

EXTERNAL FINANCIAL LIBERALIZATION IN DEVELOPING COUNTRIES : SOME ADVERSE CONSEQUENCES

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Liberalization of capital movements under a high inflation regime in a developing country would most likely lead to an uncontrolled growth of the external debt. Adverse consequences on either the rate of investment or on the trade balance are likely to follow as well. These results are valid as long as developing countries face higher rates of inflation and larger margins between loan and deposit interest rates than those observed in capitalist metropolises. Under these conditions, exchange and interest rates lose their traditional and effective functions and policy makers face extremely difficult options.

I. INTRODUCTION

Liberalization of capital movements from and to the national economy, or **external financial liberalization**, is usually considered the final component of the orthodox adjustment operation in developing countries as advocated by the Bretton Woods institutions and implemented by many Third World countries during the past decade. In practical terms it means that local agents are allowed to acquire assets and liabilities denominated in convertible currencies ("dollars" in this paper) either at home or abroad. More specifically, as a result of external financial liberalization, (i) local rentiers are allowed to move their funds into dollars or dollar-denominated deposits, bonds and shares; (ii) local firms are allowed to borrow in dollars from local or external financial institutions; (iii) local banks are authorized to act either as legitimate intermediaries or as independent agents with respect to these operations; and (iv) barriers faced by external agents (rentiers, firms and banks) with respect to capital movements into and out of the country are lifted.

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Such changes cannot be realized unless restrictions on foreign exchange operations are lifted as well. At one stage in this liberalization exercise, the prime minister (or president) may proudly announce the convertibility of the national currency.

This liberalization operation may be seen as the second stage either of financial liberalization (following the **internal** liberalization of the financial system) or of external economic liberalization (following **trade** liberalization). Hence its characterization as either external financial liberalization or liberalization of capital movements. In the end, the financial system, money and capital markets of the developing country are interlinked (and, as we shall see, become subservient) to the international financial system. The most cosmopolitan segment of the bourgeoisie, i.e. "rentiers", lose most of their remaining economic links with their country of origin. For "firms", i.e. entrepreneurial (incorporating predominantly industrial) bourgeoisie, external finance becomes a nearly complete substitute for local finance. Public agencies, state enterprises, local and even central government may start to behave like "firms"; and in due time and under favourable circumstances borrowing abroad may become a substitute for taxation or borrowing at home. These changes have serious implications for the "real" side of the national economy: Liberalization of capital movements has definite impacts on the current account items of the balance of payments, particularly for the trade balance and on the rate of capital accumulation.

The 1980s have witnessed a number of developing countries liberalizing their capital movements. Despite reversals, i.e. financial crises and the unforeseen explosion of Third World external debt, a number of countries in Latin America and a few in Asia have, at present, more "liberal" rules for foreign exchange operations than some OECD countries. This paper will study some of the inevitable adverse outcomes of such an orientation. It will be shown that as a result of external financial liberalization, various elements of the national economy are gradually dominated by the variables of the international financial system and such a development disarms the developing country of some powerful policy tools traditionally used to influence the real side of the economy. It will also be demonstrated that an uncontrolled growth of the external debt turns out to be more or less inevitable under conditions of "liberalized" capital movements.

2. RATE OF INTEREST, EXCHANGE RATE AND CAPITAL MOVEMENTS

Let us specify the determinants of the direction of international capital movements in a "liberalized" environment. If the analysis will involve a developing country, it has to differentiate between the relevant agents, i.e. **rentiers** (or, if you will, "speculators"), **firms** and **banks**. Rentiers are interest-earners and they also aim to make capital gains from their assets. Firms are borrowers and, hence "interest-payers". Banks are intermediaries; but under developing country conditions they may be acting as institutional rentiers on the basis of their foreign exchange and government bond holdings. (Capital gains from the former and interest-revenue from the latter group of assets are usually exempt from taxation.) Depending on the relevant variables, they may also borrow abroad and lend at home. Banks, however, will be left out of the following analysis which will be structured on the distinction between rentiers and firms.

We are assuming conditions where the developing country's currency can be converted to the dollar freely via an exchange rate E (defined as local money, e.g. TL per dollar) and differential interest rates (in terms of national currencies) prevail between countries. The **expected** annual rate of change of E is represented by (e) . **Domestic** and **external** average interest rates available to rentiers (via bank deposits, Treasury bills, government bonds, etc.) are represented by i_{dd} and i_{ed} , respectively. (For simplicity, let us envisage only interest rates on time **deposits** at home and abroad when using these last terms.)

If we disregard the option of holding dollar assets (e.g. dollar deposits) at home, a rentier with an initial fund K can shift his funds into dollar assets abroad or into domestic assets and compare the alternatives by the end of the period in dollar terms: If he "invests" in dollar deposits, by the end of the period his funds (in dollar terms) is expected to grow into $(1+i_{ed}) K$. If he shifts his funds into deposits in domestic currency his "investment" in **dollar terms** grows into $(1+i_{dd}) EK / E (1+e)$.

Disregarding risk differentials, the rentier will be indifferent between keeping his "capital" at home and abroad when:

$$(1+i_{cd}) K = (1+i_{dd}) EK/E (1+e)$$

Simplifying this equation, the "neutrality condition" between local and external money markets becomes:

$$i_{dd} - (i_{cd} + e + e.i_{cd}) = 0 \quad (1)$$

This equation provides the basic relation specifying capital movements based on rentiers' behaviour. Let us call its left hand side B_1 . When $B_1 = 0$, rentiers are indifferent between investing at home or abroad. When $B_1 > 0$, rentiers move into local deposits and when $B_1 < 0$ they tend to move into dollar deposits abroad. In terms of the impact of these choices on the balance of payments of the developing country, *ceteris paribus*, an increase in i_{dd} compared with i_{cd} would, after a threshold, lead to capital imports into the country. If these conditions are reversed, rentiers' behaviour would result in capital exports from the developing country - a phenomenon also labelled as **capital flight**. These types of short-term international capital movements mobilised by rentiers are also referred to as "hot money" inflows or outflows.

Let us immediately reject a neoclassical interpretation of the foregoing relations. "Rentiers' capital" incorporated in this analysis is not synonymous with the category of "capital" in the production function terminology and neither is the rate of interest offered to rentiers synonymous with the rate of return to capital as a factor of production. Therefore, it does not follow that the $B_1 > 0$ condition is normally expected to prevail in a developing country due to capital scarcity leading to capital imports. As will be shown later on (and as the recent experience of capital flight from Latin America has shown), the movement of "rentiers' capital" is far from being uni-directional.

Equation (1) can also be rewritten from the viewpoint of firms' borrowing patterns. Let i_{dc} and i_{cc} represent rates of interest in local currency or dollar-denominated credits at home and abroad, respectively. Disregarding differences in having access to local or external financial markets, a firm in the developing country would be indifferent between borrowing at home and abroad when:

$$i_{dc} - (i_{cc} + e + e.i_{cc}) = 0 \quad (2)$$

Let us call the left hand side of Equation (2) B_2 . When $B_2 = 0$, local firms are neutral between borrowing at home or abroad. When $B_2 > 0$, firms find local interest rates too high and tend to borrow abroad, leading to short-term capital imports in the balance of payments. When $B_2 < 0$, firms borrow at home.

Equations (1) and (2) are linked by the prevalence of a constant proportional margin between local credit and deposit interest rates:

$$i_{dc} / i_{dd} = a \quad \frac{\text{rate of interest in local currency}}{\text{dom. avg int. rate to rentiers}} = a \quad (3)$$

It follows that, under conditions of a liberalised regime of international capital movements, *ceteris paribus*, when local interest rates rise both rentiers' and firms' behavior would lead to capital imports once $B_{1,2} > 0$ (and vice versa). Under conventional assumptions capital imports (exports) would -either directly or indirectly- lead to a corresponding increase (decrease) in net external debt. However, this statement -and any outcome- which assumes smooth and symmetrical capital movements in both directions in response to interest and exchange rate changes has to be qualified and modified due to a number of structural features specific to developing countries.

3. QUALIFICATIONS AND MODIFICATIONS

The foregoing framework for analyzing short-term international capital movements can only serve as a **starting point**. A number of qualifications is required, particularly if the analysis involves capital movements between a developing country and the "external world", i.e. the international financial system.

Non-identical Behaviour Patterns

The first set of qualifications is related to non-identical behaviour patterns between "domestic" (i.e. developing country's) and "external" agents: For "external" rentiers, i.e. international speculators, total mobility is the rule; there is no "sociological" preference for any market. Rentiers from developing countries, on the other hand, have a definitely stronger tendency to keep their assets abroad once they have done so. Recent observations on Latin America and elsewhere suggest that complete and full repatriation of flight capital never

takes place even when economic conditions leading to capital flight in the first place are fully reversed.

Another non-symmetrical dimension is related to the impact of reserve movements: When the Central Bank of a developing country builds up its international reserves, it rarely uses them to reduce its stock of external debt. Increased imports is the most likely response. But when capital flight may lead to an erosion of reserves, it usually leads to external borrowing. This lack of symmetry creates a bias in favour of debt growth.

Similar observations can be made on the non-identical behaviour patterns of local vs. external firms, as well as local firms' approach to local vs. external finance. Regardless of the relevant parameters, firms from developed countries rarely use developing country banks for their finance. Given the opportunity and under favourable conditions, developing country firms have no inhibitions on that score. However, international finance is open to the select few in a developing country and smaller fry would either be excluded altogether or would face heavier conditions.

Another example of "non-symmetrical" behaviour relates to those developing country firms with external debts: Even when internal loan interest rates decline and e (expected rate of devaluation) rises, they rarely borrow locally so as to pay off their dollar debts although Equation (2) above would be expected to induce such behaviour. Such unrestricted and "footloose" use of borrowed funds is not, as a rule, allowed by developing country banks. Changes in (i) and (e) would therefore affect agents in developing and developed countries in a non-symmetrical fashion - a complication which Equations (1) and (2) do not incorporate.

For many countries, there may be a level of the external debt beyond which higher interest rates cannot induce short-term capital imports any further. This case of inelasticity of hot money inflows to increases in local interest rate is specific for developing countries. That is why the World Bank closely follows external debt indicators of developing countries, whereas no such monitoring is exercised for the external debt of the U.S.¹

The response of rentiers and firms *vis-a-vis* changes in interest may also exhibit non-symmetrical features. The rate of change on the exchange rate relevant for the foregoing analysis is always -both for rentiers and firms- an **expected** magnitude whereas things are a little bit more complicated with respect to the interest rate: id_d for rentiers is always a given and specific contractual rate; but variable loan rates are the rule for developing country firms borrowing under conditions of high and volatile inflation. This transforms i_{dc} in many cases to an **expected** rate as well. Rentiers and firms, therefore, may respond in differential and, at times, conflicting fashion to changing interest rates or expectations thereof. This adds another element of unstable and unpredictable behaviour to the analysis.

The Paradox of Capital Flight

Another and very important qualification is due to the phenomenon of **capital flight**, something which is peculiar to developing countries. If we consider capital movements between developed countries, hot money inflow increases the external debt of the "capital-importing country" and hot money outflow reduces its net debt. But when the country in question is a developing country, the outflow is considered **capital flight** and hot money movements in both directions increases the external debt of the country.

The mechanisms through which capital flight (i.e. export of capital) paradoxically increases the external debt of the "capital-exporting" country is beyond the scope of the present paper. But the facts are indisputable: Quantitative estimates relating rentiers' assets held abroad to external debt growth have been made for Latin American countries². Such assets belonging to rentiers from a specific developing country are not considered by international finance as belonging to the relevant country and, hence, they do not cancel out the debt increment which may have occurred due to capital flight. Such an outcome is not usual for developed countries.

Capital Movements vs. Currency Switching

If holding dollars and opening dollar deposit accounts at local banks are allowed, "shifting into dollars from the local money or *vice versa*" does not signify capital flight or hot money inflow; it merely represents **currency**

switching. Currency switching becomes a substitute to hot money movements, but without having direct implications *per se* for balance of payments. There are indirect impacts, however. Dollar deposits are highly sensitive to the state of confidence and when this deteriorates, capital flight may replace the former. Therefore interest rates higher than international rates are the rule for dollar deposits. External rentiers may move in and their deposit accounts are considered part of the external debt stock whereas residents' accounts are not.

The counterpart of dollar deposits is dollar credits to local firms at higher than international rates of interest. When loan interest rates in terms of local money are high, this may appeal to those firms which face difficulties of access to external banks. This pattern of dollarization of the economy is specific to developing countries which have committed themselves to external financial liberalization. No similar and parallel situation exists in developed capitalist economies: There are no peso or TL accounts in the financial systems of Western countries and, hence, switching into or borrowing in the currency of the developing country does not take place within developed money and capital markets. This is another lack of symmetry with respect to capital movements.

Inflation and Margins Between Deposit and Loan Interest Rates

The absolute margin between deposit and loan interest rates are significantly larger in developing countries than the developed countries. This is due to two factors: Higher rates of inflation leading to higher nominal base interest rates and the prevalence of a **proportionate** relation between deposit and loan interest rates. To give an example, the relevant coefficient between the two rates is a more or less stable magnitude of 1.4 in Turkey and this is the parameter to be used in the numerical example in the next section. A number of institutional, structural and fiscal factors are responsible for the existence of a proportionate link. We cannot go into a discussion of these factors except observing that narrowing the margin significantly has proved an almost impossible task in most cases.

The implications are very serious. When analyzing short-term capital movements between two economies, if the margin between deposit and credit rates is around two percentage points in both countries, one can use

either deposit or loan interest rates to analyze the direction of capital movements and usually arrive at the same conclusion. But -to use the example in the next section- if deposit interest rates are 60% due to high inflation and -on the basis of a coefficient of 1.4- loan rates are 84%, the margin becomes 24 points and one can no longer discuss the second country as if **de facto** a single rate of interest prevails. Behaviour of rentiers and firms may lead to capital movements in opposite directions under these circumstances. The full implications of such a situation has to be investigated separately in what follows.

4. CAPITAL MOVEMENTS, CURRENT ACCOUNT AND INVESTMENT UNDER DIFFERENT POLICY OPTIONS

Let us now investigate problems faced by policy-makers in a developing country with an exogenously given high (but not hyper-) inflation (e.g. $p_d = 60\%$) and which has decided to move in the direction of liberalizing capital movements. External inflation (p_e), deposit (i_{ed}) and loan (i_{ec}) interest rates (7%, 10% and 12%, respectively) are also exogenously given. The only potential policy tools are the exchange rate (E or e , expressing the proportional change in E) and either the deposit or loan interest rates (i_{dd} and i_{dc} , respectively), since there is a constant proportionate margin between the two ($a = 1.4$ in Equation (3) above).

Liberalizing capital movements means that either rentiers or firms or both can move into local and external assets and liabilities. We assume away the qualifications made in the preceding section on the different behaviour patterns of local vs. external agents, on currency switching and on borrowing in dollars in the local market. Given the external parameters, their choice depends on local exchange and interest rates: Deposit rates for rentiers, loan rates for firms are the relevant variables in conformity with Equations (1) and (2) above.

The policy maker, however, is also facing other problems: His policy variables, i.e. the exchange and (loan) interest rates, are also determinants of the current account (in particular, the trade balance), of the balance of payments and of the rate of investment, respectively. An unchanging real exchange rate in terms of purchasing power parity is defined as

$$(1+e) - [(1+p_d) / (1+p_c)] = 0 \quad \dots (4)$$

Labelling the left hand side of Equation (4) as C and taking a conventional view with respect to the impact of real devaluation on the balance of payments, the current account improves when $C > 0$ and vice versa. $C = 0$ signifies stability in the current account deficit (surplus) (See Row 8 of Table 1).

On the other hand, we consider real loan interest rates exceeding 10% unsustainable in view of their adverse impact on the rate of investment. More specifically, an unsustainable state of things with respect to investment policy prevails when, first of all, $[(1+i_{dc}) / (1+p_d)] - 1 > 0.1$ for domestic credits; and, secondly $[(1+e)(1+i_{ec}) / (1+p_d)] - 1 > 0.1$ for external credits (in terms of local currency) (See Rows 4 and 5 in Table 1). We reject, both on theoretical and empirical grounds, an approach based on a positive savings response to the deposit interest rate and disregard other determinants of the trade balance and of the rate of investment.

If a partially "managed" system of interest and exchange rate determination continues to prevail despite the liberalization of capital movements, the problem for the policy maker is to find an exchange rate which creates a current account deficit (surplus) and an interest rate which would just exactly create the capital inflow (outflow) to cover the deficit (surplus); but, moreover, the real (internal and external) interest rate in terms of the local currency should not exceed a level for sustaining a viable rate of investment. As we have shown, the exchange rate also becomes a determinant of the external real rate of interest when it is calculated in terms of the local currency. Such a problem is insolvable because -since loan and deposit interest rates are linked via a constant coefficient- there are two policy variables (e and i), but three variables (current account, capital movements, and investment) are expected to be endogenously determined. In a situation where (E) and (i) are determined by market forces, the set of equilibrium prices that the market will produce is unlikely to generate a satisfactory set of values for the three target variables simultaneously. The large margin between loan and deposit interest rates complicates the situation still further. The liberal's expectation that market prices will to resolve all problems is an unrealizable dream.

Table 1 : Impact of Interest and Exchange Rates on Balance of Payments Under Different Policy Options

Exogenous Variables or Parameters: $p_e = 0.60$; $p_c = 0.07$; $i_{ed} = 0.10$; $i_c = 0.12$; $i_{de}/i_{dd} = 1.4$.

	Option_A	Option_B	Option_C	Option_D	Option_E	Option_F	Option_G
(1) Rate of change in E (e)	0.645	0.346	0.495	0.495	0.495	0.403	0.571
(2) Local depo. int. rates (i_{dd})	0.760	0.760	0.543	0.645	0.482	0.543	0.543
(3) Local loan interest rates ($i_{de} = 1.4i_{dd}$)	1.064	1.064	0.760	0.903	0.675	0.760	0.760
(4) Real local loan interest rates $((1+i_{de})/(1+p_d))-1$	0.290	0.290	0.100	0.189	0.047	0.100	0.100
(5) Real external loan int. rates $((1+e)(1+i_c)/(1+p_d))-1$	0.151	-0.058	0.047	0.047	0.047	-0.018	0.100
(6) Interest rate inducement to borrow abroad $((4)-(5))$	0.139	0.348	0.053	0.143	0	0.118	0
(7) Interest rate inducement for hot money inflow $(i_{dd}-(e+i_{ed}+e i_{ed}))$	-0.049	0.280	-0.102	0	-0.163	0	-0.186
(8) Real change in E $((1+e)(1+p_e)/(1+p_d))-1$	+0.100	-0.100	0	0	0	-0.062	0.051

For symbols, definitions and relations, see text.

NOTES ON POLICY OPTIONS:

- Option_A: Real devaluation of the local currency ($e=0.645$); a high positive real interest rate for deposits (+10%) is targeted.
- Option_B: Real appreciation of the local currency ($e=0.346$); interest rate policy same as Option A.
- Option_C: Exchange rate is set with a view to neutralizing its current account impact ($e=0.495$) and the maximum real loan interest rate for a viable investment rate $((1+i_{de})/(1+p_d))-1 = 10\%$ is targeted.
- Option_D: Exchange rate policy same as Option C; deposit interest rate is set so as to neutralize renters' hot money movements.
- Option_E: Exchange rate policy same as Option C; loan interest rate is set so as to neutralize firms' borrowing decisions.
- Option_F: Interest rate policy same as Option A; exchange rate policy is used to neutralize renters' hot money movements.
- Option_G: Interest rate policy same as Option A; exchange rate policy is used to neutralize firms' borrowing decisions.

Such a situation poses a number of policy options and we shall examine these on the basis of a numerical example set forth in Table 1 under seven groups (Options A to G). The symbols and relations in the table are those already defined or discussed in the text. Although it is a hypothetical table, the local inflation rate (60%) and the possible magnitudes of the policy variables are based on the existing situation and policy discussions in Turkey.

Let us now attempt to elaborate the policy alternatives covered in the table and relate some of them with some developing country experiences.

Option A: This policy option represents orthodox stabilization and structural adjustment, at least in its initial stages. A high real positive rate of interest (+10%) to savers is offered and there is significant real devaluation of the local currency ($e=0.645$). When inflation is high, this signifies exorbitant domestic and external real interest rates for borrowers. In our numerical example, although external borrowing (in terms of local currency) is cheaper than local credits, both rates are so high in real terms that the outcome must be a declining rate of investment and stagflation. Trade balance improvement (i.e. a positive "current account impact" as set forth in Row 8) and a weak propensity to borrow abroad may compensate for a somewhat moderate inducement to capital flight (Row 7). If controls on firms' borrowing are lifted, but controls on rentiers' dollar assets are still in force, the growth of external debt may be kept under control. This corresponds roughly to the Turkish situation between 1981-84: This was a period when rentiers' dollar holdings were still under effective control. The average of annual changes for the official price of the dollar in real terms was 10.6%; under contractionary demand management average real local credit interest rates were 14.4%³ and the average annual growth of the external debt was a modest 6.1% reflecting the changes in the current account deficit.

Option B: This policy alternative represents the "new orthodoxy", i.e. the so-called monetary approach to balance of payments as implemented by Chile and Argentina during the late 1970s-early 1980s and the Turkish situation in the late 1980s and 1990: Real appreciation of the local currency is targeted (or even announced via the famous tablita) as in the Southern Cone of

Latin America. The Turkish variant has been to float the local money during a period (i.e. in 1989) when -due to a low growth rate and high local interest rates- international reserves were high leading to overvaluation of the local currency (average of annual changes in the dollar's price in real terms was -11% in 1989-90). Local interest rates are kept high so as to attract hot money inflow and induce firms to borrow abroad. In the Turkish case, real deposit interest rates for 1985-1990 averaged about 7% and real credit rates about 30%. In the numerical example of Table 1, this situation creates a strong impetus for hot money inflow and external borrowing of firms as observed in Rows 6 and 7. The outcome is an explosion of the external debt. This is what happened in the Southern Cone and a similar pattern is observed in the Turkish case where annual average growth of the external debt was about 16% during 1985-1990⁴.

Option C: This variant represents a case where, under pressure from Washington circles, the government has been pushed to liberalize international capital movements; but policy makers are still committed to use exchange and interest rates with a view of their impacts on the current account and the rate of investment: they target the exchange rate for a neutral current account impact ($e=0.495$ in the Table) and a 10% real credit interest rate ($i_{dc}=0.760$) with a view to sustain a viable investment rate. The solutions in the table produce no major inducement for firms to borrow abroad, but rather a definite inclination for rentiers to shift their resources abroad, i.e. capital flight. Unless exchange controls on rentiers are implemented, capital flight will -sooner or later- contribute to an explosion of the external debt as observed in Mexico and Argentina in the early 1980s.

Options D to G: These scenarios are "half-way houses" between external financial liberalization and an orientation on the part of policy-makers to control **either** the real exchange rate or the real interest rate for borrowers with a view on their real impacts. In Options D and E, policy makers target an unchanging real exchange rate ($e=0.495$) to neutralize current account impact and use the interest rate to control capital movements. But they can neutralize **either** rentiers' tendency towards capital flight vs. hot money inflow (Option D), **or** firms' inclination to borrow abroad or at home (Option E). In other words, given (e), the (i_{dd}) value from Equation (1) (Option D) or the (i_{dc})

value from Equation (2) (Option E) will be calculated. In the former case, there emerges a strong tendency for firms to borrow abroad (Row 6 of Option D) and control on firms' borrowing become necessary if an uncontrolled growth of the external debt is to be prevented. In the latter case, there emerges a strong tendency for rentiers towards capital flight (Row 7 of Option E) and unless rentiers are put under strict control the consequent and ultimate debt explosion is inevitable. In both cases, the real interest rate turns out to be fairly high for a viable rate of investment (Rows 4 and 5).

In Options F and G, policy makers target a viable positive rate of interest for credits ($((1+i_{dc})/(1+p_d))-1 = 0.10$) with a view to its impact on the rate of investment and use the exchange rate as the policy variable for controlling capital movements. But they can neutralize either rentiers' tendency towards capital flight vs. hot money inflow (Option F), or firms' inclination to borrow at home or abroad (Option G). In other words, given (i_{dd}) or (i_{dc}), the (e) value from Equation (1) (Option F) or from Equation (2) (Option G) will be calculated. In the former case, there emerges a strong tendency for firms to borrow abroad (Row 6 of Option F) and unless controls on firms' linkages with external finance are implemented, an uncontrolled growth of the external debt will follow. Moreover, the exchange rate of the local currency turns out to be overvalued leading to growing current account deficit (Row 8). In the latter case, there emerges a definite tendency towards capital flight on the part of the rentiers with the usual and ultimate consequences on debt growth.

The foregoing analysis suggests that under a high inflation regime in a developing country, fully-fledged liberalization of capital movements which "liberates" both rentiers and firms from exchange controls and from traditional restrictions on moving into external assets / liabilities would most likely lead to an uncontrolled growth of the external debt. Adverse consequences on either the rate of investment or on the trade balance are likely to follow as well. These results are valid as long as developing countries face higher rates of inflation and larger margins between loan and deposit interest rates than those observed in capitalist metropolises.

5. CONCLUSIONS

In the "good old times" when economic policies in developing countries were oriented towards **real** objectives such as overall growth, industrialization, self-reliance and income distribution, external debt growth of an economy depended on the rate and pattern of economic growth. Depending on the import coefficients of investment, current production and consumption⁵, the rate and structure of growth determined the import bill of the economy (consisting of payments for imports of capital, intermediate and consumption goods, respectively) and the consequent current account deficit⁶ had to be covered by external borrowing. Under such circumstances, the size of the external debt stock roughly equalled the cumulative current account deficits plus the initial stock⁷.

Under conditions of a liberalized external financial system, the link between economic growth and external debt no longer prevails. Hot money movements and firms' borrowing patterns responding to fluctuations in interest and exchange rates dominate capital movements in and out of the developing economy. Let us note that this is also a period of increased and extremely high volatility in exchange and interest rates. The two phenomena, i.e. high volatility in these rates and in capital movements are closely related. Under these circumstances growth of external debt loses its logical link with current account deficits. Countries with modest deficits (or even occasional surpluses in their current accounts such as Argentina) suddenly find out that they have accumulated huge stocks of external debt. Changing those economic variables which may have contributed to debt growth does not reverse the situation, because these movements are the outcome of non-symmetrical behaviour patterns of agents in developing vs. developed countries or of developing country agents in domestic vs. international money/capital markets. It follows that once the step towards external financial liberalization is taken, external debt starts to grow in an uncontrolled and unpredictable fashion and this process continues regardless of quantitative changes in policy parameters until the time when servicing the debt becomes unmanageable and the country moves into a debt crisis.

International finance capital's solution to the debt crisis is well known: "Keep the capital account of your balance of payments open; service your debts by creating a surplus on your current account by means of extreme

austerity." This means net transfers abroad, a serious erosion of the productive capacity of the economy and the impoverishment of popular classes. The bourgeoisie and the rentiers in particular had been the agents responsible for the explosion of the external debt; but it will be the fate of the popular classes to shoulder the burden of the same debt.

As long as they keep following the orthodox recipe, policy makers are in a fix: The policy variables (e) and (i) have lost their traditional and effective functions and they are now manipulated so as to control the adverse and harmful behaviour patterns of the parasitic elements of the bourgeoisie. But these new patterns of behaviour were created by the same policy makers: Dr. Frankenstein (the policy maker) after creating the monster (external financial liberalization) observes its destructive activities (uncontrolled debt growth); but instead of putting the monster back to sleep (bringing back traditional controls), uses all the means under its control (interest and exchange rate policies) to tame the untameable creature. This is, in short, the dismal story of external financial liberalization in developing countries during the past decade.

NOTES

¹ See Ros (1989) in this context.

² See, *inter alia*, Rishi and Boyce (1990) and Pastor (1990).

³ For real exchange rate movements and real deposit and loan interest rate series in Turkey, see Uygur (1991).

⁴ No correction has been made for the change in the stock of debt calculated in dollar terms due to fluctuations in the cross rates of major currencies.

⁵ Let us recall, however, that investment strategies under the so-called import substituting industrialization pattern aimed at realizing long-run declines of these import coefficients.

⁶ During the decades following the Second World War, systematic and structural current account deficits prevailed for most developing countries and surpluses were the exception.

⁷ The main correction which this method requires is recalculating total debt in constant dollars in response to changes in cross rates of major currencies in those cases when the stock of the external debt incorporated more than one currency. Reserve changes are disregarded.

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ÖZET

**DIŞ FİNANSAL SERBESTLEŞME : GELİŞMEKTE OLAN
ÜLKELERDE BAZI OLUMSUZ SONUÇLAR**

Gelişme yolundaki ülkelerde yüksek enflasyon koşullarında sermaye hareketlerinin serbestleşmesi, dış borcun kontrolsüz büyümesine yol açabilecektir. Yatırım oranı veya ticaret dengesi üzerinde olumsuz sonuçlar gözlenmesi olasıdır. Dış dünyaya göre daha yüksek bir enflasyonun ve kredi ve mevduat faizleri arasında daha geniş bir marjın geçerli olduğu durumlarda bu sonuçlar beklenebilir. Bu koşullarda faiz ve kur politikası geleneksel işlevlerini yitirir ve çok güç politika seçenekleri gündeme gelir.

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