The WEA Conference

The 2008 economic Crisis Ten Years On

In Retrospect, Context and Prospect

Financial Mercantilism and Developing Countries

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Abstract

International financial markets are characterized by Financial Mercantilism, FM. There are many similarities between the operation of the seventeen century merchants and today financial intermediaries. Resorting to notions derived from history of economic ideas and in particular from Smith and Marx the paper identifies the features which characterize FM and which portray the role of finance in the present phase of the capitalist system. The paper describes the features of the mercantilist and of the financial reproduction cycle, where money, M, becomes more money, M'. The appropriation of this surplus is also discussed.
Some paradoxes of the present 'savings glut' and to the debate on 'secular stagnation' are also highlighted, these facts bring about serious doubts about the role of finance in stimulating economic growth. In particular FM is not the ideal setting to channel funds towards developing countries, which risk to repeat crises form the past..
The last to sections of the paper discusses the challenges facing developing countries when they need to resort to external funds to finance their development strategies and goals. Some indications on how to mitigate the possible negative impacts of Financial Mercantilism on financing for development are also discussed. In particular the paper contends that given the nature of today's financial markets development finance should take place with separate tools and dedicated markets.

Prologue

On July 2014 a 'vulture' fund Themis Capital and Des Moines won a case against the Democratic Republic of Congo which should now repay 18 million dollars of an original debt plus 70 million as interest(The Financial Times, 27th November, 2014). The debt had been contracted in the early 1980s by Mobutu, but Themis Capital was not among the original creditors, it bought Congo's debt years later at huge discount on face value, but now should be repaid at full nominal value. Congo has an income per capita of 430 dollars, 71.3 per cent of the population below the national poverty line and most of its people were not born when the debt was contracted.

1. International finance, 'secular stagnation' and some paradoxes

In 1985 the overall value of financial derivatives was slightly more than 1 trillion dollar, in 2007 overtook 600 trillion and after eight years into the crisis it is still an amount eight times higher than the world GDP. The causes of the enormous increase in International Financial Markets date back to the end of the Bretton Woods system based on the dollar exchange standard and to the increasing financial liberalization which has taken place since the early eighties.
The privatization of financial markets is linked to the economic policies adopted by Thatcher and Reagan. The year 1976 is a particularly significant year: the essay by Lucas starts with the so-called revolution of rational expectations (Lucas 1976) and a book by two economists of Oxford Bacon and Eltis which explains how the private market is always efficient and the unproductive state

(Bacon and Eltis 1976). It imposes a vision for which private individuals know the functioning of the markets better and the markets tend to be always efficient, the hypothesis of market efficiency contributes to profound changes in the economic scenario.
Hyman Minsky predicted the damage of uncontrolled finance because the world of finance is characterized by a systemic risk (Minsky 1974). The financial markets are characterized by periods of price increase, bubbles, which at a certain point break out and lead to serious crises. Developing countries have suffered many crises, but even high-income countries suffer from them. In September 1992, international speculation forced Italy, Spain and the United Kingdom to devalue with respect to the Deutsche Mark; the currency reserves of the three central banks were not sufficient to defend their currencies.
Since 2008 economic growth is quite weak in many High Income Economies even interest rates are very low. This has led to a debate on the so called *secular stagnation* hypothesis, following Larry Summers' reappraisal of this term[1]. Many explanations of this phenomenon focus on the relationship between savings and investment and the fact that due to an excess of savings the real interest rate needed to equate investments and savings at full employment level may be negative. This means that monetary policy becomes ineffective because due to low inflation and low nominal rates there is a floor, the so called Zero Bound Level, ZBL, for nominal rates (see Baldwin and Teulings, 2014, p.2.) which makes it impossible to reach negative rates. To put it in Keynesian terms it is as if the liquidity trap had become a permanent feature of the economy(see Krugman in Baldwin and Teulings, 2014, p.15). Major explanations for the increase in savings are related to demographic reasons (ibid. pp. 11-12, 14), and to an increase in life expectancy combined with lower population growth rate, the so called "ageing society"[2].
Here we have ***two paradoxes***.
Paradox 1. In Harrod's growth model a higher saving ratio, s= S/Y, leads to a higher warranted growth rate. In Solow's version provided S=I a higher s implies a higher income per capita in the steady state[3]. Now it seems that savings is the problem and might cause a growth slowdown; of course S > I because of the lack of investments, not of course in East Asia. I is low and S tends to increase, because of the role of finance in High income economies and also Middle incomes.
Paradox 2. The three countries/areas which are saving more are China, continental Europe and Japan, the one which saves less is the US, (see Blanchard O.J., Furceri D. And Pescatori A. 2014 p.104), however the economy is now growing faster in the US than in both Europe and Japan.
This suggests that the saving glut plus demography are not sufficient elements to explain secular stagnation; one has to look for a combination of both supply and demand side causes of the slowdown of growth rates in high income economies. There is a the need for huge investments in particular in infrastructures in both high income economies(see Caballero R.J. and Farhi E. 2014, pp. 118-119) and in developing countries where population is still growing(see Wolff G.B. 2014, p. 146).
That the world of finance is characterized by ***systemic risk*** is a well known fact not only in market practices but also in economics. The best description is in the work of Hyman Minsky, the author

[1] On the various explanations for secular stagnation see Baldwin and Teulings, 2014.

[2] These phenomena lead to an increase in the dependency ratio because of the raising share of pensioners; an older population requires more savings.
[3] According to Solow's model capital should flow to low and middle income economies, because of their higher profitability, as measured by the marginal productivity of physical capital.

who probably foresaw the potential damages of uncontrolled finance in the clearest way. His contributions date back to the mid seventies when the overall market for derivatives was still puny and the consequences of the abandonment of some of the Bretton Woods pillars were not yet evident(see Minsky 1974).

2. Mercantilism then and now

Thomas Mun was one of the directors of the East India Company and the father of the mature phase of Mercantilism, characterized by the so called *balance of trade system,* according to which a surplus in foreign trade is the main cause of national wealth. It is thanks to this surplus that precious metals flew into the country coffers[4]. Of course not all countries can run a trade surplus at the same time; Mercantilism is a zero-sum-game which leads to beggar thy neighbour type of policies.[5]
Both stagnating economies and structural imbalances are stimulating neo-mercantilistic and protectionist policies; nations fiercely compete on international markets(see also UNCTAD 2014, pp. 17-19, Rodrik 2017). The east Asian countries and China in particular are often regarded as the obvious culprits, mainly because of the keeping low and undervalued exchange rates, which have helped to sustain growth and to build current account surpluses and huge reserves.
The management of the exchange rate is only one among the possible policies to generate a current account surplus. Export subsidies and import duties are the traditional tools, but we also have selective credit systems, tax exemption on reinvested profits, domestic wages/incomes compression, subsidies to Research and Development, product standards etc[6].
A first feature of Mercantilism; *in today's world, where all economies are all so much interconnected, we could consider as neo-mercantilist all those polices which rely on exports and restrain domestic demand, if you prefer you can call it export-led.*
However, in order to better understand what Mercantilism is today we must not confuse it with the lack of competition on international markets. During the last thirty years there have been very strong newcomers in international markets, the so called emerging economies, in particular in East Asia, and we can say that many sectors are now more competitive than they used to be in the fifties sixties of the last century.
However, this has very little to do with the idea of competition characterized by a multitude of independent producers and by the possibility of new producers to enter the market; this is a *competition among giants*. In many sectors: from automotive, to finance, to capital equipment, to infrastructure procurement, to international finance there is a strong concentration of productive capacity, also through mergers and acquisition. At the world level these sectors are characterised by *oligopolistic competition*[7].

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[4] "….we must observe this rule; to sell more to strangers yearly than we consume of theirs in value."(Mun 1623?, p. 5). Mun goes on defending the role of trade with the *East-indies* (ibid. p. 7).

[5] One should not easily dismiss Mercantilism which has been a fundamental aspect of the modern history of Europe and from the seventeenth to the nineteenth century mercantilist policies have been very effective in determining the economic successes of countries such as England and the Netherlands. Mercantilist thought has been part of the establishment of the nation states in Europe. Moreover Mercantilism has been a fundamental phase in the building of economics as a science.

[6] Opposition to the free movement of people quite often complements neo-protectionist policies.

[7] Do not confuse Mercantilist policies with state intervention. In many cases mercantilist authors asked the sovereign to refrain from regulating trade, for instance in the case of an old law prohibiting the export of money(see Mun 1623?, pp. 34-36). These does not make them free traders;

A second feature of Mercantilism *is the alliance between big corporations and the state and not only in East Asia. Big international companies may even turn the functions and powers of the states to their advantage*[8].

This type of alliance characterizes the Mercantilist era and this is what worries Smith because it could lead to lower growth but also modify the nature of society. It is precisely against this type of association that Smith wrote *The Wealth of Nations*(see Smith 1776, book IV in particular).

This alliance could perpetuate and even enlarge the differences between the different market players, thus increasing imbalances instead of reducing them.

On one point recent economic events seem to contradict *Mun's rule* according to which the movements of capital flows depend on the sign of the current account. As we have seen on point *e* above, the evolution of the Euro-dollar exchange rate during the last six years does not seem to support this rule. Of course the current account does generate opposite movements in the financial (a better name than capital) account. However, these movements are only a minor part in the overall financial account; most capital flows are linked to Foreign Direct and to portfolio investments.

Paradox 3. This leads us to the role of international finance and somehow paradoxically brings us back to an earlier phase of Mercantilism the so called *monetary balance system* (see Rubin 1929, pp. 26 and 43-46), prevailing in sixteenth century Europe. According to this view financial flows were not just related to trade, but depended also on the reputation of the national currency: a strong currency resulting in net inflows. This is somehow similar to modern phenomena such as 'flight to quality' and the readiness to accept zero/negative interest rates on assets denominated in a currency which is regarded as a very good store of value.

3.Financial mercantilism and the M-M' conundrum

In the old days the merchant's gain derived from his ability to *buy cheap and selling dear* and the difference was his *profit upon alienation*. In order to achieve this gain the merchant had to move the goods in space and time, even if he did not physically produce a new product; in eighteenth century France corn had be transported from the countryside to the cities; in seventeen century England spices had to leave the Indies and to reach the metropolitan area. With their value chains transnational corporations do something similar and they also do generate new types of goods. In international finance where there is no need either to go through production processes or to move goods across time and space.

In Volume 1 of *Das Capital* Marx describes money as 'the medium of circulation' and he uses the script C - M – C to depict the simple circulation of commodities (Marx 1867, vol. 1: 106, 108, 146). A commodity, C, is exchanged against money, M, in order to buy a different commodity, C. Circulation opens and closes with commodities, specific use values; "the circuit M - C- M would be absurd and without meaning if the intention were to exchange by these means two equal sums of money" (ibid.:146). Marx provides a description of the Mercantilist version of circulation: "M-M', money which begets money, such is the description of Capital from the mouth of its first interpreters, the Mercantilists" (ibid.: 153). A few lines later Marx writes that in the case of "interest-bearing capital, the circulation M - C - M' appears abridged. We have its results without

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the real issue is that they were able to influence the state to adopt or not to adopt those policies and strategies which were more favourable to national merchants. The overall mercantilist period is more complicated than its traditional representations.

[8] The term state indicates also the international bodies and organizations where individual nation states have different powers and can thus influence their decisions.

intermediary stage, in the form M - M', '*en style lapidaire*' so to say, money that is worth more money, value that is greater than itself" (ibid. italics in the original).[9]

Monetary-capital is not just a medium of circulation because it aims at a surplus-value: M - C- M', with M' = M + ΔM (ibid.:149). The exchange values rule the Mercantilist reproduction cycle, **mrc**, but the decisive element is the surplus value ΔM. The Financial reproduction cycle, **frc**, too aims at M' > M. Let us examine the similarities and differences between the two cycles.

The gain of the merchant derives from his ability to buy cheap and selling dear; in order to achieve this gain the merchant moves the goods in space and time. In eighteenth century France corn was transported from the countryside to the cities; in seventeen century England the spices of the Indies had to reach the metropolitan area.

In international markets investors behave like modern mercantilists, who gain on the difference between the selling and the buying price of any financial product. There is no need either to go through the production processes or to move goods across time and space. Capital gains are a typical example of buying cheap and selling dear a certain type of financial product. Of course when M' < M there are losses and bankruptcies. Systemic risk is there also for the big players.

Space is relevant only in so far as different financial markets are specialized in different types of products. The City of London is home to the largest foreign exchange market; financial centres apply different regulations and laws to similar products: to issue a bond in London goes under a different legislation than issuing it in Wall Street.

Time is much more relevant; financial 'products' are basically forward contracts, sort of bets, that is to say commitments to buy and to sell at some future time, at a certain price and may be conditional on some events. These are immaterial commodities, which can transfer wealth and income and make people either richer or poorer.

Mercantilists' profits depended on the quality of the product and on its locations; now profit depends upon the time of buying and of selling any type of financial product. Financial operations are quite fast and agents' behaviour is characterized by short-termism.[10]

In the age of Financial Mercantilism the separation between short-term and long-term operations is blurred. A ten years bond is long-term but it is both sold and bought in a continuous way. In the 'secondary market' long-term bond are just financial products. This is particularly dangerous for developing countries and emerging markets whose bonds usually bear a higher interest rates than those of high income economies. The search for high yields can bring in a lot of capital inflows which however will not necessarily stay for the entire maturity of the bond; in the case of a perceived crisis long term flows can always leave the country.

Pension funds have a long-term contract with their clients who save now in view of more consumption capacity in the future. However, in order to guarantee a future income to their customers the pension funds must continuously shift savings across different types of investments, in order to yield an annual return at least similar to those of their competitors.[11]

[9] These quotations are from the final page of chapter IV -*The General Formula for Capital*- of Part II- *The Transformation of Money into Capital*- of Vol. 1 of *Capital.*

[10] Short-termism is not just a feature of financial operators, but it seems to become a rather pervasive behaviour by corporate manager and some authors speak of short-term capitalism (Mallaby 2015).

[11] Returns play an important role in the decision of portfolio differentiation, but expectations about possible gains/losses are the decisive element in the considerations about buying and selling.

Money cannot rest, it must endlessly move throughout different markets and different financial products in view of a positive sign in the balance sheet.
Financial markets are characterized by a ‘zero sum game’, but they change the distribution of income and wealth, they can enrich people and depress countries.
All this takes place without going through either the production process or transportation and storage.
Not only international financial markets are characterized by price fluctuations; volatility of prices of financial products is also at the origin of the difference M’-M, it is a necessary condition for the existence of surplus-value. A higher volatility amplifies the opportunities of speculating on the difference between the buying and the selling price.
In the financial reproduction cycle, **frc**, there is a separation between the realms of use and of exchange value and the latter dominates. In Financial Mercantilism it is not necessary to go through commodity production in order to achieve a surplus value, we have:
M => **M’**.
But how can you move from money/capital to more money/capital? How can money beget more money? How is it possible to have “value that is greater than itself” “without intermediary stage” (Marx 1867, Vol. 1: 153)? An “intermediary stage” is still there and it is hidden behind the arrow. For the economy as a whole the elements inside square brackets are still there, physical and social reproduction must be secured; thus **frc** is better represented as:
M => [*L, La, K&T, Trade, Finance* => *Y*] => M’ (1)
The items inside square brackets, the concrete inputs and outputs can be objects for speculation, they are potential elements of ‘derivative’ exchange values, in particular considering expectations about their trends. But the crucial issue is that financial investment decisions are taken with no consideration of the specific use values involved and of the sustainability of society. In finance the exchange value is both the starting point and the goal.[12]

4. The surplus value and the centralization of power
There is still one question Marx would ask: how is the surplus-value ΔM appropriated? The answer can be found into the second feature of Mercantilism: the concentration/centralization of market power into the hands of few big players. In the old days it was the British East India Company; in our days it could be the overwhelming power of big international investment banks. As in the case of transnational corporations this situation violates free competition, because it generates ***huge imbalances among the different market players***. It is thanks to this superior power that the ‘merchants’ can twist the markets to their own interests.
There are at least three ways in which the largest financial organizations can manipulate the markets:
- asymmetric access to informations,
- lack of transparency in many financial products and contracts,
- some investment opportunities, usually the most lucrative ones, are accessible only to investors which have large amount of funds. Small is not so beautiful.

[12] The situation is similar that that described by Smith, for whom wealth derived from a natural order of investments: first in agriculture, then into the manufacturing sector, thirdly in domestic trade and finally into foreign trade (Smith 1776, II.v). The Mercantilists wanted to overturn that order.

The capitalistic and financial reproduction cycles are not separate entities but can combine in several ways.[13]

Inside the square brackets of (1) there is also a capital **P** which synthesizes the different ways in which market and political powers affect the production and distribution process. These powers are differently distributed among people and countries, therefore **P** is not a neutral ingredient; there are large imbalances in particular when decisions have to be taken about investments: what, how much and how to produce.

5. International finance and developing countries[14]

The age of Financial Mercantilism creates severe problems to developing countries. On September 2015 the UN General Assembly approved a resolution sometimes called Agenda 2030, with 17 Sustainable Development Goals, SDGs, to be attained by 2030. The achievement of the SDGs could require hundreds of trillion dollars. Financial flows to developing have greatly increased since 2000, in particular Foreign Direct Investments and remittances, but also Portfolio flows. A lot of the money seems to be available in financial markets.

However Since the eighties developing countries have experienced repeated major *financial crises*; to recall just the major ones: the debt crisis opening up in august 1982 with Mexico default, to Mexico (again) in December 1994, to the Asian Crisis of June 1997 to Argentina in December 2001[15].

Most of these crises were related either to defaults on commercial loans and on sovereign bonds or to the so called financial bubbles. All crises were characterized by previous huge capital inflows mainly because of either the higher interest rates offered, or the higher returns on equity investments.[16]

International financial markets should favour a better *allocation of resources* at the world level. The easier to move capitals across border the better because a larger set of financial investment opportunities should help to allocate capital in the most efficient way. Financial markets should bring savings where they are lacking and hence most needed and were they can also generate higher returns. All this follows the so called market efficiency hypothesis. International financial markets should help to increase the average world growth rate and to speed up the closing of the gap between low and high income economies; however there are serious doubts that more finance implies more growth(see for instance Arcand *et al* 2012).

Paradox 4. However East-Asian economic growth is largely explained by a combination of export–led growth, industrial policies and huge accumulation of physical capital. Capital accumulation has largely relied on domestic savings with investment ratios in the order of 25-30 per cent since the sixties; China has reached 45 per cent in 2009-2010. Not only these investments are obviously long-term, but they are largely based on self-financing by firms through reinvested profits. In the

[13] The debate about the relationship between financial and industrial capital dates back to Lenin and Hilferding(Marois 2012).

[14] A longer ananlysis of development finance is n Vaggi 2018.

[15] Between July 1998 and December 2000 Russia, Brasil, Turkey and South Africa have been hit by various types of crisis.

[16] Another debt crisis cannot be ruled out, in particular for LDCs(see Eurodad 2014 p. 16).

Japanese and Korean experience one could speak of a fundamental profit-investment nexus(see UNCTAD 1996) which has largely by passed International Financial Markets[17].

There is a large consensus that LDCs and LICs should proceed through ***a process of graduation*** from benefiting only from concessional flows to the access of International Financial Markets. This could imply moving from grants to fully concessional loans, to blended finance etc. These countries should make maximum use of *not-fully market instruments for development finance* and the whole process should be gradual and carefully monitored. Moreover this implies a careful use of countries classification based on income thresholds(see Kharas et al. 2014, p. 25), for example for access the to the World Bank IDA financial window. In practice it might be very difficult to strictly follow this route and it requires a continuous dialogue between countries and International Financial Institutions.

The lesson from the various *financial crises* of the eighties and nineties is that the ability of a country to react to a crisis rests mainly with its productive structure. Severe capital outflows are difficult to resist and can easily lead to exchange rate depreciation. But depreciation can work, in the sense of restoring international competitiveness improve the trade and current account and hopefully restart a process of economic growth, only if the country has the ability to produce and then sell products which are in high demand on international markets and possibly include value added. Following a 45 per cent depreciation of the won between November 1997 and April 1998 South Korea was able to pay back the IMF at the end of 1999 and in 1999 went back to a growth rate in the range of 5 per cent.[18] Depreciation worked because South Korea's export composition was apt to take advantage of price competitiveness in the production of commodities which were, and still are, in high demand on international markets.

6. Separate markets for development finance

Bonds represent by far the largest share in derivative markets, with more than 500 trillion dollars and bond markets can be highly volatile and generate a lot of economic instability. There is a growing interest in bonds of developing countries including countries in Sub Saharan Africa, where sovereign bond issuing has grown to more than 6 billion in 2014 bringing the overall total to more than 18 billion. 14 countries, both commodity exporters and not, have issued bonds most of them denominated in US dollars(see Tyson 2015 I, pp.3-5 and p. 19 for the countries involved)[19]. All these type of bonds are below investment grade. Most of these issues are managed by a lead underwriter which usually is a global investment bank and it could not be in any other way(see Tyson 2015 I , p. 6).[20]

Developing countries are exposed to all three major types of risk in the case of foreign debt: interest rate, currency, liquidity. I would had also country instability and in the case of commodity exporters price volatility of commodities in international markets.

[17] Solow thinks that it is "time to rethink the way the credit mechanism mediates between savers and investors and puts credit to productive use" IMF *Finance and Development* of June 2011, p. 51.

[18] Malaysia, Thailand and the Philippines followed similar patterns, but the crisis was much deeper and longer in Indonesia(see Vaggi 2002).

[19] Tyson 2015 I and II provide an exhaustive analysis of the different types of issuances and of the related problems, many points are derived from the two papers.

[20] The debt to GDP ratios of these countries are relatively small in the range of 40%(see Tyson 2015 II, p. 6) much lower than those of the eighties and nineties before debt restructuring and debt conversion initiatives HIPC and MDRI.

Bond financing is apparently long term, but in the time of Financial Mercantilism these money can easily leave the country. Even in the case very long-term bonds international markets are dominated by the search for capital gains and not only by the search of higher yields deriving from longer maturities and riskier products(see Moore in *Financial Times* 19, march 2015, p. 22) [21].
Ghana, Kenya Tanzania and Ethiopia already had to delay or cancel issuances because of expected interest rates increase when in early 2014 the Federal Reserve announced to so called "tapering". Sub-Saharan African countries do also experience capital flights following the opening of the capital account(See Tyson 2015 II, p. 8).
Flexible exchange rates are no shield against sudden deterioration of the country risk perception by financial markets. A prudent *management of capital inflows* and of the capital account in particular, with policies designed to favour the really long term ones and to penalize short term flows could help(see IMF 2011b)[22]. Chile Malaysia are examples of rather successful adoption of these types of policies in the past. Warnings about the risk of excessive borrowing by African countries come also by Rashid and Stiglitz 2013[23].
The Experts on Sustainable Development Financing ask for an enabling international environment that among others "remove the sources of international financial volatility" and strive "to reduce global financial fragility"(UN-ICESDF 2014, p. 40). They also request financial markets regulations(see *ibid*., pp. 27, 34).
Regulations are certainly useful but for many developing countries it would be much easier if in international finance there could be a separation of commercial from speculative activities. If Development Finance could enjoy *ad hoc* markets, procedures and laws that would reduce instability and volatility and the risks of default.
Financial markets have become so speculative, so much oriented to capital gains and guided by short term horizon. All the three features which are at the opposite of long-term development.
The idea of having separate markets for LDCs and LMICs issuing bonds resembles the separation between the operations of commercial banks and those of investment banks which was introduced in 1933 with the so called *Glass-Steagall Act* and has been repealed in 1999 by the American Congress with the approval of the *Gramm-Leach-Bliley Financial Services Modernization Act*. Following the financial crisis of 2007-2008 the *Dodd–Frank Wall Street Reform and Consumer Protection Act* of July 2010 has introduced many forms of controls and regulation to speculative finance, but it has not recreated that separation. The closer that we come to this separation is with the so called *Volcker rule*, which is trying to prevent United States banks from making speculative investments with the deposits of their customers. But the content of the rule has been diluted and its implementation delayed.

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[21] A simulations in ERD 2015 suggests a negative impact of "tapering" on GDP growth in SSA of 0.8% (see ERD 2015, p. 139).

[22] Eurodad 2014, p.10 too asks for provisions for capital account regulations; see also Tyson 20015 II p. 11.

[23] In an interview to *Finance and Development* Stiglitz notices that "cross-borders flows can be very destabilizing" and that lacking a global regulatory system countries should protect themselves(IMF 2011, p. 51).

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