problem: in LA changes in the capital account tend to *precede* — and are useful for the *prediction* of — changes in the current account, while in EA the time-dynamic is the opposite (see Ocampo and Palma, 2008).

This is also an important finding from the point of view of rôle of capital controls: if the primary source of the LA financial cycle is an externally induced (i.e., 'exogenous push') change in the capital account, controls on inflows are more likely to be a 'first-best' counter-cyclical policy option if one wants to deal with the excesses of the financial cycle at their *source*. In EA, meanwhile, the results of the test indicate a more macroeconomic textbook time-sequence: changes in the current account — the result of developments *in the domestic real economy* — proceed, and are useful to predict, changes in the capital account. It therefore seems less clear that in this region capital controls should be the dominant component of a 'first-best' policy to deal with the inflow-problems at source. This does not mean that capital controls cannot help; it means that they are a 'second-best' policy, since the 'first-best' one would be to deal with the domestic problems leading the changes in the current account (e.g., the levels of external-finance needed to sustain corporate investment).

### 3.1.- The Latin American story: to sterilise or not to sterilise a mainly 'exogenous push' of foreign capital – route-1 vs. route-2

Figure 8 shows some of the major differences in LA between Brazil, which decided for sterilisation, and Chile, Mexico and Argentina, which decided instead to trust the traditional beliefs of the first law of welfare economics: keep public finance in check, and let markets solve the resulting private imbalances by themselves.

FIGURE 8



- **[Cl]**=Chile; **[Mx]**=Mexico; **[Ar]**=Argentina; **[Br]**=Brazil; **[Ko]**=Korea; **[Ma]**=Malaysia; **[Th]**=Thailand; and **[KMT]**=average of Korea, Malaysia and Thailand. Percentages in Panels B and C are average *annual* rates of growth. The percentages for Argentina correspond to 1990-94.
- **Sources:** credit to the private sector, World Bank (2011); imports of consumer goods, UN (2011); stock markets, DataStream (2011); and exchange rates, IMF (2011a).

In route-1-LA, the response to the surge in private inflows was to ride them out by unloading them into the domestic economy via a credit boom (Panel A), and asset bubbles (Panel C).<sup>13</sup> The other (Brazil), was precisely the reverse: to try to stop the

<sup>13</sup> Part of the rapid expansion of the domestic-credit ratio in Chile in 1982 is due to a fall in output in the latter part of that year (after the onset of the debt-crisis). Argentina's lower domestic-credit ratios throughout (Panel A) relate to a longstanding (and well-founded) generalised mistrust of banks. In LA, part of the bubble in the stock market (Panel C) was that the opening of the capital account involved the sale of state companies as well as the floatation of private corporations. The

resulting pro-cyclical dynamics by placing an 'iron curtain' around them in the Central Bank (via sterilisation).

The crucial factor in understanding the different behaviour of Brazil is the timing of its financial liberalisation (second half of 1994); this coincided with the unfolding of the growing Mexican financial fragilities that led to the December-1994 crisis. Therefore, high degrees of sterilisation and high interest rates were continued *after* the successes of the 'Real Plan' in conquering inflation in order to avoid following a Mexican 'route-1' crisis-path.

Even though there was a similarity in the speed of credit expansion between 'route-1' and 'route-3', there also was a crucial difference: the use made of this additional credit — as mentioned above, while 'route-1' directed it towards increased consumption and asset speculation (panels B and C), Korea did so mostly towards corporate investment (see Figure 10 below). In 'route-1', a bubble similar to that of stocks took place in real estate; in Mexico, for example, the relevant price index jumped 16-fold between financial liberalisation and financial crisis, while there was little increase in the indices of Korea or Brazil (see Palma, 2003a). Finally, the cases of Malaysia and Thailand are characterised by having one foot in each camp. Their surges in inflows were initially necessary to sustain their ambitious private investment programmes — both Malaysia and Thailand brought their share of private investment in GDP above 30%. But, contrary to Korea, there was still plenty of 'spare cash' after that to follow at least one element of 'route-1' too — the spare liquidity fuelled a (near) Latin-style asset bubble in their stock markets and real estate.<sup>14</sup>

However, remarkably, in these two East Asian countries massive credit expansion was associated with a *drop* in the share of consumption in GDP — in Malaysia this share declined by nearly 10 percentage points of GDP (to 56.1%); and in Thailand by 3 percentage points (to 64.9%). No sign of a Latin 'route-1' here. So, probably no other macroeconomic variable so transparently demonstrates the different 'routes' to financial crises than the behaviour of private consumption (Panel B), and asset prices (Panel C). In terms of the former, for example, while in route-2-Brazil sales of new cars grew by only 39% between 1994 and 1997 (to fall again by 23% in the months before the 1998-crisis), in route-1-Argentina they grew *five-fold* between 1991 and the 1995-'Tequila-crisis' (McKinsey, 2004). And in terms of the stock market, 'efficient capital market' theorists were probably not very well acquainted with LA when they stated that stock prices are supposed to be a 'random walk'.<sup>15</sup> That is, particularly under risk neutrality, in stock markets there is supposed to be no scope for profitable speculation — i.e., a rational stock market cannot be beaten on any *consistent* basis.<sup>16</sup> The key point here is that if financial markets get misaligned, they are always supposed to 'self-correct'. And although in LA they surely got misaligned, they certainly failed to 'self-correct' — in Chile (1975-81), for example, the dollar-denominated value of stocks grew at 87% p.a., or 12 times faster than real GDP; in Mexico (1988-94), meanwhile, they grew 13 times faster than GDP, and in Argentina (1990-94) 6 times faster.

So, when students are taught these days that smart market players are bound to force stock prices to become rational, LA is probably not in the syllabus. The irony is that

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former were often sold first to domestic capital at much reduced prices, just to be sold again to foreign investors at multiples based on expectations of liberalised profit rates. And the latter were often floated just to be sold to foreign capital. Both operations produced a large private sector wealth effect that fuelled financial speculation and funded imports of consumer goods, but led to little or no new investments. This did not happen in Asia; there were no major privatisations, and corporations were not floated in the stock market just to make them attractive to 'gringos.'

<sup>14</sup> In Malaysia there was a 12.3-fold increase in real estate prices, while in Thailand an almost 8-fold increase (Palma, 2003a). The same happened in their stock markets (Panel C), but this bubble was dwarfed in comparison to Chile or Mexico.

<sup>15</sup> They seem to have been not well acquainted with the US either — see Lo and MacKinlay (2001).

<sup>16</sup> Not surprisingly, Warren Buffett has found amusing the idea that 'luck' is supposed to be the reason why some investors appear more successful than others (1984).



'rational' and 'selfish' agents (i.e., 'utility-maximising' agents) are supposed to do that by doing exactly the opposite of what they do in real life: take the other side of trades if prices begin to develop a pattern — as this is bound to have no substance, because share prices are supposed to exhibit no serial dependencies (meaning that there can be no 'patterns' to asset prices). In other words, for the efficient market theology a 'utility-maximising' surfer (proficient in rational expectations) is not the one that has fun riding waves, but the one that gets drowned trying to create undertows.

And in the years preceding these financial crises stock prices not only took a pattern, but they did so 'tulip mania'-style — see Panel C for clear examples in which market participants, instead of following dutifully 'non-trending random walks', were quite happy to systematically profit from market 'inefficiencies'. The key point here is that these are clear examples of markets that are driven by buyers who took little notice of underlying values — in which investors had incentives to interpret information in a biased fashion *in a systematic way*. Here, in order to have a financial crisis, there is no need for traumatic real-world events — 'fat tails' occur mostly because under these circumstances there is a high likelihood of *self-made* catastrophic events.

Finally, particularly in 'route-1' countries, the surge of inflows also distorted 'fundamentals'; panel D shows the case of the remarkable revaluation of real exchange rates — in Chile, for example, at a time when the current account deficit was reaching a level equal to all exports, and in Mexico, Brazil, and pre-Tequila-crisis Argentina one equivalent to about half their exports (or more), their exchange rates were in freefall-*revaluations*. What a contrast with EA; where a fundamental component of their Keynesian 'pro-growth macro' was to keep the exchange rate competitive *and* stable despite huge inflows and booming exports.

It is really difficult to fit LA's real effective exchange rate picture with the basic postulate of the neo-liberal creed regarding the need to liberalise, lift 'artificial' market distortions, and stop governments' 'discretionary' policies in order to allow the economy to get 'its prices right'. Massive inflows into LA, particularly in relation to exports, and the use of exchange rate based stabilisation policies (based on the oldest macroeconomic law of them all: one can only solve a macroeconomic imbalance by creating another one) brought this crucial price to a level which it would be rather hard to brand as 'right'.

Moreover, the current account was not the only casualty of the exchange rate overvaluation; the latter was also (not surprisingly) distorting the composition of what little investment there was towards the non-tradable sector. In Mexico, for example, whilst investment in residential construction doubled between 1981 and 1994, investment in machinery fell by half (and at a time in which trade liberalisation had already rendered a significant amount of the stock of capital in manufacturing obsolete; Palma, 2005). Easy access to credit, the distortion in relative prices between tradables and non-tradables, and the asset bubble in real estate set in motion a huge Kuznets' cycle — not surprisingly, the best performing sector in the Mexican stock market was construction.

This is a rather odd picture: in fact, 'route-1' economies ended up switching the engine of growth away from their supposedly desired aim — domestically financed private investment in (increasingly sophisticated) tradable production — towards a more laid-back (post-modernist?) one of externally financed private consumption, and private investment in non-tradable activities and unprocessed commodities (i.e., growth-model with a clear bias for 'low-hanging fruit'-type activities).

Finally, the collapse of savings in LA is also definitely not the 'Promised Land' of McKinnon and Shaw — who (misinterpreting Schumpeter) famously declared in 1973 that in DCs the main constrain on savings was financial 'repression': in their respective periods between financial 'liberalisation' and financial crises, gross domestic savings as a share of GDP fell in Chile by no less than 13 percentage points, in Brazil by 9, in Mexico by 8, and in Argentina by 6 (WB, 2011). The flipside was booming consumption — in Chicago-boys' Chile, the share of consumption in GDP grew by 10 percentage points (to 91%!); in Mexico by seven points (to 83%); in Brazil by 6 points (to 85%); and in Argentina by 5 points (to 85%; Ibid). The irony, of course, is that in mainstream

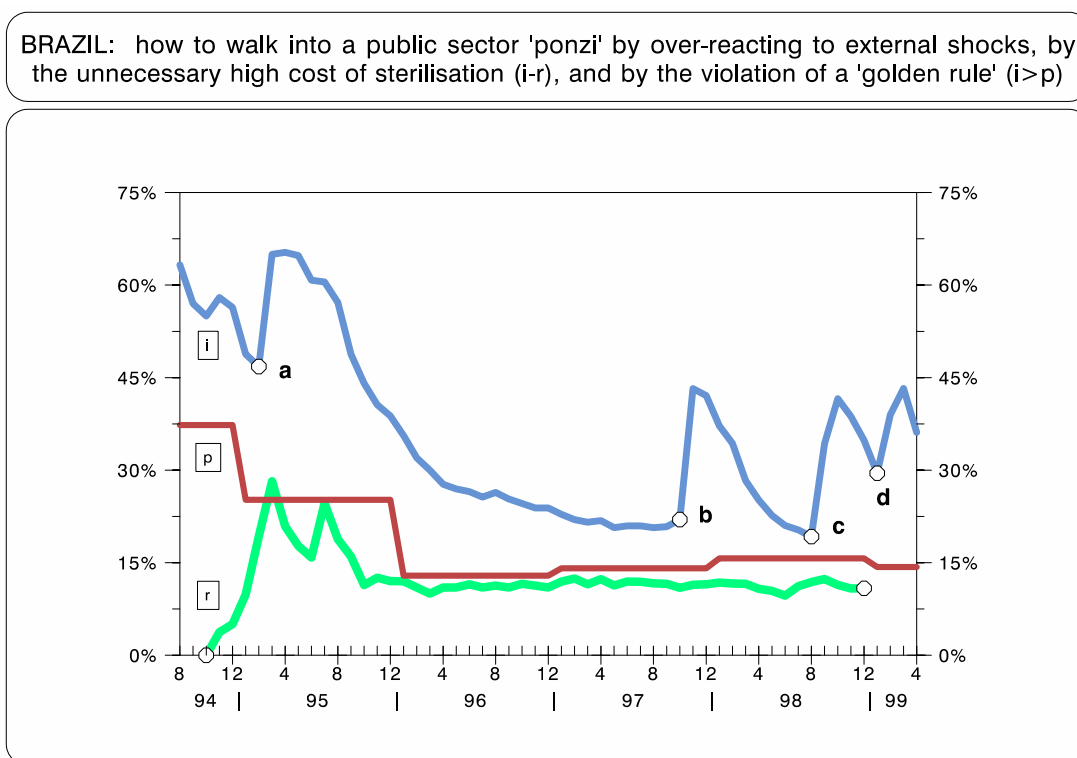
macroeconomic textbooks it is still taught today that one of the main benefits of opening up the capital account is to smooth consumption over time...

Given this evidence, it is difficult to understand how, as late as 1996, the World Bank (1996) was still preaching to DCs to continue implementing 'route-1'-type policies — i.e., preaching DCs to follow the credo of the 'efficient-capital-market' theory, and the first law of Welfare Economics. As mentioned above, the recipe was simple, as recipes from the Washington Consensus usually are (in fact, this simplicity is probably one of their main analytical attractions!): try to keep public finances in balance; and allow markets to resolve the resulting private imbalances by themselves. All the latter required was market discipline, self-regulation, and civilised 'governance'.

It is also particularly difficult to understand the mainstream insistence on the supposed counter-cyclical nature of inflows, and its aversion to counter-cyclical macro and capital controls. Let alone, its futile persistence in portraying 'complete markets' as *Paradise Lost* — the modern-day version of the Garden of Eden! Even in the very unlikely scenario that for finance 'complete markets' could do the trick, there is not much chance of this utopia taking shape this side of eternity.

Turning to 'route-2', the crucial vulnerability of Brazil lies mainly in high interest rates leading straight into a public sector 'Ponzi'-finance (Figure 9).

FIGURE 9



- [i]=annualised nominal interest rate paid for public debt; [p]=annual growth-rates of public revenues; and [r]=income received for foreign-exchange reserves (assumed to be the domestic-currency-equivalent to returns on US Treasury Bills). Domestic currency, nominal terms.<sup>17</sup>
- [a]=Mexican crisis; [b]=East Asian crisis; [c]=Russian default; and [d]=domestic default by the State of Minas Gerais.
- **Sources:** BCB (2011); and Palma (2002b, and 2006).

<sup>17</sup> Inflation between 1995 and 1998 was relatively low: the wholesale price index increased by 6.4%, 8.1%, 7.8% and only 1.5%, respectively.

First, the Brazilian Central Bank over-reacted to external shocks (an attitude I have elsewhere called 'macho-monetarism'; see Palma, 2006). In fact, at times — and even when there was no fear of devaluation — the Brazilian Central Bank set deposit rates as much as 20 percentage-points above international rates plus country risk. The crucial ideological point to understand here is that these were post 'UK-ERM-crisis' times, when 'collective memories' (and second generation models) were directing all the blame for financial crises towards Central Banks' trepidation for interest rate hikes. That is, financial crises were supposed to be the exclusive territory of feeble central bankers/finance ministers — in the case of the UK, for example, Norman Lamont's imperfect commitment to a currency peg. The uniqueness of the Brazilian political economy scenario is that the 'macho-monetarist' macro that emerged from this understanding of 'second-generation' crises ('one should not be afraid to do what it takes' macro) left a much longer-lasting effect — in fact, with other factors, it generated a path-dependent dynamic that lasts until today (leading Brazil to the highest real interest rates in the world).<sup>18</sup> Not surprisingly, in its last financial report Banco Santander indicates that one-quarter of all its world-wide profits came from its Brazilian operations despite this country having only half that share in its overall assets; meanwhile, in both Spain and the UK the relationship is exactly the other way round. In other words, Santander's profit margins in Brazil are about three times higher than those in Spain and in the UK — 32% in Brazil (as of September 30<sup>th</sup>, 2011, trailing twelve months — or ttm), while in its operations in Spain (Banco Santander Central Hispánico) it only managed 12.6%. In fact, Santander's 'operating margin' in Brazil reached no less than 48% (ttm, same period; see <http://finance.yahoo.com/q/ks?s=BSBR>).<sup>19</sup> And these asymmetries are not the result of current European difficulties, as they have been going on for a long time. These asymmetries form a crucial part of the already mentioned Latin-American 'two-times-half-style-capitalism', in which (compared with other parts of the world) institutional arrangements and political settlements are such that the domestic élite and foreign corporations are able, *grosso modo*, to get twice as much with half the effort.<sup>20</sup>

Second, the resulting high cost of sterilisation becomes evident in the difference between what was paid for the paper sold to sterilise and what was recuperated from the return on their holding of foreign-exchange reserves (i.e., between lines 'i' and 'r' in Figure 9). Finally, Brazil systematically violated the so-called fiscal 'golden-rule', by paying a much higher rate for its public debt than the rate at which it managed to increase public revenues (let alone its income per capita; on these issues, see Lopes, 2009).

Furthermore, the levels of lending rates that followed were remarkable: the annualised *real* interest rate paid for working capital peaked at 60%, while that for consumer credit did so at 115%. With these rates, of course, hardly any financial asset

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<sup>18</sup> A recent study by Brazil's 'Fecomercio' indicated that "[t]he interest rate on credit cards in Brazil's financial hub of Sao Paulo averages 238%." See <http://finance.yahoo.com/news/Creditcard-debt-may-threaten-apf-3046211331.html?x=0>. With such 'light-touch' financial regulation (that allows this type of interest rate), no wonder LA's 'new' left is paraded as an example in the annual meetings of the IMF and the World Bank...

<sup>19</sup> In the last count no less than 43% of Santander's profits were generated in Latin America, 20 percentage points more than in all its huge Continental Europe operations. And in terms of the retail side of business, the regional contrast is even more staggering ([http://tippie.uiowa.edu/henry/reports11/std\\_sp11.pdf](http://tippie.uiowa.edu/henry/reports11/std_sp11.pdf)).

<sup>20</sup> For example, the latest OECD report on broadband-related statistics (June 2011) indicates that among its 34 members Chile has the highest charge for the minimum cost of a monthly subscription (1.6 times the average), but in terms of service it has the slowest download speed (just one-quarter of the average). So, followed closely by Mexico, the only other Latin American country in the OECD, Chile has the top spot in this 'asymmetry table' ([http://www.oecd.org/document/54/0,3746,en\\_2649\\_34225\\_38690102\\_1\\_1\\_1\\_1,00.html#prices](http://www.oecd.org/document/54/0,3746,en_2649_34225_38690102_1_1_1_1,00.html#prices)). And the same phenomenon (to get twice as much with half the effort) is also found in education, and many other activities.

of the banking system (made of household and corporate debt) could perform; as discussed elsewhere, non-performing loans — as well as a remarkable lack of 'transparency' in the banking sector, weak regulatory public institutions, and the end of 'inflation-income' by the banking system — led to a succession of banking crises, each adding a significant amount to the stock of the public-sector debt due to a populist policy of indiscriminate bail-outs of both private and public banks.<sup>21</sup>

In fact, the ease with which the government could finance its domestic debt was due primarily to private banks falling over themselves to buy public paper, as this was just about the only financial asset that could perform at such rates. Regarding the rest of their portfolio, private banks (not having read — or, probably, having read but not understood — Stiglitz) tried to increase profitability by the self-defeating policy of ever increasing spreads, leading to an even faster increasing non-performing debt (see Lopes, 2009; and Palma, 2006). No prizes for guessing in which country (in both regions) the crisis of the domestic banking system came *before* the overall financial crisis (and was a major component that led up to it), as opposed to countries in which the banking crisis came *after* the crash, when sharp devaluations hit both sides of banks' balance sheets — leading to exploding foreign exchange liabilities, and bank-portfolio becoming non-performing due to falling incomes and asset-price deflation.

The case of Brazil is also very important for the critique of 'moral-hazard-type' crisis-analysis. For example, according to McKinnon and Pill (1997), the main cause of agents losing their capacity to assess and price their risk properly is that internal and external moral hazards lead to 'artificially' low interest rates; these, in turn, gave a false incentive to accumulate excessive amounts of private (let alone public) risk. However, in Brazil, although high interest rates did help to avoid a 'route-1' crisis, they did so by creating a different (but equally damaging) one ('route-2'). So, the magical realism of Brazil's 'route-2' is that it created a financial crisis by trying to avoid one...

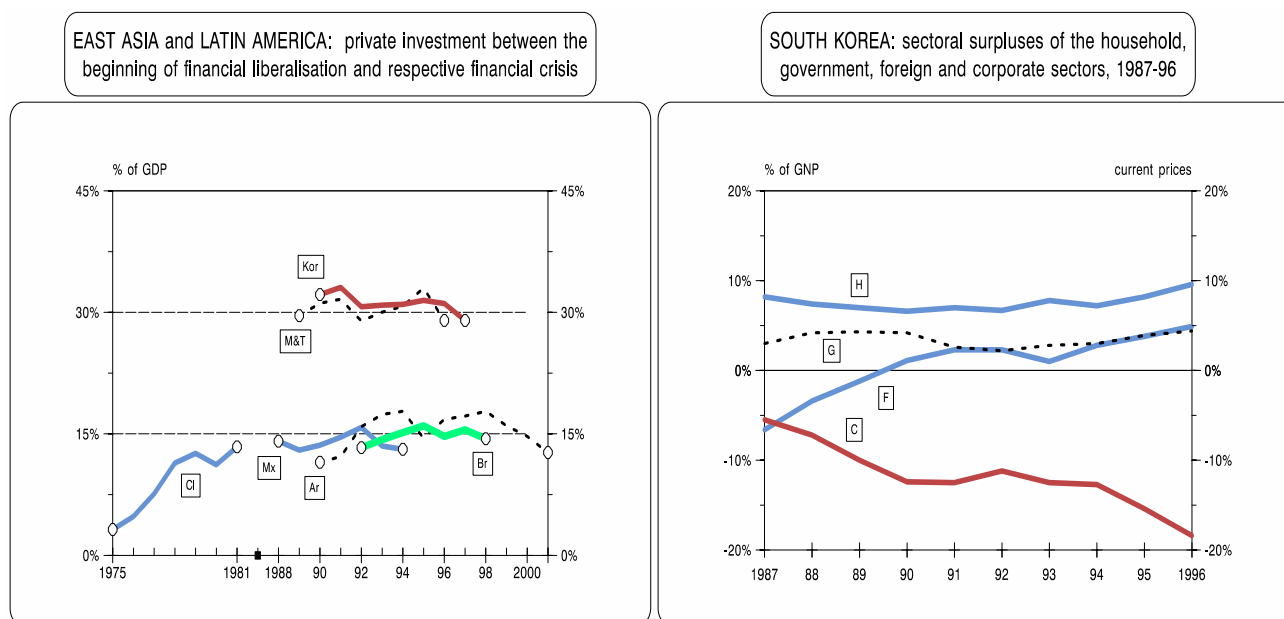
### 3.2.- The East Asia story of an 'endogenous pull' of foreign capital: the cost of maintaining high levels of investment in the face of rapidly falling profit-rates

In a sense, EA's story is less transparent than LA's. Inflows were not as remarkably large and their composition was more stable; real effective exchange rates remained stable; current accounts deficits, when looked at as share of exports, were small; interest rates were low and stable, and there was no consumption boom, no collapse of savings, and no deficits in the public sector. So, what about the often-mentioned moral-hazard-led investment boom?

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<sup>21</sup> Although part of the Real stabilisation package had been the introduction of Basle capital rules for the banking system, these rules proved hopelessly insufficient for the financial fragilities created by such high interest rates.

FIGURE 10



- [M&T]=average of Malaysia and Thailand. [H]=households; [G]=government; [F]=balance of the financial account of the balance of payments; and [C]=corporate sector. Sectoral surpluses are the differences between sectoral savings and investment.
- **Sources:** for private investment, IMF (2011b); and for Korea's sectoral surpluses, KCB (2011).

As mentioned above, the left-hand panel of Figure 10 shows that in LA (despite the tsunami of FDI) private investment seems to find a 'natural ceiling' at about 15% of GDP, while in 'Schumpeterian' EA it seems to be twice as high.<sup>22</sup> Furthermore, the graph (using IMF data) also shows that in Korea, Malaysia and Thailand there is little evidence of a pre-1997 'moral-hazard-led' investment boom (as third-generation models and the IMF would like us to believe; see Krugman, 2001 and IMF, 1998). Therefore, the key question that still needs to be answered is why the Korean corporate sector needed such large capital inflows to finance an ambitious but relatively *stable* investment effort. The right-hand panel provides the answer.

As discussed in detail elsewhere (Palma 2003a), and mainly due to declining profitability (a decline which had little to do with the Krugman TFP-type critique of Korea, and a lot to do with a 'technology-led' collapse of micro-electronic prices),<sup>23</sup> the corporate sector had to finance its high, but relatively *stable*, levels of investment switching from retained-profits to debt. This process caused the sectoral deficit of the corporate sector to increase from about 5% to nearly 20% of GNP, absorbing in the process not only all the increase in the surplus of the 'foreign sector', but also that of the household and government sectors as well.<sup>24</sup>

<sup>22</sup> Note that in LA the decision to sterilise or not to sterilise — and the corresponding huge interest rates differentials — made little difference in terms of private investment.

<sup>23</sup> The D-Ram price per megabyte, for example, fell from US\$26 (1995) to US\$10 (1996), US\$4 (1997), and less than US\$1 (1998). Memory-chips were one of Korea's main export items.

<sup>24</sup> Daewoo alone, for example, ended up with a corporate debt of US\$80 billion — more than the combined foreign debt of Chile and Colombia. One obvious question is why is it that Korean corporations did not float equities in domestic and international markets, rather than acquire so much debt? The answer is that even if they wanted to do so (something which is not clear, as Korean corporations are very 'tight' — i.e., the last thing they want is other groups, let alone foreigners, meddling in their internal affairs), there were at the time strict rules limiting foreign ownership of domestic corporations. At the same time, in the Greenspan era, interest rates were not just low, but Korean corporations could borrow with less than one percentage point spread over

Consequently, is the IMF (1998) right when it blames (together with other critics of the 'East Asian model') all on 'over'-investment? The answer is (as is so often the case) more complex than a typically 'Washington Consensus' one. The crucial issue that leads to misunderstandings in the East Asian crisis is forgetting that once you have gone into the type of high-tech exports characteristics of the region, you can only be competitive if able to produce at the cutting-edge of (a rapidly changing) technology. And to be able to remain at that level, there seems to be little option but to invest at East-Asian heights. Therefore, when profitability collapsed, the choice for Korea was not that of 'blackboard economics' – of having the technological choice of being able to produce a given amount of output (e.g., memory-chips) with different combinations of capital and labour. Rather it was whether to stay in the micro-electronics business altogether, or to look for a new type of development pattern elsewhere (and in doing so, allowing in the process for a significant amount of its accumulated physical, human, institutional, and social capital to depreciate). In the memory-chip business, for example, this meant that Korea had to invest what it took to catch-up with Taiwan's breakthrough into a 16-megabyte D-Ram chip, or to leave the industry – as nobody wanted to buy Korea's obsolete 4-megabyte chip. That is, investing what it took to keep exporting micro-chips, or switch to exporting potato-chips (as it were). Or even better, instead of exporting D-Ram memory-chips, why not follow the Latin American example – with its above-mentioned 'low-hanging-fruit-type' export-style – and return to the less capital-intensive silk and seaweed, Korea's two main exports before its massive industrialisation drive?

In fact, what might have been an effective solution for EA as a whole was a Keynesian-style programme of regional investment co-ordination, as what triggered the collapse of the price of the D-Ram memory in 1995 was massive new Taiwanese investment coming on stream at the wrong time (i.e., when prices were already weakening due to a rapidly growing supply).

#### 4.- The day of reckoning

Unsurprisingly, given the size and instability of inflows and macroeconomic imbalances, Minskyian financial fragilities quickly began to emerge – fragilities that were specific to each 'route'. Furthermore, countries in all three routes also had to face three common problems: (i) shortening of the term structure of their foreign debt (in Thailand, for example, the share of short-term debt in total debt grew from 15% to 52% between the beginning of financial liberalisation and the 1997-crisis; IMF, 2011b).<sup>25</sup> ii) In turn, there was a rapid decline in the ratio of reserves to short term debt (in Mexico this ratio fell from 1.6 in 1993 to 0.6 in 1994, while in Brazil it did so from 1.2 in 1995 to 0.6 in 1998). And (iii) the constant danger that in a financially liberalised economy the attack could also come from 'within' (particularly when the ratio of 'reserves to M2' became particularly low – in Mexico, for example, this ratio fell from 23% in 1993 to just 5% in 1994).

In sum, 'route-1' countries, after massive surges in inflows tried to keep public finances in balance, and hoped that markets would resolve the resulting private imbalances. As it happened, the result was rather different from that predicted by mainstream thinking; it was a path to financial crisis led by an explosion of credit to the private sector, declining levels of interest rates after price-stabilisation, and a rapid real-exchange revaluation. All of these produced consumption booms, asset bubbles (both in stocks and in real estate), collapsing saving, deteriorating current accounts, a bias in the already low levels of investment towards residential construction, and growing non-

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treasury bills. So, debt was very cheap, and in plentiful supply.

<sup>25</sup> If the 1997 crisis was so 'unpredictable', why were financial markets shortening their exposure to Thailand like this?

performing bank-assets.<sup>26</sup> The imbalances created by the liberalisation of capital accounts, instead of being tamed by 'automatic stabilisers', were amplified by automatic 'destabilisers' (Stiglitz, 2003). In the meantime, foreign and domestic debts exploded, while the term structure of the foreign debt deteriorated, and the balance-sheet of the corporate and banking sector became ever more vulnerable to currency depreciation. This route generated so many financial fragilities that it did not take much for it to face a sudden collapse of confidence and an abrupt withdrawal of finance, leading to major financial crises.

As in LA, events helping to precipitate such collapses are never in short supply, financial crises did follow. In 1994 Mexico, for example, in just the twelve months before the December crisis, (among other events) there was a massive indigenous uprising in Chiapas (January); the assassination of the presidential candidate of the ruling party (the PRI, March); a not-very-transparent presidential election (August); the assassination of the Secretary General of the PRI (September, with the widespread belief that the President had been involved in both assassinations); and a Central Bank that would only release information on foreign reserves every four months (giving 'insiders' a huge advantage) — and all these events, of course, providing plenty of political thrill (Armendáriz, 2003). Basically, in DCs 'utility maximising cum rational expectations' agents and 'free' markets are a little bit more complex (and original) than the idealised fictional constructions of mainstream models. In fact, at the end of 1994 it only took a relatively small external shock (a tiny increase in US interest rates in November, which produced a minor bond crisis) for the debacle to take place (Kregel, 1998; Palma, 2003a).

In the case of Argentina, the crucial issue seems to have been the difference between the two periods (1990-1994 and 1995-2001). During the first, it followed mostly a 'route-1' path to financial crisis; in the second, it got into an endless (and eventually futile) 'crisis management' mode due to its refusal to devalue and readjust after its 1995 'Tequila' crisis.<sup>27</sup>

All these crises represented huge costs for the respective economies; in Chile, for example, the 'Chicago-boys' experiment ended-up with a 20% drop in GDP (third quarters of 1981 and 1983), with unemployment over 30%, and with the share of the population in absolute poverty doubling to 55%. Furthermore, the cumulative cost of the rescue of the banking system was equivalent to 43% of GDP; in addition, the 'administrative' cost of this rescue reached an extra 9% of GDP (Barandiarán and Hernández, 1999; see also Díaz-Alejandro, 1984, and Palma, 1998).

The path to financial crisis for 'route-2'-Brazil also started with a surge in inflows; but the scene was soon dominated by the effort to avoid becoming 'another Mexico'. High interest rates and sterilisation were successful in avoiding a repeat of 'route-1', and in consolidating price-stabilisation; but soon created massive domestic financial fragility in the banking sector and in state-government finances, leading to an increase in public debt through continuous (often indiscriminate and sometimes politically corrupt) private and public banking and state-government rescue activities.<sup>28</sup> Moreover, this public debt exploded due to high interest rates — i.e., a public sector 'Ponzi' finance ballooned out of control — while the real economy imploded because of these rates. But high interest rates became ever more necessary in order to sustain the 'peg' and avoid both further

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<sup>26</sup> Non-performing loans in Mexico's banks reached nearly 10% of GDP in 1994 (see Kregel, 1998).

<sup>27</sup> In 1995, Argentina's 'Macho-monetarist' Finance Minister (Domingo Cavallo) called his Chilean counterpart at the time of the 1982 crisis a 'Sissy' for having abandoned convertibility after the crisis (and devalued the currency).

<sup>28</sup> One of these was the cost of Cardoso's re-election. In order to get the required majority in Parliament for constitutional change that would allow a President to run for re-election, Cardoso offered the opposition (that held many key state governments) to exchange their huge states' debt for low-interest ones, and to inject capital into states' banks. The direct cost of this operations (US\$100 billion; see Lopes, 2009, and Palma, 2006) probably made him the most expensive 'ego' in Brazilian political history.

domestic banking crises due to high foreign-exchange liabilities in the financial sector, and a stampede by edgy fund managers.<sup>29</sup> Again, it did not take much (just one of many of Yeltsin's follies in 1998, and a minor internal political crisis — a state-governor declaring moratorium on its state debt with the Central Bank — for this route to end up in a major financial crisis.

Finally, in 'route-3' countries, there was another massive surge in inflows leading to an increase of private credit at low interest rates. However, this did not lead to consumption booms, or collapses of saving — and in Korea not even to asset bubbles in the stock market or real estate. Rather, in the context of declining profitability (particularly the sphere of microelectronics due to collapsing prices), there was a high (though stable) level of investment — in a world where there was competitiveness only at the cutting-edge of a very rapidly changing technology. This ended up producing corporate debt/equity ratios that even in this part of the world should have caused dizziness. Added to this, Korea had some bizarre regulation that gave the corporate sector a strong incentive to borrow abroad 'short' (long-term borrowing had to face significantly more red tape), and a Central Bank that seemed to have enjoyed the thrill of living dangerously with low levels of reserves. The resulting rapid decline in the ratio of reserves to short-term debt made Korea particularly vulnerable to events in Thailand and Malaysia (at the time of the Thai devaluation, Korean reserves could only cover half its short-term liabilities; in fact, they were not even enough to cover debt with 90 days maturity or less).

Again — and despite a stunning growth record, and fundamentals that although not perfect were the envy of most DCs — it did not take much (international financial markets turning their attention to south-east Asia with some trepidation due to the return of Hong Kong to Chinese rule), for this route to also encounter a major financial crisis.<sup>30</sup> Basically, voracious fund managers — eager to profit from long-standing but only precipitately acknowledged 'peccadilloes' (the precarious balance-sheet structure of the Thai banking system) — had a much-delayed collapse of confidence that led to bank runs and a major financial crises.

5.- So, how can one explain that most of the economic profession, financial markets and the financial press still insist that these crises were mostly 'undeserved' and 'unpredictable' (i.e., why do they insist at barking up the wrong tree)?

It is difficult to understand the mainstream insistence that most of the blame for these crises should lie on very specific and supposedly avoidable 'exogenous' issues — i.e., external to the spontaneous working of highly liquid financial markets. And in some cases, just on 'chance'. Financial markets (no matter how over-liquid they are) are supposed to have the intrinsic ability to supply effectively the credit intermediation and payment services that are needed for the real economy to continue on its growth path. So, if unmanageable financial instability occurs one of two things tends to be the excuse: either a 'missing' market is creating a market 'failure', or something 'foreign' is meddling in these markets. On the whole, the second alternative tends to be favoured in the position of culprit. In the case of Mexico, for example, most of the attention in mainstream literature has been diverted towards a relatively expansionary macro-policy in an election year; in Brazil, towards the political stalemate that delayed endlessly a necessary fiscal reform (a 'Waiting for Godot'-type story); in Korea, towards a supposedly 'moral-hazard driven over-investment-cum-corporate-debt' story; and in

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<sup>29</sup> Also, it became politically difficult to lower interest rates, as the middle classes got accustomed to high returns on their savings.

<sup>30</sup> The Thai government was forced to float the baht on the 2<sup>nd</sup> of July 1997, one day after the British transfer of Hong Kong to China.



Thailand, towards a 'crony-capitalist driven unbalanced-balance-sheet' story'. In a way, this mainstream attitude of barking up the wrong tree is no different from what happened after the 2008 financial crisis, when the usual suspects blamed everything on China and/or Greenspan, or pointed at 'liberals' for the 1977 law that helps low-income people get mortgages. Anything would do (including the fall of the Berlin Wall, excessive testosterone in trading rooms, or even sunspots! — see Palma, 2009a for the 'blame list'), except the possibility that the *autonomous* outcome of the free interaction of supposedly utility-maximising agents, interacting in (excessively) 'friendly-regulated' and over-liquid financial markets, could be an *endogenous* financial crisis (rather than some sort of 'equilibrium').

So, how can one explain this attitude from most of the economic profession, financial markets, and the financial press? The answer to this complex question has at least four components. The *Wall Street Journal* provides a good insight into the first one; in an editorial soon after the beginning of the 'sub-prime' crisis it stated that: "The recent market turmoil is [...] raising the stock of one person: a little-known economist whose views have suddenly become very popular [...] Hyman Minsky." (*WSJ*, 18 August 2007). Perhaps had they read (and, more importantly, had they read and understood) such obscure economists as Keynes, Minsky, Kindleberger and so many others (including Stiglitz, and the later work of Krugman) the *Wall Street Journal* (otherwise known as the *Pravda* of Wall Street) could have become more effective at predicting financial crises — and at realising how 'deserved' they usually are. They might even have learnt how avoidable they could become under a revamp set of FDR/Keynesian-Bretton-Woods-type arrangements.<sup>31</sup>

This also applies to the 'new' left which, when in government, often follows extreme versions of the mainstream orthodoxy (both in developing and developed countries). In terms of 'friendly' regulation of financial markets, for example, nothing beats 'purity of belief' of New Labour in the form of Gordon Brown's Financial Service Authority (FSA). When in 1997 he created a new regulatory body for the financial industry (the FSA), he set it up not only as an 'independent non-governmental body' (i.e., a company limited by guarantee), but also as one that was actually financed by the financial services industry. Furthermore, he appointed ex-bankers as Chairman, Chief Executive Officer and non-executive directors. That is, he set the FSA up as operationally independent of Government, funded entirely by the financial corporations it was supposed to regulate, and led by financial-industry insiders. Thus, New Labour found a rather ingenious solution to the problem of 'regulatory capture'; if, supposedly, lobbyists inevitably succeed in capturing the regulators, why not make them the regulators in the first place?<sup>32</sup>

With this ('limited-touch') attitude towards financial regulation, perhaps it is not surprising that at the beginning of the current financial crisis the first bank failure took place in the UK (one year before Lehman's Brothers) — becoming the first UK bank in 150 years to suffer a traditional bank run. In fact, in the UK the regulatory failings in the lead up to the current financial crisis were such that for many observers it came as no surprise that its new Chair tried to regain 'the moral high ground' with his speech at the 2011 annual Mansion House banquet hosted by the Lord Mayor of London (see epigraph at the beginning of the paper).

In fact, I sometimes wonder whether mainstream economics today is just shorthand for 'nothing left to decide' — and, of course, 'nothing left to think about *critically*' (Palma, 2009b). Indeed, the attitude of many mainstream economists towards policy-making (before and after the current crisis) resembles Lord Kelvin's attitude towards physics at the end of the 19<sup>th</sup> century, when he famously declared that in physics "there is nothing new to be discovered now. All that remains is more and more

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<sup>31</sup> See, for example, Epstein and Pollin (2011).

<sup>32</sup> Probably this is what Brown meant when he famously declared that his policy on financial regulation was "... not just a light touch, but a limited touch one" (see <http://www.cbi.org.uk/nbds/press.nsf/0363c1f07c6ca12a8025671c00381cc7/ee59d1c32ce4ec12802570c70041152c?>).

precise measurement.” (Kelvin, 1900) From this perspective, the incapacity of mainstream economists to consider alternative points of view is such that even the so-called ‘New Keynesians’ still work within a ‘complete markets’ paradigm, and with the strongest version of the efficient-markets hypothesis (Buiter, 2009).

Along this line, perhaps the most amusing definition by a mainstream economist of what ‘heterodox economics’ is all about is found in a Working Paper of the Chilean Central Bank (that analyses the post-1982 banking crisis in Chile); according to the authors, “[t]he Chilean solution to the crisis was heterodox in the sense that many policies appear to have been arbitrary, and policy mistakes were made [...] along the way.” (Barandiarán and Hernández, 1999). This attitude towards alternative points of view can only be explained by the usual dynamics of idealisation: when there is an unremitting need to sustain the idealisation of something (in this case, that of a remarkably simplistic view of markets in the face of so much evidence against it the form of recurring ‘endogenous’ financial crises), what is needed is simultaneously to demonise something else (in this case, anything to do with alternative views). In fact, the more evident the flaws of what is being idealised, the stronger the demonisation of the alternative view has to be.<sup>33</sup>

Second, another (closely related) part of the answer to the above question is that in LA, as in most of the Anglo-American world, economic reforms were carried out with a peculiar political ideology — what I like to call the ‘Anglo-Iberian’ neo-liberal fundamentalism — where ‘toxic ideas’ were as damaging as ‘toxic assets’ in the lead up to the many financial crises discussed in this paper.<sup>34</sup> A case in point is Gustavo Franco, the President of the Brazilian Central Bank who led Brazil into the 1999 financial crisis; for him, “[the alternative for Brazilians today] is to be neo-liberal or neo-idiotic [neo-burros].” (Veja, 15 November 1996). And, of course, “burros” (and ‘obscure’ economists, such as Minsky) belong in intellectual Gulags. In fact, for Franco, his main task in government was to help “...undo forty years of stupidity.”<sup>35</sup> With this Anglo-Iberian ‘reverse-gear’ attitude, LA’s experiment in economic reform and financial liberalisation almost inevitably ended up as an exercise in ‘not-very-creative’ destruction.

This reminds me of what Keynes once said (discussing Say’s Law) about Ricardo conquering England as completely as the Holy Inquisition conquered Spain. Something similar has happened in LA, where neo-liberalism has conquered the region, including many in its left-wing intelligentsia, just as fiercely as the Holy Inquisition conquered Spain. In fact, this process has been so successful that it has actually had the effect of ‘closing the imagination’ to conceptualising alternatives.

Third, another part of the answer to the above question is the way in which many within mainstream economics, international financial markets and the financial press have interpreted economic news along the cycles that have led to a financial crisis. Following Steiner’s (1993) psychoanalytical understanding of the difficulties of the human mind to recognise reality when faced with particularly complex and emotionally charged problems — and of its failure to live with them, and suffer their consequences — I distinguish three stages in the ‘problem (or bad news)-awareness’ cycle: an initial ‘lack-of-awareness’ phase, which is eventually followed by a (short-lived) ‘sudden-awareness’ stage, and then by a ‘new form of lack-of-problem-awareness’ scenario. In the first (mania) phase of each financial cycle, which could be called the initial ‘turning-a-blind-eye’ stage, good news is often overstated and bad news simply ignored. And if eventually some bad news can no longer be ignored (e.g., in the current crisis, when in August 2007 HSBC announced increased provisions for non-performing sub-prime mortgages), this is reluctantly acknowledged but in the clear understanding that

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<sup>33</sup> For an analysis of the process of idealisation, see Sodr  (2009).

<sup>34</sup> In fact, we now know that Greenspan was even against tightening regulation against financial fraud, as (supposedly) rational markets can take care of themselves in this front as well. (<http://www.dailykos.com/story/2009/3/27/172419/727>)

<sup>35</sup> For Keynes, instead, the opening-up of an economy “... should not be a matter of tearing up roots but of slowly training a plant to grow in a different direction.” (1933; 759)

'everything is still under control' — even though most of the pieces of the crisis-puzzle are (or should be) already evident (see, for example, Figure 1).

The second stage of the 'bad-news-awareness' cycle comes to the fore when a catastrophic event suddenly reveals what so far has been denied (e.g., in the current cycle, Lehman's demise) — and reality sets in. Now there is an abrupt turn towards total panic, to total dismay. Suddenly, bad news is felt as devastating (and sometimes is even exaggerated) and everybody seems completely overwhelmed by the catastrophe. According to Greenspan, for example, this happened to him after Lehman's, and his reaction was one of 'shocked disbelief'; he then famously acknowledged to a Congressional Committee that what he found was nothing short of "...a flaw in my economic ideology — in the conceptual framework with which I dealt with reality." And he was "...very distressed by that fact." And when asked "[i]n other words, you found that your view of the world, your ideology, was not right, it was not working?" He replied "[yes] — precisely. That's precisely the reason I was shocked, because I had been going for 40 years or more [...] [with the idea that my view of the world] was working exceptionally well." ([http://www.pbs.org/newshour/bb/business/july-dec08/crisishearing\\_10-23.html](http://www.pbs.org/newshour/bb/business/july-dec08/crisishearing_10-23.html))

However, this second stage in the 'problem-awareness cycle' seems to be short-lived because it is often followed by a further twist (at the time of writing, what is currently going on in the global financial crisis). Basically, soon after the 'sudden-awareness' stage there is a turn towards a new form of 'lack-of-awareness' — a retreat from the (unbearable) shock into a new form of omnipotence. In a nutshell, the extent of the crash and its (ideological and analytical) repercussions are so devastating that they cannot any longer be acknowledged. When in the second stage 'truth' is recognised, it is found to be unbearable. Its sustainable recognition would involve a loss of what kept us going, and the mourning of this loss is too difficult. So, the 'shocked disbelief' begins to fizzle out, and reality begins to be evaded, misrepresented, distorted and covered up in a new 'lack-of-awareness' scenario. The most important issue here is that (very conveniently) it is as if nothing needs to be properly *mourned* — especially the economic ideology responsible for the crisis (the 'toxic ideas' that led to the financial crises). After all, the current global financial crisis is (or should be) to the grandiose Reagan & Thatcher neo-liberal counter-reformation, what the fall of the Berlin Wall was to the Communist paradigm. Only a new form of 'lack of awareness' can help avoid this. This new attitude can best be described as "actually, I can take all this on my chin; no need to have my economic ideology knocked down." In any case, this must be the fault of the 'usual (and more familiar, and less threatening) suspects'! That is, in order to sustain the *status quo* after the crash there is a new need to cover up, evade and distort. So, the focus of attention quickly (and conveniently) switched from the distressing idea of the self-destructive nature of unregulated and over-liquid financial markets, to the more familiar terrain of problems relating to China (how could it not be China!), labour 'rigidities', uncontrolled immigration, excessive regulation, and (for sure) 'big government'.<sup>36</sup> And in the UK, of course, the European Union! 'Shocked disbelief'?

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<sup>36</sup> In terms of distortions of reality and cover-ups to keep the *status quo*, few beat New York City mayor and media tycoon Michael Bloomberg when he criticised the 'occupy-Wall-Street' protesters because their complaints were 'misplaced': "...some of [their] complaints [...] are totally unfounded. It was not the banks that created the mortgage crisis. It was, plain and simple, Congress who forced everybody to go and give mortgages to people who were on the cusp (sic)." (<http://www.outsidethebeltway.com/bloomberg-dont-blame-banks-for-mortgage-crisis/>). I wonder who is the one barking up the wrong tree, as FED data now shows conclusively that it was private mortgage brokers, not Fannie and Freddie, who created the subprime housing bubble. In fact, "the predominant players in the subprime market — mortgage brokers, mortgage companies and the Wall Street investment banks that provided the financing — aren't covered under CRA [the 1997-Community Reinvestment Act]. [...]. In all, 94 percent of high-cost loans were totally unconnected from government homeownership laws." (<http://thinkprogress.org/economy/2011/11/01/358482/bloomberg-mortgage-crisis/>).

Also, Steve Forbes (the Chairman of Forbes Media and a former Republican candidate for President) argued along the same lines — that the causes of the financial crisis are simple: "over-

What 'shocked disbelief'?

In other words, first, if *until* the 'shocked disbelief' those involved (politicians, mainstream academics, financial markets and financial press) are unable to acknowledge the existence of a fundamental problem, why is anybody going to fix it? And if *after* the shock the new urgency is about moving away from the unbearable awareness, and into a new (omnipotent) phase in which the main concern is not the further revelation of truth, but the cover up of truth, what is the hope for a proper understanding? The key issue here seems to be the difficulty (perhaps impossibility?) for those involved in creating the economic environment that led to the crisis of *sustaining* their full awareness of what has happened. For example, although many things have already been said regarding the speed, the size, and the nature of the rescue operations after each financial crisis (including the urgent need to stop the rot, as well as old-boys' networks at work, corruption and so on), perhaps an *additional* component of these rescue operations (particularly their urgency) is that they are a *fundamental component of the* 'cover up'. When Clinton quickly intervened after the Mexican crisis with his more than \$70 billion rescue package (in 2010-US\$), he was not just saving his mates from Wall Street (who had been caught badly exposed in Mexico); most probably, he was *also* trying to turn the page as quickly as possible — so that one could turn a blind eye to the evidence emerging from that crisis regarding the risks associated with full financial liberalisation (especially of the capital account) in middle-income countries. The same happened with the massive IMF intervention in Brazil and East Asia. And in the case of Chile, when the government was happy to spend more than 50% of GDP rescuing the banking system after the 1982 crisis, and when most governments in industrialised countries were all too happy to shower financial markets with trillions of dollars following Lehman's downfall — bringing the concept of a 'soft budget constraint' to a totally new dimension — perhaps (among other things) they were *also* trying to cover up quickly their unbearable 'shocked disbelief'. And, inevitably, some eternally optimistic Keynesians were bound to mistake the soft budget constraint for a "...vast, Keynesian, fiscal stimuli [...]" (<http://www.guardian.co.uk/business/2009/jan/18/economic-depression>). That is, instead of being part of a cover up, keeping financial dinosaurs on life support was definite evidence that 'we are all Keynesian again'!

Moreover, in the case of the seven financial crises in middle-income DCs discussed above, as opposed to the current global financial crisis, the relatively rapid recovery of the economies involved greatly helped the cover up. In fact, perhaps Argentina is the only country of the ones discussed above where (despite the rapid recovery) there was at least an effort to learn from the pre-crisis mistakes.

Also, often the cover up extends to personal responsibility. A clear example is that of Larry Summers who, as Clinton's Treasury Secretary, led the financial de-regulation brigade that created the conditions under which financial sanity was left to depend entirely on 'self-regulation' and 'market discipline'. Summers, for example, led the repeal of the 1933 Glass-Steagall Act, and he also vehemently opposed the regulation of derivative contracts. And then, nearly a decade later, as Obama's Director of the National Economic Council, he had the task to undo a mess that to an important extent was his creation. So, it should probably come as no surprise that when he devised Obama's (so-called) 'fiscal stimulus' plan, almost all funds were diverted to keep financial relics afloat (and save his own tarnished reputation) rather than to create a proper fiscal stimulus on output and employment.<sup>37</sup> Furthermore, when he was asked

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sized government and over-burdensome regulation." Therefore, not only "the protesters should be occupying Congress and not Wall Street"; but also the solution to the financial crisis is straightforward: "If we shrank the government and got our fiscal house in order [...] inequality and joblessness that is fuelling the social frustration would begin to ease of its own accord." (<http://finance.yahoo.com/blogs/daily-ticker/steve-forbes-wall-street-protesters-occupy-congress-instead-182232426.html?l=1>).

<sup>37</sup> Six months into Obama's 'stimulus plan', while over a trillion dollars had been spent (or committed) on subsidising financial markets — together with the defence sector, the leading welfare recipients in the country — less than 1% had actually been made available for highway and

about the collapse of A.I.G. Summers' response was typical of this third stage in the 'awareness/lack-of-awareness' cycle. He answered: "[t]here are a lot of terrible things that have happened in the last eighteen months, but what's happened at A.I.G. [...] the way it was not regulated, the way no one was watching [...] is outrageous." ([http://www.bbc.co.uk/blogs/nickrobinson/2011/04/i\\_told\\_you\\_so.html](http://www.bbc.co.uk/blogs/nickrobinson/2011/04/i_told_you_so.html)).

Could it be that this is the same Summers who in 1998, in his testimony before Congress, had argued against the regulation of all types of derivative contracts (including A.I.G.'s credit default swaps), because "[t]he parties to these kinds of contract are largely sophisticated financial institutions that would appear to be eminently capable of protecting themselves from fraud and counterparty insolvencies. [...] To date there has been no clear evidence of a need for additional regulation of the institutional OTC derivatives market, and we would submit that proponents of such regulation [i.e., Brooksley Born, the chairperson of the Commodity Futures Trading Commission, who became strongly in favour of regulation in derivative markets after the LTCM debacle] must bear the burden of demonstrating that need." (Ibid.) Some would argue that Summers' 'outrage' at the lack of regulation in derivative markets was just sheer hypocrisy, but I would not be at all surprised if by then he had basically lost touch with his own past, and he actually believed what he was saying.

Moreover, in this latter, post-crash, stage (as is often the case in this phase of the 'awareness-cycle'), typically a new narrative of each crisis begins to emerge in which 'chance' is often used as a (convenient) validation of the new turning of a blind eye. Again, Greenspan provides an example; after having acknowledged the dreadfulness of his initial 'shocked disbelief', and the major flaw in his economic ideology, he soon began to argue that, after all, the 2008 crisis might well have been a 'one-in-a-hundred-year' event. That is, it was still possible that the crisis was *undeserved* and *unpredictable* after all. Even if everything was pointing in the opposite direction, there was still a chance that it was a fortuitous event. In the same spirit, in most analyses of the 1997 East Asian crisis (especially in third-generation models), the fundamental *ex post* assumption is that this crisis started with a bank-run that occurred in Thailand *by chance* — financial markets turning their attention to south-east Asia with some trepidation due to the British transfer of Hong Kong to China (Chang and Velasco, 2001). In turn, second generation models want us to believe that the ERM crisis in the UK was just a 'self-fulfilling' shock in an economy that was fundamentally sound — speculators who believe (rightly or wrongly) that other speculators were about to attack, were themselves encouraged to do so. The same happened in the 1998 Brazilian crisis; it was all supposed to be bad luck: contagion from unrelated events far away — literally, at the other end of the world (in Asia and Russia). And in the case of Korea, the crises supposedly occurred due to a random event: a sudden flight of capital from another economy that was also fundamentally sound. And so on (see Appendix 1). After all, Sophocles had already warned us a long time ago (via one of his characters) that "our mortal life is ruled by chance. There is no such thing as foreknowledge" (quoted in Steiner, 1993).

However, as Žižek explains,

Repetition, according to Hegel, plays a crucial role in history: when something happens just once, it may be dismissed as an accident, something that might have been avoided if the situation had been handled differently; but when the same event repeats itself, it is a sign that a deeper historical process is unfolding. [...] The same holds for [...] financial crises. (2011; 1)

Therefore, the convenient use of the idea of 'chance' helps preserve the *status quo*. This 'cover up' makes it possible to continue living in the phantasy world of the supremacy of unregulated 'free' markets. The key point here is that if after the shock (and the unbearable awareness) the new urgency is not about the further revelation of truth, but the cover up of truth, there is little hope for a proper understanding.

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environmental cleanup projects. ([http://money.cnn.com/2009/08/04/news/economy/stimulus\\_spending/index.htm](http://money.cnn.com/2009/08/04/news/economy/stimulus_spending/index.htm)).

And fourth, particularly as far as LA is concerned, yet another part of the answer to the above question is a specific element in the genesis of recent financial crises: the peculiar politico-institutional framework in which financial liberalisation and economic reform were carried out in the region — as opposed to the way in which they were implemented in Asia (see Palma, 2011a). Part of this framework is the 'original sin' of LA's economic reforms: the bizarre collection of 'first-generation' heads of state that initiated these reforms. Although not unfamiliar to Latin American political history, Pinochet, Salinas, Collor, Menem, Fujimori, Alemán, Bucaram (and many others) certainly deserve several entries in *The Guinness Book of Records*, particularly under the headings of opportunism, corruption, human rights abuses, electoral fraud, and petit-bourgeois parvenu-populism. Almost invariably, after having initially got into power using an *anti*-neo-liberal discourse (even Pinochet's initial discourse was closer to that of 1930s' Franco than to 1970s' Friedman), their sudden eagerness to switch to the neo-liberal camp was in part related to the opportunity to create a new structure of property rights from which massive new rents could be extracted. And, of course, the more successful they were in selling the neo-liberal programme, the more extravagant the predatory capitalism that followed could be.

From the perspective of this paper, there are two sides to this story. One is that with these 'first-generation' individuals running the show to begin with, economic reforms (particularly privatisations) never stood much of a chance. As Stiglitz has summarised it (rather politely):

[Is financial liberalisation] being designed on the basis of the best available economic theory and evidence, or is there another agenda, perhaps a special interest agenda? (Stiglitz, 2000; 1085)

The other is a more complex (and usually forgotten) aspect to this phenomenon. Basically, in their eagerness to support the process of economic reform in LA, those associated with the Washington Consensus somehow succeeded in turning a blind eye to the Russian-style, predatory nature of these reforms, especially the process of privatisation. In fact, it is quite remarkable how in these circles what was going on in this respect was basically ignored — from the 'Chicago-Boys' in Chile dismantling the huge state apparatus for their own benefit (Mönckeberg, 2001), to Salinas' privatisation extravaganza — where one privatisation alone (a telephone company) made one individual (practically overnight) the fourth largest billionaire in the world (he then began his rapid ascent to become the World's number one).<sup>38</sup> In fact, probably never in the history of the region success or failure in business has depended so much on political connections as during the first stages of the neo-liberal era. All this gives Marx's concept of 'primitive accumulation' a new meaning. And despite Menem having run a privatisation circus no different from Salinas', as late as 1998 (i.e., when the Argentinian

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<sup>38</sup> See especially Wolf (2007), and Winter (2007). As if that was not enough, Salinas handed over to Telmex exclusivity in Mexico's fixed-line market — when one of the most repeated aims of privatisation was, supposedly, to encourage competition. And this has continued afterwards — Fox, for example, appointed someone from Telmex as his Minister for Telecommunications. In fact, despite several adverse WTO rulings, Slim still has over a 90% share of the Mexican telephone market. Not surprisingly, in the latest OECD report on broadband download speed (reported above), Mexico (accompanied by Chile) had the slowest internet service among all its members (with less than 10% the OECD average). In all, Slim's share of the Mexican telecommunications market is much larger than the combined one of AT&T, MCI, Quest, Sprint, and Verizon in the US (Winter 2007). Furthermore, for a US citizen to have the same share of the US economy as Slim has of Mexico's, she or he would have to own assets of about US\$1 trillion. (Ibid.) According to Forbes, this is more than the combined fortune of the top 100 US billionaires (<http://www.forbes.com/forbes-400/list/>). And Slim is not alone; according to a recent study (quoted in Winter, 2007), of the top 10 Mexicans on Forbes' billionaires list in 2011 (with a total net worth of US\$124 billion, about five times the US\$25 billion that Mexican Forbes oligarchs had in 2000), half of them are 'creatures of the State'. Basically, they got there *a-la* Douglas North's 'limited access order' — as they first jumped from the millions to the billions thanks to a process of privatisation which was obscure even for the remarkably low standards of other privatisations in the region.

economy was already at the edge of the abyss), in the annual meeting of the IMF and the World Bank Michel Camdessus (then Head of the IMF) still introduced Menem as 'the President with the best economic policies in the world' — which is rather like praising Al Capone for the orthodoxy of the business model in his beverages venture...

And by opting for such a blatant 'turning a blind eye' to corruption and mismanagement, those associated to the Washington Consensus became unable to have a clear vision (let alone the capacity for critical analysis) of *other* aspects of the process of reform — which were also contributing in bringing these economies to their respective financial crises. In other words, by turning a blind eye to the region's worst ever 'government failures' their analytical judgement was also impeded in relation to the understanding of the huge 'market failures' unfolding in front of their eyes. Under these circumstances, all that mainstream academics and the financial press could do *ex ante*-crash was to keep repeating the traditional narrative of the desirability of the reforms (i.e., how they were the necessary and practically the sufficient conditions for economic success). And in the *ex post*-crash 'lack-of-awareness phase', instead of looking at the key lessons emerging from these financial crises (see conclusions), all they could do was to come up with such uncontroversial recommendations as 'optimal sequences', or (surprise, surprise) the need for 'good governance'. That is, mainstream economists slowly began to recommend supposedly optimal policies for closing the stable gates only well after all the horses had bolted...

## Conclusions

So, the moral of the story of the 'three routes' during the second cycle of capital inflows (from 'Brady-bonds' to the Argentinian 2001/2002-crisis) is that no matter how middle-income DCs that have opened up their capital account fully have tried to handle the absorption of the sudden surges of inflows that usually follows, they have ended up in a major financial crisis. And regarding the current third cycle, the jury is still out in terms of both how long the current unprecedented amount of inflows and favourable terms of trade would last, and on the nature of the (inevitable) 'correction' — no prizes for guessing where my money would be (Palma, 2011a).

To give an indication of the extent of the likely 'correction' ahead, although LA's current account deficits in 2010 stood at only 1.1% of GDP, had the terms of trade been those of 2003 (the year before the commodity-price-boom), this deficit would have jumped to 4.9% (Ocampo, 2011). Furthermore, this figure is particularly high for those countries that benefited most from the commodity-boom. Chile's pre-global-financial-crash current account surplus, for example (4.5% of GDP in 2007), would have deteriorated by no less than 19 percentage points of GDP (to a deficit of 14.4% of GDP) if 2003-terms-of-trade-terms had applied. Corresponding figures for 2010 were a surplus of 1.9% vs. a deficit of 15.5%! In other words, at the time of writing LA not only had already adjusted fully to its new terms of trade and abundance of inflows (as if these were a permanent state of affairs), but it has done so mostly via increased consumption. Therefore, if its terms of trade were to return to its pre-commodity-boom levels, or if the current levels of inflows were to reverse drastically (both events entirely likely), the domestic adjustment needed in many countries would be no different from that of the 1982-debt-crisis (or worse). And if both adjustments were to take place simultaneously, it could be like Greece but without German taxpayers. In other words, the post-2003 commodity-price-cum-inflows-led recovery is so fragile that candles should be lit for speculators continuing to believe commodities to be the sole remaining one-way-bet, and that China and India continue their (forced) march towards their rightful place under the sun.

Of course, with hindsight, one can always think of hypothetical ways in which the worst excesses in each route could have been avoided, but the fact is that surges in inflows into economies with newly open capital accounts have created such pro-cyclical dynamics and risk accumulation that they have proved extraordinarily difficult to absorb. And as Brazil has shown, desperate attempts to deal with the open capital

account/inflow-problem via sterilisation and 'tough' monetary policies, instead of helping to avoid a financial crisis, it just changes the nature of the crisis. As mentioned above, the paradox of Brazil's 'route-2' is that it created a financial crisis by trying to avoid one! In all probability, 'first-best' capital controls (i.e., an attempt to deal with the problem at source) could have been a much more effective way forward.<sup>39</sup>

All of the above makes it difficult to understand the direction followed by mainstream literature on financial crises. As is well known, in financial literature 'second generation' crises are supposed to be harmless to the real economy (i.e., a purely monetary phenomenon), as well as *undeserved* and *unpredictable*. And those of the 'third generation' are again supposed to be undeserved and unpredictable; however, this time they can have a major impact on output and employment due to large currency depreciation causing havoc with corporate balance sheets (see Appendix 1). From this perspective, one of the main points of this paper is to show that all three routes, but especially '1' and '2', have little to do with this 'undeserved' and 'unpredictable' scenario. Rather, what these countries had were truly *deserved* and fairly *predictable* financial crises.<sup>40</sup> The financial fragilities of 'route-3' are more intricate, but only Malaysia could possibly argue that its crisis was, to a certain extent, 'undeserved' (i.e., mostly contagion; see Ocampo and Palma, 2007).

The end result of all of the above (and in particular the four issues discussed in Section 5) is that mainstream crises-literature has ended up paying little attention to (what I believe are) the four main issues surrounding financial crises in DCs with open capital accounts: i) Why is it that the incentive mechanisms and resource allocation dynamics of 'friendly-regulated' domestic financial and asset markets have failed so badly under the pressure of surges in inflows (and the resulting abundance of liquidity) by purely *endogenous* reasons? As a result, otherwise 'utility-maximising' agents operating in 'light-touch' regulated financial markets have ended up accumulating more risk than was privately, let alone socially, efficient. This excessive amount of risk has become evident in the alternate phase of the cycle, that of the sudden-stop in external financing.<sup>41</sup> ii) Why is it that some basic adjustment mechanisms — such as relative price adjustments (e.g., real exchange rates) — have also failed badly when faced with such sharp changes in external and domestic liquidity? Instead of helping to bring these economies back to a sustainable growth path, these adjustment mechanisms have tended to augment the cycle (no 'self-adjusting' equilibria here). As mentioned above, the imbalances created by the liberalisation of capital accounts and inflow-booms, instead of being tamed by 'automatic stabilisers' have been amplified by automatic 'destabilisers'. iii), Why is it that in financially-liberalised economies market forces have often pushed governments and central banks into *pro-cyclical* policies (and politics!) rather than into counter-cyclical ones? And iv) as the successful Chilean and Colombian experiences with capital controls in the 1990s show, there is a clear rôle for 'proactive agency' (e.g., public policy and regulation) in order to counteract the pro-cyclical dynamics of open capital accounts — and of financial liberalisation in general. In fact, mainstream economics aversion to them ('any intervention would simply make things worse'-type attitude) resembles what a Chilean President famously said at the beginning of the 20th Century: "In life there are two types of problems, those that will get solved by themselves, and

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<sup>39</sup> Despite its 1998/99 financial crisis, Brazil has continued with many of its 'route-2' policies, leading to a situation in which the current cost of sterilisation has reached a level well above US\$50 billion a year — not least because its recent taxes on inflows (only applied in the heat of a presidential campaign in which the official candidate was not doing very well) are so porous that speculators only have to pay them if they have a bad accountant. This is perhaps not surprising, because for the Brazilian government to have forced the current Central Bank to implement capital controls is equivalent to having forced a vegetarian to manage a butcher-shop.

<sup>40</sup> For a prediction of the Mexican crisis, see TDR (1994). For that of Brazil, see Palma (1998). For a pre-crisis warning on East Asia's growing financial fragilities, see BIS (1997); and for one of the current crisis, see Rajan (2005).

<sup>41</sup> For Kindleberger (2000), there is one thing international financial markets can do that is even more damaging for DCs than 'over-lending': to halt that lending abruptly.



those that have no solution" (see Palma, 2009b). The contemporary mainstream version of this ('market-submissive', and rather unambitious) world-view is that now in financial markets there are only two types of problems: those that markets can be solved by themselves (helped by more liberalisation), and those that have no solution."

My main argument in this paper is that the fundamental explanation of these crises points not just to a major 'market failure', but to a *systemic market failure*: evidence suggests that some financial crises, as those studied here, are basically the *spontaneous* outcome of actions by supposedly utility-maximising cum 'rational' expectations agents, freely operating in 'light-touch' regulated, *over-liquid* financial markets.

One issue here is that financial markets, (as opposed to many other markets), invariably have had the capacity to clear *regardless of their amount of liquidity*. And they do so only partially by reducing charges, margins and spreads to traditional customers; they also do so by opening-up new 'outlets' for that liquidity (in which they actually do the opposite). That is, they did not only opened-up a new sub-prime 'outlet', but after a short 'teaser' period, sub-prime mortgages usually became two to three times more expensive than normal mortgages.

The issue here is that only when financial markets operate as a 'sellers markets' (i.e., relative shortage of liquidity), they can unload their liquidity without accumulating an amount of risk that is privately — let alone socially — inefficient. But when excess liquidity turns them into a 'buyers markets', the process of 'clearing' invariably leads to the opposite environment, as they have to create (i.e., literally invent) a sufficient level of demand for that liquidity (no matter what). In extreme cases, any new demand would do — even people with 'no income, no job, and no assets', as the famous 'NINJA' mortgage in the recent sub-prime debacle, when financial markets under the pressure of having to clear excess liquidity (and after having exhausted every possible alternative, and independently from the 1977-Community Reinvestment Act), change their business-motto to 'Redlining is no more!' That is, when financial markets began a process known as 'reverse redlining' — i.e., when lenders and insurers begin to target specifically those consumers that had been previously denied those services altogether (consumers that had been previously part of redliners' blacklists).

And in order to create new 'outlets' for their liquidity, financial markets usually follow an age-old device: they lower their operational standards, and they reduce the transaction costs of this liquidity (a signature would do). Also, as the current Chair of the FSA recently stated at the annual Mansion House banquet (quoted above), "swollen financial markets" tend to produce "socially useless products and innovations, including a number of derivatives and hedging products, and aspects of the asset management industry and equity trading. [So] markets are not always wise" (<http://www.ft.com/cms/s/0/ab724158-a7a2-11de-b0ee-00144feabdc0.html#axzz1eUzyS4Yq>). And yet another traditional clearing mechanism by 'swollen' financial markets (especially relevant for the subject of this paper) is the re-discovery of emerging markets — as mentioned above, for international financial markets DCs have traditionally played a 'customer of last resort' rôle (e.g., in the 1820s, 1860s, 1920s, 1970s and 2000s.<sup>42</sup>

Another crucial component in the dynamics leading to the creation of the necessary clearing levels of demand has been emphasised by Kindleberger (2000): a sudden access to easy credit invariably leads to a surge in expectations and animal spirits. This process then reinforces itself, becoming yet another self-fulfilling prophesy. Easy access to cheap credit fuels the expectations of future performance — a performance that is enhanced by the additional expenditure brought about by the extra borrowing. 'Over-lending' and 'over-borrowing' became therefore not only the result of a closely interrelated process, but also one that had a clear *direction of causality*: the propensity to 'over-lend' led to the propensity to 'over-borrow.'

In other words, markets as a whole are not always right — indeed, in the case of

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<sup>42</sup> For how this connects to the technology cycle, see Pérez (2002).

financial markets they can be seriously wrong *as a whole*. For example, in the financial crises analysed in this paper there is plenty of evidence that over-liquid and 'light-touched'-regulated financial markets can be driven by buyers who take little notice of underlying values — i.e., when investors have incentives to interpret information in a biased fashion *in a systematic way*. At the same time, as LTCM learnt the hard way (one year after its founder winning the Nobel Memorial Prize in Economics), high liquidity can easily make assets that appeared to belong to independent clusters in the past to become correlated — so, diversification against those clusters cannot provide sufficient 'staying power' anymore. Also, as the recent collapse of 'MF Global' (and its 'missing' customer funds) indicate — a collapse brought about by an over-reliance on short-term funding, which dried up as revelations of its leveraged bets on European sovereign debt came to light — the capacity of agents operating in unregulated financial market to learn from previous mistakes seem rather limited. For Keynes, perhaps, this would not come as a surprise; according to Deane,

"[t]he iconoclastic conclusion of [Keynes'] analysis was that there was no invisible hand translating private self-interests into social benefit. This was the nub of the Keynesian heresy." (1980, 182)

In reality, in over-liquid financial markets there seem to be no invisible hand able to translate private self-interests into private benefits *in a sustainable way* either! From this point of view, maybe the invisible hand is so invisible simply because it does not really exist — or, if it does, there is plenty of evidence that indicates that it becomes overwhelmed by the dynamics of over-liquid financial markets. Or, perhaps, under these circumstances it just prefers to take sabbatical leave.

The essential point here is that mainstream economists will continue to find it difficult to get anywhere near a proper understanding of financial crisis until they give up their 'idolatry' of the market — idolatry in the sense of a 'worship of a thing' (see Britton, 2002). As Stiglitz has said, this crisis is not just the outcome of a market failure here or there, "but of a total failure of financial markets" (<http://www.youtube.com/user/TheFlawMovie?blend=3&ob=5>). And the argument that this only happened because we still do not have 'complete markets' sounds increasingly hollow — A.I.G., for example, with its new type of derivatives, had moved precisely into previously 'missing' insurance markets.

In fact, over-liquid financial markets are so difficult to tame that one should not idealise the effectiveness of financial regulation either. Paraphrasing Churchill, perhaps the best thing one could say about 'regulated' financial markets is that "many forms of resource allocation have been tried and will be tried in this world of sin and woe. No one should pretend that under excess-liquidity conditions the one done by 'regulated markets' is perfect or all-wise. Indeed, it has been said that under these conditions regulated financial markets are the worst form of resource allocation, except for all those other forms that have been tried from time to time."

In other words, there is no substitute for avoiding that financial markets become over-liquid in the first place. That is, the first best option is to keep them 'tight', because once they become 'swollen', even New-Deal/Bretton-Woods-type regulation would inevitably struggle.

As Keynes once remarked, 'markets can remain irrational far longer than you or I can remain solvent.' Even Adam Smith thought that irrational behaviour could have a real impact on the markets. As emphasised before, the environment in which this is more likely to happen is that of excess liquidity — leading agents to accumulate more risk than what is privately efficient via increased and growingly fragile leverages, asset bubbles, and so on. Excess liquidity is also bound to create conditions which exacerbate problems such as skewed incentives for managers, herding behaviour among traders, investment bankers and hedge fund managers who are under constant threat of withdrawals of funds if they under-perform the market, etc. In DCs, sudden surges of inflows have proved to be a paradigmatic case of this, where stock markets can grow on average at 87%, 49% and 48% p.a. for many years in a row (as in Chile, Argentina and Mexico, respectively; see Figure 8 above). It would take a very brave investment manager, blessed with infinitely patient investors, to fight trends like these — even if

they patently are deviations from fundamental values (Rajan, 2005). And DCs are not alone in this: in Portugal between 9/11 and the 2008 financial crisis, for example, the value of the stock of financial assets grew 17 times faster than GDP; in Spain it did so by 8 times, and in Greece by 6 — as the value of its stock of financial assets grew at no less than 24% p.a. (i.e., in Greece, of all countries, the value of the stock of financial assets *trebled* in the five years before the crisis). Can anybody argue with a straight face that something *real* was actually happening in these economies to justify these financial euphorias? Or that in, say, Greece or Portugal asset prices were rising like this in order to reflect new available information, or more solid fundamentals? In the meantime, in Eastern Europe the value of the stock of financial assets also grew far ahead of GDP (eight times faster), in LA six times, and in Africa five (see Figure 1 above). To dismiss these types of experiences as simply 'not empirically efficient' (Malkiel, 2007) is what gives economics a bad name.

As Pascal once said (1662), "man is equally incapable of seeing the nothingness out of which he was drawn and the infinite in which he is engulfed." Despite the insistence of mainstream analysis, many financial crises (like those studied here) take place mostly due to factors that are *intrinsic* (or inherent) to the workings of over-liquid and under-regulated financial markets — rather than to *extrinsic* (or relational) ones. That is, it is unlikely that the same over-liquid and under-regulated financial markets would have worked much differently had they been operating in different surroundings. From this point of view, the main weakness of the mainstream understandings of financial crises is that they suffer from 'extrinsicism', or the tendency to place major emphasis on external matters rather than on more profound realities.<sup>43</sup> And by doing so, most mainstream economists miss the point entirely: the tragedy of these financial crises does not lay on the supposed inevitable recurrence of government failures — and certainly not on chance — but in the fact that these crises, more often than not, are fully *deserved* and fairly *predictable*.

From this point of view, they belong to what Oscar Wilde calls 'the real tragedies of life', those that "occur in such an inartistic manner that they hurt us by their crude violence, their absolute incoherence, their absurd want of meaning, their entire lack of style. They affect us just as vulgarity affects us. They give us an impression of sheer brute force, and we revolt against that." (1890)

Even new behavioural psychology approaches, no matter how appealing, so far have just highlighted biases in individuals and committees and not in 'unregulated and over-liquid' financial markets; i.e., the latter are still idealised as such — i.e., the problems do not lie in them, but in the fact that (unfortunately) they are populated by imperfect individuals.<sup>44</sup> After all Adam Smith had already warned us long ago that

"The overweening conceit which the greater part of men have of their own abilities is an ancient evil remarked by the philosophers and moralists of all ages." (1776; B.1, Ch. 10) Perhaps the main lesson of these financial crises is that it is about time to think again (as some are trying — e.g., Taylor (2010); Davidson (2009); Harcourt (2011); Bibow (2009) — just to mention a few) about all the complex theoretical issues that led Minsky to conclude that finance could so easily become fragile; that led Kindleberger to warn us about how excess liquidity leads us to oscillate between manias and panics; and, especially, that led Keynes to conclude that: "[...] above all, let finance be primarily national." (1933; 759).

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<sup>43</sup> An analogy in ethics would be in the difference between emphasising the external observance of laws and precepts, and emphasising the ultimate principles underlying moral conduct.

<sup>44</sup> In a seminar on the subject, the speaker concluded that investment banks should have more 'balanced' trading teams in terms of age and gender (to avoid excessive risk-taking at the wrong time by the usual testosterone-abundant young-male brigades). However, I argued that if that was the problem maybe a more efficient trading strategy would be to play like in American football, and alternate the trading teams according to the circumstances — sending a 'defensive formation' to the trading floor (i.e., with an appropriate age and gender structure) when a more cautious strategy is required, and an 'offensive' (testosterone-plentiful) one only when the opposite strategy is more likely to yield higher returns...

Needless to say, a fundamental part of this task is to turn Lucas' famous 'residue of things' upside-down — according to him (see epigraph at the beginning of the paper),

"The problem that the new theories, the theories embedded in general equilibrium dynamics of the sort that we know how to use pretty well now — there's a residue of things they don't let us think about. They don't let us think about the U.S. experience in the 1930s, or about financial crises and their real consequences in Asian and Latin America, they don't let us think very well about Japan in the 1990s." (Lucas, 2004; 23)

That is, part of the task ahead is about transforming these 'odd things' that mainstream economics sees as 'residue' — including, of course, the current global financial crisis — into the events which form part of the corner-stone of our analytical thinking on how financial markets actually work in the real world.<sup>45</sup>

However, given the complex current political and economic environment, to be able to think again about these complex theoretical 'things' one has to deal with at least two main risks. One is that unless the above 're-thinking' is done with a purpose, heterodox economics runs the risk that its discourse could be overcome by 'the narcissism of lost causes.' That is, sometimes it's just too easy to admire the sublime beauty of critical reason doomed to be marginalised. The other risk, of course, is (in a sense) the opposite: it is also too easy to avoid marginalisation by quitting *critical* thinking, and absorbing the fundamentals of the alternative hegemonic (mainstream) paradigm — ending up with a 'prudent' discourse made of *scepticism* cum a progressive social substance (although with the latter in the area of 'diminishing returns' — *a-la*-'new' left?). The problem with critical thinking, of course, is that it is a distancing, even debilitating, activity. It distances us from conventions, from established assumptions and from settled beliefs. It takes what we know from familiar, unquestioned settings and makes it strange. And it does so not necessarily by supplying new information, but by inviting and provoking a new way of seeing. Therefore, a key challenge ahead for heterodox economics is how to steer a course that avoids both types of evasion: that of the beauty of the 'lost-cause', and that of prudent 'uncritical' thinking — not least because when reality is evaded, it is also bound to be distorted and misrepresented.

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<sup>45</sup> Charles Kindleberger used to say that when economists run time series in which dummies are used to account for 'special' events, more often than not the only analytically interesting thing in the whole regression is what happened in those events accounted for by dummies.

## Appendix 1

The main issue behind the existence of 'generation-models' of financial crises is that mainstream economics cannot accept the possibility that the *autonomous* outcome of the free interaction of supposedly utility-maximising cum 'rational' expectations agents, interacting in (excessively) 'friendly-regulated' financial markets, could be an *endogenous* financial crisis. The outcome of the above could only be some sort of 'equilibrium'; this may well be a 'sub-optimal' one, but it has to be an equilibrium of sorts. From this point of view, a financial 'crisis' proper can only take place if there is some kind of interference in the incentive mechanisms and/or resource allocation dynamics of financial markets. Examples of the latter are lax fiscal discipline, fixed exchange rates with a wrong peg, central bankers/finance ministers unwilling to take tough action when necessary, self-fulfilling loops (e.g., bank runs), and so on.<sup>46</sup> As these 'interferences' vary from one crisis to another, their models can only be developed *after the event*.

The so-called 'first generation' models tried to explain the currency crises in the US in the early 1970s. Presidents Johnson and Nixon followed inconsistent macroeconomic policies: persistent deficits with a fixed exchange rate peg. So, the US got the crisis it deserved — Nixon run out of reserves. This was an inevitable outcome (given the policies); and its timing was fairly predictable. Finally, 'first-generation' crises seem to do no harm, as they only reveal an economic problem that was there in the first place.

The inspiration for second-generation modelling was the speculative attack on the European fixed-exchange currency system (ERM), which started with the run on the Pound Sterling in 1992. The UK had entered the ERM in October 1990, but was forced to exit in 1992 when its currency came under major pressure from speculators. There were several obvious differences between the UK 1992-crisis and the assumptions of 'first-generation' models. Seignorage was not the issue, but the willingness of the British government to defend the peg; as many considered that the pound sterling had entered the ERM at an overvalued rate, the British government had to show that it would do what it took to defend that peg. Therefore, the crisis took place not because the government run out of reserves (as in the US); the abandonment of the peg was a matter of policy choice: in 1992 the British Chancellor chose not to pay the price for defending the peg (higher interest rates), while French officials made the opposite decision a year later (when it was the turn of the Franc to come under attack). So, 'second generation' models are about an imperfect commitment to a currency peg. When the peg ceases to be credible, investors will demand higher interest rates in order to hold assets denominated in the country's currency. As macroeconomic policies before the crisis are not irresponsible, crises are not 'deserved'; neither are they 'predictable', as their nature is mostly about chance — i.e., 'self-fulfilling' crises of confidence in which speculators who believe that other speculators are about to attack are themselves encouraged to do so. As everything is about forcing a currency off its peg, there is no reason for a negative shock on output or employment. In fact, as a result of the crisis an artificial policy constraint is removed (the peg), its impact could well be positive.

Finally, as the latter was clearly not the case in 1997-East Asia, 'third-generation' models try to explain why abandoning a peg could be at times so harmful to output and employment. There are several narratives. One is the 'moral-hazard-driven' investment-booms creating excessive external debt; others are open-economy versions of bank-runs (crises occur due to a sudden flight of capital from economies that were not fundamentally unsound); finally, a third story stresses the balance-sheet implications of currency depreciation. At the end, the most common narrative mixed several of the above issues: problems began due to moral-hazard-driven bubbles, which were followed by balance-sheet driven crises when the bubbles burst. Therefore, in 'third-generation' models crises become harmful because they are no longer about problems with monetary policy. Basically, they are also about chance: something — as Krugman (2001) says, it could be almost anything — causing a sudden large currency depreciation; and this depreciation creating havoc with balance sheets. On their liability side, if the price of foreign exchange suddenly rises, and firms have substantial foreign currency debts, their net worth falls. And on the asset side of balance sheets, the story is one of a decline in confidence leading to a fall in asset prices, which leads to a fall in investment that validates both the decline in asset prices and the fall in confidence. The economy thus plunges into a crisis in the real economy on both accounts. In sum, in first-generation models scenarios crises are supposed to be 'deserved' and predictable, but not harmful to the real economy. In second-generation ones, instead, crises are 'undeserved' and unpredictable, but still not harmful. Finally, in third-generation scenarios, financial crises are again 'undeserved' and unpredictable, but this time they are instead harmful (as they are not just about problems with monetary policy).

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<sup>46</sup> For a brief summary and bibliography, see Krugman (2001).

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