1. Introduction

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BACKGROUND TO THE VOLUME

Many observers thought that the financial crisis of 2007–08 would be a watershed moment in global finance. They believed the crisis would demonstrate, once and for all, the instability and inefficiency of this hyper-speculative global financial system, and finally bring an end to the destructive “neoliberal moment” and its “Washington Consensus” dictates in domestic and global economic policy (see, for example, Blanchard, Dell’Ariccia and Mauro, 2010). But, something surprising happened to “neoliberal financialization” on the way to the “dustbin of history”: it escaped. Financial deregulation and “neoliberal” populism in finance are in the ascendant in the United States and elsewhere, and the bankers are laughing, well. . . all the way to the bank.¹

To be sure, there are important cracks in the old free market consensus on international financial issues. These cracks are leading to what Ilene Grabel (Chapter 5, in this volume) calls “productive incoherence” in theory and practice, which is leading to important opportunities for policy change in some areas. But, in many other areas, the old theories and practices are being resurrected after near-death experiences in the period following the crisis.

This raises a number of important questions in the political economy of international finance. What are the important cautionary lessons from the crisis of 2007–08 that we must remember if we are to push back against a repeat of this unfortunate history? At a deeper level, what are the underlying economic and power structures that allow these destructive practices to survive and thrive in the aftermath of such a catastrophic meltdown? How do these underlying structures affect different nations differently, and why? Moreover, if the underlying forces of instability and inequality are continuing, how can countries manage these destructive forces and not be drawn into the whirlpool of instability, as afflicted many countries during the Global Financial Crisis?

In this volume, the authors address these questions mostly from the perspective of the so-called “emerging market countries” and other countries

at the “periphery” of the developed capitalist economies. In doing so, they study these countries with lenses not often utilized by economists: they analyze institutions and power relations – in addition to economic forces – to understand the experiences, constraints, and opportunities facing countries as they try to navigate the riptides of global finance.

The title of this volume – *The Political Economy of International Finance in an Age of Inequality: Soft Currencies, Hard Landings* – reflects two key, related aspects of the “political economy” of international finance: the structures of inequality that both undergird and result from the relations of international finance; and the important distinction between soft and hard currencies that is a central aspect of these structures of inequality. “Hard currencies,” in contrast to “soft currencies,” can easily be used to buy goods, services and assets from virtually anyone in the world. Soft currencies can be used primarily only in the country of issue, and must usually be exchanged for hard currencies for buying foreign-owned goods, services and assets. It turns out that this distinction puts people and institutions from developing and emerging countries at a significant disadvantage in the global economic and political arenas. *Soft Currencies, Hard Landings* explores numerous examples of this disadvantage.

With respect to inequality, it is well known that income and wealth inequality have been dramatically on the rise in the last several decades, even as poverty levels in some key developing countries have dramatically fallen (Milanovic, 2016; Saez et al., 2018). The causes of this rise of inequality are diverse, though not completely understood. Still, it is safe to say that they partly result from deep underlying structures of inequality embedded in the global architecture of international economics, including international financial relations (Akyüz, 2017). In this volume, we identify a number of those key structures and show how these can lead to inequality as well as instability.

This inequality stems from four aspects of current-day international finance: the scale and complexity of international financial transactions; their concentration in a relatively small number of banks and other financial institutions; the prominence of a handful of international currencies – primarily the US dollar – at the center of these transactions; and inequalities in military and underlying economic power that, in many ways, lie at the very foundation of this edifice. A key implication is that this structural architecture gives oversized economic and political power to a relatively small group of international banks and financial institutions and to institutions and policymakers that control the supply of and access to hard currencies (primarily US dollar assets).² And it means that those soft currency countries without easy access to these hard currencies are at a profound structural disadvantage in the global

financial system: they must rely on a handful of countries and financial institutions for credit that they can use internationally, for reserves that they can use to manage their exchange rates, and for access to currencies for international transactions of all kinds (Ocampo, 2017; D'Arista, 2018).

Scale and Complexity

Estimates of the size of international financial markets are so large they are either dumbfounding or mind-numbing. The Bank for International Settlement's most recent estimates for the amount of trading in foreign exchange indicates that in 2016, an average of \$5.1 trillion dollars in foreign exchange traded hands *daily*, and this figure is actually *down* from \$5.3 trillion three years before. To take another huge number: the Bank for International Settlements (BIS) estimates that that amount of credit given by US banks alone to borrowers outside the United States has exploded from \$2 trillion in 2000 to over \$10 trillion in 2017 (BIS, 2017). By comparison, US gross domestic product (GDP) in 2016 was about \$18 trillion.

But even this huge number is likely to be an *underestimate* of the total credit lent by creditors in general and US financial institutions in particular across borders in recent years. As with evolving estimates of the number of planets and moons in the universe, estimates of the size of the international financial system keep growing as researchers generate measures of massive numbers of "missing" transactions that had not been accurately seen or measured before. As a recent study by researchers at the BIS explains:

Every day, trillions of dollars are borrowed and lent in various currencies. Many deals take place in the cash market, through loans and securities. But foreign exchange (FX) derivatives, mainly FX swaps, currency swaps and the closely related forwards, also create debt-like obligations. For the US dollar alone, contracts worth tens of trillions of dollars stand open and trillions change hands daily. And yet one cannot find these amounts on balance sheets. This debt is, in effect, missing. (Borio, McCauley and McGuire, 2017, p. 37)

Borio and colleagues estimate that the credit generated in these "hidden" markets add more than \$10 trillion to balance sheet debt of institutions in the global economy, much of this denominated in US dollars. Of this, lending to so-called emerging market countries has grown significantly since the Global Financial Crisis (BIS, 2017). The size and complexity of this arena has a number of important implications, including the difficulties in monitoring and managing these markets, and the large impacts they can have.

Concentration and Market Power of a Small Number of Large Financial Institutions

This last point about hidden credit in the forms of swaps and other derivatives stems from the complexity and opacity of many international financial transactions. Complexity and opacity, in turn, facilitate both the accumulation of power and profits by institutions that can profit from this complexity and opacity (Crotty, 2017). The sale of complex financial instruments such as credit default swaps, are highly concentrated among a few large international banks who are able to make substantial profits by controlling these markets. Only huge banks with large amounts of assets on their balance sheets can manage and finance these complex and opaque debts. Moreover, in a dynamic feedback loop, the opacity and complexity of these markets feed the profits of these few massive financial institutions.

Dominant Role of a Few Hard Currencies and the Power of their Central Banks

The size and power of these private financial institutions, mostly headquartered in the center countries, is greatly facilitated by the government institutions – and especially the central banks – that have the capacity to create an extremely large – some say an unlimited – supply of hard currency, to undergird the operations of these financial institutions and their supply of hard currency credit.³ Among these hard currencies, there is one – the US dollar (and its central bank, the Federal Reserve) – that stands supreme. As the most recent BIS triennial survey of foreign exchange trading shows:

[t]he US dollar held its place as the dominant currency – it was on one side of 88% of all trades in April 2016. The euro remained the second most actively traded currency, but its share fell to 31% in April 2016, well below its peak of 39% in April 2010. Many emerging market currencies saw an increase in their share of global trading. The renminbi's share doubled to 4% as it became the world's eighth most actively traded currency. (BIS, 2016a, citing BIS, 2016b)

This dominant role of a handful of hard currencies, and especially the US dollar, is the third component of this underlying structure of inequality that profoundly affects the workings of the international financial system. For one thing, as recent research has shown, the interest rate policies of the Federal Reserve have an outsized impact on international economic trends (Rey, 2015; Avdjiev et al., 2018). In addition, as mentioned earlier, soft currency countries must gain access to these hard currencies to import needed goods, to manage their exchange rates, to finance key investments,

to diversify their financial portfolios. This dependence on hard currencies places these countries' governments, households and businesses in a subordinate economic and political position in the international financial system. And they provide privileges to hard currency country banks and financial institutions. This privileged connection was made clear, for example, in the Global Financial Crisis when the Federal Reserve used its ability to create dollar credit out of "thin air" to bail out the large US financial institutions that had got themselves – and the world economy – into severe straits with their toxic behavior. This dollar-based bailout allowed these banks and bankers to maintain their central role in the global financial system.

Importantly, the Federal Reserve not only bailed out US banks; it also lent dollars freely to foreign central banks so that the large European banks that had made terrible dollar-denominated bets on the US housing bubble, could also be bailed out. In other words, the US Federal Reserve acted as an "international lender of last resort" (ILOLR) (D'Arista, 2018; Dutt, Chapter 7, in this volume).

Political and Military Power and the Structure of International Finance

This point about the role of the Federal Reserve as an ILOLR introduces the fourth aspect of the underlying international financial structure: inequality in military and political power in the global economy. This fourth aspect both underpins and results from global inequality. Asymmetries in underlying military, economic and political power in the world system and how the dominant country/countries choose to exercise their superior power are crucial. Mainstream economists mostly ignore these issues. There is, however, one "entry point" that the famous economic historian Charles Kindleberger introduced to the profession. In his important study of the causes of the Great Depression of the 1930s, Charles Kindleberger introduced the economics profession to the concept of "hegemony."⁴ His thesis, now hotly debated, argued that the international financial system needs a hegemonic country to remain stable, because these systems are fundamentally, inherently unstable. According to Kindleberger's (1973) argument, the Great Depression was caused by an interregnum between hegemons – when the British were no longer powerful enough to manage the international financial system, and before the United States became politically willing to take over from the British. From this perspective, it matters greatly how the "hegemonic" government and central bank behave.⁵

International finance economists have not sufficiently generalized Kindleberger's argument, which is fundamentally about the role of power in the structuring of the international financial system. That is, underlying

the international financial system is a structure of power that has profound impacts: for example, it can increase inequality, or it can reduce it. It can contribute to international financial stability or to instability. As Francisco Perez argues in Chapter 11 in this volume, hegemons can be “good” in the sense of contributing to equality and stability of the system, or they can be “bad” hegemons, doing just the opposite.

The role of military and political power in the structure of international finance is pervasive and is explored by a number of the authors in this volume. Even the existence and certainly the pervasiveness of international financial markets, operating across national borders with no international courts to adjudicate contracts or global military force to enforce property rights, illustrates the tenuous underlying structure of international lending and borrowing (Epstein and Gintis, 1992). In this world, international lending and borrowing depend on other mechanisms to enforce contracts and ensure repayment. In older times, gunboats from the dominant creditors were an important enforcer. These days, subtler, but no less effective means, emanating from economic and political threats from the leading financial and governmental institutions, take the place, for the most part, of gunboats. But, as Majd and Arora show in Chapters 9 and 10 respectively, military and political power of creditors to protect property and contract are never that far from sight.

OVERVIEW OF THE BOOK

Part I: Capital Flows and Financial Crises

In the previous section, we have seen the mindboggling size and discussed the complexity of current day financial markets. This size and complexity were reflected in the highly destructive Great Financial Crisis of 2007–08. (Wolfson and Epstein, 2013; Akyüz, 2017; Ocampo, 2017; D’Arista, 2018; Tokunaga and Epstein, 2018).

As Elissa Braunstein shows in Chapter 2, “Financial crises among emerging and developing economies in the modern era,” these large and highly speculative markets can create large problems for “emerging and developing economies” (EDEs). Braunstein sets the stage for the *Soft Currencies*, *Hard Landings* with an overview of the nature of capital flows and their impacts on financial instability and crises in developing countries in the last several decades. Braunstein shows that these capital flow “bonanzas” as she calls them, are much more likely to have caused financial crises than other culprits often identified by neoliberal economists and policymakers – such as government regulations or budget deficits. Though

not all countries receiving capital inflow bonanzas experience financial crises, they make having such a crisis much more likely.

Nina Eichacker, in Chapter 3 “Too good to be true: What the Icelandic crisis revealed about global finance,” details a particularly devastating example of global finance gone wild. As Eichacker shows, some of the standard suspects such as corrupt bankers and politicians played important roles in the drama, but there were also fundamental political economy forces driving excessively risky and unsustainable capital flows into Iceland. Neoliberal ideology was also to blame, with exceptionally “rosy scenarios” being drawn by key mainstream economists.

In Chapter 4, Khalil reminds us that financial crises, such as the Great Financial Crisis, can have very different effects on different groups. Contributing research to a hugely understudied subject, Khalil analyzes “the gender-specific effects of the Great Recession” on the OECD countries. This is an example that relates clearly to the subject of our volume: *The Political Economy of International Finance in an Age of Inequality*. Khalil’s study raises key questions about a common interpretation of the recession following the financial crisis as a “mancession,” that is, that it affected men more than women. Khalil shows that the negative impact of the recession on women was in fact much more severe than most analysts have realized. Her chapter makes a significant contribution to this important but woefully understudied area in international finance.

Part II: Managing International Capital Flows: Costs and Dilemmas

The chapters in Part I detailed some of the large problems and costs experienced by countries as a result of financial instability and financial crises stemming from international financial flows. Naturally, as a defensive measure, governments try to manage and protect themselves from the negative consequences of these flows. The tricky part, however, is that many of these governments want also to try to *benefit* from these capital inflows. Finding the balance that works and the tools to achieve this balance is difficult as the authors of the chapters in this part of the book show.

Ilene Grabel, in “Capital controls in a time of crisis” (Chapter 5) describes an important tool that countries can use – capital controls. As Grabel describes, developing and emerging market countries have not had complete freedom to choose whether they use this valuable tool to manage flows. Because of their historical dependence on hard currencies and their desire to attract loans and investments from abroad, they have depended on the approval of international investors to attract credit (Epstein and Gintis, 1992; Akyüz, 2017; Grabel, 2018). Typically, getting this approval

depended on the “blessings” of the International Monetary Fund (IMF). The focus of Grabel’s chapter is the evolving view of the IMF toward capital controls. In a fascinating analysis, Grabel shows that, while for years the IMF was adamantly opposed to the adoption of controls by developing countries, with the financial crisis came a re-evaluation of the role of controls and a complex, grudging acceptance of them. Grabel describes this important evolution and calls it an example of the “productive incoherence” of current policy views at the IMF in particular and among mainstream economists in general.

A more common tool that developing countries have adopted to help them manage the massive flows of global finance is the accumulation of hard currency reserves. The idea is that governments can use these reserves – usually controlled by their central banks – to manage their exchange rates, and to make it less likely that they will have to turn to foreign institutions, including the IMF, for help in a period of crisis. Two chapters in Part II address the possible benefits and costs of holding on to such large amounts of foreign exchange reserves.

In “Easing the trilemma through reserve accumulation? The Latin American case” (Chapter 6), Luis D. Rosero takes a new look at the impact of reserve accumulation by emerging market countries in Latin America on exchange rate stability and crisis vulnerability. As Rosero details, economists and policymakers have claimed that foreign exchange reserve accumulation has significant stabilizing benefits for emerging market economies. But with a series of statistical exercises, Rosero casts significant doubt on the existence of these benefits, at least in the case of Latin America. Importantly, he shows that the one exception to this negative verdict is for countries that accumulate an extremely large trove of reserves.

But, as Devika Dutt shows in Chapter 7, “The costs of foreign exchange intervention” (Chapter 7), the holding and utilizing of reserves to stabilize exchange rates can be very costly for developing countries. Together, Rosero’s and Dutt’s chapters demonstrate that hard currency (foreign exchange) reserve holding is no panacea for soft currency countries.

Interestingly, Dutt’s chapter also links up with the issues of the political economy of access to support from the center countries. She shows evidence that suggests that countries that have access to ILOLR help from the Federal Reserve face fewer costs in terms of managing reserves. This implies an asymmetric power relationship between the key central banks and these developing countries relative to countries that do not have access.

In the final chapter of Part II (“Monetary policy under financial dollarization: The case of Eurasian Economic Union,” Chapter 8), Zhandos Ybrayev discusses another way in which countries deal with the hard currency/soft currency dilemma: their countries become “dollarized,” that

is, the hard currency is used domestically as money. He shows that a high degree of financial dollarization can create difficulties for these countries. In his chapter, Ybrayev studies the case of the Eurasian Economic Union countries and specifically looks at the impact of dollarization on the ability of these countries to conduct monetary policy. He also looks at whether inflation targeting monetary policy is a useful tool to manage dollarization.

As these chapters show, there are various policy tools that developing and emerging market countries can utilize to help them deal with the massive and destabilizing financial forces emanating from the global financial markets. But none of these policies come without significant costs and none is fail-safe. As long as countries want to try to attract financial flows, they might have to make significant sacrifices (see also, Epstein and Gintis, 1992; Akyüz, 2017; Ocampo, 2017).

Part III: Power Relations in the International Financial System: Global and Regional Dimensions

This final part of *Soft Currencies, Hard Landings* explores the underlying inequalities in political and economic power that structure the financial relationships examined in the previous two parts of the book.

In “The cost of a SWIFT kick: Estimating the cost of financial sanctions on Iran” (Chapter 9), Mariam Majd analyzes the costs of raw economic and political power as can only be exercised by a hegemon. In a very original study, Majd examines the unprecedented US financial sanctions imposed on Iran in 2012. They required that Iran be blocked from using the Society for Interbank Financial Telecommunication (SWIFT) payments platform which is a crucial infrastructure for making and receiving international financial payments. Though touted by the United States as a form of “smart sanction” designed to hurt elites without harming the general population, Majd finds that these sanctions had very large economic costs to the whole country. This raw and asymmetric power through which financial transactions are structured can be utilized for political ends by the dominant countries, and also helps to further these countries’ economic and political dominance. However, populations in less developed countries can suffer under these circumstances.

In the second chapter of Part III, Mohit Arora pursues a similar theme. In “Changing rules of the game of global finance: Glimpses from Argentina’s sovereign debt restructuring” (Chapter 10), Arora explores the political economy of international debt contract enforcement and its recent evolution, using Argentina as an example. Arora describes the problems of debt enforcement in the international arena. Because of the general absence of an international court of law with enforcement powers

(so-called “exogenous enforcement”), the international financial markets have resorted to other mechanisms of enforcement, which have involved the exercise or threat of exercise of power by powerful financial institutions, or powerful governmental or quasi-governmental entities, like the IMF, or creditor governments. In the nineteenth century and earlier, such force or threat of force was usually backed up by military might – “gunboat diplomacy”; in more recent years, by threats of economic or financial sanctions by creditors, their governments and/or their agents, like the IMF.

Arora then outlines the attempt by powerful creditors to create legal, rather than diplomatic or military, contract enforcement mechanisms, in the recent case of Argentina’s debt restructuring. Focusing on the successful action by so-called “vulture funds” to get full repayment through the New York courts, Arora describes the costs that this kind of “exogenous enforcement” can impose on debtor developing countries. Arora notes that, given these costs, it is hard to see how such “exogenous enforcement” could work to the benefit of the debtor countries.

The final two chapters in *Soft Currencies, Hard Landings* look at the underlying power dynamics in currency unions. Currency unions are an attempt by countries to join forces to create a larger economic and political entity to help stabilize financial and monetary relations and exchange rates. These are attempts to create cooperative financial relationships among countries as a possible solution to some of the difficult problems, such as financial instability, that can arise in market-based international financial flows. In “Solidarity vs similarity: The political economy of currency unions” (Chapter 11), Francisco Perez takes a unique and insightful look at three attempts at the creation and sustenance of common currency unions: the Eurozone, the African Currency Union, and the East African shilling. In this original and insightful chapter, Perez examines with fresh eyes the conditions that are likely to enable currency unions to succeed. Perez argues that for currency unions to succeed, “political solidarity” is likely to be more important than economic similarity, which is often stressed by mainstream economists. An additional key characteristic in a situation of unequal power in currency unions – a situation that is almost always the case – the behavior of the hegemonic country is crucial. In particular, a supportive hegemon can be crucial to the success of the currency union. Perez argues that, whereas the French government has been a willing hegemon in West and Central Africa, ensuring the survival of the CFA franc,⁶ Germany has not played that role in Europe, contributing to the severe problems facing the euro and many of the countries that adopt it.⁷

The connection between capital flows and political power – a theme emphasized throughout this volume – is the central issue in the final chapter

of *Soft Currencies, Hard Landings*. Hasan Cömert in “International financial flows and the future of EU–Turkey relations” (Chapter 12) argues that Turkey’s acceptance of large capital flows from the international markets, including from the EU, not only makes it more vulnerable to crises – a point emphasized in Part I of this volume – but also weakens Turkey’s bargaining position with respect to political issues such as political integration with Europe. This chapter well illustrates the themes of Part III in that it illustrates the intimate, two-way connections between international financial markets and political and economic power. It also illustrates asymmetries and inequalities inherent in these relationships.

NOTES

1. The term “neoliberal” populism might seem like an oxymoron, but it is meant to convey the juxtaposition of populist rhetoric with neoliberal financial policy so characteristic of neoautocratic regimes, such as those in the United States under Donald Trump and in contemporary Turkey, India and Hungary, among other places.
2. For a pioneering and informative quantitative discussion of the role of these factors in the architecture of the international financial system, see Avdjiev et al. (2016, 2018). However, Avdjiev et al. do not discuss the political economy implications of their analysis, which, by contrast, is on center stage here.
3. There is a debate about the structural limits of hard currency central banks’ credit supply, which revolves around the issue of market confidence in the value of the currency, and whether this confidence declines – and even evaporates – if the supply of hard currency credits get too large. The so-called “Modern Money” theorists generally argue that these limits are non-existent or highly exaggerated. Their critics point to many historical examples of limits imposing themselves through rapidly accelerating inflation and exchange rate collapses as in 1920s’ Germany and 1980s’ Latin America.
4. Hegemony is defined as “leadership or dominance of one country or social group over another.”
5. Barry Eichengreen and others have claimed that hegemony is not necessary because cooperation among nations is a good substitute for hegemony (Eichengreen, 1989). Another strand of the debate, initiated by libertarians, claims that the free market is inherently stable and, therefore, neither hegemony nor cooperation among states is necessary. Note that the Great Financial Crisis, the Great Depression and other international crises should have laid the free market claim of stability to rest a long time ago.
6. See Perez, Chapter 11 in this volume, or Wikipedia for the definition and somewhat complex history of the CFA franc.
7. For a vivid description of this point, see Varoufakis (2017). For a fascinating discussion of the financial aspects of Britain as a “bad hegemon” in the days of the British Empire, see De Cecco (1984).

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