Managing the Faustian bargain: monetary autonomy in the pursuit of development in Eastern Europe and Latin America

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MONETARY AUTONOMY IN THE PURSUIT OF DEVELOPMENT IN EASTERN EUROPE AND LATIN AMERICA

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International capital markets have grown to be a major force shaping today's world economy, presenting a range of opportunities and threats to developing countries. Capital market liberalization created large pools of much-needed capital that developing economies could access, but tapping these funds often came at the cost of increasing economic vulnerability, lost policy-making autonomy and a range of structural distortions that could ultimately undermine development in the long-term. As the potential threats of integrating one's country into global capital markets has become apparent, countries have devised a range of strategies to buffer themselves from the strains of global capital markets. This article considers the pursuit of monetary autonomy with reference to a typology of the strategies that policy-makers can use to open their markets to international capital, while simultaneously attempting to buffer themselves from the economic and political pressures of global financial integration. Such autonomy can be purchased in a myriad of ways, and a discussion of the choices facing Latin American and Eastern European countries is presented.

Globalization and economic liberalization promised developing countries improved opportunities for capital investment and, in turn, accelerated economic development. These promises helped cultivate a rush across the developing world to create favorable conditions for capital investors. Increased inward capital flows did occur, but frequently retreated rapidly, helped spark systemic volatility and, for many countries, ultimately resulted in a disappointing development record (Rodrik and Subramanian 2008). By the turn of the millennium, there emerged a strong sense that the interests of capital investors and national economic development could diverge and even oppose one another. Governments increasingly saw global capital markets as a potentially destructive force, and sought ways to manage the perils of modern financial capitalism.

Today's enlarged, mobile and powerful global capital markets present policy-makers with a tightrope. These markets can undermine development efforts as easily as they help, but there are many means by which governments can insulate their economies from these adverse effects. This chapter focuses on how governments can manage capital markets strains with a special focus on monetary policy. Strains occur when there is a rapid and/or sustained flight of resources from a national money, which can create a range of policy problems when it occurs, including currency devaluation, inflation, government insolvency, and bankruptcy epidemics. When a monetary system becomes especially unstable, it can hurt economic prosperity and, in extreme cases, undermine general political-economic order.

Under many circumstances, opening one's markets to global capital flows creates increased risk of monetary problems that policy-makers can attempt to mitigate by various means. Five generic strategies for insuring one's economy against capital market strain are considered. *Incentivization* attempts to discourage capital flight by making one's economy maximally attractive for capital investors. *Intervention* attempts to impede capital flight by using the state's legal powers and resources to restrict or manipulate the movement of capital. *Financial accumulation* is a strategy in which governments attempt to arm themselves with access to large pools of financing that can be used to act against market sentiment on markets themselves. *Cooperation* involves coordination among states that pool resources to act against markets. *Dependency* is an arrangement in which a weaker country surrenders economic sovereignty to a stronger one in exchange for the latter's sponsorship of monetary stability. Each of these strategies face practical difficulties and potential problems.

Countries in Latin America and Eastern Europe will have to consider the blend of monetary defense strategies that they will use in the years to come. Many European countries have sought refuge in the European Monetary Union. This arrangement offers first-rate monetary protection, but places them in a position in which the strains of dependency could eventually be strong, although the system's current workings seem to be more cooperative in nature. Concerns that political shifts may change the Euro bloc into something that serves the interests of its core countries, perhaps at the expensive of the newly-admitted, is an issue that policy-makers in that region will have to engage. In Latin America, these choices are more complicated. Cooperative and dependency arrangements look less desirable, and accumulation somewhat less practical. The region seems stuck with blends of incentives and interventions, which are likely to be less effective than European options. What may help the region most is a change in attitudes among the world system's core countries on their role in fostering global development.

Managing Money under Financial Capitalism: Some Preliminaries

Policy-makers embraced financial liberalization for many reasons, particularly a belief that it would rescue them from the economic quagmires of the 1970s and 1980s. By engaging markets, these countries exposed their economies to financial pressures that affected economic stability, policy-making autonomy and, in turn, the social infrastructure by which their economies were organized. Capital flows grew to be large and volatile, and often overwhelmed governments' ability to maintain financial order and ultimately may have undermined economic progress. The destructive side of the global financial boom is a force that policy-makers now respect, and present an important consideration that should be integrated into any national economic strategy.

The Rise of Financial Capitalism. After World War II, the Western allies sought to embed financial markets in a web of stringent, cooperatively-enforced regulations institutionalized in the Bretton Woods Accord of 1944. This accord established a regime of coordinated exchange rate fixing, mutual macrofinancial insurance and active public sector control of financial markets. It was pursued in part as a result of the practical difficulties involved in reestablishing the liberal prewar international economic regime, in part to insulate governments from the tumult that resulted in the Great Depression, and in part in an effort to protect government policy-making from pressures from financial markets (Bordo 1993; Helleiner 1994; Ruggie 1982; Sachs and Warner 1995). By controlling capital's ability to shake exchange rates, price system stability or government solvency, private financiers' ability to sanction governments for enacting anti-capital policies were limited, thereby helping states institute the interventionist policies of the mid-20th century (Cohen 2008). The participation of the world system's core members suppressed financial volatility globally.

This system faced a slow chipping-away in the 1950s and 1960s, then a breakdown by 1971 (see Block 1977; Helleiner 1994). The 1973 oil shock created a combination of serious economic stagflation across the world and an environment of very loose credit for governments, which culminated in states weathering economic crises through deficit spending. Governments accumulated massive debts, culminating in a financial crisis in 1982. Insolvent governments faced an inability to finance their operations, political gridlock proved to be a hurdle to aggressive financial restoration, and many policy-makers addressed this situation through seigniorage. The result was severe inflation and chronic stagnation throughout the 1980s, amounting to a "lost decade" of development for many countries. What seemed to be the patent failure of governments' macroeconomic management delegitimized the postwar portrayal of the state as a prudent safeguard against market excesses, and helped usher in a range of policy initiatives designed to cut the state's size, scope of operations and regulatory hold on markets. The collapse of the Soviet system by the 1990s solidified sentiments that opposed government interventionism, and brought many of the world's developing states into this rising liberal system.

Excitement about the Cold War's end and opportunities for capital infusion-led economic development triggered an "emerging markets" investment boom in the 1990s. Global financial flows grew to be large. Median gross FDI and gross private capital flows grew by factors of almost four and seven respectively, as a percentage of GDP at the median between the 1980s and 2000s. Among the top quartile of wealthier countries, market capitalization of listed companies almost tripled from the 1980s to 2000s, as more of their countries assets were channeled to equity markets. Through government and private sectors, capital poured into developing countries, introducing capital inflows on a previously-unseen scale, and for which unprepared regulatory authorities and immature financial institutions had not been ready. The degree to which these doors were opened to capital varied (see Taylor 2006), but everywhere emerging capital markets were a force that took root in economic life.

Liberalization not only opened the doors to financial inflows but also outflows, and the 1990s showed the money could flee a country easily and sometimes in ways that suggested indiscriminate panic or sanction. These crises could occur unexpectedly and for reasons not direct tied to identifiable underlying problems, for example as the result of financial communities' self-fulfilling prophesies of impending panic (Obstfeld 1996) or as a form of collective punishment resulting from general flights from all developing markets when particular countries or regions fell into problems (Fratzscher 2003; Kaminsky and Reinhart 2000). The economic costs of such crises could be profound, sparking exchange rate drops, inflation, trade disruption, credit crises and severe recessions. In extreme cases, such as Indonesia in 1998 or Argentina in 2001, financial crises unleashed political crises, undermined social order and destabilized states.

Financial Pressures under Economic Liberalism. Contemporary economic history shows that adverse reactions by capital markets can hurt an economy, and in turn threaten a political regime's tenure. The destructive capacity of capital flight is a threat of which policy-makers are aware, and has been argued to sway the economic policies that countries adopt. In this way, some argue that financial liberalization undercuts the autonomy of policy-makers, who are pushed to tailor policies to the interests of international capital holders (Andrews 1994; Haggard and Maxfield 1996). Financial pressures' encroachment on policy is most visible when countries fall into crisis. Under these circumstances, victims have sometimes found themselves having to make policy concessions to external bailout financiers, for example through IMF conditionality (reviewed in Dreher 2008) or in bilateral negotiations (e.g., see Kirshner 2006 on South Korea's concessions to the US after its 1997 crisis). Even in the absence of crisis, governments might anticipate capital markets' desires, and implement policies that prioritize catering to that sector's demands, even at the expense of other national economic priorities.

Such an encroachment on autonomy made sense after the 1980s, when governments appeared to use their power over the regulatory environment to make patently misconceived, or even politically-expedient, financial decisions, often in ways that seemed to be at the expense of the economy-at-large. Giving capital markets power over the economy makes sense as long as we assume that there is an affinity between the interests of capital investors and general economic prosperity. Given the overall questionable effect of financial globalization's effect on development, assuming such an affinity seems hasty. Some kinds of policy concessions are ones that reduce regulation or maximize the ease with which they can flee an economy, precisely the kinds of reforms that make countries more vulnerable to strain. In some cases, financial concerns can lead governments to enact policies that disadvantage other economically-important sectors. For example, artificially inflating a country's exchange rates can reduce the risk to which locally-denominated debt-holders are exposed, but it also hurts exports. Providing tax inducements to foreign investors shifts the tax burden to local enterprise and consumers, and does nothing to help bolster government finances if liberalization does not help spur strong development. At best, the development benefit of financial liberalization appears to be mixed (Kose et al. 2006).

Seeking a Defensive Posture. Over the past decade, perspectives on the ultimate benevolence of free international capital markets have changed. Rodrik and Subramanian (2008) argue that the net development effect of capital market liberalization has been "disappointing", and suggest that part of the problem is that opening the doors to capital does not mean that investment opportunities in the potential recipient country will be good. A mere welcoming of capital as a solution to economic problems does nothing to help the many, underlying institutional conditions that influence investment viability, and trying to wholesale change institutions and liberalize a wide range of markets all at once is likely an impractical endeavor. History suggests that any multitude of underlying problems can make a country vulnerable to the flight of the capital upon which they come to depend, and prominent analysts have argued that capital markets are something against which countries should defend themselves (Feldstein 1999). How can a country achieve such insulation? Countries have pursued numerous strategies in the 21st century, each of which has its own costs and benefits. We turn to a typology of these strategies next.

Maintaining Monetary Autonomy: Five Generic Strategies

Monetary autonomy refers to a situation in which government policy is not pressured by financial markets, and thus does not have to grapple with the threat of economic crisis and is not pushed to implement pro-financier policies (see Cohen 2008). As recent events in the US suggest, no country is fully insulated from these pressures, but differences in exposure to these forces exist. A policy-maker seeking to mitigate international financial markets' encroachments on the policy-making process has several potential strategies at his or her disposal. Below, I present a typology of five such strategies: incentivization, intervention, accumulation, coordination and dependency. Each strategy has its own costs and benefits.

Incentivization

Strictly speaking, the hands of government can be tied by situations that policy itself has created. This occurred in the 1980s, when monetary systems confronted a myriad of problems, many of which were government policy's own making. Political forces sway the state, and this context ushered in policy directives that served to erode general economic order and formal economy participation, often leaving these countries with largely ungovernable economies. Morales and Sachs (1989) discussion of Bolivia's Siles administration is an illustrative example. Given this paper's basic premise that the threat of capital flight is a key pressure on policy-makers, such a strategy might seem wrong-headed at first glance. Seeing its underlying logic requires a conceptual separation of the state from a country's political forces, and an acknowledgement that certain political environments can cripple a state's ability to manage its own economy. Financial systems represent social orders, and such orders can fall into a kind of chaos that neither the government nor private enterprise can control well.

A reestablishment of governments' sway over economic activity required a restoration of price stability and public finances. One way to do this is to privatize the economy and chase global capital, which can infuse an economy with hard currencies, shed costly and politically-charged public enterprises, and help alleviate pressures on balances of payments and fiscal deficits, and, perhaps most importantly, undercut bad governments' policy-making autonomy. The Washington Consensus and similar reforms can be seen as a cover for the tough decisions that seemed impossible through strictly domestic deliberations. Although some portray economic liberalization as a choice that was an imposition for foreigners' will on developing countries, closer examinations suggest that domestic constituencies have also favored such reforms (e.g., Armijo and Faucher 2002).

Many of the policies implemented under the early 1990s' wave of liberalization could be described as *incentivization,* a means of asserting state economic control by attempting to reestablish financial order through attracting needed capital inflows by maximizing the incentives international financiers have to transfer resources into a developing country. Some of these reform include basic elements of the original Washington Consensus – privatization, deregulation, tax and expenditure reduction, easing restrictions on foreign inward investment and the reinforcement of property rights, though the liberalization of capital outflows was not part of this consensus (Williamson 1990). Once basic reforms were implemented, however, capital outflow liberalization was soon argued to help inflows and were ultimately implemented (Labán M. and Larraín B. 2001; Schadler et al. 1993).

The chief benefits of these liberalization strategies are that they help countries make difficult decisions by externalizing the cause of politically-difficult decisions (Przeworski and Vreeland 2000), like unloading money-losing public enterprises or cutting government expenditures. They also help establish basic environmental conditions that are likely to be necessary if a country wants to enjoy any of the benefits conferred by First World financial systems, like strong property rights or effective contract enforcement. The global investment boom and widespread quelling of inflation during the 1990s (see Cohen and Centeno 2006) suggesting that liberalization can provide governments and economies with the resources to quell stagflation. It also seems clear that, regardless of the financial pressures faced by governments since 1990s, developing countries' states have a dramatically enhanced ability to exert fiscal and monetary power within their own economies.

Problems with this strategy emerge when a country is no longer mired in general economic crisis, and there is actually large amounts of circulating capital to flee. At such a point, the interests of the state and international capital markets can diverge. States may want to regain lost control of privatized strategic sectors, as many countries did with their oil deposits over the past decade. They might want successful foreign-owned enterprises to help fund public initiatives, and try to raise the taxes levied on them. Once capital flight emerges as a threat to national prosperity, governments may want to restrict capital mobility to retain its existing capital or prevent disruptions from hot money. All of these solutions are problematic. In one sense, they can amount to a violation of an implicit contract with capital markets, who often assume the risk of entering troubled markets in hopes of large future profits. Changing these terms can lead to reputation damage, and perhaps future prospects for attracting investment. Some reassertions of state ownership can amount to serious violations of property rights, like the recapture of oil rights by Russia, Venezuela or Bolivia. Also, opening the door to international capital markets creates entrenched interest groups and institutions, and undoing these policies can spark serious political conflict and strain relationships with investors' home countries.

Incentivization appears to have been used as a crisis strategy, which comes at the cost of lock-in to external vulnerability and control over strategically-important parts of the economy. At some point, the interests of international capital markets and domestic development may diverge, making countries vulnerable to many of the problems that came up during the 1990s. In this sense, one can characterize incentivization as a kind of Faustian bargain: to sell control over one's economy to international markets to alleviate crisis, but then have to live with their potentially-negative influence once the crisis has passed.

Intervention

Intervention is a means of asserting governments' economic power by using legal power and prerogatives to constrain or influence the choices available to international investors. While the 1990s has been characterized here as an era of rapid liberalization and financial deregulation, it is important to note that most governments engaged in piecemeal reforms, holding on to many mechanisms of regulatory control. Examples of such interventions include capital flow restrictions, regulated direct investment, restrictions on foreign borrowing or exchange rate manipulations, and were retained in various combinations across the developing world (see Taylor 2006).

As noted earlier, governments resorted to strong capital controls during the mid-20th century, although many observers argue that they were poorly-conceived and often circumvented (Bruton 1998; Isard 2005). More generally, tight financial regulation is thought by many *laissez-faire* proponents to eschew some of the free market's primary benefits. They make capital allocation subject to purely political pressures, can suppress the information transmission that takes place through price changes, and saddle policy-makers with the impractical task of fine-tuning a capital allocation system that must fund something as staggeringly complex as an aggregate economy. Such regulations may also shift enterprises attention away from innovation and productivity enhancement towards lobbying (Krueger 1974). Furthermore, they have a record of not working well, and have been dismissed by some observers as relics of a policy ideology whose time has passed (Dornbusch 1998). Finally, such regulations may discourage the inflow of capital that provides a key incentive for engaging these markets in the first place.

Since 1997, analysts have become more skeptical about the development-related benefits of capital market integration. Attitudes towards capital controls have become more positive, particularly with respect to restrictions on short-term flows (e.g., Montiel and Reinhart 1999). Regulation has also become more topical given recent financial problems in the United States, which was itself a principle source of advocacy for the benefits of unfettered financial markets. Overall, there is a deep ambivalence about the use of regulation to steer financial market outcomes among policy experts. This uncertainty reflects the view that many forms of financial market regulation can be undermined, even while actors nominally adhere to the letter of its policies (Healy and Palepu 2003). Americans have shown an inclination to deal with financial problems by enacting policies designed to maximize transparency in financial reporting (like the Sarbanes-Oxley Act), although such redresses have been criticized as ignoring fundamental problems associated with financial systems that still leave much financial power in the hands of private actors and thus remain vulnerable to the systematic failing of *laissez-faire* systems (e.g., Soederberg 2008). A central problem with intervention is that policy is much less nimble than capital markets, and private actors can find a myriad of ways to circumvent them. Regulation nevertheless remains a practical option for coping with perceived problems in the financial system, given that governments can implement them unilaterally.

Financial Accumulation

A country seeking to forge its own counterweight to markets need not act against the basic logic of the market, but rather attempt to forge autonomy from markets through markets. *Financial accumulation* is a strategy in which countries acquire large reserves, and deploy these reserves to buy against market sentiment in times of financial panic. The idea here is that many strains are a product of herding behavior and panic about impending collapse. One way to insulate a country from the early onset of financial strain is to buy up excess supplies of one's own currency on markets, or, failing that, use reserves to finance strategically-important imports or debt obligations. This is a delaying tactic (B. Cohen 2006), and is premised on the idea that many strains are essentially short-lived, unless the momentum of a currency crash and extended crisis leads to sustained losses of faith in a country's currency. Should a government help its own currency weather the storms of a panic, other market actors might begin to speculate in favor of currency appreciation, or, failing that, governments are given the time to find longer-term bailout financing to start the process of financial recovery. This tactic is not likely to be sustainable over a longer period of time, as currency market turnover dwarfs most countries' capacity to hoard reserves. In 2005, daily global forex turnover was estimated to be $1.8 trillion (Bank for International Settlements 2005), while most countries bank less than $100 billion in reserves (International Monetary Fund 2008).

Reserve accumulation is typically explained as the result of currency sterilization, although time-series data suggests that reserve hoarding accelerated after the 1994 Mexican peso crisis, and rose rapidly after the 1997 East Asian Crisis (Cohen 2008). During this period, reserve holdings rose across the world, even in countries that were suffering from balance of payments deficits. In a recent study, I show that developing countries that have banked reserves experience faster economic growth, net of other commonly-cited growth determinants and the potential effects of currency sterilization (Cohen 2008). Reserve accumulation appears to be a strategy that pays off, perhaps by smoothing the chronic boom-and-bust cycles that have plagued economic development in the late-20th century, and much of the world's policy-makers appear to be cognizant of these benefits, given that such a wide range of countries have stocked reserves that are huge by historical standards.

A key benefit of this strategy is that it attempts to control the excesses of markets without violating the basic logic of the market. Banking reserves does nothing to threaten property rights, nor presents any problems to the original terms of investment in which capital first entered the developing world. It need not create calcified rules that distort economic allocation. Reserve banking is unlikely to attract the ire of the world system's most dominant players, especially the US, particularly because America relies on this reserve hoarding to sustain its own large budget deficits. Some argue that America's reliance on this reserve banking helps developing countries gain influence over US policy (Dooley, Folkerts-Landau and Garber 2003; 2004). This strategy may be a difficult option in practice for many countries, as it requires a form of savings from governments that are already hard-pressed to find financial surpluses. Furthermore, although there is some evidence suggests that it is effective, the strategy may face practical limits once it is seriously tested.

Cooperation

A fourth option for countries seeking insulation from international capital markets is *cooperation*, in which countries engage in a form of mutual insurance against capital market strain. The basic idea here is that individual countries may lack the reserves, regulatory power and other resources to contain the vast majority of strains on a currency, but their chances improve as their resources are pooled. Arguably the Bretton Woods Accord, which successfully contained capital market excesses for roughly two decades, was such an arrangement, whereby the victorious Allied countries pooled resources and capacities to ensure that financial pressure would not inordinately affect the Accord members' efforts to reform their economies after WWII. More recently, the European Monetary Union can be seen as a form of coordination, in which its countries jointly face strains to the Euro together, and do so within a governance framework that gives reasonable influence to smaller countries.

The Euro illustrates some of the benefits of coordination among strong players. Together, EMU members command large reserves, hold regulatory jurisdiction over many important private sector actors, and have been able to create a strong currency that commands a significant proportion (roughly one-third) of international currency market turnover. This last feature of the Euro is especially important, because the integrity of the global financial order is reasonably dependent on a stable Euro. Serious threats to this currency likely pose problems across the world system, meaning that it is likely that Europe would enjoy cooperation from a range of non-EMU countries, and perhaps major non-governmental actors, should a serious threat emerge.

Like any form of insurance, there exists the threat of a free rider problem, whereby a particular member feels empowered to make financially irresponsible decisions, like running large budget deficits, without worrying about the repercussions that would follow under independence, in effect passing the burden of monetary stabilization to others. Within the Euro framework, the imposition of financial discipline has been reasonably successful, to the point that it might encourage it in countries that might not pursue prudent policy if they weren't in, or aspiring to join, the Union. For other regions, particularly those with a history of chronically resorting to deficit spending or inflationary policy, like Latin America, it may not be as easy to find the political will to impose such discipline for the purposes of fortifying a mutual insurance pact, given that they often cannot find the will to insulate themselves.

Moreover, some regions are unlikely to be able to pool enough economic power and resources to effectively control markets' impact. Regions like Latin America or Africa are populated by financially-strained governments that hold regulatory power over relatively minor players in the global financial system. Furthermore, efforts to unionize have reportedly been met with opposition from the United States, for example in its opposition to the formation of the Asian Monetary Fund proposal after the 1997 East Asian Crisis (Kirshner 2006). Coordination among developing countries may represent a threat to US financial dominance, and that country may be willing to squash efforts that erode their influence if it is able to do so.

Even without formal pacts, there is a possibility that *de facto* coordination exists among some countries. Benjamin Cohen (2006) argues that, beyond the power to delay the effects of monetary strain, countries may also be able to defend themselves from shock by "deflecting" their impact by enlisting the help of other countries that are likely to suffer should the afflicted economic system collapse. For example, it seems unlikely that the advanced industrial countries would allow one of its own currencies to collapse, given the amount of interdependency that exists among them and the broader geostrategic implications of allowing a key ally to fall into critical crisis. America's rapid response to Mexico in 1994 suggests that, when confronted with a financial threat that could levy severe problems on the United States itself, that country is ready to help quickly. Although its tough bargaining with South Korea in 1997 may offer a counter-example, that country was ultimately given help and not left to the total collapse to which was Argentina was subjected in 2001. Other central banks have been quick to extend credit to the US during the present mortgage crisis. Coordination may be effective for wealthy countries, but has been difficult to implement elsewhere.

Dependency

There is a fine line between cooperation among mutually-defending countries and dependency relationships that act as a means by which powerful countries can coerce or exploit minor ones. *Dependency* is a monetary defense strategy in which an economically weaker country submits to bargaining terms largely drawn out by a larger power, in hopes that it will stabilize a financial system. Jonathan Kirshner (1995) offers comprehensive discussions of monetary dependency. Given that it is rare for countries in an economic pact to have the kind of financial parity that exists between, for example, France and Germany, one might expect any political arrangement at mutual defense may also provide stronger countries opportunities to wield power over smaller countries that depend on that pact.

Dependency can be a helpful strategy for coping with monetary strain, provided that these dependent relationships benefit (or at least not exploit) the weaker country. A transnational monetary relationship is rarely a clear manifestation of dependency or cooperation, as most official discourse will describe such relationships as if they were the latter, and may even be seen by its participants in such terms. There are clear examples of power plays that expose the vulnerabilities that can inhere in dependency relationships. Kirshner (1995: 121 - 140) offers an extended discussion of how 1930s Germany was able to exploit currency difficulties in Southeastern Europe to bind these countries to a stabilization plan that relied on the Reichsmark, thereby creating a sense of common economic fate among these countries and Germany, and perhaps increased economic and political influence from the former to the latter. Thacker (1999) presents evidence that countries are more likely to receive IMF help if they support the United States in other international political matters, like aligning their UN votes with America. Monetary politics is a tool of statecraft, and countries always try to pressure each other to advance their own geopolitical agendas. By embedding one's country in a dependency relationship, a developing country leaves itself vulnerable to such power plays.

Choices for Latin America and Eastern Europe

Financial pressures are a perpetual concern for governments, particularly during historical periods in which international capital is mobile and powerful, as is the case today. In our current context, in which the capitalist system is experiencing financial instability at its core, the prospect of turbulence seems especially strong. Governments in Latin America and Eastern Europe will have to find ways to buffer themselves in this environment. However, these regions face particular circumstances that influence the viability of different strategies.

In Eastern Europe, policy-makers have sought protection by embedding their systems in the European Monetary Union, and thus under the auspices of Western Europe's major continental powers. Such a solution presents gold-standard protection from market pressures, and presents a range of clear non-monetary benefits to member countries (e.g., lower transaction costs with Western Europe, a friendlier investment environment for enterprises that serve the Euro area, or the reduction of exchange rate uncertainty). Furthermore, the regulations governing Union membership encourage monetary discipline, thus conferring some of the benefits sought in the post-1980s pursuit of liberal incentivization strategies.

Here, the long-term concerns of such an arrangement are the other means by which such an arrangement ties the hands of government. The EMU can be a coordinative or dependency relationship, depending on the tenor of the policies taken by its central bank, which is itself constrained by the politics of its powerful countries. Such a change can occur in situations where the interests of the Union's core members see a divergence from those of the East. By adopting the Euro, Eastern Europeans are foregoing an ability to tailor monetary and exchange rate policies to suit the exigencies of the particular local pressures they face. In effect, adopting the Euro is a solution that foregoes governments' political control over the money system to combat a loss of policy autonomy on a broader range of policy issues due to pressure from a wider range of sources.

The lingering question here is whether Eastern Europe is entering another kind of Faustian bargain, in which it becomes entrenched in a system that ultimately does not treat the region's development as a key priority. The current situation of Italy is an instructive example, where that country could benefit from exchange rate devaluations to spur its struggling export sector. Under the EMU, Germany, France, Finland and Belgium have enjoyed enhanced competitiveness as a result of differential inflation, while price disadvantages have been accruing to high inflation countries like Italy, Portugal and Spain (Fischer 2007). This does not suggest that the EMU systematically disadvantages weaker or more financially-troubled countries. One can easily find policies that suggest embattled European countries are in a situation for which they are partly responsible. However, it does highlight the difficulties that can occur when a country is deprived of locally-responsive exchange rate and monetary policies. A second potential concern is the use of a monetary union as a vehicle for transferring economic burdens from strong to weak countries. For example, France and Germany have repeatedly breached the terms of the Stability and Growth Pact, and the EU repeatedly failed to implement the sanctions laid out by the accord (Annett and Jaeger 2004; Wypolsz 2006). In fact the EU's large countries have been the worst fiscal offenders in the Union, leaving the burden of fiscal discipline to its smaller, SGP-compliant members.

I do not wish to suggest that Eastern Europe should adopt a strong dose of Euroskepticism in matters related to money. In fact, most observers believe that the benefits of EMU integration are large (for example, improved within-continent trade) and that some of the stresses (like asymmetry of shocks) will diminish in the long-term (Frankel 2005). However, pure economics are not the sole determinant of central banking policy. Bretton Woods itself became mired in problems when the US used its monetary power to finance the Vietnam War, and local political currents in the core EMU countries have the capacity to pressure EU policy if a strong enough will develops. The point being made here is that integration into the Euro zone entails deep institutional changes that cannot be undone easily, and those that make the leap will have to remain cognizant of, and develop explicit economic *and* political strategies for, the dependency relations that will develop.

In Latin America, no such gold standard insulation from international market forces seems to be available. Monetary union – either among themselves or with the US through dollarization – looks like a poor option. The former choice, by many analyses, does not seem to make economic sense. Latin American countries do not trade much with each other, and different parts of the region experience an asymmetry of economic shocks, implying that there are few gains resulting from economizing on transaction costs and a unified response to shocks would probably always make someone unhappy (Belke and Gros 2002; Edwards 2006; Hochreither, Schmidt-Hebbel and Winckler 2002). The second option – dollarization – is likely to produce a monetary policy that is completely unresponsive to local economic conditions, and makes less sense as Latin America trades more with other countries. America's economy has little exposure to Latin American fortunes (except perhaps Mexico), and a long history of indifference to that region's development, compared with what seems to be Western Europe's current attitudes towards the East.

Barring any serious concerted effort to bring the real economies of Latin America together, that region's countries are forced to seek monetary autonomy on their own. Incentivization remains an important part of such a strategy, because the region generally lacks the public finances or robust trade sectors to forego foreign investment. Furthermore, financial governance in that region has been – and often continues to be – loose and in need of some sort of discipline. For some observers, finding ways to constrain monetary policy is paramount for the financial stabilization of Latin America (Mishkin and Savastano 2000). Some countries, notably Brazil, do look strong, and have been able to generally potentially strong export markets and accumulation Asian-style massive reserves. Others, like Venezuela, appear to be stuck in policies that led to the continent's financial demise in the 1980s.

In wide measure, Latin American countries have sought to deal with their problems through intervention, resorting to technically clever policy devices like flexible pegging or inflation targeting, and these policies are believed to have helped fight inflation (e.g., Corbo and Schmidt-Hebbel 2001). Latin America has never had a lack of economic expertise, and most cutting-edge strategies ultimately have a limited shelf life. A key question is whether the region's recent successes are context-dependent – a product of general calm in international capital flows and a global commodity boom – or whether these successes are the result of rock-solid strategies with real long-term viability. If we conceptualize this region's financial dealings as the product of economic power, rather than flows and balances, this region does not command the strength wielded by other middle-income regions. They remain economically dependent, although recent distancing from IMF or US export market reliance may be helpful. True autonomy probably requires political changes on a range of issues, like enhancing regional trade or fortifying individual national finances. This is hardly a new perspective, but the issues still remain pertinent.

More broadly, improved financial stability in the developing world could be helped by changing attitudes in the developed world. Often, there exists an implicit assumption – justified or not – that financial calamity and its associated political problems are attributable to victim countries. The sentiment is encoded in the language of monetary policy when we discuss "discipline", as if these governments were *gourmands* who need to stop gorging themselves, or unruly schoolboys in need of detention. This may be partly true, but it neglects the role that the rich world has played in fostering these problems – the 1982 debt crisis was prompted by irresponsible US private lending and the currency crises by narrow, US-mandated policy prescriptions , playing at least the role of an enabler of bad decisions, and these economic problems are likely contributors to governance problems.

In our quest for good governance in the developing world, developed countries (particularly the US) might do well to recognize that they themselves are likely to be stung by the private markets that they have done much to nurture, despite any assumption of fundamentally good governance here. Developing countries can be helped by genuine attitudes that government *can* be working towards their own economic good, and that bad policies there are often the byproduct of political complexities with which we have to deal here. If the First World genuinely wants to help the Third, its monetary policies might see some interest in providing more non-disciplinary help. The benefits of such an attitude could extend well beyond the economic, tempering negative attitudes towards globalization, the North or the US specifically. Doing so would rob bad governments of a tried-and-true scapegoat.

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