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MARKETING THE THIRD WORLD:
THE CONTRADICTIONS OF PORTFOLIO INVESTMENT IN THE GLOBAL ECONOMY*

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Ilene Grabel

Assistant Professor
Graduate School of International Studies
University of Denver
Denver, CO 80208, USA
Office: 303/871-2546; FAX: 303/871-2456
Home: 303/331-8003

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ABSTRACT

While international portfolio investment (PI) in emerging markets has flourished during the 1990s, the macroeconomic and political dilemmas introduced into site economies by this development have not been adequately explored. This paper presents a Keynesian analysis of the effects of these inflows. The paper argues that a dependence on PI can constrain the autonomy of macroeconomic policy and introduce increased risk in site economies. The paper then applies this framework to recent Mexican experience. The paper concludes with a call for aggressive management of portfolio investment, and outlines some measures toward this end.

1. INTRODUCTION

One of the most significant trends in international finance in the 1990s is the growth of "emerging markets" in Third World and former socialist countries. In Latin America, Chile, Argentina, Brazil, and (until December 1994) Mexico have been heralded in turn as among the most dynamic of the world's emerging markets. China, Indonesia, the Philippines, Turkey, Greece, Poland, Hungary and Russia have also been active sites of emerging market activity.

Growth in capitalization in emerging markets over the last decade has been spectacular: total capitalization grew from \$146 billion in 1984 to \$1.7 trillion in 1993 (IFC, 1994).□ Share prices in these markets reflected this growth: the International Finance Corporation's global emerging market index, which was equal to 100 in December 1984, was valued at 489.40 in February 1995, having dropped from its peak of 623.87 in September 1994 (de Palma, 2/26/95).

By 1989-1990 portfolio investment inflows to developing countries began to increase dramatically.

(TABLE 1 HERE)

As shown in table 1, in 1983 there were no net inflows of portfolio investment to developing countries. By 1989 net portfolio investment inflows had grown to \$3.5 billion, and in 1993 they reached \$13.2 billion. The 277% increase in net portfolio investment inflows to developing countries between 1989 and 1993 far outpaced the increase in net direct foreign investment (127%) and net official development assistance (52%) during this period.

The recent crisis in Mexico has focused attention on the risks facing investors due to the volatility of emerging markets.□ In contrast, there has been little attention paid to the risks facing developing countries associated with emerging market activity in general, and the current reliance on portfolio investment inflows in particular. This paper takes up these issues. In short, the paper presents a post-Keynesian analysis of the contradictions inherent in national economic development strategies that are predicated on the maintenance of portfolio investment inflows.

Over the past decade a substantial amount of research has investigated the dangers associated with unrestrained external "openness" on the part of developing countries (e.g., essays in Banuri and Schor, 1992; Diaz-Alejandro, 1985; Felix, 1993; Fischer and Reisen, 1993; Maxfield, 1990; OECD, 1993; Taylor, 1991). This research has encompassed multiple aspects of openness, including direct foreign investment, aid, external debt, foreign branch banking and portfolio investment.□ Much of the post-Keynesian work in this area has also cautioned against excessive reliance on market-led financial systems in developing countries, including but not limited to the promotion of stock markets [e.g., Burkett and Dutt, 1991; Diaz-Alejandro, 1985; Gabel, 1995a, 1995b; Singh, 1993).

This paper focuses attention on the consequences of one aspect of openness in the developing world--the recent strategy of marketing developing countries as attractive sites for portfolio investment. I argue that a reliance on portfolio investment inflows introduces two general, mutually reinforcing problems in developing country economies. These are termed the problems of "compromised policy autonomy" and "increased risk potential."

This paper proceeds as follows. The next section presents theoretical arguments regarding the contradictions of portfolio investment for developing country economies. This section also compares these problems with those generally associated with other forms of capital inflows into developing countries. The following section explores the relevance of the abstract arguments of the paper to the recent Mexican experience. In contrast to the emerging common wisdom, I argue that the Mexican experience is indicative of the types of problems that are apt to occur when any developing or former socialist country relies heavily on uncontrolled portfolio investment inflows. The final

section teases out the broad policy implications of the foregoing analysis, and argues for the aggressive management of portfolio investment inflows.

2. THE CONTRADICTIONS OF PORTFOLIO INVESTMENT

The "emerging market phenomenon" of the late 1980s and early 1990s is an outgrowth of a number of developments.□ Certainly the financial liberalization programs adopted by developing countries from the late 1970s onward (and later by the former socialist countries) have played a key role in attracting portfolio investment inflows.□ Financial liberalization introduced dramatic institutional changes in these countries, including the creation of new financial markets and instruments. These changes, coupled with the ensuing investor euphoria, led to a general speculative appreciation of asset prices, extremely high real interest rates, and an overall shift in aggregate economic activity toward financial trading and away from industrial activities (Grabel, 1995a). In this context price bubbles often emerged as early investor success induced new infusions of capital.

Emerging market investments also became more attractive as investment prospects in developed country markets (especially the US) dimmed following the 1987 downturn in US stock prices.□ The easing of US monetary policy in 1990-1993 was particularly important in this regard. In this context, investors were eager to look abroad for more attractive investment sites (Wysocki, 6/22/95). At the same time, managers of burgeoning mutual funds in developed countries looked to emerging markets as a means of diversifying their portfolios. Finally, these developments occurred in the global context of very active trading on financial markets.

Many economists and policymakers hailed portfolio investment as an unambiguous benefit to developing countries. They interpreted the inflow of portfolio investment as a vote of confidence by market participants in neoliberal reform efforts--and therefore as validation of government policy. Moreover, inflows of portfolio investment were seen to provide a means to overcome capital shortages (WIDER, 1990) without introducing constraints on national sovereignty that were associated with direct investment, commercial bank loans, or aid. Direct foreign investment had proven hazardous, as multinational corporations usurped national sovereignty (Wolff, 1970); commercial bank borrowing had proven equally constraining as foreign government and multilateral lending institutions imposed strict conditions on borrowing governments.□

Despite the fact that portfolio investment can and does provide developing countries with capital, it has two negative, mutually reinforcing effects on these economies. These are (1) the exacerbation of constraints on policy autonomy; and (2) the increased vulnerability of the economy to risk, financial volatility and crisis.

(a) Constrained policy autonomy

As with other forms of capital inflows, portfolio investment entails restrictions on site country policy autonomy, although its constraining effects are indirect. The range of acceptable macroeconomic, exchange-rate and social policies that are compatible with the objective of creating an attractive climate for portfolio investment is indeed quite narrow.

Countries that become dependent on portfolio investment inflows need to adopt or maintain restrictive monetary policy in order to secure investor confidence and rentier rewards. To market the economy as an attractive site for portfolio investment, governments may be compelled to maintain interest and exchange rates at levels higher than they otherwise would prefer. The maintenance of high interest rates may hamper industrial and agricultural production insofar as they are highly debt dependent. Similarly, the maintenance of high currency values may mean that export performance is sacrificed to the effort to attract portfolio investment (see Reisen, 1993).□

International portfolio investors--in developing or developed country financial markets--may be expected to be biased toward tight monetary policy in site countries to protect the domestic currency value of their foreign returns (Frieden, 1991). In the same vein they may also expect the government to adopt contractionary fiscal measures as a means to dampen inflationary pressures in the economy. But in the particular case of developing countries, foreign investors may be especially concerned that macroeconomic policy be contractionary because of the greater perceived currency, political and inflation risk in these countries. Hence, while the constraint on policy autonomy generally obtains today in all countries, it obtains to different degrees in developing and developed countries. Moreover, if investors were recently harmed by a currency depreciation, their concerns about currency risk might be magnified. This constraint on policy autonomy may exacerbate what are already significant existing constraints on policy autonomy in developing countries that may, for example, stem from foreign creditor or donor influence in economic affairs and limited domestic resources.

Privatization programs may also be required to create an appropriate climate for portfolio investment. In addition to securing new capital inflows by creating profit opportunities, privatization addresses investor concerns that government support of industries or particular firms may fuel budget deficits. In addition, measures to liberalize the economy are likely to be necessary to assure investors that economic efficiency will not be undermined by government intervention. Political repression, involving suppression of labor or popular opposition to restrictive macroeconomic policy, may be required in order to demonstrate to investors that the government has the political will to pursue neoliberal economic programs.

In short, a developing country government that seeks to attract and maintain portfolio investment inflows may be severely constrained in the ex ante sense: the construction of an appropriate investment climate requires the adoption of a fairly restrictive set of policies. Portfolio investors may become the ultimate arbiters of national macroeconomic policy, to the detriment of economically vulnerable, disenfranchised groups. Investors' "veto power" is not expressed through conspiracy or brute force, of course--or even through formal conditionality agreements--but through the mechanism of portfolio reallocation (see Frieden, 1991). But the indirectness of the threat of capital flight does not reduce its power as a constraint on policy autonomy.□

In addition to the ex ante constraint on policy autonomy, there is the possibility of an ex post constraint as well. This may obtain if, in the advent of capital flight or financial or currency crises, the government is compelled to adopt measures aimed at reversing the outflow of portfolio investment. These measures would likely involve intensification of the policies initially pursued in efforts to market the economy as an attractive site for portfolio investment. For example, Haggard and Maxfield (1996) argue that in the context of a balance of payment crisis, developing country governments are more likely to pursue greater financial openness. This is because domestic political constituencies favoring financial openness may be able to press successfully for such measures during crises and/or because openness may be used by governments as a signal to important external actors, such as investors or multilateral institutions.

Governments may also face an ex-post constraint on currency depreciations in the context of capital flight or financial crises. In such circumstances, governments may take drastic steps to protect their currencies in order to prevent an investor stampede. All told, the constraints that obtain in the context of a crisis may exacerbate the pro-investor policy bias with detrimental effects on vulnerable groups.

In the particular case of developing countries, an economic crisis that threatens foreign portfolio investors is likely to induce assistance from foreign governments and/or multilateral institutions. But such assistance

introduces a further ex-post constraint on policy autonomy. Those providing assistance may do so with the proviso that they be given substantive influence over policymaking. This constraint is particularly problematic for developing countries that seek portfolio investment inflows as a means of lessening external influence over their economies.

(b) Increased risk potential

The second problem associated with developing country dependence on portfolio investment is termed the problem of increased risk potential. To be clear, this problem does not refer to the multitude of factors that render portfolio investment risky to investors.□ Rather, the term refers to the manner in which the risk (or the realization) of portfolio investment flight introduces into site economies the potential for greater macroeconomic instability and financial crisis.

The increased risk potential of portfolio investment is an outcome of the high degree of liquidity of such investment and of financial openness. Liquidity is an important precondition of investment, of course. But coupled with flighty, endogenously determined investor expectations, liquidity contributes to the instability of aggregate investment and the macroeconomy (Keynes, 1964; Crotty, 1994).

Given the volatility of investor expectations, perceptions regarding the attractiveness of opportunities seen to be available in particular markets are likely to be fleeting. Investors may be "bullish" (for a variety of reasons) about portfolio investment in some country for some period, only to reverse that view and turn aggressively "bearish." Changes in conventional wisdom may be sparked by "news" (whether accurate or not) or speculation regarding, for example, changes in political developments, impending currency depreciations, changes in interest rates abroad, or the emergence of a newer (emerging) market expected to offer richer rewards. By acting on changes in conventional wisdom, investors force its realization: fears of a market collapse can be self-fulfilling.

Liquidity and financial openness provide investors with an international exit option that, if exercised, can give rise to financial crisis and cross-border contagion. While the risk of flight is endemic to portfolio investment in all countries, investors may be more prone to exit suddenly from developing country financial markets given the greater perceived risks in these markets. The greater risk of portfolio investment flight in developing countries strengthens the ex-ante constraint on policy in these countries.

Not only is the risk potential of portfolio investment greater in developing countries, but its realization is also more costly to the economy. In capital scarce developing countries, large, sudden withdrawals of portfolio investment may threaten the viability of domestic investment as available financing dwindles. Furthermore, under floating exchange rates, such a withdrawal of portfolio investment may trigger (or exacerbate) a nominal and real depreciation of the domestic currency in the likely event that the government does not have foreign exchange reserves sufficient to stabilize the currency value.□ These circumstances are likely to threaten the stability of the macroeconomy, and may trigger a broad-ranging financial crisis.□

In the event that portfolio investment flight does occur, the macroeconomy and vulnerable segments of the citizenry ultimately bear the social and economic costs of the austerity measures generally taken in the wake of crisis (Taylor, 1991). The loss in purchasing power that stems from sudden currency depreciations may cause dislocation among the significant proportion of wage-earners in developing countries who are dependent on imported wage goods. Currency depreciation also increases the cost of imported capital goods and external debt service obligations.

Following financial crises, problems of increased risk potential and constrained autonomy may be mutually reinforcing as measures undertaken to stem crises may further constrain autonomy. If governments deplete scarce foreign exchange reserves in efforts to stem losses in currency value, they reduce the resources available to mitigate the consequences of economic downturns. Additionally, the government may be compelled to implement macroeconomic policies (like restrictive monetary policy) aimed at reducing portfolio

investment outflows (and/or inducing new inflows). This may mean that in the advent of a crisis, the government is not only precluded from taking measures designed to ease the dislocation that accompanies economic crises, but may also be encouraged to take steps that aggravate the consequences of the crisis for many groups. The conditionality that is tied to foreign assistance in the wake of the crisis would exacerbate these pressures.

(c) The uniqueness of portfolio investment

It may be helpful to contrast the problematic aspects of portfolio investment with those problems typically associated with other types of capital inflows into developing countries. Table 2 presents four types of capital inflows--foreign aid, commercial bank loans, direct foreign investment and portfolio investment--and describes the sources of constrained policy autonomy and increased risk potential that are associated with each type of inflow. Table 3 ranks from "highest" to "lowest" the severity of the constraints and risks associated with each of these inflows.□

(TABLES 2 - 3 HERE)

(i) Constraints on policy autonomy

All types of inflows threaten to constrain policy autonomy. Donors, creditors and direct foreign investors may be afforded opportunities to intervene directly or indirectly in domestic decision making (see table 2). Site country governments may be compelled explicitly or implicitly to meet certain conditions as a prerequisite for the initial capital inflow or for the maintenance of such inflows. But as shown on table 3, the severity of the constraint is highest in the case of portfolio investment and lowest in the case of direct foreign investment.

Direct foreign investment may entail sector- or firm-specific constraints on policy autonomy. Investors may require special treatment with respect to taxation, profit repatriation, and regulation that is not available to domestic investors. In addition, foreign governments may exert pressure on the site government to protect owners' property rights and interests. Finally, the employment creation and control over strategic resources and/or advanced technologies may provide foreign owners with various means of influence over government policy.

But while the specific constraints attending direct foreign investment may be substantial, they generally are mitigated by two factors. First, direct foreign investors do not have a homogeneous interest with respect to the course of macroeconomic policy. Investment directed to producing for the site economy market may benefit from expansive macroeconomic policy; that intended to serve as an export platform may benefit from the opposite. On balance, macroeconomic policy is likely to be a secondary concern, with protection of property rights and firm-specific treatment of greater relevance to corporate success. Second, direct foreign investment is far less liquid for the corporation undertaking the project than other forms of investment. Illiquidity renders the threat of exit less credible and hence less effective as a bargaining strategy. This is particularly the case in those circumstances where it is not feasible or desirable (especially in the short run) to relocate. Thus, the leverage that direct foreign investors may have over site governments is much greater in the period preceding the investment than it is once a significant and site-specific project is in place.

Portfolio investment may be distinguished from direct foreign investment by virtue of the nature of the ex ante constraint that is associated with it. Unlike direct foreign investors, portfolio investors have a significant stake in deflationary macroeconomic policy, as we have seen. Hence, the constraint that portfolio investment entails may be expected to have a much broader impact on the site country's economy (and its inhabitants) than that associated with direct foreign investment. Moreover, unlike direct foreign investment, the high degree of liquidity of portfolio investment makes the threat of exit

particularly credible. A perceived or actual mis-step by the government (e.g., acquiescence to union demands) or an external event (e.g., a change in monetary policy abroad) may lead to sudden outflows as investors seek "safer" climes.

Foreign aid and commercial lending stand somewhere between these two poles. Those giving aid generally rely on political, security and/or humanitarian criteria alongside strictly economic conditions in making their allocations. Their diverse objectives may make them less likely to impose strict economic conditionality on aid and, in any event, make it unlikely that they will articulate a uniform set of macroeconomic policies. Commercial lenders also may have divergent interests, depending on whether they lend to private firms or the government, the size of their commitments in a country, etc. Moreover, insofar as foreign lending to developing countries generally takes the form of variable rate loans and requires repayment in the lender's currency, lenders do not face currency and interest rate risk to the same degree as do portfolio investors. They therefore have a lesser stake in deflationary macroeconomic policy, so long as borrowers (and/or their governments) maintain the ability to service their loans. Nevertheless, in the event of a crisis that threatens the ability of the debtor to meet its financial obligations, lenders and multilateral institutions may impose strict conditionality (e.g., structural adjustment programs). Finally, commercial lenders may not have the immediate exit option available to portfolio investors, because of the contagion effects that flight might induce (see below).

(ii) Increased risk potential

As shown on table 2, the site economy's increased vulnerability to risk from each of these types of inflows comes from its termination or reversal. Again, due to its liquidity, portfolio investment is associated with the highest degree of risk (see table 3). Aid is least risky in this regard because a significant, surprise withdrawal of aid in reaction to economic events is unlikely. In the case of direct foreign investment, the risk to the economy of a sudden withdrawal is also minimal (see above).

The case of commercial lending is more complicated. In this case, the greatest risk to developing countries comes from the possibility that the terms of outstanding loans will be adversely affected by changes in economic conditions in creditor country economies. Variable rate loans exemplify this risk, as debt-service obligations increase with rising interest rates.

In comparison with the risk of exit of posed by portfolio investment, however, the threat of a sudden withdrawal of commercial loans is far less severe. Lenders as a group are somewhat constrained by the vulnerability of the debtor, whose default could set off an international financial panic. Lenders tend to be few and large, allowing the International Monetary Fund (IMF) to reestablish some degree of order. Although IMF involvement generally signals a substantial loss of developing country policy autonomy, as discussed above, it generally suffices to ensure a continued willingness of commercial lenders to make new loans to the affected country. In contrast, the large number of autonomous portfolio investors prevents the IMF (and the site country) from exerting the same degree of control over sudden portfolio flight from a troubled economy.

We now turn to the recent Mexican financial crisis. Following a description of key aspects of this crisis, I argue that the general arguments presented here apply to Mexico's experience. In the following section I consider whether the Mexican crisis is anomalous and therefore of little relevance to other site countries.

3. THE 1994-1996 MEXICAN FINANCIAL CRISIS

For the second time in the post-WWII period, events emanating from Mexico's financial markets sent shock waves through international markets. The first event was Mexico's threatened default on its international loans in 1982.

This event marked the beginning of the debt crisis, triggering a drastic reduction in new private bank and bilateral lending to developing countries.□

At the time of the 1982 announcement, contagion scenarios held sway over the US banking and policy communities. These scenarios involved visions of widespread defaults by developing country debtors, resulting in a collapse of bank share prices. The combined effects of these events were, at the time, thought to threaten the stability of the global, and especially the US, financial systems (see Cohen, 1991). These fears provided the impetus for the Baker and Brady Plans in 1985 and 1989, respectively. In the event, Mexico's default never came to pass, and the global financial system did not collapse. The real losers from this crisis were the economically vulnerable groups in Mexico and elsewhere in the developing world, who suffer tremendous hardship in the aftermath of the debt crisis and the associated austerity measures.□

(a) The marketing of Mexico in the 1980s

In less than a decade, portfolio investors returned to Mexican financial markets with a vengeance. The second shock to emanate from Mexican financial markets relates to this development. As early as 1989, Mexico was being marketed as a model of successful developing country reform efforts.□ A recent retrospective on Mexico captures well the spirit of investors' conventional wisdom on Mexico from the late 1980s up until the spring of 1994:

Mexico was coming to be viewed as a showcase of successful stabilization and economic reform, institutional stability and financial predictability. Mexico was becoming what Chile already had become and what all of Latin America hoped to be... (Dornbusch and Werner, 1994, p. 253).□

During this time, Mexico was promoted as the site of one of the world's most dynamic, emerging markets. Investment guides and the business press promoted Mexico's newly privatized giants (like Telmex) as extremely attractive investment opportunities.□ Several factors abetted the rush to Mexican financial markets. One was the Mexican government's gestures toward political democratization and economic liberalization; these received wide attention in the US. A second, related development was the drive to liberalize trade through the negotiation of NAFTA. NAFTA was seen to create substantial investment opportunities in Mexico, while further demonstrating Mexico's willingness to pursue a neoliberal agenda. And, in furthering economic integration between the US and Mexico, NAFTA was seen to bind tightly the fates of these two nations, something that foreign (and especially US) investors apparently counted on in the event that Mexico experienced difficulties. NAFTA thus offered a sort of implicit US guarantee on investments in Mexico.

The high returns offered on short-term Mexican government debt were also extremely attractive to individual investors and pension and mutual fund managers. Both the dollar-indexed short-term bond called the tesobono□ and the peso-denominated short-term bond called the cete offered returns that far exceeded returns available elsewhere, especially in the US where lower interest rates during 1993 encouraged investors to look abroad (see table 4).

(TABLE 4 HERE)

As shown on table 4, between 1982 and 1989 the cete rate ranged from 44.9% to 95.97%, and between 1990 and 1993 the rate ranged from 14.9% to 34.76%. The tesobono rate was similarly attractive to investors: it peaked at 29.8% in 1988, and was at 10.9% in 1991, before falling to 4.08% in 1993.

Attracted by these high returns, portfolio investment began to pour into booming Mexican debt and equity markets. Although Mexico experienced a net portfolio investment outflow of \$1.7 billion in 1989, within one year the direction of flow was reversed: Mexico enjoyed a net inflow of portfolio investment of \$5.9 billion in 1990, followed by net inflows of \$19.6 billion in 1991, \$21.1 billion in 1992, and \$28 billion in 1994 (Dornbusch and Werner,

1994; Economist, 1/28/95).□ Given the influx of portfolio investment, it is hardly surprising that the stock market index gained value every year after 1989: Mexican share prices rose 50.09% in 1990, 124.67% in 1991, 24.45% in 1992, and 48.03% in 1993 (see table 4).

As is by now widely noted inside and outside of Mexico, the peso was fixed at a progressively overvalued rate (in nominal and real terms) by the Mexican government during this period of increased private capital inflows (BBC, 1/23/95). While counterfactual estimates of the degree of overvaluation are imprecise,□ it is clear that the only way that the Mexican government could have maintained the exchange rate during this time was to deplete its foreign exchange reserves.

A tightening of US monetary policy beginning in February 1994 began to diminish the appeal of Mexican portfolio investment (see Fidler, 1/27/95; Wysocki, 6/22/95). By April 1994 the Mexican bubble began to lose steam, completely collapsing in December of that year. During 1994 the stock market lost 30% of its value and there were several speculative attacks on the peso. In efforts to stabilize the peso, the government depleted \$10 billion dollars of foreign exchange reserves (Dornbusch and Werner, 1994, p. 283). The conjunction of this financial instability, the Chiapas revolt, and the assassination of the leading candidate in the presidential election finally led the new President, Ernesto Zedillo, to devalue the peso by 40% in December 1994.

Rather than stabilize Mexican financial markets, the devaluation triggered a mutually reinforcing outflow of portfolio investment and a collapse of the peso, plunging Mexico further into financial crisis (see Lustig, 1995).□ Within the first month of 1995 alone the Mexican government depleted almost 50% of its foreign exchange reserves (falling from \$6 billion at the end of 1994 to \$3.5 billion by the end of January 1995 (Economist, 2/4/95) in efforts to calm investors by stabilizing the peso.

With the peso and Mexican markets entering a free fall, the dismal state of Mexican financial markets again triggered fears of global financial contagion. This time, however, the triggering mechanisms of the contagion were different. The first aspect of this contagion scenario involved what was seen as the Mexican government's near certain default on short-term bonds--the cetes and especially the tsesobonos.□ The reasoning behind the default scenario is familiar to any student of Minsky (1986). In Ponzi fashion the Mexican government has been deficit financing its expenditures and obligations with short-term debt, rendering the government vulnerable to a shock from financial markets. The depletion of the government's already scarce foreign exchange reserves and the flight of portfolio investment beginning in mid-1994 left the government unable to meet its immediate short-term obligations to bondholders (equal to tens of billions of dollars). As of the end of January 1995, the government had spent about \$13 billion in order to cover tesobono obligations (Fineman, 4/5/95).

The Clinton administration and financial industry analysts argued aggressively that a default on Mexican government bonds would trigger a general flight from Mexican financial markets and a further collapse of the peso. Not only did this conjure visions of disaster within Mexico, but it was also seen as the harbinger of significant problems within the US, given its deepening integration with Mexico. Specifically, analysts feared that the Mexican crisis (and the austerity measures it would induce) would threaten the anticipated boost to the US economy promised by NAFTA, fuel the uprising in Chiapas, and, in the context of widespread anti-immigrant sentiment in the US, spur a new wave of legal and especially illegal immigration (see Economist, 2/4/95). Analysts also began to conjure up US financial crisis scenarios, as institutional and individual holders of Mexican government bonds were left with worthless paper.

The Mexican crisis also led to predictions of systemic financial crisis in the developing world. Analysts feared capital flight from other emerging

markets (such as Argentina and Brazil), as formerly bullish investors turned starkly bearish on emerging markets.□ Indeed, the Argentine government expressed such fears early on (see Sims, 3/12/95). In a final feedback effect, many feared that a systemic crisis in emerging markets would cause developing country policymakers to repudiate the free-market reforms and outward orientation adopted in the 1980s (e.g., Lewis, 2/11/95). Crisis threatened a return to the past--to nationalist, inward-oriented, state-led development programs.

The Clinton administration responded to the crisis by pressing for Mexican relief. In exchange for a \$20 billion US bailout and \$28 billion in additional international loans,□ the Mexican government committed to further the 1980s reform agenda of privatization, stabilization, and economic liberalization. It also agreed to implement highly restrictive monetary policy, to reduce budget and current account deficits, and to increase the value-added tax and the prices of goods produced by the state (e.g., electricity and gasoline). More controversial than the renewed commitment to neoliberalism on the part of the Mexican government were the requirements that the lion's share of all of the bailout funds be used to cover tesobono and other outstanding bond obligations□, that the government be able to draw on a \$10 billion portion of the bailout earmarked as an emergency fund only at the discretion of the US, that the government get permission from the US for most major economic policy decisions, and that the receipts of Mexico's state-owned oil company, Pemex, be used as collateral for the US loans and loan guarantees.

On February 22, 1995 the Mexican central bank raised interest rates to 59% (in nominal terms) in efforts to restore foreign confidence in the financial system and to attract capital back to Mexico, and to meet the US bailout conditions. This action precipitated a general increase in the cost of all types of credit. Even conservative business analysts have expressed grave concerns that the high level of Mexican interest rates is likely to lead to investment stagnation, recession, and social dislocation (Economist, 2/25/95; 8/5/95; de Palma, 2/26/95; 5/13/95). Meanwhile, Mexico's banks, already suffering from large loan losses□, are being confronted with further losses as borrowers default on high variable rate loans (Moody's, 2/23/95; Smith, 1/22/96; see also Grabel, 1995a).

(b) Constrained autonomy and increased risk potential

The arguments developed above regarding the general problems associated with developing countries' reliance on portfolio investment inflows speak directly to recent Mexican experience.

An ex-ante constraint on policy autonomy was apparent in the period following 1989 when the Mexican government implemented the package of economic reforms that was required under the terms of the Brady Plan. These privatization and financial and economic liberalization programs played an important role in signalling to private (foreign and domestic) investors that it was safe to return to Mexico. Coupled with the implicit NAFTA investor guarantees, these neoliberal policies were decisive in attracting high levels of portfolio investment inflows to Mexico after 1989 and "rehabilitating" the economy. The success in attracting portfolio investment was critically important because new direct foreign investment, private and multilateral lending and aid flows were all inadequate to Mexico's capital needs.

When the crisis occurred in 1994, the Mexican government's policy autonomy was further constrained in an ex-post sense. The government was compelled to try to stem the capital outflow, stabilize the peso, and calm portfolio investors. These steps principally involved the expenditure of vast quantities of foreign exchange reserves. But this strategy did not stabilize financial markets as investors recognized that the government's resources were well below those needed to make good on its bond obligations. The depletion of foreign exchange reserves also impaired the government's ability to finance ameliorative

policies aimed at easing the dislocation associated with the crisis and its aftermath.

The stringent provisions of the bailout provide the most direct indication of ex-post constraints on policy autonomy. The influence of the US and the IMF over Mexican macroeconomic and social policy has been substantially increased; indeed, the entire direction and import of policy in the post-crisis period is principally aimed at restoring investor confidence.□

The arguments advanced above regarding increased risk potential, too, are germane to recent Mexican experience. To be sure, the expansion of portfolio investment inflows following 1989 provided the government and private corporations with resources to which they might not have otherwise had access. But the liquidity of this portfolio investment ensured that the December 1994 peso devaluation, coupled with the tightening of US monetary policy in February 1994, would destabilize markets and trigger rapid and substantial portfolio investment outflows. The devaluation was especially destabilizing to tesebono investors, who feared that the risk of default on these bonds was especially great (Lustig, 1995). When investors again began to exit Mexican financial markets in the spring of 1995, the flight dynamic was self-reinforcing and a crisis obtained. Thus, the realization of the increased risk potential of portfolio investment had the effect of triggering a withdrawal contagion, and hence inaugurating a downward spiral of flight and financial crisis.

The interaction of increased risk potential and constrained autonomy are also relevant here. In order to try to contain the crisis after December 1994, the bailout provisions necessitated the introduction of greater foreign influence in economic decision making. But by further opening the economy to capital inflows (as the neoliberal tenor of the bailout provisions require), the vulnerability of the Mexican economy to future crises may be exacerbated, necessitating future bailouts and increased foreign intervention in the economy.

(c) The uniqueness of Mexico?

In the aftermath of the Mexican crisis something of a "Mexican exceptionalism" thesis has begun to emerge among policy analysts. Both the IMF and the World Bank (1995) have contended that the Mexican experience is unique and that it therefore is of little relevance to the former socialist and other developing countries that have become active sites of portfolio investment inflows. Rather than interrogate the Mexican crisis as evidence of inherent shortcomings of portfolio investment, the crisis has been largely dismissed as an aberration stemming from Mexico's peculiarities. The latter include Mexico's mismanagement of its economic affairs and its political corruption.

Is this interpretation meritorious? The arguments about Mexican economic mismanagement are suspect. This is not to deny the existence of significant current account deficits and low levels of foreign exchange reserves in Mexico. But these economic problems are in no respect unique to Mexico. Other countries facing current account deficits, inadequate foreign exchange reserves, or other important macroeconomic problems are similarly vulnerable to investor flight when conventional wisdom turns bearish.□ In the context of a speculative bubble, a country's current account deficit may be seen as regrettable, but not terribly important. However, when conventional wisdom shifts--because of changes in domestic or international economic or political conditions or just because investor sentiment changes--these economic problems themselves become reasons for a self-exacerbating investor withdrawal made possible by financial openness.

It is noteworthy that the exceptionalism thesis overlooks the most important aspect in which Mexico is unique. Mexico enjoys a special relationship with the US. Over the past two decades the economies of these two countries have become increasingly integrated; the NAFTA agreement codifies the general trend while symbolizing the unusual relationship that has emerged between a developing country and an economic superpower. The question that

should be broached, then, is whether this peculiar relationship does make the Mexican crisis anomalous.

It may be true that NAFTA euphoria increased the rate of portfolio investment inflows into Mexico, leading to price bubbles that would otherwise not have occurred. But if true, this validates one of the central themes of this paper, to wit, that portfolio investment flows are driven by all manner of hunches and guesses and by sentiments that may be fleeting and unwarranted. Moreover, investor euphoria about Mexico also stemmed from numerous other circumstances that are not in any way unique to Mexico. Specifically, financial liberalization and privatization programs created investment opportunities for those individual and institutional investors in developed countries (especially the US) that were looking abroad for investment sites, especially after US monetary policy eased. These circumstances created investor interest not just in Mexico, but in numerous developing and former socialist countries that like Mexico have been active sites of portfolio investment.

But on balance it might be concluded that the special relationship between Mexico and the US should have decreased the likelihood of the kind of crisis that Mexico experienced. Given the strategic importance of Mexico in the US campaign to liberalize trade and investment flows in the Americas, and given the degree to which successive US Administrations invested political capital in Mexico's success, investors should have been reasonably certain that the US government would intervene forcefully to prevent financial instability in its southern neighbor. What is remarkable about the Mexican experience, thus, is that the implicit ex ante guarantee of the US counted for so little when investor sentiments about Mexico changed in the face of disturbing political and economic news. The special relationship with the US may have counted more in managing the crisis after the fact--but if so, then we may rightly conclude that what was anomalous about the Mexican crisis is that it was not more severe! In this case, other site countries can take little solace from the notion that Mexico is somehow "different."

4. IS SELF-FINANCE THE ANSWER?

I have argued that developing country dependence on portfolio investment could have unanticipated and undesirable consequences for these countries. The shift away from direct foreign investment, lending and aid, while thought to resolve concerns about foreign control and capital scarcity, could exacerbate problems of constrained autonomy for developing countries and introduce increased risk into the economy. These problems are self-reinforcing. While the arguments presented here are highly general, they are certainly germane to the dynamics of the recent Mexican financial crisis. Moreover, the Mexican crisis itself can not be written off as a strictly anomalous event. Dynamics similar to those evidenced in Mexico could easily obtain in the very large number of developing and former socialist countries that are today active sites of largely unregulated portfolio investment.□

What do these arguments imply about the means by which developing countries should meet their capital needs? At the broadest level, it implies that financial openness and policies aimed specifically at attracting portfolio investment inflows introduce and exacerbate significant problems. In particular, the high degree of liquidity of portfolio investment means that it is a problematic solution to the capital scarcity faced by developing countries. If portfolio investment is to be encouraged at all, developing country policymakers would be advised to manage it aggressively, even at the risk that such management will reduce the overall volume of inflows.

Management of portfolio investment itself may take a variety of forms.□ The most extreme measure would involve outright restrictions on openness in the form of stringent capital controls, especially aimed at outflows. These measures might be in the spirit of Keynes' (1933) prescriptions. Given that any individual developing country today undertaking such measures would be placed at

a competitive disadvantage in attracting funds, such measures would have to be pursued on a regional or South-South basis (see, e.g., Taylor, 1991).

But are South-South capital controls impractical in today's global economy? It may be argued that capital controls are at odds with the zeitgeist and IMF mandates both of which celebrate openness, that they are not feasible politically, that they are not effective because they are too easily evaded, and that they might trigger a crisis in emerging markets as investors flee these markets in anticipation of controls. However, the inevitability and immutability of openness should not be taken for granted. Multilateral organizations such as the UN and the OECD are beginning to investigate the complicated effects of openness. They have begun to examine the viability and desirability of dampening openness and reducing the hyper-liquidity of capital markets (see UNDP, 1994; Fischer and Reisen, 1993). For example, a recent OECD study of financial openness in developing countries argues for the "late" removal of capital controls in developing countries (Fischer and Reisen, 1993). While the specification of what constitutes "late" removal is a bit unclear, the study identifies the achievement of sound government finances and an appropriate institutional and regulatory structure for financial sector supervision as important preconditions for the removal of capital controls. Against these criteria, many developing countries today appear to be good candidates for capital controls.

The successful use of stringent capital controls by South Korea and Japan during their periods of rapid economic development is instructive in this regard. Despite the World Bank's (1993) recent "revisionist" analysis of the lessons of the East Asian successes, the consensus in the literature on East Asian development confirms that capital controls were an integral part of the achievements of these developmental states (e.g., Amsden, 1989; Hart-Landsberg, 1993). During Japanese industrialization, for example, there was an outright prohibition on foreign ownership of securities and equities. In South Korea, violations of prohibitions on overseas capital transfers were punishable by a minimum sentence of ten years in prison and a maximum sentence of death (Amsden, 1989, p. 17).

It is unfortunate (though not terribly surprising) that in the wake of the Mexican crisis and in view of the success of East Asian capital control policies, the IMF and World Bank have failed to call for developing country control over portfolio investment inflows (see Dadush and Brahmabhatt, 1995). In fact, a recent World Bank (1995) study acknowledges that short-term, liquid capital inflows are potentially volatile. But, the Bank argues that the so-called tequila effect is avoidable provided domestic policymakers maintain sound macroeconomic policies (e.g., minimize current account deficits), channel inflows to "productive" uses, and avoid excessive reliance on short-term capital inflows. Indeed, this is seen by the Bank as a key distinguishing feature of those countries that have successfully harnessed private capital inflows (i.e., East Asian countries) versus those that have not (i.e., Latin America and Mexico, in particular). Hence, the Bank dismisses outright the efficacy of capital controls in accounting for the financial stability and macroeconomic performance of East Asian countries.□

An alternative to capital controls is the use of volume- or price-based restrictions on asset purchases and sales as means to manage portfolio investment and to slow the pace of flight during crises. Similarly, the implementation of "circuit breakers" which essentially call a halt to sales during periods of crisis would accomplish the same aim. A variety of measures aimed at dampening financial market volatility and encouraging (foreign and domestic) investors to lengthen their time horizons are currently in place in some developing countries (see Economist, 4/8/95). For example, in Colombia foreign investors are free to engage in (less-liquid) direct investment, but are precluded from purchasing debt instruments and are discouraged from purchasing

corporate equity. In Chile, foreign portfolio investors are required to keep their cash in the country for at least one year.

The tax system can also be used to dampen portfolio investment volatility and to provide some compensation for the costs of liquidity as Tobin (1978) has proposed (see also UNDP, 1994, p. 70). This uniform, global transaction tax has been taken up recently by the United Nations and several prominent development economists (Felix, 1993; Singh, 1993; see also Diaz-Alejandro, 1985, p. 22).□ For example, Felix (1993) proposes that the proceeds of such a globally imposed transactions tax of about one-half to one percent could be collected by national authorities over residents within their jurisdiction. The proceeds of this tax would be transferred to a central fund controlled by the IMF or the World Bank and used for long-term relending to developing countries. It is instructive to note in this regard that aside from the US, nearly all OECD countries today have transaction taxes in place (Hakkio, 1994; Summers and Summers, 1989). These taxes are designed to "throw sand in the wheels" of portfolio churning so as to reduce volatility and lengthen investor time horizons. Moreover, as Felix (1993) points out, there are already a variety of measures in place globally or within the G7 countries that establish a framework for supranational financial policy and cooperation. These comprise agreements to share tax information, coordinate macroeconomic policy, and impose uniform capital standards and bank regulation. It may also be the case that developing countries could pursue a uniform South-South tax in the event that a global tax proves to be too difficult to negotiate at present.

It may be that any of the measures outlined here would diminish the attractiveness of portfolio investment in developing countries by reducing the market's liquidity. But if the arguments presented here are correct--as the Mexican experience suggests--then a reduced level of portfolio inflow may be a worthwhile price to pay for enhanced macroeconomic stability and policy autonomy.

□ Mullin (1993) provides a useful empirical survey of emerging market characteristics and activity. Business Week (2/12/96) surveys US investment bank efforts to establish footholds in these markets.

□ This focus is peculiar in light of the protection afforded investors in Mexico thanks to the US-led bailout (Fineman, 4/5/95; Lewis, 2/11/95). In a review of the recent Mexican crisis, a US investment banker noted this point: "It's ironic that to encourage capitalism in emerging economies you must socialize the risk for US investors" (Lewis, 2/11/95). Diaz-Alejandro (1985) (among others) made this same point about the developing country debt crisis of the 1980s.

□ Stallings (1987) is the classic historical study of US portfolio investment in Latin America.

□ At the micro level investment decisions are driven by factors specific both to the investor's objective function (e.g., maximization of rate of return, diversification of holdings, etc.) and to the type of instrument purchased (e.g., equity or mutual fund shares, corporate or government bonds, etc.). For our purposes, we can generalize as to the key structural factors that underpinned the dramatic increase in investor interest in emerging market investments during this time.

□ A discussion of the political and economic forces propelling the move toward financial (and economic) openness is beyond the scope of this paper. Suffice it to say that external pressure from developed country governments and multilateral institutions played a significant role in this regard. Technocratic elites in developing countries also pushed for openness.

□ Note that capital inflows to emerging markets comprised not just foreign investors' capital, but also repatriated (domestic) flight capital (Reisen, 1993).

□ Lender conditionality has had disastrous effects on the standard of living of many groups in developing countries. See George (1990) and Altvater, Hubner, Lorentzen and Rojas (1991) for discussion of these issues.

□ Of course, under floating exchange rates a currency appreciation may be a result of high levels of portfolio investment inflows. This appreciation can lead to a worsening of trade performance, giving rise to the so-called Dutch Disease. This indicates that portfolio investment inflows (and not just outflows) can be problematic.

□ Keynes wrote presciently in 1933 of the constraining effect on domestic politics posed by the threat of capital flight (see Crotty, 1983). This dilemma was not confined to Britain in the 1930s; neither is it confined to any region of the world more generally today. In a world in which even the poorest countries have open capital markets offering highly liquid investment opportunities, investors may "discipline" errant policymakers through portfolio reallocation. It is widely held, for instance, that Jamaica's President Michael Manley in 1972-1973, French President Mitterand in 1981-1982 and US Presidents Carter in 1978-1979 and Clinton in the fall of 1992, were disciplined by the occurrence or threat of investor flight (see Greider, 1987; Halimi, Michie and Milne, 1996; Hall, 1986; Thomas, 1998; Woodward, 1994). See also Banuri and Schor (1992), Crotty (1983), Frieden (1991), Magdoff and Sweezy (1992), Strange (1986), and Wachtel (1986).

□ The risks borne by investors are numerous. For example, corporate and government bonds carry default risk, equity investments are associated with commercial risk, foreign investment carries exchange-rate risk, and in countries with histories of high inflation, the returns on portfolio investment may be undermined by inflation risk.

□ Of course flight may both cause real currency depreciations and be triggered by real currency depreciations (or expectations thereof) (see, e.g., Taylor, 1995).

□ See Eichengreen and Portes (1987), Krugman (1991) and Wolfson (1986) for a general discussion of the contagion or transmission mechanisms for domestic and international financial crises. See also Taylor's (1995) generalization of Minsky (1986) that is motivated by an attempt to develop a general theory of the etiology of financial crises.

□ These severity rankings should be seen as approximate, as the severity of the autonomy constraint and risk potential depends on many factors that can not be taken into account here. For example, the liquidity of direct foreign investments varies depending on whether the investment is in an extractive resource, the degree to which the investment entails substantial expenditures on plant, equipment or technology, etc.

□ Nevertheless, political developments (such as a change in regime) in either the site or donor country may lead to sudden changes in aid flows.

□ Felix (1994) and Reisen (1993) argue that there are important parallels between the dynamic and (likely) outcome of the over-lending/over-borrowing of the 1970s and the over-investing taking place today.

□ See, e.g., Barkin (1990) and George (1990).

□ See Dornbusch and Werner (1994) and Economist (3/18/95) on the "rehabilitation" of Mexico after 1982 until the current crisis. Cf., evidence of the hardships suffered by the majority of the Mexican population during this time.

□ Similar views were echoed by US Treasury Secretary Robert Rubin (see Sanger, 2/5/95).

□ Privatization was associated with reduction in the size of the public sector and employment therein. In 1982 there were 1,155 individual public enterprises in Mexico, by 1986 that number had fallen to 737, and by 1992 the number fell further to 217 (Dornbusch and Werner, 1994, table 5).

□ The initial dollar-indexed vehicle, the pagafe, was replaced by the tesobono in 1990-1991.

□ Other Latin American countries experienced similar inflows. From 1989-1990 Brazil received \$40 billion and Argentina \$10 billion in portfolio investment (Economist, 2/4/95).

□ See Dornbusch and Werner (1994) for one such estimate.

□ It is important to note that it was both foreign and domestic investors that were exiting Mexican portfolio investment. In fact, evidence suggests that Mexican investors were the earliest class of investors to flee (Economist, 8/26/95).

□ For example, see accounts in Economist (2/4/95), Sanger (2/5/95) and Fineman (4/5/95).

□ For discussions regarding the fear of systemic flight from emerging markets, see, e.g., Business Week (1/23/95), de Palma (2/26/95), Economist (2/4/95; 3/11/95; 3/18/95; 5/13/95), Lewis (2/11/95; 2/12/95), Sanger (2/5/95).

□ See Financial Times (2/16/95) for details on the bailout package, including discussion of the Clinton-administration's overstatement of the size of the package.

□ \$4 billion of the first \$5.2 billion installment on the \$20 billion dollar US-financed portion of the bailout was used to redeem, refinance, or repurchase those tesobonos that were being offered for sale on secondary markets (Fineman, 4/5/95). Much the same use is planned for future installments of the bailout funds. Some portion of the bailout funds will also be used to stabilize the shaky Mexican banking sector.

It should be noted that as of the end of March 1994 the Mexican government still owes \$16.1 billion on tesobonos that will come due in the future, and \$100 billion in other outstanding dollar- and peso-denominated debts. Under these circumstances it seems very likely that this is just the first of many bailouts (Fineman, 4/5/95).

- In 1993, 7.1% of total loans were classified as nonperforming (Dornbusch and Werner, 1994, p. 284). The "bad loan problem" is likely to worsen following the rise in interest rates. In fact, by the end of February 1995 the finance ministry had already lent \$1 billion to assist troubled banks (Economist, 2/25/95). By January 1996, past-due loans exceeded \$17 billion--18% of outstanding loans made by Mexican banks (Smith, 1/22/96).
- The Mexican government's "Alliance for Recovery," signed by government, business and labor leaders in October 1995, reaffirms the commitment to neoliberal economic policies for the foreseeable future. This is especially the case in regards to the agreement on wage restraints.
- Indeed, the likelihood of persistent current account deficits is increased by the attainment of conditions necessary to the creation of an attractive climate for portfolio investment.
- Indeed, the freewheeling nature of the Russian stock exchange has received much attention of late; e.g., see Liesman (10/23/95) and Middleton (4/28/96).
- Note that the discussion here does not address what can be done on the "supply-side" to curb the volatility of portfolio investment. See Grabel (1996).
- Reisen (1993) argues that the key to East Asian success in preventing capital inflows from undermining trade (and hence macroeconomic performance) is not the use of capital controls, but in the sterilization of "hot money" inflows.
- Summers and Summers (1989) and Baker, Pollin and Schaberg (1994) make a case for the implementation of such a tax in the US, while Eichengreen, Tobin and Wyplosz (1995) do so in the European context. Hakkio (1994) reviews neoclassical arguments against such a tax.

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