Book Précis
Hot Money, Cold Money: Managing Global Capital Flows in Chile, South Korea, and Turkey

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SUMMARY

Financial opening and the liberalization of capital flows across national borders, one of the most salient aspects of globalization, has had a significant role in shaping the economic and social development trajectory of developing and emerging economies since the 1980s. This book manuscript seeks to determine the conditions under which emerging economies embrace as well as curtail capital mobility. It distinguishes between policies that favor hot money (e.g., portfolio investment flows) over cold money (e.g., foreign direct investment), policies that eliminate restrictions on cold money while restraining hot money, and policies that tend towards full capital mobility without making a distinction between hot and cold money flows. Through a comparative-historical examination of financial opening in Chile, South Korea, and Turkey and by drawing on 36 interviews with high-level policy-makers, it illustrates how these policies can be seen to fall into two different trajectories of financial opening: (1) expansionary (observed in South Korea and Turkey), which is prone to ignoring the risks associated with embracing capital mobility, and (2) limited (observed in Chile), characterized by policies targeting long-term economic growth and stability rather than economic expansion in the short-term. An expansionary trajectory occurs when state elites lack disciplinary power over capitalists, and when the state's fiscal power and economic coordination capacity are weak or weakened prior to financial opening episodes. In contrast, limited financial opening occurs when state elites can discipline the consumption and investment demands of capitalists and upper middle classes through an alliance with export sectors. This directly depends on state's economic coordination capacity and fiscal resources. This book makes an important sociological contribution to the existing research on the globalization of finance and its consequences for developing and emerging economies. First, it demonstrates the perilous nature of mobilizing capital in emerging economies and how the inherent risks are linked to the economic growth and social development strategies implemented in those countries. Second, in contrast to the presuppositions of neoclassical economics, it shows that states weak in infrastructural power with powerful capitalist classes oriented towards consumption suffer from the globalization of finance.

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Introduction

On December 18, 2006, the recently installed military government in Thailand announced its plan to implement controls on capital inflows, effective the next day.[1] An unpleasant chain of events followed the Thai government's announcement of capital controls. Within one day, Bangkok's SET index dropped by 15 percent and the Thai markets showed signs of financial crisis. The Thai administration revoked capital controls on December 19, in a move *Financial Times* called "an astonishing retreat" and "a new record in short-lived economic strategies."[2] Within two days, the Thai government learned a bitter lesson: that hot money can leave almost as easily as it comes and that the economic consequences of its mass flight are perilous. Today, as the world goes through a severe financial crisis, hot money flows taking advantage of the historically low interest rates in advanced industrialized countries prove again that capital mobility is a continuing policy issue for developing and emerging economies.[3]

The policy problem described above highlights a particular dilemma that policy-makers in emerging economies face: whether or not to allow capital inflows and outflows and to which extent such flows should be regulated. Capital inflows allow emerging economies to spend and invest beyond their means. This might be highly beneficial, if the borrowed foreign funds are channeled toward productive investment. Yet, the dilemma of emerging economies under capital mobility is that the funds borrowed often finance consumption and government deficit. This is not sustainable in the long-run, because it does not add to the productive capacity in these economies. When capital flows out as a result of diminishing appeal for foreign investors or for reasons stemming from global markets, the consequences range from economic recession to significant crises.

The risks in capital account reforms are associated with the liquidity of capital flows. Some capital flows, such as portfolio investment (e.g., investment in publicly traded common stocks), are highly liquid. Such finance capital can leave a country at any moment desired. Indeed, significant amounts of portfolio investment can move from one country to another country within instants of pushing a computer button. Other types of capital flows, such as foreign direct investment (FDI), are highly costly to move from one country to another, because they are tied to physical and human capital. Capital that is highly liquid is often denoted as *hot money*; capital with limited liquidity is also known as *cold money*.[4]

Despite the inherent risks, there has been a widespread movement toward greater capital mobility and financial opening since the 1980s. However, the convergence observed in financial opening policies hides a complex picture of *uneven financial opening*. Indeed, some emerging economies allow cross-border capital flows, when such flows carry significant risks of income inequality and financial crises; others curtail capital flows, even when free capital mobility offers opportunities of income increase and output expansion. Furthermore, the regulation of different types of capital flows varies from country to country.

This book is concerned with emerging economies' responses to the surge in global capital flows since the 1970s, and particularly in the early 1990s. It aims to explain: (1) the adoption of capital

[1] "Thailand acts to aid its currency," *The International Herald Tribune*, December 19, 2006. The control was a 30 percent unrenumerated reserve requirement on new foreign currency deposits, similar to the Chilean *encaje* of the early 1990s.

[2] "Thailand retreats on investment controls," December 20, 2006.

[3] "Worried nations try to cool hot money," *Financial Times*, November 19, 2009.

[4] In other words, the distinction between *hot* and *cold money* refers to the *ex ante* potential of finance capital to move across borders.

mobility in emerging economies, (2) the great variation in the policies adopted vis-à-vis different types of capital flows.

Literature and Alternative Explanations

There is no shortage of theories that attempt to explain financial liberalization and capital account opening. For example, recent scholarship views liberalization processes in each country as dependent on the behavior of other countries, and emphasize transnational factors (Simmons and Elkins 2004). These factors include, among others, coercion and conditionality by the Bretton-Woods organizations (Thirkell-White 2005; Woods 2006), the hegemonic influence of the United States (Helleiner 1994, 1995; Stiglitz 2002), competition for finance capital among different nation-states (Cerny 2005), and the role of technocrats who are educated at U.S. academic institutions and who share similar mental models on economic governance (Roy, Denzau and Willett 2007). Other scholars focus on the domestic factors shaping financial liberalization. These scholars treat international and transnational processes as exogenous influences mediated by domestic structures and actors (Sobel 1994, 1998; Schamis 1999; Frieden 1991).

The findings of this book, informed by detailed case-studies of Chile, South Korea, and Turkey, confirm that the starting point in explaining policy variations in capital account policies is the fact that there has been a common trend toward higher capital mobility in the world since the early 1980s. Three factors stand out in explaining such trend: policy diffusion, ideology and the role of neoliberal economists, and the role of supranational organizations.

Policy diffusion denotes a process where "the decision to liberalize (or restrict) by some governments influences the choices made by others" (Simmons and Elkins 2004: 171–172). The novelty in this approach lies in seeing the liberalization decisions of governments as resulting from interdependence among different countries. As a consequence, policy diffusion is distinguished from processes such as different governments responding similarly to common phenomena (Simmons and Elkins 2004). A number of mechanisms can be identified as causes of policy diffusion. Simmons, Dobbin and Garrett (2006) distinguish four: coercion, competition, learning, and emulation.

Explanations emphasizing the role of economists argue that the turn toward the liberalization of markets can be explained as an alignment in ideas about how to govern the economy (Chwieroth 2007; Fourcade-Gourinchas and Babb 2002). According to these authors, different countries faced similar economic hardships that were caused by the collapse of the Bretton-Woods system and the crisis of ISI. Dissatisfaction with previous economic policies paved the way for a new set of ideas favoring market liberalization. These ideas gradually assumed a dominant role in shaping the economic orientation of technocrats and politicians (Fourcade-Gourinchas and Babb 2002: 568–569). Gains from financial opening and capital mobility are among such ideas (Schulze 2000). Thus, this perspective posits that as professional economists fill the ranks of economic bureaucracy in emerging economies, the policy orientation will shift toward greater capital mobility.

A third approach places emphasis upon the persuasive influence of and coercion by supranational organizations. There are three supranational organizations that promoted capital account opening in emerging economies: the IMF, the World Bank, and the OECD. These organizations were especially active in advocating full-scale financial opening during the 1980s and the 1990s (Woods 2006). Until the publication of Rawi Abdelal's *Capital Rules* (2007), these organizations' policy stance was associated with the hegemonic roles of the U.S. Treasury and Wall Street. To a certain extent, both the U.S. Treasury and the Wall Street advocated capital account opening, but such advocacy was more important in what Woods (2006:4) calls "high profile" cases such as Russia. Abdelal (2007) shows that it was European policy-makers who promoted complete capital account opening, whereas the U.S. policymakers approached capital account opening on a case-by-case basis. Regardless of the sources of policy direction in these organizations, it is clear that the IMF, the World Bank, and the OECD exercised influence over capital account policies by legitimizing financial opening as sound and desirable policy.

There is no doubt that these mechanisms are at work in shaping the momentum toward the liberalization of cross-border flow of finance capital. Nevertheless, although financial opening is a common trend, there are significant differences among the set of policies implemented in each country, as well as their consequences. The main premise of this study is that a great part of this variation in capital account policies can be explicated by investigating the domestic political economy of emerging economies in addition to the factors highlighted above. This is because financial opening followed by integration with world financial markets causes significant changes in key prices and macroeconomic aggregates of an emerging economy. Such changes have important distributional consequences for economic sectors and social classes. Furthermore, the anticipated and actual transformations in emerging economies following financial opening affect the political landscape and calculus that policy-makers face.

Argument

The following analysis derives a number of propositions that guide the empirical analysis in this book. The first set of propositions pertains to (1) the economic mechanisms that transmit the effects of capital inflows and outflows in an emerging economy, and (2) how such effects lead to regulation or deregulation of capital mobility by policy-makers, conditional on the influence of different economic sectors and social classes over economic policy. The second set of propositions is concerned with the interests and objectives of policy-makers; they draw a distinction between policies that favor economic expansion in the short run and policies that aim long-term economic growth and stability. Finally, the third set of propositions emphasizes how state capacity and capabilities constrain available policy choices.

Prices and the Supply of Loanable Funds: Exchange Rate, Credit, and Asset Prices

The exchange rate is of primary importance in the determination of export-import balance in developing and emerging economies. In this context, the effect of heavy capital inflows is particularly noticeable. These inflows adversely affect the traded/non-traded goods price ratio (Jones 1971; Mayer 1974; Mussa 1974; Samuelson 1971) and lead to currency appreciation in a developing country, hurting its exports and trade balance (Eatwell and Taylor 2000; Frieden 1991). Thus, an overvalued exchange rate is an implicit tax on exports even in the absence of tariffs and trade quotas. From the perspective of domestic business, this makes importing more advantageous vis-à-vis exporting (Sachs 1989: 14). The consequence of a long period of overvalued exchange rate is a shift of investment and economic activity away from exporting to importing. The cumulative effect is an imbalance in the trade pattern, along with a growing trade deficit. Furthermore, sharp movements in capital inflows and outflows exert a heavy influence on the volatility and level of exchange rate. Overall, high volatility in exchange rate is detrimental to the export performance of developing and emerging economies. Furthermore, high volatility negatively affects investment in tradable-goods sectors in these economies, since such volatility increase uncertainty in these sectors.[5] Conditional on the influence of the export sectors over economic policy on capital flows and conditional on the political alliance between export sectors and economic policy-makers, such an analysis leads to the following proposition:

> Proposition 1. The more economic policy is oriented toward maintaining a competitive level of and low volatility in exchange rate, the higher the likelihood that policy-makers will curtail capital mobility.

Exchange rate is a crucial variable in understanding the effects of capital inflows and outflows (Broz and Frieden 2006). However, in developing and emerging economies, equally important are how domestic asset prices and credit supply react to the transfer of foreign funds into the domestic economy. Suppose that capital inflows occur in an environment of limited sterilization policy and managed float (a realistic scenario). The effects of capital inflows in such an economic environment are manifold. First, there is an increase in money demand, due to the following chain of events. As foreign funds flow in, domestic borrowers and foreign investors exchange foreign currency for domestic currency in order to carry out transactions in the domestic economy. Since monetary authority does not sterilize all inflows, it accommodates the rising money demand by creating domestic currency (Calvo, Leiderman, and Reinhart 1996: 133).[6] As domestic borrowers and foreign investors acquire domestic assets, the amount of checkable deposits increases. Thus, capital inflows to a developing country raises domestic money supply in the short run (both central bank money and commercial bank money increase). Second, domestic asset prices go up because of increased residential and business investment. Finally, as domestic and foreign agents deposit money into bank accounts, the liabilities of banks increase. Accordingly, domestic banks increase their assets in loans and bonds in order to balance their assets and liabilities.[7] This implies that the credit supply, as well as the willingness of domestic financial intermediaries to finance public spending, increase.

Thus, both asset prices and credit supply are likely to be affected by capital inflows and outflows. In the case of significant inflows and outflows, one can expect sharp movements in asset prices and credit supply. While their precise effects on economic sectors and social classes are historically contingent,[8] such movements are not benign in terms of distributional implications. In countries where assets are a significant source of wealth and viable sources of investment, price increases are favorably received by the sectors and social classes who benefit from such gains in value. Similarly, credit supply increase is a welcome development in countries where there is a high latent demand for investment and consumption loans.

> Proposition 2. The more social classes accumulating wealth and gaining income from domestic assets have an influence on economic policy, the higher the likelihood that policy-makers will favor liberalizing the mobility of cross-border capital flows.

> Proposition 3. The more there is a latent demand for the supply of loanable funds by various sectors and classes who have an influence on economic policy, the higher the likelihood that policy-makers will favor liberalizing the mobility of cross-border capital flows.

[5] Various studies confirm this diagnosis. See Arize, Osang and Slottje (2008) for a review of the literature.

[6] Otherwise, the increased demand for domestic currency will put pressure on the exchange rate. It is assumed here that the monetary authority prioritizes a stable exchange rate rather than an erratic one.

[7] It is assumed that the reserve requirement ratio for banks is fixed in the short run. Again, this is a realistic assumption.

[8] As the empirical analysis of Chile, South Korea, and Turkey in this book demonstrates.

Short-Term Economic Expansion versus Long-Term Economic Growth

Financial opening and the opportunity to use savings from the rest of the world offer two major incentives for policy-makers in developing and emerging market countries. One is to expand the domestic economic pie by "importing" capital. The other is to increase the growth rate of domestic capital accumulation. In a world where a significant amount of finance capital (relative to the size of GDP) from the global markets can be channeled into a developing or emerging economy, such incentives are tempting for policy-makers.

Financing investment, private consumption, or government consumption through capital flows from the rest of the world has consequences for both income growth and the distribution of income among social groups. Imagine an increase in capital flows from the rest of the world.[9] The effect of such surge of funds available to economic agents' consumption and investment needs is an increase in the mean income. Yet, that is not the sole positive effect of capital flows from the rest of the world. Equally important is the potential increase in the future domestic output as funds from the rest of the world become available. Consider again the case of an economy that receives inflows of capital from the rest of the world. Suppose that the increase in disposable income finance investment, i.e., that it leads to greater capital accumulation. Suppose further that there is a relative abundance of labor, that labor can be allocated between different sectors, and that the outputs of new investment are marketable. Under these assumptions, greater capital accumulation raises potential output of domestic industries. Thus, it leads to an increase in the future potential domestic output. The opportunity to boost domestic capital formation is much desired in the developing world. This follows from the relative scarcity of capital and abundance of labor in developing countries, a contrast when compared to advanced industrialized countries. Development economists have long stressed the importance of increasing domestic capital stock under such conditions.

In brief, as Eichengreen and Hausmann (2005: 3) note, expectations about increases in capital formation and current consumption have been central promises for capital account liberalization. Naturally, the abundance of finance capital—high global liquidity—strengthens the twin promises of financial opening. Since the collapse of the Bretton-Woods system, high global liquidity has been a recurring aspect of global economy. During the 1970s, one of its main causes was the abundance of petrodollars. During the late 1980s and early 1990s, it was low real interest rates in advanced industrialized countries that led to the abundance of finance capital seeking higher returns. Indeed, the drop in the world's most influential interest rate, the Federal Funds rate, was 5 percent in real terms between 1989 and 1993 (Brenner 2002: 68). In the period after September 11, it is high corporate savings and global imbalances in trade patterns that are feeding the previously unseen levels of global liquidity. Regardless of its causes, high global liquidity means a considerable decrease in the cost of acquiring capital for emerging market countries.

These opportunities notwithstanding, global capital flows result in adverse consequences and carry significant risks. The adverse consequences include (1) inefficient allocation of borrowed funds, (2) loss of monetary policy autonomy, (3) negative impact on the export sector if the country is a recipient of large capital inflows, and (4) increased volatility and instability in the domestic economy. These risks are particularly associated with short-term and highly liquid capital flows.

Facing such risks, policy-makers in emerging economies might limit capital mobility through various capital controls. Such a cautionary policy capitalizes on exchange-rate competitiveness and monetary autonomy. Capital controls, either on inflows or outflows, enable emerging country authorities to maintain a certain level of monetary and fiscal policy autonomy as well as keeping

[9] An even distribution of the new funds is assumed. This is an assumption that is relaxed later in the analysis.

their exchange rate aligned. Such measures indicate a willingness to stimulate capital accumulation and long-term economic growth by shielding domestic financial markets against the negative consequences of financial opening.

> Proposition 4. The more policy-makers value long-term economic growth and stability, the higher the probability that the capital account policies will favor cold money over hot money flows.

However, this policy entails economic and political costs. Limiting capital mobility prevents tapping into the savings pool of the rest of the world. Domestic saving becomes a more binding constraint on investment and consumption expenditures. Thus, governments choosing this strategy repress investment demands of capitalists and consumption demands of various social classes. The opportunities of financing public deficit and carrying expansionary fiscal policies are discarded as well. Furthermore, from a politician's perspective, the most taxing political cost is relinquishing the opportunity to enlarge the economic pie in the short-term. This amounts to blocking spending demands of various social groups. In brief, the fruits of greater accumulation of capital will be collected only in the medium-to-long-run whereas political costs impose themselves in the short run.

The alternative is to pursue a high level of capital account openness. It is easy to see the political allure of this strategy. Generating income growth is a key to any political and electoral success, and even more so in developing and emerging economies, where stable economic growth is often interrupted by economic crises. Furthermore, the ability to generate income growth by overcoming the limitations of domestic economy becomes even more attractive when there are strong distributional pressures. Redistributive demands from powerful social groups are difficult to accommodate in the absence of strong economic growth. In a way, capital account liberalization followed by inflows from the rest of the world enables politicians to overcome distributive and expansionary pressures without facing adverse economic consequences such as higher inflation in the short-term.

> Proposition 5. The more policy-makers orient their economic policies toward economic expansion and political success in the short-run, the higher the probability that capital account policies will aim liberalizing short-term capital flows.

Infrastructural Power

Infrastructural power, as defined by Mann (1993: 59), refers to "the institutional capacity of a central state ... to penetrate its territories and logistically implement decisions." This institutional capacity involves the utilization of infrastructures—"routinized media through which information and commands are transmitted" (Mann 2008)—to organize and facilitate social life. It is based on physical infrastructure (e.g., highways, transportation, and electric power) as well as "soft" infrastructure (e.g., fiscal organization, information supply, rules and regulations and their enforcement). In other words, infrastructural power denotes the "capabilities" of the state (Soifer 2008), or "the resources potentially at its disposal" (Mann 2008: 357).

Two dimensions of a state's national capabilities are consequential for the regulation of cross-border capital mobility: penetrative and extractive capacity. The first dimension comprises penetration into a realm of social activity; and, as a consequence, it involves the capacity to enable, regulate, and coordinate social cooperation among social actors within that realm (Weiss and Hobson 1995: 7). The second dimension is the capacity of a state to extract resources and revenue from its territories

(Weiss 2006; Weiss and Hobson 1995: 4). That capacity is the base determinant of a state's ability to erect infrastructures and mobilize resources to realize its objectives.

These two dimensions are important because how policy-makers interpret the benefits and costs of capital account liberalization depends on the adopted economic policy horizon. That is to say, whether or not policy-makers have the foresight to differentiate between the consequences of capital mobility in the short and long run makes a difference in their approach to capital account liberalization. The state's infrastructural power—the penetrative and extractive power of the state—is the key determinant of the adopted economic policy-making horizon.

Economic policy horizon varies significantly in emerging economies. In fact, the capacity to devise economic policies by calculating the long-term consequences is rare. This is because limitations in penetrative and extractive capabilities of a state shorten the horizon of economic policies. First of all, weakness in penetration into a certain realm of economic activities results in poor information and expertise, which leads to the inability to calculate the long-term consequences of state's economic policies. Second, weak extractive power implies that a state has weak fiscal resources and fiscal health. As a consequence, the state's capacity to mobilize resources for long-term objectives declines.

> Proposition 6. The weaker the penetrative power and the extractive power of the state, the higher the probability that policy-makers in an emerging economy adopts capital mobility without making a distinction between different types of capital flows.

In the extreme case of very weak penetrative power and very weak extractive power, the state lacks the capacity to design and implement economic policies with long-term goals in mind. Furthermore, the gap between revenues and expenditures forces the state authorities to seek financing on a perpetual basis. Such a dire situation is not uncommon in emerging economies, and many states succumb to a fragile fiscal situation and a heavy-burden of public debt. In such cases, it is likely that policy-makers will be prone to see short-term and highly mobile capital flows as a resource that can be used to finance public expenditures and debt. This is because the cross-border mobility of short-term capital flows, abundant in the world economy during the periods analyzed in this study, enables domestic and foreign actors to lend money to the central state. Such financial exchange often comes with a high interest rate cost to the public budget. Yet, as long as high indebtedness is sustainable, further financing opportunities are an attractive option in a situation of poor extractive power and sizeable differences between revenues and expenditures. The following proposition recognizes the different nature of such cases:

> Proposition 7. The higher the gap between state revenues and expenditures and the burden of public debt, the higher the probability that policy-makers in an emerging economy give precedence to the liberalization of short-term capital flows.

Methodology and Research Design

The stylized analysis in this book aims to provide an accurate picture of the core mechanisms that shaped the different paths of opening to capital flows in Chile, South Korea, and Turkey. These three countries are selected for two reasons. The first is to assess the relative merit and weight of the proposed mechanisms in relation to three general alternative explanations summarized above. Each case provides a unique opportunity to confront and evaluate a particular mechanism shaping financial liberalization. The second one is to obtain significant variation in the underlying characteristics of the emerging economies under study. The different historical trajectories and developmental patterns of Chile, South Korea, and Turkey ensure such wide variation.

The first financial opening in Chile, between 1978 and 1982, stands as the case where a particular economic ideology played an important role. The Chicago boys, as a group, shared an unusually coherent set of ideas on how to govern the economy. Motivated by a textbook-style set of stipulations about the efficiency of capital account opening, they did not hesitate to implement a rapid opening to global capital flows. The simplicity and single-mindedness of their economic ideas were strong contributing factors to the disastrous 1982 financial crisis in Chile.

The Turkish economic liberalization in 1980 is a clear example of the IMF and the World Bank exercising decisive influence with the help of sympathetic policy-makers. The Turkish economy was severely depressed and in dire need of external finance in the late 1970s. Under these conditions, the government under the leadership of Turgut Özal implemented a structural adjustment program with the support of the IMF and the World Bank, which supplied the much-needed financing. The military intervention in September 1980 strengthened the IMF-supported liberalization program by abolishing political participation and repressing opposition forces.

In Korea, both the Chun Doo Hwan and Kim Young Sam governments exhibited efforts at emulating liberal economic policies in order to continue the high growth trajectory of the Korean economy. Furthermore, the Kim Young Sam government elevated OECD membership and the liberalization of the economy to the status of a national goal. Applying liberal economic prescriptions to address the problems of the Korean economy was seen as part and parcel of the modernization of South Korea.

The empirical analysis in this book confronts the aforementioned alternative mechanisms in three different emerging economies. Thus, the goal of the research design is to assess the contribution of a perspective placing analytical emphasis on domestic political economic factors vis-à-vis explanations stressing policy diffusion, ideology, and the role of supranational organizations.

Empirical Chapters

Chile: Boom, Crash, Restraint: The Politics of Taming Capital Flows

Chile confronted global capital inflows earlier than South Korea and Turkey. Following the military *coup d'état* that ended the democratically elected Allende government (1973), Chilean financial markets and capital account were deregulated in a swift and careless manner. This first episode of financial opening produced an economic boom that served the Pinochet regime in terms of political legitimacy. However, economic boom was financial and to a certain extent fictitious; by the end of 1982, Chile experienced the worst financial crash among all Latin American countries. Chile had access to international finance only through sovereign borrowing after the financial crisis. When voluntary capital inflows returned at the end of the 1980s, the newly elected center-left coalition government of President Aylwin followed a path of prudent financial opening. Most importantly, the Aylwin administration implemented—and in one case invented—sophisticated policies to curb short-term capital inflows to Chile.

Accordingly, this chapter compares two episodes of capital flow management in Chile. The first period studied is the financial opening between 1978 and 1982 that brought the 1982 financial meltdown. The second period analyzed is 1989—1992, when capital controls—the most important being an unremunerated reserve requirement (the *encaje*)—were imposed on capital flows.

In each episode, the focus is on highlighting political and economic factors that culminated in sharply contrasting policies. In the first episode (1978—1982), the Chilean authorities pursued an imprudent financial opening strategy. The imprudent financial opening observed after 1978 was the underlying cause of a significant economic boom between 1978 and 1982. This economic boom supported a sense of euphoria in the Chilean society. Consumption surged, growth was strong, and construction activity boomed. The main beneficiaries of the rapid growth and expansion were the large finance-based *grupos*. Although export sectors were building up dynamism as a result of greater integration with the rest of the world, the neoliberal economists at the time were blind to the adverse affects of appreciating domestic currency. The Chilean economy boomed, regardless of export sectors' performance. The Pinochet regime focused on solidifying an authoritarian regime and its technocrats spent their energies in establishing a market society. As such, the military regime did not have a long-term perspective; a short-term economic boom was sufficiently satisfactory. As a result, they neglected the rapid financial expansion that did not have a basis in the real economy. This was not just an oversight or coincidence; global capital flows fed a booming economy, which provided the much-needed political legitimacy to the military regime. Furthermore, the most influential economic actors, big financial conglomerates, owed their power to their financial investments. Thus, despite significant appreciation in the real exchange rate, damage to small and medium businesses, and eroding competitiveness in export sectors, the Chicago boys of the military regime did not see a need for restricting capital flows. The economic consequences were grave.

The economic boom came to an end with the financial meltdown in 1982 and left Chile with a massive debt crisis. Such adverse conditions underpinned the change in the orientation of Chilean policy-makers. It was necessary to have large trade surpluses, so that Chile could service its debt payments and could overcome the crisis. The Chilean state not only promoted macroeconomic policies conducive to strengthening export performance but also subsidized the export sectors. Export sectors, already with significant potential as a result of decades-long accumulation, took advantage of Chile's comparative advantage in natural resources. The result was a remarkable recovery based on export dynamism. At the same time, the Chilean state stood apart from other Latin American states in terms of public finances. Partly as a result of orthodox macroeconomic management and partly as a result of revenues from nationalized copper industry, the Chilean state maintained a healthy balance between its revenues and expenditures.

The management of capital flows between 1989 and 1992 stood in stark contrast to the first episode. After the debt crisis of the early 1980s, Chile lacked access to international finance. As growth resumed by the second half of the 1980s and as global economic conditions changed, Chile started receiving large amounts of capital, both in the form of FDI and short-term capital inflows. Such inflows put pressure on the exchange rate and threatened macroeconomic stability. The economic team in the Aylwin administration rejected short-term economic expansion and chose to defend a competitive exchange rate by implementing novel capital controls. The concern for long-term growth based on export dynamism was paramount in shaping this decision. The newly elected government after the military regime identified economic growth as originating in export sectors and designed its macroeconomic policies accordingly.

At the end, it was the export dynamism that determined Chile's prudence when confronted with massive amount of capital inflows for the second time. Given that such inflows surged during the transition to democracy and given that income inequality was extremely high in Chile, the implementation of capital controls was a remarkable outcome. This outcome was the result of a political alliance between the center-left coalition government and export sectors. The *Concertación* government wanted to ensure smooth transition to democracy. Its leaders identified stable growth in the long run as the best guarantee of avoiding political instability. In this task, they relied on export dynamism as the engine of growth. Consequently, there was not much hesitation in implementing capital controls to maintain a competitive exchange rate.

South Korea: Embracing Hot Money, Rejecting Cold Money

South Korea has a remarkable record of economic development in the twentieth century, during which the country transformed itself from an agricultural economy to an industrial powerhouse. The roots of rapid industrialization and economic development harken back to the interwar period, when Korea was under the Japanese colonial rule (Cumings 1984). The Japanese colonial rule introduced industrial production into Korea and was instrumental in the creation of the modern infrastructure (Kuznets 1994). This rule ended in 1945 and the subsequent division of the peninsula into two nation-states culminated in the Korean War. The war was devastating for the new Republic of Korea (ROK). The severity of the devastation and loss of life in the Korean War left South Korea in a desolate state and the country faced severe economic problems in the 1950s and the early 1960s. Yet, the economic growth after 1965 was in double-digits for many years. By the end of the 1980s, Korea was an industrial economy and the Korean firms were competing in global markets. Rapid economic growth halted in 1997, when an unprecedented financial crisis shook the Korean economy. South Korea's opening to international capital flows and poorly designed capital account reforms were among the main factors leading to the crisis.

The Korean capital account reforms during the 1990s were risky. Korean authorities liberalized various short-term capital inflows and outflows while maintaining restrictions on long-term capital flows. Such policies enabled domestic firms to borrow heavily, either directly from international markets or through banks and non-bank financial institutions. Korean financial institutions borrowed short-term from international markets but they lent with longer-term maturities. The economy grew quickly as a result of heavy investment by big conglomerates. However, strong investment relied on financial institutions accumulating increasing amounts of short-term liabilities and long-term assets. This created a significant maturity risk for financial institutions. Equally important was the currency mismatch risk, since Korean financial institutions borrowed in foreign currencies but supplied credit in domestic currency.

This chapter offers an account of how and why Korean authorities adopted friendly policies toward short-term borrowing and shied away from long-term borrowing. The dangerous, poor design of capital account reforms was the direct outcome of the gradual collapse of the developmental coalition between state actors and big business groups (*chaebols*). This pact between capitalists and the Korean state was successful, for a number of reasons, in bringing forth industrialization between 1965 and 1979. Central to the rapid economic growth were high levels of investment in productive capacity. High investment could be sustained because Korean firms were successful in finding demand for their products in export markets. Most importantly, high investment could be maintained because the Korean state undertook the role of nurturing big business and their entrepreneurial activities through its tight control over credit supply and allocation. *Chaebols* grew because they expanded their size and productive capacity through high indebtedness. The Korean state made this risk public by supplying finance to successful companies, even when they were under stress. Control over finance was also the means to discipline *chaebols* and to pick the best performing firms. Thus, there was a particular constellation of state power, finance, and entrepreneurship that sustained high levels of productive investment and rapid economic development.

The alliance between the Korean state and *chaebols* began to crumble in the 1980s; then, the balance of power between state actors and *chaebols* began to favor big business groups. The Korean state's control over credit and finance was already under pressure through the development of private financial intermediaries in the 1970s, but this control was further loosened by design in the following decade. By the early 1990s, Korean firms were eager to move into the next stage in the product cycle and explore production in high value-added activities such as electronic goods. However, by this time, the Korean state was not capable or willing to provide the necessary credit for such investment. The surging capital flows in the early 1990s provided an attractive financing opportunity for the *chaebols*. The Korean authorities were aware of the dangers of rapid liberalization of capital flows, but the economic bureaucracy was neither coherent nor strong enough to resist pressures for rapid liberalization. Furthermore, a newly elected government under Kim Young Sam came to power with the mantra of change and liberalization and saw globalization as a solution to the problems of Korean economy and society. The resulting set of capital account reforms amounted to embracing hot money and partially rejecting cold money. This combination contributed greatly to the financial meltdown during the 1997 Asian crisis.

Control over credit, and thus finance capital, was the mortar that held together the coalition between state actors, economic bureaucracy, and *chaebols*. Once the Korean state began the long process of relinquishing its control over credit, it shattered the developmental coalition that powered the rapid Korean industrialization. The gradual collapse of the developmental coalition inevitably led to a change in the capacities of political actors to shape economic policies. While *chaebols* gained tactical power in the articulation of their interests, state actors were losing the resources that had enabled them to discipline big business. Such a fundamental transformation occurred in the context where *chaebols* continued and enlarged their institutional practice—itself a relic of the past—of high leverage and high investment to increase their size.

The availability of large amounts of funds from the rest of the world was thus embraced by the *chaebols*. The Korean economic bureaucracy resisted the calls for greater liberalization only partially and was to a certain extent complicit in allowing big business to tap into cheap—but risky—external funds. Had the Korean state retained tighter control over credit allocation, the financial opening of the Korean markets would have been much more cautious and gradual. Yet, the political developments under Chun Doo Hwan and Roh Tae Woo made such a cautious opening formidably difficult to manage for the Korean state actors.

In that regard, the argument advanced in this chapter is in line with the consensus on the causes of the Asian crisis (Eichengreen 2003: 10). The capital account liberalization policies pursued by the Korean policy-makers in the 1990s conformed to the Korean development model. However, such conformity came at a great cost. The marriage between capital account liberalization and the Korean development model was a happy marriage only for a short while, because it contained great contradictions. This chapter highlights such contradictions and shows how they culminated in the 1997 financial crisis.

Turkey: Premature Financial Opening and Boom-Bust Cycles

In 1989, Turkey became one of the first—and few—emerging economies to fully liberalize its capital account. This was an unexpected policy decision. Prior to capital account liberalization, the Turkish economy ran persistent trade deficits with the rest of the world. The public sector could only continue its operations by borrowing at increasing rates. The inflation rate was on the rise toward 100 percent. The domestic interest rates exhibited significant spreads compared to world interest rates. Furthermore, capital accumulation in Turkey prior to financial opening relied on public infrastructure investment, and the private sector's share in fixed capital investment was in decline. It was doubtful that the liberalization of capital movements across borders would stimulate growth. The political party in government, the Motherland Party, manifested a strong tendency to recourse into economic populism. There was the risk that funds from the rest of the world would finance public sector borrowing and consumption, rather than productive investment.

The main argument of this chapter is that the capital account liberalization was a political decision rather than an economic one: the government at the time responded to increasing political competition, risk of stagflation, and high public sector borrowing by liberalizing the movement of capital across the Turkish borders. In retrospect, the 1989 capital account liberalization was premature. Since then, the Turkish economy sank deeper into a vicious cycle, where short-term capital flows from the rest of the world fed economic booms that periodically ended in crises. The Turkish economy had two major financial crises, in 1994 and 2001, and a serious recession in 1998—99. In 1994 and 2001, hot money was directly responsible for triggering the collapse of the Turkish financial markets. This chapter traces how expansionary, distributional, and myopic concerns could dominate the decision to liberalize capital movements across borders, and lead to adverse consequences with long-term implications.

Turkey started the liberalization of its financial markets with a turn in economic policy-making on January 24, 1980. The deep depression of the late 1970s and the 1980 military takeover provided an environment which enabled free-market reforms. Turkish authorities deregulated deposit interest rates in 1980. Despite a financial crisis in 1982 (which led to the reimposition of controls), both deposit and loan rates were liberalized by the late 80s (Akyüz 1990; Balkan and Yeldan 1998: 132; Snowden 1996: 67). In the first half of the 80s, restrictions on foreign exchange transactions were removed. A foreign exchange market was established in 1988 (Aşıkoğlu 1992: 106; Balkan and Yeldan 1998).

Several economic, social, and political developments under the Motherland Party governments during the 1980s led to the comprehensive financial opening in Turkey. The Motherland Party came to power after the 1980 military intervention. It exploited the lack of political competition successfully. Under the leadership of Turgut Özal, this political party advanced a bold liberalization reform. While it repressed workers and farmers, it nurtured big businesses and export industries. It relied on center-right political rhetoric, rapid economic growth, and high levels of public sector spending and investment in building a successful political coalition. In other words, in order to compensate for the deteriorating economic well-being of the fixed-income groups, the Motherland Party adhered to high levels of spending on public transfers and public investment.

The Motherland Party's dominant position in Turkish politics faced significant challenges beginning in 1987, as the leaders of the previous era returned to politics. The rapid economic growth turned out to lack a solid base. The export industry utilized the excess capacity built in the previous era of import substitution industrialization, but did not invest further in productive capacity. Furthermore, the export-oriented industries owed their comparative advantage in world markets to various forms of state subsidies. The Turkish economy became increasingly unstable in 1988. The public sector borrowing, which contributed greatly to the economic growth in the 1980s, reached an unprecedented percentage of the Turkish GDP. The result was an increasing public sector borrowing requirement in an economy with high inflation and low economic dynamism. At the same time, workers and farmers began to recover from a decade-long repression. The Motherland Party government reacted to these pressures by implementing populist policies, which further stimulated inflation and growing debt stock. It was under these conditions that the Motherland Party and Turgut Özal chose to liberalize the Turkish capital account, apparently with the hope to relax restrictions on external borrowing and stimulate economic growth. The public sector borrowing requirement was a strong motivation for this decision.

The Turkish case is an example of how financial opening due to expansionary and myopic concerns can lead to long-term adverse consequences. Instead of taking a cautionary approach to capital account liberalization, the Turkish authorities opted for a comprehensive liberalization that did not distinguish between different types of capital flows. The subsequent course of the Turkish economy brings to light the substantial risks that this approach entails. The Turkish economy became dependent on external capital flows—especially the short-term variety—during the 1990s. Such dependence carried costs. Within a span of 13 years, the Turkish economy experienced two massive financial crises that were directly linked to short-term capital flows. The 1990s were the lost decade of Turkey. The capital account liberalization in 1989 was an important factor that led to this outcome.

To sum up, the Motherland Party government followed a rapid and unbalanced economic growth strategy following the liberalization reforms of January 24, 1980. At the heart of the rapid growth strategy were the public infrastructure drive, high levels of domestic and foreign debt, and the repression of real wages. In order to compensate for the deteriorating economic well-being of the fixed-income groups, the Motherland Party adhered to high levels of spending on public transfers and public investment. Rising inflation, high interest rates, and labor militancy in 1988 and 1989 put the viability of the Motherland Party government in jeopardy. Under such conditions, capital account liberalization became an attractive option for Turgut Özal and the Motherland Party. Policy-makers at the time chose to fully liberalize the Turkish capital account under unfavorable economic conditions, with the hope of obtaining foreign funds that would finance public debt and spur economic growth.

Conclusion

This book identifies two different patterns in capital account liberalization. The first is the short-term expansionary path of financial opening, which is prone to ignoring the risks associated with capital account liberalization. Chile's first financial opening between 1978 and 1982, South Korea's risky opening to short-term capital flows in the early 1990s, and the Turkish capital account liberalization in 1989 are clear examples of this pattern.

In the case of Chile, international capital flows from 1978 onwards were crucial in creating an economic boom. The economic boom benefited mainly the large *grupos* that controlled financial intermediaries. However, its effects were visible for a significant portion of the Chilean society. The urban classes enjoyed a remarkable abundance of novel consumer products after decades of scarcity. Asset values, especially in housing, increased considerably. In contrast, export sectors and small to medium-scale enterprises suffered despite the economic boom. The Chilean authorities did not pay sufficient attention to the dangers of capital account liberalization and to the grievances of certain sectors. This was because the economic boom, financed by capital inflows, was crucial for the legitimacy of the military regime. It was also instrumental in promoting a conservative agenda (i.e., protected and technified democracy) for the future of the Chilean society.

In the case of Turkey, the Motherland Party government followed a rapid and unbalanced economic growth strategy following the liberalization reforms of January 24, 1980. At the heart of the rapid growth strategy were the public infrastructure drive, high levels of domestic and foreign debt, and the repression of real wages. In order to compensate for the deteriorating economic well-being of the fixed-income groups, the Motherland Party adhered to high levels of spending on public transfers and public investment. Rising inflation, high interest rates, and labor militancy in 1988 and 1989 put the viability of the Motherland Party government in jeopardy. Under such conditions, capital account liberalization became an attractive option for Turgut Özal and the Motherland Party. Policy-makers at the time chose to fully liberalize the Turkish capital account under unfavorable economic conditions, with the hope of obtaining foreign funds that would finance public debt and spur economic growth.

The case of Korea is also an example of expansionary opening. Korean economic growth stemmed from a number of elements, all directly linked to the export success of its industries. One was the alliance between the state and big businesses. The second element was the institutional practice of high investment. The third—and in retrospect the most crucial—element was the state's financial intermediation that supported private entrepreneurship and enabled Korean authorities to discipline big businesses for continued economic performance in world markets. Intermediation of finance was essential in maintaining the balance of power between the Korean state and *chaebols*. When the state's power over financial intermediation eroded, the alliance and the balance of power between the Korean state and *chaebols* were shattered. The collapse of the political alliance also spurred the loss of coherence in Korean economic policies. However, *chaebols* continued to follow the strategy of growth with high levels of indebtedness. International capital flows provided the funds necessary for such an institutional practice. The Korean state kept various capital controls intact, but its regulation and supervision over the banking system and big businesses' overseas borrowing fell apart under pressure from *chaebols*. The result was a trajectory of perilous financial opening that maintained high economic growth until 1997.

The second pattern of financial opening involves a cautionary approach to the liberalization of the capital account, where policy-makers value long-term economic growth and stability more than short-term economic expansion and distribution. Thus, under this pattern, certain capital controls remain intact. The second financial opening experience of Chile between 1991 and 1998, which involved the curbing of capital inflows through an unremunerated reserve requirement, characterizes this pattern.

Global capital flows lead to changes in the exchange rate, rental price of capital, asset values, and domestic credit supply. The analysis on Chile confirms how important the exchange rate can be in shaping the management of global capital inflows. It was export dynamism that underlay Chile's economic success in the second half of the 1980s. Such dynamism required a competitive exchange rate. When capital inflows to Chile surged and put pressure on the exchange rate, the Chilean authorities wanted to defend a competitive exchange rate level. This was achieved through controls on capital inflows. The alliance between the newly elected *Concertación* government and export sectors was crucial in solidifying the determination of the authorities to follow a competitive exchange-rate policy.

Chilean cautionary financial opening between 1991 and 1998 provides an interesting comparison with South Korea. Both the Korean and Chilean economic successes followed from the dynamism of their export sectors. While the pact between the Korean state and the big businesses began to falter in the 1980s, the Chilean state and export sectors managed to build a political alliance that secured Chile's export success and high growth.

Turkey stands in contrast to both the Chilean and South Korean cases, by virtue of the growing dependence of the country on global capital flows during the 1990s. Although both South Korea and Turkey initiated highly risky capital account liberalization reforms, the Korean case did not fall into a populist pattern. The fiscal health of the Korean state and the strength of its industries prevented the development of the debt trap observed in Turkey. The *chaebols* were borrowing short-term from overseas markets, but such borrowing was to finance investment in production. In Turkey, overseas borrowing was employed to roll over the existing debt.

To sum up, financial opening is both a blessing and a curse for developing countries. On one hand, financial opening gives these countries access to scarce capital at cheaper prices in the world markets. On the other hand, it takes away policy autonomy, preventing developing countries from formulating policies that aim at industrial transformation and full employment through monetary and fiscal policies. Furthermore, it increases their vulnerability to the vagaries of international and underdeveloped domestic financial markets.

Despite the risks involved, financial opening and integration of financial markets have been the most central aspects of international economic cooperation in the last thirty years. This book explains a crucial aspect of global financial integration that is neglected in the largely economic literature on capital account liberalization: the politics of hot and cold money in emerging economies. In conclusion, it is worth remembering that the challenges posed by financial opening in developing and emerging economies have not come to an end. In fact, many developing and emerging economies are dependent on continuous capital inflows to maintain the dynamism in their economy. Countries such as Argentina, Hungary, and Turkey are all examples of such dependence. As the analysis of the Turkish case demonstrates, such dependence is very costly. In contrast to emerging economies that are fully open to and dependent upon global capital, a host of countries such as China, India, and Taiwan jealously guard their financial markets against global capital inflows. Although the theory advanced here cannot be automatically extended to explain cases such as China and Taiwan, the comparative findings of this research should provide useful clues in understanding the politics of capital mobility in other emerging economies.

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Appendix A. List of Interviewees

Chile

1. Ricardo Lagos Escobar, President of Chile from 2000 to 2006.
2. José de Gregorio, former Minister of Finance, Vice-President of the Central Bank.
3. Jorge Desormeaux, Member of the Central Bank Board.
4. Pablo García S., Head of the Financial Policy Division, Central Bank.
5. Carlos Massad Abud, former Governor of the Central Bank.
6. Pablo Piñera, former Member of the Central Bank Board.
7. Ricardo Zahler, former Governor of the Central Bank.
8. Manuel Marfán Lewis, former Minister of Finance, Member of the Central Bank Board.
9. Rodrigo Valdés, Head of the Research Division, Central Bank.
10. Ricardo Ffrench-Davis, prominent economist, former Head of the Research Division, Central Bank.
11. Guillermo Le Fort, economist, former Member of the Research Division, Central Bank.

South Korea

1. Kong Il Sa, former Minister of Finance.
2. Kwon Tae-Kyun, Deputy Minister, Commissioner of the Financial Intelligence Unit.
3. Kyong Shik Kang, former Minister of Finance.
4. Chung Duck Koo, former Minister of Finance.
5. Park Se Il, former Senior Secretary, Presidential Office of the Republic of Korea.
6. You Jong Il, Economist, Korea Development Institute.
7. Kim Tae Dong, Former Chairman of the Presidential Committee on Policy Planning, Former member of the Monetary Policy Committee.
8. Choi Gong Pil, Economist, Korea Institute of Finance.

Turkey

1. Sümer Oral, former Minister of Finance.
2. Zekeriya Temizel, former Minister of Finance.
3. Hasan Kılavuz, former CEO of a public bank.

4. Osman Şıklar, former Governor of the Central Bank.
5. Biltekin Özdemir, former Undersecretary to the Minister of Finance.
6. Işın Çelebi, former Minister of Treasury.
7. Zekeriya Yıldırım, former Vice-President of the Central Bank.
8. Yavuz Canevi, former Governor of the Central Bank, former Secretary of Treasury.
9. Kaya Erdem, former Minister of Finance, former Vice Prime Minister.
10. Ekrem Pakdemirli, former Minister of Finance, former Secretary of Treasury.
11. Güneş Taner, former Minister of Treasury.
12. Selçuk Demiralp, former Secretary of Treasury.
13. Hikmet Uluğbay, former Minister of Treasury, former Vice Prime Minister.
14. Nevzat Saygılıoğlu, former Head of the Revenues Department of the Ministry of Finance.
15. Ali Tigrel, former Head of the State Planning Agency.
16. Gazi Erçel, former Governor of the Central Bank.
17. Cemil Çakmaklı, former Member of Parliament.