Monetary and Financial History

Masters' in Monetary and Financial Economics

LISBON SCHOOL OF ECONOMICS & MANAGEMENT
UNIVERSIDADE DE LISBOA

Financial Globalization

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The Political Economy of Global Financial Liberalisation in Historical Perspective

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- 1. Introduction + Available Data
- 2. Theory - 2 possible models
- 3. History - Prewar and Interwar
- 4. Conclusion

Fundamental Questions

- Is Globalization a new phenomenon?
- Which is the link between trade and finance?

Introduction

- Scope of the paper
  - *The "political processes behind the first wave of financial liberalisation during the nineteenth and early twentieth century and its demise after World War I"*
- Before WW1, there was a general consensus that capital mobility should not be tampered with
- Some authors speculate that this would have been reversed regardless of WW1

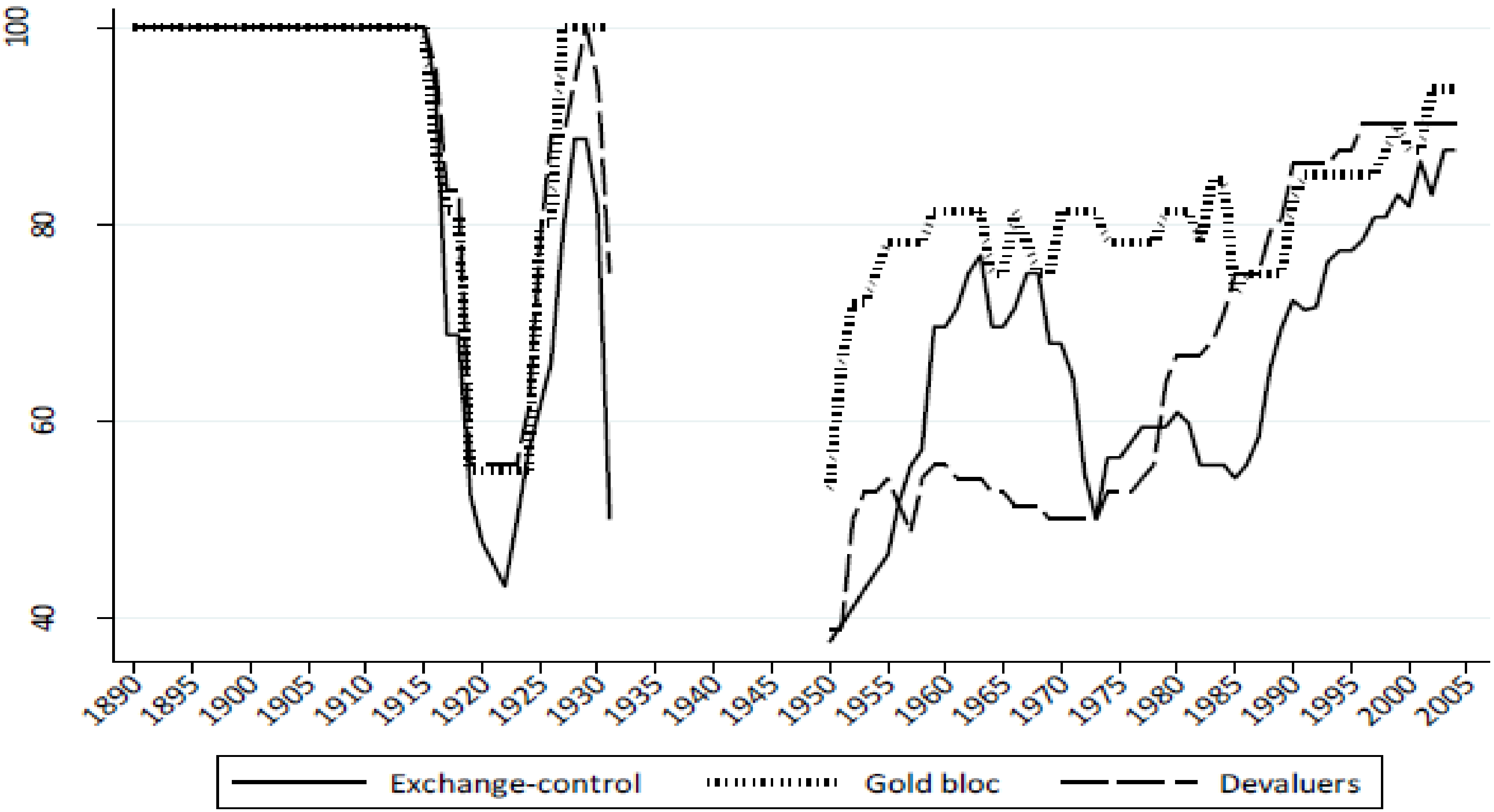
Available Data

Measurements

- Legal/*De Jure*
  - Regulatory restrictions
- *De Facto*
  - Political and economical circumstances
  - Differential risk and liquidity
  - Legal barriers

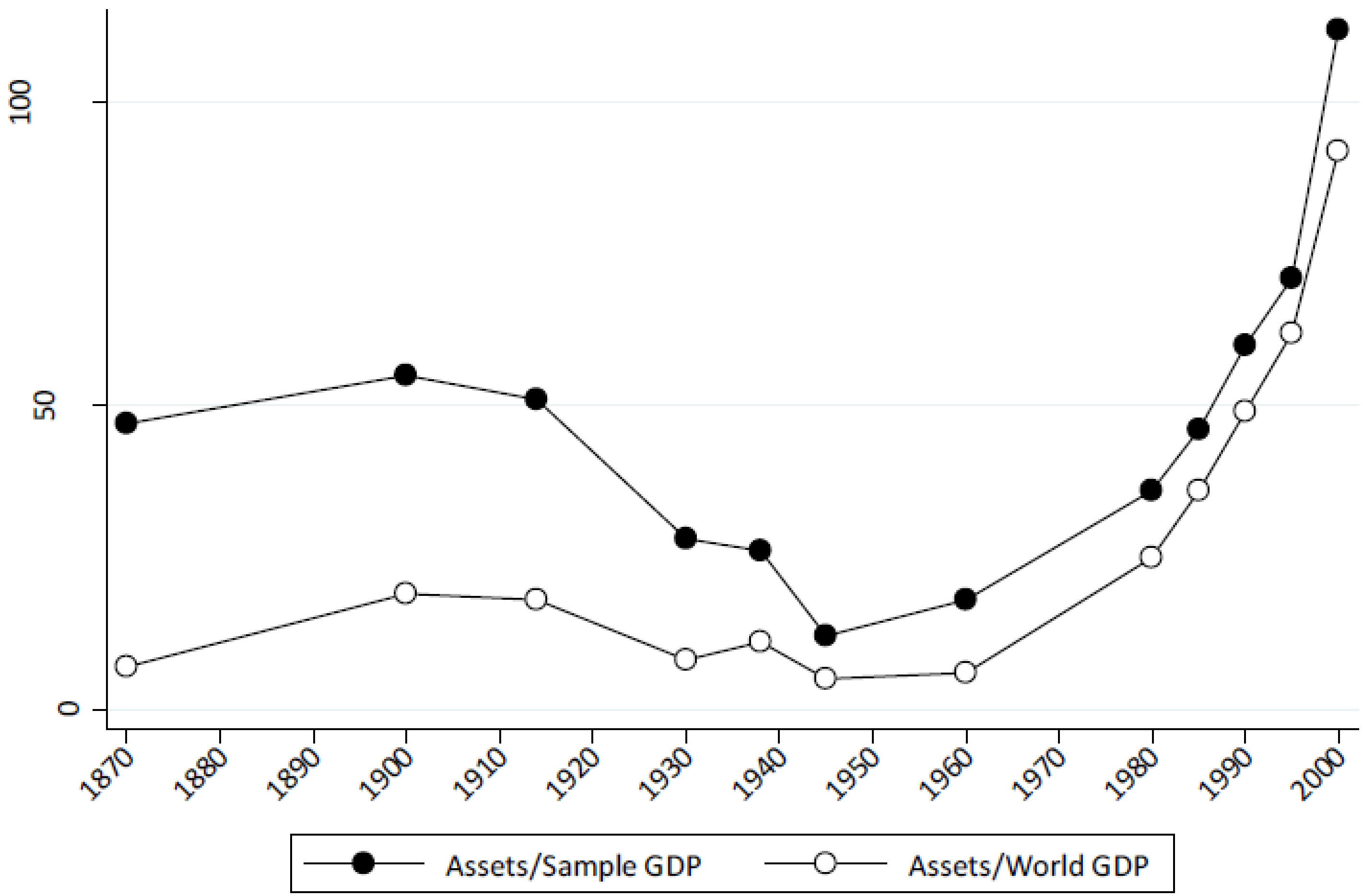
Limitations of data availability

Average Capital Account Openness, 1890-2004



Source: Quinn (2003)
Average values by group of nations, normalized for 100=total openness

Foreign Capital Stocks, 1870-2000



Source: Obstfeld and Taylor (2004: 52-53)
Countries in sample: UK, US, France, Germany, Netherlands, Canada and Japan.

Two groups of models that support capital controls

- Second-best
- Political Economy

These models consider countries individually

Second-Best models

Removing a distortion (Capital Controls) may not be optimal when there are other distortions.

What other distortions?

- Asymmetric information
- Moral hazard due to low liability
- Positive externalities of domestic investment
- Negative externalities of exporting capital
- Exposure to financial crisis

Political Economy models

Individuals are separated into two classes: workers (L) and capitalists (K).

The class with the relatively abundant factor supports liberalization, while the other class opposes it. These classes will compete for political power, so as to enforce their will.

The separation can be sectorial, rather than factorial.

Political Economy models

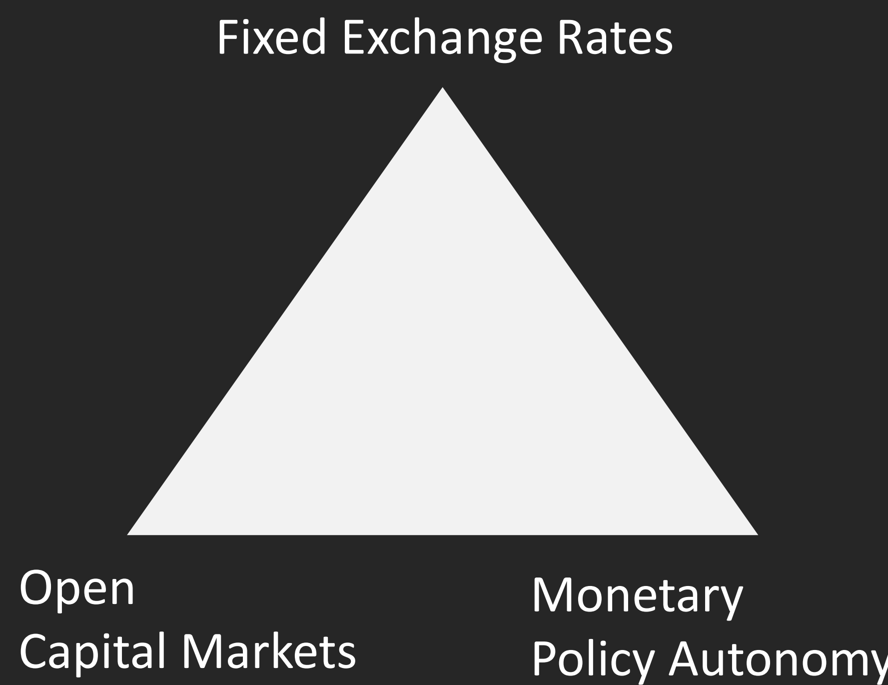
Financial sector and Industrial sector

Industrial firms want financial liberalization to access better financing conditions.

Finance firms want trade liberalization to expand their clientele.

Political Economy models

Monetary Policy Trilemma



Historical Evidence

- Prewar
- Interwar

Prewar

- Free Worldwide Capital Circulation before 1914

- A few small to moderate distortions (originating from Capital Exporting nations):
  - Discrimination if favor of ex-colonies:
    - *Diplomacy and Imperialism*
    - *Political Reasons*
  - Taxation of investment and income of foreign securities

Prewar

- Crises were less common (Gold-Standard, less currency crises) but as severe as today
- Currency collapses did not endanger solvency of domestic banking sectors

Was globalization seen as fundamentally good in the prewar period?

- Capital Exporting Countries
  - Arguments against:
    - Crowding out of domestic industry
    - Risk associated with informational and juridical asymmetries – “second best” scenario

Was globalization seen as fundamentally good in the prewar period?

- Capital Exporting Countries
  - However:
    - No big industrial-agricultural coalition against Capital Exports
      - Worldview of peace, democracy and progress
      - Meant there was no opposition to gold peg and capital openness
      - Some optimists even argued there was a positive feedback in the form of demand for exportable products

Was globalization seen as fundamentally good in the prewar period?

- Capital Importing Countries
  - Two groups:
    - Recent Settlement
    - European Periphery

Was globalization seen as fundamentally good in the prewar period?

- Recent Settlement
  - Americas, South Africa, Australasia
  - Capital and Labor Inflows
  - Capital-chasing-labor and British preference for ex-colonies as alleviating factors
  - Externalities and economic frontier expansions as favorable elements

Was globalization seen as fundamentally good in the prewar period?

- European Periphery
  - Capital Inflows, Labor Outflows
  - Capital Imports reinforced trend of increasing real wages
  - Investment in Infrastructure and Finance
  - Loss of monetary autonomy was not severe because of unreliable authorities
  - Monetary Integration meant advantageous business cycle synchronization, but increased vulnerability

Interwar

- Liberal order of free capital and labour
- Relatively free trade
- Exchange rate stability within the gold standard

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- Capital Controls
- Anti-immigration laws
- Proteccionism
- Managed exchanges rates

Reasons for the Interwar reversal

- Costs of war
- Loss of manpower
- Reconvertion of the industry of war to civil production
- Serious balance of payments problems

Consequences of the interwar reversal

- Institucional transformations
- Conservative national policies

Uncompromising atittude of both debtors and creditors

↓

Inflationary process

Interwar Inflationary Process

- Fiscal stabilization over monetary stability and cooperation
- Capital controls to phase-in macro adjustments to stabilize both currencies and balance of payments

Great Depression

- Autarkic policies and Exchange rate rigidity
- Tariffs and foreign Exchange control or devaluations
- Fiscal redistribution and strategic trade policy

Great depression consequences on emerging nations

Emerging nations suffered from the decline of terms of trade

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Autarkic growth model based on distortions on the pattern trade and capital flows

Controls on foreign ownership of domestic productive assets

Consequences of the process on developed nations

- Stabilizing the business cycle
- Domestic equilibrium of prices and unemployment
- Capital Openess and toward domestic policy

International Stability

- Stability of the international monetary system and the power configuration in the core countries
- As Kindleberger considered, hegemons are the crucial point of international stability
- Market contrasts in terms of internacional growth and stability

International Financial Globalization

- Trade and comparative advantages to receiving countries from capital openness
- Allowed a credible adherence to stable exchange rates, which allowed countries to specialize
- Emerging countries openess to foreign finance paid off in faster convergence and higher levels of income

Financial Integration and Shocks

- Shocks to Integration can disturb it’s path
  - **Prewar**: small shocks enough to disturb equilibrium
  - **Interwar**: WWI and Great Depression
    - Political Desintegration

- Cooperation between authorities and limited franchise protected them from short-term political pressure before the war

- Capital mobility was spared by anti-globalization forces -> less adversarial consequences of capital openess

Bibliography

- Esteves, R. (2011). The Political economy of Global Financial Liberalisation in Historical Perspective. *Number 89, Discussion Papers in Economic and Social History, University of Oxford.*