

*The Open Economy and its Financial Constraints*, by Penelope Hawkins, Cheltenham and Northampton: Edward Elgar, 2003, ISBN: 1843760282, 273 pages.

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A series of financial crises in the 1990s questioned the efficacy of foreign capital inflows in promoting economic growth. A rapid increase in international capital inflow accelerated by the financial liberalization and deregulation of domestic markets has significantly increased economic fragility. Even growth rates have slowed down regardless of the huge capital inflows. Did orthodox economists and policy-makers find any solutions? Yes, more deregulation and liberalization! In this book, however, Penelope Hawkins challenges such orthodox panacea and suggests alternative theoretical frameworks from a Post Keynesian perspective. In the first half of the book, she delineates and extends Post Keynesian theories in that the liquidity preference theory should be applied to the issue of capital flows. In the second half, she applies theoretical arguments to some highly vulnerable countries such as Thailand, Brazil, and South Africa. Overall, this is book very insightful and informative.

In the first chapter, Hawkins examines different notions of constraints. The traditional concept of constraints (i.e., budget constraints) in economic theory is narrowly defined and is applicable only to a closed system. In an open system that is characterized by interdependency, uncertainty, and non-ergodicity, she argues, the term ‘constraining tendency’ is suitable. Furthermore, in a monetary production economy liquidity preference is a ‘constraining tendency’ in an open economy and, also, in an open system (p. 13). It means that financial constraints of individual agents (firms, banks, and households) and sovereign countries are endogenous with respect to creditworthiness, prospective yields, growth rates, and other external conditions. In chapter 3, Hawkins develops the concept of financial constraints into three states: financial exclusion, financial fragility, and financial vulnerability. In this context Hawkins explains that capital inflows during expansion periods are absorbed by the domestic economy as long as the boom is sustainable. At the same time, by the very nature of speculative foreign capital movements, it is highly susceptible to unexpected credit withdrawal if a country is on the fringe of international capital provision or is ‘vulnerable’ (chap. 3). Liquidity preference of lenders (banks) and domestic borrowers might exacerbate a situation since they are more risk-averse when expectations are going bearish. Thus, Hawkins’ constraining tendency is a better theoretical and practical concept than that of the orthodoxy. In chapter 6 and 7, Hawkins strengthens her argument by explaining the experiences of Thailand, Brazil, and South Africa.

From a Post Keynesian perspective, liquidity preference, endogeneity of money supply, and the multiplier effect are essential elements in the theory of effective demand in a monetary production economy. In this line of reasoning, Hawkins argues that the ‘conditional’ endogeneity of money should be accompanied with the theory of liquidity preference (as a constraining tendency) (pp. 36-45). That is, the liquidity preference of

private lenders constrains monetary transaction in the form of price or quantity rationing ('financial exclusion', in Hawkins' terms). Thus, financial provisioning is subject to business cycles as well as lender's degree of risk aversion and borrower's creditworthiness. Moreover, financial provisioning (credit expansion and bank lending) have a close positive relationship with investment, employment, and economic growth.

A theoretical strength of Hawkins' analyses of financial constraints comes from the distinction between center and periphery countries. Conventionally, there is no significant difference in the orthodox analyses of capital movements between developed and developing countries. It is, in orthodox theories, an arbitrage opportunity that matters for lenders and borrowers. By contrast, Hawkins convincingly argues that individual countries can be stratified through a spectrum of financial provision (pp. 63-67). In particular, borrowers of periphery countries standing on the fringe between the financially included and excluded try to hoard liquid assets of center countries. So, their desire for foreign capital might not be met. On the other hand, lenders, mostly from center countries, abstain from providing funds to periphery countries. Furthermore, even the lenders easily withdraw outstanding credit from periphery. Therefore, economic circumstances of periphery countries are inevitably vulnerable and fragile if they are highly exposed to foreign capital flows. Additionally, Hawkins suggests an alternative measure of the vulnerability index (chap. 5). The index includes not only trade openness, but also financial exposure (measured by financial account, FDI, portfolio investment flows, and debts). Consequently, the index shows more realistic implications.

Following Hawkins' theoretical and empirical arguments throughout the book, it is apparent that the argument that financial liberalization would promote economic growth is paradoxical. The more domestic markets are liberalized and deregulated, the more likely to face financial vulnerability and fragility. The aforementioned orthodox remedy makes the vulnerable countries more unstable and unsustainable in terms of employment and growth. For the purpose of sustainable and socially favorable development, "vulnerable economies have to devise growth policies which move them beyond their speculative standing in world markets" (p. 235). Rather than too much reliance on international capital, therefore, domestic demand management and institutional improvement are more important for the development of vulnerable countries.