FINANCIAL POWER IN THE GLOBAL VILLAGE:
FINANCIAL GLOBALIZATION AND THE UNITED STATES

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ABSTRACT

This dissertation empirically investigates the roots and motives of financial globalization, and analyzes its various aspects and far-reaching influence on global financial markets. The existing research focuses on how technical development and market forces brought financial globalization, while this dissertation argues that the hegemonic financial power has greatly influenced modern financial globalization. Applying systems theory, hegemonic stability theory, and levels of analysis, it examines the structural power of the United States and its behavior in constructing globalization in international financial markets from an international political economic perspective. The United States has strenuously pursued bilateral and multilateral foreign policies to persuade industrialized countries and applied pressure on developing countries to participate in global financial liberalization. Due to this external pressure and domestic needs, developing countries opened their financial markets, and used foreign capital to finance their current account deficit and economic development. As financial globalization proceeded, volatile speculative short-term capital rushed into developing countries, which further opened their financial market without preparing a sound supervisory system and following proper sequencing. This caused serious policy dilemmas and frequently led to financial crises. Managing these financial disasters, the United States and international financial institutions (IFIs) designed a financial governance framework (New International Financial Architecture, NIFA) adopting various international financial standards, financial sector assessments, and encouraging transparency in monetary and financial policy by strengthening the role of IFIs. Many developing countries criticized that NIFA
facilitates unilateral policy reforms toward developing countries, and ignores a direct prescription to regulate hazardous speculative short-term financial capital. As an alternative proposal, global civil society groups promote the ‘Tobin tax,’ which imposes a steep tax on short-term financial capital inflows. However, industrialized countries are unwilling to accept this prescription. Through a critical evaluation of contemporary global governance of international finance, this dissertation highlights the need for a global forum to adjust various financial sector governance proposals, and a global disclosure system to monitor and control speculative capital motilities as alternatives to construct a stable international financial system.
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CHAPTER I

INTRODUCTION

1.1 Purpose of the Study

The main purpose of this dissertation is to empirically examine the roots and motives of financial globalization, and to analyze the various aspects and far-reaching influence on global financial markets through financial liberalization and globalization. The second objective is to examine the United States role and behavior as well as other supportive international organizations (the International Monetary Fund, the World Trade Organization, and the World Bank) in constructing financial liberalization and globalization from the international political economic perspective. The third objective is to explore the causal relationship between financial liberalization and financial crises in developing countries in general and South Korea specifically. The last objective is to search for global governance in international finance to construct stable international financial markets and to prevent future financial crisis.

Nearly all International Relations scholars agree that monetary and financial relations among countries are emerging as a critical area of study. Likewise, financial globalization has been widely recognized as a major phenomenon in the contemporary world. Moreover, the United States' role as a proponent of financial globalization, and the relations between the United States and other countries in the international financial system are essential to understanding international monetary and financial relations.

Since the late 1970s, the trend of financial liberalization in international financial markets has expedited free capital movement across borders and contributed to the
growth and development of the world economy. The tremendous volume of portfolio
investment, foreign direct investment, and uncontrollable short-term financial capital
flows in international financial markets has led to closer integration of financial markets
around the world. In 1973, the average global daily turnover in foreign exchange trading
was $15 billion, by 2001 this total was about $1.2 trillion.¹ The same year, the average
global daily turnover in over-the-counter (OTC) foreign exchange derivatives amounted
to $1.4 trillion.² As global financial liberalization has proceeded in recent decades,
international capital rushes to emerging financial markets. The total of net long-term
financial flows to developing countries tripled between 1990 and 1999 from $98.5 billion
to $290.7 billion. Furthermore, private capital flows highly grew nearly six-fold from
$42.6 billion in 1990 to $238.7 billion in 1999 and accounted for 82 percent of the total
flows, while the official capital flows decreased from $55.9 billion in 1990 to $52.0
billion in 1999.³

This present volume of global financial flows caused by financial globalization is the
most conspicuous trend in postwar international political economy. As the world
economy has continued to integrate into one global market, monetary and financial issues
have become one of the most important research areas for political science as well as
economics. This dissertation examines the roots of globalization in international financial
markets, and its far-reaching impact on the international system. It also analyzes the
political and economic reasons why international financial markets have so rapidly
become integrated into one global market. This thesis answers the following primary

¹ Bank for International Settlements (BIS), Triennial Central Bank Survey: Foreign Exchange and
² BIS, 15.
research questions. What are the key factors causing financial globalization? Why have nations opened up their financial markets? Have countries simply launched financial liberalization in their markets because of the development of new technologies and communication, or because of market pressure related to the expansion of international financial markets?

In this dissertation, financial liberalization means the deregulation or removal of all barriers to international transactions such as controls on financial investment, capital flows, and the purchase and sale of financial or real assets across borders. As long as this financial liberalization aims to lift restrictions on foreign investment, remove limitations on foreign ownership of assets, and eliminate exchange rate controls, it will promote free international financial transactions around the world. The fundamental belief of this thesis posits that financial liberalization was the starting points for free capital movements on a global scale as characterized by financial globalization. Financial globalization (globalization in international financial markets) in this dissertation means the process of integrating regional or national financial markets into one global financial market to promote free financial capital movement across borders. However, this dissertation argues that the real meaning of financial globalization goes beyond this simple definition. It identifies the United States as a hegemonic financial power that has highly contributed to financial globalization, after being confronted with the change of market forces and technological developments. The structural power of the United States in international financial systems and major international financial institutions (the International Monetary Fund and the World Bank) has accelerated financial globalization.

The financial power of the United States is illustrated through a variety of financial and economic data. The United States is the world’s largest financial market, exporter and importer in foreign direct and portfolio investments, and shareholder in major international financial institutions (the IMF and World Bank). Since financial globalization has been built by a hegemonic financial power, it probably contains that financial power’s cultural, political, and economic ideologies (neo-liberalism⁴ and the Washington Consensus⁵), and its national interests. The U.S. national interests originated from its domestic emphasis on liberalism and strong connection between the Treasury Department and Wall Street which drives its unflinching effort to construct and establish financial liberalization policies in the international financial system. Furthermore, the efforts of U.S.-led global financial liberalization is intended to construct a favorable world financial order primarily to maintain its dominant roles and priorities in the international financial system.

Generally, a dominant financial power tries to build a favorable international financial system by maintaining its existing rules and orders, in this case through promoting its policy of financial liberalization as a source of financial globalization. Previously, British political and economic interests reflected the 19th century international monetary and financial system. During the period from 1870-1914, the British (based on exploiting the cheapest raw materials from its colonies) largely invested in foreign government

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securities and foreign infrastructure such as railroads and port facilities. In contrast, in
the 20th and 21st century the United States depended on its position as the strongest
military and economic power to defeat aggressive, hostile forces in two world wars and
to build a liberal democratic world order after the end of the Cold War.

In recent decades, the United States has pressed other nations to open their financial
markets to assist U.S. financial capital investment. As the founder and largest investor in
the IMF and the World Bank, the United States makes use of these powerful financial
international organizations to construct a liberalized financial world order. Examples of
the United States' proactive role for financial liberalization and globalization include the
prominent role of financial liberalization after the collapse of the fixed exchange rate
regime of the Bretton Woods, input liberalization of financial services issues in the
multilateral trade rounds in General Agreement on Trade and Tariffs (GATT), the attempt
to legalize the Multilateral Agreement on Investment in the OECD, the enactment of the
Financial Services Agreement in the Uruguay Round, and the promotion of the
Strengthening Global Financial Architecture policy in the IMF.

Some scholars argued that the current financial globalization is not a new
phenomenon and actually represents a restoration of the pre-World War I levels when
capital moved freely across borders with few restrictions. However, the current financial
globalization is totally different in size and complexity from that period. At that time,
there were no computers and high technology innovations like the Internet, numerous
financial intermediaries, and financial transactions such as futures, swaps, global bonds,

International Economics, 1990), 7-38.
and other derivatives. In the nineteenth century, most trading in foreign exchange was to settle international trade among countries. Furthermore, financial transactions for financing trade only accounted for about two percent of the global currency movement of which substantial portions are foreign direct investment or short-term and highly speculative portfolio investment.

The old patterns of globalization were first disrupted by the Great Depression and two world wars which led most countries to focus on trade protectionism and strong capital controls as part of national strategies for survival. Since most countries believed capital outflows could deplete their foreign exchange holdings and make their exchange rates unstable, they often maintained capital controls and financial regulations. This was internationalized with the Bretton Woods agreement under which most governments extensively intervened in their economies and financial systems due to the needs of post-war reconstruction. However, after the collapse of the Bretton Woods fixed exchange rate monetary system in the late 1970s, the United States began to open up its financial market, and other industrial and many developing countries began to follow the path of financial liberalization.

Owing to the proactive role of U.S. financial liberalization, international financial markets could develop and increase the efficiency of the allocation of global capital, but the fruits of financial globalization were not evenly distributed in developing countries which have experienced recurrent financial crises. Contrary to the intention of U.S. neoliberals, financial liberalization stimulated a rapid expansion of financial capital, increased volatility, and instability in international financial markets. Financial

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6 Vincent Cable, “The Diminished Nation-States: A Study in the Loss of Economic Power,” in *What Future*
liberalization thus has made it difficult for any nation to regulate the huge amounts of speculative capital flows across borders and to be free from its harmful effects. The Bank of London, for instance, a well-developed financial market, was severely damaged by speculative financial attack and had to seek an IMF bail out. Similarly, many developing countries that have opened their financial markets, later experienced disastrous financial crises: Mexico and many Latin American counties in 1994-95 (again in Brazil in 1998-99 and Argentina and Uruguay in 2001-02), East Asian countries including five affected nations (Thailand, Indonesia, Malaysia, Philippines and South Korea) in 1997-98, Russia in 1998, and Turkey in 2000-01.

These recurrent financial crises make many scholars, including this author, question the real meaning of financial liberalization and financial globalization. For whose benefit does financial liberalization and financial globalization really operate? Could financial liberalization really improve the efficiency and development of international financial markets? Are there any causal relations between financial liberalization and financial crises in developing nations (Latin American Southern Cone, or East Asian Countries)? How could the international community prepare a global governance scheme to prevent future financial crises and build stable international financial markets? These research questions are also examined in this dissertation.

Based on lessons from the successful emerging market economies’ financial crises, the global community led by the United States, other G-7 counties, and major international financial institutions (IFIs) tried to build safety networks (global governance) under the name of *The New International Financial Architecture* (NIFA) to

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*for the States?, Daedalus 124, no. 2 (Spring 1995): 24.*
facilitate stable international financial markets and to prevent future financial crises. The NIF A mainly concerns fundamental economic reforms in the emerging market economies through various international financial standards, financial sector assessments, and transparency in monetary and financial policy to prevent financial crisis by strengthening the role of IFIs. To implement the NIF A, broad support from many developing countries is needed, especially to improve policy harmonization among these countries. Many global civil society groups criticize the NIF A for attempting to render unilateral policy reforms toward developing countries, and ignoring a direct prescription to regulate the hazardous speculative short-term financial capitals. As an alternative proposal to regulate short-term speculative capital volatility, which is asserted to be one of the main causes of financial crises in developing countries, many civil society groups try to convince the global community to introduce the ‘Tobin tax’, which imposes a steep tax on short-term financial capital inflows. However, many industrialized countries (including the United States) will not accept this extreme prescription because they are preoccupied with large capital exports and the option would restrict their policy autonomy.

Thus, the main contribution of this study can be summarized in the following four points. First, its tries to shed light on the nation-state actor’s role, particularly through the financial power of the United States, whereas most research has been focused on financial globalization from the rapid development of technologies and communication in the financial world. This research would add to the existing research and help to fill this gap. Second, it will examine financial globalization through an international political economic approach using both systems theory and levels of analysis. Existing research on this topic has mainly taken an economic approach, excluding politics, which has made it
difficult to explain the political factors associated with financial liberalization in a comprehensive context. Explanations about governmental behavior as the subject of financial liberalization policy decision-making, and the international or internal environments surrounding national actors could be analyzed through an international political economic analysis. This approach can encompass economic factors as well as political factors, and will analyze and define the topic in a more detailed and broad manner. Third, this work will provide meaningful policy alternatives and suggestions through the examination of the causal relationships between financial liberalization and financial crises. From the comparative case studies in developing countries (East and Southeast Asian countries and Latin America), we could understand common factors and more broad characteristics of the linkage between financial liberalization and crises, and come closer to a generalization. In addition, the case study of financial liberalization and crisis in South Korea sheds light on the gray area of U.S. financial liberalization policy toward developing countries. Although some scholars implicitly suggested that the United States had pressed the South Korean financial market opening, this dissertation clearly demonstrates the external pressure on the South Korean financial liberalization process. Fourth, this study will suggest a better understanding of financial globalization as a part of globalization in general and will help to analyze the broad features of international relations.
1.2 Organization of the Study

This dissertation consists of seven chapters. Chapter II presents this study’s research methods and various theoretical considerations and literature reviews about the historical background of capital control, financial liberalization, globalization, and financial crises. It debates the strengths and weaknesses of international systems theories, hegemonic stability theory, and level of analysis in analyzing financial globalization and the U.S. role in the transformation of the global financial systems. Through systems theory, the transformation in international financial systems from the control-oriented international financial system to the liberalized international financial system is presented. It also describes the usefulness of the levels of analysis research framework to examine the domestic concerns of the United States and South Korea toward financial market opening.

Chapter III elucidates U.S. financial power and its prominent role for financial liberalization and globalization. This chapter focuses on how and why the United States has promoted the globalization in international financial markets since the early 1970s. The structural and hegemonic power resources of the United States are laid out based on financial and economic statistical data including the key currency position of the U.S. dollar, world shares of foreign direct investment and portfolio investments, the foreign assets and sales of transnational corporations, the scale and capacity of the financial service sector, and stock markets performance in international financial markets. The historical background of U.S. financial liberalization, U.S. strategy for financial globalization through multilateral agreements, and the theoretical foundation of neoliberalism and the Washington Consensus are introduced.
Chapter IV examines how U.S. financial globalization policy influenced the change in international capital flows during the last three decades. Through a comparative study in East Asian and Latin American countries, this chapter examines the linkage between global capital flows and financial crises in developing countries. It then investigates common characteristics and composition of financial capital flows, empirical explanations of the factors behind financial surges and reversals, brief case studies of the financial liberalization process, and policy responses toward the international financial flows in these two regions.

Chapter V analyzes the process of financial liberalization in South Korea from the perspective of financial globalization. The South Korean financial liberalization case study provides a resourceful example of financial market opening of developing countries that has been highly influenced by the external pressure of the United States, the IMF, the World Bank, as well as by domestic interest groups. The international political economic relations between the United States (a strong financial power) and South Korea (a weak financial power) exemplified the typical foreign pressure for financial liberalization. The causes of the Korean financial crisis in the context of the East Asian financial crisis are analyzed by the two mainstream theoretical viewpoints: “fundamentalist” and “self-fulfilling” models.

Chapter VI describes global governance attempts to prevent financial crises and construct stable international financial systems. As a result of financial globalization, many developing countries have experienced a series of financial crises one by one, so the global community including the G-7, international financial institutions, and global civil society groups, concentrate on building global governance in the international
financial sector. From a critical evaluation of each proposal, this chapter explores a more efficient method of global governance in the international financial system.

Chapter VII summarizes the research results and the major findings of this study and suggests directions for further inquiry.
CHAPTER II

THEORETICAL FRAMEWORK FOR ANALYSIS

This dissertation focuses on the role of hegemonic power (the United States) and its far-reaching impact on developing countries by analyzing the patterns and process of financial liberalization and globalization in the international financial system. As a predominant economic and military power, the United States has occupied a central position in global political economy. The gigantic U.S. trade and financial markets, production of goods and services, and financial capital flows in the global economy make policy-makers in the rest of the world pay attention to a small change of American economic policy and the health of its economic conditions. Current U.S. Federal Reserve Board Chairman Alan Greenspan’s remarks on interest rates highly influence the interest rates abroad as well as the choice of worldwide economic policy-makers and global fund mangers. Thus, the pervasive effect of U.S. policy toward the global political economy is already one essential phenomenon to understand world political economy. In this chapter, we examine various research methods to analyze the prominent role of the United States, its influence, and its mechanisms in the global financial system. As a framework for analysis, this study applies systems theory, hegemonic stability theory, and levels of analysis research tools. In addition, from various economic theoretical perspectives, we will review the historical background of financial globalization.
2.1 Analytical Frameworks

2.1.1 Systems Theories

As a primary methodological tool of this study, systems theory provides a useful framework to analyze the proponent role of the United States in financial globalization and to describe the spreading impact of financial liberalization in international financial markets. Kenneth N. Waltz identified a system “as a set of interacting units.” A system is composed of a structure and of interacting units. The structure is not a collection of units but rather an arrangement (a set) of its units.1 According to this concept of a system, we can infer an international system. Stanley Hoffmann identified that

[an international system is a pattern of relations among the basic unit of world politics, characterized by the scope of the objectives pursued by those units and of the tasks performed among them, as well as by means used to achieve those goals and perform those tasks. This pattern is largely determined by the structure of the world, the nature of the forces that operate across or within the major units, and the capabilities, pattern of power, and political cultures of those units.]2

If we consider the distribution of political and military power capabilities of various units and their patterns of relations in world politics, we can develop various types of international political systems. For example, Morton A. Kaplan proposed six types of international systems – a “balance of power, loose bipolar, tight bipolar system, universal, hierarchical, and unit veto system.”3 Waltz argued that the purpose of systems theory is to show how the units and the structure operate and interact.4

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4 Waltz, Theory of International Politics, 40.
One can ask how A and B affect each other, and proceed to seek an answer, only if A and B can be kept distinct. Any approach or theory, if it is rightly termed “system,” must show how the systems level, or structure, is distinct from the level of interacting units. If that is not shown, then one does not have a systems approach or a system theory at all.\textsuperscript{5}

Consequently, a systems theory presents “a series of statements about relationship among independent and dependent variables, in which changes in one or more variables are accompanied, or followed, by changes in other variables or combinations of variables.”\textsuperscript{6}

Systems theory, therefore, focuses on the distribution of capability among the actors of the international system and investigates the behavior patterns of these actors within that system.

Applying systems theory to the international financial system, this study posits that the global financial system consists of several key actors and its structure (environment). In the current world, the United States, Japan, and the European Union have maintained a large share of foreign direct and portfolio investments in the international financial system, and the key international financial institutions (the IMF and the World Bank) have played an important role to construct the global financial system. These actors have cooperated with each other to construct and manage a global financial system through several codes and agreements. As members of international organizations, these national actors have assumed an important role in financial deregulation. For instance, the 1961 Code of Liberalisation of Capital Movements among OECD countries, and the 1997 Financial Services Agreement in the WTO have forced all member countries to lift their financial regulations. These main codes and agreements have functioned as rules of the

\textsuperscript{5} Waltz.

\textsuperscript{6} James E. Dougherty and Robert L. Pfaltzgraff, Jr., Contending Theories of International Relations: A
game in the international financial system and accelerated the pace for financial globalization.

In the international financial system, a state actor's financial power, which influence or change the rules and norms of the international financial system, will be proportionate to its volume of financial assets, size of financial markets, and advanced techniques for employing financial capital. On the other hand, the international organization actors' financial power will be based on the sum of the number of the members including strong state actors, the scope of the issues areas (such as monetary, finance, and banking), and restrictive force to their members. Financial power relations among actors and the distribution of financial power in the world help to understand the structure and environment of the international financial system. As a hegemonic financial power, the U.S. economic and financial policy change and behavior have made far-reaching impacts on the rest of the world. For instances, the primary role of the United States in building and maintaining the liberal international economic order after the Second World War has brought economic stability and development, whereas the Nixon Doctrine in 1971 has made an enormous structural changes in the international monetary system.

From a systems theoretical viewpoint, this study broadly categorizes two international financial systems as the control-oriented financial system after World War II to the mid-1970s, and the liberalized financial system from the mid-1970s to the present. The tradition of capital controls and financial regulation are the cardinal characteristics of the former financial system, and financial liberalization and globalization is the main feature of the current financial system. From the financial control oriented system to the current

financial liberalized system, the United States, as the strongest financial power, has played an important role in transforming the international financial system. For example, the abolition of the "International Equalization Tax" (IET) which was a major legal mechanism restraining capital outflows in February 1973, the introduction of regulation-free International Banking Facilities (IBFs) in December 1981, elimination of the 30 percent withholding tax on interest payments to foreign holders of U.S. government bond in 1984, and the enlisting of Treasury bonds in Euromarkets in 1984 were highly influential on the financial market opening in industrial countries and global financial liberalization. These U.S. initiatives for financial liberalization are very powerful because of its key currency status in the Bretton Woods international monetary regime, and status as the largest financial market in the world.

Further, the Treasury Department and Wall Street, armed with neo-liberalist ideas, designed the "Washington Consensus" to provide a theoretical background for financial liberalization with the IMF and World Bank. The United States has also tried to legalize financial liberalization through the Multilateral Agreement on Investment in the OECD, and propelled the multilateral trade rounds such as the Financial Services Agreement (FSA) of the Uruguay Round. Besides the United States, the IMF, the World Banks, and the WTO are powerful international organizations that have implemented financial market openings in many developing countries. Through the structural adjustment program of the IMF, and the FSA of the WTO, these efforts for financial liberalization have cemented financial globalization trends as an environment of the international financial system. This global financial liberalization has functioned as the foreign pressures to open many industrial countries and developing countries' financial markets.
2.1.2 Hegemonic Stability Theory

The hegemonic stability theory is an international system-centered approach, with strong theoretical descriptive and explanatory power to examine the role of the United States in international political economy. It was developed by many scholars, such as Charles P. Kindleberger,7 Stephen D. Krasner,8 Robert O. Keohane9, and Robert Gilpin,10 and posits that the hegemon who has the predominant material resources contributes to the stability and continuous development of the international political economic system. According to Keohane, "hegemonic structures of power, dominated by a single country, are most conducive to the development of strong international regimes whose rule are relatively precise and well obeyed."11 Both Great Britain in the nineteenth century and the United States after World War II had leading roles in managing the stable international political economic system. During the nineteenth century, Britain implemented economic hegemony over a large part of the world. Under the hegemonic power of Britain, international trade markets were opened fairly, the gold standard international monetary regime worked well, and financial capital freely moved across borders. After the two world wars, the United States assumed the leadership role in international political economy, and became actively involved in continuing a liberal international economic order and maintaining a stable world economy based on the General Agreement on

The theory contains two distinct theoretical traditions to explain the stability of the international system: Kindleberger’s collective goods version, and Gilpin and Krasner’s security version. Kindleberger’s hegemonic stability theory is based on the ‘logic of collective good.’ He argues that only the hegemonic country has the power and motivation to produce the collective good (the stability of the international economy). Under the leadership of a hegemon, all countries benefit from international economic stability. On the other hand, Gilpin and Krasner agree on the collective good version, but their theory points out the international economic interactions of state power and national security. If a dominant state has hegemonic power in an international system, the state could advocate liberalization without threatening primary security objectives because the liberalized international system could guarantee economic growth, and power for the hegemonic state, and because the symbolic, economic, and military capabilities of the hegemon can be used to attract or induce others to accept an open trading regime or monetary structures.

Gilpin argues that every international monetary system is dependent on a particular political order. Because the rules and order of the international monetary system are important for the interests of nation-states, states try to influence the nature of the system. Accordingly, the rise and decline of hegemonic powers highly affects the international system.

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13 Kindleberger, The World in Depression, 205.
14 Webb and Krasner, 184.
monetary system.\textsuperscript{15} He believes that "the United States has been motivated more by enlightened self-interest and security objectives. The United States has assumed leadership responsibilities because it has been in its economic, political, and even ideological interests to do so, or at least it has believed this to be the case."\textsuperscript{16} Just as the Britain in the nineteenth century, the United States, a capitalist hegemon, prefers liberalized an (open) international monetary, finance, and trade system because these countries hold great power resources such as high technology, vast trade and financial markets, abundant financial capital, and raw materials.

After the collapse of the Bretton Woods regime, many scholars were concerned about the decline of U.S. hegemony and the stability of the international system. Bruce Russett\textsuperscript{17} tried to verify a relative decline of American power introducing several power base indicators (a ‘power index’ for hegemons) and emphasized the United States has provided its own benefits (private goods) as well as collective goods. He proposed a "crucial distinction between power base and power as control over outcome" in examining the decline of hegemony.\textsuperscript{18} Unlike the simple hegemonic stability theory expectation of which control over outcomes will deteriorate as a power base decline, American cultural hegemony (democratic, capitalist, mass-consumption, and anti-communist) has provided a major resource to the United States in maintaining its more general hegemony.\textsuperscript{19}

\textsuperscript{16} Gilpin, 88.
\textsuperscript{17} Bruce Russett, “The Mysterious Case of Vanishing Hegemony; or, is Mark Twain Really Dead?,” \textit{International Organization} 39, no. 2 (Spring, 1985): 207-231.
\textsuperscript{18} Russett, 207.
\textsuperscript{19} Russett, 228-230.
On the other hand, Susan Strange\textsuperscript{20} denied any decline in American hegemony in suggesting various power bases such as nuclear forces, percentage of total output, availability of credit denominated in dollars, and the knowledge structure of the United States.\textsuperscript{21} Strange also strongly supported that the U.S. is the most powerful in the international political economy utilizing her own 'structural power' concept.

Structural power is the power to choose and to shape the structures of the global political economy within which other states, their political institutions, their economic enterprises, and (not least) their professional people have to operate. This means more than the power to set the agenda of discussion or to design (in American Phraseology) the international "regime" of rules and customs. ....

Structural Power is to be found, not in a single structure, but rather in four separate but interrelated structures. ..... 
. with the person or group able to exercise control over – that is, to threaten or to defend, to deny or to increase – other people’s security from violence; 
. with those able to control the system of production of goods and services; 
. with those able to determine the structure of finance and credit through which (in all but the most primitive economies) it is possible to acquire purchasing power without having either to work or to trade it; 
. with those who have most influence over knowledge, whether it is technical knowledge, religious knowledge, or leadership in ideas, and who control or influence the acquisition, communication, and storage of knowledge and information.\textsuperscript{22}

Strange explains that the United States has the structural power to change the options of other governments, foreign banks, and trading corporations in the global financial system. United States policies and its economy in general have had dominant effects in the international monetary system since the mid-1960s and have influenced changes in interest rates world-wide.\textsuperscript{23} Thus, the general theoretical assumptions and empirical research cases of the hegemonic stability theory would be a strong research tool to examine the U.S. hegemonic role in international political economy. Chapter III examines

\textsuperscript{21} Strange, 566-571.
\textsuperscript{22} Strange, 565.
both the general and financial power base of the United States, and explains the
process of the application of U.S. structural power to accelerate financial liberalization
and globalization in the international financial system.

2.1.3 Levels of Analysis

Levels of analysis help us to analyze international relations providing various factors and
different aspects of explanation and understanding. Initially, J. David Singer\textsuperscript{24} introduced
the idea of levels of analysis and suggested two broad levels: international system level
and the national state (sub-systems). In the international system level, we are able to
study the pattern of interaction between the system and its environment.

By focusing on the system, we are enabled to study the patterns of interaction which the
system reveals, and to generalize about such phenomena as the creation and dissolution
of coalitions, the frequency and duration of specific power configurations,
modifications in its stability, its responsiveness to changes in formal political
institutions, and the norms and folklore which it manifests as a societal system. In other
words, the systemic level of analysis, and only this level permits us to examine
international relations in the whole.\textsuperscript{25}

The national states (sub-systems) level of analysis allows us to consider decision-making
approaches, and to explain individual or collective behavior, and a strong proclivity of a
goal-seeking approach in national policy.\textsuperscript{26} Singer's two levels of analysis were
elaborated into five levels of analysis (the individual, role, governmental, societal, and

\textsuperscript{24} J. David Singer, "The Level-of-Analysis Problem in International Relations," in \textit{The International
University Press, 1961), 77-94.
\textsuperscript{25} Singer, 80.
\textsuperscript{26} Singer, 82-89.
systemic level) by James N. Rosenau. The individual level considers important aspects of the decision maker, such as values, talents, and prior experiences. The role level refers to the impact of the office on the behavior of its occupant. The governmental level is focused on "those aspects of a government's structure that limit or enhance the foreign policy choices made by decision makers." The societal level consists of those characteristics of the nongovernmental aspect of a society that influence its external behavior. The systemic level manages the external environment that surrounds the state and non-state actors.

In this study, three levels of analysis (international systemic, domestic, and individual levels) are introduced to analyze the U.S. role in financial globalization and the financial liberalization in South Korea. Although the five levels of analysis could explain various factors and characteristics of these case studies, this study only applies three levels of analysis tools due to the difficulties in collecting empirical evidence. Chapter III examines the international political economic background of U.S. policy and pressures on other countries' financial market opening throughout the transformation from the control-oriented financial system to the liberalized financial system at the international systemic level of analysis. In the domestic system and individual levels, the process of the adoption of neoliberalism in the U.S. economy and its propagation to the developing countries, the role of the Treasury Department in financial liberalization, and the various

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lobbies and pressures from the Wall Street’s business groups to extending their business interests toward foreign countries financial market opening are investigated.

In a case study of financial liberalization in South Korea, the three levels of analysis could provide a more broad explanation. At the international systemic level, the global financial liberalization environment or trends have had a great influence on Korean financial liberalization. The United States, the OECD, and the IMF have significantly influenced Korea’s financial liberalization. Particularly, the United States has pressed the Korean government to lift its financial market regulations. As its largest trading partner as well as the strongest supporter in the security realm, the United States has great leverage on the Korean government’s financial market opening to the outside world. When the Korean government joined the OECD in the middle of the 1990s, the OECD pressured the Korean government to accept a coordinate level of financial market opening legalized in the Code of Liberalisation of Capital Movements. Recently, the financial crisis led Korea to end all financial regulations. To attain IMF relief, the Korean government was forced to follow the full width of the IMF reform policy as well as signing the WTO’s Financial Services Agreement. At the domestic and individual levels, the role and relationship between the Korean government and the chaebol will be examined. For several decades, the Korean government has monopolized the allocation and mobilization of financial resources in order to support rapid industrialization. Under the heavy and chemical industrialization policy, the chaebol could accumulate huge financial assets and become a strong domestic interest group. These large big business conglomerates have influenced the Korean government’s financial market liberalization since financial liberalization allows the chaebol easy access to foreign capital resources, which have a
low interest rate. Under the foreign and domestic pressure to financially liberalize, the
Korean government voluntarily stepped up the effort to open their financial market
through several financial sector reforms plans that explain the Korean government’s role
in the financial liberalization process.

2.2 Historical and Theoretical Background of Financial Globalization

Since the mid-1970s, the deregulation of financial markets, technological developments
in communication, and the advent of new financial instruments have promoted a highly
integrated international financial system. In 1973, the average global daily turnover in
foreign exchange trading was $15 billion, by 2001 this total was about $1.2 trillion.29 The
same year, the average global daily turnover in over-the-counter (OTC) foreign exchange
derivatives amounted to $1.4 trillion.30 As global financial liberalization has proceeded in
recent decades, international capital rushes to emerging financial markets. The total of net
long-term financial flows to developing countries tripled between 1990 and 1999 from
$98.5 billion to $290.7 billion. Furthermore, private capital flows highly grew nearly six-
fold from $42.6 billion in 1990 to $238.7 billion in 1999 and accounted for 82 percent of
the total flows, while the official capital flows decreased from $55.9 billion in 1990 to
$52.0 billion in 1999 (see Table 3.1).31 This tremendous volume indicates a real
foundation of financial globalization, which is the most conspicuous trend in the postwar
international political economy.

29 Bank for International Settlements (BIS), Triennial Central Bank Survey: Foreign Exchange and
30 BIS, 15.
Table 2.1 Net Long-term Flows to Developing Countries, 1990-1999

(Billions of U.S. Dollars)

<table>
<thead>
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</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>98.5</td>
<td>124.0</td>
<td>153.7</td>
<td>219.2</td>
<td>220.4</td>
<td>257.2</td>
<td>313.1</td>
<td>343.7</td>
<td>318.3</td>
<td>290.7</td>
</tr>
<tr>
<td>Official flows</td>
<td>55.9</td>
<td>62.3</td>
<td>54.0</td>
<td>53.4</td>
<td>45.9</td>
<td>53.9</td>
<td>31.0</td>
<td>39.9</td>
<td>50.6</td>
<td>52.0</td>
</tr>
<tr>
<td>Private flows</td>
<td>42.6</td>
<td>61.6</td>
<td>99.7</td>
<td>165.8</td>
<td>174.5</td>
<td>203.3</td>
<td>282.1</td>
<td>303.9</td>
<td>267.7</td>
<td>238.7</td>
</tr>
<tr>
<td>International Capital Markets</td>
<td>18.5</td>
<td>26.4</td>
<td>52.2</td>
<td>99.8</td>
<td>85.7</td>
<td>98.3</td>
<td>151.3</td>
<td>133.6</td>
<td>96.8</td>
<td>46.7</td>
</tr>
<tr>
<td>Debt flows</td>
<td>15.7</td>
<td>18.8</td>
<td>38.1</td>
<td>48.8</td>
<td>50.5</td>
<td>62.2</td>
<td>102.1</td>
<td>103.4</td>
<td>81.2</td>
<td>19.1</td>
</tr>
<tr>
<td>Bank lending</td>
<td>3.2</td>
<td>5.0</td>
<td>16.4</td>
<td>3.5</td>
<td>8.8</td>
<td>30.4</td>
<td>37.5</td>
<td>51.6</td>
<td>44.6</td>
<td>-11.4</td>
</tr>
<tr>
<td>Bond financing</td>
<td>1.2</td>
<td>10.9</td>
<td>11.1</td>
<td>36.6</td>
<td>38.2</td>
<td>30.8</td>
<td>62.4</td>
<td>48.9</td>
<td>39.7</td>
<td>25.0</td>
</tr>
<tr>
<td>Others</td>
<td>11.3</td>
<td>2.8</td>
<td>10.7</td>
<td>8.7</td>
<td>3.5</td>
<td>1.0</td>
<td>2.2</td>
<td>3.0</td>
<td>-3.1</td>
<td>5.5</td>
</tr>
<tr>
<td>Equity flows</td>
<td>2.8</td>
<td>7.6</td>
<td>14.1</td>
<td>51.0</td>
<td>35.2</td>
<td>36.1</td>
<td>49.2</td>
<td>30.2</td>
<td>15.6</td>
<td>27.6</td>
</tr>
<tr>
<td>Foreign Direct Investment</td>
<td>24.1</td>
<td>35.3</td>
<td>47.5</td>
<td>66.0</td>
<td>88.8</td>
<td>105.0</td>
<td>130.8</td>
<td>170.3</td>
<td>170.9</td>
<td>192.0</td>
</tr>
</tbody>
</table>

In fact, we could not imagine these huge amounts of financial transactions in international financial markets at least before the 1970s. Historically, most nations, including the United States, implemented various types of capital controls which regulate and restrict the free movement of money, credit, capital goods, foreign direct investments, and portfolio investments across borders. Further, they had regulated their financial markets because capital outflows could deplete their foreign exchange holdings, and make their exchange rates unstable.\textsuperscript{32}

Donald J. Mathieson and Liliana Rojas-Suarez\textsuperscript{33} identified the purposes of capital controls as limiting volatile short-term capital flows, retention of domestic savings, and maintenance of the domestic tax base. Since capital controls could restrict extremely volatile short-term capital flows across borders, it helps to manage unstable exchange rates and balance of payments crises. Second, capital controls could help to restrain domestic savings by reducing the return on foreign assets and by limiting access to foreign assets. The third reason for capital controls was the need to maintain the authorities’ ability to tax financial activities, income, and wealth. According to Jessica G. Nembhard,\textsuperscript{34} capital controls can be a combination of official, legal, and quasi-legal instruments of a nation. She classified four categories of capital controls as foreign

\begin{footnotesize}


\end{footnotesize}
exchange regulations, quantitative and tax policies, investment and credit regulations, and trade or commercial restrictions.

During the 1920s and 1930s, capital controls were regarded as critical policy options for obstructing financial chaos. Most countries widely used capital controls in the interwar period and immediately after World War II. In addition, the Bretton Woods Conference in July 1944 accepted the principle of capital controls and restrictions on international capital flows. In particular, Article VI, section 3 of the IMF *Article of Agreement* prescribed the code of conduct as following.

*Controls of capital transfers*- Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which restricts payments for current transactions or which will unduly delay transfers payments for current transactions or which will unduly delay transfers of funds in settlements of commitments....

Under the Bretton Woods monetary system, governments extensively intervened in most nation’s economies and financial systems due to the needs of postwar reconstruction. They believed that capital controls were critical policy options for obstructing financial chaos. Generally, the investments of bank assets were restricted and interest rates were capped. Governments regulated financial markets to support credit toward strategic sectors, and pushed the implications for the balance of payments to the limit. Thus, government intervention in the financial system (including the setting of interest rates, the imposition of high reserve requirements, and quantitative restrictions on credit allocation) was a fairly common practice.

However, this common practice of financial regulation or capital control was highly

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36 Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System* (Princeton,
challenged by neo-liberal economists since the late 1960s. Neo-liberal economists argued that financial markets should determine the allocation of credit and be free from government intervention. Removing ‘financial repression’ such as an interest rate ceiling, directed credit programs, and reserve requirements should guarantee successful economic growth. For instance, Raymond W. Goldsmith\(^{37}\) initially proposed financial liberalization, and Ronald I. McKinnon\(^{38}\) and Edward S. Shaw\(^{39}\) followed this line.

Bruce Greenwald, Joseph Stiglitz, and Andrew Weiss,\(^{40}\) also maintained that free capital movement from the capital-abundant to capital-scarce countries increases welfare in these countries as well as guarantees a more efficient global allocation of savings and direct resources toward their most productive uses. Therefore, financial liberalization means the following policy suggestions: 1) deregulation of interest rates, 2) removal of credit controls, 3) privatization of government owned banks and financial institutions, 4) liberalization of restrictions on the entry of private sector and foreign banks and financial institutions into domestic financial markets, and 5) liberalization of capital accounts (see the Table-2.2).\(^{41}\)

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Table 2.2 Typology of Financial Liberalization

<table>
<thead>
<tr>
<th>Liberalization of:</th>
<th>Direction of liberalization</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Capital Movement</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Inward</td>
</tr>
<tr>
<td>1. Liberalization of rules governing foreign direct investment, including sectoral restrictions, screening practices, and performance requirements</td>
<td>1. Deregulation of outward direct and portfolio investment by nationals</td>
</tr>
<tr>
<td>2. Liberalization of foreign access to domestic equities and real estate</td>
<td>2. Liberalization of restrictions on repatriation of capital and investment by foreign nationals and firms</td>
</tr>
<tr>
<td>3. Liberalization of rules governing foreign borrowing by domestic firms and the international operations of domestic banks</td>
<td>3. Liberalization of restrictions on payments for invisibles, including profits and dividends</td>
</tr>
<tr>
<td>4. Deregulation of sale and purchase of short-term domestic securities by foreigners</td>
<td>4. Deregulation of domestic foreign currency accounts, for residents and nonresidents</td>
</tr>
<tr>
<td>2. Entry</td>
<td>Liberalize entry of foreign banks securities firms and other nonbank financial intermediaries</td>
</tr>
</tbody>
</table>

Beside the neo-liberal economists proposal for the needs of financial liberalization, the rapid environmental change of the global financial markets could bring financial globalization around the 1970s. Scholars have suggested various explanations what factors contributed to financial globalization and why many industrialized countries went to financial liberalization. John B. Goodman and Louis W. Pauly\textsuperscript{42} maintained that the rapid growth and transformation of global financial markets, and multinational corporations expedited the financial liberalization trend in the 1970s and 1980s. The continuing growth of international banking markets with rapid technological development was already far ahead the growth of world gross domestic product and world trade between 1972 and 1985. The development of multinational corporations and international banks encouraged the rapid growth of foreign direct investment, and also increased the opportunities to evade capital controls and business restrictions imposed by the home governments.\textsuperscript{43}

Furthermore, the Eurocurrency markets\textsuperscript{44}, which appeared in the 1960s, have greatly contributed to financial globalization, and become a free capital movements pool of short-term mobile capital, deposits and loans since the 1970s. These offshore markets easily eroded national financial barriers existing under the Bretton Woods system because they offered various advantages such as high interest rates for depositors, no reserve requirements and no foreign borrowing interest equalization tax that was imposed by the U.S. government to regulate capital outflows in the 1960s for foreign currencies.


\textsuperscript{43} Goodman and Pauly, 57-58.

\textsuperscript{44} "The Eurocurrency markets are markets in which assets and liabilities denominated in a particular currency are held outside the country of that currency (dollar-denominated assets held outside the United
transactions.\textsuperscript{45} In 1974, the Euromoney markets absorbed about $30 billion of 'petrodollars', of which the main resource came from the Organization of Petroleum Exporting Countries (OPEC). Owing to the increase of oil prices during the oil shock of 1973-74, the OPEC members accumulated huge amounts of international reserves and this money went to the Euromarkets for high return. From 1974 to 1980, a total of $150 billion petrodollars went to the Euromarkets, seeking the most lucrative investment location, and large part of the capital was used for the developing countries financing of their economic crises.\textsuperscript{46}

On top of the dramatic change to international financial markets, the main reasons for globalization in financial markets could be traced to the United States financial liberalization policy reactions. The U.S. removal of capital controls and deregulation of its domestic financial markets brought peer group pressure on other industrial countries, and made these countries liberalize their financial markets. Eric Helliner,\textsuperscript{47} Philip G. Cerny,\textsuperscript{48} and Anne Y. Kester\textsuperscript{49} stressed that financial liberalization in the United States in the late 1970s facilitated international capital flows and led to the removal of capital controls in other developed countries. The United States' abolition of the Interest Equalization Tax (IET) which was a major legal mechanism restraining capital outflows

in February 1973. The introduction of regulation-free International Banking Facilities (IBFs) in December 1981, elimination of the 30 percent withholding tax on interest payments to foreign holders of U.S. government bond in 1984, and the enlisting of Treasury bonds in Euromarkets in 1984 were also highly influential on financial market openings in industrial countries and global financial liberalization. These U.S. initiatives for financial liberalization are very powerful because of its key currency status in the Bretton Woods international monetary regime, and status as the largest financial market in the world.

Confronted with the U.S. initiative, developed countries proceeded with financial liberalization during the 1970s and 1980s. The process of financial liberalization in developed countries was very slow in the early stages and was not fully accomplished until the late 1980s (except for the United States, Canada, and Switzerland). Due to the collapse of the Bretton Woods monetary system in the early 1970s, developed countries introduced a floating exchange rate system and had a degree of freedom in domestic monetary policies, yet these countries did not proceed with financial liberalization immediately. Germany reduced its regulation on capital movements in the 1970s, the United Kingdom removed its exchange rate controls in 1979, Japan in the early 1980s, and France and Italy in the late 1980s.50

If we call the financial liberalization trend in industrial countries during the 1970s and 1980s the first wave of financial globalization, than we can entitle the second wave of financial globalization that of the developing countries. Most industrialized countries had relatively successfully implemented the financial liberalization process due to their

50 Peter J. Quirk and et. al., “Capital Account Convertibility: Review of Experience and Implications for
advanced financial markets and resourceful financial capital, whereas the financial liberalization process of the developing countries has proceeded since the late 1980s. Furthermore, these countries have experienced financial crises, such as the Latin America Southern Cone countries and the Asian financial crisis cases. Besides the 1982 Mexico debt crisis, restarted in 1994, Thailand and other East Asian Countries in 1997, Russia, Brazil, Argentina, and other countries, have suffered from the volatile flows of speculative “hot money,” stock market collapses, and financial panic owing to financial liberalization.\(^5\) Like the chronic problem of the developmental gap between the global North and South, the major lenders and investors of financial capitals reside in the global North (industrialized countries). Thus, the global South (developing countries) had to depend on the industrialized countries' capital from the IMF and the World Bank on their economic developmental resource or finance for the balance of payments deficits. In addition, developing countries have to commit themselves to a series of rigid economic and structural reforms at the price of financial assistance from the IMF and the World Bank. Since this structural adjustment program was based on the "Washington Consensus"\(^5\) which was supported by U.S. neo-liberalism and financial liberalization policy, most developing countries had little choice but to open their trade and financial markets.

Thus, financial liberalization in developing countries has occupied one of the most

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controversial areas of study in international political economy. Carlos Diaz-Alejandro\textsuperscript{53} investigated the experiences of financial liberalization in the Southern Cone countries (Argentina, Chile, and Uruguay) during the late 1970s and the early 1980s, and exposed the relations between financial crises and financial liberalization. Graciela L. Kaminsky and Carmen M. Reinhart\textsuperscript{54} carried out an empirical investigation for the link between banking and balance of payment crises and financial liberalization in twenty country cases during the period between 1970 and 1995, and concluded these crises are the inevitable result of unimpeded financial liberalization. Asli Demirguc-Kunt and Enrica Detragiache\textsuperscript{55} verified that banking crises are more likely to occur in liberalized financial systems based on their fifty three country case study for the period 1980-95. Regarding the cause of the Asian financial crisis, James W. Dean,\textsuperscript{56} Morris Goldstein,\textsuperscript{57} and Manuel F. Montes\textsuperscript{58} argued that the affected countries' weak domestic financial system, and volatile capital flows made by the financial globalization were the main reasons for the crisis. Therefore, Jose Maria Fanelli,\textsuperscript{59} Manuel R. Agosin and Ricardo Ffrench-Davis,\textsuperscript{60}

\textsuperscript{56} James W. Dean, "Asia's Financial Crisis in Historical Perspective," \textit{Journal of the Asia Pacific Economy} 3, no.3 (December 1998): 338-346.
\textsuperscript{58} Manuel F. Montes, "Global Lessons of the Economic Crisis in Asia," \textit{Asia Pacific Issues}, no. 35, (March 1998).
\textsuperscript{60} Manuel R. Agosin and Ricardo Ffrench-Davis, "Financial Liberalization and Development: A View for Emerging Economies," \textit{Estudios de Economfa} 24, no. 2 (December 1997).
and Yilmaz Akyuz, recommended that financial liberalization should adopt a gradual process, and short-term capital should be opened only after other forms of liberalization (such as foreign direct investment liberalization, macroeconomic policy stabilization, and improved prudential supervision) are in place.

Further, the U.S. Treasury Department and Wall Street armed with neo-liberalist idea designed the "Washington Consensus" to provide a theoretical background for financial liberalization with the IMF and World Bank. The United States has also tried to legalize financial liberalization through the General Agreement on Trade in Services (GATS), Multilateral Agreement on Investment (MAI) in the OECD, and propelled the multilateral trade rounds such as the Financial Services Agreements (FSA) of the Uruguay Round. Besides the United States, the IMF, the World Bank, and the WTO are powerful international organizations that have implemented financial market openings in many developing countries. Through the structural adjustment program of the IMF, and the FSA of the WTO, these efforts for financial liberalization have cemented financial globalization trends as an element of the international financial system. This global financial liberalization has functioned as the foreign pressures to open many industrial countries and developing countries' financial markets.

These theoretical arguments regarding financial regulation and financial liberalization are still controversial among many scholars. In general, proponents of financial liberalization argue that capital liberalization creates three benefits. First, capital market

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liberalization increases the efficiency of financial intermediation. Second, liberalization of international capital markets enhances financial services to international business, commercial interests, and portfolio investors. Third, free capital movement imposes a salutary form of discipline on national policy-makers to maintain sound fundamentals in their macroeconomic and monetary policies. This argument is based upon the “Washington Consensus,” the idea that the U.S. Treasury Department, Wall Street, and the IMF are the chief proponents of this liberalization process.

On the other hand, critics insist that financial liberalization can be attended by four types of costs. First, international investment is dependent on inadequate information and uncertainty. Second, global financial liberalization limits the national autonomy of central banks to set their monetary policies. Third, free capital mobility encourages domestic governments to follow contractionary macroeconomic and monetary policies. Fourth, the volatility of capital flows increases real economic instability. These arguments are supported by many scholars including Jagdish Bhagwati, Jeffrey D. Sachs, James Tobin, and Joseph E. Stiglitz. Major proponents include UNCTAD and other civil movement groups.

Thus, there is as long historical background and numerous theoretical arguments for analyzing the transformation from financial control to the financial liberalization process. To understand financial globalization, which is one critical part of globalization, we need to have an overview of various discussions of globalization. Globalization is an

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63 Blecker, Taming Global Finance, 10-16.
64 Blecker, 16-37.
overarching effect in the contemporary world, and there has been wide and intensive
debate about globalization. Many scholars agree globalization is a type of economic
phenomenon in that it increases transactions of international trade, investment, and
capital flows across borders, and forces national economic systems into a single
integrated global economic market. Helen V. Milner\textsuperscript{65} identified that globalization refers
to the increasing integration of national economies into a global one. According to Robert
W. Cox,\textsuperscript{66} globalization has two principal aspects: (1) global organization of production,
and (2) global finance. Globalization has complex transnational networks of production
that offers the most advantage on costs, markets, taxes, and access to suitable labor.
Globalization could bring the advantage of political security and predictability, and it
would increase the broad unregulated transactions of money, credit, and equities. Like
other aspect of globalization, global finance emerges from a very largely unregulated
system of transactions in money, credit, and equities.

On the other hand, Robert O. Keohane and Joseph S. Nye Jr.\textsuperscript{67} believed globalization
is to be “a state of the world involving networks of interdependence at multicontinental
distances.” The long-distance transfer of goods, services, and capital flows make the
linkage that evolves economic globalism. Globalization is a phenomenon whereby the
growing integration and interdependence of national economies develops into a global
one. Thus, financial globalization is one aspect of a broader trend toward globalization
which could allow countries, financial institutions, savers and borrowers to make

\begin{flushright}

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transactions across borders in global financial markets. This financial globalization can be transformative, as an inevitable pressure, and may force all countries to change their policies and institutions in certain ways: liberalization of trade policy, deregulation of capital controls, opening of financial markets to foreign investors and downsizing the role of the state in the economy. Also, financial globalization increases the power of investors (e.g. George Soros), transnational firms, and financial institutions that have tremendous amounts of capital. These actors could demand that nation-states change their financial or economic policies to open their markets to free capital movements. Thus, financial globalization is sometimes seen as an irreversible power.  

Based on the above theoretical framework, this dissertation argues that financial liberalization is a crucial starting point for financial globalization. Also, as a great financial power, the United States has used its powers to propel financial globalization. The next chapter describes the power of the United States and its resources in general, as well as its financial position. This investigation offers resourceful answers to why the United States was highly involved in financial globalization.

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68 Milner, “International Political Economy”, 120-121.
CHAPTER III

U.S. POWER AND FINANCIAL GLOBALIZATION

In the early 1970s, the United States initially eliminated various existing domestic financial control measures and promoted free capital inflows. Since then, the United States has stood in the forefront of global financial liberalization and exercised its hegemonic power to construct a liberalized international financial system and pressed other nations to abolish various capital and financial controls in other countries. Behind the U.S. effort for global financial liberalization, American business interests have deeply engaged in designing the liberal international economic order (free trade and open markets) and neoliberalism (Washington Consensus). Furthermore, the United States has exercised its structural power to promote global financial liberalization utilizing multilateral institutions such as the IMF, the World Bank, GATT, and the WTO. Following this U.S. initiative, all industrial countries opened up their financial markets to free international financial transactions, and many developing countries had to lift restrictions on foreign investment, remove limitations on foreign ownership of assets, and eliminate exchange rate controls.

This chapter examines primary power bases of the United States, and how and why the United States has promoted globalization in the international financial system. The main point of this chapter proposes that the United States hegemonic power has highly contributed to global financial liberalization that was the starting point for free capital movements on a global scale. From this perspective, this chapter will examine several
research questions. Where can we find the structural power resources of the United States? How much power does the United States possess in the global financial system? Why has the United States strongly supported global financial liberalization? How did the United States pursue financial liberalization in the international financial system? Why did all nations keep the capital controls under the Bretton Woods system, and how did they open their financial market? Could financial liberalization really improve the efficiency and development of international financial markets?

This chapter is organized into three sections. Section 3.1 presents the hegemonic and structural power resources of the United States. Major financial and economic data are laid out to measure U.S. financial power. Section 3.2 investigates the process and historical background of U.S. domestic financial liberalization during the early 1970s. Section 3.3 explores U.S. strategy and structural power excises to promote global financial liberalization. It focuses on the U.S. efforts to construct the foundation of financial globalization through multilateral agreements. In addition, U.S. financial liberalization policies to the developing countries is explored from the viewpoint of the Treasury and Wall Street’s business interest with the Washington Consensus.
3.1 U.S. Power in the International Political Economy System

3.1.1 Power in International Relations

Power has been applied by many scholars as a main concept to the analysis of international relations as well as international political economy. Although there have been many studies to solidify the concept of 'power,' many political scientists have cited Robert A. Dahl's definition. According to Dahl, power is the ability to get another actor "to do something he would not otherwise do by promising to make him better off than he is now, threatening to make him worse off than he is now, or both."1 This concept of power could be defined in international relations "as the ability of an actor on the international stage to use tangible and intangible resources and assets in such a way as to influence the outcomes of international events to its own satisfaction."2 Hans J. Morgenthau argues that "[i]nternational politics, like all politics, is a struggle for power," and "[w]hatever the ultimate aims of international politics, power is always the immediate aim."3 Susan Strange, also agrees that "[i]t is impossible to study political economy and especially international political economy without giving close attention to the role of power in economic life,"4 and claims that "there are two kinds of power exercised in a political economy- structural power and relational power."5 Relational power is a conventional term described by realist scholars as the same definition of Dahl, whereas structural power means "the power to shape and determine the structures of the global political economy within which other states, their political institutions, their

4 Susan Strange, States and Markets s: An Introduction to International Political Economy (New York,
economic enterprises and (not least) their scientists, and other professional people have to operate. In other words, relational power could measure or exercise the relationships between more than two actors, while the structural power is "more than the power to set the agenda of discussion or to design (in American academic language) the international regimes of rules and customs that are supposed to govern international economic relations." On the other hand, Joseph S. Nye Jr. suggests that there are two types of power in accordance with exercising power. "Military power and economic power are both examples of hard command power that can be used to induce others to change their position." What he calls "soft power" is "based on the ability to set the political agenda in a way that shapes the preferences of others" as "getting others to want what you want."

How much power does a state have? In order to measure the size of an actor's power in an international system, we should consider its power resources or assets. Morgenthau proposes the elements of national power as geography, natural resources, industrial capacity, military preparedness (technology, leadership, and quantity and quality of armed forces), population (distribution and trends), national character, national morale, the quality of diplomacy, and the quality of government. Strange suggests that four aspects of structural power lie in security, the system of production of goods and services, the structure of finance and credit, and knowledge. The state, which is dominant in these

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5 Strange, 24.
6 Strange, 24-25.
7 Strange, 25.
9 Nye, 9.
10 Morgenthau and Thompson, 127-169.
four aspects of structural power, is the most powerful state in the international political economy.\textsuperscript{11}

These foundations of power resources of a state have been changed from the military to economic and financial resources due to the interdependency and globalization in international political economy.\textsuperscript{12} Traditionally, realist scholars have stressed military force as the main power resource of a state, but the importance of economy and financial resources is increasingly a measurement of a state's power resources. Though military force and security can still play an important political role in certain regions, we can hardly consider the possibility of attack by one another particularly among industrialized states in the current world. Moreover, most countries cannot use military force to achieve their economic and ecological welfare goals.\textsuperscript{13}

\subsection*{3.1.2 U.S. Power in General Power Resource}

The power of the United States can be measured according to these power resources. Although there had been a series of controversies regarding the decline of U.S. hegemony during the late 1980s,\textsuperscript{14} unlike the expectation of many scholars who argued the U.S. hegemony would decline, many scholars such as Susan Strange, Joseph S. Nye Jr., and G.

\footnotesize
\begin{itemize}
  \item \textsuperscript{11} Susan Strange, "The Persistent Myth of Lost Hegemony," \textit{International Organization} 41, no. 4 (Autumn 1987): 565.
  \item \textsuperscript{13} Keohane and Nye, 23-24.
\end{itemize}
John Ikenberry agree that the United States is still a predominant power in key international issue areas (the military, economic, technology, and the soft power).  

In military power resources, the United States is the most powerful country with both nuclear weapons and conventional forces to reach all over the world. The defense budget of the United States in 2003 is greater than those of the next 15-20 biggest countries combined. In expenditure on military research and development (R & D), the United States spends three times more than that of the next six big powers combined. No other state is even close to this kind of military predominance in the modern history of international politics.

Economically, the United States became the world's largest economy by the end of World War II. At the time, the United States occupied half of the world product. In 2000, the United States had a 27 percent share of world product that was equal to the sum of the share of Japan, Germany, and France. As shown in Table 3.1, U.S. GDP in terms of purchasing power parity in 1999 amounts to $9.3 trillion, which is three times bigger than that of Japan. In fact, California's economy based on market exchange rate estimates surpasses France's economy and is just followed by the United Kingdom. In foreign direct investment (FDI), more than one-third of world FDI were inflows to the United States in 1999. The total volume of inflow and outflow of the U.S. FDI was nearly twice as big as those of the United Kingdom, the world's second largest FDI country.

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Table 3.1 Power Resources in 2000

<table>
<thead>
<tr>
<th></th>
<th>U. S.</th>
<th>Japan (EU)</th>
<th>Germany (EU)</th>
<th>France (EU)</th>
<th>Britain (EU)</th>
<th>Russia</th>
<th>China</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Basic</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
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</tr>
<tr>
<td>Territory in</td>
<td>9,269</td>
<td>378</td>
<td>357</td>
<td>547</td>
<td>245</td>
<td>17,075</td>
<td>9,597</td>
</tr>
<tr>
<td>thousands of Km²</td>
<td></td>
<td></td>
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<td></td>
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</tr>
<tr>
<td>Population in</td>
<td>276</td>
<td>127</td>
<td>83</td>
<td>59</td>
<td>60</td>
<td>146</td>
<td>1,262</td>
</tr>
<tr>
<td>millions (1999)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Literacy rate</td>
<td>97</td>
<td>99</td>
<td>99</td>
<td>99</td>
<td>99</td>
<td>98</td>
<td>81.5</td>
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<tr>
<td><strong>Military</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nuclear warheads</td>
<td>12,070</td>
<td>0</td>
<td>0</td>
<td>450</td>
<td>192</td>
<td>22,500</td>
<td>&gt;40</td>
</tr>
<tr>
<td>(1999)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Budget in billions</td>
<td>288.8</td>
<td>41.1</td>
<td>24.7</td>
<td>29.5</td>
<td>34.6</td>
<td>31</td>
<td>12.6</td>
</tr>
<tr>
<td>of dollars (1999)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personnel</td>
<td>1,371,500</td>
<td>236,300</td>
<td>332,800</td>
<td>317,300</td>
<td>212,400</td>
<td>1,004,100</td>
<td>2,480,000</td>
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<tr>
<td><strong>Economic</strong></td>
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<td></td>
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<tr>
<td>GDP in billions of</td>
<td>9,255</td>
<td>2,950</td>
<td>1,864</td>
<td>1,373</td>
<td>1,290</td>
<td>620</td>
<td>4,800</td>
</tr>
<tr>
<td>dollars in purchasing</td>
<td></td>
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<td></td>
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<td></td>
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<tr>
<td>power parity (1999)</td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Per capita GDP,</td>
<td>33,900</td>
<td>23,400</td>
<td>22,700</td>
<td>23,300</td>
<td>21,800</td>
<td>4,200</td>
<td>3,800</td>
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<tr>
<td>in purchasing power</td>
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<tr>
<td>parity (1999)</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Manufacturing</td>
<td>1,344</td>
<td>1,117</td>
<td>556</td>
<td>290</td>
<td>214</td>
<td>NA</td>
<td>309</td>
</tr>
<tr>
<td>valued added, in</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>billions of dollars</td>
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<td>(1996)</td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>High-tech exports,</td>
<td>637</td>
<td>420</td>
<td>112</td>
<td>69</td>
<td>96</td>
<td>87</td>
<td>183</td>
</tr>
<tr>
<td>in billions of</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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</tr>
<tr>
<td>dollars (1997)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of personal</td>
<td>570.5</td>
<td>286.9</td>
<td>297</td>
<td>221.8</td>
<td>302.5</td>
<td>37.4</td>
<td>12.2</td>
</tr>
<tr>
<td>computers per</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>thousand population</td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>


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18 Brooks and Wohlforth, 22.
In terms of soft power resources, the United States is the top film and television exporter in the world. Through American movies, television episodes, and popular music many citizens in the world are influenced by American culture and life. Every year, most foreign students head to U.S. graduate schools and colleges to get an advanced and high quality education. In 2000, over 500,000 foreign scholars studied at American educational institutions.  

This predominant position in military, economic, and soft power forms was strongly supported by its world leading technological power such as computers, aerospace, biotechnology, and telecommunication. The real figure for U.S. R&D expenditure roughly equaled those of the next seven richest countries combined in the late 1990s, and verifies the superiority of U.S. technology.

3.1.3 U.S. Financial Power

Moreover, the U.S. power is more evident if we consider U.S. global financial power: the key currency role of U.S. dollars in the international financial market, shares of foreign direct investment and portfolio investments, the foreign assets and sales of transnational corporations (TNCs), the scale and capacity of the financial services sector, and stock markets performance. First of all, the top currency status of the U.S. dollar in international political economy reminds one of Strange’s arguments that “[a]ny state economically strong enough to possess the international economy’s Top Currency will also exert substantial power and influence.” During the past decade, the U.S. dollar

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19 Nye, 36.
20 Brooks and Wohlforth, 23.
share in total identified official holdings of foreign exchanges has consistently increased from 55.3 percent in 1992 to 68.3 percent in 2001 (see Table 3.2).

Table 3.2 Shares of Key Currencies in Total Identified Holdings of Foreign Exchange

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. dollar</td>
<td>55.3</td>
<td>57</td>
<td>68.1</td>
<td>68.3</td>
</tr>
<tr>
<td>Japanese yen</td>
<td>7.6</td>
<td>6.8</td>
<td>5.2</td>
<td>4.9</td>
</tr>
<tr>
<td>Pound sterling</td>
<td>3.1</td>
<td>3.2</td>
<td>0.7</td>
<td>0.7</td>
</tr>
<tr>
<td>Deutsche mark</td>
<td>13.3</td>
<td>13.7</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>French franc</td>
<td>2.7</td>
<td>2.3</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Euro</td>
<td>-</td>
<td>-</td>
<td>13.0</td>
<td>13.0</td>
</tr>
</tbody>
</table>


The highest demand and attractiveness of U.S. dollars in global financial markets also reflect the daily average volume of currency foreign exchange transactions. According to the BIS Annual Report, the U.S. dollar occupied over 90 percent of total foreign exchange turnover that includes spot, outright forwards, and foreign exchanges swaps transactions in April 2001 (see Table 3.3).22

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Table 3.3 Foreign Exchange Turnover Net of Local and Cross-border Inter-dealer Double-counting by Instrument, Counterparty and Currency in April 2001 (Total Reported Transactions in all Currencies)

(Daily averages in millions of US dollars)

<table>
<thead>
<tr>
<th>Category</th>
<th>Total</th>
<th>Specified currency against all other currencies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>US dollar</td>
<td>Euro</td>
</tr>
<tr>
<td>Specified currency against all other currencies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Spot</td>
<td>386,963</td>
<td>326,648</td>
</tr>
<tr>
<td>Outright forwards</td>
<td>130,575</td>
<td>110,795</td>
</tr>
<tr>
<td>Foreign exchange swaps</td>
<td>655,528</td>
<td>622,998</td>
</tr>
<tr>
<td>Total</td>
<td>1,173,066</td>
<td>1,060,441</td>
</tr>
</tbody>
</table>


FDI data may be one of the most appropriate indicators of U.S. financial power. Since FDI includes corporate activities such as businesses building plants or subsidiaries in foreign countries, and buying controlling stakes or shares in foreign companies, the figure indicates the global network of investments together with portfolio investments. The United States, the world's largest economy, remains the largest FDI recipient and investor in the world. U.S. FDI inflows and outflows (the total of U.S. firm investments abroad and foreign firm investments in the U.S.) have grown from $8.9 billion in 1970 to $465 billion in 2000 (see Table 3.4). Although FDI inflows and outflows in 2001 ($238 billion) decreased in half by 2000 because of the economic slowdown and the September 11 terrorist attacks, the United States still holds its position as the world’s largest FDI recipient and investor.
Table 3.4 Foreign Direct Investment Inflows and Outflows of G-7

(Millions of Dollars)

<table>
<thead>
<tr>
<th></th>
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<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>United States</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FDI Inflows</td>
<td>1,260</td>
<td>2,560</td>
<td>16,918</td>
<td>20,490</td>
<td>48,422</td>
<td>58,772</td>
<td>300,912</td>
<td>124,435</td>
</tr>
<tr>
<td>FDI Outflows</td>
<td>7,590</td>
<td>14,244</td>
<td>19,230</td>
<td>13,388</td>
<td>30,982</td>
<td>92,074</td>
<td>164,969</td>
<td>113,977</td>
</tr>
<tr>
<td>Total FDI</td>
<td>8,850</td>
<td>16,804</td>
<td>36,148</td>
<td>33,878</td>
<td>79,404</td>
<td>150,846</td>
<td>465,881</td>
<td>238,412</td>
</tr>
<tr>
<td><strong>United Kingdom</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FDI Inflows</td>
<td>1,488</td>
<td>3,319</td>
<td>10,123</td>
<td>5,476</td>
<td>30,460</td>
<td>19,968</td>
<td>116,552</td>
<td>53,799</td>
</tr>
<tr>
<td>FDI Outflows</td>
<td>1,678</td>
<td>3,001</td>
<td>7,881</td>
<td>11,068</td>
<td>43,560</td>
<td>17,947</td>
<td>253,929</td>
<td>39,462</td>
</tr>
<tr>
<td>Total FDI</td>
<td>3,166</td>
<td>6,320</td>
<td>18,004</td>
<td>16,544</td>
<td>78,026</td>
<td>37,915</td>
<td>370,481</td>
<td>93,261</td>
</tr>
<tr>
<td><strong>France</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FDI Inflows</td>
<td>622</td>
<td>1,564</td>
<td>3,283</td>
<td>2,595</td>
<td>9,049</td>
<td>23,673</td>
<td>42,930</td>
<td>52,623</td>
</tr>
<tr>
<td>FDI Outflows</td>
<td>374</td>
<td>1,338</td>
<td>3,095</td>
<td>2,243</td>
<td>27,097</td>
<td>15,755</td>
<td>175,504</td>
<td>82,814</td>
</tr>
<tr>
<td>Total FDI</td>
<td>996</td>
<td>2,902</td>
<td>6,378</td>
<td>4,838</td>
<td>36,146</td>
<td>39,428</td>
<td>218,434</td>
<td>135,437</td>
</tr>
<tr>
<td><strong>Germany</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FDI Inflows</td>
<td>770</td>
<td>689</td>
<td>333</td>
<td>494</td>
<td>2,962</td>
<td>12,025</td>
<td>195,122</td>
<td>31,833</td>
</tr>
<tr>
<td>FDI Outflows</td>
<td>1,070</td>
<td>2,178</td>
<td>4,702</td>
<td>5,298</td>
<td>24,235</td>
<td>39,049</td>
<td>49,793</td>
<td>43,257</td>
</tr>
<tr>
<td>Total FDI</td>
<td>1,840</td>
<td>2,867</td>
<td>5,035</td>
<td>5,792</td>
<td>27,197</td>
<td>51,074</td>
<td>244,915</td>
<td>75,090</td>
</tr>
<tr>
<td><strong>Canada</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FDI Inflows</td>
<td>1,823</td>
<td>3,387</td>
<td>5,807</td>
<td>1,372</td>
<td>7,582</td>
<td>9,255</td>
<td>66,617</td>
<td>27,465</td>
</tr>
<tr>
<td>FDI Outflows</td>
<td>931</td>
<td>1,252</td>
<td>4,098</td>
<td>3,862</td>
<td>5,237</td>
<td>11,462</td>
<td>47,499</td>
<td>35,472</td>
</tr>
<tr>
<td>Total FDI</td>
<td>2,754</td>
<td>4,639</td>
<td>9,905</td>
<td>5,234</td>
<td>12,819</td>
<td>20,717</td>
<td>114,116</td>
<td>62,937</td>
</tr>
<tr>
<td><strong>Italy</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FDI Inflows</td>
<td>624</td>
<td>645</td>
<td>577</td>
<td>1,072</td>
<td>6,411</td>
<td>4,842</td>
<td>13,377</td>
<td>14,873</td>
</tr>
<tr>
<td>FDI Outflows</td>
<td>114</td>
<td>343</td>
<td>740</td>
<td>1,736</td>
<td>7,394</td>
<td>7,024</td>
<td>12,319</td>
<td>21,476</td>
</tr>
<tr>
<td>Total FDI</td>
<td>738</td>
<td>988</td>
<td>1,317</td>
<td>2,808</td>
<td>13,805</td>
<td>11,866</td>
<td>25,696</td>
<td>36,349</td>
</tr>
<tr>
<td><strong>Japan</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FDI Inflows</td>
<td>94</td>
<td>226</td>
<td>278</td>
<td>642</td>
<td>1,753</td>
<td>41</td>
<td>8,322</td>
<td>6,202</td>
</tr>
<tr>
<td>FDI Outflows</td>
<td>355</td>
<td>1,763</td>
<td>2,385</td>
<td>6,452</td>
<td>48,024</td>
<td>22,630</td>
<td>31,558</td>
<td>38,088</td>
</tr>
<tr>
<td>Total FDI</td>
<td>449</td>
<td>1,989</td>
<td>2,663</td>
<td>7,094</td>
<td>49,777</td>
<td>22,671</td>
<td>39,880</td>
<td>44,290</td>
</tr>
<tr>
<td><strong>G-7 Total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FDI Inflows</td>
<td>6,681</td>
<td>12,390</td>
<td>37,319</td>
<td>32,141</td>
<td>106,639</td>
<td>128,576</td>
<td>743,832</td>
<td>311,230</td>
</tr>
<tr>
<td>FDI Outflows</td>
<td>12,112</td>
<td>24,119</td>
<td>42,131</td>
<td>44,047</td>
<td>160,916</td>
<td>231,554</td>
<td>735,571</td>
<td>374,546</td>
</tr>
<tr>
<td>Total FDI</td>
<td>18,793</td>
<td>36,509</td>
<td>79,450</td>
<td>76,188</td>
<td>267,555</td>
<td>360,130</td>
<td>1,479,403</td>
<td>685,776</td>
</tr>
<tr>
<td><strong>World</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FDI Inflows</td>
<td>12,586</td>
<td>26,580</td>
<td>54,945</td>
<td>57,596</td>
<td>202,782</td>
<td>330,516</td>
<td>1,491,934</td>
<td>735,146</td>
</tr>
<tr>
<td>FDI Outflows</td>
<td>14,141</td>
<td>28,607</td>
<td>53,674</td>
<td>62,163</td>
<td>233,315</td>
<td>356,404</td>
<td>1,379,493</td>
<td>620,713</td>
</tr>
<tr>
<td>Total FDI</td>
<td>26,727</td>
<td>55,187</td>
<td>108,619</td>
<td>119,759</td>
<td>436,097</td>
<td>686,920</td>
<td>2,871,427</td>
<td>1,355,859</td>
</tr>
</tbody>
</table>

Regarding FDI, we should consider the foreign assets and sales of TNCs because large parts of FDI involve the TNCs’ transactions in the global market. According to the World Investment Report 2002, there are about 65,000 MNCs with about 850,000 foreign affiliates across the globe today. In 2001, foreign affiliates have about 54 million employees, compared to 24 million in 1990; their sales account for $19 trillion which is more than twice as high as world exports in 2001.23 The United States is the home economy to six of the world’s top twenty-five non-financial TNCs, ranked by their foreign assets (compared to four for Germany and three for the United Kingdom) as Table 3.5 shows. The total assets and sales of the six U.S. TNCs account for over one-third of the total volume of top twenty-five TNCs. If we consider the total sales volume of TNCs, U.S. ExxonMobil would rank first, which is 18 times bigger than that of the United Kingdom’s Vodafone which ranks top on foreign assets base.

The United States also occupies the top position in global portfolio investment. The IMF announced that portfolio holdings of equity and long-term debt securities of the main investing countries reached about US$5.2 trillion at the end of 1997 in the Coordinated Portfolio Investment Survey, the first survey of portfolio investment.24 Of course, the United States was the largest investing country in that report.

Table 3.5 The World's Top 25 Non-financial TNCs, 2000

(Millions of dollars and number of employees)

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Corporation</th>
<th>Home Economy</th>
<th>Assets</th>
<th>Sales</th>
<th>Employment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Foreign</td>
<td>Total</td>
<td>Foreign</td>
</tr>
<tr>
<td>1</td>
<td>Vodafone</td>
<td>U.K.</td>
<td>221,238</td>
<td>222,326</td>
<td>7,419</td>
</tr>
<tr>
<td>2</td>
<td>General Electric</td>
<td>U.S.</td>
<td>159,188</td>
<td>437,006</td>
<td>49,528</td>
</tr>
<tr>
<td>3</td>
<td>ExxonMobil</td>
<td>U.S.</td>
<td>101,728</td>
<td>149,000</td>
<td>143,044</td>
</tr>
<tr>
<td>4</td>
<td>Vivendi Universal</td>
<td>France</td>
<td>93,260</td>
<td>141,935</td>
<td>19,420</td>
</tr>
<tr>
<td>5</td>
<td>General Motors</td>
<td>U.S.</td>
<td>75,150</td>
<td>303,100</td>
<td>48,233</td>
</tr>
<tr>
<td>6</td>
<td>Royal Dutch/Shell</td>
<td>U.K.</td>
<td>74,807</td>
<td>122,498</td>
<td>81,086</td>
</tr>
<tr>
<td>7</td>
<td>BP</td>
<td>U.K.</td>
<td>57,451</td>
<td>75,173</td>
<td>105,625</td>
</tr>
<tr>
<td>8</td>
<td>Toyota Motor</td>
<td>Japan</td>
<td>55,974</td>
<td>154,091</td>
<td>62,245</td>
</tr>
<tr>
<td>9</td>
<td>Telefonica</td>
<td>Spain</td>
<td>55,968</td>
<td>87,084</td>
<td>12,929</td>
</tr>
<tr>
<td>10</td>
<td>Fiat</td>
<td>Italy</td>
<td>52,803</td>
<td>95,755</td>
<td>35,854</td>
</tr>
<tr>
<td>11</td>
<td>IBM</td>
<td>U.S.</td>
<td>43,139</td>
<td>88,349</td>
<td>88,396</td>
</tr>
<tr>
<td>12</td>
<td>Volkswagen</td>
<td>Germany</td>
<td>42,725</td>
<td>75,922</td>
<td>57,787</td>
</tr>
<tr>
<td>13</td>
<td>Chevron Texaco</td>
<td>U.S.</td>
<td>42,576</td>
<td>77,621</td>
<td>65,016</td>
</tr>
<tr>
<td>14</td>
<td>Hutchison Whampoa</td>
<td>HK, China</td>
<td>41,881</td>
<td>56,610</td>
<td>2,840</td>
</tr>
<tr>
<td>15</td>
<td>Suez</td>
<td>France</td>
<td>38,521</td>
<td>43,460</td>
<td>24,145</td>
</tr>
<tr>
<td>16</td>
<td>DaimlerChrysler</td>
<td>Germany</td>
<td>38,521</td>
<td>43,460</td>
<td>24,145</td>
</tr>
<tr>
<td>17</td>
<td>News Corporation</td>
<td>U.S.</td>
<td>36,108</td>
<td>39,279</td>
<td>12,777</td>
</tr>
<tr>
<td>18</td>
<td>Nestle</td>
<td>Switzerland</td>
<td>35,289</td>
<td>39,954</td>
<td>49,928</td>
</tr>
<tr>
<td>19</td>
<td>TotalFinaElf</td>
<td>France</td>
<td>33,119</td>
<td>81,700</td>
<td>82,534</td>
</tr>
<tr>
<td>20</td>
<td>Repsol YPF</td>
<td>Sapin</td>
<td>31,944</td>
<td>487,763</td>
<td>15,891</td>
</tr>
<tr>
<td>21</td>
<td>BMW</td>
<td>Germany</td>
<td>31,184</td>
<td>45,910</td>
<td>62,167</td>
</tr>
<tr>
<td>22</td>
<td>Sony</td>
<td>Japan</td>
<td>30,214</td>
<td>68,129</td>
<td>42,768</td>
</tr>
<tr>
<td>23</td>
<td>E.On</td>
<td>Germany</td>
<td>30,214</td>
<td>68,129</td>
<td>42,768</td>
</tr>
<tr>
<td>24</td>
<td>ABB</td>
<td>Switzerland</td>
<td>28,619</td>
<td>30,962</td>
<td>22,528</td>
</tr>
<tr>
<td>25</td>
<td>Phillips Electronics</td>
<td>Netherlands</td>
<td>27,885</td>
<td>35,885</td>
<td>33,308</td>
</tr>
</tbody>
</table>

Table 3.6 records the result of the latest benchmark survey of U.S. portfolio investment which is investigated by a joint effort of the Department of the Treasury, the Federal Reserve Bank of New York, and the Board of Governors of the Federal Reserve System. Between 1984 and 2000, U.S portfolio investment has increased rapidly as Table 3.6 shows. U.S. holdings of foreign security approximately measured $2.2 trillion, with $1.6 trillion held in foreign equities, $508 billion in foreign long-term debt securities, and $117 billion held in foreign short-term debt securities as of December 31, 2000. Foreign holdings of U.S. security is beyond the level of U.S. holding of foreign securities always that reflects the profitability and stability of the U.S. financial market as the world's most attractive investment location. Foreign holdings of U.S. security reached $3.6 trillion with $1.7 trillion held in U.S. equities and $1.8 trillion held in U.S. debt as of March 31, 2000.

The U.S. financial service sector is functioning as an engine to operate U.S. power in the global political economy. As Table 3.7 shows, the financial service sector contributes 8.3 percent of the total GDP in 2000. The total GDP grew 6.5 percent in 2000, compared with 1999, while the financial services sector grew 8.0 percent (the largest increase among all sectors of U.S. GDP). In 2001, the total assets of the U.S. financial services amounted to $37.6 trillion (Table 3.8), and its employment reached 6.2 million people and occupied 5.7 percent of the total U.S. employment. In the same year, U.S.

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25 The financial service sector include four categories: property/casualty and life/health insurance companies; banks and other depository institutions, such as thrifts and credit unions; finance companies, which are nondepository institutions offering consumer and business financing; and securities brokers and dealers, which include investment banks and mutual fund managers. Insurance Information Institute, *The Financial Service Fact Book 2003* (New York: Insurance Information Institute, 2003), 1.
27 Insurance Information Institute, 5.
households’ financial assets became $32.1 trillion, about twice as much as the $16.4 trillion in 1991.

Table 3.6 U.S. Portfolio Investment

<table>
<thead>
<tr>
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<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>U.S. holding of Foreign Securities (estimates)</strong></td>
<td>89</td>
<td>314</td>
<td>890</td>
<td>2,000</td>
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<tr>
<td>Equities</td>
<td></td>
<td></td>
<td></td>
<td>2,224</td>
</tr>
<tr>
<td>Long-term Debt Securities</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Short-term Debt Securities</td>
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<td></td>
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<td></td>
</tr>
<tr>
<td><strong>Foreign holding of U.S. Securities</strong></td>
<td>268</td>
<td>847</td>
<td>1,244</td>
<td>3,558</td>
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<tr>
<td>Equity</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>357</td>
<td>1,161</td>
<td>2,134</td>
<td>5,558</td>
</tr>
</tbody>
</table>


Table 3.7 Financial Services vs. Total U.S. GDP Growth, 1990-2000

<table>
<thead>
<tr>
<th>Year</th>
<th>Total GDP</th>
<th>% change from prior year</th>
<th>Finance, insurance and real estate</th>
<th>% change from prior year</th>
<th>Finance and insurance</th>
<th>% change from prior year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>5,803.2</td>
<td>5.7</td>
<td>1,010.3</td>
<td>5.8</td>
<td>344.6</td>
<td>6.4</td>
</tr>
<tr>
<td>1991</td>
<td>5,986.2</td>
<td>3.2</td>
<td>1,072.2</td>
<td>6.1</td>
<td>383.1</td>
<td>11.2</td>
</tr>
<tr>
<td>1992</td>
<td>6,318.9</td>
<td>5.6</td>
<td>1,140.9</td>
<td>6.4</td>
<td>415.7</td>
<td>8.5</td>
</tr>
<tr>
<td>1993</td>
<td>6,642.3</td>
<td>5.1</td>
<td>1,205.3</td>
<td>5.6</td>
<td>453.7</td>
<td>9.1</td>
</tr>
<tr>
<td>1994</td>
<td>7,054.3</td>
<td>6.2</td>
<td>1,254.8</td>
<td>4.1</td>
<td>463.4</td>
<td>2.1</td>
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<tr>
<td>1995</td>
<td>7,400.5</td>
<td>4.9</td>
<td>1,347.2</td>
<td>7.4</td>
<td>514.6</td>
<td>11.0</td>
</tr>
<tr>
<td>1996</td>
<td>7,813.2</td>
<td>5.6</td>
<td>1,436.8</td>
<td>6.7</td>
<td>565.2</td>
<td>9.8</td>
</tr>
<tr>
<td>1997</td>
<td>8,318.4</td>
<td>6.5</td>
<td>1,569.9</td>
<td>9.3</td>
<td>649.8</td>
<td>15.0</td>
</tr>
<tr>
<td>1998</td>
<td>8,781.5</td>
<td>5.6</td>
<td>1,708.5</td>
<td>8.8</td>
<td>726.9</td>
<td>11.9</td>
</tr>
<tr>
<td>1999</td>
<td>9,268.6</td>
<td>5.5</td>
<td>1,810.6</td>
<td>6.0</td>
<td>759.4</td>
<td>4.5</td>
</tr>
<tr>
<td>2000</td>
<td>9,872.9</td>
<td>6.5</td>
<td>1,936.2</td>
<td>6.9</td>
<td>819.9</td>
<td>8.0</td>
</tr>
</tbody>
</table>

Table 3.8 Assets of Financial Services Sectors, by Industry (Year-end 2001)

(Billions of dollars)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Banking</strong></td>
<td>9,563.7</td>
</tr>
<tr>
<td>Commercial banking</td>
<td>6,875.6</td>
</tr>
<tr>
<td>Savings institutions</td>
<td>1,298.0</td>
</tr>
<tr>
<td>Credit unions</td>
<td>505.5</td>
</tr>
<tr>
<td>Bank personal trusts and estates</td>
<td>884.6</td>
</tr>
<tr>
<td><strong>Insurance</strong></td>
<td>4,186.9</td>
</tr>
<tr>
<td>Life insurance companies</td>
<td>3,305.8</td>
</tr>
<tr>
<td>All other insurers</td>
<td>881.1</td>
</tr>
<tr>
<td><strong>Securities</strong></td>
<td>7,940.7</td>
</tr>
<tr>
<td>Mutual and closed-end funds</td>
<td>6,503.3</td>
</tr>
<tr>
<td>Securities broker/dealers</td>
<td>1,437.4</td>
</tr>
<tr>
<td><strong>Pensions</strong></td>
<td>6,338.2</td>
</tr>
<tr>
<td>Private pension funds</td>
<td>4,161.5</td>
</tr>
<tr>
<td>State and local government pension funds</td>
<td>2,176.7</td>
</tr>
<tr>
<td><strong>Government-related</strong></td>
<td>5,129.6</td>
</tr>
<tr>
<td>Government lending enterprises</td>
<td>2,301.4</td>
</tr>
<tr>
<td>Federally-related mortgage pools</td>
<td>2,828.2</td>
</tr>
<tr>
<td><strong>Other</strong></td>
<td>4,457.7</td>
</tr>
<tr>
<td>Finance companies</td>
<td>1,152.9</td>
</tr>
<tr>
<td>Real estate investment trusts</td>
<td>76.9</td>
</tr>
<tr>
<td>Mortgage Companies</td>
<td>37.2</td>
</tr>
<tr>
<td>Asset-backed securities issuers</td>
<td>2,104.8</td>
</tr>
<tr>
<td>Funding corporations</td>
<td>1,085.9</td>
</tr>
<tr>
<td><strong>Total All Sectors</strong></td>
<td>37,616.8</td>
</tr>
</tbody>
</table>

The United States also boasts the world’s largest securities industries, which includes securities brokers and dealers, investment banks and advisers, and stock exchanges. As Table 3.9 shows, the United States has the largest stock market in the world. The capitalization of the U.S. stock market amounts to $16.6 trillion, which is four times bigger than that of Japan, which had the second largest stock market in the world in 2000. The New York Stock Exchange (NYSE) is the world’s largest stock market, and the NASDAQ is second. NYSE and the American Stock Exchange (AMEX) have long traditions in stock exchange and trading, while, the NASDAQ has specialized for the over-the-counter (OTC) securities market. Considering the growth and exchange activities, the U.S. stock market has grown faster than Japan or European countries during the past decade. In 2001, the volume and value of shares traded on the NYSE increased about seven times from those of 1991 (Table 3.10). In the case of NASDAQ, the volume and shares increased eleven and fifteen times respectively during the same period.

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28 Market capitalization indicates the market value of the stock market. The market capitalization is calculated by multiplying the share price by the number of shares outstanding in the stock market.

29 Generally, the securities traded in the OTC market are not listed in major exchanges (NYSE and AMEX). They include technology and small company stocks, asset-based securities, and U.S. government and corporate bonds. In the United States, there are seven regional exchanges and others that specialize in
Table 3.9 World’s Largest Stock Markets

<table>
<thead>
<tr>
<th>Country</th>
<th>Market capitalization</th>
<th>Value traded</th>
<th>Turnover ratio</th>
<th>Listed domestic companies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ millions</td>
<td>% of GDP</td>
<td>% of GDP</td>
<td>value of shares traded as % of capitalization</td>
</tr>
<tr>
<td>United States</td>
<td>3,059,434</td>
<td>16,635,114</td>
<td>53.2</td>
<td>181.8</td>
</tr>
<tr>
<td>Japan</td>
<td>2,917,679</td>
<td>4,546,937</td>
<td>98.2</td>
<td>104.6</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>848,866</td>
<td>2,933,280</td>
<td>85.9</td>
<td>203.4</td>
</tr>
<tr>
<td>France</td>
<td>314,384</td>
<td>1,475,457</td>
<td>25.9</td>
<td>103.0</td>
</tr>
<tr>
<td>Germany</td>
<td>355,073</td>
<td>1,432,190</td>
<td>22.2</td>
<td>67.8</td>
</tr>
<tr>
<td>Canada</td>
<td>241,920</td>
<td>800,914</td>
<td>42.2</td>
<td>126.1</td>
</tr>
<tr>
<td>Italy</td>
<td>148,766</td>
<td>728,273</td>
<td>13.5</td>
<td>62.2</td>
</tr>
<tr>
<td>Netherlands</td>
<td>119,825</td>
<td>695,209</td>
<td>40.5</td>
<td>176.6</td>
</tr>
<tr>
<td>Switzerland</td>
<td>160,044</td>
<td>693,127</td>
<td>70.1</td>
<td>268.1</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>83,397</td>
<td>609,090</td>
<td>111.5</td>
<td>383.2</td>
</tr>
</tbody>
</table>

Table 3.10 Exchange Activities, 1991-2001

<table>
<thead>
<tr>
<th>Year</th>
<th>NYSE Reported share volume (millions)</th>
<th>NYSE Value of shares traded ($ millions)</th>
<th>AMEX Share volume (millions)</th>
<th>AMEX Value of shares traded ($ millions)</th>
<th>NASDAQ Share volume (millions)</th>
<th>NASDAQ Value of shares traded ($ millions)</th>
<th>Regional Share volume (millions)</th>
<th>Regional Value of shares traded ($ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>45,266</td>
<td>1,520,164</td>
<td>3,367</td>
<td>40,919</td>
<td>41,311</td>
<td>693,852</td>
<td>7,255</td>
<td>204,292</td>
</tr>
<tr>
<td>1992</td>
<td>51,376</td>
<td>1,745,466</td>
<td>3,596</td>
<td>42,238</td>
<td>48,455</td>
<td>890,785</td>
<td>8,526</td>
<td>234,147</td>
</tr>
<tr>
<td>1993</td>
<td>66,923</td>
<td>2,283,390</td>
<td>4,582</td>
<td>46,737</td>
<td>66,540</td>
<td>1,350,100</td>
<td>9,809</td>
<td>284,569</td>
</tr>
<tr>
<td>1994</td>
<td>73,420</td>
<td>2,454,242</td>
<td>4,523</td>
<td>58,511</td>
<td>74,353</td>
<td>1,449,301</td>
<td>9,514</td>
<td>279,514</td>
</tr>
<tr>
<td>1995</td>
<td>87,217</td>
<td>3,082,916</td>
<td>5,072</td>
<td>72,717</td>
<td>101,158</td>
<td>2,398,214</td>
<td>11,446</td>
<td>355,879</td>
</tr>
<tr>
<td>1996</td>
<td>104,636</td>
<td>4,063,655</td>
<td>5,628</td>
<td>91,330</td>
<td>138,112</td>
<td>3,301,777</td>
<td>12,289</td>
<td>414,201</td>
</tr>
<tr>
<td>1997</td>
<td>133,312</td>
<td>5,777,602</td>
<td>6,170</td>
<td>143,230</td>
<td>163,882</td>
<td>4,481,691</td>
<td>14,809</td>
<td>573,212</td>
</tr>
<tr>
<td>1999</td>
<td>203,851</td>
<td>8,945,205</td>
<td>8,231</td>
<td>477,822</td>
<td>272,605</td>
<td>11,013,192</td>
<td>27,794</td>
<td>1,147,556</td>
</tr>
<tr>
<td>2000</td>
<td>262,478</td>
<td>11,060,046</td>
<td>13,318</td>
<td>945,391</td>
<td>442,753</td>
<td>20,395,335</td>
<td>40,058</td>
<td>1,716,869</td>
</tr>
<tr>
<td>2001</td>
<td>307,509</td>
<td>10,489,323</td>
<td>16,317</td>
<td>817,042</td>
<td>471,217</td>
<td>10,934,572</td>
<td>42,990</td>
<td>1,206,088</td>
</tr>
</tbody>
</table>


Major U.S. financial services industries have been ranked at the top position or included in the world top ten, which have become increasingly global in scope. For instance, General Electric and Citigroup are ranked first and second respectively among the world's largest financial services firms in the Global Fortune 500 in 2002. Bank of America Corporation and J.P. Morgan Chase are ranked the fourth and fifth respectively.
in the top ten global commercial and savings banks in 2001. American International
Group and State Farm Insurance are ranked second and third respectively, and another
three U.S. companies ranked six to ten in the top ten global property/casualty insurance
companies in 2001. Further, American companies were the top four global securities
Brothers Holdings) and the top six global diversified financials (1. General Electric, 2.
International) in the same year. \(^{30}\)

With the globalization of financial markets, the importance of the U.S. financial
market (as the most attractive investment place) and financial industries (as the largest
financial exporter) are more conspicuous. Thus, the world’s largest financial services
industries and financial market become the crucial asset of U.S. power as well as an
essential national interest. To secure and increase the foreign markets access of U.S.
financial industries, it is natural that U.S. foreign economic policy is oriented to open and
liberalize other nations’ financial markets. During the last three decades, while the U.S.
trade and current accounts deficits were increasing, only the financial service sector is
continuously showing surplus, which could make up a large part of U.S. twin deficits. In
this context, the Treasury Department strongly support and represents Wall Street’s
interest.

\(^{30}\) Insurance Information Institute, 133-144. The ranking is made by revenue based on Global Fortune 500.
3.1.4 U.S. Structural Power in International Financial Institutions

On top of these U.S. financial power resources, we should consider the U.S. power portion in crucial international financial institutions. As a major founder, the United States has highly influenced the main decisions and policies of the World Bank and the IMF. These two international financial institutions have mainly served as U.S. foreign financial and economic policy tools to liberalize and stabilize the international economic order since World War II. Although the U.S. voting power in these two institutions have shrunk compared to their founding (see Table 3.11), the United States not only preserves the largest voting power but also exerts an effective veto power.

Table 3.11 U.S. Voting Power in International Financial Institutions

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>World Bank</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td>35.1</td>
<td>30.7</td>
<td>26.3</td>
<td>22.7</td>
<td>19.7</td>
<td>17.0</td>
<td>16.45</td>
</tr>
<tr>
<td>G-7</td>
<td>61.7</td>
<td>60.0</td>
<td>54.9</td>
<td>51.3</td>
<td>49.7</td>
<td>43.3</td>
<td>43.10</td>
</tr>
<tr>
<td><strong>IMF</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td>35.6</td>
<td>31.4</td>
<td>25.8</td>
<td>22.9</td>
<td>20.1</td>
<td>18.3</td>
<td>17.16</td>
</tr>
<tr>
<td>G-7</td>
<td>65.5</td>
<td>64.4</td>
<td>57.6</td>
<td>54.4</td>
<td>49.4</td>
<td>45.9</td>
<td>45.51</td>
</tr>
</tbody>
</table>


In 2002, the United States had 16.45 percent voting power at the World Bank, and is the only country to exercise a veto power over some constitutional issues which require a special majority of 85 percent. U.S. voting power is two times larger than that of Japan (7.89 percent) which is the second largest voting power. Even if the major European
countries (Germany: 4.51 percent, United Kingdom: 4.32 percent, and France: 4.32 percent) vote together, their total vote is still less than that of the United States. U.S. predominant influence in the World Bank is shown by the fact that each president of the Bank is always a U.S. citizen appointed by the United States, and a large number of the Bank’s staff and economists overwhelmingly share a common American academic background. In addition, the U.S. executive director who represents the interests of the State Department, Commerce Department, Federal Reserve, International Cooperation Agency, Export-Import Bank, and Treasury conventionally exercise the most powerful decision making portion in the Bank.

In theory, the Bank’s Articles of Agreement prohibits any political interference from its lending activities as described in Article IV, section 10 (Political Activity Prohibited) “[t]he Bank and its officers shall not interfere in the political affairs of any member; nor shall they be influenced in their decisions by the political character of the member or members concerned.” However, in reality the Bank’s lending activities were highly influenced by political considerations and policy-linked to U.S. national interests such as Nicaragua, Indonesia, Vietnam, Chile, etc. Sometimes, it would be difficult to access the Bank’s lending for other countries without U.S. approval or cooperation.

35 See more detail cases in Gwin, 64 -76.
always seems to speak for the U.S. government's national interests. In fact, large parts of the policy prescriptions of the World Bank are very similar to U.S. policy directions. The U.S. government utilizes the Bank for channeling capital to developing countries according to U.S. interests and ideology.\(^{37}\) In the early 1980s, the Bank admitted that the neo-liberal foreign economic policy ("Washington Consensus") was designed by the U.S. Treasury, and forced these policy prescriptions on many developing countries at the price of its loans.\(^{38}\) Thus, the World Bank was highly influenced by the United States and served the U.S. foreign economic policy goals well.

U.S. power and influence on the IMF could be examined through four indicators: decision making procedure, "staff selection (particularly the managing director), policy parameters (for example, looser or tighter conditionality in IMF lending), and individual country programs."\(^{39}\) From the beginning, the United States, as the founder of the Fund and the largest member, has highly influenced the IMF. Since the U.S. dominance is nearly absolute, the IMF staff always follows and negotiates under guidance from the U.S. Treasury Secretary.\(^{40}\) U.S. voting power and its veto power indicate its central position at the IMF. In 2002, the United States had 17.16 percent voting power, while Japan had 6.16 percent and other larger European nations had 19.96 percent (Germany: 6.02 percent, France: 4.97 percent, and United Kingdom: 4.97 percent).\(^{41}\) Although the

\(^{37}\) Ascher, 118-119.
\(^{39}\) Miles Kahler, "The United States and the International Monetary Fund: Declining Influence or Declining Interest?," in Karns and Mingst, 93.
European states and Japan have gained financial power and quotas in the Fund, no major decisions are taken against the strong wishes of the United States. The United States is the only country that could demonstrate an effective veto power in major decisions, which requires either 70 or 85 percent of the total voting, such as an amendment of the Articles of Agreement (three-fifths of the members having 85 percent of the voting power), balance of payments assistance to developing country members, and others.\footnote{For detailed special voting majorities of financial decisions of the IMF see Treasurer's Department International Monetary Fund, \textit{Financial Organization and Operations of the IMF} (Washington, D.C.: IMF, 2001), 172.}

The United States exercises its leading position in the selection of the managing director, and other nations tend to accept American primacy. While each of the managing directors of the IMF have been selected among Europeans traditionally, if a managing director’s activities did not meet the U.S. interest, the United States would oppose tenure renewal. For maintaining close connection with the IMF, a “Treasury man” has always occupied the deputy managing director.\footnote{For detailed special voting majorities of financial decisions of the IMF see Treasurer’s Department International Monetary Fund, \textit{Financial Organization and Operations of the IMF} (Washington, D.C.: IMF, 2001), 172.}

During the last three decades, many IMF members which experienced banking and currency crises received a bailout from the Fund. In the process, the Fund has engaged in country programs which were mainly designed by the U.S. Treasury. Since the August 1982 Mexico financial crisis, the U.S. Treasury prepared the structural adjustment program (what is known as the “Washington Consensus”) to ensure adequate financing package for the major debtors. The IMF embraced this guideline which represents monetary and fiscal austerity, liberalizing trade and finance, cutting public subsidies, and deregulating the economy, and forced every affected countries to follow the Washington
Consensus guideline as a conditionality or structural reform.\(^{44}\) In accordance with the IMF guideline, many developing countries had to open their financial market and to liberalize capital movements through the 1990s.\(^{45}\)

U.S. power influenced the IMF’s lending decisions to attract new allies and punish defectors during the Cold war period, and has continued to influence IMF lending since. The United States pressed the Fund for political reasons to approve loans for its allies such as South Africa, El Salvador, and Haiti and to deny loans for its enemies such as Vietnam regardless of the Fund’s economic standards.\(^{46}\) Even though the United States repeatedly denied their influence on IMF lending, the American politicization of the IMF lending is illustrated by many cases across Latin America, East Asia, and Russia. Thus, the IMF and World Bank lending has served U.S. interests and were highly influenced by American political interests.

Thus, U.S. power over the IMF and the World Bank are greater than its shares of the votes, and is symbolized by the fact that the headquarters of the World Bank and the IMF are located a stone’s throw from the U.S. Treasury in Washington D.C. These two international financial institutions have played an important role to spread financial liberalization and free capital movement to all developing member countries as powerful tools of U.S. foreign economic policy.

\(^{43}\) Kahler, 94.


Since the 1970s, the United States has utilized its structural power resources as a strong tool to construct a financially liberalized global order. The U.S. proponent role of financial liberalization (globalization) was driven bilaterally as well as multilaterally. The United States not only has strongly pressed other government to open and liberalize their financial markets (for instance, East Asian nations including Japan and South Korea, and other Latin American countries as a sort of ‘market access activism’), but also has tried to implant globalization in international financial markets through multilateralism (for instance, service negotiation of the GATT Uruguay Round, the Multilateral Agreement on Investment, and the Financial Services Agreement).

3.2 U.S. Domestic Capital Controls and Financial Liberalization

3.2.1 U.S. Domestic Capital Controls

Historically, most governments implemented capital controls and regulated their financial markets for the purpose of exchange rate stability and maintenance of foreign exchange reserve to finance international trade. Remarkably, the experience of the financial disruptions of the Great Depression in the 1930s made most governments consider capital controls as critical policy options to prevent financial chaos and protect their financial markets. This old tradition of capital controls continued under the Bretton Woods system following World War II. Article VI, Section 3 of the IMF’s Article of Agreement prescribed that “members may exercise” capital “controls as are necessary to regulate international capital movements.”

Although the Bretton Woods agreement and the GATT made an effort to liberalize world trade, they paid little attention to free capital

47 IMF, Articles of Agreements.
movements. Major industrial countries including the United States imposed regulations of international capital movements. 48

Even the United States, the champion of financial liberalization, imposed various capital controls in the 1960s such as the Interest Equalization Tax (IET) of 1963, and the Voluntary Foreign Credit Restraint Act (VFCR) of 1965 to restrain capital outflows. 49

During the late 1950s and early 1960s, the United States was pressed by the balance-of-payments deficits, which partly results from higher interest rates in the major international financial markets. Especially, most European countries tended to have higher interest rates than those of the United States for the purpose of attracting U.S. capital. If the Kennedy government had not introduced any capital control measures such as the IET in July 1963, it was evident that the American economy would not escape from its recession nor slow the continuous capital outflow from the U.S. searching for higher profits in other foreign financial markets. The IET imposed 1.05 to 15 percent surcharges on U.S. purchase of stocks and bonds toward Western Europe, Japan, Australia, South Africa, and New Zealand according to their maturities. 50 The IET could reduced capital outflows toward the target countries, but did not change the total outflows not because investors could escape the tax to third exempted countries such as Canada, but because the IET did not regulate the banks’ loans. During the Johnson government, the U.S. Congress adopted VFCR to curb their banks’ loans to foreign countries in February 1965, and extended its limit to regulate short-term capital outflows to other

48 Kester and Panel on International Capital Transactions, Following the Money, 19.
50 Congressional Quarterly Service, “Interest Equalization Tax Background,” Congress and the Nation,
developed countries in 1966. In addition, the Johnson administration tried to established voluntary guidelines to slow U.S. corporations’ foreign direct investment.\textsuperscript{51}

This common practice of capital controls and regulations of financial markets were relaxed and eliminated starting in the United States in the early 1970s. Although there was a movement to eliminate financial control in developed countries in the early 1960s, it ended as a mere scrap of paper. On December 12, 1961, the Organization for Economic Cooperation and Development (OECD) countries agreed to abolish the capital control and signed the Code of Liberalisation of Capital Movement (CLCM).\textsuperscript{52} Article 1 of the CLCM states that “[m]embers shall progressively abolish between one another,” and Article 2 prescribes that “restrictions on movements of capital to the extent necessary for effective economic co-operation.”\textsuperscript{53} However, during the 1960s and 1970s, no other countries kept this agreement. Only the United States began to eliminate capital controls after the early 1970s.

3.2.2 U.S. Domestic Financial Liberalization

Why did the United States eliminate existing capital controls and move to financial liberalization during the early 1970s? U.S. domestic conditions and international political economy provide the context. After World War II, the United States, as the world’s strongest economic and military superpower, could assume the role of construction and operation of the liberal world economy. The United States economy was not only

\textsuperscript{51} Neely, 24.


unharmed by the war, but also had superiority in its largest market, huge productive
capability, financial facilities, and a strong currency. U.S. hegemonic power and
leadership was vital for the management of global political economy and the Bretton
Woods system. However, the hegemonic role of the United States in global political
economy had begun to decline in the late 1960s due to the escalation of the Vietnam War
and President Johnson’s Great Society program, which deteriorated American’s balance-
of-payments and increased monetary instability in the global economy.\(^{54}\)

Furthermore, the various existing capital controls mechanisms (IET or VFCRP) of the
United States to restrain capital outflows did not work well due to the rise of the
Eurodollar markets during the 1950s and 1960s. Ironically, the financial restrictions on
private capital movement helped to encourage investors to enter the Eurodollar market.
Since the Eurodollar market had no reserve requirements and capital movement
restrictions, and offered high interest rates, many American bankers and investors headed
for this offshore international financial market to avoid domestic financial regulations.
American banks and multinational corporations preferred the Euromarkets in London to
the U.S. financial market for lending and investments.\(^{55}\)

After all, the rise in capital mobility in Euromarkets and the chronic balance-of-
payments deficit of the United States served to undermine the Bretton Woods fixed
exchange system. On August 15, 1971, President Nixon’s announcement that the dollar
would no longer be convertible into gold (the fundamental of the fixed exchange rate
system) signaled the collapse of the Bretton Woods system. At this critical moment, U.S.

\(^{54}\) Gilpin, *The Political Economy of International Relations*, 138; Helen V. Milner, “International Political
Economy,” 115.

\(^{55}\) Frieden, *Banking on the World*, 84.
officials struggled to find a breakthrough to lessen its growing external and internal
deficits, and preserve U.S. policy autonomy. They recognized a more open and liberal
international financial system could promote free capital movements and further help to
finance their burden for growing deficits. This consideration was evident through the
currency crisis in February 1973, and the Nixon government announced the abolition of
capital controls programs (IET and VFCR).

Owing to the U.S. deregulation of capital controls, foreign capital could come to the
U.S. financial market easily, and absorb the country's large current account adjustment
burdens. Furthermore, the United States neglected its external deficit and encouraged
private financial operators' speculations against the dollar. Thus, U.S. financial
liberalization policy and laissez-faire behavior urged foreign governments to choose two
policy alternatives: either increase their domestic money supplies in order to prevent the
devaluation of the dollar, or accept a revaluation of their currencies. Since most countries
should preserve huge amounts of dollar holding as their foreign exchange reserves
followed the key currency status of the dollar under the Bretton Woods system, foreign
governments' policy options had to be limited. By 1973, U.S. financial liberalization
policy had succeeded to eliminate a large part of the country's current account deficit.

Besides the international political economic background, lobbying and pressure from
domestic business groups influenced the removal of capital controls by the Nixon
government. At the time, many American banks and multinational corporations
complained that their difficulty in competing with large foreign corporations in the

56 Helleiner, States and the Reemergence of Global Finance, 112.
57 Sobel, State Institutions, 56.
58 Helleiner, 112-113.
Eurodollar market was due to the country's capital controls, and pressed the government to eliminate or relax these regulations. During the 1968 presidential election campaign, the Republican candidate Nixon pledged to remove capital controls to placate the business groups' interests, and ordered the elimination of capital controls at the very first meeting of his Cabinet Committee on Economic Policy. In this period, U.S. financial liberalization was also influenced by a domestic political shift. During the Nixon and Ford administrations, major government officials who were responsible for international financial policy were occupied by supporters of neoliberalism. For example, Gottfried Haberler, a leader of the Austrian neoliberal school, served as Nixon's international financial issues advisor. George Shultz, who had close relations with the famous neoliberal economist Milton Friedman and the University of Chicago, served as Treasury secretary after mid-1972. William Simon (succeeding Treasury secretary) and Thomas Willett (senior staff economist to the Council of Economic Advisers in the Nixon government) were the advocators of the neoliberal idea. These neoliberalist officials had more concern for U.S. policy autonomy in the global economy as well as the desirability of a liberal international financial order and continually pursued liberalization in global financial markets.

The United States believed that a more liberal international financial system could ensure its long-term policy autonomy. Owing to the most competitive financial market in the world and the dollar status as the world reserve currency, foreign investors would still

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59 Sobel, 82-84.
60 Friedrich Hayek and Milton Friedman provide the theoretical background of neoliberalism. They believe that a liberal international financial order contributes to a more efficient allocation of capital between countries and facilitates economic growth in the international economy.
61 Helleiner, 115.
want to invest in the U.S. financial market and this capital inflow could finance their current account deficits. This U.S. policy consideration drove their foreign economic policy goal of free international financial movements. Due to the Nixon shock, international financial markets were very unstable and strained from speculative financial capital flows. In December 1971, the Group of Ten met at the Smithsonian Institution in Washington and agreed to the fixed exchange management. However, the Smithsonian Agreement lasted a mere 15 months due to speculative financial attack. Confronted with this financial instability, in 1973 the European and Japanese officials made a proposal to strengthen IMF power to obligate its members to cooperate in controlling financial movement. This proposal was broadly supported by IMF staff who understood that disruptive capital movements made unstable international financial markets and was one of the main reasons for the collapse of the Bretton Woods system. Yet this proposal would not come true due to the U.S. structural power of supporting financial liberalization. In advance, the United States tried to persuade foreign governments to remove their capital controls through the reform talks for constructing a fully liberalized international financial system.

This U.S. financial liberalization, which was the critical moment for financial globalization, facilitated free financial movement in the international financial market during the transition period from the Bretton Woods fixed exchange system to a flexible exchange system. Particularly, in the mid to late 1970s, huge amounts of oil funds from

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62 Beth A. Simmons, “The Internationalization of Capital,” Continuity and Change in Contemporary Capitalism, eds. Herbert Kitschelt et al. (New York: Cambridge University Press, 1999), 40-41.
64 Eric Helleiner, “Explaining the Globalization of Financial Market: Bringing States Back In,” Review of
the Organization of Petroleum Exporting Countries (OPEC) through two oil crises accelerated financial globalization. Large parts of this oil fund flowed into the Eurodollar markets and was used for financing many developing countries budget and balance-of-payments deficits.

Beginning in the early 1980s, U.S. financial liberalization induced large capital inflows for the finance of the country's budget deficits much like during the Nixon administration. In the 1980s, the Reagan government’s supply-side economics and military buildup made the largest budget deficits in American history. The federal budget deficit of $73.8 billion in fiscal year 1980 (2.8 percent of the GNP) was highly increased to $207.8 billion in 1983 (6.8 percent of the GNP). Measured as a share of GNP, the federal deficit averaged 0.8 percent in the 1960s, and 2.1 percent in the 1970s. The Reagan government had to finance its budget deficits and economic recovery through financial liberalization to induce foreign capital inflows. Various liberalization measures of the U.S. domestic financial market were introduced. In 1980, the Federal Reserve agreed to phase out Regulation Q. In December 1981, regulation-free International Banking Facilities (IBFs) were introduced. In 1984, the 30 percent withholding tax on interest payments to foreign holders of U.S. government and corporate bonds was eliminated and special Treasury bonds directly enlisted into the Euromarket were issued

International Political Economy 2, no. 2 (Spring 1995): 322-323.


66 Regulation Q was introduced by the Federal Reserve in the Great Depression, under which it was able to set a ceiling on the interest rates banks could pay on deposit. Regulation Q was aimed at limiting competition following the failure of U.S. banks. Problems emerged in the 1960s when unregulated interest rates shot up, money-market funds were able to offer investors better returns than those available from the banks and saving-and-loan associations and bank deposit bases shrank. The Fed agreed in 1980 to phase out Regulation Q.
for the first time. In addition, the relaxation of portfolio investment regulations on pension funds, insurance companies, and mutual funds was implemented, and various restrictions on the banking activities were removed. These domestic financial liberalization measures lowered financial institutional barriers and increased firms and individual's opportunities to adjust their claims and liabilities, and diversify their risks. Further, these measures facilitated international capital movement in global financial markets and capital inflows into the U.S. financial markets. These U.S. efforts at financial openness had the same policy considerations of the early 1970s: a more open and liberal financial system would help the United States to finance its large budget and current account deficits. During the Reagan era, foreign purchases of U.S. government and corporate bonds surged, and a large part of these foreign funds were used to finance its dual deficits.

3.3 The United States: A Strong Proponent of Financial Globalization

3.3.1 U.S. Financial Liberalization as Peer Pressure on Developed Countries

As a proponent and leader of financial liberalization, the United States provided strong peer pressure on other foreign countries. U.S. initiatives for financial liberalization served as the starting point of contemporary financial globalization in that the country's policy aimed at the abolition of interest rate ceilings, the relaxation of FDI and portfolio investment restrictions, and the removal of a variety of restrictions on the permissible activities of banks, has promoted huge monetary transfers across borders, and has been a strong force for financial globalization. Through successful financial liberalization, U.S.

67 I.M. Destler and C. Randall Henning, Dollar Politics: Exchange Rate Policymaking in the United States
policy-makers became more active proponents of financial liberalization, and the Treasury Department pressured other governments (e.g. Japan) to liberalize their financial markets.

Confronted with the U.S. initiative to financial liberalization and increasing financial mobility, other developed countries proceeded with financial liberalization during the 1970s and 1980s. However, the process of financial liberalization in developed countries was very slow in the early stages and was not fully accomplished until the late 1980s except for the United States, Canada, and Switzerland. Canada and Netherlands lifted capital controls in 1974. Beginning in 1977, Britain liberalized exchange controls on capital movements, and existing exchange controls were fully removed in October 1979. France removed capital controls to enter the European Community’s single market in financial services in 1986 and completed the task by 1990. Italy began to eliminate capital controls in 1987. Under U.S. pressure, Japan had to accelerate the liberalization and deregulation of its financial system throughout the 1980s. Thus, the United States broader financial liberalization had an important effect on promoting similar liberalization movements in developed countries. The interaction of these developed national financial liberalization policies has produced massive capital flows across national boundaries and highly contributes to financial globalization.

68 Quirk and et al., “Capital Account Convertibility”, 11.
69 Simmons, 41.
3.3.2 U.S. Strategy for Financial Globalization through the Multilateral Agreements

The United States strongly propelled financial globalization and financial liberalization through the Multilateral Agreements. The U.S. efforts at liberalization, deregulation, and globalization in the international financial system have evolved bilaterally, through multilateral agreements, and the international organizations (the IMF and the World Bank). Since the late 1980s, U.S. pressure for financial liberalization has been more strenuous and institutionalized. Multilateral agreements, such as liberalization of trade in services in the GATT Uruguay Round, the FSA in the WTO, the MAI in OECD, and the international organizations, such as the IMF, the World Bank, and the WTO are arenas for U.S. financial globalization. American attempts to free capital movements have exhibited a strong foreign pressure on all the other countries in the world. These attempts have been a strong motive to promote the financial liberalization for industrial countries, while American initiatives for financial market opening have become a strong foreign pressure on developing countries.

3.3.2.1 Liberalization of Trade in Services in the GATT Uruguay Round

After the break down of the Bretton Woods system, U.S. government officials have pursued financial liberalization that encourages capital inflows to the country's domestic financial market and lessen their burden of current account deficits due to its attractive financial position. This American initiative was strenuous to build a more open and liberalized international financial system through multilateral agreements such as the trade in services in the Uruguay Round.

70 Destler and Henning, 29.
During the 1980s, the Reagan administration recognized the decline of U.S. manufacturing and rise of the country's service economy, and tried to remove other countries' trade barriers in service sectors particularly in financial services. The world's largest service-based economy including insurance, banking, information technologies, and motion pictures (that produced 69 percent of the GDP and employed 75 percent of its work force) was the top priority for U.S. economic interests.\(^{71}\) The reorganization of the other countries' protectionism would harm the U.S. advantage in services, and made the U.S. offer to remove trade barriers in services such as import restrictions, subsidies, tax discrimination, and restrictive government procurement practices in the General Agreement on Tariffs and Trade's (GATT) Tokyo Round (held in Geneva from 1973 to 1979), but most developed countries maintained a lack of interest.

After the Tokyo Round, the Reagan administration, along with former U.S. Trade Representative William Brock, set the liberalization of services a high priority in the GATT Round.\(^{72}\) Since early 1981, this agenda had been vigorously debated between Brock and many U.S. financial services firms led by American Express Company (under its chairman Jim Robinson), and shared the importance of their need. Generally, three groups had pushed the extension of financial services in multilateral trade agreement. U.S. financial services industries led by the American International Group (AIG) and American Express sought to ensure continuous foreign market access in contrast with various restrictions from foreign countries. These firms insisted on market-access provisions that enabled them to increase their sales in international markets through exports and local sale by foreign affiliates. Another group was public officials and other

business leaders, who insisted that the United States comparative advantage had moved from goods to services. The United States firms could increase their sales through both export and direct investment so that the opening of world markets in these areas was essential. The other group was the United States trade policy experts. They believed that the introduction of service areas was a way to reanimate GATT and arrange it to a globalizing world economy.\textsuperscript{73}

Under these circumstances, the U.S. trade delegation officially raised the services issue at the ministerial meeting of GATT in November 1982, and promoted this agenda to other countries thereafter. Notwithstanding a lack of enthusiasm and even indifference on the part of most industrial countries, and strong unwillingness of most developing countries led by Brazil and India, GATT members agreed to the services agenda at the new trade negotiation table of the Uruguay Round at the November 1985 meeting.\textsuperscript{74} The U.S. efforts for liberalization in services realized in the General Agreement on Trade in Services (GATS) of the Uruguay Round,\textsuperscript{75} and for financial liberalization in global level came true in the World Trade Organization's Financial Services Agreement.\textsuperscript{76}

\textsuperscript{72} Shelp, 71.
\textsuperscript{73} Rachel McCulloch, “Services and the Uruguay Round,” \textit{The World Economy} 13, no. 3 (September 1990): 334.
\textsuperscript{74} See detailed discussion in Shelp, 71-76.
\textsuperscript{75} The Uruguay Round, 1986-1994, dramatically revised the structure of the GATT and created a new organization, the WTO, to administer a much broader mandate and more powerful regulatory tools, and introduced services sectors (tariffs and issues of trade in financial services, tourism and construction, trade involving copyrights and patents, and regulations restricting foreign direct investment) into the multilateral negotiations.
\textsuperscript{76} The WTO's Financial Services Agreement was completed on December 13, 1997 and took effect March 1, 1999. The FSA is a legal framework for cross-border trade and market access in financial services and a mechanism for dispute settlement. The FSA was extended by the General Agreement on Trade in Services (GATS) that negotiated within the Uruguay Round agreement. Wendy Dobson and Pierre Jacquet, \textit{Financial Services Liberalization in the WTO} (Washington D.C.: Institute for International Economics, 1998), 1.
During the Uruguay Round negotiation, the United States took the initiative in aggressively pushing other counties to bring about agreements. The 1988 Trade Act with its 'super 301' provisions and 'most-favored nation' (MFN) exemptions were used as strong bargaining tools. Through these bargaining tools, if U.S. firms could not access foreign countries effectively, the U.S. government would be able to block the foreign companies' business activities in the U.S. market and withdraw the MFN principle. Since most foreign institutions already had access to the U.S. financial services markets on a national treatment basis, the U.S. MFN exemption was formidable to persuade the U.S. firms' foreign market access.\(^7^7\) Behind the strong U.S. initiative, U.S. domestic groups had an important role for the U.S. negotiation process. U.S. domestic interest groups such as Citicorp and American Express allied with the Coalition of Service Industries, the Bankers Association for Foreign Trade, and Financial Services Council to continuously monitor and push the U.S. government's negotiation process.\(^7^8\) In October 1989, the United States presented the first draft of a legal agreement on trade in services at the negotiating group's meeting. Most developing countries criticized the U.S. proposal for failing to manage the problem of their services sectors. In addition, Japan expressed reservations about the application of a 'reciprocal market access approach' at the negotiating group meeting in December 1989.\(^7^9\) Accordingly, the U.S. intention to include financial services in the Uruguay Round GATS was frustrated, and had to be moved to the World Trade Organization's (WTO) Financial Services negotiation.

\(^7^7\) See detailed discussion in Sydney J. Key, Financial Services in the Uruguay Round and the WTO, Occasional Papers, no. 54 (Washington, D.C.: Group of Thirty, 1997), 33-43.
3.3.2.2 The WTO’s Financial Services Agreement

According to the agreement of the contracting parties, the financial services negotiation could extend to July 1, 1995. The July 1995 interim agreement on financial services set December 31, 1997 as the new deadline for a final agreement. When the negotiation resumed in the spring of 1997, the deadline was advanced to December 12 of the same year.

As same as the U.S. initiative to services in GATT Uruguay Round, the United States strongly pressed other nations (in particular Japan and Southeast Asian countries) through the country’s structural power for the FSA. The U.S. intention was shown in the testimony of Steve Judge, Senior Vice President of Government Affairs Securities Industry Association. In 1998, U.S. financial services firms contributed $626 billion to the United States Gross Domestic Product (GDP), about 7.7 percent of total GDP. These firms have six million employees. During the period 1980-1997, the U.S. securities industries’ contribution to total output of the U.S. economy increased by 8.4 times- three times the increase of the overall economy. The United States’ main purpose in the financial service negotiation was to remove the barriers for extending financial services to developing countries. Owing to these efforts, U.S. financial institutions are now permitted to enter nearly all WTO member countries.

During the negotiation process, most developing countries and even Japan were unwilling to commit to a substantial and binding opening of their financial sectors. Because most developing countries had underdeveloped and outmoded financial services

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79 Underhill, 134-135.
80 SIA Testimony before the Subcommittee on Trade House Committee on Ways and Means United States House of Representatives, August 5 1999,
sectors compared to those of industrial countries, if they would agree to the FSA without any safety mechanisms, it is evident that the developing countries’ financial markets would be severely eroded by the advanced financial intermediaries of the developed nations. On the other hand, the United States and the OECD countries were unwilling to commit the MFN-based multilateral agreement of trade in financial services with the developing countries since their financial services sectors were already relatively open and left only a few new commitments. This free rider problem was a major obstacle in the financial services negotiation.  

Confronted with this obstacle, the United States strongly pressed Japan to open its financial market and achieve significant progress through the powerful MFN exemption bargaining tools. Under U.S. pressure, Japan agreed to a bilateral U.S.-Japan insurance agreement on October 11, 1994, and a comprehensive bilateral financial service agreement which covered “asset management, corporate securities, and cross-border financial transactions” on February 13, 1995. Finally, Japan agreed to full commitment of the FSA by 2001.

In addition, in June 1995, the United States was unsatisfied with the offers of the emerging markets which were far behind U.S. expectations, and strongly pressed the nations through the announcement of the full withdrawal of its offer on financial services and the inducement of an MFN exemption. Under the disadvantageous offer from the United States, developing countries had no choice but to follow the multilateral rule of

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81 Dobson and Jacquet, Financial Services Liberalization in the WTO, 81.
82 Dobson and Jacquet, 82.
83 Key, Financial Services, 4.
the FSA, and to implement full financial market liberalization following the member's 'Schedule of Commitment'.

Thus, U.S. leadership and its structural power successfully concluded FSA in December 1997, and it entered into force in March 1999. The FSA contributed to increasing the sales and market shares of the U.S. financial service industry including insurance, banking, securities and financial data services in the world financial markets. Thus, the Agreement has opened the world financial services market and fostered unprecedented financial globalization.

Under the GATS, financial services have the following features. Between WTO member countries, all financial services suppliers should be treated equally (Article II: MFN treatment). Following the member's schedule of Commitment, all financial markets of member countries should be opened (Article VI: Domestic Regulation). Members cannot construct any specific measures that would restrain market access unless these restrictions are clearly recorded in the schedule of Commitment (Article XVI: Market Access). The Annex on Financial Services contains a prudential carve-out and definitions of financial services in three main sectors: insurance, banking and securities. "Members should not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons" (2. Domestic Regulation: Prudential carve-out).

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84 See the original text of GATS in <http://www.wto.org/english/tratop_e/Serv_e/gatsintr.htm> (3
3.3.2.3 The Multilateral Agreement on Investment

The U.S. power to build a liberalized global financial system has highly propelled the negotiations of the Multilateral Agreement on Investment (MAI) in the OECD. As the world's largest foreign direct investor, the United States wanted to protect its investors and secure a more stable investment place from the other governments' regulation and discriminatory practices and to assure the flow of financial movements across borders.

According to the OECD's International Direct Investment Statistics Yearbook 1998, the United States is the leading importer ($90.7 billion) and exporter ($114.5 billion) of foreign direct investment (FDI). From 1992 to 1997, the U.S. annual inflow of FDI increased by 472 percent, whereas its annual outflow of FDI increased by 268 percent. After 1990, investment outflow began to exceed inflow, and U.S. FDI began to surpass export growth.\(^85\) The United States claimed that the MAI will provide needed protections for the United States and other international investors against discrimination and expropriation. The agreement should open new markets to U.S. investors on favorable terms and improve the efficiency of global financial markets. These U.S. economic interests are supported by the U.S. Council for International Business, the National Association of Manufacturers, and the European-American Chamber of Commerce.\(^86\)

Along with U.S. priorities, most OECD countries recognized the need of the MAI since they occupied more than half of the world's FDI. The OECD has maintained a multilateral approach to investment through the Codes of Liberalisation and the Declaration and Decision on International Investment and Multinational Enterprises, but

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\(^{86}\) Center for Economic and Policy Research (CEPR), *The Multilateral Agreement on Investment: Basic*
the codes were not comprehensive and were ill-prepared for the effective dispute settlement procedures. Thus, the United States and OECD members share the common benefits of free investments in global financial markets and the need for more wide-ranging and helpful investment rules.\(^8^7\)

Negotiations with the OECD started in May 1995, and the basic purpose, structure, and provisions of the agreement and confidential draft of the MAI were reached by January 1997. OECD delegates had initially agreed to complete negotiation by the OECD Ministerial meeting scheduled for May 26, 1997.\(^8^8\) However, the negotiation process was confronted with specific differences among negotiators until March 1997. According to a Clinton Administration official, each nation was opposed to the MAI's scope and type of exemptions. Based on a "top-down" negotiation principle, all economic sectors were covered, and all countries must negotiate limited exemptions to the agreement. France, Canada and Belgium were especially concerned with preserving their cultural heritages, so they proposed a "cultural" exemption. If these countries open their movie and publishing industries to other countries (particularly to the United States), they are seriously worried that their cultural heritages would be harmed. On the other hand, the European Union (EU) countries had argued for a proposed exemption for Regional Economic Integration Organizations (REIOs) like the EU. They proposed that preferential treatment to a member would be unavoidable to facilitate integration, so they need an exemption for these measures. Confronted with these disagreements, the United

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\(^8^8\) OECD, *Multilateral Agreement on Investment (Report by the Chairman of the Negotiating Group)*, DAFFE/MAI(98)9/FINAL (20 April 1998), 2.
States vigorously opposed any exemption that would bring disadvantage to U.S. business.\textsuperscript{89}

On April 27 and 28, 1998, the OECD Ministerial meeting discussed the fate of the MAI and concluded that they would not complete the MAI and delayed talks until October 1998. Yet the fate of the MAI was very cloudy due to the French Prime Minister Lionel Jospin’s denial to participate in the meeting on October 15, 1998. At the time, French civil society strongly protested the MAI. Despite the strong U.S. support, negotiations ceased in December 1998.\textsuperscript{90}

According to the OECD’s MAI Report, the MAI is a sort of comprehensive investment agreement, aimed to cover all economic sectors. The “investment” in the MAI is more broadly defined to cover direct investments, portfolio investments, real estate investments and rights under contract. The MAI was to be a “free standing international treaty, open to all OECD members and the European Communities, and to accession by non-OECD Member Countries.” Its objective was to “provide a broad multilateral framework for international investment with high standards for the liberalization of investment regimes and investment protection and with effective dispute settlement procedures.”\textsuperscript{91}

\textsuperscript{89} CEPR, 2.
\textsuperscript{91} OECD documents, \textit{Multilateral Agreement on Investment: Documents Relating to the 1995-1998}
3.3.2.4 *Washington Consensus: U.S. Financial Liberalization as a Tool toward Developing Countries*

Unlike the U.S. peer pressure on developed countries' financial liberalization, the Treasury Department has strongly pressed other developing countries’ financial market opening and liberalization. U.S. pressure backed up by the country’s large financial institutions’ interest for access to emerging markets, has directly forced developing countries through bilateral relations (e.g. South Korea) or was indirectly exercised through the IMF and World Bank’s structural adjustment programs. The U.S. financial liberalization policy sought to open developing countries’ financial markets. The neoliberals’ ideas were developed into the concrete policy proposals for financial liberalization which is known as the “Washington Consensus.” The term was coined by John Williamson of the Institute for International Economics in Washington, DC. It is used to describe the institutions of Washington - the International Monetary Fund, World Bank, the U.S. Treasury, the U.S. Federal Reserve, the various likeminded political lobbying groups, and think-tanks (funded by large banks and transnational corporations) - that successfully promoted a free-market (“neoliberal” or “structural adjustment”) approach to economic policies. The Washington Consensus entailed a combination of free trade, tighter budgets (through lower taxes on corporations and wealthy individuals), higher interest rates (to attract foreign capital and boost domestic savings), liberalized financial flows, and deregulation of business. In addition, this policy insists on less state intervention and ownership in activities that could be carried out by private firms.


The United States has fully utilized its dominant structural power to make the IMF and the World Bank espouse the “Washington Consensus” policy proposal as a main theoretical framework for financial liberalization in developing countries. The United States and the IMF believe that financial market liberalization will increase economic growth and development by allocating global capital to its most efficient uses. Since the late 1980s and early 1990s, the United States and the IMF have urged many developing countries to open their financial markets to allow free flows of short-term investments.94

The U.S. push for free capital movement in other countries began during the Reagan Administration. In 1985, President Reagan declared “[o]ur task is to knock down barriers to trade and foreign investment and the free movement of capital.”95 Japanese financial market opening and liberalization was recorded as the main achievement of the Reagan Administration. This foreign financial policy to free financial movement continued in the Bush and Clinton Administrations. President Bush described his Latin American program as “free markets and to the free flow of capital, central to achieving economic growth and lasting prosperity”96 for U.S. financial intermediaries. This idea harshly pushed financial liberalization and market opening in Mexico in the North American Free Trade Agreement (NAFTA) negotiation of 1991-1993. At the time, Mexico protected domestic bank industries from the foreign banks’ advanced business activities through the quantitative restrictions on the total deposits share. In order to increase the market share of the U.S. banks, the U.S. government strongly pushed the Mexican government. After

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93 Williamson, 7.
96 Kristof with Sanger, A10.
the 1994 financial crisis, Mexico had to eliminate this measure exchange for the rescue money from the United States. The Clinton government strenuously pushed financial liberalization, particularly on East Asian governments. As the most attractive emerging market, East Asian economies had succeeded in rapid economic growth since the late 1970s, but they maintained various types of financial market regulations, which block the U.S. financial industries access. The Clinton Administration created the National Economic Council and spurred the free market ideology to lift financial regulations. This push for financial liberalization directly led to the Asian financial market opening. One of the conspicuous targets of the United States was South Korea. Since South Korea was dependent on its national security and the largest export market of the United States, the U.S. pressure for financial market opening was effective. Furthermore, some financial regulations were fully removed through the conditionality attached by the IMF bailout that the U.S. Treasury pressed.

The U.S. financial market opening and liberalization was met by domestic policy considerations from the East Asian countries which believed that financial capital inflows would be used to finance their current accounts deficits and economic developments. However, they did not fully understand the perils of the short-term capital movement until the 1997 Asian financial crisis. Under pressure from the United States and the IMF, and some aspects of domestic consideration, several developing countries had to open their financial markets. Yet in a short period, these developing countries (such as East Asian and Latin American countries) experienced a tremendous increase of bank lending and portfolio investment. Before long, these developing countries' financial markets

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97 Robert Wade, "The US Role in the Long Asian Crisis", 204-205.
collapsed, beginning with the Mexican economy in December 1994 and leading to several East Asian countries in 1997. During the negotiation process between the IMF and affected East Asian countries around the bailout and structural adjustment program, the U.S. Treasury Department strongly pushed the IMF for the full financial liberalization and market opening of the affected countries.

A series of continuous financial crises in successful emerging market economies awakened many political economists and government officials to reconsider financial market liberalization and the need for global governance to lessen the danger of speculative short-term financial movements. Joseph Stiglitz, the World Bank’s former chief economist, argued that the main reason for the East Asian financial crises originated from the financial liberalization during the early 1990s. “East Asian countries had liberalized their financial and capital market – not because they needed to attract more funds but because of international pressure, including some from the U.S. Treasury Department.”98 This financial liberalization had a critical moment to provoke a huge amount of short-term capital in these economies and brought a financial crisis due to the abrupt pull out of this capital. Stiglitz also criticizes the IMF recommendation for affected economies such as raising interest rates, or tightening monetary policy (Washington Consensus policy proposal) which might increase bankruptcies and make it even harder to restore confidence. He tried to lobby the IMF to change the policy, but it was impossible due to the invisible pressure of the U.S. He found that “[i]n theory, the fund supports democratic institutions in the nations it assists. In practice, it undermines

the democratic process by imposing policies."\(^{99}\) In addition, Stiglitz criticized the Clinton Treasury Departments' financial liberalization toward the developing countries. The main reason for the U.S. financial liberalization policy was less because it allowed the economic growth and the efficient allocation of capital in the international financial market "than because it allowed the department to promote policies helpful to U.S. commercial and financial interests."\(^{100}\) Thus, after World War II the central aim of US economic policy focused on "the worldwide acceptance of free-market ideology – the belief that the free flow of goods, services and capital is to the mutual benefit of all.” Multilateral financial institutions, the IMF and World Bank, have been important vehicles for financial liberalization and globalization.\(^{101}\)

3.3.2.5 Wall Street and the Treasury Complex: An Engine of Financial Globalization

Consequently, the United States' incessant efforts to construct financial liberalization in the international financial system have been a forceful propellant for financial globalization. The financial liberalization and market opening could bring huge amounts of capital inflows and outflows across borders that highly contribute to the globalization of international financial markets. This globalization has been supported by the U.S. initiative. According to Jagdish Bhagwati, the "Wall Street and the Treasury complex" has supported these efforts for global financial liberalization of the United States.\(^{102}\) Bhagwati insisted that the "Wall Street and the Treasury complex" has a very powerful

\(^{102}\) Jagdish Bhagwati, “The Capital Myth: The Difference between Trade in Widgets and Dollars,” *Foreign Affairs*
influence in global financial markets and always seeks to open financial markets
everywhere. Large Wall Street financial firms such as Morgan Stanley always try to
extend their business ventures all over the world through free capital investments. These
interests are strongly connected with the Treasury Department, the State Department,
the IMF, and the World Bank and routinely support free capital movements in global
financial markets.

Robert Wade agreed with Bhagwati's argument, and added the IMF to the "Wall
Street and the Treasury complex." His "Wall Street-Treasury-IMF complex" collaborated
to proliferate free capital movement and to produce to the WTO's FSA. Further, the
complex has pressured the IMF to amend its Articles of Agreement to remove capital
controls and adopt full capital account convertibility among member countries. In April
1997, U.S. Treasury Secretary Robert Rubin attended a G-7 finance ministers meeting
and issued a statement "promoting freedom of capital flows" and pushed for the
amendment of the IMF Articles of Agreement for capital account liberalization. This
attempt was realized at the Hong Kong Annual Meetings of the IMF in September 1997.
The Interim Committee agreed in principle that the IMF has to recommend an aggressive
policy to member countries for full capital account convertibility.

Affairs 77, no. 3 (May/June 1998): 7-12.
103 "Secretary Rubin comes from Wall Street, Altman went from Wall Street to the Treasury and back;
Nicholas Brady, President Bush's Secretary of the Treasury, is back in finance as well; Ernest Stern, who
has served as acting president of the World Bank, is now managing director of J.P. Morgan; James
Wolfensohn, an investment banker, is now president of the World Bank. One could go on." Quoted from
Bhagwati, 12.
104 Robert Wade and Frank Veneroso, "The Asian Crisis: The High Debt Model Versus the Wall Street-
105 Bhagwati, 7; Wade and Veneroso, 19.
107 The Interim Committee issued a Statement on the Liberalization of Capital Movements Under an
Amendment of the IMF's Articles of Agreement. The statement proposed that "the liberalization of capital
flows is an essential element of an efficient international monetary system in this age of globalization." In
Thus, the United States has powerfully propelled financial globalization and financial liberalization. The U.S. efforts at liberalization, deregulation, and globalization in the international financial system have evolved bilaterally or through international organizations. Since the late 1980s, U.S. pressure for financial liberalization has been more strenuous and institutionalized. Multilateral agreements, such as the liberalization of trade in services in the GATT Uruguay Round, the WTO’s FSA, the MAI in OECD, and the international financial institutions (the IMF and the WTO) are the arenas for the United States’ financial globalization. American attempts to free capital movement have exhibited a strong foreign pressure on all the other countries in the world. These attempts have provided a strong motive to promote financial liberalization for industrial countries, while American initiatives for financial market opening have become a strong foreign pressure on developing countries. After all, the U.S. proponent initiative for financial liberalization that was backed up from the country’s all mighty financial power could contribute to the deregulation and elimination of every country’s financial control to promote globalization in international financial markets.

CHAPTER IV

INTERNATIONAL CAPITAL FLOWS AND FINANCIAL CRISES

As investigated in chapter III, U.S. hegemonic support for global financial liberalization since the early 1970s has highly assisted the growing cross-border capital movement and quickened the development and integration of international financial markets. Owing to financial liberalization, many private financial intermediaries in developed countries have been able to extend their investment to overseas financial markets (especially in emerging economies) searching for higher returns and the opportunity to diversify risk. On the other hand, a series of financial liberalizations in developing countries aimed at the removal of governmental regulations in domestic financial markets and other barriers to deter free capital movement from international financial markets greatly contributed additional fund resources for developing countries’ economic development and the financing of balance-of-payments deficits. However, financial liberalization without preparing proper safety networks in developing countries seemed likely to unbar the gate that protected their underdeveloped financial markets from outside speculative financial capital attack.

Many emerging economies, particularly those of East Asia and Latin America, experienced a rapid increase in volume of international capital inflows during the 1980s and 1990s when they liberalized their financial markets, almost certainly experienced financial crises as a result. The experiences in these two regions reveal a common feature of global capital flows - a gradual surge followed by financial liberalization and an abrupt decline of capital right before the financial crisis. The volatility of the financial flows not
only brings policy dilemmas and challenges to many emerging economies, but also a severe and recurrent strain on international financial markets. In fact, such financial crisis hit many emerging economies one by one. Even the countries that have sound macroeconomic fundamentals and performance have been no exception, such as the five affected East Asian countries that had been previously praised by the IMF and World Bank as successful models of economic development.

This chapter examines the general trend and characteristics of global financial flows from industrialized countries to emerging market economies during the last three decades. Through a comparative case study in East Asia and Latin America, this research investigates the linkage between global capital flows and financial crises in developing countries. It explains what factors encouraged the industrialized countries' financial capital to rush into, and abruptly withdraw, from those regions. It considers how those emerging market economies could attract foreign capital and what kind of policy dilemmas and challenges from these surges and reversals of international financial flows they experienced. Further, it will specifically introduce two financial crises in Mexico and East Asia, and analyze the origins of each crisis.

This chapter is organized into four sections. Section 4.1 investigates the common characteristics and composition of the financial flows to the developing countries, mainly focused on East Asia and Latin America. Section 4.2 introduces the factors behind the financial surges and reversals with a brief study of the financial liberalization process in emerging market economies (Latin America and Asia). Section 4.3 examines developing countries' policy dilemmas and challenges due to international financial inflows, and
introduces the episodes of Mexican and East Asian. Section 4.4 analyzes the linkage problem between financial crises in emerging economies and financial liberalization.

4.1 Trends and Characteristics of Financial Flows to Developing Countries

As global financial liberalization proceeded, international financial flows to developing countries have fundamentally changed in their composition and volume during the past three decades.¹ Under the Bretton Woods monetary regime, international financial capital flows were highly controlled by national governments. At the time, most governments believed that capital outflows would deplete their foreign exchange holdings, and make their exchange rates unstable, so they tried to control their financial systems.² Accordingly, the main sources of capital flows in the international financial system were official or commercial banks’ loans until the early 1970s. During the 1980s, beginning with U.S. financial liberalization, developed countries eliminated various FDI and portfolio investments restrictions, and encouraged their private financial intermediaries to oversee financial transactions. In addition, most developing countries also opened their financial markets and induced the developed countries private financial capital after the 1980s.


During the period from 1973-82, other strong market forces, such as the growth of ‘Euromarkets’, the breakdown of the fixed exchange Bretton Woods monetary regime, and the recycling of ‘petrodollars’ helped to deregulate the former capital control mechanisms in developed countries. First, the Euromarkets were the venue for many financial institutions and investors that tried to circumvent various domestic capital control mechanisms to the proper investment locations across-borders. Euromarkets attract a significant amount of international financial capital since they were guaranteed high interest rates and no reserve requirements. Second, the collapse of the Bretton Woods fixed exchange regime announced by President Nixon on August 15, 1971 (the dollar would no longer to be convertible into gold)\(^3\) gave strength to international financial markets as a key field for free capital mobility beyond the states’ capital control mechanism. Third, the two oil crises of 1973-74 and 1979 gave huge surpluses to the Organization of Petroleum Exporting Countries (OPEC), and accelerated rapid private capital flows in international financial markets.\(^4\) These petrodollars flooded into Western commercial banks and Euromarkets, and turned to the developing countries, which experienced corresponding deficits from the higher priced oil import.

Table 4.1 summarized the transformation of international financial flows from the developed countries to developing countries from 1973-79. The annual average of other investments during 1973-82 occupied the largest part of net private capital inflows to developing countries in which the volume covered 81 percent in Latin America and Asia.

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\(^4\) Andrew C. Sobel, *State Institutions, Private Incentives, Global Capital* (Ann Arbor, Michigan: The
The pattern was unchanged from 1977-82 when other investments reached $30 billion in all developing countries and $20 billion in the Western Hemisphere. Thus, commercial banks' lending was the dominant channel of international capital flows. Geographically, U.S. multinational banks played important roles as the largest lenders to middle-income countries as well as the Western Hemisphere. In low-income Asian and African countries, the World Bank and the regional development banks provided the primary capital resources.\(^5\)

For developing countries, the period from 1979-82 was the hardest time because of the second oil crisis in 1979 and the ensuing recession in global economies followed by the shift in U.S. macroeconomic policy. Even the United States, the world’s largest economy, could not evade the oil shock. Due to the surge in oil prices, the U.S. economy experienced more than 12 percent inflation in 1979 after 9 percent in 1978. To halt the runaway inflation, the U.S. Federal Reserve contracted monetary supply and raised short-term interest rates that pushed the global economy into a deep recession.\(^6\) Higher interest rates in the United States and other industrialized countries imposed a big burden of external debt financing to developing countries. When Mexico was unable to service its huge external debt in 1982, it had no choice but to announce a moratorium on its repayment. The Mexican debt crisis quickly spread over many other Third World countries from the Western Hemisphere to Africa and Eastern Europe. Net capital inflows to developing countries noticeably fell from 1983-89. Average annual flows


sharply dropped from around $31 billion during 1977-82 to less than $9 billion from 1983-89. Largely due to the commercial bank debt finance, Western Hemisphere countries experienced an annual average of $17 billion in net capital outflows from 1983-89 (see Table 4.1).

### Table 4.1 Net Private Capital Inflows* to Developing Countries, 1973-89

(Billions of U.S. dollars)

<table>
<thead>
<tr>
<th></th>
<th>1973-76&lt;sup&gt;2&lt;/sup&gt;</th>
<th>1977-82&lt;sup&gt;2&lt;/sup&gt;</th>
<th>1983-89&lt;sup&gt;2&lt;/sup&gt;</th>
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<td><strong>All Developing Countries</strong></td>
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<tr>
<td>Total net capital inflows</td>
<td>14.8</td>
<td>30.5</td>
<td>8.8</td>
</tr>
<tr>
<td>Net foreign direct investment</td>
<td>3.7</td>
<td>11.2</td>
<td>13.3</td>
</tr>
<tr>
<td>Net portfolio investment</td>
<td>-5.5</td>
<td>-10.5</td>
<td>6.5</td>
</tr>
<tr>
<td>Others</td>
<td>16.6</td>
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</tr>
<tr>
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<td></td>
<td></td>
</tr>
<tr>
<td>Total net capital inflows</td>
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<td>15.8</td>
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<td>2.7</td>
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<tr>
<td>Net portfolio investment</td>
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<td>0.6</td>
<td>1.4</td>
</tr>
<tr>
<td>Others</td>
<td>5.3</td>
<td>12.5</td>
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<tr>
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<td>3.7</td>
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<tr>
<td>Net portfolio investment</td>
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<td>-12.7</td>
<td>6.3</td>
</tr>
<tr>
<td>Others</td>
<td>0.7</td>
<td>-2.1</td>
<td>-1.3</td>
</tr>
</tbody>
</table>


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

<sup>2</sup> Annual averages.

* A minus sign indicates an increase.

During the same period, Asian countries’ net capital inflows slightly increased, owing to the rise in foreign direct investment (FDI) from $3 billion from 1977-82 to $5 billion in the period 1983-89. The increase in FDI in Asia resulted from the investment boost by Japanese commercial banks and investors, which mainly resulted from the real appreciation of the Japanese yen following the Plaza Accord and continued Japanese growing current account surpluses. Asian countries’ successful economic reforms, such as the government role for preparing a stable macroeconomic environment, opening up their economies, and stable exchange rates served as internal factors to induce foreign capital.

4.1.2 Recent Trend of Financial Flows, 1990-98

From the early 1990s, developing countries experienced a dramatic resumption of the surge of capital inflows. As shown in Table 4.2, the total net capital inflows of the developing countries tremendously increased from $48 billion in 1990 to $212 billion in 1996. Yet, the total net capital flows fell sharply, over 50 percent in 1998 due to the East Asian financial crisis. The recent fluctuation of the net capital flows to emerging markets reflected the financial crises in Brazil and Argentina, but the volume has gradually recovered and was expected to reach around $113 billion in 2004.

During the period from 1990-96, strong economic performance and financial reforms in many Asian countries attracted high levels of capital inflows. Many Asian countries

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deepened the financial liberalization of their capital accounts, which highly contributed to capital inflows to this region. In addition, the Mexican peso crisis in 1994 drove the industrial countries institutional investors and banks to reallocate their large share of financial capital to Asia. The rise in net capital inflows in Asia was mostly led by FDI, with a significant rise in portfolio investment. Taiwan, Hong Kong, and South Korea became the major recipients of FDI inflows from industrial countries.

Major countries in the Western Hemisphere experienced large foreign capital inflows as the 1980s debt crisis was resolved and economic adjustment programs were set up. Compared to that of Asia, the FDI also increased substantially, but the portfolio investment significantly accounted for the surge of net foreign capital inflows in the Western Hemisphere. The portfolio investment increased over three times from $18 billion in 1990 to $61 billion in 1994. Besides the domestic factors, the industrial countries’ economic recession of 1989-90 and the U.S. interest rate cut down in the early 1990s contributed to the investment rush to these two regions as an external factor.

The surge of capital inflows to the Western Hemisphere and Asia suddenly dissipated because of the 1994 Mexican Peso crisis and the 1997 East Asian financial crisis. In particular, the Western Hemisphere recorded an excessive decline of net portfolio investment in 1995 that reflected highly volatile portfolio investments in the Mexican

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peso crisis. The five affected Asian countries\textsuperscript{13} also experienced a large decrease in bank loans and other investments from $33 billion in 1996 to negative $60 billion in 1997. As a result, these countries were quite vulnerable to short-term bank loans or liquidity, including a large portion of inter-bank lending in the East Asian financial crisis. After the crises, the capital inflows in these regions were recovered as the economic and structural reforms proceeded.

Comparing the general trend of international financial flows to the total in developing countries between the late 1970s-80s and the 1990s, there is a big change in the composition of international financial flows (see Table 4.1 and 4.2). During the late 1970s-80s, developed countries' commercial bank lending was occupied with the largest part of capital inflows to developing countries, whereas during the 1990s, portfolio and foreign direct investments became the dominant source of capital inflows. Moreover, the previous commercial bank lending to developing countries now directly passed through to the private sector, often channeled through banks and other financial institutions. Thus, most developing country governments have relied more on issuing debt securities rather than foreign commercial bank loans for their balance-of-payments finance.\textsuperscript{14}

\textsuperscript{13} The five Asian countries, Indonesia, Malaysia, Philippines, South Korea, and Thailand, which experienced a financial crisis in 1997, are categorized as a ‘Five Affected Asian Countries.’

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<td>1.7</td>
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<td>10.4</td>
<td>-19.2</td>
<td>5.8</td>
<td>4.3</td>
</tr>
</tbody>
</table>


1. Total net private capital inflows: net foreign direct investment plus portfolio investment plus net other investment.
2. Five affected Asian countries: Indonesia, South Korea, Malaysia, the Philippines, and Thailand.
4.2 Factors Behind the Surge of International Financial Flows

The increasing private capital inflows to developing countries, particularly in the 1990s, displayed a process of integration of developing countries with international financial markets and financial globalization. One of the fundamental factors behind the surge of the capital flows was the global financial liberalization in the developing and industrialized countries. Since the mid-1980s, most developing countries (in Latin America and Asia) have embarked on structural reforms in their economies and liberalizations in their financial and trade markets. The removal of capital controls and the liberalization of the domestic financial systems ensured the free capital movements across-borders and accelerated the financial flows from the capital rich industrialized countries to the capital scarce developing countries. In addition, industrialized countries’ major institutional investors’ consideration seeking high returns and risk diversification of their portfolio, and U.S. monetary policy change (lowered interest rates) could explain the large capital rush to the Latin America and Asia. Thus, financial liberalization in developing countries functioned as a pull factor to induce foreign capital - type of FDI or portfolio investments. The desire of the industrial countries investors and the monetary policy change in the United States supported the push factor of international financial capitals flows as the external factors.

15 World Bank, Private Capital Flows to Developing Countries: The Road To Financial Integration (New York: Oxford University Press, 1997), 81.
16 Guillermo A. Calvo, Leonardo Leiderman, and Carmen M. Reinhart, "Inflows of Capital to Developing
4.2.1 A Push Factor: The Desire of Investors and U.S. Interest Rates Change

The development and increase of financial capital in industrialized countries brought a remarkable change in investment patterns during the 1980s. What was called the ‘institutionalization of saving’ phenomenon took place in industrialized countries. The largest portion of funds in depository institutions (commercial banks) were transferred to pension funds, life insurance companies, mutual funds, and investment trusts as repositories for the majority of savings. For instance, in the United States, the total financial sector assets of institutional investors increased from 32 percent in 1978 to 52 percent in 1993, while that of depository institutions decreased from 57 percent to 34 percent during the same period. As the financial assets of institutional investors expanded, their role in international financial markets and the volume of the financial capital transactions across borders also increased. From the various sources of international financial statistics, we can recognize that most of the international financial capital flows directed to emerging market economies originated from the financial resources of capital abundant countries (specifically the G-7 countries). Table 4.3 demonstrates the portion of international financial capital resources distributed by the institutional investors in the G-7 and the Organization for Economic Cooperation and Development (OECD) countries.

### Table 4.3 Financial Assets of Institutional Investors in OECD Countries

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<td>406.0</td>
<td>416.1</td>
<td>423.7</td>
<td>371.0</td>
<td>294.1</td>
<td>324.0</td>
<td>426.3</td>
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<td><strong>United Kingdom</strong></td>
<td>1,116.8</td>
<td>1,275.2</td>
<td>1,207.2</td>
<td>1,543.6</td>
<td>1,522.1</td>
<td>1,814.9</td>
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<td>2,624.4</td>
<td>2,889.9</td>
<td>3,264.8</td>
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<td>Insurance companies</td>
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<td>517.0</td>
<td>669.2</td>
<td>660.1</td>
<td>817.1</td>
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<td>1,213.5</td>
<td>1,384.1</td>
<td>1,587.1</td>
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<tr>
<td>Pension funds</td>
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<td>599.4</td>
<td>552.4</td>
<td>683.2</td>
<td>660.5</td>
<td>759.7</td>
<td>893.2</td>
<td>1,066.6</td>
<td>1,136.5</td>
<td>1,226.3</td>
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<td>142.1</td>
<td>137.7</td>
<td>191.1</td>
<td>201.5</td>
<td>238.1</td>
<td>310.7</td>
<td>344.3</td>
<td>369.3</td>
<td>451.4</td>
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<tr>
<td><strong>France</strong></td>
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<td>906.4</td>
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<td>1,230.0</td>
<td>1,314.0</td>
<td>1,329.2</td>
<td>1,629.7</td>
<td>1,695.7</td>
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<td>0.0</td>
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<tr>
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<td>549.2</td>
<td>574.3</td>
<td>586.5</td>
<td>564.5</td>
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<td>773.3</td>
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<tr>
<td><strong>Germany</strong></td>
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<td>665.2</td>
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<td>453.7</td>
<td>555.8</td>
<td>678.8</td>
<td>691.3</td>
<td>666.1</td>
<td>782.3</td>
<td>732.9</td>
</tr>
<tr>
<td>Pension funds</td>
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<td>56.0</td>
<td>56.6</td>
<td>47.6</td>
<td>55.5</td>
<td>65.3</td>
<td>64.8</td>
<td>60.6</td>
<td>69.5</td>
<td>63.3</td>
</tr>
<tr>
<td>Investment companies</td>
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<td>172.8</td>
<td>228.4</td>
<td>293.6</td>
<td>369.1</td>
<td>411.8</td>
<td>475.2</td>
<td>647.1</td>
<td>732.8</td>
</tr>
<tr>
<td><strong>Canada</strong></td>
<td>332.7</td>
<td>374.7</td>
<td>376.8</td>
<td>420.6</td>
<td>438.8</td>
<td>491.3</td>
<td>559.9</td>
<td>615.5</td>
<td>614.2</td>
<td>748.4</td>
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<td>145.2</td>
<td>150.3</td>
<td>147.3</td>
<td>163.0</td>
<td>173.1</td>
<td>179.9</td>
<td>176.1</td>
<td>201.7</td>
</tr>
<tr>
<td>Pension funds</td>
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<td>180.1</td>
<td>177.9</td>
<td>187.8</td>
<td>197.3</td>
<td>221.3</td>
<td>245.2</td>
<td>261.5</td>
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<td>30.4</td>
<td>44.0</td>
<td>55.7</td>
<td>82.5</td>
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<td>107.0</td>
<td>141.6</td>
<td>174.1</td>
<td>197.1</td>
<td>236.4</td>
</tr>
<tr>
<td><strong>Italy</strong></td>
<td>146.6</td>
<td>257.8</td>
<td>225.3</td>
<td>258.7</td>
<td>326.6</td>
<td>360.7</td>
<td>484.6</td>
<td>608.7</td>
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<td>73.6</td>
<td>76.4</td>
<td>100.0</td>
<td>120.3</td>
<td>146.1</td>
<td>151.8</td>
<td>184.9</td>
<td>204.0</td>
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<tr>
<td>Pension funds</td>
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<td>49.6</td>
<td>38.3</td>
<td>33.9</td>
<td>35.5</td>
<td>39.0</td>
<td>39.2</td>
<td>34.4</td>
<td>36.3</td>
<td>33.2</td>
</tr>
<tr>
<td>Investment companies</td>
<td>41.9</td>
<td>48.8</td>
<td>41.3</td>
<td>64.6</td>
<td>79.9</td>
<td>80.0</td>
<td>129.1</td>
<td>209.3</td>
<td>409.6</td>
<td>477.6</td>
</tr>
<tr>
<td>Others</td>
<td>0.0</td>
<td>80.7</td>
<td>72.2</td>
<td>83.9</td>
<td>111.1</td>
<td>121.4</td>
<td>170.2</td>
<td>213.3</td>
<td>308.6</td>
<td>363.6</td>
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<tr>
<td><strong>G-7 total</strong></td>
<td>11,908.7</td>
<td>13,437.1</td>
<td>14,323.0</td>
<td>16,539.2</td>
<td>17,808.2</td>
<td>20,572.3</td>
<td>22,412.3</td>
<td>24,739.6</td>
<td>28,521.0</td>
<td>32,635.1</td>
</tr>
<tr>
<td><strong>Other OECD countries</strong></td>
<td>1,597.6</td>
<td>1,698.8</td>
<td>1,710.5</td>
<td>1,765.7</td>
<td>2,225.2</td>
<td>2,510.7</td>
<td>2,998.0</td>
<td>2,747.9</td>
<td>3,465.0</td>
<td>3,512.2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>13,506.3</td>
<td>15,135.9</td>
<td>16,035.5</td>
<td>18,304.9</td>
<td>20,034.9</td>
<td>23,083.0</td>
<td>25,410.3</td>
<td>27,487.5</td>
<td>31,986.0</td>
<td>36,147.3</td>
</tr>
</tbody>
</table>

From the table, we know that the total financial assets of the G-7 countries were almost 90 percent of that of the OECD, and that portion had almost tripled (2.7 times) by 1999. Among the G-7 countries, the United States and Japan held 67 percent of the total financial assets. In particular, U.S. institutional investors held 49 percent ($6.6 trillion) of the total financial assets in the world in 1990, reaching 53 percent ($19.3 trillion) in 1999. Meanwhile, pension funds and investment companies have become more prominent U.S. financial institutional investors (they have 68 percent of U.S. financial assets in 1999), and thus have been major global financial actors in the world.

The fundamental driving force to push the enormous financial assets in industrialized countries to emerging market economies was the global financial liberalization led by the United States. From the mid-1970s, the United States initiated capital account liberalization and gave a peer pressure to deregulate other industrialized countries’ financial markets. Followed by the liberalization trend in industrialized countries, most developing countries in Latin America and Asia began to open their financial markets. Thus, financial liberalization has been widely adopted in both industrialized and developing countries, the opportunity for cross-border investment has highly increased, and international financial capital could freely shift to the appropriate investments locations around the world.

In addition, industrialized countries were gradually confronted by acute competition and rising costs in domestic markets along with the development of transportation and communication technologies, so they had to encourage their firms to look for new opportunities to lessen production costs and increase the efficiency of their businesses abroad. This consideration drove multinational corporations and industrialized countries
firms' "efficiency-seeking" foreign directive investments to the developing countries and led to the progressive globalization of production.\textsuperscript{19} During these three decades, the total net FDI in the developing countries exponentially increased from the average $4 billion from 1973-76 to $129 billion from 1996-98 (see Table 4.1. and 4.2).

Furthermore, the change in the financial structure of industrialized countries such as the United States, served as another push factor to drive its financial capital to developing countries. As institutional investors such as mutual and pension funds acting as financial intermediaries in industrialized countries have emerged as important financial actors, they have to find efficient ways to secure their financial assets and to diversify investment risk. Therefore, institutional investors were responsive to high returns and the opportunities for risk diversification of their portfolio investment from emerging markets. Since most emerging market economies, such as in Latin America and the Newly Industrialized Countries (NICs) of Asia, maintained high interest rates to attract foreign capital financing for economic development and balance-of-payments deficits, industrialized countries' institutional investors benefit from their investment in those emerging markets.

Besides these factors, U.S. monetary policy changes and a sustained decline of interest rates in industrialized countries contributed to increasing portfolio investments and FDI to the developing countries in the early 1990s.\textsuperscript{20} As the world's largest economy and financial market, the United States has become both a major recipient of, and resource for, international financial capital. As a result, monetary policy change in the United States, such as an increase or decrease of the prime rate, is very sensitive to the

\textsuperscript{19} World Bank, \textit{Private Capital Flows To Developing Countries}, 13-14.
direction of international financial capital flows. The fact that most powerful fund
managers in the world are monitoring small possible changes in the American economy
including the trends of interest rates, exchange rates, and the daily market conditions of
the New York Security Exchanges, verifies how much American financial markets are
important in international financial markets.

When the United States decreased interest rates and easy monetary policy at the
beginning of 1991 and 1992, Latin American and Asian countries experienced increasing
capital inflows (see Figure 4.1). On the contrary, when the U.S. tightened monetary
policy and increased the short-term interest rate in early 1994, those countries
experienced capital outflows.\(^1\) In fact, at the beginning of 1991 and by late 1992, the
U.S. Federal Reserve aggressively lowered interest rates to boost the domestic economy
to the lowest levels since the early 1960s. Before the 1992 presidential election
campaign, former President George Bush made desperate efforts to fight a stagnating
economy. In spring 1991, U.S. Treasury Secretary Nicholas Brady persuaded the OECD
and G-7 governments to reduce interest rates. President Bush himself called for help to
lower interest rates to the G-7 ministers and central bank governors in a meeting at the
White House at the time of the April Interim Committee meeting.\(^2\) Thus, a series of
interest reductions in the United States and other G-7 countries drove the investors to the
high-investment yields and prospective economies in Latin America and Asia. Figure 4.1
illustrates the causation between the average interest rates in the major industrialized

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\(^{20}\) Calvo, Leiderman, and Reinhart, “Inflows of Capital to Developing Countries in the 1990s”: 125-128.
\(^{21}\) Peter Monte and Carmen M. Reinhart, “The Dynamic of Capital Movements to Emerging Economies
During the 1990s,” in Short-Term Capital Flows and Economic Crisis, eds., Stephany Griffith-Jones,
\(^{22}\) C. Randall Henning, Currencies and Politics in the United States, Germany and Japan (Washington,
countries and the net financial flows to Latin America and Asia. From 1989-93, the average interest rates in developed countries declined while the total net portfolio and FDI of the Latin American and Asian countries increased.

Contrary to the case of interest rates cuts, in early 1994 tight U.S. monetary policy and the resulting rise in interest rates made investment in Latin America and Asia relatively less attractive. Furthermore, the higher interest rates fostered an enormous burden of debt financing in developing countries and resulted in the Mexico peso crisis in 1994. As shown in Figure 4.1, Latin American countries' portfolio and FDI precipitously fell in 1994. Indeed, the rise in U.S. interest rates triggered capital outflows from Latin America and moved into the other emerging Asian markets. The change in relative rates of return is the most critical option for every investor whose financial funds quickly translate into the most profitable cross-border places in highly integrated and technologically sophisticated financial markets.

4.2.2 A Pull Factor: Financial Liberalization in Latin America and Asia

Major countries in Latin America and Asia had taken various financial liberalization policies during the 1980s and 1990s. Developing countries have liberalized their financial markets primarily to attract foreign capital for economic development and balance-of-payments, as well as from foreign pressure to open financial markets to ease investment.

Following the progress of financial liberalization, those countries experienced large capital inflows.
4.2.2.1 Financial Liberalization in Latin America

During the 1960s and 1970s, Latin American countries were fairly distant from international financial flows. Besides the very limited volume of FDI, there was also very little private capital flow to this region. Similar to the general trend of private financial flows to developing countries, Latin America largely depended on official capital flows from the World Bank, the Inter-American Development Bank (IADB), and the International Monetary Fund (IMF) throughout the same period. 23 When most of the Latin American countries launched a series of financial liberalizations in the late 1980s and early 1990s, they experienced large volumes of FDI and portfolio investments.

Financial liberalization in Argentina has been a gradual process with many reversals since the government tried to mitigate the external shocks from the 1982 debt crisis. The government partly liberalized the capital accounts and removed some barriers to domestic allocation of financial resources, such as the interest rate ceiling in 1977-78. Yet, the government did not maintain these financial reforms because the 1982 debt crisis brought major disasters to its financial system such as increasing non-performing loans, the loss of international reserves, and bankruptcy of major banks. 24 During the late 1980s and early 1990s, a series of financial liberalization resumed. Beginning with the introduction of privatization and deregulation measures in 1987, the exchange rate was unified in 1989, and regulations of foreign investment were subsequently eliminated. Under the Convertibility Plan, implemented in 1991, Argentina eliminated all controls on foreign

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exchange, and adopted a currency board to manage the foreign exchange reserve. In 1994, the government enacted the Financial Institutions Law, which improved market access for foreign financial institutions, and encouraged the foreign competition in their financial market.\textsuperscript{25}

Brazil was famous for hyperinflation rates that recorded averages of 856 percent from 1985-90.\textsuperscript{26} The government had to continue increasing expenditures in order to finance large foreign debts. In 1988, the new Constitution strengthened the state power to control financial markets, and disallowed foreign financial institutions opening new branches or increasing market share in Brazil without government permission or through negotiations in an international agreement. In late 1994, the government adopted the Real Plan and made an effort at fiscal sector reform and banking industry restructuring. Widespread banking crises in late 1995 led the government to implement financial sector reforms and lowered foreign investment regulation. The February 1995 amendment to the Constitution encouraged FDI, and an executive decree in August 1995 allowed foreign participation in their financial services industry.\textsuperscript{27}

After enduring debts crisis in the early 1980s, Mexico embarked on economic reforms, but its financial sector was highly regulated until 1988.\textsuperscript{28} Mexico joined the General Agreement on Tariffs and Trade (GATT) in 1986, concentrated on deregulating trade and investment market barriers, and initiated financial sector liberalization

\textsuperscript{26} Economic Commission for Latin America and the Caribbean (ECLAC), \textit{Latin America and the Caribbean: The Economic Experience of the Last 15 Years} (Santiago: ECLAC, 1995), 21.
\textsuperscript{27} Fischel and Weitz, "Case Studies: Brazil", 139-150.
beginning in the late 1980s. From 1991-92, interest rates and quantitative credit
controls were removed, and the banking industry was privatized. Through the 1993
Foreign Investment Law, existing barriers to FDI, which occupied roughly three-quarters
of Mexico’s industrial sectors, were removed. Furthermore, in 1994, the commitment of
the North American Free Trade Agreement (NAFTA) and incorporation into the OECD
were critical moments for Mexico’s financial market opening. Under the provisions of
national treatment in financial services, U.S. and Canadian firms are entitled to 100
percent ownership of Mexican bank subsidiaries. Following the peso crisis, in 1995 the
government amended the Law on Credit Institutions, which increased permissible foreign
ownership for both NAFTA and non-NAFTA firms entering the financial services
sector.29

Moreover, Colombia had highly controlled their financial system like those of the
other Latin American countries until the late 1980s. Following the vision of President
César Gaviria, the government embarked on a set of economic and financial reforms from
1990-94. The government abolished the former exchange rate controls, and relaxed the
controls over financial sectors: the banking and insurance industry. Adapting to this
financial liberalization, Peru, Bolivia, and other countries followed a similar trend.30

Figure 4.2 presents the evolution of net financial flows to Latin America during the
American countries’ (Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela)
data are summarized. The surges of net financial flows exactly coincided with the early

1990s when most of the Latin American countries liberalized their financial markets.

In addition, the reversal of net financial flows correctly reflects the Latin American debt crisis in the 1980s, Mexican peso crisis in 1994, and Brazil’s currency crisis in 1999.

Compared to that of the five affected Asian countries, the Latin American countries experienced a steeper increase in portfolio investment.

Figure 4.2 Net Financial Flows to Latin American Countries


1 Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela
4.2.2.2 Financial Liberalization in Five Affected Asian Countries

The five affected Asian countries experienced huge capital inflows during the early 1990s when they deregulated their financial markets and liberalized capital account transactions. The process of financial liberalization in the five Asian countries is similar to those of the Latin American cases. However, the economic success of the Newly Industrialized Countries' (NICs) in East Asia provides a completely different story from those of Latin America, and needs more analytical explanations. 31 In the five Asian countries, capital inflows contributed to economic growth and financed their current account deficits and the financial liberalization process roughly occurred during the period between the early 1980s and the late 1990s.

Indonesia had maintained highly controlled bank lending and frequently used special credit programs to promote favored groups until the early 1980s. In 1983, the government lowered the liquidity credit programs of the central banks, and abolished the state-owned banks' interest rate control, which required certain deposit rates for the credit ceiling. 32 Begun in 1988, the government introduced various financial reforms known as Pakto to promote competition in the financial sector. It removed most restrictions on newcomers for licenses of private and foreign joint-venture banks, allowed new openings of branches, and eased the requirements of foreign exchange bank openings. It also lowered the deposit ratio of state-owned enterprises, permitted banks and non-bank financial

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institutions (NBFIs) to issue certificates of deposit, to raise equity capital in the stock markets, and to lower the entry to leasing, insurance, and consumer finance.\textsuperscript{33}

In 1989, the government permitted domestic banks access to international markets, and phased out the remaining liquidity credits in 1990. By the mid-1990s, Indonesia reached a deep capital account liberalization process prior to financial-sector reform, and so doing, the underdeveloped legal framework and accounting system did not administer the instability of capital outflows and inflows until the Asian financial crisis.\textsuperscript{34}

Financial sector reform in Malaysia followed a severe financial sector crisis in the early 1980s. In response, the central bank let the ringgit become freely convertible in 1986 and reduced liquidity and reserve requirement ratios of commercial banks. From 1985-87, the Malaysian government liberalized the investment regime moving from foreign capital to domestic capital (by encouraging ethnic Chinese investment). Since the late 1980s, the government began to liberalize the capital market and introduced competition.\textsuperscript{35} After the collapse of poorly regulated deposit-taking cooperatives (DTCs), the Parliament enacted the Banking and Financial Institutions Act (BAFIA) in 1989 for financial system governance. Meanwhile, the government broke off the Kuala Lumpur Stock Exchange (KLSE) from the Stock Exchange of Singapore (SES) in 1990, and prepared subsequent measures such as the 1992 passage of the Security Act and the


establishment of the Security Commission for persistent stock market expansion. In addition, the government launched a massive financial liberalization reform (an 18-point financial market liberalization program) in order to enhance its status as a major international financial center. The program allowed foreign stock brokerage companies to increase their equity share in local brokerage firms with tax incentives, guaranteeing foreign investors' greater access to the KLSE with the reduction or removal of capital gains as well as dividends withholding taxes. In response to these measures, Malaysian financial markets emerged as the most liberalized market in the region, and KLSE capitalization reached more than double its annual GNP by 1996.

Financial liberalization in Thailand began in the early 1990s. The Bank of Thailand (BOT) and the Ministry of Finance introduced 20 financial reform bills. To enhance the efficiency of savings allocation, interest rate ceilings both on the deposits in 1990 and the lending side in 1992 were abolished. In May 1990, with the agreement of the acceptance of the Article VIII of the IMF Agreements, Thailand liberalized foreign exchange transactions respect to current account in 1990 and one-year later capital account transactions. Furthermore, to promote Thailand as a regional financial center for easy access to foreign capital and to ensure more competition for domestic commercial banks, the Anand government planned offshore banking institutions under the Bangkok International Banking Facility (BIBF). Following this measure, the Chuan government introduced the BIBF and tried to attract foreign funds offering various preferred tax

37 Chin and Jomo, 116-118.
38 Laurids S. Lauridsen, "Thailand: Causes, Conduct, Consequences," in Tigers in Trouble, 142-143.
incentives in 1993. Instead of Thailand's hope that the BIBF would concentrate more on overseas business (raise funds from abroad) in order to finance its trade and foreign investment, the BIBF intensified the role of acquiring foreign loans for the domestic market. Even large parts of capital inflows through the BIBF went to non-traded sectors and encouraged a real appreciation causing deterioration in the current account. Furthermore, many BIBFs had realized a profit from the spread between the lower interest rates of foreign short-term credit and higher long-term domestic lending. As long as the foreign credit was renewed, the economy was stable. However, the BIBFs worsened the Thai economy by increasing the risk exposure to currency and maturity mismatch, encouraging over-borrowing in foreign currencies without prudential regulations measures, and finally led to the 1997 financial crisis. 39

Financial liberalization in South Korea began in the early 1980s. From 1981-83, the government implemented various financial liberalization measures such as privatization of all commercial banks, lowering entry barriers for NBFIs, and granting permission to open foreign security companies. The government relaxed the restriction on domestic FDI in 1984, liberalized the capital account through the amendment of the Foreign-Exchange Management Act (FEMA) in 1990, and liberalized the interest rates through the Four-Stage Plan for Interest Rate Regulation in 1991. Moreover, the 1993 Blueprint for Financial Reform reduced the long-term and short-term capital flows, and deregulated various controls of the financial sector. Admission to the OECD in 1996 drove the government to relax and abolish many restrictions on financial services and foreign exchange transactions of portfolio and foreign direct investments. Yet, after the 1997

39 Bhanupong Nidhiprabha, “Premature Liberalization and Economic Crisis in Thailand,” in Financial
financial crisis, South Korea fully removed all financial regulations through the Korea-IMF Stand-By Arrangement and the WTO's Financial Services Agreement (FSA). 40

In the Philippines, comprehensive financial reforms were introduced by the IMF and World Bank structural adjustment in 1980. In the period from 1981-84, the government eliminated restrictions on financial intermediation, gradually liberalized all interest rates, and eliminated the agricultural credit programs. The central bank lifted the suspension on the entry of new domestic banks in 1990, and bank branching regulations were revised in 1991, so commercial banks could increase their new branches as long as the soundness of their management standards such as capital adequacy and profitability were met. 41 The restriction on foreign investment was not implemented until 1994. Only four foreign banks operated as commercial banks in the Philippines in 1994, but 12 additional foreign banks could enter the market from 1994-97. Under the partial removal of the expansion of the branch network in 1994, foreign banks could operate on a full-service basis, and add up to six new branches. 42 In 1992, the government liberalized the foreign exchange market, which remained highly regulated throughout the 1970s and 1980s. In addition, the restrictions on current account transactions were eliminated, and the regulations on capital movements across the border were greatly diminished. After the liberalization of

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the foreign exchange market, the Philippines experienced a surge of capital inflows from 1990-96, followed by a rapid reversal in July 1997.43

Thus, the deepening of financial liberalization in the five Asian countries, particularly the capital account liberalization in the 1990s, is the main reason for a rapid increase in net financial flows. As shown in Figure 4.3, these five Asian countries experienced a surge of net financial flows from 1990-96 and an abrupt reversal in 1997. In the 1994-96 period, the five Asian countries experienced a steep increase in net bank lending and portfolio investment that would be explained by the international investors response to the Mexican peso crisis in 1994. The investors tried to reallocate their portfolios from Latin America to the more stable Asian financial markets that guaranteed a high return.44 Besides the financial liberalization, the high interest rates of the five countries45 (compared to that of other industrial countries with strong economic growth) induced foreign capital with the expectation of high returns. As shown in the Figure 4.3, the five countries experienced high capital outflows in the net bank lending and portfolio investments, while the major Latin American countries depended highly on portfolio investment during the Mexico peso crisis in 1994.

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43 Gochoco-Bautista, 143-144.
45 For example, the interest rate of Korea averaged 15 percent during the period from 1987-94. Even in the case of Indonesia, the interest rate averaged 18 percent during the same period.
4.3 Policy Responses toward International Financial Inflows and Financial Crises

Financial liberalization and structural reforms in Latin America and Asia are fundamental factors to attract foreign capital. However, the surge of short-term capital inflows to developing countries brought a series of policy dilemmas, and even a sharp reversal caused various financial crises in Latin America and Asia. Unlike the industrialized countries experience which already had well developed financial systems and a free market-oriented economic system, financial liberalization in developing countries left them susceptible to unfavorable macroeconomic challenges.
4.3.1 Policy Responses and Macroeconomic Effects from Large Capital Inflows

Neoliberal economists argue that free capital movement from the capital-abundant to capital-scarce countries increases welfare in these countries as well as guarantees a more efficient global allocation of savings and direct resources toward their most productive uses. This academic argument could be applicable only in industrialized countries that succeeded in building a strong financial system over an extended period of time, while many developing countries were exposed to the peril of unexpected surges and reversals of short-term capital flows, frequently challenged by financial crisis, and experienced less desirable macroeconomic effects from the volatile free capital movements.

Empirical evidence in Latin America and Asia suggests that rapid short-term foreign capital inflows brought various unfavorable macroeconomic effects on the recipient countries. These effects are different from country to country based on the size and composition of the capital inflows, the foreign exchange rates system, the development of domestic financial markets, the deepening of financial liberalization, and the availability and flexibility of the macroeconomic policy measures. Generally, many developing countries experienced rapid monetary influx, pressures of inflation and real exchange rate appreciation, and increasing current account deficits from the large capital inflows.


47 World Bank, Private Capital Flows to Developing Countries, 174-190; Calvo, Leiderman, and Reinhart, “Inflows of Capital to Developing Countries in the 1990s”: 128-131.
First, the surge in capital inflows brought a rapid growth in monetary supply in the domestic economy and created appreciation of the nominal and the real exchange rates. As shown in the last column of Table 4.4, Latin American and Asian countries experienced rapid growth in the money supply as a result of large capital inflows during the period of 1988-94. In addition, most Latin American countries recorded an appreciation of the real exchange rate, while three Asian countries (except the Philippines) were able to curve the pressure of appreciation of their exchange rate. Those Asian countries seriously intervened in their exchange rate market, issuing a broad volume of exchange rate stabilization bonds such as, the Thai Exchange Equalization Fund in Thailand and the Bank Indonesia Certificates in Indonesia. If those countries did not heavily intervene in their financial markets in order to protect their export sectors and maintain a favorable price competition for their goods in overseas markets, the countries would record an appreciation of their currencies.

Second, most developing countries could absorb a sizeable portion of the surge in capital inflows into their foreign exchange reserves buildup, but if the large capital inflows went to non-traded good sectors, then it would see increasing current account deficits. As show in Table 4.4, Malaysia, Thailand, Argentina, and Brazil had accumulated fairly large amounts of international reserves owing to large capital inflows from 1990-94. Still, both Latin America and Asia have accumulated about $209 billion in international reserves over the same period, but the pace of reserve accumulation has lowered and turned toward a large current account deficit since the mid-1990s.

Table 4.4 Recipients of Large Capital Inflows and Macroeconomic Performance

<table>
<thead>
<tr>
<th>Country</th>
<th>Year in which the capital inflows began</th>
<th>Reserve (billions of US dollars)</th>
<th>Real effective exchange rate (%)</th>
<th>Real GDP</th>
<th>Prices</th>
<th>Broad Money/price level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>1990</td>
<td>7.0</td>
<td>-6.2</td>
<td>6.8</td>
<td>8.7</td>
<td>14.1</td>
</tr>
<tr>
<td>Malaysia</td>
<td>1989</td>
<td>19.4</td>
<td>-3.9</td>
<td>8.7</td>
<td>3.6</td>
<td>13.5</td>
</tr>
<tr>
<td>Philippines</td>
<td>1992</td>
<td>2.4</td>
<td>20.9</td>
<td>2.3</td>
<td>8.5</td>
<td>9.1</td>
</tr>
<tr>
<td>Thailand</td>
<td>1988</td>
<td>25.1</td>
<td>1.9</td>
<td>10.0</td>
<td>5.0</td>
<td>14.3</td>
</tr>
<tr>
<td>Latin America</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>1991</td>
<td>10.2</td>
<td>20.1</td>
<td>7.7</td>
<td>52.8</td>
<td>16.6</td>
</tr>
<tr>
<td>Brazil</td>
<td>1992</td>
<td>26.9</td>
<td>57.9</td>
<td>3.0</td>
<td>1,941.9</td>
<td>6.0</td>
</tr>
<tr>
<td>Chile</td>
<td>1990</td>
<td>9.5</td>
<td>13.5</td>
<td>6.4</td>
<td>17.5</td>
<td>12.7</td>
</tr>
<tr>
<td>Colombia</td>
<td>1991</td>
<td>3.5</td>
<td>37.1</td>
<td>4.1</td>
<td>25.6</td>
<td>7.7</td>
</tr>
<tr>
<td>Mexico</td>
<td>1989</td>
<td>0.8</td>
<td>23.4</td>
<td>3.0</td>
<td>16.1</td>
<td>10.1</td>
</tr>
</tbody>
</table>


Lastly, portfolio investment labeled 'hot money' is assumed to be less stable than FDI (cold money) conventionally, and specifically short-term capital inflows have increased the probability of subsequent financial crises in emerging market economies.50 Since the

49 Calvo, Leiderman, and Reinhart, 128; Park and Song, 115.
early 1990s, both the Latin American and Asian countries experienced sharp increases in stock and real estate prices accompanied by a surge in portfolio inflows. Owing to capital account liberalization, the easy access of domestic financial institutions to cheap funds from overseas became worse as capital inflows contributed to the building of non-performing loans held by local banks and non-bank financial institutions. Since the countries maintained a pegged exchange rate system, the sterilized intervention of the central banks has a limit to protect their real economies from the impact of foreign capital inflows.

In addition, according to the empirical research of the World Bank, the policy makers of developing countries should be concerned with the following three types of macroeconomic management problems faced with a surge in capital inflows:

1. The potential for macroeconomic overheating, in the form of an excessive expansion of aggregate demand as a consequence of capital inflows.
2. The potential vulnerability to abrupt and large reversals of capital flows because of changes in creditor perceptions.
3. The more general, longer-term implications of financial integration for the conduct of macroeconomic policy. As integration advances further, policymakers will have to manage the increased macroeconomic volatility that may prevail when the economy is more exposed to external shocks. In addition, they will need to face these and other shocks with reduced policy autonomy.51

In theory, a country could adopt the monetary, exchange rate, or fiscal policy to mitigate the impact of capital inflows and to maintain sustainable growth with price stability. In a real economic situation, it is very difficult to manage exchange rates and the monetary supply separately since the domestic economy is highly linked with the

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51 World Bank, *Private Capital Flows to Developing Countries*, 33-34.

international economy. Primarily, the central bank will have two types of monetary policy to manage large capital inflows. First, faced with the increased demand for domestic assets without any monetary market intervention, the central bank simply allows domestic currency to appreciate. In this case, there would be no accumulation of international reserve and no expansion in the monetary base, but the appreciated domestic currency could deteriorate a competitive price of export goods and will bring a balance of trade deficits. Otherwise, the central bank resorts to issue central bank securities or increase reserve requirements by a reduction in domestic liquidity (called ‘sterilized intervention’). This measure allow the central bank to increase foreign exchange reserves by reducing domestic liquidity, but it will apply to a long period, and the central bank has to pay interest for the reserved volume.

Fiscal policy would be considered an alternative policy option in dealing with capital inflows. For example, large budget supply could alleviate the inflationary pressure and appreciation of real exchange rates from large capital inflows. However, the real economic conditions, which most developing countries desperately need, place a large demand on government investments in social service and construction of infrastructure, forcing them to depend on large budget deficits. Furthermore, fiscal policy is not an effective method in dealing with short-term speculative capital inflows since it is mainly working for a longer-term period effect.

As financial globalization proceeds, and more developing countries pursue financial liberalization, international financial markets have become more integrated and more exposed to volatile speculative short-term financial flows, following a herd behavior. Unlike the industrialized countries, since most developing countries have not built strong
banking and financial sectors with a solid regulatory framework and accommodating
macroeconomic policy, they are more vulnerable to real and policy shocks from greater
volatility of capital flows, and are even susceptible to sudden capital outflows
accompanied by a herd behavior from incomplete and asymmetric information.

Frequently the IMF and World Bank recommend professional policy proposals to
emerging markets countries to lessen the perils of rapid reversals in capital flows. They
should pursue sound macroeconomic policies, strengthen their domestic financial
systems, phase capital-account liberalization appropriately, and provide information to
the markets.\textsuperscript{52} However, developing countries still have a long way to go to establish a
stable financial system with rigorous preconditions needed for successful financial
integration.

\section*{4.3.2 Financial Crises in Emerging Markets}

The recurrent financial crises in developing countries (the Latin America debt crisis in
1982-83, the Mexican peso crisis in 1994-95, East Asian financial crisis in 1997,
financial crises in Brazil and Argentina in recent years) since the early 1970s are closely
related to global financial capital flows. Financial crises in developing countries are part
of the process of financial globalization and the result of a general trend of global
financial liberalization, and tend to last longer. Particularly the episodes in Mexico in
1994-95 and East Asia in 1997-98 suggest a new variety of financial crises in
international financial markets. First, the imperfection of international financial markets
was the main source of the financial crises. Volatile short-term capital flows on a massive

\textsuperscript{52} Fisher, "Capital-Account Liberalization and the Role of the IMF," 4-8.
scale, haunted by incomplete and asymmetric information, frequently adopt a herd behaviors and display a psychological contagion effect causing financial panic.\textsuperscript{53} Second, private sector problems rather than public finance such as fiscal deficits played a key role. Both Mexico and East Asian countries maintained operational budget balances unlike many others in Latin America. Furthermore, a large portion of external borrowing was by private sectors, mainly bank loans in East Asia and debt portfolios in Mexico.\textsuperscript{54} Third, these countries implemented a series of financial liberalization measures without accommodating domestic prudential regulation and supervision. For example, ambitious and comprehensive financial liberalization in Mexico and South Korea for admission to the OECD without a sound financial mechanism was the potential reason for the crisis. Fourth, financial crisis hit the successful emerging markets and the sudden large scale of the capital flows reversals put the developing countries into a disastrous socioeconomic trauma.

4.3.2.1 The Mexican Peso Crisis

Recovering from the disastrous 1980s debt crisis, Mexico adopted economic adjustments and reforms that reduced inflation and stabilized exchange rates and strengthened fiscal consolidation. Mexico also undertook ambitious economic reforms and wide-ranging financial liberalization that facilitated a commitment to NAFTA and admission into the OECD in 1994. Owing to this performance, Mexico attracted large private capital inflows


from 1990-93. As shown in Table 4.5, the net private capital inflows sharply increased from $5.8 billion in 1990 to $30.2 billion in 1993, mainly as a result of portfolio investments.

Table 4.5 Major Economic Indicators in Mexico, 1990-95

<table>
<thead>
<tr>
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<tbody>
<tr>
<td><strong>Balance of Payment</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current Account Balance</td>
<td>-7.4</td>
<td>-14.6</td>
<td>-24.4</td>
<td>-23.4</td>
<td>-29.7</td>
<td>-1.6</td>
</tr>
<tr>
<td>Net private capital inflows</td>
<td>5.8</td>
<td>19.9</td>
<td>23.5</td>
<td>30.2</td>
<td>10.3</td>
<td>-13.3</td>
</tr>
<tr>
<td>Net official capital inflows</td>
<td>5.0</td>
<td>2.4</td>
<td>2.0</td>
<td>-0.9</td>
<td>0.9</td>
<td>24.5</td>
</tr>
<tr>
<td>Net change in external reserve position</td>
<td>3.4</td>
<td>7.7</td>
<td>1.0</td>
<td>5.9</td>
<td>-18.4</td>
<td>9.6</td>
</tr>
<tr>
<td><strong>Private Capital Inflows</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign direct Investment</td>
<td>2.6</td>
<td>4.8</td>
<td>4.4</td>
<td>4.4</td>
<td>11.0</td>
<td>9.5</td>
</tr>
<tr>
<td>Portfolio Equity</td>
<td>2.0</td>
<td>6.3</td>
<td>4.8</td>
<td>10.7</td>
<td>4.1</td>
<td>0.5</td>
</tr>
<tr>
<td>Bonds</td>
<td>1.1</td>
<td>1.3</td>
<td>3.6</td>
<td>6.3</td>
<td>2.8</td>
<td>-0.5</td>
</tr>
<tr>
<td>Bank</td>
<td>9.1</td>
<td>7.9</td>
<td>1.6</td>
<td>3.6</td>
<td>-0.3</td>
<td>-4.3</td>
</tr>
<tr>
<td><strong>Total Stock of Tesobonos</strong></td>
<td>n.a</td>
<td>0.6</td>
<td>0.7</td>
<td>2.0</td>
<td>30.1</td>
<td>0.3</td>
</tr>
</tbody>
</table>


Since Mexico pegged its currency to the U.S. dollar, these large capital inflows reflected a real exchange appreciation from 1990. Through the Bank of Mexico’s sterilization

effort, some capital inflows were properly absorbed in foreign reserve, but it was inevitable to allow a current account deficit. As the capital inflow continued, Mexico’s current account deficit increased from $7 billion in 1990 to $30 billion in 1990 (see Table 4.5).\textsuperscript{55}

The continuous capital inflows dried up from March 1994 onwards. Foreign investors began to flee Mexico fearing political instability, following the assassination of Luis Donaldo Colosio, presidential candidate for the dominant political party, Partido Revolucionario Institucional (PRI). As a result, Mexican authorities tightened the monetary policy and devalued the peso in order to reduce the ongoing foreign capital exodus, but subsequent capital outflows did not stop. To hold the loss of reserves, the Mexican government issued large quantities of Tesobonos indexed to the U.S. dollar with various short-term maturities. However, another assassination, this time of the PRI secretary general in September 1994, led to a sharp drop in the Mexican stock market and more reserve losses. Although the newly elected Mexican government tried to relieve the capital outflows, the Bank of Mexico had no choice but to let the peso float on December 20, 1994. The depreciation of the peso caused a large increase in the dollar value of the outstanding Tesobonos. In trying to redeem these Tesobonos, Mexico fell into enormous budgetary costs, leading to a default, just as in its 1982 debt crisis.\textsuperscript{56}

Meanwhile, the Mexican crisis spread to other countries. Argentina and Brazil suffered from a sharp fall in stock prices and abruptly spread to Brady bonds. International currency markets highly fluctuated and the Argentine peso, Thai baht, 


\textsuperscript{56} Peter B. Kenen, \textit{The International Financial Architecture: What's New? What's Missing?} (Washington,
Brazilian real, Philippines peso, and Hong Kong dollar came under attack one after another. A serious victim of the "tequila effect" was Argentina, which lost more than a third of its currency reserve in three months due to the Mexican devaluation. In the end, Argentina suffered a severe banking crisis and was forced to seek an IMF bailout.\(^{57}\)

According to Sachs, Tornell, and Velasco, the Mexican crisis was not the result of bad economic fundamentals (irresponsible fiscal behavior) unlike many others in Latin America, but rather foreign investors' perceived risk of financial collapse, a sort of self-fulfilling panic.\(^{58}\) This analysis effectively pinpoints an immediate cause of the Mexico crisis as well as the prevalent imperfections of current international financial markets. Furthermore, the political instability and premature financial market opening were additional factors. Had Mexico taken a more cautious and gradual financial liberalization process, the authorities could have controlled the volume and speed of the surge of capital inflows.

### 4.3.2.2 East Asian Financial Crisis

The East Asian financial crisis began in Thailand, which had experienced large capital inflows since the early 1990s. While capital inflows had built up its foreign exchange reserves, significant amounts of that financed the foreign currency credits to domestic borrowers. In 1993, the opening of the Bangkok International Banking Facility (BIBF) was a critical moment to attract more foreign funds to finance increasing current account deficits. The BIBF allowed local and foreign banks to make deposits or to borrow in

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\(^{57}\) Kenen, 25.

\(^{58}\) Sachs, Tornell, and Velasco, "The Collapse of the Mexican Peso," and "The Mexican Peso Crisis".
foreign currencies from overseas, and lend the money both in domestic and foreign financial markets. As a result, Thailand easily absorbed a huge amount of offshore borrowing. Before the crisis in March 1997, the external debt which had been only US$40 billion in 1992 reached US$80 billion. Despite the Bank of Thailand’s sterilization effort to channel large capital inflows, the credits creation extended continuously. Under the pegged exchange rate system, the large volume of short-term capital inflows destabilized the sterilization effort.

In 1996, Thailand’s economy was slowing down due to various events. First of all, the political instability of the Banharn (1995-96) and Chavalit (1996-97) governments eroded investor confidence, both foreign and domestic. After April 1995, the sharp appreciation of the dollar against the yen undermined Thailand’s price competitive advantage because the Thai baht was pegged to the dollar. In addition, the advent of new trade rival (China) in the world trade market caused Thailand to lose its traditional competitiveness in labor-intensive industries such as footwear, textiles, garments, and plastic products. Thus, Thailand experienced negative export growth and large current account deficits (-7.9 percent of GDP). Meanwhile, the stock market lost around one-fifth of its value during the first nine months of 1996. On February 5, 1997, the first Thai company, Somprason Land defaulted on a foreign loan repayment. Late in the month, the largest finance company Finance One was seeking a merger in order to evade bankruptcy. Faced with continuous financial uneasiness, foreign creditors and investors

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60 Laurids S. Lauridsen, “Thailand: Causes, Conduct, Consequences,” 143-149.
recognized the danger of the loss of their investments, and abruptly pulled their portfolio out of Thailand. This financial panic made a contagion effect and hit the other four countries.

On July 11, 1997, less than two weeks after the baht collapsed to speculative attack and was set free to float, foreign capital suddenly rushed out of the Philippines. The central bank Banko Sentral Pilipinas (BSP) tried to defend the peso widening the band within which the peso was allowed to fluctuate with almost US$2 billion of international reserve. Three days later, the Philippines had to ask for an IMF bailout. The contagion spread quickly to Malaysia, where currency speculators attacked vulnerable financial markets. The Malaysian central bank Bank Negara Malaysia lost several billion US dollars to defend the ringgit from the speculative attack. Soon, Hong Kong’s financial markets received a sharp speculative attack, followed by Indonesia. On July 11, the Indonesian central bank widened the intervention band for the exchange rate form 8 to 12 percent, and raised the interest rate from 7 percent to 30 percent between July 22 and August 18 to hold the capital outflows. On August 14, the Indonesian central bank had to abandon the crawling peg and allow the rupiah to float, and on October 8, Indonesia announced that it was turning to the IMF for assistance.62

The continuous speculative attack migrated to Taiwan, but Taiwan was able to evade the financial panic owing to its abundant foreign reserve and 6 percent margin of Taiwan dollar depreciation. The depreciation of the Taiwan dollars led to speculative hedge funds in the Hong Kong stock market. The Hong Kong currency board could defend its currency value through an extreme increase in short-term interest rates, but the Hong

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Kong stock market fall precipitously, which triggered a worldwide fall in stock prices at the time.\textsuperscript{63} The final destination of the contagion was South Korea. After early 1997, the continuing bankruptcy of several big business firms (Hanbo, Sammi, Jinro, and Kia) brought heavy pressure on commercial banks, which had to liquidate bankrupted big business firms' liability since most of the credits were deeply indebted to foreign banks. In mid-1997, South Korea experienced a stock market crash and suffered from redemption of short-term foreign debt. As a result, Korean foreign reserves declined and fell by $15 billion in November 1997, and on November 21, 1997, the Korean authorities sought help from the IMF.\textsuperscript{64}

4.4 The Linkage Problems between the Financial Crisis and Financial Liberalization

In analyzing causes of the financial crises in developing countries, many scholars in international political economy examine whether the crises were caused by the weak economic fundamentals such as macroeconomic imbalance and other domestic structural economic problems ('fundamentalist' viewpoint) or by the financial panic which was triggered by speculative short-term capital regardless of the macroeconomic fundamentals ('self-fulfilling' or 'panic-stricken' viewpoint).\textsuperscript{65} Paul Krugman represents the fundamentalist viewpoints termed first-generation crisis model. This model argues that a government's excessive monetary expansion in order to finance persistent budget

\textsuperscript{62} Montes and Abdusalamov, "Indonesia: Reaping the Market", 175-178.
\textsuperscript{63} Kenen, The International Financial Architecture, 31-34.
\textsuperscript{64} See Inseok Shin, The Korean Crisis: Before and After (Seoul: Korea Development Institute, 2000).
deficits could bring a serious shortage of its foreign exchange reserve to defend a fixed parity, and ultimately reach an unsustainable condition of balance of payments crisis under the investors' speculative attack.\textsuperscript{66} This model could explain such financial crises as the 1980s' Latin American debt crisis, which was caused by excessive budget deficits and unstable macroeconomic conditions. However, this model does not sufficiently explain the Mexican peso crisis in 1994, the European Monetary System (EMS) crisis in developed countries, or financial crisis in successful emerging economies (1997 Asian financial crisis).\textsuperscript{67} Hence, Maurice Obstfeld proposed a self-fulfilling model as an alternative set of explanations for financial crisis, termed the second-generation model. According to the model, financial investors frequently overreact to the underlying problems in a country, so speculators initiate attack and exacerbate the situation based on their belief regardless of the willingness or effectiveness of policy makers' economic and political positions.\textsuperscript{68}

\textsuperscript{66} Paul Krugman, "A Model of Balance-of-Payments Crises," \textit{Journal of Money, Credit, and Banking} 11, no. 3 (August 1979).
### Table 4.6 Major Economic Indicators of the Five Affected Countries

<table>
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</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>7.2</td>
<td>7.8</td>
<td>4.6</td>
<td>8.7</td>
<td>8.0</td>
<td>6.6</td>
<td>-2.5</td>
<td>-3.7</td>
<td>-2.9</td>
</tr>
<tr>
<td>Korea</td>
<td>7.8</td>
<td>7.1</td>
<td>5.5</td>
<td>6.6</td>
<td>4.9</td>
<td>4.4</td>
<td>-1.2</td>
<td>-4.8</td>
<td>-1.9</td>
</tr>
<tr>
<td>Malaysia</td>
<td>8.8</td>
<td>8.6</td>
<td>7.8</td>
<td>3.7</td>
<td>3.5</td>
<td>2.7</td>
<td>-5.9</td>
<td>-4.9</td>
<td>-5.1</td>
</tr>
<tr>
<td>Philippines</td>
<td>2.3</td>
<td>5.7</td>
<td>5.1</td>
<td>11.0</td>
<td>8.4</td>
<td>5.1</td>
<td>-3.8</td>
<td>-4.7</td>
<td>-5.2</td>
</tr>
<tr>
<td>Thailand</td>
<td>8.9</td>
<td>6.4</td>
<td>-0.4</td>
<td>5.0</td>
<td>5.8</td>
<td>5.6</td>
<td>-6.7</td>
<td>-7.9</td>
<td>-2.0</td>
</tr>
</tbody>
</table>

Source: BIS, 68th Annual Report (June 1998), 34.

### Table 4.7 Macroeconomic Structure of the Five Affected Countries

<table>
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</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>32.6</td>
<td>32.1</td>
<td>33.8</td>
<td>31.2</td>
<td>0.9</td>
<td>-1.0</td>
<td>15.9</td>
<td>20.4</td>
<td>19.2</td>
</tr>
<tr>
<td>Korea</td>
<td>33.9</td>
<td>36.8</td>
<td>36.4</td>
<td>35.2</td>
<td>0.3</td>
<td>0.0</td>
<td>30.7</td>
<td>28.9</td>
<td>32.9</td>
</tr>
<tr>
<td>Malaysia</td>
<td>32.7</td>
<td>42.2</td>
<td>35.8</td>
<td>42.6</td>
<td>-3.2</td>
<td>0.7</td>
<td>44.3</td>
<td>78.9</td>
<td>25.1</td>
</tr>
<tr>
<td>Philippines</td>
<td>20.5</td>
<td>23.2</td>
<td>17.5</td>
<td>15.6</td>
<td>-1.9</td>
<td>0.3</td>
<td>16.4</td>
<td>31.2</td>
<td>20.5</td>
</tr>
<tr>
<td>Thailand</td>
<td>36.3</td>
<td>42.2</td>
<td>33.5</td>
<td>35.9</td>
<td>2.1</td>
<td>0.7</td>
<td>20.9</td>
<td>34.9</td>
<td>32.6</td>
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1 Central government
2 Ratio of average exports and imports to GDP
3 Incremental capital/output ratio, shown here as its inverse, i.e. the real rate of GDP growth over investment/GDP.
Analyzing the Asian financial crisis, many scholars agree that all five countries have no critical evidence of weak macroeconomic fundamentals generating financial crisis as suggested by the first generation model. Throughout the late 1980s and the 1990s all five countries maintained a sound economic performance, relatively high savings and investment ratios, strong GDP growth, fiscal balance, and modest current account deficits (see Table 4.6 and 4.7). A sound macroeconomic background with persistent structural reforms in those countries made them a favored region as emerging financial markets and thus attracted large private financial capital.

Compared with the Mexican peso crisis, the highest current account deficits of Thailand in 1996 (7.4 percent of GDP) among the five affected countries is worse than that of Mexico in 1993 (6.4 percent of GDP), but the country had recorded similar levels of deficits since 1990. Furthermore, empirical studies verified that a large current account deficit would not trigger financial crisis. The macroeconomic fundamentals of the Asian economies were essentially correct, so the fundamental viewpoint would not perfectly fit for analyzing the Asian financial crisis.

Although advocates of the self-fulfilling approach acknowledge that Asian governments made some policy mistakes, they are more concerned about the unstable international financial system and premature financial liberalization of the Asian governments to identify the root of the crisis. Inherently, international financial markets

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69 Paul Krugman, "What Happened to Asia?"; Jeffrey A. Frankel, The Asian Model, the Miracle, the Crisis and the Fund (Washington D.C: The U.S. International Trade Commission, April 16, 1998); Radelet and Sachs, "The Onset of the East Asian Financial Crisis".

70 Frankel, 1.

are very unstable and market failure is very natural. Foreign investors are frequently exposed to very limited information from other countries, so they have to depend on their own decisions that is further driven by a herd behavior and self-fulfilling predictions. The short-term capital rushed to where it was best rewarded and fled from the market whenever it would not secure the highest return of investment. The international capital market does not operate by textbook models of economic principle, and market failure is an intrinsic character. Under the circumstances, financial liberalization means that a country's financial market is fully open to casino rules.

As the result of a series of financial liberalization measures (capital account opening) in the Asian countries and an expectation of high profit returns for foreign investors, the countries experienced a huge amount of private capital inflows. By 1996, the year before the Asian financial crisis, private capital inflows continuously increased and reached a peak of $62.4 billion, or 30 percent of the total capital inflows to the global emerging markets. However, the extremely large portion of the banks and non-banking private sector encouraged the risky lending practices, such as speculative real estate and stock markets that aggravated the mismatch between the banks' liabilities and their assets by the eve of the crisis. As to the maturity of international lending, Asian countries recorded large external foreign bank loans, and further, most of the debt had a high rate with short-term maturity mostly from the private sector (see Table 4.8). In sum, Asian countries depended too much on short-term foreign debt, unlike in Mexico.


Table 4.8 The Composition of International Lending to Asia and Mexico

<table>
<thead>
<tr>
<th></th>
<th>Distribution by maturity</th>
<th>Distribution by sector</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Up to and including one year</td>
<td>Over one year</td>
</tr>
<tr>
<td></td>
<td>in percentage of total consolidated claims</td>
<td></td>
</tr>
<tr>
<td>Mid-1997</td>
<td></td>
<td></td>
</tr>
<tr>
<td>South Korea</td>
<td>67.9</td>
<td>19.8</td>
</tr>
<tr>
<td>Indonesia</td>
<td>59.0</td>
<td>35.0</td>
</tr>
<tr>
<td>Thailand</td>
<td>65.7</td>
<td>30.4</td>
</tr>
<tr>
<td>Philippines</td>
<td>58.8</td>
<td>41.2</td>
</tr>
<tr>
<td>Malaysia</td>
<td>56.4</td>
<td>30.8</td>
</tr>
<tr>
<td>Mid-1994</td>
<td>46.8</td>
<td>46.4</td>
</tr>
<tr>
<td>Mexico</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


Faced with the surge in capital inflows, the five Asian countries managed heavy sterilization through tight monetary policy and high interest rates to curb the appreciation of exchange rates in the initial phase. Yet, their premature capital-account liberalization such as deregulation of foreign borrowing of private financial institutions without appropriate supervisory measures encouraged large commercial banks loans and speculative short-term portfolio investment, and did not alleviate vulnerability to the speculative attacks. In the end, the fatal mistake of the five Asian countries as well as many developing countries is that they did not seriously follow the right sequencing manner of financial liberalization. These cases show that the haphazard manner of
financial liberalization brings serious disaster based on the banking crisis in the Southern Cone of Latin America in the late 1970s and early 1980s. Since then, many scholars warned of the problem of financial liberalization and concentrated empirical research to identify an appropriate process. Among those scholars, Ronald I. McKinnon presented the most detailed discussion of the correct order of financial liberalization through various empirical studies. McKinnon emphasized that financial liberalization should build upon a strong macroeconomic foundation and that capital account liberalization should be implemented in the final stage of the sequence. Before the capital market opening for free borrowing and lending, the first and most essential step is to maintain a stable macroeconomic policy. Prior to financial liberalization, a government should try hard to maintain proper fiscal controls to attain a balanced budget. After privatizing state-owned enterprises, the government quickly establishes a regularized tax system and raises sufficient revenue to avoid inflation. The second step of liberalization is the opening of the domestic capital market. Only after tight fiscal controls are successfully implemented should the banking system be deregulated from strict reserve requirements and official guidelines of interest rates on deposit and loan. Moreover, the government should launch commercial laws to properly adjudicate private debts contracts. In the third stage, it should consider liberalization of the foreign exchange, but only after successful domestic trade and financial liberalization. Various government controls on current account transactions such as a screening system of trade license,

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quotas, and tariffs liberalized much faster than international capital flows. In the final stage, free foreign exchange convertibility on capital accounts should be liberalized. ⁷⁵

Unfortunately, the five affected Asian countries undertook capital account liberalization in haste without maintaining macroeconomic stability and establishing an adequate prudential safety network. Instead, they liberalized the capital account transactions prior to the liberalization of the other measures in the appropriate order.

Before the financial crisis, most policymakers in Asia believed that financial liberalization would automatically solve many of their structural problems and bring an efficient financial system based upon neo-liberal free market principles. It was not until economic disaster swept over the region that they recognized this belief was very naive and in fact, a total misunderstanding.

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⁷⁵ McKinnon, 4-10.
CHAPTER V

FINANCIAL LIBERALIZATION IN SOUTH KOREA

Investigating the process of financial liberalization in developing countries, the case study of South Korea provides a resourceful model since the country has experienced very dynamic political and economic developmental patterns. As a typical developmental state, Korea had strongly controlled its domestic financial sectors to achieve a rapid economic development supporting key export-oriented big business industries that could compare with those of Japan, Taiwan, and Singapore. Periodically, Korean financial liberalization agreed in time of the global financial liberalization trend in developing countries during the 1980s and 1990s. Like most developing countries, Korea had persistently received financial market opening pressures from the external and internal sources. After adopting various financial reform plans, the country experienced sizeable capital inflows with volatility of financial capital as we have examined in chapter IV.

In addition, the passage to financial crisis in Korea was very similar to the Mexican experience in that both countries had to speed up their financial market opening in order to join the OECD without considering a proper sequencing of liberalization, which was finally connected to their financial crises. Of course, Korea was forced to entertain Washington Conesus oriented structural adjustment programs from the IMF and the United States at the price of a rescue fund as several Latin American and Southeast Asian

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1 After this, the dissertation will use “Korea” for “South Korea,” and “Korean government” for “South Korean government.”
countries did. Thus, the process and experience of financial liberalization in Korea is applied and compared to other countries’ cases.

Financial liberalization, as a general trend in the era of globalization, has been no exception in the Korean financial market. Korean financial liberalization has proceeded from the government’s policy autonomy, but it has been highly influenced by the big business conglomerates (chaebol) as a powerful domestic interest group, in addition to the foreign pressure of the United States, the OECD, and the IMF. Notwithstanding that financial liberalization was a long and gradual process, it was too premature to create a stable financial system because Korea suffered from a financial crisis in 1997. Through the long financial liberalization period from the 1980s to the 2000s, the entrance of the OECD and the 1997 financial crisis were important moments to expedite the financial reform process, and the Korean financial market has now reached the same level as the OECD countries.

This chapter examines the process of financial liberalization in Korea from the perspective of the global financial liberalization, and focuses on political factors such as the foreign and domestic pressures through an international political economic approach. Most work on this topic focuses mainly on economic rather than political factors. Yet, the economic approach revealed serious limitations to analyze the government’s policy autonomy, and the international or domestic environmental factors surrounding

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government actors. On the other hand, much political economic research accepts the foreign pressures on Korean financial liberalization, but there is no detailed research results from this so far. This study seeks to fill these research gaps. This chapter is organized into four sections. Section 5.1 introduces the methodological frameworks: a systems theory and three levels of analysis. Section 5.2 focuses on the Korean experience of financial controls from 1945 to 1979. Section 5.3 presents the financial liberalization process in the county. Section 5.4 examines the Korean financial crisis in the context of the Asian financial crisis and diagnose the causes of crisis.

5.1 The Case of Korea: A Levels of Analysis Approach

From a systems theory perspective, the Korean financial system could be divided into three financial systems: tightly controlled financial system, loosely controlled financial system, and liberalized financial system. During the period of 1948-1979, the financial system was tightly controlled by the government to support the chaebol for rapid industrialization and export-oriented economy under the Rhee and Park regimes. During the period of 1980-1993, the financial control of the government was loosened and deregulated by the Chun and Roh regimes. The Chun regime started the various deregulations in domestic financial markets and the Roh regime continued this measure under the U.S. pressure for financial liberalization. Since 1993, the Korean government has introduced several comprehensive financial reform policies under the pressure of the United States and the chaebol, a domestic interest group. Kim Young Sam government’s ‘Segeywha’ (Globalization) plan and the 1996 entry into the OECD was the critical
moment to implement a comprehensive financial reform. For better explanation of the transformation of Korean financial systems, this study introduced the governments’ policy reactions to manage stable macroeconomic conditions and autonomy to manage the pressure from the external and international sources.

As another research method, the levels of analysis (international systemic level, domestic level, and individual level) could describe more detailed feature of Korean financial liberalization. At the international system level, the global financial liberalization environment or trends have had a great influence on Korean financial liberalization. The United States, the OECD, and the IMF have significantly influenced Korea’s financial liberalization. Particularly, the United States has pressed the Korean government to lift its financial market regulations. As its largest trading partner as well as the strongest supporter in the security realm, the United States has great leverage on the Korean government’s financial market opening to the outside world. Until the 1970s, the United States not only allowed the Korean goods and services to access its market completely, but also it was not willing to make an issue regarding the Korean governments’ various regulations in order to protect its infant financial system against the U.S. financial corporation. The United States gradually urged the Korean government to make coordinate reciprocal relations in trade and finance. The Korean government used to suggest a piecemeal from the U.S. needs, but the concession would not fully quench the U.S. Thus, the issue of financial market opening in Korea was a regular menu item between two countries. When the Korean government joined the OECD in the middle of the 1990s, the OECD put pressure on the Korean government to accept a coordinate level of financial market opening legalized in the Code of Liberalisation of Capital
Movements. The financial crisis disarmed all financial regularization of Korea. To attain the IMF’s relief fund, the Korean government was forced to follow the full width of the IMF reform policy as well as signing WTO’s the FSA.

At the domestic and individual levels, the state and business relation has occupied crucial standings in the process of financial liberalization. For several decades, the Korean government has monopolized the allocation and mobilization of financial resources in order to support rapid industrialization. Under the heavy and chemical industrialization policy, the chaebol could accumulate huge financial assets and become a strong domestic interest group. These large big business conglomerates have influenced the Korean government’s financial market liberalization since financial liberalization allows the chaebol easy access to the foreign capital resources, which have a low interest rate. Under the foreign and domestic pressure to financially liberalize, the Korean government voluntarily stepped up the effort to open their financial market through several financial sector reforms plans that explain the Korean government’s role in the financial liberalization process.

5.2 Financial Liberalization Process in Korea

This section analyzes the Korean experience of financial regulation to the financial liberalization during the period from 1945-2000. From the Rhee Syng Man to Park Chung Hee regimes (1948-1979), Korea used the tightly controlled financial system to support its industrial development strategy. The Chun Doo Hwan and Roh Tae Woo regimes (1980-1993) only entered the financial liberalization after strong pressure from

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3 Bank of Korea, *Financial System in Korea* (Seoul: Bank of Korea, 1990); Bank of Korea, *Financial
the United States. The two Kim's (Kim Young Sam and Kim Dae Jung) government (1993-February 2003) saw the maturation of financial liberalization and Korea reached the level of the developed countries in the OECD.

5.2.1 Tightly Controlled Financial System: 1945-1979

The financial repression in Korea from 1945 to the 1950s was similar to the experiences of European countries after World War II under the Bretton Woods regime. At the time, most developed nations intervened extensively in their own financial markets in order to rebuild their economies following the destruction of World War II. The main reasons for financial regulation in Korea were the same as that of the developed nations. Newly established small weak economy lacked financial resources to rebuild the nation and depended almost totally on the aid of the United State. Although the relatively modern financial system and industrial bases were introduced by the Japanese for a colonial purpose to siphon off Korean resources, almost all of these facilities were destroyed by the Korean War. Thus, Korea had no choice but to fully depend on the U.S. aid for its economic recovery and security. From the shape of the political system to building up the economic system, the fundamentals of Korean state building were strongly influenced by the United States.

The Korean government was established in 1948, but the government expenditure fell far short of managing the basic government functions such as public security and national defense. The Rhee government solved the liquidity shortage by heavy reliance of the U.S. aid funds such as the International Cooperation Administration (ICA) and Public Law System in Our Country (Seoul: Bank of Korea, 1993).
Concerning the financial system, Arthur I. Bloomfield and John P. Jensen, economists of the Federal Reserve Bank of New York, who were commissioned by the Rhee government, drafted the Bank of Korea Act and the Banking Act and transplanted the U.S. Federal Reserve system to Korea. On June 12, 1950, the Bank of Korea began its official operation, but the typical operations of a central bank such as rediscount rate operations, reserve requirement ratio adjustment, and open market operation could not be enforced due to the chronic shortage of funds, and underdeveloped financial markets. The Rhee government had to exercise strong financial regulation of direct or selective control of money and credit in order to channel funds toward productive sectors.

The April 19, 1960, student uprising ousted President Rhee from power, and the Chang Myon government was instituted as a democratic government. The Chang government set out to draft a five-year economic development plan and tried to forge a democratic tradition. On May 16, 1961, Park Chung Hee, a military general, seized the government in a coup d'etat. In 1963, he was elected president and started the industrial drive for economic development. He believed that the national wealth and security should be based on rapid industrialization and economic development.

During the period of the 1960s and 1970s, the Korean government pursued an export-oriented industrial developmental strategy. This industrialization policy started from the

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4 See detail explanation in Woo, Race to the Swift, 19-42.
6 Arthur I. Bloomfield and John P. Jensen, Banking Reform in South Korea (Seoul: Bank of Korea, 1963); Woo, Race to the Swift, 51.
8 See more detail discussion in Nam, “Korea’s Financial Reform Since the Early 1980s,” 2-5.
recognition of the United States hegemonic decline in international political economy, demonstrated by the collapse of the Bretton Woods monetary regime and the defeat in the Vietnam War. In addition, the partial withdrawal of the U.S. troops on the Korean peninsula under the Nixon Doctrine, and President Carter’s threat of continuous withdrawal of U.S. ground troops led the Korean government to proceed with heavy industrialization. President Park Chung Hee believed that the heavy and chemical industries (HCIs) could develop its infant defense industries and strengthen the competition for the export industry.

Under these strategic considerations, the financial system played an important role in supporting the government’s developmental policy. Supporting the HCIs, the Korean government actively intervened in its financial market through extensive capital and interest controls and a variety of subsidies and export credits in the form of “policy loans.” Particularly, the August 3, 1972 *Presidential Emergency Decree for Economic Stability and Growth* was an extraordinary measure to relieve the financial burden of many business firms. These government protections and strategic considerations contributed to the rise of big business conglomerates (chaebol).

The heavy industrialization of the 1970s suffered serious ordeals due to the global recession that resulted from the second oil crisis in 1979. As indicated in Table 5.1, the

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10 The heavy and chemical industries are steel, petrochemicals, metals, shipbuilding, electronics, and machinery.
11 Policy loans carried an exceedingly low interest rate with a longer maturity in order to support the heavy and chemical industries with the strong support of the Korean government.
12 This measure was prepared for supporting the chaebol that included the conversion of short-term curb markets loan into long-term loans, a reduction of the corporate tax burden, and a lowering of interest rates.
inflation rate, despite the government’s extensive price controls and substantial real appreciation of the Korean currency, reached the second highest ever, 22.8 percent and the current account deficit skyrocketed to $4.7 billion during the period from 1979-1981. In addition, the heavy industrialization policy brought about the excessive and duplicated investments problems made by the chaebol.14

Table 5.1 Major Macroeconomic Trends

<table>
<thead>
<tr>
<th></th>
<th>71-73</th>
<th>74-75</th>
<th>76-78</th>
<th>79-81</th>
<th>82-85</th>
<th>86-88</th>
<th>89-90</th>
</tr>
</thead>
<tbody>
<tr>
<td>GNP Growth (%)</td>
<td>8.9</td>
<td>7.3</td>
<td>10.9</td>
<td>3</td>
<td>9</td>
<td>12.6</td>
<td>7.9</td>
</tr>
<tr>
<td>Current Account Balance (billions of U.S.$)</td>
<td>-0.5</td>
<td>-2</td>
<td>-0.5</td>
<td>-4.7</td>
<td>-1.6</td>
<td>9.5</td>
<td>1.4</td>
</tr>
<tr>
<td>CPI Inflation (%)</td>
<td>9.5</td>
<td>24.8</td>
<td>13.2</td>
<td>22.8</td>
<td>3.8</td>
<td>4.3</td>
<td>7.2</td>
</tr>
<tr>
<td>Wage Increase (%)</td>
<td>14.8</td>
<td>30.7</td>
<td>34.2</td>
<td>24.1</td>
<td>11.1</td>
<td>11.3</td>
<td>20</td>
</tr>
<tr>
<td>Exchange Rate (won/$, period-end)</td>
<td>398</td>
<td>484</td>
<td>484</td>
<td>701</td>
<td>890</td>
<td>684</td>
<td>716.4</td>
</tr>
<tr>
<td>M2 Growth (%), year-average</td>
<td>30.1</td>
<td>27.6</td>
<td>35.1</td>
<td>36.7</td>
<td>17.4</td>
<td>18.1</td>
<td>19.8</td>
</tr>
<tr>
<td>Unified Budget Balance (% of GNP)</td>
<td>-2.8</td>
<td>-4.3</td>
<td>-2.7</td>
<td>-3.1</td>
<td>-1.8</td>
<td>0.6</td>
<td>-0.5</td>
</tr>
</tbody>
</table>


In early 1979, President Park made a macroeconomic stabilization and structural reform plan that included financial market liberalization after the intra-bureaucratic conflict between the proponents for the heavy industrial policy and the technocrats for market-confirming strategy,15 but this plan was not realized due to the assassination of

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15 Mahn-Je Kim, Jae-sok Chong, and Kyung-Shik Kang supported for the market-confirming strategy in the Economic Planning Board (EPB), while the Ministry of Commerce and Industry upheld the HCI plan in
President Park. The government’s financial regulation could effectively accomplish rapid industrialization and economic development, but it deprived itself of the opportunities for the development of a free capital market. The government’s financial regulation and credit policy made the cheabol dependent on debt financing. This policy was not a problem when the economy boomed, but the government always had to support the debt financing and continued heavy controls over the banking sector in order to bail out the troubled industries when the economy recessed such as during the oil shock. Even the government’s credit policy could exacerbate the moral hazard problem that was one of the main reasons for the 1997 financial crisis. The chaebol believed the motto of “too big to fail,” and strongly depended on the debt-financing management under the umbrella of the government’s financial regulation and credit policy. The capacity of the commercial banks’ non-performing loans increased due to the government bailout and the cheabol’s debt-run management. If the big business group was troubled, the government pushed commercial banks to bailout, then the volume of the non-performing loans of the commercial banks increased over and over. This vicious cycle of financial regulation recurred in the Korean economy in 1969-1970, 1972, 1979-1981, 1986-1988, and the Korean economy finally broke down in 1997.


5.2.2 Loosely Controlled Financial System: 1980-1992

In May 1980, Chun Doo Hwan, who seized power through a coup d'état, gave an initiative for the financial liberalization to the technocratic reformers who were experienced as economic bureaucrats in the former government or researchers like those at the Korean Development Institute (KDI).\(^{17}\) The fact that these technocrats, who were led by Kim Jae Ik, earned their doctorate degree in the United States influenced their policy considerations for financial liberalization as they fully supported the introduction of the neo-liberal idea (the Washington Consensus) into Korea's developmental strategy.\(^{18}\) Furthermore, the lack of political legitimacy made the Chun regime bow to U.S. pressure for financial liberalization as he sought U.S. support to gain authority.

In the early 1980s, the Chun regime implemented a number of financial liberalization and internationalization measures.\(^{19}\) With the privatization of all commercial banks from 1981 to 1983, two new nationwide commercial banks (Shin-Han and Korean-American bank) were established in 1982 and 1983 respectively. The entry barriers for non-bank financial institutions (NBFIs) were lowered. Also, the business areas of commercial bank were enlarged (e.g. the sales of commercial bills, credit card business, sales of government and public bonds under repurchase agreements\(^{20}\) (RPs), negotiable

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\(^{20}\) “Repurchase Agreements (also called a repo) is an agreement between two parties whereby one party sells the other a security at a specified price with a commitment to repurchase the security at a later date for another specified price. Most repos are overnight transactions, with the scale taking place one day and being reversed the next day. Longer repos – called term repos – however, can extend for a month or more.
certificates of deposit\textsuperscript{21} (CDs), etc. Foreign security companies could open their representative offices in Korea, and domestic security companies permitted the same measure. In 1984, the restriction on foreign direct investment was relaxed, and the positive list system was changed into a negative list system. In 1985, the restriction on activities of foreign banks eased, and foreign banks allowed accessing to the rediscount window of the Bank of Korea on the same terms as local banks.

The financial liberalization on this period took a consideration of the current account deficit of the period of 1980-1984 as seen in the Table 5.1. In order to attract the foreign capital for financing these current account deficits, financial reform plans allowed foreign capital and conditional foreign banks’ capital inflows. However, the financial sectors and capital market still remained under the government’s controls.

For these financial reforms, the chaebol seemingly welcomed the increasing opportunities for accessing foreign capital. Yet, in fact they feared the rapid foreign capital inflows that would put upward pressure on the exchange rate and have a negative effect on their export goods. For the export-oriented large chaebol, this result could weaken their price competitiveness.\textsuperscript{22}

As the results of the 1980s financial liberalization, Bank of America, Citibank, Chase Manhattan, Manufacturers’ Hanover, and Lloyd Bank recorded high returns amounting to 359 percent of their investments in Korea.\textsuperscript{23} In 1984, these banks’ net profit was

\textsuperscript{21} Certificates of Deposit is a special type of deposit account with a bank or thrift institution that typically offers a higher rate of interest than a regular savings account.

\textsuperscript{22} Haggard and Maxfield, “The Political Economy of Financial Internationalization,” 58.

increased to 26.6 percent from those of the past year. Therefore, more American and European banks eagerly wanted to enter the Korean market, and the existing ones sought more freedom to expand their operations. These American banks' strongly lobbied for financial deregulation, and equal treatments or lowering barriers for their operations directly connected to the U.S. Treasury Department. In order to support the interests of their financial institution, the Reagan administration put considerable pressure on the Korean government and these efforts for a financial open door policy to Korea gained momentum.

During the period from 1986-1989, Korea experienced large current account surpluses (see Table 5.2) that resulted from the recovery of the world economy and of the competitiveness of Korean exports originating from the rapid appreciation of the yen. Owing to this current account surplus, the foreign-exchange reserve highly increased from $2.8 billion at the end of 1985 to $15 billion at the end of 1989. Unlike the financial liberalization in the first half of 1980s, Korean government began to liberalize capital outflows. The government allowed domestic commercial banks to establish more overseas branches and subsidiaries. At the same time, certain restrictions on the operation of Foreign Bank branches were relaxed, equalizing them with the domestic banks. The foreign banks' swap facilities at preferential rates were gradually reduced, and

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25 Business Korea, June 1984, 35.
new sources of local currency funding were allowed. In 1988, domestic institutional investors could invest in the foreign stock market up to $30 million by security companies and $10 million by insurance and investment trust companies.

In fact, the main motive for the financial liberalization of the late 1980s was the United States pressure rather than the current account surplus. At the time, the United States strongly pushed the Korean life insurance market openness that could guarantee highly lucrative and life time deposits. The United States skillfully used the investigation of Section 301 of the U.S. Trade Act as leverage to open the Korean insurance market.\(^{28}\)

In addition, the U.S. Treasury Department indicated Korea as an exchange manipulating country and launched the *Financial Policy Talks* for the intervention of the Korean financial reforms.\(^{29}\)

Under the circumstance, the Korean government had to open their life insurance market to the foreign life insurance companies in 1987. In the following year, Korea began to relax the foreign exchange controls. At the same time, the Korean government agreed to accept the obligations on foreign exchange controls of the IMF Article VIII.\(^{30}\)

In addition, a foreign currency call market continuously opened and U.S. dollar call market was established in 1989. In the next year, the existing exchange rate system (Multiple Currency Basket Peg System: MCBS) was changed into a market average rate (MAR) system.\(^{31}\)

\(^{28}\) Woo-Cumings, "Slouching toward the Market," 82.

\(^{29}\) "Under the 1988 trade bill, the U.S Treasury Department was authorized to determine whether countries manipulated their exchange rates to prevent effective adjustment or to gain competitive advantage." Cited in Haggard and Maxfield, "The Political Economy of Financial Internationalization in the Developing World," 59.

\(^{30}\) IMF’s Article VIII prohibits the imposition of restrictions on payments and transfers for current account transaction.

In 1990, due to global economic deflation, rising domestic wages and real appreciation of the won, the Korean economy showed a current account deficit (The current account deficit jumped $8.7 billion in 1991). Confronted with this economic hardship, the Korean government once again liberalized the capital account through the amendment of the *Foreign-Exchange Management Act* (FEMA). Under the FEMA, transactions that followed the capital inflows were liberalized, and restrictions on direct investment by non-residents was almost completely lifted. After January 1992, foreign investors could directly invest in the Korean stock market under the limitation of 10 percent of the total equity share of a listed company.

Regarding interest rate liberalization, the government announced the *Four-Stage Plan for Interest Rate Regulation* in 1991. At the first stage (1991), most of the short-term lending rates of banks and non-banks financial institutions were deregulated. At the second stage (1993), all lending rates of bank and non-bank financial institutions that excluded loans financed by the government or by the Bank of Korea's rediscounts were undertaken. At the third stage (1994), the other interest rate deregulation was implemented. In addition, the minimum maturities of CDs, large-value RPs and CP were shortened. Following these schedules, all lending rates and deposit rates would be freely determined by financial institutions at the last fourth stage in July 1997.

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Liberalization in the WTO, 236.

According to the *Far Eastern Economic Review*, this *Four-Stage Plan* was prepared by U.S. pressure and the World Bank's recommendation. In order to successfully enforce the plan, the officials of the Finance Ministry negotiated with the World Bank and asked for a structural-adjustment loan of about US$100 million to be spent on modernizing the financial-service industry. In response, the Korean government had to put these measurements requested by the World Bank into the plan.

However, in January 1992, President George Bush visited Korea and pressed the Roh Tae Woo regime to open up the Korean financial market. The Bush Administration warned the Roh regime about the faithful fulfillment of the interest reform plan with mention about the equal treatment bill. At the time, the U.S Congress introduced a bill demanding "reciprocal national treatment" of US banks and financial intermediaries in other countries. This bill would put pressure on foreign government for equal treatment of US financial institution in other countries, but the Bush Administration held it up.

### 5.2.3 Liberalized Financial System: 1993-2000

In March 1992, the Ministry of Finance (MOF) presented a document (new blueprint for the comprehensive liberalization of the financial sector) and explained the financial reform plan to the United States at the Financial Policy Talks. However, the United States did not relax the pressure for the Korean financial reforms. For instances, the Deputy U.S. Trade Representative Charlene Barshefsky told the Korean government that

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Washington strongly wanted Korea to accelerate its deregulation and liberalization plans at the June 1993 U.S.-Korea economic consultation meeting in Seoul.39

After all, the MOF announced the comprehensive five-year (1993-1997) four-stage financial market restructuring plan in May 1993.40 The main focus of this plan was the accelerating interest rate deregulation, ensuring all financial systems’ soundness, breaking down of “policy loan,” eliminating the credit control system, and reducing non-performing bank loans. In addition, the domestic financial institutions’ overseas investment ceilings were sharply increased, several regulations about the long-term and short-term capital flows were relaxed, and the margin of fluctuation for the exchange rate to plus or minus 1 percent was widened. With the acceleration of the financial market reform, the Korean financial market was made more competitive, and domestic financial institutions experienced difficulty to compete with other foreign financial institutions.

Since the early 1990s, the United States pressure for financial liberalization was more strenuous and institutionalized. Multilateral agreements (e.g. the Uruguay Round and MAI in the OECD) and the international organizations (e.g. the IMF and the WTO) provided the arenas for the United States’ financial globalization. After taking office in 1993, President Bill Clinton placed higher priority on the completion of the Uruguay Round and he received “fast-track” negotiation authority from the Congress for the rapid termination of the negotiation.

President Clinton visited Seoul in July 1993 and held a summit meeting with President Kim Young Sam. In this meeting, Clinton discussed the North Korean

39 Business Korea, July 1993, 73.
withdrawal from the Nuclear Non-Proliferation Treaty in March, and emphasized to President Kim the need for finalizing the Uruguay Round global trade talks. Partially because of the Korea's strenuous objection to the opening of rice and agricultural markets, a strong target of Clinton's trade pressure, the global trade talks were delayed. Clinton also put pressure on Korea for financial liberalization, protection of intellectual property rights and easiness regulation on foreign investment because Washington was dissatisfied with Korea's regulated financial sector that undermined the performance of U.S. financial firms in Korea. 41

Besides the United States pressure, the Korean government received other pressure for financial liberalization. Although the Korean government had policy autonomy in preparing for a series of financial liberalization measures, it could not free itself from the influence of the chaebol lobby as a strong domestic interest group. Particularly, under the "democratization" slogan of the Roh Tae Woo regime, the chaebol could enjoy a relative autonomy in the business arena unlike their position under the Park regime, and the government's influence on the chaebol began to shrink. The challenge for the presidency of Chung Joo Young, the chairman of Hyundai, serves to verify rising power of the chaebol. 42

During the 1980s, the chaebol had been strongly opposed to interest rate deregulation due to their high debt burden. Yet in the 1990s, they could withdraw the objection of the interest rate deregulation. Owing to the government's financial liberalization, they could enjoy free access to credit from the NBFIs or other financial resources. Through broad

41 *Business Korea*, July 1993, 73.
financial reforms, the chaebol were able to diversify their credit line to finance and mobilize a substantial amount of funding from the NBFIs. In fact, the chaebol could raise huge capital in international financial markets without the government’s help. These chaebol had a great influence on shaping the plan and course of financial liberalization in the 1990s. In the domestic financial sectors, the chaebol lobbied the government to relax the ownership of the NBFIs and interest deregulation. In the external liberalization, the chaebol strongly demanded that the government liberalize international financial transactions and financing from international financial markets. The chaebol demand for financial liberalization coincided with the government’s interest in gaining entrance into the OECD.43

President Kim Young Sam’s “Segeyhwâ” (Globalization) plan44 was connected to Korea’s entry as the 29th members of the OECD in 1996. Entrance into the OECD was a very powerful motive to expedite the financial liberalization of Korea. In order to be an OECD member, all countries have to endorse the national treatment principles such as the Codes of Liberalisation of Capital Movements and Codes of Liberalisation of Current Invisible Operations.45 Under the binding regulations of the codes, all member countries are required to remove specific restriction on capital movements and invisible operations including foreign direct investment in financial services, foreign portfolio investment, and financial services in cross-border trade.46 For obtaining membership in the OECD, the OECD urged the Korean government to enact a comprehensive financial reform

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44 The initiative of the “Sekeyhwâ” originated from the “Sydney Idea” of President Kim, Young Sam in November 1994.
45 OECD, Code of Liberalization of Capital Movements (Paris: OECD, 1997); OECD, Code of
program. For instance, William H. Witherell, director of financial, fiscal and enterprise affairs of the OECD, visited Korea and proposed that Korea prepare more steps for liberalization of capital inflows and allow mergers and acquisitions (M & A) of domestic firms by foreign investors. He also suggested to the Korean government several detailed policy recommendations about foreign direct investment, exchange controls, financial services, international taxation issues, and others. In return for this, the Korean government announced a blueprint for financial reform for the five-year period (1993-1997) in 1993.

Following this schedule, the Korean government had to accelerate the pace of financial reform. After a series of negotiations with the OECD, the Korean government broadened the width of the financial reforms and announced the specific financial reform plan in September 1996. In this plan, the government promised the gradual removal of barriers to financial services from OECD countries' foreign direct investment and portfolio investment. The government promised a financial reform schedule through the OECD commitments in 1996, whereby the ceiling of the foreign individual investment in the stock market would be increased 10 percent by 2000. The gradual opening of the Korean bond market and favorable mergers and acquisitions would be allowed. These comprehensive financial liberalization plans could lift several regulation mechanisms in the Korean financial market and make it easy for free capital movements across the border. Particularly, since the early 1990s, a large increase in short-term foreign portfolio


Dobson and Jacquet, Financial Services Liberalization in the WTO, 237-238.


Dobson and Jacquet, Financial Services Liberalization in the WTO, 238.
investment became the main source of foreign capital inflow to Korea that accounted for 68 percent of the total debt by mid-1997, and created a very fragile financial system in Korea. This financial liberalization increased the chaebol’s influence for the NBFI s and made it easy to access foreign capital, while the government did not construct the monitoring and supervision mechanism. A series of chaebol bankruptcies (Hanbo, Sammi, Jinro, and Kia) broke the weak financial system, and huge amounts of short-term foreign capital outflows created the Korean financial crisis in December 1997.50

The Korean government totally disarmed all financial regulations at the expense of the $57 billion IMF loan package. The Korea-IMF Stand-By Arrangement,51 and the Letter of Intent to the IMF52 contained several measurements of financial sector reforms. Regarding capital account liberalization, the ceiling on aggregate ownership was increased from 26 percent to 50 percent and on individual ownership was increased from 7 percent to 50 percent by the end of 1997. The restrictions on foreign investors’ access to domestic money market instruments and to the corporate bond market were eliminated, while the restriction on foreign direct investment was reduced. In addition, the Korean government had to abolish the daily range of fluctuation in exchange rate, and to eliminate the interest rate ceiling on resident foreign exchange accounts below three months. Based on the following WTO commitments, trade relates subsidies, restrictions on import licensing, and the import diversification program introduced in 1973 for the

52 Sohn and Yang, 11-47.
purpose of alleviating the Japanese trade deficits were eliminated through the United States and Japan pressures.

According to the testimony of an official of the Ministry of Finance and Economy (MOFE), through the negotiation process, the Korean officials keenly recognized the fact that the IMF is controlled by the United States. Since the United States is the largest member of the Fund, no major decisions are taken against its wishes. As of 2000, the United States has 17.35 percent voting power, enough for a formal veto power of the Fund. The United States urged Korea and other East Asian countries who underwent financial crises to accept the alternative suggestions of the "Washington Consensus" at the price of the IMF's bailout. According to Michel Chossudovsky, the blueprint for a 'Structural adjustment program' for Korea "had already been decided in advance in consultation with the US Treasury, Wall Street's commercial and merchant banks as well as with major banking interests in Japan and the European Union." In addition, an official of the Korean Ministry of Finance testified that the United States was a strong power behind the negotiation process between the IMF and Korea. He observed several moments when the lead IMF economist Hubert Neiss obtained an approval from U.S. Under Secretary of the Treasury for International Affairs, David Lipton while staying at the Hilton Hotel in Seoul, Korea.

During the negotiation, the United State continuously pressed the Korean government. Deputy Treasury Secretary, Lawrence H. Summers visited Korea on January 16, 1998.

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53 Chosun Ilbo, 1 December 1997.
and strongly urged the elimination of the *Foreign-Exchange Management Act* (FEMA) and to allow of hostile mergers and acquisitions (M & A). Moreover, he asked that the scheduled all market opening measures between the Korea and the IMF should be recorded in the negotiation text of the WTO's FSA agreement. These conditions were followed with an $8 billion loan package from the United States and G-7 countries. He also mentioned that the cooperation of the international society and a strong policy required the stability of the Korean financial market and restoring Korean confidence.\(^{57}\)

In September 1998, the Korean government eliminated the FEMA under pressure from the United States, and prepared the Foreign Exchange Transaction Act (FETA).\(^{58}\)

To make matters worse, the Korean government proceeded with the WTO financial service agreement (FSA)\(^{59}\) negotiations at the same time as negotiating with the IMF. It is obvious that Korea was unable to use bargaining power under the circumstances. The Korean government was forced to bind its OECD commitments that promised to open its banking, securities, and insurance industry to foreign competition within the context of the WTO agreement.\(^{60}\)

In April 1999, the MOFE announced the Two-Stage Foreign Exchange liberalization Plan.\(^{61}\) The government eliminated various regulations on foreign exchange transactions by 2000, and some residual regulations of the capital and current account transactions were fully eliminated as well. Since the financial crisis, Korea has implemented and

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58 See full text of the FETA in <http://210.182.137.31/cgi-pub/content.cgi?code=e_if&no=25> (3 June 2000).
60 Dobson and Jacquet, *Financial Services Liberalization in the WTO*, 239.
61 See the web page of the MOFE <http://www.mofe.go.kr/korea/data/k_news/a062201.htm> (3 May
accelerated all financial reforms. Consequently, the Korean financial market opening could reach the level of the OECD financial market in the end of 2000.

In sum, the Korean financial liberalization process which began in the 1980s and took more than twenty years failed to create a strong financial system and thus suffered financial crisis in 1997. What are the main reasons for this Korean financial crisis? First, Korean financial liberalization highly encouraged the opening of the short-term capital markets before the long-term capital markets. In so doing, many Korean chaebol and commercial banks were highly dependent on short-term loans as their type of foreign loans, so they had a serious shortage of liquidity under the excessive devaluation of the Korean currency during the financial crisis. Second, Korean financial liberalization did not have a balance between the openness of its domestic financial market and the foreign investments of its domestic banks and companies. Korea has been reluctant in opening their financial market toward foreigners, while liberalizing its foreign borrowing for their domestic financial institutions. These measures not only encouraged imprudent foreign borrowing by domestic financial institutions, but also created a moral hazard problem. By and large, most Korean financial institutions enjoyed low interest rate foreign capital borrowing and loaned capital to improperly-run domestic chaebol or speculated on other emerging foreign capital markets such as Thailand for the maximizing of its spread of interest margins. Furthermore, many Korean financial institutions experienced huge amount of loss due to the lack of a proper hedging mechanism for these speculative capital investments on the eve of financial crisis. Third, Korean financial liberalization was not implemented evenly through all parts of the markets. For instance, the Korean
government had continuously increased the ceiling on foreigners’ investment in its stock market, whereas it had delayed those of its bond markets. Since the bonds market investment is a key portion of a portfolio investment strategy, it would have been an alternative institutional mechanism to discourage foreign capital outflows. The openness of bond markets for foreign investors would have been an efficient alternative institutional mechanism to delay the continuous foreign capital outflow through a raising of interest rates to confront the 1997 stock market crash.

5.3 Korean Financial Crisis in the Context of Asian Financial Turmoil

In analyzing the Asian financial crisis, there are many viewpoints, but the key issues are whether it was caused by the weak economic fundamentals such as macroeconomic imbalances and other domestic structural economic problems ("fundamentalist" view) or by the financial panic that was encouraged by speculative short-term capital regardless of the economic fundamentals ("self-fulfilling" view).62

The fundamentalist viewpoints are represented by Paul Krugman’s “the first generation” crisis model that excessive monetary expansion for financing a government’s persistent budget deficits could bring a serious shortage of its foreign exchange reserve to defend a fixed parity, and ultimately reach an unsustainable condition of balance of payments crisis under the investors’ speculative attack.63 The Krugman’s model could

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explain a financial crisis such as the Mexican debt crisis in 1982 which showed an excessive budget deficits well, yet it has a limit to clarify the European Monetary System (EMS) crisis. Hence, Maurice Obstfeld proposed a self-fulfilling model that “speculative anticipations depend on conjectured government response, which depend, in turn, on how price changes that are themselves fueled by expectations affect the government’s economic and political positions.”

Many scholars agree that all Asian countries including Korea have no critical evidences of weak macroeconomic fundamentals that could generate financial crisis as suggested by the first generation model. According to Paul Krugman, the economic fundamentals of all Asian governments are solid; these economies are “more or less in fiscal balance,” engaged in responsible “credit creation or runaway monetary expansion,” and “their inflation rates were quite low.” He argues the main reasons for the Asian financial crisis as below.

The problem began with financial intermediaries- institutions whose liabilities were perceived as having an implicit government guarantee, but were essentially unregulated and therefore subject to severe moral hazard problems. The excessive risky lending of these institutions created inflation - not of goods but of asset prices. The overpricing of assets was sustained in part by a sort of circular process, in which the proliferation of risky lending drove up the prices of risky assets, making the financial condition of the intermediaries seem sounder than it was.

Jeffrey Sachs, also agrees that “[t]here is no “fundamental” reason for Asia’s financial calamity except financial panic itself.”

Asia is reeling not from a crisis of fundamentals, but from a self-fulfilling withdrawal of short-term loans, one that is fuelled by each investor’s recognition that all other investors are withdrawing their claims. Since short-term debts exceed foreign exchange

65 Krugman, “What Happened to Asia?”
reserves, it is “rational” for each investor to join in the panic.\textsuperscript{66} 

Some scholars criticized the Asian economic developmental model as an example of crony capitalism, corrupted government and business connections, and lack of a transparency in business.\textsuperscript{67} However, this dark side of the Asian developmental model lasted long before the crisis. In addition, most foreign investors and creditors in Asian financial markets had already recognized these problems. If the economic fundamentals of the Asian economies were so bad to generate a financial crisis, why did huge amounts of capital inflows come to this region? 

As Table 5.2 shows, $182.5 billion total net private capital flows (86 percent of the total net private capital flows in emerging markets) went to Asia and the Western hemisphere in 1996. In addition, the five affected Asian countries (Indonesia, Korea, Malaysia, the Philippines, and Thailand) received $62.4 billion (29 percent of the total) in 1996. This figure was reversed $19.7 billion net outflows during the 1997 crisis. In those affected economies, large parts of private investment occupied portfolio investment and bank loans ($52.9 billion; 85 percent of the total in 1996). During the 1990s, the portfolio investment increased 66 times, whereas the bank loans outgrew 1.8 times.

Table 5.2 Net Private Capital Flows to Emerging Markets

(In billions of U.S. dollars)

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<td>96.7</td>
<td>115.0</td>
<td>140.0</td>
<td>131.0</td>
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<td>Net portfolio investment</td>
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<td>51.1</td>
<td>113.6</td>
<td>105.6</td>
<td>41.2</td>
<td>80.8</td>
<td>66.8</td>
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<td>16.3</td>
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<tr>
<td>Total net Private capital flows (^1)</td>
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<td>17.9</td>
<td>57.3</td>
<td>66.4</td>
<td>95.1</td>
<td>100.5</td>
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<td>14.8</td>
<td>33.0</td>
<td>45.3</td>
<td>49.8</td>
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<tr>
<td>Total net Private capital flows</td>
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<td>55.9</td>
<td>62.6</td>
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<td>10.4</td>
<td>-19.2</td>
<td>5.8</td>
<td>4.3</td>
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\(^1\) Net foreign direct investment plus net portfolio investment plus net other investment

\(^2\) Indonesia, Korea, Malaysia, the Philippines, and Thailand
These huge amounts of private capital inflows reflected a financial liberalization (capital account opening) in these countries as well as an expectation of high profit returns for foreign investors. In other words, financial globalization highly encouraged the free capital movements across borders, and these large-scale foreign capital inflows into the Asian economies was the main reason for the crisis. Starting with the July 1997 Thailand crisis, many creditors and investors recognized the danger of the loss of their capital, and abruptly pulled their investments out of these affected countries. This financial panic made a contagion effect in region.

Roberto Chang and Andrés Velasco argue that the Asian financial crisis is a sort of liquidity crisis. Financial liberalization (capital account opening) in Asia encouraged large capital inflows, and made a mismatch of asset and liabilities. As seen in the Asian crisis, most creditors fell into a panic and refused to rollover short-term loans. If the major creditors and investors in the Asian economies had not panicked, and monitored these economic conditions more carefully, the Asian crisis would have not happened.

Likewise, there are many competing perspectives on the Asian financial crisis. Specifically, the Korean financial crisis has been analyzed from many viewpoints. Although two highly conflicting perspectives have their own good points, one must be careful in applying these analyses to the Korean financial crisis.

From the macroeconomic viewpoints, the Korean economy experienced increasing current account and trade account deficits since 1990 (see Table 5.3), and a loss of price competitiveness in the export market due to the devaluation of the currency in China and the depreciation of the Japanese yen relative to the dollar. Korea’s major export sectors

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(such as semiconductors, automobiles, and ships) had declined in demand from global and Japan (Japan is the largest trading partner). The majority of the current and trade deficits were financed by the capital inflows (portfolio investment and short-term loans).

Table 5.3 Balance of Payments, 1989 - 1997

(In millions of U.S. dollars)

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<th>Year</th>
<th>Current account</th>
<th>Trade account</th>
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<td></td>
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<td>Other investment</td>
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<td>Nov</td>
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<td>614.5</td>
<td>-122.4</td>
<td>-669.3</td>
</tr>
<tr>
<td>Dec</td>
<td>3,456.5</td>
<td>2,852.4</td>
<td>-279.4</td>
<td>621.4</td>
</tr>
</tbody>
</table>


Since the early 1990s, a large increase in short-term loans and foreign portfolio investment became the main source of foreign capital inflow to Korea that accounted for 68 percent of the total debt by mid-1997 (see Table 5.4), and created a very fragile financial system in Korea.
Table 5.4 Korea’s International Claims Held by Foreign Bank, 1995-1997

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Outstanding</th>
<th>Distribution by maturity</th>
<th>Distribution by sector</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Short-term in % of total</td>
<td>Long-term in % of total</td>
</tr>
<tr>
<td>mid-1995</td>
<td>71,430</td>
<td>51,439</td>
<td>13,520</td>
</tr>
<tr>
<td>end-1995</td>
<td>77,383</td>
<td>54,130</td>
<td>14,611</td>
</tr>
<tr>
<td>mid-1996</td>
<td>87,844</td>
<td>62,187</td>
<td>16,872</td>
</tr>
<tr>
<td>end-1996</td>
<td>99,953</td>
<td>67,506</td>
<td>19,991</td>
</tr>
<tr>
<td>mid-1997</td>
<td>103,432</td>
<td>70,182</td>
<td>20,505</td>
</tr>
</tbody>
</table>


Particularly, the 96 percent of the total lending distributed by the banks and non-bank private sectors in the mid-1997 illustrate the typical structural problems of the Korean economy that is a by-product of rapid industrialization and export-oriented economic growth aided by the chaebol. Since the Korean government did not build a transparent regulatory and supervisory system for corporate governance with financial liberalization, it failed to monitor the chaebol’s huge amounts of short-term foreign borrowing. In June 1997, Korea’s short-term bank loan amounted to $70 billion among total loan of $103.4 billion, the second largest figure among the five affected economies in the Table 5.5. This lopsided abnormal debt structure exacerbated Korea’s vulnerability under a continuous series of chaebol’s bankruptcies among large chaebol. Beginning with Hanbo, many big business groups (Sammi, Jinro, and Kia) went bankrupt in 1997, and amplified the loss of confidence of the foreign creditors and investors who had large claims in the Asian economies.
Table 5.5 Affected Countries’ International Claims Held by Foreign Banks (Distribution by Country of Origin), 1995-1997

(in millions of US dollars)

<table>
<thead>
<tr>
<th>Year / Countries</th>
<th>Total Outstanding</th>
<th>Japan</th>
<th>U.S.</th>
<th>U.K.</th>
<th>Germany</th>
<th>France</th>
<th>All others</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>end-1995</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Korea</td>
<td>77,383</td>
<td>21,309</td>
<td>7,590</td>
<td>3,861</td>
<td>7,318</td>
<td>6,990</td>
<td>30,315</td>
</tr>
<tr>
<td>Indonesia</td>
<td>44,851</td>
<td>21,297</td>
<td>2,778</td>
<td>2,727</td>
<td>3,893</td>
<td>3,288</td>
<td>10,868</td>
</tr>
<tr>
<td>Malaysia</td>
<td>16,750</td>
<td>7,289</td>
<td>1,523</td>
<td>1,158</td>
<td>2,249</td>
<td>2,049</td>
<td>2,482</td>
</tr>
<tr>
<td>Philippines</td>
<td>8,330</td>
<td>987</td>
<td>2,946</td>
<td>631</td>
<td>711</td>
<td>1,155</td>
<td>1,900</td>
</tr>
<tr>
<td>Thailand</td>
<td>63,029</td>
<td>37,056</td>
<td>4,097</td>
<td>2,822</td>
<td>4,977</td>
<td>3,711</td>
<td>10,366</td>
</tr>
<tr>
<td>Sub-total</td>
<td>210,343</td>
<td>87,938</td>
<td>18,934</td>
<td>11,199</td>
<td>19,148</td>
<td>17,193</td>
<td>55,931</td>
</tr>
<tr>
<td><strong>end-1996</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Korea</td>
<td>99,953</td>
<td>24,324</td>
<td>9,355</td>
<td>5,643</td>
<td>9,977</td>
<td>8,887</td>
<td>41,767</td>
</tr>
<tr>
<td>Indonesia</td>
<td>55,523</td>
<td>22,035</td>
<td>5,279</td>
<td>3,834</td>
<td>5,508</td>
<td>4,463</td>
<td>14,404</td>
</tr>
<tr>
<td>Malaysia</td>
<td>22,234</td>
<td>8,210</td>
<td>2,337</td>
<td>1,417</td>
<td>3,857</td>
<td>2,641</td>
<td>3,772</td>
</tr>
<tr>
<td>Philippines</td>
<td>13,289</td>
<td>1,558</td>
<td>3,902</td>
<td>1,173</td>
<td>1,820</td>
<td>1,873</td>
<td>2,963</td>
</tr>
<tr>
<td>Thailand</td>
<td>70,147</td>
<td>37,525</td>
<td>5,049</td>
<td>3,128</td>
<td>6,914</td>
<td>4,583</td>
<td>12,948</td>
</tr>
<tr>
<td>Sub-total</td>
<td>261,146</td>
<td>93,652</td>
<td>25,922</td>
<td>15,195</td>
<td>28,076</td>
<td>22,447</td>
<td>75,854</td>
</tr>
<tr>
<td><strong>mid-1997</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Korea</td>
<td>103,432</td>
<td>23,732</td>
<td>9,964</td>
<td>6,064</td>
<td>10,794</td>
<td>10,070</td>
<td>42,808</td>
</tr>
<tr>
<td>Indonesia</td>
<td>58,726</td>
<td>23,153</td>
<td>4,591</td>
<td>4,332</td>
<td>5,610</td>
<td>4,787</td>
<td>16,253</td>
</tr>
<tr>
<td>Malaysia</td>
<td>28,820</td>
<td>10,489</td>
<td>2,400</td>
<td>2,011</td>
<td>5,716</td>
<td>2,934</td>
<td>5,270</td>
</tr>
<tr>
<td>Philippines</td>
<td>14,115</td>
<td>2,109</td>
<td>2,816</td>
<td>1,076</td>
<td>1,991</td>
<td>1,678</td>
<td>4,445</td>
</tr>
<tr>
<td>Thailand</td>
<td>69,382</td>
<td>37,749</td>
<td>4,008</td>
<td>2,818</td>
<td>7,557</td>
<td>5,089</td>
<td>12,161</td>
</tr>
<tr>
<td>Sub-total</td>
<td>274,475</td>
<td>97,232</td>
<td>23,779</td>
<td>16,301</td>
<td>31,668</td>
<td>24,558</td>
<td>80,937</td>
</tr>
<tr>
<td><strong>end-1997</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Korea</td>
<td>94,180</td>
<td>20,278</td>
<td>9,533</td>
<td>6,924</td>
<td>9,616</td>
<td>11,135</td>
<td>36,694</td>
</tr>
<tr>
<td>Indonesia</td>
<td>58,388</td>
<td>22,018</td>
<td>4,898</td>
<td>4,492</td>
<td>6,174</td>
<td>4,773</td>
<td>16,033</td>
</tr>
<tr>
<td>Malaysia</td>
<td>27,528</td>
<td>8,551</td>
<td>1,786</td>
<td>2,014</td>
<td>7,197</td>
<td>2,883</td>
<td>5,097</td>
</tr>
<tr>
<td>Philippines</td>
<td>19,732</td>
<td>2,624</td>
<td>3,224</td>
<td>1,607</td>
<td>2,999</td>
<td>2,165</td>
<td>7,113</td>
</tr>
<tr>
<td>Thailand</td>
<td>58,835</td>
<td>33,180</td>
<td>2,533</td>
<td>2,361</td>
<td>6,028</td>
<td>4,718</td>
<td>10,015</td>
</tr>
<tr>
<td>Sub-total</td>
<td>258,663</td>
<td>86,651</td>
<td>21,974</td>
<td>17,398</td>
<td>32,014</td>
<td>25,674</td>
<td>74,952</td>
</tr>
</tbody>
</table>


* All others include Austria, Belgium, Canada, Denmark, Finland, Italy, Luxembourg, Netherlands, and Spain.
The crisis in Thailand generated a wide-ranging contagion effect in the five affected economies including Korea, and gave a “wake-up call” to international investors. Some scholars argued that Japanese commercial banks, as the largest creditor in this region, triggered the Asian financial crisis. In mid-1997, Japan’s credits in the five affected countries amounted to $97.2 billion (35.4 percent of the total outstanding) as the Table 5.5. Since the Japanese financial system deteriorated with non-performing loans and bankruptcies of several financial intermediaries in the second half of 1997, most Japanese commercial banks could not rollover their short-term loans in Asian countries on the eve of the crisis. As shown in Figure 5.1, Japanese commercial banks withdrew $3.4 billion in Korea during the last half of 1997. Thus, one of the largest creditors to Korea started to refuse to rollover short-term loans in Korea, and many other creditors fell in the panic and joined the withdrawal of their investments. In summary, the crisis in Korea results from financial liberalization as the main reason, as well as financial panic as a fundamental problem of the international financial system, and a weak macroeconomic condition as an immediate reason.

69 Goldstein, The Asian Financial Crisis, 17-19.
Figure 5.1 Change in Bank Loan to Korea

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>21.3</td>
<td>24.3</td>
<td>23.7</td>
<td>20.3</td>
</tr>
<tr>
<td>U.S.</td>
<td>7.6</td>
<td>9.4</td>
<td>10.0</td>
<td>9.5</td>
</tr>
<tr>
<td>U.K.</td>
<td>3.9</td>
<td>5.6</td>
<td>6.1</td>
<td>6.9</td>
</tr>
<tr>
<td>Germany</td>
<td>7.3</td>
<td>10.0</td>
<td>10.8</td>
<td>9.6</td>
</tr>
<tr>
<td>France</td>
<td>7.0</td>
<td>8.9</td>
<td>10.1</td>
<td>11.1</td>
</tr>
</tbody>
</table>

CHAPTER VI
GLOBAL GOVERNANCE IN
THE INTERNATIONAL FINANCIAL SYSTEM

Financial liberalization in international financial markets has expedited free capital movement across borders, and contributed to the growth and development of the world economy as well as financial globalization. As the arguments of neoliberalism, free capital movement without restriction could encourage an efficient allocation of global capital from sources of abundant financial capital to places of scarce capital. However, reality differed from this rose colored expectation, evidenced by the recurrent financial crises in many developing countries. Financial liberalization has frequently driven short-term speculative capital flows to locations one could expect a high return on investment. Further, it arose during sudden massive withdrawals of short-term capital caused by unfavorable factors in financial markets.

Most developing countries, which rushed to open their financial markets without improving rigorous forms of regulatory safety networks, were attacked by the hazardous, and speculative short-term financial capital. As financial globalization proceeds, financial crises in emerging financial markets are regarded as an inevitable phenomenon in the international financial system. In recent decades, financial crises in emerging economies hit Mexico and many Latin American countries in 1994-95 (again in Brazil in 1998-99 and Argentina and Uruguay in 2001-02), East Asian countries including five affected nations (Thailand, Indonesia, Malaysia, Philippines and South Korea) in 1997-98, Russia in 1998, and Turkey in 2000-01.
Since the recurrent financial crises in emerging markets not only disrupt the
affected nations’ economy and population, but also bring about far reaching strain to the
entire international financial system in a globalized economy, the prevention of further
financial crisis and the construction of more stable international financial systems is a
very urgent assignment in this global village. So far, the global community has prepared
various financial sector reform proposals (global governance in international financial
markets). Broadly categorized, the existing financial sector global governance presents
capital regulation, reforming international financial institutions (IFIs: the International
Monetary Fund and the World Bank), establishing new IFIs, and other middle way self­
help guidelines. These numerous divergent proposals prescribe ways to prevent financial
crisis and construct a stable financial system according to the planners, and their
theoretical backgrounds.

This chapter examines various global governance proposals and evaluates their
usefulness and feasibility to prevent future financial crisis and construct a stable
international financial system. This study also suggests practicable ways for the global
financial sector governance through the comparsion of strength and weakness of each
proposal with a critical evaluation. For these purposes, this chapter is organized into five
sections. Section 6.1 briefly reviews the current divergent pathways of global governance
efforts in financial sectors. Section 6.2 examines the United States, G-7, and IFIs’ NIFA
proposals in historical backgrounds and its main schemes with a critical evaluation.
Section 6.3 investigates the Tobin tax proposal and the empirical cases in Chile and
Malaysia. Section 6.4 introduces the other financial governance proposals such as
reforming IFIs, launching new IFIs, and the middle way or self-help guideline for the emerging financial markets. Section 6.5, calls attention to a global forum to manage the current financial global governance plan and the search for feasible ways to narrow the gaps among these proposals.

6.1 Global Governance in the International Financial System: Divergent Pathways

Faced with recurrent financial crises in emerging economies, the global community has concentrated on their efforts to prepare for various measures to prevent financial crises and to construct a stable international financial system. We call these continuous efforts as financial sector global governance. Regarding the definition of ‘global governance’, there is no generally accepted definition. In this study ‘global governance’ is defined as a series of “organizing collective actions”\(^1\) to set up rules of the games that “serve to define social practices, assign roles, and guide interactions among the actors of these roles.”\(^2\)

Thus, global governance in the international financial system is the collective efforts to build a stable international financial system among many financial actors – state actors, international financial institutions (the IMF, the World Bank, the BIS, and so on), non-governmental organizations, global civil society groups, and private financial intermediaries. In accordance with the actors that seek global governance, their beliefs, and the content of the proposal, the efforts of global financial governance are broadly categorized: the Tobin tax proposal, reforming the IFIs, self-help guidelines (a middle way), and the NIFA.

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The NIFA\(^3\) is underway through the cooperation of the G-7, G-20, and the IFIs. This proposal mainly concerns fundamental economic reforms in the emerging market economies through various international financial standards, financial sector assessments, and transparency in monetary and financial policy to prevent financial crisis by strengthening the role of IFIs. To implement the NIFA, broad support from many developing countries is needed, and should improve the policy harmonization problem among these countries. Many global civil society groups criticize the NIFA for attempting to render unilateral policy reforms toward developing countries, and ignoring a direct prescription to regulate the hazardous speculative short-term financial capitals.

As an alternative proposal to regulate short-term speculative capital volatility, many civil society groups try to convince the global community to introduce the ‘Tobin tax’, which imposes a steep tax on short-term financial capital inflows. However, many industrialized countries including the United States will not accept this extreme prescription because they are occupied with large capital exports and the option would restrict their policy autonomy.

On the other hand, Martin Feldstein\(^4\) and other scholars argued neither the IMF nor the NIFA would help to build stable international financial markets, so emerging economies should protect themselves through self-help. The IMF no longer stands as a

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lender of last resort as proved in the East Asian financial crisis because it does not have enough fund resources to support the future crisis-hit countries. In other words, emerging economies should build up large foreign liquidity and try to avoid high short-term foreign debts to avoid a future financial crisis. In addition, some scholars and practitioners suggest launching new financial institutions such as a world central bank, an international supervisory institution, or a global international clearinghouse. However, these plans are too costly to realize.

Thus, the global governance in the international financial system has proceeded through divergent pathways, and each reform plan suggests different directions to follow. Now we stand on the crossroads of global governance in the international financial system and should consider the best way forward for the global village.

6.2 The New International Financial Architecture

So far, the NIFA is considered as an official proposal because of the strong support from the financial powers such as the United States, G-7, and other powerful IFIs. Under the structural power of the United States, the main scheme of NIFA has proceeded through the G-7 summits and the cooperation of the U.S.-led IFIs in the aftermath of the two major financial crises in Mexico (1994-95), and the East Asia (1997-98). The NIFA proposed the strengthening roles of the IFIs to serve nations’ economic and financial policy, the promotion of standards and transparency, and liberalization of capital movement to build a stable international financial system. From the Mexican peso crisis to now, the section will examine the process and main framework of the NIFA.
6.2.1 The Mexican Peso Crisis and the IFA

The Mexican peso crisis in 1994-95, which brought a ‘tequila effect’ to neighboring countries as well as other emerging economies in the world, ignited the concern over the stability of the international financial system. After the crisis, many policy-makers and scholars began to discuss how they should reform the international system and what policy proposals would help to reduce future crises in emerging markets. The G-7\textsuperscript{5} Halifax Summit in June 15-17, 1995 was the critical venue to discuss global governance in the international financial system.

At the Halifax Summit, the G-7 proposed an “early warning system” to reduce the future risk of financial crisis through strengthening the IMF roles of “surveillance of national economic policies and financial market developments,” and disclosure of major economic and financial data to each country. To this purpose, the G-7 endorsed that the IMF should “establish benchmark for the timely publication of economic and financial data,” and should prepare for the standards to adopt member countries with strict policy advice.\textsuperscript{6}

The G-7 also advocates the IMF preparing for a follow-up measure, “Emergency Financing Mechanism” (EFM), whereby countries could access the Fund financing faster. To accumulate enough financing resource for this activity, the General Arrangements to Borrow (GAB) should be doubled up from the financial support of the G-10 and other countries.\textsuperscript{7}

\textsuperscript{5} The G-7 countries are Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. The G-10 countries are exactly 11, adding Belgium, the Netherlands, Sweden, and Switzerland to the G-7.


\textsuperscript{7} Group of 7, paragraph 17 and 18.
encouraged intimate international cooperation to protect the financial system and to maintain prudential standards. Second, it called for the international financial institutions to propose policy advice and supervise the countries that keep removing capital market restrictions.

The IMF rapidly implemented some of these recommendations, adopting the EFM, and began to develop statistical standards for the prompt publication of key economic and financial data: a Special Data Dissemination Standard (SDDS). Increasing the Fund financing arrangements to help countries that may be hit by a future financial crisis, the IMF Executive Board agreed to establish the New Arrangements to Borrow (NAB) with effect from November 1998, instead of enlarging the GAB. The existing GAB has remained, but the NAB is now the primary source of the Fund credit. The maximum asset of the two resources amounts to SDR 34 billion (about $47 billion).

Regarding the proposal of removal of capital market restrictions, the IMF Interim Committee agreed to the Executive Board preparing a new amendment to the Fund's Articles to make the promotion of capital account liberalization a specific IMF purpose and jurisdiction on April 28, 1997, right before the East Asian financial crisis.

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10 IMF, *Interim Committee Communiqué of the Board of Governors of the International Monetary Fund* (April 28, 1997), paragraph 7, <http://www.imf.org/external/np/cm/1997/cm970428a.htm> (14 January 2004). "Under the plan, two Articles were to be amended - Article I, where 'orderly liberalization of capital' would be added to the list of the Fund's formal purposes; and Article VIII, which would give the Fund the same jurisdiction over the capital account of its members as it already enjoys over the current account. The language would also have required countries to commit themselves to capital liberalization as a goal." Cited in Benjamin J. Cohen, "Capital Controls: The Neglected Option," in *International Financial Governance Under Stress: Global Structures versus National Imperatives*, eds., Geoffrey R.D. Underhill
6.2.2 The Asian Financial Crisis and the NIFA

The East Asian financial crisis in 1997-98 gave a shock to the global community because many scholars, the IMF, and the World Bank had praised the region as a successful model case of economic development, and did not expect the crisis. Many scholars agree that the five affected countries’ macroeconomic fundamentals were fairly sound, unlike the Latin American cases, which showed large budget deficits. In addition, the main reasons for the crisis were brought by the investors’ financial panic behavior of abrupt withdrawal of their portfolios in the regions under the contagion effect, and the countries’ large contingency on the private sectors’ short-term debts. These facets of the crisis persuaded contemporary scholars to reconsider whether financial globalization and liberalization would guarantee the efficient allocation of global capital.

However, the U.S. government acting through the G-7, and U.S.-led IFIs tried to set up a ‘Washington Consensus’ proposal which strongly supported the free capital movement across the borders in the framework of the NIFA. They believed that the Asian crisis revealed the difficulties of the implementation of the Halifax strategy, instead of the fundamental approach itself. Two years after the Asian crisis, the IMF developed the core parts of the NIFA. The Interim Committee of the Board of the Governors of the IMF on October 4, 1998 endorsed the NIFA, and embarked on their efforts to establish core architectural reform.

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and Xiaoke Zhang (New York: Cambridge University Press, 2003), 73.
The Committee welcomed the progress that has been made during the past six months in the work on aspects related to the strengthening of the architecture of the international monetary system. Recent crises have, however, exposed broader and deeper difficulties in the system, underscoring the need to widen the scope of recent work to encompass other crucial aspects with respect to the management and resolution of financial crises. These pertain, in particular, to mechanisms for the allocation of capital and for the management of risk, the regulation and supervision of financial sectors, and standards of transparency.\textsuperscript{15}

The five tenets of the financial architecture reform are the promotion of internationally acceptable standards to raise the transparency of economic policy and to enable good practices in financial markets; transparency and reporting to improve the availability of data on reserves, external debts, and other capital flows, particularly short-term private flows; private sector involvement in preventing and resolving financial crises; liberalization of capital movement in an orderly, gradual, and well sequenced manner, and; the Fund support and cooperation.\textsuperscript{16}

Meanwhile, the U.S. Treasury and the G-7 reconfirmed the five tenets of NIFA through the Declaration of G-7 Finance Ministers and Central Bank Governors in 1998,\textsuperscript{17} and invented new bodies as designated in the Report of G-7 Summits in Cologne in 1999.\textsuperscript{18} In March 1999, the G-7 created the Financial Stability Forum (FSF) "in order to promote international financial stability, improve the functioning of markets, and reduce

\textsuperscript{16} The IMF.
systemic risk." The FSF is a council to coordinate a number of institutional actors - the G-7, the BIS, the IMF, the World Bank, OECD, and the key emerging economies. The IMF and the World Bank jointly set up the Financial Sector Assessment Program (FSAP) and Financial System Stability Assessments (FSSAs) to develop appropriate policies for stable financial sectors in June 1999. Strengthening the role of the IFIs, the IMF Interim Committee was converted into International Monetary and Financial Committee (IMFC) as a permanent committee of the Board of the Governors of the IMF.

In addition, the U.S. Treasury cooperated with the G-7 to add ‘systemically important’ emerging markets, the G-20, into the existing decision making body of NIFA (the G-7, the IMF, and the G-10 ‘Basel Process’) in a September 25 meeting in Washington, DC. The members of the G-20 consists of the G-7, a representative from the European Union, the IMF, the Fund’s IMFC, the World Bank, as well as the Bank’s Development Committee, and the emerging economies: Argentina, Australia, Brazil, China, India, Indonesia, South Korea, Mexico, Russia, Saudi Arabia, South Africa, and Turkey. The main reason to create the G-20 was to reflect the U.S. interests that use the official link between the industrialized countries and important developing countries to legitimate the NIFA. Thus, various actors and financial institutions have involved the design of the financial architecture.

6.2.3 Main Framework of the NIFA

Progress toward this new architecture is underway, but the main directions could be summarized into three parts: transparency and accountability; strengthening financial system and capital account liberalization, and; financial crisis management and involving the private sector.

6.2.3.1 Transparency and Accountability

Most efforts of NIFA involve increasing the transparency and accountability of individual countries. The IMF and the World Bank have prepared various codes and standards for this issue. The IMF believes that if all parties in international financial systems can access the best information of financial and macroeconomic data of each country, then it would be easy to build a stable financial system. To attain this purpose, the Funds urged each country and the IFIs to share their efforts. Under the Fund's Special Data Dissemination Standard (SDDS), and General data Dissemination System (GDDS), currently 111 members (over 60 percent of the Fund member) either subscribe to the SDDS or participate in the GDDS, and provide their national economic and financial data and share this information.23 Another transparency initiative was the Code of Good Practices on Transparency in Monetary and Financial Policies of the Fund. The code established the framework for fiscal transparency focusing on sound fiscal management as vital for macroeconomic stability and economic growth.24 The Fund encouraged members to release Public Information Notice (PINs) under the Article IV consultations, and began to publish its quarterly Emerging Markets Financing Report since August 2000.

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The IMF and the World Bank embarked on a joint program, Reports of the Observance of Standards and Codes (ROSCs) that assesses the observance of selected standards regarding private and financial sector development and stability from their Financial Sector Assessment Program (FSAP). The Fund set up the “modules” for the financial sectors – monetary and financial policy transparency, banking supervision, security market regulation, payment systems, and deposit insurance. The World Bank has the role to measure the corporate governance, accounting and auditing, and insolvency regimes and creditor rights. 25 Regarding the transparency of the private sectors, which highly involved the onset of the Asian crisis, the OECD endorsed non-binding Principles of Corporate Governance in May 1999. In addition, the International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC) prepared for the international accounting and auditing standards. 26

6.2.3.2 Strengthening Financial System and Capital Account Liberalization

The IFIs agreed that recent financial crises, especially the Asian financial crisis, was brought on by a weak and poorly monitored banking and financial system. In order to strengthen the domestic financial system, sound practices for supervision, settlement, accounting and disclosure should be implemented. The G-22 working group proposed that each IFI should have the role of establishing a framework of the key elements and share responsibility for financial stability. For financial stability, the IMF needs to set up

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a standard and report the data. Resolving financial crises and destructing the financial system, the working groups ask the World Bank to try to work on financial sector development and build efficient tools. In addition, the Basel Committee on Banking Supervision (BCBS) in producing the Basel Committee’s Core Principles for Effective Banking Supervision, the International Organization of Securities Commissions (IOSCO) in producing the Statement on Objectives and Principles of Securities Regulation, and the International Accounting Standards Committee (ISAC) should cooperate to establish the international regulatory and standard setting.

For the robust financial system building, the IMF and the World Bank launched the Financial Sector Assessment Program (FSAP) in May 1999. A one-year pilot program of 12 countries conducted in May 1999, and extended to another 24 countries during May 2000 to April 2001. FSAP assessments with help from standard setting bodies, national supervisory agencies and central banks, are to identify strength, vulnerabilities, and risks in the financial system, and to assist in financial sector development and technical needs, and to help priority policy actions. Based on the FSAP, the IMF established Financial Sector Stability Assessments (FSSAs), and the assessment are being undertaken. The IMF collaborated with other international organizations, and initiated a research program on

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27 "The Basel Committee, established by the central-bank Governors of the Group of Ten countries at the end of 1974, meets regularly four times a year. It has about thirty technical working groups and task forces which also meet regularly. The Committee’s members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States. Countries are represented by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank. The present Chairman of the Committee is Mr. Jaime Caruana, Governor of the Bank of Spain, who succeeded Mr. William J McDonough on May 1, 2003.” Cited in BIS, <http://www.bis.org/bcbs/aboutbcbs.htm> (2 November 2003).


macroprudential indicators to measure financial sector health. In addition, the FSAP helps the building of an offshore financial central report of the Financial Stability Forum.\(^{30}\)

The IFIs believe that capital account liberalization guarantees the substantial benefits to international financial markets, so emerging economies should engage the financial liberalization through careful management and a sequencing manner to minimize the risk. The G-7 encouraged the Fund to continue its work on the appropriate pace and sequencing of capital account liberalization in the Cologne Summit in 1999, and their continuous summits.

Capital account liberalization is an important component of the broader process of financial liberalization. In this context, capital account liberalization should be undertaken as part of an integrated strategy comprising a stable macroeconomic environment (including a sustainable exchange rate policy), a strong prudential framework in the financial sector (including the adoption of relevant standards and codes), appropriate monitoring of statistical data, sound risk and liquidity management practices both in the public and private sectors, and complementary structural (including social sector) reforms, to ensure that liberalization does not create new areas of vulnerability.\(^{31}\)

The IMF fully agreed on the direction of the G-7, and the Executive Board prepared for broad principles from a case-by-case approach to capital account liberalization to the launching of improved prudential policies to manage the risks from international capital flows. The Board also examined the linkage between capital account liberalization and financial stability, and how stability can secure the process of liberalization.\(^{32}\)

\(^{30}\) IMF, Reforming the International Architecture.

6.2.3.3 Financial Crisis Management and Involving the Private Sector

After the Asian financial crisis, the G-22 working groups agreed that the NIFA should focus on the prevention and management of international financial crisis. To prevent future crisis, the working group stressed four issues for emerging economies: limiting emerging economies government guarantees to the private sector; increasing innovative financing techniques to minimize market volatility; maintaining appropriate exchange rate regimes; and employing effective insolvency and debtor-creditor regimes. The working group also highlights the IFIs supporting role to propose a strong program of policy adjustment and to qualify for financial assistance in the crisis countries.

Through the Asian financial crisis, many scholar and officials worried about the lender of last resort role of the Fund, and believed the role would no longer come into action, due to the Fund’s lack of resources. At the time, the usable resources were less than US$150 billion, while the external debt of the developing countries is well over US$2 trillion. Finally, the G-7 emphasized the need to increase the Fund’s resources and the speed to finance crisis-hit countries. To increase IMF resources, the NIFA considered both a quota increase and the approval of the New Arrangements to Borrow. In 1999, the IMF created the Contingent Credit Lines (CCL) as a new instrument of crisis prevention. The CCL is designed to prevent future balance of payments problems caused by international financial contagion with the major components of the reform efforts.

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32 IMF, Reforming the International Financial Architecture.
34 G-22 Working Group, 26-27.
The G-7 and IFIs considered that the importance of the proper control of the private sector is essential for crisis prevention through the experience of the Asian crisis. The G-7 agreed that the needs to establish an advanced framework of principles and tools for involving private sectors in the prevention and resolution of crises. Following the guideline of the G-7, the IFIs and other standard-setting bodies set up various standards (see Table 6.1).

The G-7 also emphasized the need to share information and enhance the channel of communication between countries and their private creditors. For this purpose, they recommended that the Fund should play a role to build a solid program to review the requirement and procedure in accessing the Fund’s financing, to analyze the countries’ mid-term debt and balance of payment profile, to provide detailed sources of private financing, and to maintain intimate coordination with the Paris Club.\textsuperscript{37} The IMF established frameworks to improve risk assessment and risk management to the private sector, to advance specific proposals in the financial system, and to build constructive dialogue guidelines between private creditors and debtors.\textsuperscript{38}

\textsuperscript{38} IMF, \textit{Reforming the International Architecture}. 
Table 6.1 12 Key Standards for Sound Financial Systems

<table>
<thead>
<tr>
<th>Area</th>
<th>Standard</th>
<th>Issued by</th>
</tr>
</thead>
<tbody>
<tr>
<td>Macroeconomic Policy and Data Transparency</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Monetary and fiscal policy transparency</td>
<td>Code of Good Practices on Transparency in Monetary and Financial Policies</td>
<td>IMF</td>
</tr>
<tr>
<td>Fiscal policy transparency</td>
<td>Code of Good Practices in Fiscal Transparency</td>
<td>IMF</td>
</tr>
<tr>
<td>Data dissemination</td>
<td>Special Data Dissemination Standard/ General Data Dissemination System</td>
<td>IMF</td>
</tr>
<tr>
<td>Institutional and Market Infrastructure</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insolvency</td>
<td>2</td>
<td>World Bank</td>
</tr>
<tr>
<td>Corporate governance</td>
<td>Principles of Corporate Governance OECD</td>
<td>OECD</td>
</tr>
<tr>
<td>Accounting</td>
<td>International Accounting Standards (IAS)</td>
<td>ISAB 4</td>
</tr>
<tr>
<td>Auditing</td>
<td>International Standards on Auditing (ISA)</td>
<td>IFAC 4</td>
</tr>
<tr>
<td>Payment and settlement</td>
<td>Core Principles for Systemically Important Payment Systems/ Recommendations for Securities Settlement Systems</td>
<td>CPSS/IOSCO</td>
</tr>
<tr>
<td>Market integrity</td>
<td>The Forty Recommendations of the Financial Action Task Force/ 8 Special Recommendations Against Terrorist Financing</td>
<td>FATF</td>
</tr>
<tr>
<td>Financial Regulation and Supervision</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banking supervision</td>
<td>Core Principles for Effective Banking Supervision</td>
<td>BCBS</td>
</tr>
<tr>
<td>Securities regulation</td>
<td>Objectives and Principles of Securities Regulation</td>
<td>IOSCO</td>
</tr>
<tr>
<td>Insurance supervision</td>
<td>Insurance Core Principles</td>
<td>IAIS</td>
</tr>
</tbody>
</table>

1. Economies with access to international capital markets are encouraged to subscribe to the more stringent SDDS and all other economies are encouraged to adopt the GDDS.
2. The World Bank is coordinating a broad-based effort to develop a set of principles and guidelines on insolvency regimes. The United Nations Commission on International Trade Law (UNCITRAL), which adopted the Model Law on Cross-Border Insolvency in 1997, will help facilitate implementation.
3. Relevant IAS are currently being reviewed by the IAIS and IOSCO.
4. The International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC) are distinct from other standard-setting bodies in that they are private sector bodies.

6.2.4 The Limits of the NIFA

The NIFA frameworks would be an ambitious plan to build a stable international financial system, and to prevent future financial crisis. However, implementation of the NIFA in the international financial system not only reveals many problems lacking a general consensus among countries, but is also confronted by many critics from liberal economists as well as global civil society NGOs. Generally, many scholars point out the important shortcomings of the NIFA, it has an apolitical approach to global governance, holds insufficient policy harmonization with the local conditions of different countries (political constraints on national policy changes), and has a one-size-fits-all standard. 39

The global NGOs and civil society groups harshly criticized that the NIFA has a critical legitimacy problem because it excluded many emerging economies from their designs and decision-making procedures. Furthermore, the NIFA focused largely on the victims of crisis through reducing the affected countries’ vulnerability rather than considering the real causes. 40


As the most fundamental problem of the NIFA, it overlooks the political approach to global financial governance. The architecture mainly recommends that many countries' existing monetary, finance, and fiscal policies should be reformed, followed by the architecture's new standards and codes. However, the NIFA does not seriously consider the political and institutional factors that underlie the implementations on the country side. For example, if a country would accept the policy suggestions of the NIFA, such as a new code of fiscal, monetary, and financial policy, the country should consider preparing to the administer expenditures and legal procedures to improve various laws and regulations to meet the realistic policy needs. Considering the national differences in socioeconomic and institutional systems, the costs would be too expensive to put into practice. Given the differences in legal systems and political cultures, the standards and codes should be satisfactory for domestic lawmakers, economic agents, and interest groups.

The top-down style of guidelines from the G-7 and U.S.-led IFIs seriously conflicts with the local contexts of emerging economies that bring harmonization problems. When the G-7 and IFIs invent a new framework for a stable international financial system, and implement the proposal, they should bear in mind the local conditions of emerging economies. The reform of financial, monetary, and fiscal sectors in emerging economies will bring far-reaching effects into political stability, legitimacy, society, and democratic governance as in the cases of the post-crisis economies. More market-oriented reforms would give incentives to the globalized domestic business actors and the multinational

42 Kahler, 253-255.
firms, and it should involve the social and industrial restructuring of vulnerable market actors and social groups, so it is inevitable to create potential political resistance. Principally the official consensus of the NIFA is based on the Washington Consensus (neoliberal oriented proposal) that underlines the liberalization, privatization, and market oriented macroeconomic principle. Every corner of the proposal underpins the financial system toward unilateral market-oriented neoliberal practices in emerging economies. Although some major emerging economies have already accepted the ‘Washington Consensus’ oriented policy proposals, partly from the rescue package of the IMF and partly from the Financial Services Agreements of the WTO, they still have to struggle to adjust their existing financial systems and corporative sectors to the architecture guideline.

Divergent tracks of the NIFA propose too many standards and codes urging emerging economies to observe. For example, the Financial Stability Forum (FSF) identifies 12 key codes and standards including 64 standards regarding stable financial system construction. Furthermore, these codes and standards are now developing their own schedules, so it is very difficult for emerging economies to meet the levels of each direction. This “one-size-fit-all approach” casts doubt on how emerging economies could observe the NIFA. Since many countries have their own particular economic and

43 Underhill and Zhang, 373.
44 Underhill and Zhang, 374.
institutional systems, the various regulation formats of the NIFA would impede its effective operation. In addition, many countries would spend enormous budgetary costs to employ the numerous codes and standards, and further they might need extra money for technical assistance or training. Though the IMF, the World Bank, FSF, and the G-20 are working together to provide unified standards and codes, there are too many architecture proposals.

Many global civil society groups criticized the NIFA for not reflecting the needs or wishes of many emerging economies because these countries were excluded from the architecture design. Although, the G-7 included 'systemically significant' emerging economies into the G-20, this does not represent the majority of developing countries. They believe that the G-7 desires to keep controlling the NIFA agenda with their own selection basis, rather than sharing the initiatives with other important emerging economies. In the end, the main components of the reform agenda have been managed by only a few powerful G-7 countries, and the IFIs, while the implementation of the agenda would affect the most part of the developing countries. If the G-7 and the IFIs want to launch international standards, they should pursue a more legitimate process of negotiation.

The NIFA agenda mainly assigned its task to the crisis fatalities through reducing their vulnerability rather than on the perpetrators of crisis. Along with the remediation of the weak financial sectors of emerging economies, the NIFA should consider various

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50 Culpeper, "Improving Global Financial Governance."
measures to check the industrial countries’ investor and creditors in the same manner. For example, the architecture must arrange a series of safety networks to regulate secretive hedge funds and short-term speculative capital investments of the G-7.\(^{51}\) For this matter, the next section examines the Tobin tax proposal which sought to control the speculation in short-term capital directly through a portion of the tax rate.

6.3 Tobin Tax Proposal as a Type of Capital Control

In 1972, James Tobin, Sterling Professor of Economics at Yale University, and a Noble Laureate, proposed a currency transactions tax in order to reduce speculative currency transactions and to afford governments more discretionary power in managing their own domestic monetary and fiscal policy after the collapse of the Bretton Woods fixed exchange regime.\(^{52}\) According to Tobin, the real problem in the international financial system is not the exchange rate regime, but the excessive international mobility (currency) of private financial capital. The extreme financial capital mobility severely restricts the policy ability of the central banks and government to pursue proper monetary and fiscal policies.\(^{53}\) Tobin proposed that introducing the “internationally uniform tax on all spot conversions of one currency into another, proportional to the size of the transaction,” is essential for limiting the peril of short-term speculative capital mobility.

The proposal is an internationally uniform tax on all spot conversions of one currency into another, proportional to the size of the transaction. The tax would particularly deter

\(^{51}\) Culperper.


short-term financial round-trip excursions into another currency. A 1% tax, for example, could be overcome only by an 8 point differential in the annual yields of Treasury bills or Eurocurrency deposits denominated in dollars and Deutschmarks......The impact of the tax would be less for permanent currency shifts, or for long maturities. Because of exchange risks, capital value risks, and market imperfections, interest arbitrage and exchange speculation are less troublesome in long maturities. Moreover, it is desirable to obstruct as little as possible international movements of capital responsive to long-run portfolio preferences and profit opportunities.54

6.3.1 Different Standpoints

Since Tobin proposed the tax initiative in the early 1970s, many scholars and global civil society groups55 have advocated the realization of the proposal. Currently, global civil society groups, such as the New Rules for Global Finance, the War on Want, ATTAC, etc., enthusiastically supported the Tobin tax proposal, concentrated their efforts to develop more feasible options, and led global campaigns through various civil society movements and policy network.56 Moreover, Jagdish Bhagwati’s article, “The Capital Myth,” in Foreign Affairs in 1998 where he argues “any nation embrace of free capital mobility must recon with these costs and also consider probability of running into a crisis,”57 kindled a fire to the awareness of the susceptibility of the hazardous short-term capital volatility in the global financial sector. From the experience of the Asian financial crisis, the public could recognize that there is no safe place, neither in industrialized countries nor in the successful emerging economies, from the speculative ‘hot money’ attack, and sympathized with the need for capital control.

On the contrary, the United States, the hegemonic financial power, did not accept

54 Tobin, 155.
capital controls. Rather, it has strongly supported free capital flows in global financial markets as the *U.S. Treasury Press Release sp061297*.

The United States has been at the forefront of efforts to build a truly global capital market by supporting efforts aimed at liberalizing capital flows, developing domestic financial markets and promoting greater access by foreign financial firms to domestic markets. This is an integral part of our strategy to build a global economy and to spread prosperity. 58

Of course, the G-7 and IFIs stick to the same guidelines of the U.S. Treasury by means of the architecture plan. Since the structural power of the United States and the IMF strongly refuse to accept any significant revival of the capital control options, many developing countries hesitate to introduce capital controls 59 except for the cases of Chile and Malaysia so far. Regardless, the current hesitance toward capital controls, and the debates around the usefulness of the Tobin tax have become controversial issues in global governance in the international financial system.

### 6.3.2 Pros and Cons of the Tobin Tax

Besides the conflict between the G-7 and civil society groups, there is another controversy concerning the feasibility and efficiency of the Tobin tax. Proponents argue that the Tobin tax helps to reduce financial instability and is a feasible option. Generally,

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they have the same opinion of the Tobin tax, and make three broad points. First, the Tobin tax could lessen currency volatility and discourage speculation in the international financial system. Second, the Tobin tax enhances the power of governments and central banks policy autonomy to manage their monetary and fiscal policy. Third, it could help to raise significant tax revenue for each country to protect their currencies from devaluation and financial crisis. Since 1973, the average daily turnover of foreign exchange (average around $15 billion) has tremendously increased to $1.2 trillion in 2001. Based on maturity, 78 percent of over-the-counter (OTC) foreign exchange derivatives occupied within one-year period, and 69 percent of foreign exchange swap transactions were within seven days at the end of the June 2001. In addition, 89 percent of all transactions are involved in OECD countries’ currencies. As the intention of the Tobin tax proposal, if each short-term transaction would be taxed at 0.1 percent of the volume, this money will raise the revenue of each nation and would reduce short-term transactions.

Regarding feasibility, there are two proposals: one set concerns whether the policy makers would wish to accept it administrative and technically and the other set relates whether it is politically acceptable. Considering many countries successful transaction taxes in asset markets, the application of the Tobin tax in security and currency transaction would not prevent the efficient function of the existing system. In the political application of the tax, it needs to be applied on a global bases in a coordinated, uniform fashion, otherwise traders will adjust their transactions to engage in off-shore markets.

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62 BIS, 27 & 73.
evading tax jurisdiction. Proponents argue that if the United States and other G-7
countries imposed the Tobin tax, then the greatest volume of currency transactions would
be captured.\footnote{Palley, “The Economic Case for the Tobin Tax”, 7.}

In another respect, opponents counter that the Tobin tax is unachievable, and could
even aggravate financial instability. They believe that the Tobin tax is a waste of time and
efforts to pursue the proposal are politically unrealistic; it cannot be accomplished
technically or administratively without an unreasonably high costs, and; it would not
achieve its purported goal of stabilizing financial markets.\footnote{Dean Baker, “The Case for a Unilateral Speculation Tax in the United States,” \textit{Briefing Paper}, Center for Economic and Policy Research (July 26, 2000).} First, for the imposition of
the Tobin tax, sufficient political power is necessary in the agreement of the detailed
conditions, such as the ratio of the tax, the method of reallocation of the revenue,
collection, and enforcement, so it is very challenging work. Second, since the Tobin tax
will hamper most of the world’s financial and commercial interests, most financial
exporting countries will not agree to the taxation. Third, in reality, the difficulties of
surveillance and new rules enforcement in unregulated OTC market are indicated as
another barrier. For example, if the tax were imposed in only part of a region, then it
would lead to capital exodus searching for a tax haven. Fourth, a small portion of tax
rates in the 0.01 percent to 0.25 percent range is not the sufficient mechanism to restrain
speculation on the likely devaluation of a currency by 20 to 50 percent.

Thus, the imposition of the Tobin tax is not an easy job for the global financial system,
but the empirical cases of the capital control in Chile and Malaysia offer some useful

lessons for the feasibility issues of the Tobin tax.

6.3.3 Two Empirical Cases of Capital Control: Chile and Malaysia

The Chilean experience provides important lessons for the usefulness and the limitation of capital controls on short-term inflows. While most of the Latin American countries suffered debt crisis and contagion effect during the 1990s, Chile has maintained steady policies toward capital inflow and exchange rate management. Generally, Chilean controls on capital inflows could control the excessive volatility of short-term capital inflows and prevent extreme exchange rate appreciation. Beginning in 1991, Chilean monetary authorities adopted two main mechanisms in order to discourage capital inflow. First, all foreign loans were levied a tax of 1.2 percent per year (proportionately less on shorter periods). Second, foreign borrowing, bank deposits in foreign currency, and some portfolio inflows reserve requirements were imposed which was equal to 20 percent of the investment, and were maintained at the central bank for a period from 90 days to one year depending on the maturity of the loan. In 1992, the reserve requirement was raised to 30 percent of the foreign loan and it had to be held at the central bank for a fixed year no matter the maturity of the loan. In addition, there is a longstanding requirement that all FDI stay in the country for at least one year.

As a result, Chilean agents had to pay more costs in three ways: they should borrow funds based on their need in order to meet the reserve requirement; they have to pay

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67 Agosin and Ffrench-Davis, 23.
foreign credit tax; and if they borrow less than one year maturities, then they must keep reserves on deposits for longer that the maturity of their loan. These mechanisms were designed to prevent overvaluation of the Chilean peso, which gave the negative effects to the country’s export-oriented growth policies, while encouraging more long-term capital inflows for development purposes. Owing to these policy options, Chile could induce a high proportion of foreign direct and portfolio investments, and succeeded in obtaining moderate and stable net capital inflows. Chile also has successfully defended its financial systems from the contagion attacks from both the Mexican and Asian crisis. However, Chile could not mange the significant real appreciation of the peso confronted with very large capital inflows (over 10 percent to its GDP) in 1996-97 despite the central banks heavy purchases of foreign exchange. Through the experience of Chile, the relatively small Chilean economy’s tougher restriction on capital inflows and foreign exchange could not fully insulate it from the huge amount of external financial pressures, and finally the effectiveness of the policies may erode over time. However, the Chilean case provides a lesson that carefully designed capital control could restrict the speculative short-term capital as well as encourage long-term capital inflows. The following Table 6.2 summarizes the comparison between the Tobin tax proposal and Chile’s deposit requirement on capital inflows.

69 Agosin and Ffrench-Davis, 27; Simone and Sorsa, 5.
70 Agosin and Ffrench-Davis, 23-26.
Table 6.2 The Comparison between the Tobin Tax and Chile’s Case

<table>
<thead>
<tr>
<th></th>
<th>Tobin tax proposal</th>
<th>Chile’s deposit requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Motive</td>
<td>Reduce volatility in exchange rate (and raise revenue)</td>
<td>Prevent over-indebtedness</td>
</tr>
<tr>
<td>Tax applied to</td>
<td>All foreign exchange transactions, including trade</td>
<td>Capital inflows</td>
</tr>
<tr>
<td>Paid immediately by</td>
<td>All traders (mostly banks)</td>
<td>Foreign investors</td>
</tr>
<tr>
<td>Paid immediately to</td>
<td>Tax authority</td>
<td>Central bank</td>
</tr>
<tr>
<td></td>
<td>(domestic revenue)</td>
<td>(foreign currency earnings)</td>
</tr>
<tr>
<td>Relationship of tax</td>
<td>Invariant to interest rate</td>
<td>Rises with foreign interest rate</td>
</tr>
<tr>
<td>amount to interest rate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Relationship to</td>
<td>Fixed amount. In % per year terms, falls continuously with maturity</td>
<td>Fixed amount (falling with maturity in % per year terms) when maturity &lt; 1 year</td>
</tr>
<tr>
<td>maturity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Where imposed</td>
<td>Must be world-wide</td>
<td>One country (facing inflows)</td>
</tr>
<tr>
<td>Probable level of tax</td>
<td>Low (to avoid distortions and substitution)</td>
<td>Moderate</td>
</tr>
<tr>
<td>rate</td>
<td></td>
<td>(30 % times interest rate)</td>
</tr>
</tbody>
</table>


For another example, the Malaysian case suggests how tougher capital controls and exchange controls could stabilize an economy. Opposing the speculative attacks during the Asian financial crisis, the Malaysian government prescribed drastic measures. To defend its currency value and financial system, the Malaysian government introduced selective capital control measures insulating its domestic economy from external uncertainty on September 1, 1998. For the stabilization of their currency, the government pegged the ringgit to the U.S. dollar at a rate of RM 3.80 to US$1.00, and prohibited the transaction of the ringgit outside Malaysia. Also, the outflow of short-term capital flows

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was strictly controlled by various measures for normal function of the fixed exchange rate system. For instance, all settlement of exports and imports must be made in foreign currency; travelers are not allowed to import and export ringgit over RM 1,000 per person; the export of foreign currency by resident travelers only allowed under RM 10,000; non-resident portfolio investors should hold their investment for at least one year in Malaysia, etc. In addition, all dealings in securities listed on the Kuala Lumpur Stock Exchange (KLSE) must trade in the KLSE or through a stock exchange authorized by the Malaysian government. Thus 112 Malaysian companies on the Central Limit Order Book, an OTC market in Singapore, could not trade in the Singapore Stock Exchange.73

These exchange and capital controls gave the Malaysian governments policy autonomy in monetary and financial policy, and the breathing space to drastically restructure the financial and corporate sectors. From the Malaysian experience, imposing certain types of capital controls would be an effective policy option to protect the financial system and to prevent further financial turbulence.74 Besides the two country cases, many scholars points to how China and India which have underdeveloped financial systems, could evade the regional contagion of the Asian financial crisis mainly because they do not allow full convertibility of their currencies (capital account liberalization).75 Therefore, the Tobin tax and the partial capital controls in emerging economies in Chile, Malaysia, China, and India, would allow emerging economies to regulate efficiently to prevent financial crises and the speculative short-term volatility.76 Though these options

73 Zainal-Abidin, 138-139.
75 Khor, 58; Underhill and Zhang, “Toward Good Governance”, 362.
76 See more detail discussion in Frankel, “Proposals Regarding Restrictions on Capital Flows.”
are strongly objected to by the United States, the Tobin tax and partial capital controls should be included as a part of the global governance in international financial system in a possible way to prevent further financial crises in emerging economies.

6.4 Other Suggestions for the Global Financial Governance

Besides the Tobin tax proposal and the NIFA, there are many proposals for global financial governance, such as reforming international financial institutions (mainly focused on the IMF), launching new IFIs, and a middle way suggestion to fill the gap between the NIFA and the emerging economies financial markets condition.

First, the issue of reforming international financial institutions was originated from the criticism about the IMF’s role to manage the Asian financial crisis. Since the late 1990s, the IMF’s failure to prevent the recurrent financial crisis in emerging economies, and its unfit structural adjustment program to the Asian crisis hit countries have led to broad criticism by prominent scholars. There are many viewpoints, from a radical viewpoint to call for abolishing the IMF to minor reform viewpoints. Regarding the Fund’s decision-making reform proposal, many NGOs and global civil society group


78 Anna J. Schwartz, "Time to terminate the ESF and the IMF," *Foreign Policy Briefing*, no. 48 (August 26, 1998).

largely argued to reallocate voting power, change the veto power rule, guarantee minority shareholders participation to evaluate IFIs programs and project, create a transparent process to selecting the heads of the IFIs, and strengthen the relationship between the IFIs and the UN to help to make the IFIs more accountable and supportable to the fair decision and evaluation of global financial matters.

Second, most proposals for launching new global financial institutions are focused on three categories: a world central bank, an international supervisory institution, and an international monetary clearinghouse. Jeffrey E. Garten advocates that a global central bank could provide more financial resources to manage future financial crises under the current condition of the IMF’s lack of true central banking powers. As a regional alternative, Japan proposed an ‘Asian Monetary Fund’ that was obliterated by the strong objection of the United States, but still attract broad consensus in the Asian region because of the large foreign currency reserves and positive external creditor position of Japan, China, and Taiwan. To prevent large trade imbalances and support enough financial resources, Paul Davidson proposes to create an international monetary clearinghouse. In a similar context, George Soros suggests an International Credit Insurance Corporation.

Third, as a middle way suggestion to the financial sector governance, Martin Feldstein offered a type of self-guideline to fill the gap between the NIFA and the

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84 George Soros, “Avoiding a Breakdown: Asia’s Crisis Demands a Rethink of International Regulation,” Financial Times (December 31, 1997).
developing countries position. Feldstein recommends guideline of "boosting liquidity" by three measures - reducing short-term foreign debt, accumulating liquidity reserves, and organizing a collateralized credit facility - to the emerging market economy, if they want to be insulated from future attacks. 86 Joseph E. Stiglitz 87 argues that the NIFA is only just a start and need to go much further, and his key reform proposals should take a part of the existing NIFA for helping developing countries to take the right direction for stable financial system. Stiglitz proposes seven key reforms: "acceptance of the danger of capital market liberalization and the short-term capital flows; bankruptcy reforms and standstills, less reliance on bailouts, improved banking regulation, improved risk management, improved safety nets, and improved response to crises." 88

6.5 A Proposal for a Global Forum and a Global Disclosure System

Thus, global governance in the international financial system is currently underway. Despite the promises of global governance to build a stable international financial system, the international community should find a feasible way to enact their governance plan. Although the leadership of the United States, other industrialized countries, and the IFIs are very crucial to reach an agreement for global financial governance, fostering the broad participation of many developing countries is very essential. Under the current situation, no country could cut the connection from the outside economic shocks. As the recent Asian financial crisis brought a shock in the world economy, financial disasters in other countries drives many financial intermediaries to constrain their liquidity and to

86 Feldstein.
88 Stiglitz.
avoid credit risk. Financial instability in an emerging market economy could affect
the financial markets in other countries and tends to spill over the whole economy easily.

In this interconnected world economy, the need for international consensus between
developed and emerging market economies to discuss reforming the international
financial system is very urgent. Therefore, this dissertation strongly recommends the
formation of a venue to examine various existing financial governance proposals. A
global forum that includes many decision-makers from important developing countries,
global civil society groups, NGOs, IFIs, and the G-7 would be a desirable negotiation
field to prepare a design of coherent strategy of financial governance that affects every
corner of the international financial system. This global forum would develop multilateral
negotiation rounds where every financial actor could guarantee an opportunity to
consider possible acceptance schedule with concessions bases on their legal and
socioeconomic backgrounds. In the forum, many developing countries cooperated with
global civil society actors to propose measures to limit a certain country’s influential
control of the IMF and the World Bank, and to review IFIs’ structural adjustments
program for debt countries. This global forum should embrace the Tobin tax proposal in a
serious manner to take care of speculative short-term capital volatility. If many countries
prefer stable exchange rates and national monetary autonomy, they will restrict
speculative short-term international capital flows as long as the regulation would not
disrupt the benefits of free financial capital investments. To increase the transparency and
accountability of individual countries’ financial sectors, various proposals from the NIFA
such as Special Data Dissemination Standard should be considered from an equal manner
both developed and developing countries.
Besides, the global forum should consider introducing a disclosure system in international finance. Many countries have utilized a disclosure system for the purpose of fostering investor confidence, providing investors with important information, contributing fair and orderly transactions between traders, and restraining fraud in the public offering, trading, and tendering securities. It would be a challenging work to combine the segmented disclosure system in each national boundary. However, considering the financial and economic data dissemination program in the NIFA, the disclosure system will highly contribute to increasing transparency of financial transactions and accountability of each country. If many countries could access the information about large parts of the short-term financial capital's management, volume, or ownership of foreign financial intermediaries, these countries could take a measure to meet an abrupt financial panic in advance. According these rigorous procedures and disciplines, the global disclosure system will ask very detailed information and management of the short-term financial capital including all hedge funds, financial derivatives, swap, futures, etc. This system should help to trace the dangerous speculative capital flows and to establish more secured surveillance of the financial capital supply resources in industrialized countries.
CHAPTER VII

CONCLUSION

The main purpose of this dissertation has been to investigate the roots and motives of financial globalization, and its far-reaching impact on global financial markets. As methodological frameworks, this dissertation applied systems theory, hegemonic stability theory, and levels of analysis. From the perspective of systems theory, this study broadly divided the international financial system into two categories, the control-oriented financial system after World War II to the mid-1970s, and the liberalized financial system from the mid-1970s to the present. This study verified that the U.S. initiative to deregulate its domestic financial controls and encourage financial inflows during the early 1970s were the starting point of global financial liberalization.

The policy changes of the greatest financial power had far-reaching influence on the other key actors (industrial countries as well as the developing countries) in the international financial system. The United States tried to regain its policy autonomy and hegemonic power role under the Bretton Woods regime while facing various external market force challenges, namely the emergence of a Eurocurrency market, technological development in communication and transportation, and increasing foreign investments of multinational corporations.

At the domestic level, the intentions of the neoliberal-minded U.S. officials to find breathing room to finance increasing U.S. balance-of-payments deficits coincided with the agenda of domestic interest groups (banking industry and multinational corporations) to extend their business area in overseas markets, and tried to launch various domestic
financial reforms. This U.S. policy direction led to financial liberalization in global markets. The United States desired to create a favorable environment for its national interests and utilized the country's structural power to enhance the levels of free financial investments in industrialized countries and to deregulate various financial control measures in developing countries as the hegemonic power stability theory assumes.

The United States has fully utilized the country's structural power for free capital movements and financial globalization. The U.S. power resources covered all areas from the military, economy, finance, and culture. Particularly, the predominant U.S. financial power results from being the world's largest financial market investor (FDI and portfolio investments), and based for financial industries. Based on these structural power resources, the U.S. Treasury Department, which was actively lobbied and pressured by various domestic financial industries interests, has strongly propelled a global financial liberalization policy. The U.S. global financial liberalization has proceeded at two strategic levels. In the first strategic level, the United States exercises its structural power to open up and deregulate financial markets in other nations (country to country). The United States achieved its first strategic goal in the developed countries from the 1970s-80s, and has accomplished the same in the developing countries since the late 1980s. The U.S. initiative seeking financial liberalization during the 1970s made a strong peer pressure on other developed countries to eliminate their existing financial regulations and made them follow the same line of global financial liberalization. For empirical evidence in developing countries, this research investigated financial liberalization in Korea in depth and suggested lessons from the cases of Japan and Mexico briefly. In the second strategic level, the United States implemented its financial power to propose and legalize
financial liberalization through multilateral agreements in international systemic level. This study investigated the U.S. proactive role introducing various empirical cases of liberalization in trade in services in the GATT Uruguay Round, the WTO’s Financial Services Agreement, the Multilateral Agreement on Investment in OECD, and the amendments of the IMF’s Articles of Agreement for financial liberalization.

From the globalization perspective, the first wave of financial globalization drove through the industrial countries during the period of the 1970s-80s. Industrial countries had already prepared for this financial liberalization, so there were no major problems in financial deepening and sequencing. The second wave of global financial liberalization has focused on the developing countries such as East Asia and Latin America since the late 1980s. Unlike the developed countries, most developing countries, which liberalized their financial market following the proposals of neoliberalism and the ‘Washington Consensus’ without preparing safety networks and considering the proper manner of financial liberalization sequencing, experienced tremendous increases in bank lending and speculative short-term portfolio investment, and consequently suffered from disastrous recurrent financial crises. Many experts recommended that financial liberalization should follow gradual stages and short-term capital should be opened only after other forms of liberalization such as the foreign direct investment liberalization, macroeconomic policy stabilization and improved prudential supervision. However, many developing countries’ financial liberalization proceeded under pressure from financial globalization without considering expert advice for a prudential strategy. After these developing countries experienced financial crises, they learned that financial liberalization should proceed with care and follow the proper sequencing.
The IMF, closely following the recommendations of the U.S. Treasury Department, applied its traditional prescriptions of currency devaluation, budget cutting, and high interest rates to these countries. This IMF prescription failed to contain the contagion of the financial crisis, as well as deepening financial panic. The IMF bailout program protected the interests of large multinational banks of industrial countries from their large and risky lending practices rather than assisting debtor countries to restore destitute economic conditions. As a result of these conditions, the Washington Consensus nearly lost its policy foundation. However, even today, the United States and IMF assume that financial liberalization will increase the efficiency of the global financial system. Consequently these policies proposals place great pressure for reform on debtor countries and require these countries to make fundamental changes in their domestic financial institutions to prepare for massive foreign capital inflows.

Chapter III focused on the U.S. hegemonic role in accelerating financial globalization, whereas Chapter IV reviewed the impact of U.S. financial liberalization policy on change in the general trend of international capital flows to developing countries during the last three decades. From the various cases of financial liberalization in Latin America and Asian countries and the two financial crises in Mexico in 1994 and East Asia in 1997-98, this research tried to find a linkage between financial liberalization and financial crises. Until the early 1970s, the main sources of financial capital flows in international markets were from commercial banks or official loans owing to most nations' traditional beliefs about financial controls. The trend of global financial liberalization, entrenched mainly by U.S. hegemonic power, contributed greatly to growing cross-border financial capital movements and to speeding up the development and integration of international financial
As financial liberalization spread all over the world during the 1980s and 1990s, the current prevalent type of capital flows (large volume of portfolio and foreign direct investments) replaced commercial banks and official loans in major emerging markets in Latin America and Asia. Increasingly private capital flows were integrated into emerging markets' financial systems, and the emerging markets themselves displayed a process of financial integration and globalized into a single international financial market.

Considering the supply and demand functions of international financial markets, the risk diversification and expectation of high return portfolio investments in developed countries fit the high demand of the emerging markets, which needed financial capital for their economic development and current account financing. Frequently, huge amounts of capital inflows to developing countries brought a series of policy dilemmas, and sometimes a sharp reversal caused various financial crises in Latin America and Asia. Developing countries' macroeconomic policy response toward large capital inflows are different from country to country based on the size and composition of the capital flows, the foreign exchange rate system, the development of domestic financial markets, the deepening of financial liberalization and flexibility of macroeconomic policy measures. Yet, generally most developing countries experienced real exchange rate appreciation, increasing current account deficits, and increases of stock and real estate prices. These macroeconomic effects could be managed by various sterilization policies, but sometimes the management costs went beyond their ability and led to financial disasters. The cases of the Mexican peso crisis and East Asian financial crisis epitomize these macroeconomic policy responses well.
There are two opposing viewpoints, “fundamental” and “self-fulfilling,” used to analyze the causes of financial crises in developing countries. The “self-fulfilling” viewpoint is more convincing to explain both the Mexican and Asian crises. We cannot deny that the affected countries had persuasive enough reasons for expecting crises such as high dependency on short-term financial capital, weak financial systems lacking accommodating supervisory mechanisms, and accumulating current account deficits, etc. Yet, we can assume that these macroeconomic problems were widely known common characteristics in most developing countries, so the question rationally arises, if the economic fundamentals were so bad so as to make financial crisis likely, why did foreign creditors and investors put their money in these regions? Perhaps the expectation of high returns outweighed the risks. Beyond this answer, we should also acknowledge the imperfection of the international financial system and consider preparing for preventing recurrent financial crises in emerging markets. Developing countries had better listen to the IMF and World Bank appeals for sound macroeconomic policy, strengthening domestic financial systems, appropriate financial liberalization, and improved financial information. In addition, the international community should prepare a safety-network to stabilize international financial systems. Some form of global governance is needed in the international financial system.

The history of financial liberalization in Korea provides many useful lessons to study and apply to other developing countries. This case study shows how U.S. financial power was exercised to open up Korean financial markets. In addition, the study exemplifies the policy dilemmas of the government confronted with external and internal financial liberalization pressures, and suggests the risks and challenges inherent in financial
liberalization. Korea was praised as a successful model of economic development for developing countries by major international financial institutions. But it could not evade financial disaster, and its fate made many scholars review the real meaning of financial liberalization in developing countries.

From systemic viewpoints, this study subdivided the history of the Korean financial system of the past fifty years into three financial periods and systems: the tightly controlled financial system, the loosely controlled financial system, and the liberalized financial system. During the period 1948-1979, the financial system was tightly controlled by the government to support the chaebol for rapid industrialization and promoted on export-oriented economy under the Rhee and Park regimes. During the period of 1980-1993, the financial control of the government was loosened and deregulated by the Chun and Roh regimes. The Chun regime started the various deregulations in domestic financial markets and the Roh regime continued these measures under the U.S. pressure for financial liberalization. Since 1993, the Korean government has introduced several financial reform policies under pressure from the United States and the chaebol, the premier domestic interest group of industrialists. Kim Young Sam’s government ‘Segeywha’ (Globalization) plan and Korea’s entry into the OECD in 1996 provided the critical moment to implement a comprehensive financial reform.

Despite the Korean financial liberalization that has proceeded in a gradual strategy over two decades, the process was unsuccessful in averting the 1997 crisis due to improper sequencing of reforms and the lack of prudential supervision take place in. Many experts recommended that financial liberalization should follow gradual stages,
and short-term capital should be opened only after other forms of liberalization such as foreign direct investment liberalization, macroeconomic policy stabilization, and improved prudential supervision. However, Korean financial liberalization proceeded without considering expert advice for a prudential strategy. After the Korean government experienced the financial crisis, it learned that financial liberalization should be careful and follow proper sequencing.

While the Korean government has had policy autonomy for financial liberalization, it nevertheless was strongly influenced by foreign and domestic actors, global financial liberalization trends, and environmental factors in the international financial system. At the domestic level, the elite group who studied in the United States and was influenced by the neo-liberal school (Washington Consensus) and the KDI, constructed the foundation of financial liberalization in the early 1980s.

The chaebol was another important domestic actor as a strong interest group. Although the chaebol played an important role in the industrialization and economic development of Korea, the huge debt and insolvent management of the chaebol was a major factor contributing to the financial crisis. The chaebol’s demands or pressures for financial liberalization have depended on their changing relationship with the government. In the 1960s and 1970s, the chaebol, as a beneficiary of the government’s financial regulation and controls, resisted financial liberalization. As the chaebol became a global business conglomerate in the 1980s-1990s, it changed its position and strongly demanded financial liberalization and free access to international financial resources. Also, it continuously lobbied the government for the ownership of commercial banks and non-bank financial institutions.
In the external system level, the United States has always pressed the Korean government for financial liberalization. The fundamental reason for these pressures resulted from the domestic interest of Wall Street's financial institutions and its huge amount of money and financial capital. The United States pressure was delivered to the Korean government through several channels (summit meetings, U.S. government officials' visits, Financial Policy Talks, several academic seminars, etc.). Moreover, the United States utilized international organizations and multilateral agreements for financial liberalization. The Korean government felt pressured to follow U.S. financial policy because the United States was and is its largest trading partner and the guarantor of its military security. These systemic conditions make Korea vulnerable to U.S. pressure.

The IMF has also functioned as another strong financial actor implementing full financial liberalization in Korea through the bailout negotiations. As the last important factor, the global financial liberalization trend was an unavoidable powerful influence in Korea. The financial liberalization process in Korea took the same financial globalization and liberalization line as other developing countries during the 1980s-1990s, and similar to other developing countries, such as the Southern Cone and Southeast Asian countries, which also suffered financial crises, Korea experienced its financial crisis as an unavoidable outcome of financial globalization.

A series of financial crises in successful emerging economies drove the international community to prepare global governance frameworks to build a stable international financial system and to prevent further financial crises in emerging economies. Numerous proposals for reforming the international financial system have been presented. Although
the idea and policy suggestions are different from the issuing bodies and scholars, they have the same purposes: to build a stable international financial system and to prevent future financial crisis. The new international financial architecture and the Tobin tax proposal have continued to develop and be discussed in the global community. The New International Financial Architecture (NIFA), which was authorized by the United States and the G-7, established more broad and detailed reform plans covering the areas of international standards and codes for transparency and accountability, strengthened the financial system, capital account liberalization, private sector regulation, and financial crisis management. However, the NIFA has mainly concentrated its efforts on the financial and corporate sectors of emerging market economies, instead of managing the real problems of capital exporting resources.

In fact, the United States and other G-7 countries contribute greatly to financial capital investments in emerging markets economies as financial capital exporters, whereas most emerging economies are recipients of foreign direct and portfolio investment supplied by the industrialized countries. Therefore, the NIFA should have evenly considered both the problems in capital supply and capital demand sectors. Much theoretical and empirical evidence strongly confirms that the matching of the hazardous perils of short-term capital volatility and the haphazard manner of capital account liberalization triggered recurrent financial crises in emerging economies. However, the NIFA would not seriously consider the short-term capital controls regulation, and further emphasized that restructuring the financial sectors with strong macroeconomic fundamental building could eliminate financial disaster. Furthermore, the NIFA's apolitical approach brought a serious problem of legitimacy and harmonization. From the
viewpoint of the industrialized countries which have already built sound financial systems with a strict legal tradition, the continuing reform plans of the NIFA would not disrupt their existing financial system. Yet, if we consider the emerging economies’ socioeconomic conditions, the imposition of new standards and codes would constitute a kind of challenging extortion in that they would have to prepare many auxiliary legal systems and supervisory mechanisms to upgrade their outmoded financial system to meet global standards. If the G-7 countries really want to introduce the NIFA, they must gain the broad support of developing countries and follow a more legitimate process of negotiation.

As a strong alternative to the global governance proposal, the Tobin tax has continuously secured broad support from global civil society groups and NGOs. Despite some critics of its feasibility, the Tobin tax proposal can help to reduce the financial instability from short-term speculative attacks and enhance the power of governments and central banks to manage their monetary and fiscal policy. If many countries introduce the Tobin tax and build a significant volume of tax revenue, it should help a government to lessen the shock from devaluation and future financial crises. The two empirical cases of Chile and Malaysia give us the important lesson that carefully designed capital controls can and do restrict speculative short-term capital attacks.

Regardless of their shortcomings, it is evident that two proposals should help to construct a more stable international system and prevent further dangers of financial crises. This study strongly recommends the formation of a venue to discuss these proposals and consider the right manner to impose policies on global financial markets. To encourage the broad participation of emerging markets’ economies, a global forum
that includes every emerging economy, the global civil society groups and NGOs, International Financial Institutions, and the G-7 should be created. This global forum might have a type of multilateral negotiation rounds where every nation could guarantee an opportunity to consider possible acceptance schedule with concessions based on their legal and socioeconomic backgrounds. This global forum should embrace the Tobin tax proposal in a serious manner to control speculative short-term capital volatility. In addition, the global forum should consider introducing a global disclosure system to report industrial countries’ short-term capital investments to emerging market economies, including all hedge funds, financial derivatives, swap, futures, etc. This public notice system should help to identify and trace dangerous speculative capital flows and to establish more secured surveillance of the capital supply resources in industrialized countries.

For further research, this dissertation suggests some directions. Throughout this research, this study described globalization in international financial markets as an irrevocable market force, and the role of human beings in organized forms of power as capable of controlling and managing market forces, and as essential parts of the ultimate research question. Although this dissertation researched the U.S. and Korean cases, and briefly described Latin American and Southeast Asian countries, it should help to construct a concrete theoretical framework if we extend the research to consider more comprehensive and deep comparative experiences of many other developing countries’ decision-making. In addition, artificial micro-level research is needed for this study. In analyzing the impacts of global financial liberalization in developing countries, the collection of more specific time-series data sets in certain countries are important to trace
the spreading effects on domestic financial systems at a microeconomic level following policy changes of financial liberalization. This dissertation has focused mainly on macroeconomic and global systemic level change. In addition, an everlasting research question is returning to financial global governance efforts. So far, most researchers in the global financial governance area have limited themselves to reviewing or evaluating governance proposals. We need more policy-oriented research to search for technical and practical methods, to predict the costs and benefits of alternative future governance regimes, and to assess the impacts of such proposals in the real world. The future of global financial stability depends on pragmatic decision-making and acceptable reforms.
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