The Neoliberal global triad and the Latin American financial trap: Contending explanations of macro-financial crises

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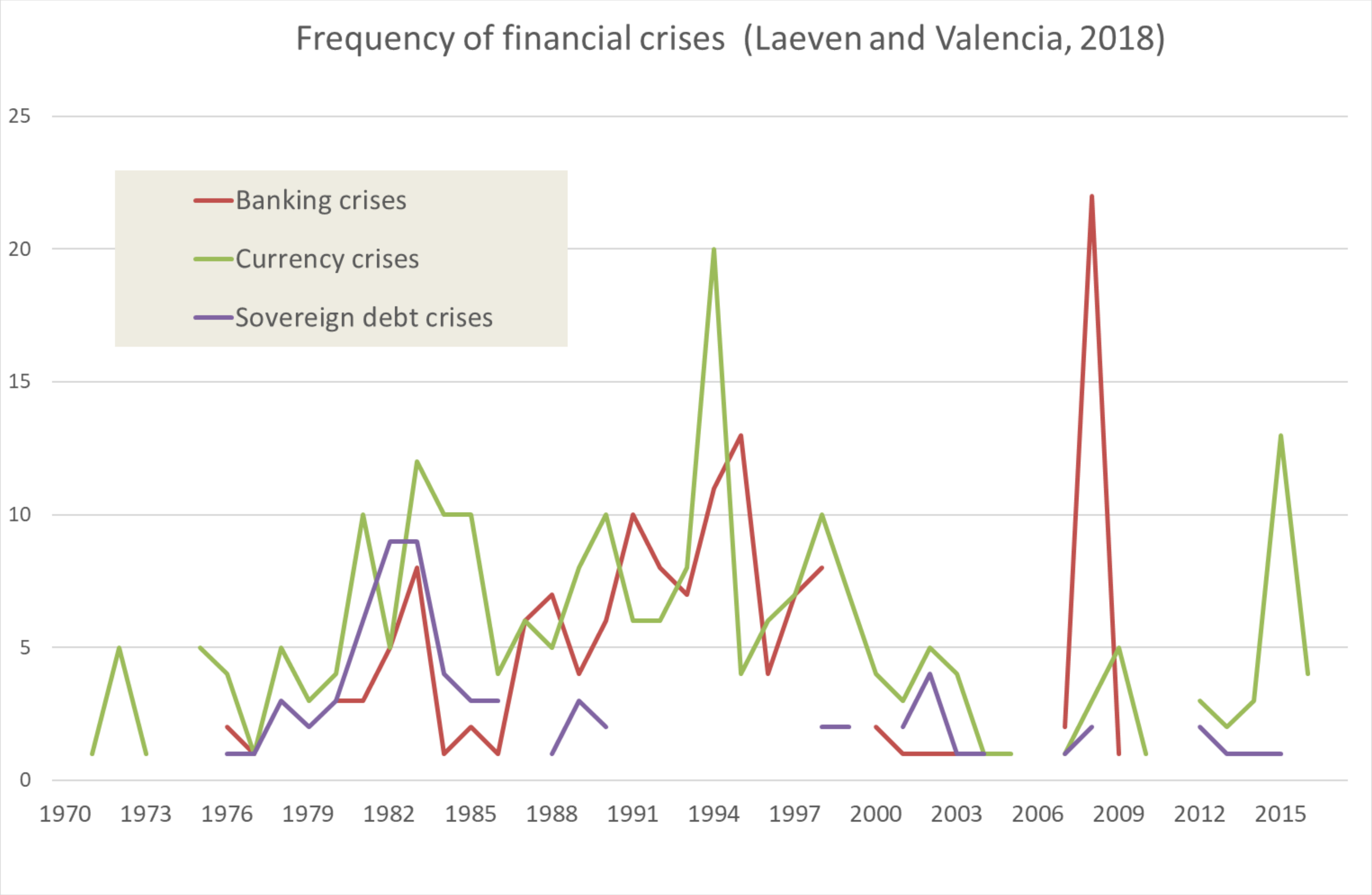
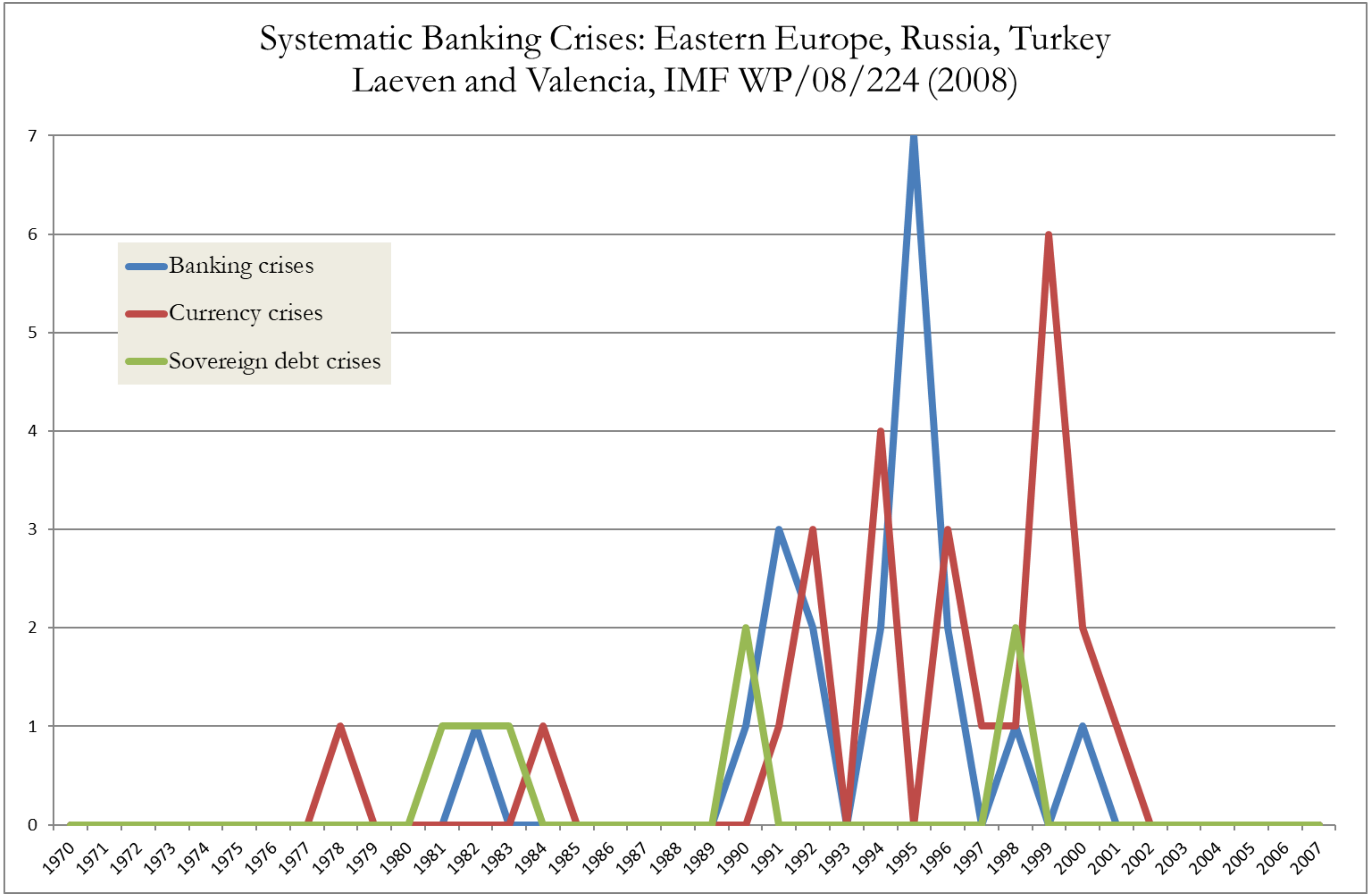
The argument in a nutshell

1. From the 1980s to the present period of ‘debt-driven, low-investment growth’, developing economies have had to contend with recurrent financial crises.
2. Economists’ explanations of developing-economy financial crises, which have evolved from moral-hazard arguments to twin post-GFC hypotheses about ‘global financial cycles’ and the ‘shortage of safe assets’, have overlooked key aspects of the dynamics at work and thus have misled policy interventions.
3. Our alternative framework emphasizes two overlooked causal factors - power relations and the role of aggregate demand – that shape the global geography of macro-financial processes. This geography is shaped by a ‘Neoliberal global triad’: the hegemony of the US dollar; a shadow banking complex centred on a set of too-big-to-fail US megabanks; and the shifting global locus of manufacturing.
4. The Neoliberal global triad creates imbalances of trade and financial flows that systematically advantage some global regions and disadvantage others. Latin America’s frequent cross-border financial crises, and its nations’ systematic overborrowing of foreign reserves, is due in part to the workings of this global triad.

An empirical baseline




Systematic Banking Crises: Eastern Europe, Russia, Turkey
Laeven and Valencia, IMF WP/08/224 (2008)
Banking crises
Currency crises
Sovereign debt crises
0
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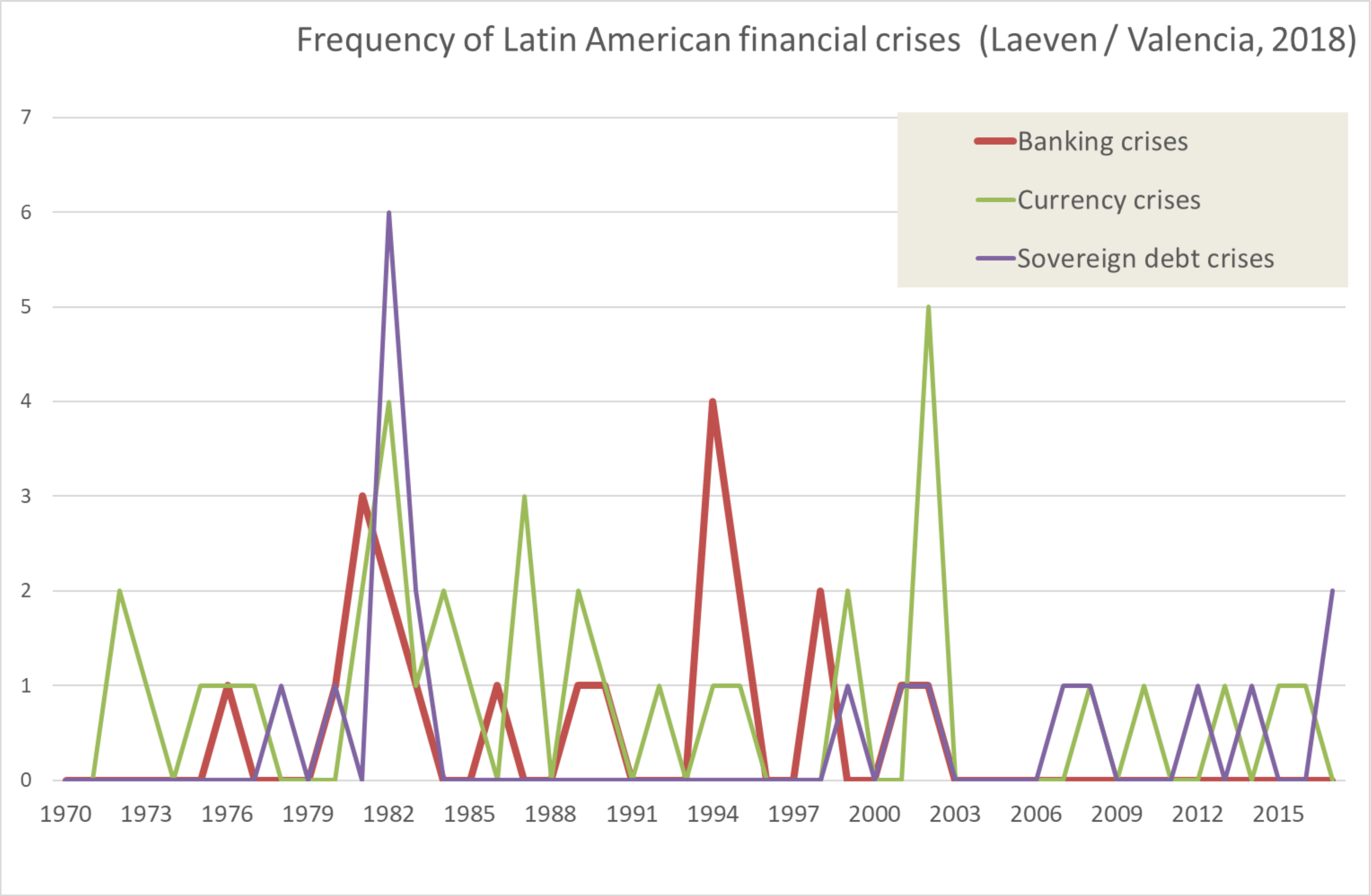
1970 1971 1972 1973 1974 1975 1976 1977 1978 1979 1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007


Frequency of Latin American financial crises (Laeven / Valencia, 2018)
Banking crises
Currency crises
Sovereign debt crises
7
6
5
4
3
2
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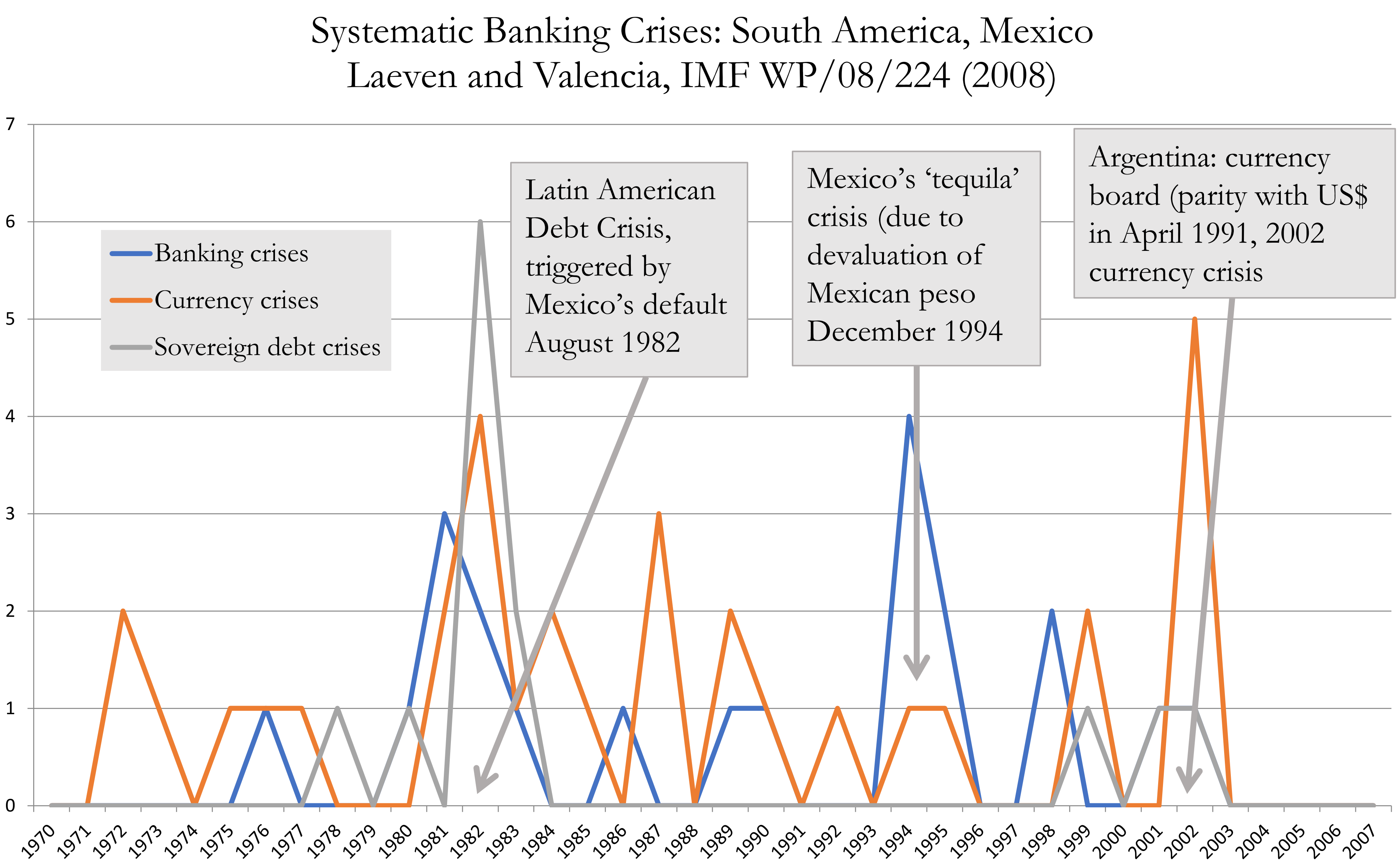
Systematic Banking Crises: South America, Mexico
Laeven and Valencia, IMF WP/08/224 (2008)
Banking crises
Currency crises
Sovereign debt crises
Latin American Debt Crisis, triggered by Mexico's default August 1982
Mexico's 'tequila' crisis (due to devaluation of Mexican peso December 1994
Argentina: currency board (parity with US$ in April 1991, 2002 currency crisis
0
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3
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5
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Financial crises (all categories) in the IMF Financial Crisis Database (Laeven and Valencia, 2008, 2018)

	Latin America and Caribbean	Western Europe	Eastern Europe	South Asia	East Asia
1970s	10	1	1	2	3
1980s	39	5	5	1	7
1990s	18	5	41	1	15
2000s	19	20	11	0	1
2010-17	13	2	6	0	1
Totals	99	33	64	4	27

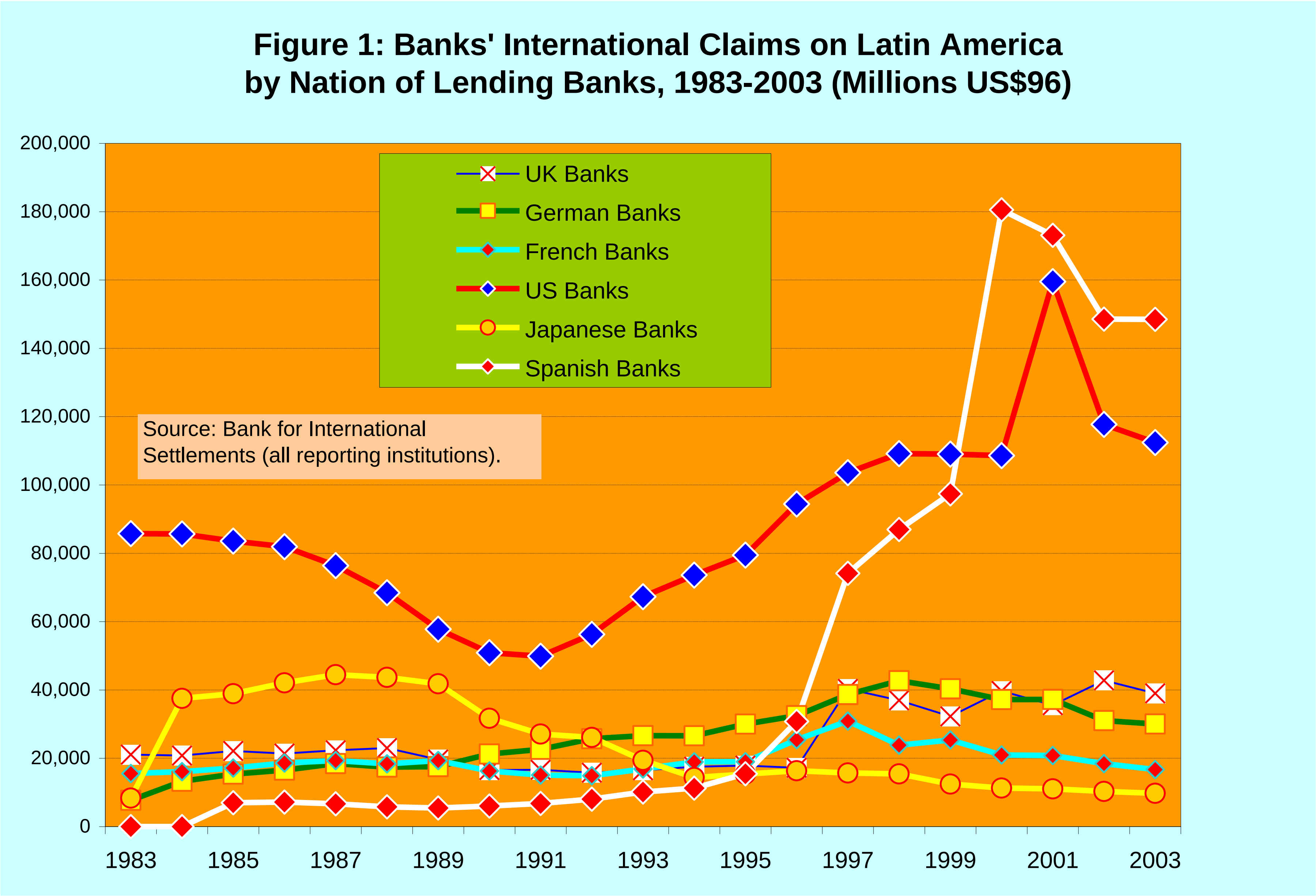
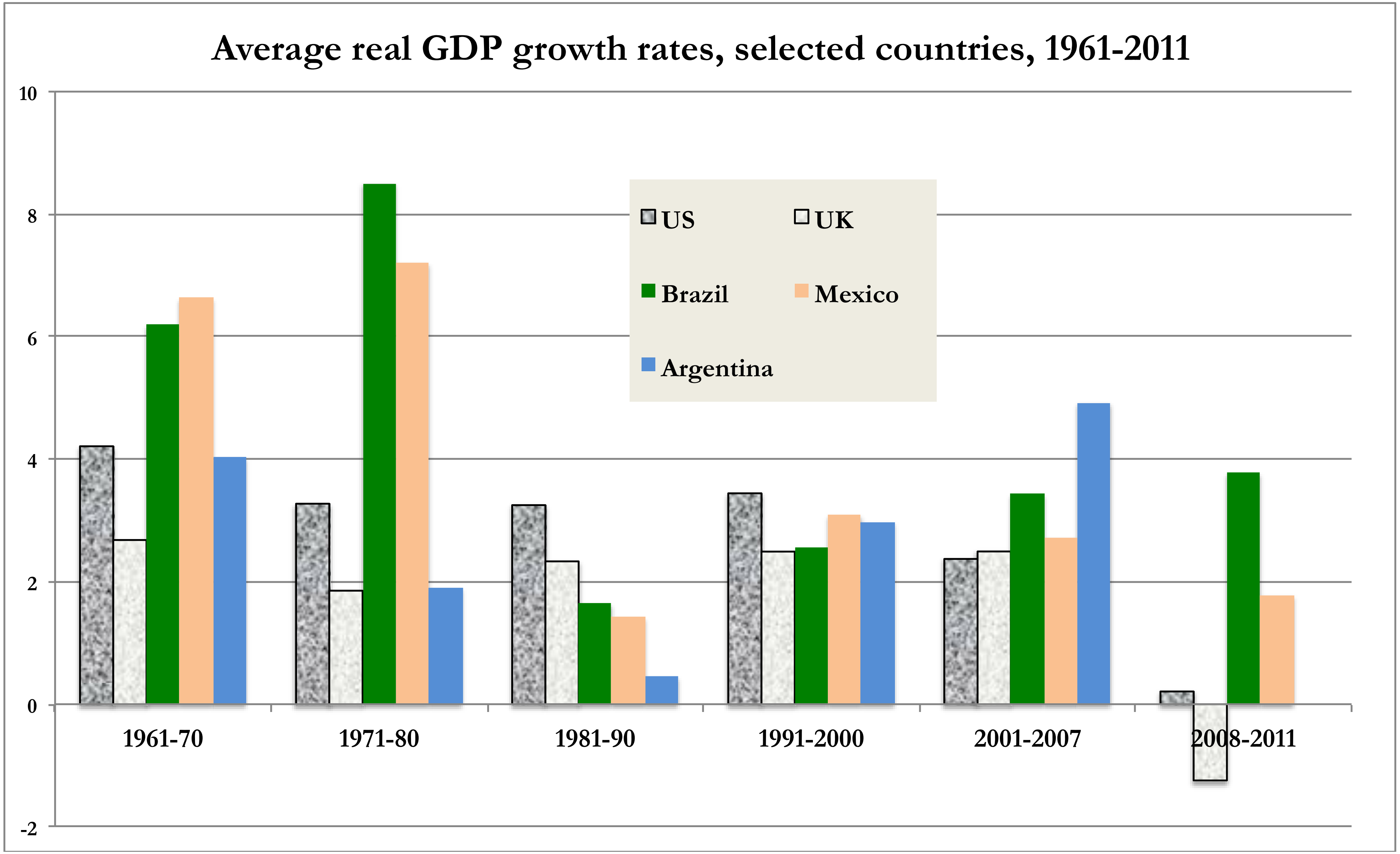


Figure 1: Banks' International Claims on Latin America
by Nation of Lending Banks, 1983-2003 (Millions US$96)
200,000
180,000
160,000
140,000
120,000
100,000
80,000
60,000
40,000
20,000
0
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003
UK Banks
German Banks
French Banks
US Banks
Japanese Banks
Spanish Banks
Source: Bank for International Settlements (all reporting institutions).



Source: IMF/World Bank database. No data for Argentina after 2006.

Mainstream explanations of global financial crises before 2008

- Before the 1982 Latin American debt crisis, explanations focused on structural situation of borrower nations
  - Diaz Alejandro (1983, 1984): deterioration of internal conditions
  - Krugman (1979): 'first generation' currency crisis model: weak growth and policy fundamentals creates susceptibility to severe devaluations

- After 1982 – with structural Keynesian models being replaced by dynamic equilibrium macro models, 'New Keynesian' game-theoretic models emerged to explain market failure in the context of principal-agent problems with asymmetric-information. These were applied to sovereign debt crises.
  - Eaton, Gersovitz, and Stiglitz (1986): moral hazard (willingness to repay) is the root of the problem of 'country risk'.
  - The borrower country 'chooses' between repayment and default based on size of penalty.
  - The existence of defaults means penalties are systematically set too low: so there is the paradox of why sovereign lending ever occurs.

Mainstream explanations of global financial crises before 2008

Figure 1: Agent-based microfoundational explanation of borrower crisis dynamic

(1)		(2)		(3)		(4)
[Desire/policy to live beyond One's means]	→	[Credit demand registered via an open channel]	→	[Credit supply offered by a lender willing/able to ignore prudential limits]	→	[Overindebtedness crisis for borrower, realized default risk for lender]

- The 'original borrowing parties' are ignored, in favor of a 'borrower nation' that will live beyond its means if it can.
  - Krugman (1998): 'crony capitalism' model of the East Asian crisis
  - Eaton (1993): sovereign-debt framework
- Critiques registered:
  - Global financial-market segmentation ('Loan pushing', Darrity and Horn, 1988)
  - Class conflict in borrower country (Dymski and Pastor, 1990)
  - Impossibility of reconciling 'rational lenders' with repeat-default borrower countries (Eichengreen and Lindert, 1989)

IMF studies of cross-border financial crises

- By the 1990s, bank lending crises were matched by currency crises, and IMF researchers looked more generally at cross-border financial crises.
  - Demirgüç-Kunt and Detragiache (2005, p. 69) explain: ‘With the arrival of the 1990s, financial crises in which the banking sector played centre stage and macroeconomic consequences were sharp and – at times – protracted, became more and more widespread. … Bank fragility was pervasive and multifaceted, a phenomenon ripe for more systematic empirical investigation.’
  - IMF researchers began assembling systematic time-series of cross-border financial crises from across the world, looking for patterns and explanations.
  - But no one cause was found: a weak macroeconomy and high real interest rates (Demirgüç-Kunt and Detragiache, 1998); financial liberalization (Demirgüç-Kunt and Detragiache, 2005).
  - This replicated the explanatory dead end in the companion literature on finance and growth.

- Theoretical investigations turned to factors external to borrower countries.
  - ‘Second generation’ models of currency crisis focused on ‘sunspots’ – small changes in beliefs by investors – leading to ‘sudden stops’ in cross-border lending/investment.

Post-2008 explanations: Global 'financial cycles' and shortages of 'safe assets'

- Recurrent financial crises led from the fitness of nation-states as borrowers to the logic of cross-border financial flows as such.
  - The reference point here is the 'impossible trinity': independent monetary policy, fixed exchange rates, and open financial borders are incompatible.
  - While Fleming saw financial openness as a 'booster' for domestic policy choices, Mundell saw financial openness and flexible exchange rates as assuring efficient cross-border financial markets.
- Financial openness, in a world of deregulated, market-share-hungry financial funds, leads to 'global financial cycles'.
  - Borio (2012): self-reinforcing feedback loops between asset prices and collateral values leads policy authorities to react to the financial cycle, not the business cycle. 'Unfinished business cycles' (as per the 'Greenspan put' in early 2000s) lead to asset boom/busts and more severe business cycles.
  - Passari and Rey (2015) see co-movement of gross capital flows, bank leverage, credit creation: so monetary policy has no effect, nor does exchange-rate fixes. So there is a dilemma, not a trilemma – developing countries only choice is how open they will be to capital flows.

Post-2008 explanations: Global 'financial cycles' and shortages of 'safe assets'

- So what triggers financial cycles – to what do globally mobile investors react?

1. **Global savings glut**: Ben Bernanke (2005) blamed a savings glut in Asia: China's suppression of aggregate demand leads to excess savings that seek out US assets and enable the US current-account deficit.
2. **Global shortage of safe assets**: Caballero and Krishnamurthy (2009) argue there is global excess demand for riskless assets; foreign savers find them in the US, facilitating its current-account deficit and leading to an excess of risky assets in the US.
   - So savers balance their portfolios across 'safe' and 'risky' assets, with the population of 'safe' assets changing endogenously.

     > *'The neoclassical growth model is behind many of our economic intuitions regarding why the free flow of capital could be beneficial. Within this model, financial integration brings improvements in allocative efficiency (capital flows to places with the highest marginal product) and better risk sharing. Interestingly … gains tend to be small.'* (Rey, 2015)

   - As Dominguez (2008) points out, this explanation blames underdeveloped financial markets (especially in emerging Asia) for global financial cycles - US fiscal and monetary policies play no role.

Post-2008 explanations: Global 'financial cycles' and shortages of 'safe assets'

- So what triggers financial cycles – to what do globally mobile investors react?

3. **Excessively expansionary monetary policy**: 'the "excess financial elasticity" of domestic policy regimes, ie it exacerbates their inability to prevent the build-up of financial imbalances, or outsize financial cycles' (Borio, 2014).
    - This view disagrees with the first two theories: macroeconomic policy is not irrelevant; instead, financial markets' generative dynamics react to – and are not independent of – domestic policy decisions.
    - Instead of shortages of safe assets (implicitly a 'classical' view of macroeconomic dynamics), Borio focuses on market imbalances rooted in excessive risk-taking in a financial system underwritten by overly-permissive regulators/monetary-policy decisions (a 'more' Keynesian view of things).

The financial architecture of power in finance

An alternative understanding of the global financial dynamic and of the sources of global financial instability emerges with two changes in the analytical basis of the Caballero/Rey framework:

1) first, substituting a Post-Keynesian for a New Classical macro framework;
2) second, account for asymmetric power in cross-border relations.

Post Keynesian 'Real Time': the possibility of a 'flight to safety' due to erosion of confidence or crumbling conventional beliefs – not 'rational portfolio choice'

Power Asymmetries: the idea of 'real space.'

- Consider Sheila Dow's idea of credit starvation in a nation's periphery in periods of financial stress. The centralization of liquidity exposes a power asymmetry between centre and periphery.
- Take this to the case of nation-states, building on the ideas of Richard Peet (2013), who defines the geography of power as 'the concentration of power in a few spaces that control a world of distant others.'

The financial architecture of power in finance

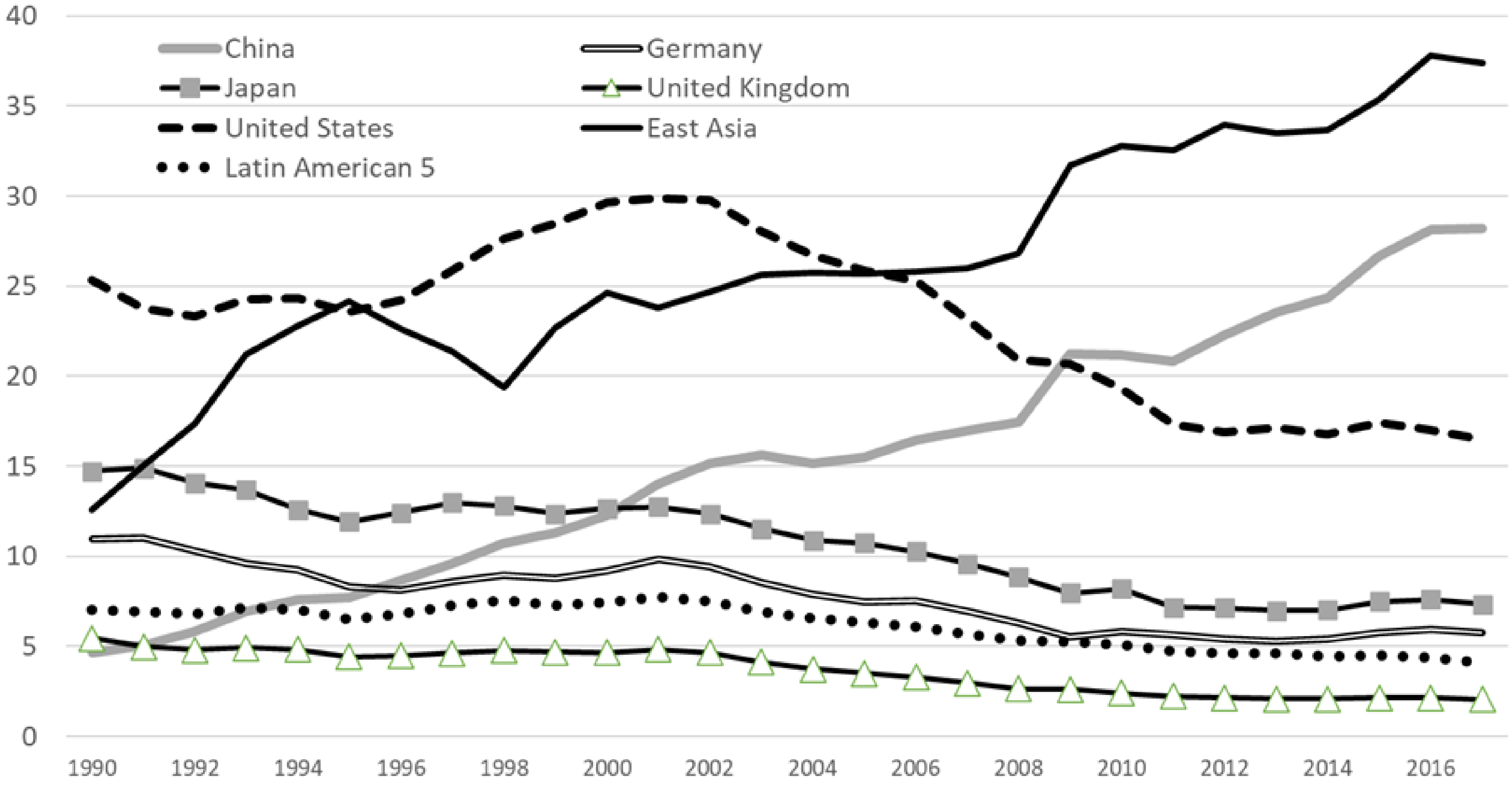
Origins of the financial architecture of power in finance:

- In the post-Bretton Woods world, the US Federal Reserve demonstrated both the willingness and capacity to support (insolvent) US money-centre banks in the wake of the 'triple banking crisis' of the 1980s.
- The US current account has been in deficit since then, paralleled by a capital account surplus – and all based on the 'exorbitant privilege' of the US dollar and the need for 'safe haven' assets in a world of increasingly frequent financial crises.
- This stable neoliberal structure confers positional power – the ability to define the rules of the game. Deregulation across the advanced countries permitted the rise of, and global penetration by, the US megabank-centred shadow-banking system.
- The result is a global pyramid (D'Arista, 2018), wherein only the country at the top can stop crises when they occur across borders. Global holdings of US liabilities support financialization globally, thus increasing pressures that destabilize governments and increase the returns to financial predation and speculation.

The global financial periphery and the Neoliberal global triad

- The first test of a sovereign nation's financial power is whether its residents and businesses use the currency it issues in everyday transactions.
  - If so, then: is its currency is held in reserve stocks by other nations?
  - Can it settle contracts or contract debts across borders in its own currency?
  - Are financial services for agents from third-party countries available within its borders?
- The lack of financial status generates financial fragility, as when its residents and firms can only borrow from overseas lenders in foreign currencies.
- To overcome this financial dependency, build a current-account surplus – via commodies, manufacturing, or services: the global factory.

Figure 3: Global % shares of manufacturing value-added, 1990-2017, by country and country group (Source: UN Department of Economic and Social Analysis)



Note: China and Japan are included in 'East Asia' here; they are shown separately for reference. East Asia includes UNDESA's ASEAN group of nations plus its 'East Asia (industrialized)' group, with double-counting accounted for. The Latin American 5 are Argentina,

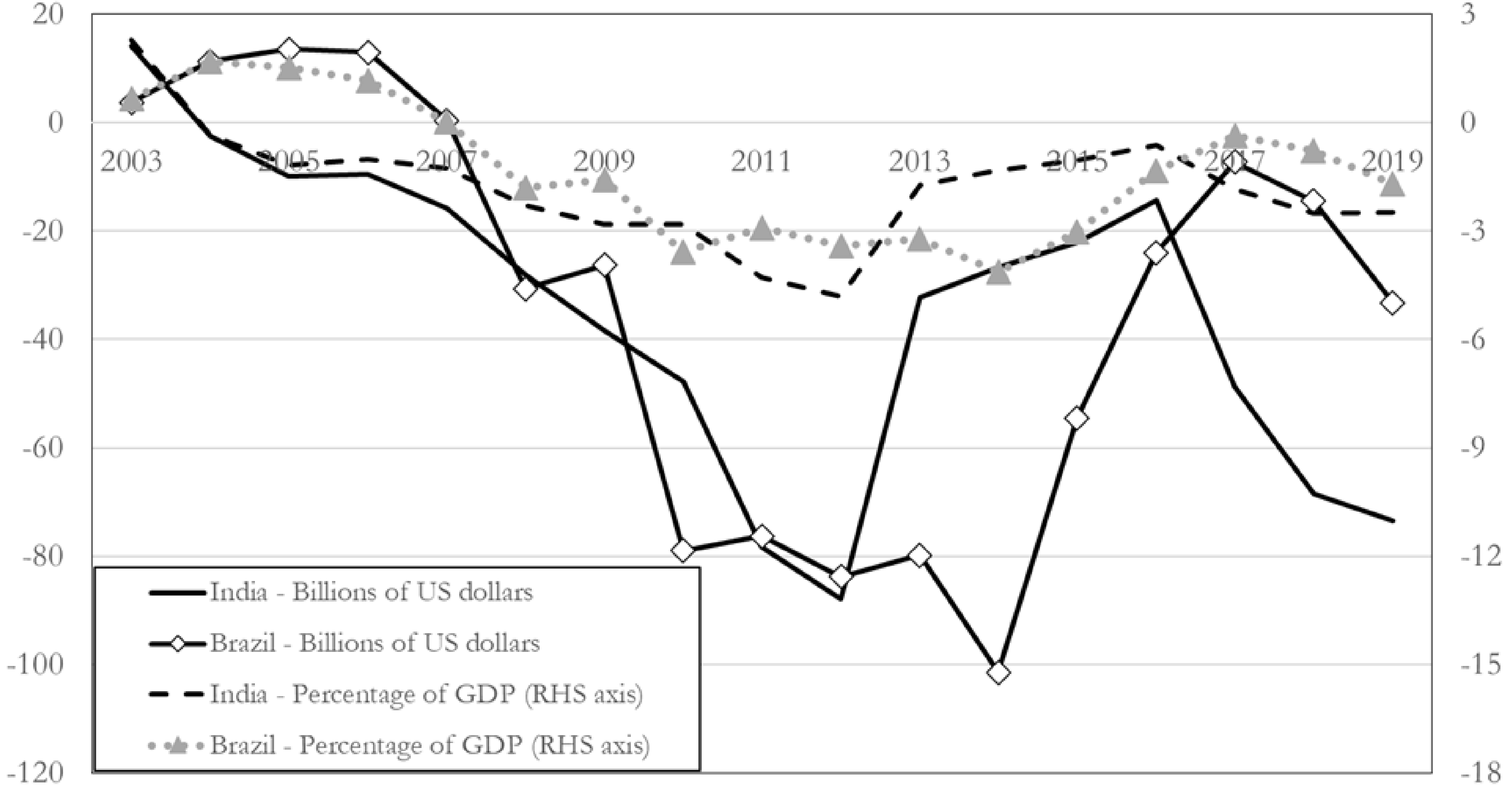
The global financial periphery and the Neoliberal global triad

- So the Neoliberal global triad consists of locations along 3 dimensions: the hegemony of the US dollar; the megabank-dominated global financial system; and the global factory.
  - One extreme position is the **financial core** of the global system, the US itself: the 'safe haven' of the US dollar in a world of financial crises, and megabanks are able to underwrite global risk, earn fees, and exchange zero-sum bets in firms that are too big to manage.
  - The other extreme is the **manufacturing core** - East Asia, especially China.
  - These cores are interdependent: US dependence on East Asia's exports, and East Asian reliance on US consumer and investment markets.
  - Other nations' global positions is measured in their distance from these two poles: City of London, say, vs. Vietnam or Bangladesh.
  - There is an **extensive peripheral margin**, whose member nations have risks along both dimensions – fragilities of provisioning, and financial fragilities.
    - We can make sense of remittances, guest labour in these terms (eg Philippines).

The global financial periphery and the Neoliberal global triad

- **Global financial fragility**: Here we have to go a step beyond Minskyian financial fragility, which involves the buildup of debt claims against an entity with finite cash flow/carrying capacity.
  - Country risk is one form: the possibility that a loan made to borrowers in a sovereign nation may not be able to pay, and that that sovereign nation could not make good on their loans
  - Exchange risk: the possibility that the value of assets or claims in a given currency may lose value (or become unpayable) because of the movement of global exchange markets against it.
  - Note that these forms of risk add to other forms of financial fragility.
- Nations at or near the core of both poles are immune from speculative attack. Other nations are exposed to global financial fragility
- Nations so exposed can offset this vulnerability by accruing defensive power:
  - Imposing inward capital controls
  - Imposing requirements on the productive use of foreign capital (FDI or borrowed funds)
  - Build up excess stocks of foreign-currency reserves
- **Defensive power** is defined as protection from speculative attack on national currency/asset values: the power to be left alone.
  - We see examples of countries building up excess reserve stocks – irrational except to backstop defense power.

Figure 4: Two Measures of Current-Account Balance, 2003-2019, India and Brazil
(Source: International Monetary Fund)



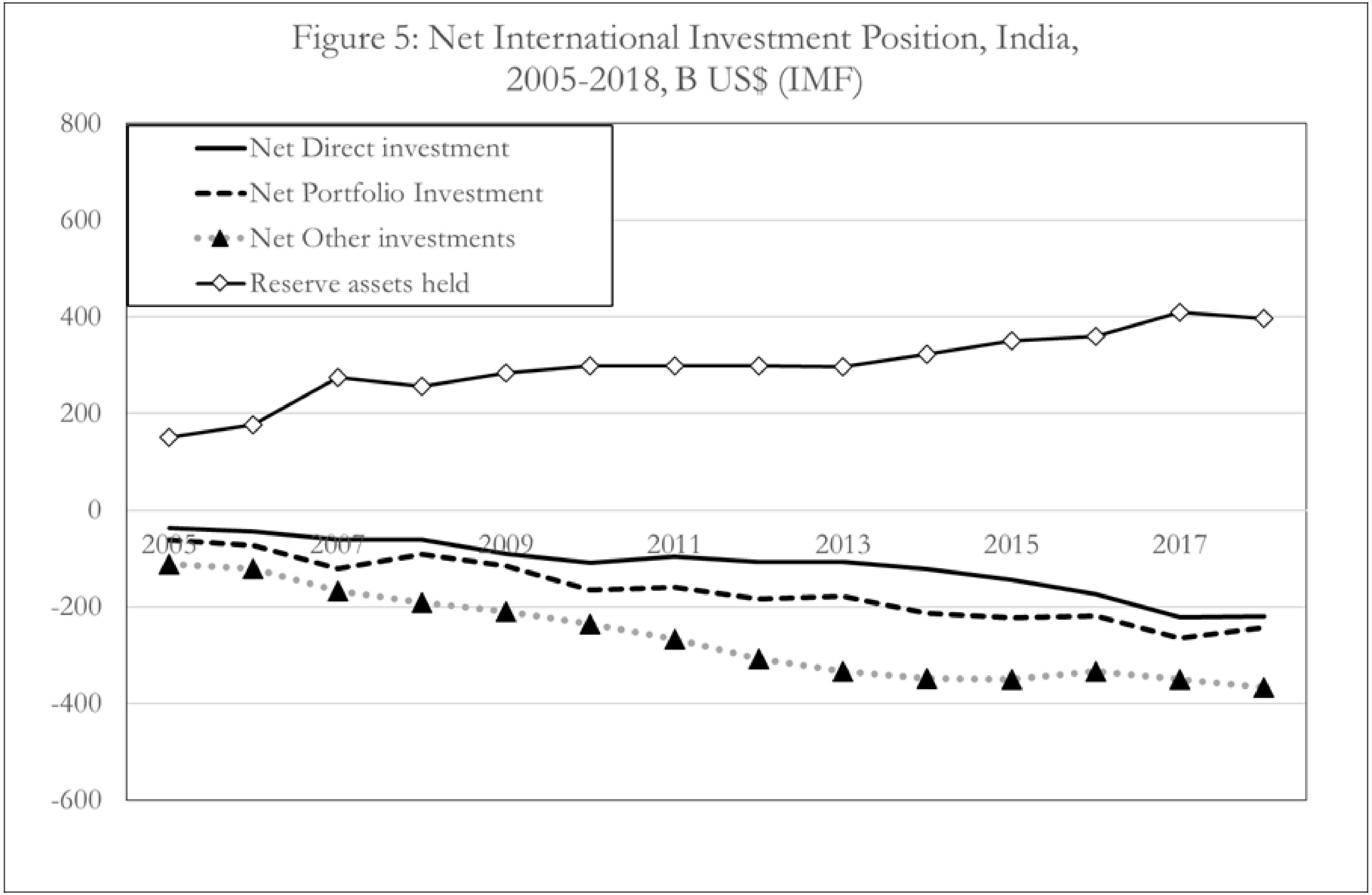


Figure 5: Net International Investment Position, India, 2005-2018, B US$ (IMF)
Net Direct investment
Net Portfolio Investment
Net Other investments
Reserve assets held
800
600
400
200
0
-200
-400
-600
2005
2007
2009
2011
2013
2015
2017

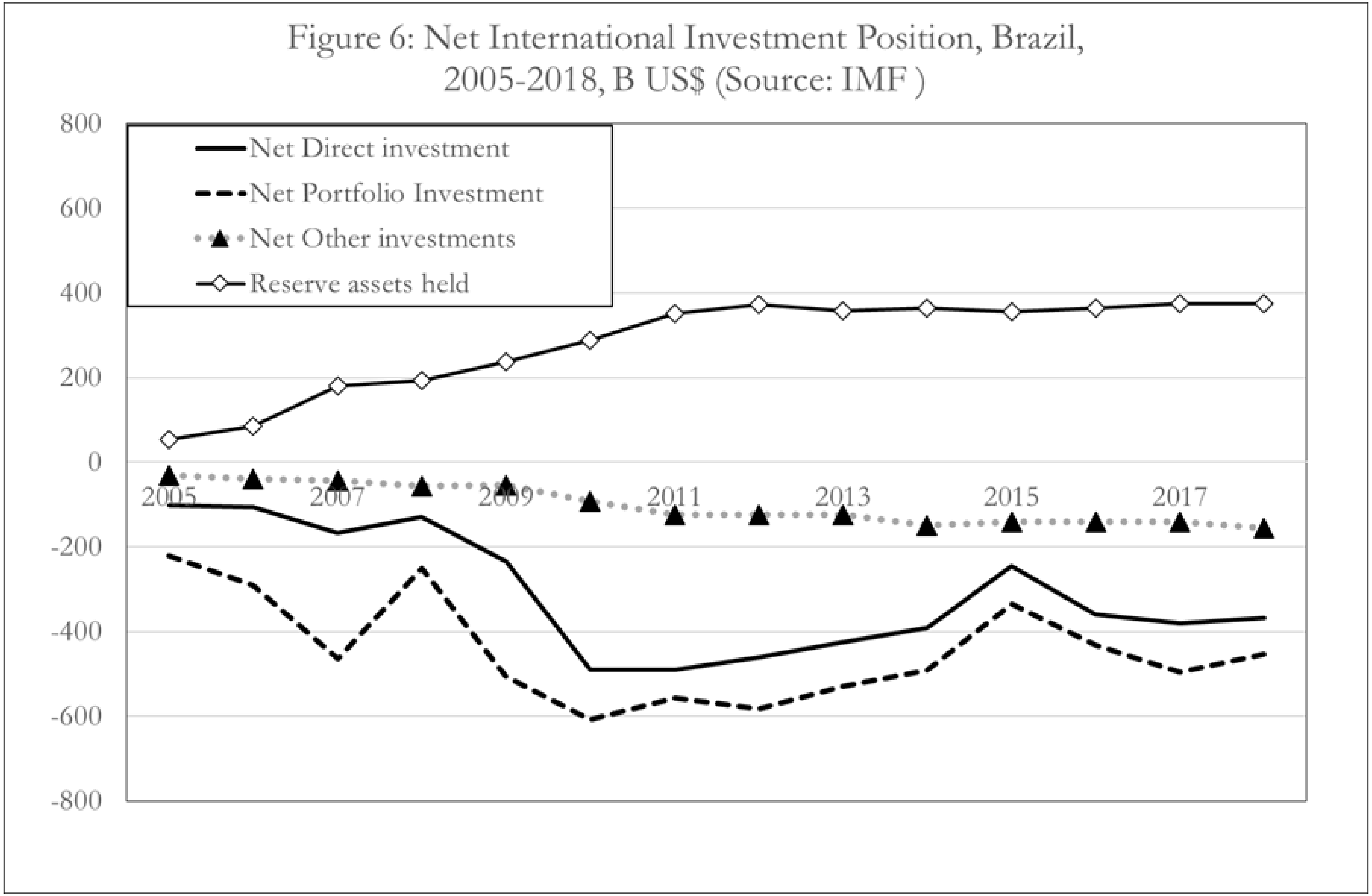


Figure 6: Net International Investment Position, Brazil, 2005-2018, B US$ (Source: IMF)
800
600
400
200
0
-200
-400
-600
-800
2005
2007
2009
2011
2013
2015
2017
Net Direct investment
Net Portfolio Investment
Net Other investments
Reserve assets held

Building financial barriers rather than infrastructure in Latin America

- The patterns observed in Figures 4-6 obtain for all of Latin America. [Figures 7-8]
- The subordinate global position of Latin America: primary exports exported to the imperial centre, underdeveloped industrialization – and thus dependency on other nation's industrial exports.
- Latin America remains trapped in uneven development:
  - The inadequacy of its nations' capacity to accumulate capital leaves it unable to build a proper industrial sector (Prebisch 1981).
  - This region's lack of industrialisation leaves it dependent both on exports from core countries (Furtado 1975, 1990) and on the US dollar.
- This peripheral position along both financial and industrial dimensions, combined with these nations' continuing dependence on the export of commodities, has created extreme – and politically volatile – extremes of wealth and poverty, and led to ever-increasing financialization.

Figure 7: Latin American Reserve Assets and Current Account Erosion

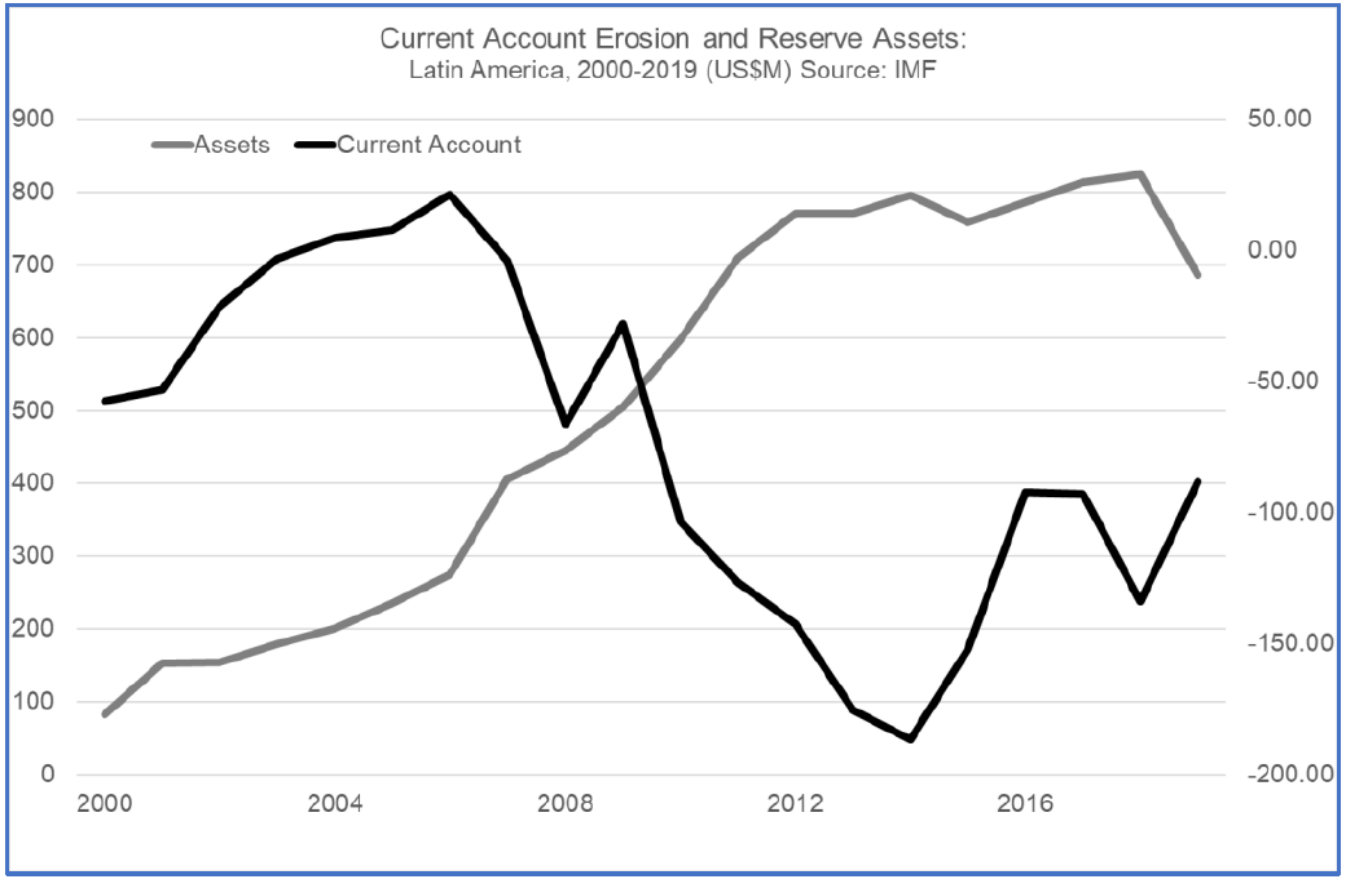
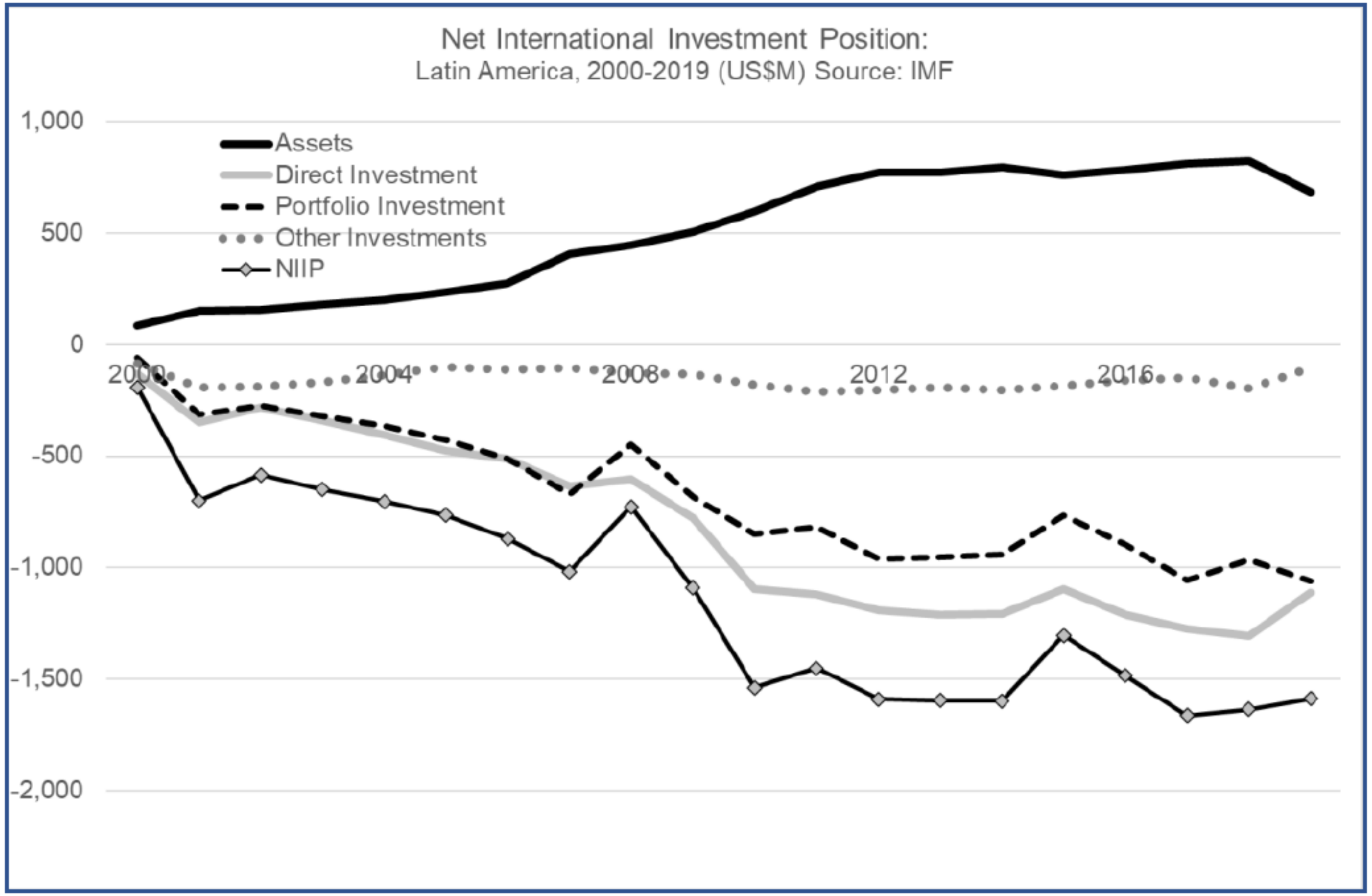


Figure 8: Latin American Net International Investment Position



The Latin American financial trap

The two arms of the trap

- On the one hand, the region's current account has both deterioriated and oscillated wildly in the last 20 years, due to its commodity-dependence.
- On the other, because of these nation-states' weak currencies, they've build up stocks of reserve assets.

Global megabank-centred shadow banks' guard-labour role

- Globalized financial firms will implement financial attacks to take gains from nations exposed to global financial fragility.
  - To avoid this, nations have to overborrow to protect themselves: building up reserve asset stocks even as their current account balances deteriorate.
  - It is not the poorest nations – the LIDCs – that are targets in this zero-sum speculative games; it is those in the middle-income tiers that are exposed. Latin American nations are nearly uniformly in this category – they constitute an 'asset class.'

Global cycle or spatial bind: Beyond the ‘excessively expansionary monetary policy’ and ‘shortage of safe assets’

- Borio’s notion that ‘excessively expansionary monetary policy’ may be the cause of the global financial cycle doesn’t apply to Latin America – as shown, its banking systems have been remarkably crisis-free. But it is exposed to the free movement of excess financial capital seeking bubble-driven growth opportunities.
- And what Rey and her co-authors ignore is that the US does not just provide ‘safe assets’: maintaining its pole position on the financial power axis, given its weak manufacturing base, requires that it backstop its megabank-dominated shadow-banking sector.
  - And these megabanks and the hedge funds and investment entities gathered around them take zero-sum actions that sustain the ‘unsafety’ of nations outside of the dual global power nexus.
  - Indeed, the US is in a ‘unilemma’ category: it has to maintain low interest rates, absorb unwanted financial assets, and sustain liquidity. This is not a choice, if its position at the centre of global financial power is to be sustained.

Conclusion

- The post-crisis literature on global financial cycles argues that deregulated flows of global finance constitute an unstoppable force that limits the autonomy of national macroeconomic policy.
- The trio of factors highlighted here, which represent structural features of the global macro-financial system, are not considered in these mainstream explanations. Why not? lack of a Keynesian analytical foundation, and their inattention to the problem of power.
- Latin America's subordination – currency instability, the withering of manufacturing capacity, and dependence on foreign capital and credit, and currency – are a consequence of the asymmetric structure of global financial power, in the midst of a world system with a polarized structure of global manufacturing/trade.
- The support pillars sustaining this system, which creates and recreates global financial fragility and imposes stagnation and losses on people throughout the world – that is, the global megabanking system and the key currencies' central banks – remain in place, even as the political foundations of the global order give way.