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**Financial Markets and
Governments**

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FINANCIAL MARKETS AND GOVERNMENTS

A survey of the changing relationship between the market for political services and the market for financial services

1. THE BANKERS' BARGAIN

Modern financial markets and nation states grew up together. The development of nation-wide banking systems in Europe in the eighteenth and nineteenth centuries gave enormous new potential power to the governments of these nation-states, enabling them to borrow on a vastly greater scale - a power used mainly to wage wars of historically unprecedented cost. Increasingly, governments turned to central banks as instruments through which they hoped to centralize the control of credit and gain privileged access to it.

However, the financial markets have never been the passive mechanisms which they are often portrayed as being in the textbooks. The entrepreneurs who created these markets have always been aware of the double-edged role of the state - on the one hand, a source of secure profit and support, on the other hand, a potential threat to their very survival. Thus banks have always been anxious to reach a "modus vivendi" with the state.

The nature and terms of this "understanding" have been subject to many variations over time and from one country to another. The relationship has, however, had some relatively constant features. Thus bankers have always set a high value on their social status (it helps to collect debts), and the seating order at official functions is of the highest significance; they have also requested such basic conditions as enforcement of the sanctity of financial contracts, "last resort" loans

from the central bank when needed to and maximum freedom of movement for financial operations (e.g. removal of credit controls domestically and exchange controls internationally). Naturally, they have always justified these freedoms and privileges as being in the public interest. For their part, governments have wanted credit and also to avoid responsibility for financial crises in the commercial banking system - hence the delegation of supervisory and lender-of-last resort roles to the central bank.

In the century since the development of modern central banking, governments have provided these conditions whenever politically feasible and bankers have kept their side of the bargain - a liberal supply of credit. But in the past ten to fifteen years this balance has been upset. The potential for financing has again been vastly expanded by the globalization of markets, but the markets have raised the stakes. When governments are strong, they have generally been able to resist the more extreme pressures from "the markets". In the past 15 years or so, however, they have increasingly felt compelled to comply. This has resulted, among other things, in a gradual extension of the umbrella of state protection over the entire financial sector. Banks and other financial institutions have in effect extended their claims to political support under three headings:

1. Sanctity of contracts: Governments of the big industrial countries are now expected to provide strong (if discreet) support for banks' claims on other governments, especially in developing countries.

2. Lender of last resort (LLR): Governments now interpret this very widely, to include support for the property market, securities markets and other financial

markets in which banks have become deeply involved, and also to include large-scale cash support for insolvent financial institutions.

3. Fuller protection for the profitability of the financial sector.

It is not generally recognized how new all this is:

1. The principal creditor state of the nineteenth century, Britain, generally succeeded in maintaining its official policy of non-intervention in private disputes between bondholders and foreign governments.¹ Thus default was able to serve as a safety-valve. Of course, it was not exactly encouraged - moral pressure could be brought to bear. But it was regarded as one of those facts of life, an occasionally necessary purging of excesses, or a result of "force majeure". In marked contrast, during the recent debt crisis of developing countries, this natural safety-valve was suppressed, partly at least by pressure brought to bear on borrowers bilaterally and by the International Monetary Fund (representing in this regard the combined forces of the Group of Seven industrial countries). This may well have resulted in a distortion of the normal market signals and pressures operating on commercial creditors and on borrowing governments, and thus have delayed a

¹ See D.C.M.Platt (1968). After a full survey of the evidence on this contentious point, the author concludes as follows: "It is perfectly clear, then, that official intervention was denied bondholders unless their loans were under British government guarantee, or unless some incident had transformed their claims from the level of private debt-collecting to that of an international obligation. Bondholders, as far as the British government was concerned, were individuals choosing to invest abroad for their own profit; in doing so, they were acting independently of the interests of the nation and gambling merely on a higher return on their capital" (page 41).

settlement. Bluntly, so long as banking creditors could count on the support of the G-7 countries, they had no reason to settle for anything less than the full amount of their claims.

2. Similarly, the lender of last resort function, which was traditionally proposed for use only when the stability of the financial system was at risk in times of "panic" has recently been used as a cover for all manner of interventions and subsidies. In Britain, it remains arguable that official action in the secondary banking crisis which erupted in 1974 should have been confined to lender-of-last resort lending of the classical type, i.e. to eligible banks: but the authorities panicked and bullied these big banks into recycling the deposits withdrawn from the fringe banks in trouble through the collapse of the property market (the "lifeboat" operation); and when these fringe banks turned out to be insolvent rather than just illiquid, the Bank of England and the big banks picked up the bill. (These costs would have soared further if the Bank of England had not persuaded the Government to rescue the property market, by relaxing rent controls). In the Johnson Matthey (Bankers) scandal in 1984-5 the Bank of England again took over a failing institution at public expense - this time largely to prevent the gold market moving to Zurich. Neither of these episodes were "lender of last resort" operations in the classical sense. But both had the great benefit to commercial banks of confirming that none of them would be allowed to fail.

These operations were, however, dwarfed by the cost of rescuing or merging insolvent US Savings and Loan associations, estimated at up to \$150 billion, which was about ten times the aggregate profits of the biggest 100 US banks in 1987. The bankruptcy of many S & Ls was

caused partly by their attempt to compete with the money market funds and other new financial instruments offering market rates on deposits at a time when the assets of S & Ls were still mostly in fixed-rate loans, and partly by their poor (and sometimes fraudulent) management of new business which Congress had been persuaded to allow them to take on. Risky business could be conducted safe in the knowledge that the bill would be picked up by the US Government.

Take-overs of stock-market firms by banks raised the further question whether the state would be obliged to underwrite the underwriters as well as the bankers. Central banks' refusal to accept this was one of the reasons for the separation of deposit from investment banking in most countries. But the Federal Reserve's actions in immediately injecting cash to the system after a stock-market relapse in October, 1987, before evidence that any bank was directly threatened, was widely applauded. It suggested at the very least an extreme sensitivity to the potential effects on financial institutions of stock market volatility.²

² The following is an account by Martin Feldstein, former chairman of the President's Council of Economic Advisers:

"How shall we judge what the Fed did at the time? I think the Fed basically had learned the lesson of the 1930s. They knew it was important to provide liquidity...But there was something else that has received a lot less attention...:the problem of the securities firms. Some of the securities firms were in trouble and they came to the Federal Reserve and asked for credit. The Federal reserve quite properly said to them that they were very sorry, but they were in the business of lending to banks and couldn't lend to securities firms; such firms didn't have the privilege of the discount window. However, the Federal Reserve said that it would do some leaning on their friends at the banks to make sure that the banks were receptive when the brokerage firms came along. So the brokerage firms went to the banks, the Federal Reserve stood behind the banks, leaned on them, and the two parties managed to make a deal that would not otherwise have been possible....Now we have to ask ourselves, How will the securities firms behave in the future? What

3. Markets expect governments (through central banks or specialized agencies) to supervise banking and financial institutions to ensure that the security of participating institutions is beyond question - essentially by enforcing agreed capital adequacy tests, licensing and "supervision" requirements. This is not to deny that such supervision may serve to protect the consumer, though at some cost, but merely to point out that it also is in the interests of the firms being supervised, especially if they can also use the supervising institution as a means of communicating their concerns to politicians.

Because it is easier to supervise and manage a few large banks than many smaller ones, most governments (at least European ones) favour oligopolistic banking systems with high barriers to entry. The industry predictably is characterized by high levels of concentration (the world's largest 34 banks account for a quarter of the assets of all 500 top banks), high profitability in "normal" times and occasional outbreaks of "cut-throat" competition, which the biggest players regularly try to forestall by forming cartels. These excess profits are required to provide reserves against loan losses incurred as a result of loans extended under the influence of "moral hazard" (due to the security provided by 1 and 2 above).

But what most upset the equilibrium between financial and political interests was governments' realization

kind of risks will they be willing to take? Will they take more excessive risks in the future because they have seen that when the crunch comes, the Fed, while not prepared actually to lend to them, is prepared to do something which is equivalent?"

Dr Martin Feldstein, quoted in the Eastern Economic Journal, Volume XIV, No 4, October-December 1988, page 339.

that, although they had extended further privileges to the financial sector, they had not gained greater policy autonomy. On the contrary, market processes contributed to the gradual erosion of the effectiveness of policy instruments. Exchange rate "overshooting" in the volatile foreign exchange market persuaded many governments to dedicate monetary policy to exchange rate stabilization.³ More generally, many of the difficulties facing both monetary and fiscal policy could be traced back to increasing financial sophistication on the part both of individuals and firms and their ability to "see through" discretionary policy changes, due partly to growing familiarity with financial market processes.

What has been behind the increasing influence of the financial markets? To gain an idea of the forces involved, this paper takes a broad historical survey of the relationship between governments and financial markets. The answer tentatively suggested is that, although several forces have been at work, two have been particularly strong: first, the interaction between political and financial entrepreneurship (the politicians' desire to underwrite new programmes interacting with the profit motive of financial entrepreneurs), and, secondly, social changes; each decade since World War I has seen a new generation of customers with rising expectations of political and financial services. But an increased supply of political services required financing, and an increased supply of financial services required government support.

³ Most central bankers would probably claim that monetary policy can still be made effective, even in integrated financial markets, by improved techniques of control over bank reserves and especially through greater flexibility in short-term interest rates; but in practice, policy is increasingly geared to external objectives, and even where it is not, the political resistance to interest rate flexibility reduce the authorities' freedom of action.

The processes through which market power has encroached on governments can be seen in the experience of widely differing countries in recent years: smaller European countries in the early-to-mid 1970s, Britain in the late 1970s, France in the early 1980s during its experiment in Keynesianism, and the developing countries in the debt crisis. The creation of the EMS in 1978, explicitly to counter market turbulence resulting from dollar weakness, recognized the loss of monetary sovereignty.

By the late 1980s, bankers were well aware of the strength of the resistance to "financial openness". Bankers' big worry was that a regionally-based, political backlash (already well-advanced in the EC) could gradually undermine the global markets from which they derived their real strength vis-a-vis governments. Their priority therefore was to stop attempts by countries to recover through regional groups, defaults and controls some of their lost power.⁴

The following survey shows, however, that it is wrong to assume that the erosion of policy instruments is a necessary accompaniment of technological forces over which governments and bankers have no control. Whether one welcomes or deplores the shift in the balance of power, where the balance should be struck is a legitimate matter for public debate, choice and action.

⁴ An illustration is the "open letter" sent by a group of 18 bankers representing institutions from the US, Canada, Japan, the UK, Switzerland, Germany and France to Mr Gerald Corrigan, President of the Federal Reserve Bank of New York, drawing his attention to the dangers of Europe restricting banking operations of non-EEC institutions. The fact that the letter was addressed to a US central banker in the hope that he would use influence to pressure foreign governments throws a sidelight on commercial banks' expectations. See *Financial Times*, December 1, 1988.

11. WHEN THE BARGAIN WAS KEPT

The Gold Standard era

Since the development of deposit banking, the Gold Standard has been the only system that has imposed tight constraints both on governments and on the markets. Governments' autonomy was limited by the objective of maintaining convertibility at the fixed price. All other objectives of policy were subordinated to that aim. By linking gold flows and domestic money supplies (admittedly with some "management" by central banks), in all countries subscribing to the standard sustained outflows of gold could be relied upon to contract the domestic money supply. It is very doubtful whether even Britain, as the dominant power, really enjoyed "autonomy" in monetary policy: as the keeper of the central cash reserve, with a direct link to the national money supply, its domestic economy was immediately influenced by shocks from any other point of the system.

The financial markets were also constrained. Some prices, including exchange rates and the price of gold, were taken out of the market arena. Moreover the governments' commitment to convertibility implied that market forces could never be seen to threaten that commitment. It was regarded as a moral issue. Because of such moral sanctions, including the doctrine of the balanced budget, market participants expected the fundamental parameters of policy to remain unchanged indefinitely. There was no equivalent to most present activity in financial markets, which consists in offering insurance cover against the pervasive

uncertainty about future exchange and interest rate movements, and notably about government policy itself.

Ironically, although no system offered less formal "autonomy" in monetary policy, the gold standard reigned at a time when European nationalism and the ideal of political sovereignty were at their peak. Countries were anxious to join the gold standard club. To the governing classes of the time, the advantages of belonging to the system plainly outweighed the costs. Among the advantages cited was the availability of commercial credit to cushion short-term payments and access to long-term capital. But above all, the system was viewed as the "modern" monetary system, the mark of a civilized nation.⁵

Even now it is unclear how large the costs of the sacrifice of monetary autonomy really were. The Keynesian revolution, with its stress on price-wage rigidity, emphasised the costs involved in requiring the internal economy to adjust to the balance of payments, and this, together with the experience of the 1920s, gave the Gold Standard a bad name, saddling it with responsibility for the international spread of inflations and depressions. Yet interpretations of how economies interacted under the Gold Standard continue to evolve. The traditional view that international adjustment of payments was brought about by gold

⁵ Leland Yeager quotes a certain Dr Foregger, deputy in the Austrian Parliament, as saying in the debate on the issue that the "scap of paper" economy of Austria degraded the country economically to a second-rate power:

"We demonstrate that our Empire does not have the strength to introduce among us, too, the means of payment, hard money, that holds sway in the civilized world. We thereby incessantly damage our credit, our economic flexibility and competitiveness." See *The Image of the Gold Standard*, by Leland B. Yeager, in *A Retrospective on the Classical Gold Standard*, Bordo and Schwartz (1984).

movements, with a country in payments deficit forced to deflate via a reduction in the country's money supply, followed by changes in its price level and terms of trade, has been challenged by the "revisionist" school, under which prices of tradeable goods and relative national price levels were aligned by generalized commodity arbitrage. On this view, adjustment of international payments was similar to adjustments within a country, with changes in expenditure patterns across countries coordinated through small interest rate changes so as to match trade deficits and surpluses with net capital flows.⁶ Long swings in the world economy were due rather to the use of gold as a numeraire than to fixed exchange rates and the automatic link to domestic money supplies.

What is clear is that the system was both a cause and a reflection of a greater integration of the world economy than was attained at any time between the outbreak of World War 1 and the 1980s - and that it went along with the most strident assertions of political sovereignty.⁷

The inter-war period: some potted history

In the 1920s the rise of the labour movement and the break-up of the old empires made the constraints imposed by the gold standard rules intolerable. The failure of

⁶ See *An International Gold Standard without Gold*, by Ronald McKinnon (mimeo), 1988 and *The Success of Purchasing Power Parity: Historical Evidence and its Implications for Macroeconomics*, by Donald N. McCloskey and J. Richard Zecher, in Bordo and Schwartz (1984).

⁷ As indicated by proportions of trade to GDP, long-term capital flows and sustainable ratios of debt to GDP; see tables 1-3 and figure I.

the short-lived attempt to restore the standard (1925-31) was directly attributable to the fact that parities were restored at unrealistic rates, but the change in conditions since the war meant that such an international monetary system could no longer be supported.

After Britain went off gold in 1931, governments reacted to the international panic by reaching for physical controls. At least, they felt, they could control domestic credit. New social programmes, rearmament, and massive projects of social engineering could all be accomplished by such control. Even the mild democratic governments sought to regain autonomy with the help of foreign exchange and import controls. Both Britain in 1931-32 and the United States in 1933-34 resorted to exchange controls under emergency regulations, and Britain went on to set up the Exchange Equalization Account (insulating its money supply from foreign exchange flows) and to form the sterling bloc. But the totalitarian powers were far more energetic: Germany's Reichsbank under Hjalmar Schacht instituted the world's first comprehensive system of controls. This system was used not only to subject the business of German residents to state control but also to fix artificial exchange rates for the system of countertrade (clearing agreements) with countries that came under German domination. The purpose was to finance the Nazi programme of industrial and military expansion.

These controls represented attempts by governments to assure themselves privileged access to cheap credit and to exploit fully the potential of the deposit-banking systems. They set up powerful market reactions which

faced governments with the problem of enforcement. Experience soon showed that, for a society that does not resort to police-state methods, restrictions on the freedom of individuals to transfer money abroad can be enforced only if these restrictions command widespread consent.

Exchange controls pushed trade into bilateral channels. This was another lesson of the period: Britain concluded preferential trading agreements with many of the Commonwealth countries and the other countries that had pegged their currencies to sterling after 1931, and gave them privileged access to the London capital market. Access of other foreign borrowers was curbed; and Germany used controls to regulate the direction, volume and terms of its international trade, especially with east European countries.

Markets and controls under Bretton Woods, 1947-71

This period provides the only example of an attempt to subject the financial markets and national governments to an internationally-agreed set of rules and institutions. Certainly, the system was designed to further American foreign policy and business interests, and was sustained by American power. Yet at least an attempt was made to justify and legitimize the rules in terms of universally-accepted "rational" norms.

Governments of member countries were constrained by (a) the commitment to a liberal, multilateral world economy

enshrined in the Articles of Agreement of the IMF and the GATT (b) the need to justify internationally any proposed change in a country's par value, (c) the fact that exchange rate changes were again increasingly regarded, especially by bankers, as raising moral issues and were always fraught with political difficulties because any change hurt some sectoral interest and (d) the programme for removal of remaining trade and payments restrictions under Article VIII of the Fund. Thus although Keynes hoped that the system would increase the freedom of countries to follow macroeconomic policies for full employment, under the rules he helped to draft governments gave up the right to determine national credit creation. This was implicit in the exchange rate mechanism.

The instruments available to make these commitments effective in the markets included capital controls, credit controls, interest rates, fiscal policy and limited credit facilities from the Fund. These instruments were effective only so long as financial market activity was at a low level, domestic and international markets remained segmented, and so long as such constraints on national autonomy were viewed as legitimate. While these conditions held, governments were in control.

The belief that the system had legitimacy and respectability was very important in sustaining it. This was illustrated in Britain's "Radcliffe Report" published in 1959.⁸ This report was controversial and

⁸ Report of the Committee on the Working of the Monetary System, August, 1959.

ambiguous in that its recommendations supported the maintenance and even extension of post-war direct controls while the clarity of its exposition forcefully suggested that rapid market developments could quickly make these recommendations invalid.

The report regarded currency and credit controls as legitimate policy instruments. But it also made clear that, even in the 1950s, before the invasion of US banks and the growth of the international money markets, these controls could not prevent large short-term capital movements. For instance, countries holding sterling could draw on their balances instead of using their currencies to make payments, multinational corporations could borrow in the United Kingdom and run down borrowing abroad, long-term investment continued on a considerable scale and there were large and unavoidable swings in the timing of current payments, the "leads and lags".

The report demonstrated the close connection between contemporaries' perception of the country's international obligations and policies to secure domestic objectives of full employment and growth. The authors were aware of the possibility of inconsistency among these objectives, but felt that the international monetary system would provide enough latitude to call only for moderate sacrifices of national objectives. Membership of international organizations, notably the I.M.F., gave "reality" to the nation's duties and aspirations as a member of an international community. Any policy measures, it stated, "not only must be reconcilable with the rules of these organizations but should foster the spirit of mutual aid that underlies

them all". Being part of this international community allowed the country "to pursue in active cooperation with them the objectives of economic growth".

This regime was weakened by social changes and financial innovation. The 1960s saw the rise of a new class of internationally mobile individuals - notably international corporate executives and professionals involved in services such as insurance, ship and air chartering, civil engineering, medicine, law, banking, and the new international agencies - for whom it was increasingly a matter of choice where they called home. As these groups joined the ranks of the old rich, the pool of internationally-mobile (and tax-avoiding) funds rose, swelled further by capital flight from developing countries. It was this pool that the new Euromarkets would tap, from the early 1960s, in addition to the liquid funds of the corporations themselves. Exchange control became gradually less enforceable.

The growth of multinational corporations was spearheaded by US corporations, riding the great waves of US foreign direct investment encouraged by the creation of the European Economic Community in 1958. The 1960s also witnesses an expansion of US banking overseas on an unprecedented scale. Whereas formerly only a few American banks maintained a handful of foreign branches, mainly in London and South America, by the end of the decade they had scattered branches throughout the capitalist world, including many developing countries.

Everywhere, by the early 1960s, these American bankers were breaking down time-honoured and hallowed traditions

of their local societies. Openly flouting local conventions, they created their own financial markets along with their clubs and schools. Simply by picking up the telephone and borrowing or re-depositing dollars from other US banks in Europe, they created havoc among local banks for whom London was still two days' journey from Milan and for whom it was unthinkable to undercut other banks abroad or at home. Everywhere in Europe, cartels supporting wide differentials in interest rates collapsed. The Americans recognized a new frontier when they saw one.

Their physical presence was an essential ingredient in this impact. Throughout the world, the logos of Citibank, Chase and Bank of America appeared suddenly in city centres, beacons to the new generation of business leaders and consumers. Thanks to the personal contacts they established, young trainees from central banks soon found themselves in studentships at MIT and the Harvard Business School. Thanks to the fall in transportation costs, these personal contacts were maintained in following years, and helped to create the Euromarkets (based on agreements made over the telephone, making personal trust an essential ingredient of the new markets).

Governments continually attempted to reassert control, partly by direct action on financial flows and partly through the creation of swap lines between central banks to defend the dollar but such policies spurred further innovation. Everywhere market segmentation started to erode. In time, these market changes overthrew the post-war reliance on direct

controls. Too many new and quite legal channels of financing were available.

By the 1960s, these social changes generated new markets that placed the fixed exchange-rate system under strain: Germany revalued, France devalued, Britain held out for three years (partly in deference to the United States) before devaluing in 1967 and the United States itself resorted to controls.⁹ The 1963 Interest Equalization Tax was levied on the income of American investors and forced a large part of the US capital market overseas, giving birth to the modern international bond market.¹⁰ Whether the US experiment with capital controls was "effective" has always been hard to determine. All that is certain is that they did not succeed in their objective of preserving the existing monetary system, that they helped establish off-shore markets in all major currencies and that they undermined the effectiveness of other countries' existing controls.

⁹ See *Money on the Move: The Modern International Capital Market*, by M.S. Mendelsohn, pp 32-36, on which the following two paragraphs are based.

¹⁰ In February 1974 the IET was extended to bank loans at one to three years to most foreign borrowers, and in 1965 this was reinforced by the Voluntary Credit Restraint Programme and the rules of the Office for Foreign Direct Investment. These programmes required US companies to improve their individual balance of payments with industrial countries in a variety of specified ways - including by borrowing abroad. This led to a surge of foreign borrowing initially from foreign banks, until the IET on lending by US bank branches overseas was lifted to enable them to compete - the start of the great boom in syndicated, medium-term Eurocredits.

III. HOW THE BARGAIN WAS UPSET: MARKETS AND POLICY SINCE THE 1970S

In terms of the relationship discussed in this article, Bretton Woods collapsed because market growth created a new set of incentives: governments saw that they could do better outside the official system. The markets used sticks as well as carrots. Carrots were good enough for the credit-hungry Americans and British. President Johnson had already been granted credit to finance the Vietnam War without raising taxes: this fuelled a rapid expansion of Eurodollar credit which was then used to finance massive speculation against the dollar (borrowing dollars on the market and selling them spot) which resulted eventually in the collapse of the Bretton Woods system. The British government needed no persuasion: egged on by commentators, Prime Minister Heath and Chancellor Barber floated the pound in 1972 in their "dash for growth" and inaugurated an unprecedented overseas borrowing spree which in less than five years was to send Britain begging to Saudi Arabia, the IMF and any other creditor it could find. But sticks were needed to beat down German resistance. This victory was achieved in March 1973, when the Bundesbank surrendered in the battle to save the Deutschemark from the onslaught of speculative capital inflows, unpegged the exchange rate and inaugurated the era of generalized floating.

Governments took the market solution because it offered freedom, but found that they had in fact surrendered both their freedom and, in some cases, their credit also. Finance, not government, was the real beneficiary of floating. Floating resulted in a vast expansion of demand for financial intermediation and new financial

services. This was for two main reasons. First, inflationary economic policies, previously held in check by fixed rates, needed vast amounts of financing: floating by itself was found not to give sufficient autonomy. Without credit, exchange rates had a politically alarming tendency to fall through the floor. Secondly, huge differences in expectations about exchange rate movements, linked to rapidly-shifting inflationary expectations, entailed an immediate increase in the risks of all financial contracts (especially longer-term contracts). Suddenly there was no international money, nothing that could serve as a standard of deferred payments. So the markets got into the business of creating risks, or at least financing risk-taking, and, at the same time, providing new techniques for reducing these risks, while attributing the whole process to irresponsible governments.

Additional private and official demand for new financing created a new banking system analogous to the development of domestic banking systems in the eighteenth and nineteenth centuries. Admittedly, bank reserves still had to be provided by governments but the new markets allowed banks to economize on use of reserves. More important was what banks did with them - to develop a world-wide lending and deposit-taking business on the foundations built, mainly by US banks, in the 1960s. The inflationary potential of this new banking system led economists to call for the application of reserve ratios to Eurocurrency deposits but they were brushed aside by the Bank of England.

Predictably, this international credit was used mainly to finance new government projects, which showed up in

an increase in current account imbalances and the oil price shocks. Without sufficient finance, OPEC's attempt to raise the oil price would have caused a world deflation that would have brought down the oil price very quickly. From this perspective, the shocks that are usually assigned a prime role in the problems of the 1970s were, rather, by-products of the unbridled expansion of international finance.

Governments were greedy customers. They made no attempt to limit cross-border financial flows - the fear was, rather, that there might not be enough of them. Deficit countries borrowed heavily while creditor governments went on providing guarantees to private banks in the form of deposit insurance, export credit guarantees and safety-nets for all "big" banks - safety-nets that could only be justified in the context of the more controlled system of finance of the immediate post-war era. To provide guarantees against insolvency while taking all restraints off lending and simultaneously raising the risks involved was a recipe for disaster - moral hazard on a quite immoral scale. The new technology of the markets merely ensured that the disaster would be global in scope. ¹¹

Both developing and developed countries first enjoyed and then suffered from the greater autonomy offered by floating rates and elastic credit supply. The promise was not entirely illusory. To quote Carlos Diaz-

¹¹ For instance, before the globalization of markets it is not clear that the suspension of debt payments by Mexico in 1982 would have led to that of Brazil a few months later, since the latter was precipitated by panic withdrawals of bank credit: indeed, some have argued that the Mexican crisis itself was produced partly by nervousness about East European credits.

Alejandro again "probably no capital market in history enjoyed a lower degree of political interference, to the dismay of cold warriors and "strategic minds" like Henry Kissinger's".¹² Within the constraints of the prevailing regime, the markets of the 1970s clearly extended the options available to economic policy-makers in developing countries. But the bill was presented in the 1980s.

Developed countries began to count the costs of the new-style autonomy in 1974-75, when annual inflation rates averaged 13 per cent in the OECD:

"Nobody knew where it would go. The last time a world system had been in inflation was in the third and fourth centuries under the Roman empire, and then it had lasted more than 100 years."¹³

Although this inflation was curbed in the recession of 1980-82, the outcome was to give even more freedom to the financial markets. These years saw a "changing of the guard" in terms of the prevailing ideology of economic policy, with the new generation of monetarists taking over key policy-making posts. The monetarists welcomed financial deregulation and their belief that the markets could be controlled by adopting monetary targets proved misplaced. Such feeble defences caused the markets much less trouble than Bretton Woods had done. Indeed, this was when the markets really started to have fun.

¹² See Diaz-Alejandro (1988).

¹³ See Sir Jeremy Morse, "The great inflation and its aftermath" in Eizenaga et al (ed) 1988.

IV TECHNOLOGY'S PASSIVE ROLE

To what extent was this official retreat forced by technical characteristics of the new markets? Technological advances were clearly indispensable to the development of many of the new tradeable instruments. However, the financial revolution was driven throughout mainly by demand factors.

The demand was stimulated initially by the increased volatility of asset prices, the financing of mergers and acquisitions and the pervasive uncertainty generated by fluctuating inflation rates and expectations.¹⁴ As in previous periods of rapid innovation, financial institutions were also motivated by a desire to evade official regulations. The pressure on capital-asset ratios gave a strong impetus to the growth of off-balance sheet business.

The demand for hedging instruments and the shift from banks to securities issuing and trading was strongest in the United States and United Kingdom, partly because monetary policy was particularly volatile in those countries. These were countries also where financial resources had become highly concentrated in institutional ownership (By the early 1980s institutions owned about 90 per cent of long-term government bonds in the United States and 75 per cent in Britain compared with 55 per cent in Japan). Thus the preliminary stages

¹⁴ The variance of inflation rates increased from 0.6 per cent in the 1960s to 6.7 per cent in the 1970s. (IMF: *International Capital Markets*, April, 1988, page 40)

of the process were dominated by domestic market changes, especially the development of money market and NOW accounts at the retail level and "wholesale" methods for underwriting bond issues in the United States. However, the fact that the process of innovation was led by institutions in the world's leading *international* financial centres greatly stimulated the international diffusion of the new techniques. The association of the innovations with New York and London and the breathless enthusiasm with which they were written up in the financial magazines made company treasures everywhere believe that they could benefit. The rising demand by companies for access to these instruments clearly strengthened the lobby for deregulation and more openness at the national level.

Again, social changes influenced demand. The late 1970s and 1980s witnesses a rapid rise in personal financial asset holdings, swollen by the stock market boom. The "yuppies" demanded a far wider range of financial services, including particularly a better rate of interest on their bank deposits, than their parents had done. Moreover, the new generation was well aware of the case for portfolio asset diversification and expected the institutions that looked after their savings also to diversify internationally. The impact of this group was particularly marked in Japan, where bank depositors had been strongly discriminated against ever since World War 11 (to provide low-interest loans to industry). Having grown up with the jumbo jet and personal computer, this generation took unrestricted financial and personal mobility for granted - and they were certainly not going to go to Switzerland to avoid controls. Young professionals in developing countries, open to the cosmopolitan culture, were equally aware of the new

opportunities - and often had a much greater incentive to avoid any domestic controls by maintaining foreign bank accounts and not declaring the interest (Taiwan is said to be the world's largest market for Reuter's monitor screens because it has exchange controls which everybody circumvents by gaining direct access to the markets).

By providing corporations with possibilities for direct dealing previously open only to banks, technology eroded the distinctions between them. It also afforded the potential for much greater control over risk exposure (itself monitored automatically). The enhanced sense of control encouraged rapid international diversification of security portfolios, especially by institutional investors. This institutional diversification was probably the single most important force in the financial markets of the 1980s. Several trillion dollars were diversified out of domestic portfolios. Technology also encouraged the standardization of financial services that were previously provided on a tailor-made basis, and of financial contracts. At the retail level, to the extent that loans, deposits, insurance and brokerage services can be automated, any company with a large customer base could provide a range of financial services as cheaply as banks.

In response to these opportunities, financial institutions started to lobby hard for greater freedom to offer services internationally, a freedom restricted by remaining exchange controls and other restraints on openness. There were two main strands here. First, as financial expertise and capital concentrated in the major international centres, various national financial

centres found they were losing not only international business but a significant fraction of their domestic corporate business as well to these world centres. Thus the German government was informed by its central bank that unless it relaxed restrictions on capital market business in Germany, its big banks would migrate to London. Secondly, governments were aware that trade in services has been growing significantly faster than trade in goods (the proportion of invisible trade in total world trade has increased from 23 per cent in 1976 to 27 per cent in 1986). Financial services are an integral part of the provision of invisible services generally. Countries which have large financial earnings are also large exporters of other services: the City of London's invisible earnings increased from £1.5 billion net in 1976 (out of a total invisible earnings of £4.7 billion) to £9.4 billion in 1986, out of a total of £13 billion. The other services closely linked to banking are insurance, the stock exchange, commodity markets, ship and air brokerage, portfolio management and investment income. But most countries allowed foreign banks to operate in their countries only on the basis of reciprocity - a principle that forced openness on countries that wished to participate in the boom in financial services. Another example of the way in which pressures towards "openness" build up is provided by the European Community, discussed below.

Summary of the influence of technology

The markets take what they want from the "shelf" of technology that is available in any period; carrier pigeon, cable, telephone and real-time, world-wide direct dealing are all stages in the development of

financial technology. But what the financial institutions take is shaped by demand from customers, and the role of technology and social changes in creating those new demands is much more important than its direct role in the hardware of the financial markets themselves. The demand of the 1980s is for international asset diversification, and protection against volatility and uncertainty - in sum, a demand for substitutes for the stability that had once been provided by an international monetary system sustained by a leading power or by collective action. Not surprisingly, the markets could not supply such public goods.

V THE LIMITED OPTIONS FACING GOVERNMENTS

With the breakdown of the implicit contract between finance and the state made in the nineteenth century, and sustained essentially until the 1960s, the markets gained the upper hand. This can be seen as the result of the systematic exploitation by financial entrepreneurs of the new freedoms that they had wrested from governments, assisted by technological and social changes. The market's ascendancy was reflected in, and further re-inforced by, the move to floating exchange rates among major currencies in the early 1970s, after which for a time markets became the main mechanism for coordinating national policies (as well as financing them). The availability of Euromarket finance promised greater autonomy because it allowed adjustment to be postponed, but because adjustment had to be effected eventually, exchange and interest rates moved "disruptively" to force governments to make the necessary policy changes.

In the next stage, traditional instruments of economic policy were steadily eroded. Starting with smaller open countries, government were gradually led to use monetary policy to target the exchange rate - as the only way to reduce electorally-damaging exchange-rate fluctuations. This process of "internalizing" the necessary coordination of policy was taken farther in countries which, from 1978, decided to link exchange rates formally in the European Monetary System, but applied increasingly to others. Even in the United States major changes in policy, such as the adoption of monetary targets in 1979, and the attempt to manage the dollar's decline in 1985-88, were prompted by exchange rate

concern. Then it was realized that the other classic instrument of demand management, fiscal policy, had also been undermined by a number of factors related to the spread of "market-oriented" attitudes among consumers and voters: these included growing perception of the national debt as a "burden", opposition to budget deficits, the popularization of supply-side economics, increased attention to incentive effects and resistance to taxation levied to finance rising interest payments. From this perspective, policy effectiveness has been diminished not so much by the integration of capital markets and "financial openness" as by increased levels of financial sophistication of individuals and corporations and the associated loss of money and fiscal illusion.

The reactions of governments have taken various forms. Here we follow the typology outlined by Richard Cooper and Ann Hollick in their discussion of the effects of technological change on international relations.¹⁵ These authors characterize the possible reactions of governments to the erosion of their traditional controls under four headings: defensive, accommodative, aggressive and cooperative.

a) *Defensive responses.* These "involve attempts by governments to stop erosion of their actions by steps that reduce the openness of their national economies, for example, by reducing the mobility of firms or funds". In terms of the policy options discussed in this

¹⁵ See Richard N.Cooper and Ann. L.Hollick in National Academy of Sciences (1985), p 235.

paper, this response would involve, for instance, imposing limits on capital movements.

The basic problem with this response is that the efficient conduct of a business enterprise in the 1980s requires management to have a large degree of discretion in financial policy. This extends not only to the financing of foreign trade but also the monitoring and control of cash flow, short-term borrowing and fund placement and longer-term capital raising functions.

First, to remain competitive, firms have to be given some leeway in the timing of current payments (spot) and in the use of forward market operations, and both of these vehicles must also be available for speculative transactions which provide liquidity to the markets. Moreover, governments of countries with ambitions to be exporters of capital goods allow the exporters or their banks to provide long-term export credit (ten to fifteen years) and to refinance such credits in accordance with changing market conditions. Since in practice it is not feasible to separate trade from capital transactions, any increase in trading openness tends to increase financial openness as well.

Second, given the fact that only a few countries have a viable and competitive domestic capital market, access to the Eurocapital market has become essential to finance corporate expansion at competitive borrowing costs, especially in the industrial economies in Scandinavia, East Asia, Australasia and southern Europe. Equally, most countries allow large institutional investors, such as insurance companies, to invest part of their portfolio abroad, so that they can diversify their risks and improve overall performance. Virtually all countries also allow foreign companies to establish

subsidiaries and domestic firms to operate abroad; true, conditions can be required, but these invariably permit scope for adjustment of cash and investment positions. The volume of funds that is able to flow freely across borders for such business reasons often exceeds by a large margin the country's foreign reserves.

Thirdly, there is the exit option. This is one area where the technological revolution is of prime importance: transport and telecommunications costs have been drastically cut (30 years of experience with commercial jets have demonstrated improvement of 30 per cent a decade in fuel efficiency); computation charges have dropped by 90 per cent in each of the past two decades; and communications satellite charges have dropped by nearly 90 per cent in real terms between 1965 and 1982. This technological revolution enables companies to shift the location of production and even domicile at low cost, permitting many of them the option of moving out of countries that levy taxes exceeding the international norm, and capital controls are a form of taxation.

b) *Accommodative responses.* In this category, governments "do not resist erosion of traditional policy measures, but rather adapt their measures to the new prevailing circumstances". This has plainly been a frequent response, and it serves the interests of the most credit-worthy corporations. Several studies demonstrate that the largest multinational corporations have managed the floating system effectively, through shifting the location of production and sourcing and taking full advantage of new financing techniques for hedging exchange risk. As the case of Europe shows, big business could have the best of both worlds - privileged

access to cheap capital and protection from exchange rate risk. Governments and local authorities frequently engage in competitive bidding for new foreign investment, and for providing regulatory environment favourable to banking services. But this response tends to erode further the governments' position vis-a-vis banks, corporations and their electorates and gradually transforms official authorities into agents of businesses or even into businesses themselves, with the privatization of government services.

c). *Aggressive responses*, whereby "in the face of decreasing effectiveness in their actions (governments) try to extend their reach to cover the escaping parties". Examples here include US claims to extra-territorial jurisdiction, German and Swiss attempts to stop their currencies being used as currencies of denomination for securities issued outside their countries, and export subsidies. But as this list suggests, the scope for such "aggressive" responses in the economic and financial field is inherently limited. An individual state (legal jurisdiction) can only suppress activities of which it disapproves which take place outside its borders by gaining the cooperation of other states.

d) *Cooperation* "to overcome the erosion of policy measures due to the greater mobility of firms and funds". Cooper and Hollick mention attempts at economic policy coordination and moves to establish minimum standards (e.g. in pollution control but the same principle would apply to banking supervision). They note that the formation of the EEC itself was "an attempt to surmount the limitations that individual European

governments increasingly felt, or recognized that they would feel, in an increasingly interdependent world".

Yet the defects of cooperation as a means of restoring policy effectiveness are also clear: essentially, this usually makes explicit the loss of policy effectiveness at the national level and transfers the conflict to a supranational level where the same issues are played out - with presumably much the same result in the long run.

The underlying problem in attempts to "delink" an economy from the world market is that, at a time when technology has increased the mobility of ideas, techniques and capital, but where labour is less mobile, the ability of a people inhabiting a particular territory to engage successfully in the "global confrontation" depends on a range of factors in addition to traditional trading competitiveness. In particular, evidence suggests that countries gain many benefits from developing corporations with particular "firm-specific" advantages able to seek out and exploit profit opportunities anywhere in the world. Finland provides a good example. In 1980 Finland only had 3 or 4 truly multinational corporations - defined in Finnish terms as companies the bulk of whose activities are conducted outside Finland itself: this number had risen to 20-25 by 1988. Even more dramatically, the proportion of total employment of industrial companies represented by foreign employees rose from an estimated 5 per cent to 20 per cent in the eight years to 1988, when the volume of foreign direct investment rose from FIM 500 million to FIM 8 billion. The benefits are seen in Finland as deriving from the opportunity to increase exports of high-tech capital goods and to continue moving up the technological ladder, where highly attractive profit margins are available because of specific expertise as

represented by managerial, technological and marketing abilities. Without this very rapid internationalization of the 1980s it is believed in Finland that its technological capacities would have declined well below best international levels, leading over time to the possibility of an absolute decline in living standards.

This growing necessity for even small countries to develop their own multinational corporations is enhanced by the "policy rents" emerging as a result of growing regionalism and protectionism. With the development of many kinds of economic integration, including bilateral agreements, free trade areas, customs unions and monetary unions, discriminatory barriers (and hence excess profits for those inside) are also growing rapidly. Countries which lack companies that can exploit such rents by getting "inside" the barriers are at a disadvantage in the global confrontation.

This clearly does not imply that it is physically impossible to reduce the degree of integration, or even to disengage from "global confrontation"; it does suggest that the economic costs of doing so are growing. As long as the people in a territory are aware of those costs and willing to bear them, perhaps for the sake of other values that they hold, the world economic system should be able to accommodate that desire. Again, Nordic experience suggests that the crucial restrictions required are those on foreign ownership of enterprises, real estate and natural resources, and on immigration.

Banking on democracy

This paper has attempted to analyse the historical relationships between finance and the state as

components in a single "economic system" in which financial and political services are produced in response to changing consumer tastes driven by social and technological change (the consumer here seen as demanding political as well as economic goods and services). The relationship is symbiotic, as each "organism" depends closely on the other and they have grown up together. But over time the political demand for financial support, as an "input" into the production of political services, has proved far stronger than banks' need for political support. Governments have made repeated attempts to regain control and "autonomy" in monetary and economic policy, and the markets have had some setbacks, notably during the world wars and their aftermaths. But the general trend towards increasing market dominance has been maintained.

Some of the underlying causes of this are suggested in previous sections. First, the initial conditions favoured the markets in that they could take the existing legal and institutional structure of society for granted as a public good (along with legal protection of financial contracts) whereas states had to compete in the market-place for finance along with other borrowers (though they frequently tried to monopolise credit). Secondly, the nature of banking risks and the desire to avoid big bank failures are such that the public sector has in the twentieth century in all countries provided "backstops" to banking in the form of LLR function and other forms of support, but the "quid pro quo" for this support in the form of supervision and regulation has never been tight enough to offset its effects in increasing "moral hazard" and periodic over-expansion of credit. Indeed, in many countries governments and central banks have deliberately cultivated an oligopolistic banking structure. Yet the

further banks expand, the more they need even greater freedom from exchange controls or other restrictions in order to allow them to "grow out" of the trouble in which they invariably find themselves.

Finally it is no coincidence that this whole cycle started at a time, 60-80 years ago, that also witnessed the advent of adult suffrage in most democracies. The gold standard was aristocracy's way of keeping financial markets in their place. Democracy has not yet found a substitute.

Appendix I

Classification of Trade and Payment Restrictions

(excluding tariffs and direct taxes on imports and exports)

The IMF's annual report on "Exchange Arrangements and Exchange Restrictions" describes each country's restrictions, including import licensing, advance deposit requirements, import surcharges, travel taxes, export licensing and export incentive schemes. The account is organized under the following categories:

Exchange arrangements: the structure of exchange markets e.g. whether separate exchange rates are applied for different types of transaction; how the exchange rate (or rates) is set.

Administration of control: e.g. whether it is centralized (e.g. in the central bank) or delegated to authorized banks.

Prescription of currency: Where a country has concluded payments agreements with other countries, the currency to be used for specific categories of payments is often prescribed.

Non-resident accounts: the freedom of non-residents to maintain accounts in a country may be circumscribed - and many countries maintain many types of account for non-residents.

Imports and Import Payments: import licensing, advance deposit and other requirements may be imposed on payments for imports.

Payments for Invisibles: e.g. these often require approval, especially for residents travelling abroad, non-residents' travel, interest payments, remittance of non-resident working in the country, the export of notes and foreign exchange.

Export and export proceeds: e.g. export licensing requirements, and whether it is compulsory for exchange receipts to be surrendered, and if so in which market.

Receipts from invisibles: e.g. regulations on remittances of national working abroad, and on foreign exchange earnings of residents.

Capital: special regulations or limitations may be attached to international capital movements:

(i) Banks' foreign transactions

These are a large variety of restrictions on different types of flows, such as short-term trade credit and medium or longer-term bank lending: restrictions on foreign exchange market activity: special taxes or reserve requirements on foreign deposits:

(ii) Portfolio investment

Restrictions on foreign purchases of domestic securities and residents' purchases of foreign

securities; channelling such transactions into a separate "investment currency market" has been one method used, e.g. by France and the UK; other countries prohibit, e.g. foreign investment in domestic government bonds.

(iii) Direct investment

Restrictions may be applied to direct investments by foreigners in domestic enterprises, real estate or natural resources, and this is sometimes exercised through exchange control authorities as well as the relevant sectoral authority.

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