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Financial Crises and Center-Periphery Capital Flows

Ali Tarhan

Abstract: The core of the world financial system is based on large investment and commercial banks which are located in leading financial centers. This core both holds and routes significant amounts of the world's financial funds considering the needs of their respective countries. On the other hand, peripheral countries with persistent current account deficits have to manage with the surplus funds of core countries or, worse, during times of financial turbulences be obliged to feed the core with their capital or absorb the excess funds of the core. In most cases, this dilemma creates an asymmetrical relationship between these two groups of countries. As financial crises mostly emerge in core countries, due to lack of domestic funding, they necessarily spread to the periphery as well. Thus, the Tobin Tax frequently gains popularity as a protective measure in the periphery. This study intends to redefine financial crises with their asymmetrical and endogenous aspects as well as to draw attention to the internal imbalances of peripheral countries.

Keywords: asymmetric capital flows, core-periphery analysis, financial crises, predatory state

JEL Classification Codes: F02, F33, F59

Financial crises are alien to none in the modern world, both on micro and macro levels. The history of economics also has a rich portfolio of crises. However, the financial crisis of 2008 was on a scale not witnessed since the big crash of 1929. The enormity of the crisis in monetary terms, and its widespread effects globally, not only started a debate on the credibility and responsibility of the financial sector, but also re -ignited age-old arguments about financial crises. Thus, the crisis reinforced divisions among economists instead of creating a consensus on this latest financial disaster. The cyclicality of economic and financial crises represents the central part of this debate. This dilemma indicates an ongoing persistence of some diagnostic problems. Moreover, it becomes clear that, unless the cyclical problem is satisfactorily solved, it will be difficult to reach a compromise on the ways to overcome the crisis.

Economic and financial crises always give rise to theoretical discussions. However, the contradictory and hardly self-evident nature of these crises also repeats itself in theoretical arguments. Some heterodox economists have a tendency to explain economic crises as expressions of the changing patterns of the capitalist

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Ali Tarhan is an expert in the Central Bank of the Republic of Turkey. *The author thanks Prof. Phillip A. O'Hara at Curtin University of Technology for correspondence on the topic and his comments. This paper was submitted to the annual meeting of the Association for Evolutionary Economics, January 4-6, 2013, in San Diego, California.*

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accumulation process, with their long booms and downturns. As for financial crises, they can only trigger the ongoing economic crises to slumps (Shaikh 2011). Therefore, economic crises and their cyclicality are intrinsic to the capitalist system. Conversely, the efficient markets hypothesis of neoclassical economics tries to explain economic crises by labor input, consumption, and investment fluctuations. However, within the framework of this approach, economic crises remain as *sui generis* puzzles, or simple malfunctions, not system failures (Cole and Ohanian 1999). The common denominator of both heterodox and neoclassical approaches emerges as the capitalist system's unsolved and unpredictable ability of crisis recovery (Dunn 2011).[1]

Another issue raised during these discussions is the blurred borders of economic and financial crises. Financial crises do not play a central role in radical economists' analyses. However, neoclassical economists tend to delegate a more disruptive role to financial crises during times of economic turmoil. The linear evolutionist logic of the neoclassical school does not allow neoclassical scholars to acknowledge internal inconsistencies of liberal economics (Preiswerk 1984). Despite theoretical divergences, both parties have an apparent agreement regarding the exhaustive effects of financial crises on national and international capital flows. This study intends to examine financial crises within the framework of international capital flows by using a core-periphery analysis.

The Core

Broadly defined, a core indicates a relatively powerful position in relation to others in one or more areas. When referring to a "core country," this powerful position may come in the forms of economic, political, military, financial, or technological might of the respective country. Even a core country's oligopolistic firms, by blocking competitiveness, can establish financial, economical, or technological power networks that force the remaining firms to depend on these centers (Korzeniewicz 1999). Regardless of the institutional form of this core, the power center's final aim is to create a subordinate periphery within its jurisdictional realm (Brown 1999). The core, as a big player, can influence the world order or markets with its actions (Koppl 2002). Therefore, strong institutional bodies characterize the core countries – including states, big oligopolistic corporations, as well as industrial and technological power.

Beginning with the 1980s, a series of monetary deregulations in the Unites States and the United Kingdom created bold financial markets. The most significant of these deregulations in the US were the Depository Institutions Deregulation and Monetary Control Act of 1980, the Garn-Saint Germain Depository Institutions Act of 1982, the Gramm-Leach-Bliley Act of 1999, and an amendment of the Glass-Steagall Act in 1999. Margaret Thatcher's government in the UK enacted similar measures in 1986. Consequently, both countries' financial markets developed highly leveraged instruments to bolster their profits (Congleton 2009). Having been unchained from regulatory burdens, New York and London became the financial cores of the western hemisphere. In the following decades, these deregulations,

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coupled with the support of market-friendly governments in both countries, made enormous contributions to transforming big American and British investment banks into giant, accountability-free corporations that became the protagonists of the 2008 crisis.

The Semi-Periphery

The semi-periphery is simply the subordinate unit of the core. Power relations with the core divide the periphery into two parts. The part of this division that is directly ruled forms the periphery. Institutional, political, economic, and technological weaknesses as well as strong dependencies on the core countries are basic features of peripheral countries. The institutionally developed part of this division, on the other hand, is the semi-periphery. The relatively strong development of the semi-periphery safeguards it from the direct, coercive control of the core. Consequently, the relationship between core and semi-peripheral nations strongly resembles a suzerain-vassal relationship in terms of subordination. The subordination of the semi-periphery to the core comes in many forms, depending on the type of power applied by the core. Subordination then determines the asymmetric power relations, where the core represents the ruler, and the semi-periphery is the ruled. However, this modern rule of power relations takes an indirect form, the intensity of which depends on the level of democracy in both the core and semi-periphery and/or on the compliance proclivity of the semi-periphery (Gerring et al. 2011).

There are also strong institutional similarities and differences between core and semi-peripheral countries. The institutions of the semi-periphery differ from those of the core in two main ways. The first lies in the functionality of semi-peripheral institutions: Any similarity between core's and semi-periphery's institutions is mostly in outer-appearance and procedures rather than in functionality and service (McCurdy 1999). The second is in the internal administrative systems of semi-peripheral states. These countries are generally subject to predatory rule. The lack of well-established political institutions and society's powerlessness to control its administrators create a power vacuum that would be filled by rent-seeking administrators (Levi 1989). For this reason, investors in semi-peripheral countries tend to invest less so as to avoid the (perceived as) unjust taxation policies of the state. Consequently, semi-peripheral states suffer from problems of self-inflicted capital accumulation and diminishing tax revenue. The steadily deterioration of state revenues keeps the semi-peripheral countries in a constant need of foreign resources. To sum up, semi-peripheral countries face the same relationships of subordination internally as they face internationally. To a certain degree, this is also true for core countries in regard to their oligopolistic market structure.

Power Relations and Asymmetries between Core and Semi-Periphery

Modern power relations between core and semi-peripheral countries are taking more and more sophisticated forms. First, the existence of a powerful core almost

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automatically eliminates the use of coercive power over the semi-periphery. In order to avoid the use of direct coercive power, the core can create a self-repressive mechanism within the semi-periphery via its over-arching power and institutions. Once this is done, coercion becomes unnecessary (Dugger 1980). The other important usage of power is delaying crucial decision-making — something the less powerful parties can hardly afford to do (Bardhan 1991). Delays, especially in an era of financial turmoil, can take the forms of monetary rationing or simple blackmailing of the semi-periphery by core countries. Diminishing tax returns and the lack of readily available foreign financial resources further contribute to the semi-peripheral states' already weak positions vis-à-vis the core states. Consequently, the semi-periphery is always vulnerable to the power fluctuations among the core. Under normal circumstances, the power imbalance tends to remain stable or break down to the detriment of the less powerful parties.

Lately, but especially in the 2000s, the relations between the core and the semi-periphery have changed substantially, with semi-peripheral countries having seemingly gained independence. This tendency has emerged and developed in parallel with rising globalization. A closer look reveals two aspects of the changing global financial and political environment. First, a relative independence does not always indicate real independence. Paradoxically, the disappearance of formal authoritative relations may disguise the interdependence between the core and semi-periphery. This interdependency often provides the stronger side with the power of control (Burt 1992; Granovetter 1973).

Another theoretical problem arises from the relations of core–semi-periphery within the context of globalization. The concept of globalization implies equal relationships among equal partners, which clearly do not exist in actuality. Therefore, accepting globalization within the framework of mainstream paradigms creates more puzzles and leaves the core–semi-periphery interdependency issues unresolved. Reconstructing globalization as the integration of the semi-periphery's financial markets into the core's financial centers as sub-prime units can help explain the actual role of the semi-periphery within the global financial order, as well as the relative independence of these subordinated countries. Consequently, the relative independence of semi-peripheral countries only covers the political, technological, or military spheres, which cause no direct harm to the financial core. On the contrary, these spheres have had to become less dependent on domestic and international financial services in order to survive. Therefore, only the fear of being excluded from the game and the loss of opportunities, coming from affiliation with financial centers, keep semi-peripheral financial markets within the world network. This symbiotic relationship between the core and the semi-periphery had underwritten the structure of world finance until the big slump of 2008.

Financial Crises and Asymmetric Capital Flows

It is almost impossible to imagine a financial crisis without the banking system's involvement.[2] However, the sophisticated transactions of investment banks in an

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unregulated environment and the (non-)interventions — or, worse, crisis misinterpretations — of central banks defy readily available analyses. Bank runs by panicked investors generally accompany these crises. Still, when comparing the two major financial crises of the twentieth and twenty-first centuries respectively, it is possible to gain a deeper insight into these runs. The withdrawal of large amounts of brokers' loans was the major cause for the cumulative panic during the 1929 stock market crash (Kindleberger 1986). On the other hand, the trigger for the 2008 crisis became the run from mortgage loans created by the shadow banking system (Gorton and Metrick 2009).[3] One can claim that the bank runs on deposits constitute the secondary effects of runs on investment markets in both cases. The familiar pattern, preceding these runs, is the sudden disappearance of over-speculative investors' confidence in financial intermediaries. The first effect of the collapse in financial institutions and markets is the severe interruption in the in- or outflows of capital — the lifeblood of every capitalist system (Harvey 2011). Disrupted capital flows cause damages to the economy at large, as a result of which the borrowing abilities of the real economy weakens, and the vicious circle of the crisis closes.

The effects of financial crises vary from one part of the world to another and from one social class to another. When it comes to capital flows, the financially weaker parties always carry the brunt of the crisis. The weaker the country or social class, the bigger the brunt it carries. This brunt is more readily observable in the immediate financial barriers being erected, especially in obtaining funds, before certain borrowers, since lenders in unregulated markets have discretionary powers to cut off credit lines (Kraus 2011). Consequently, the poorest parties become the most vulnerable in crises when it comes to capital flows. In times of relative prosperity, the core financial centers loan their excessive funds to comparatively safe semi-peripheral countries and enjoy higher interest rates. In times of crises, however, they withdraw these funds to fill the financial deficits in their home countries. This way, with the aid of liberalized capital flows, semi-peripheral countries serve as giant ATMs for the core countries' financial systems. Not unsurprisingly, the Tobin Tax is generally introduced in semi-peripheral countries, when the outflows of capital become hazardous, but it is quickly forgotten as soon as the crisis passes.

The giant ATM model of the semi-peripheral countries needs further elaboration.[4] Like the real ATMs, the ATMs of the semi-periphery are subject to two conditions. First, the funds they hold are mainly short-term-demand deposits. Second, the semi-peripheral ATMs are subject to sudden stops or withdrawals of funds by core depositors. Because of the unpredictability of these deposit reserves, semi-peripheral countries have not been able to use such funds toward long-term investments for much of the 2000s. The short-term character of these reserves only allowed semi-peripheral countries to invest in unproductive land development projects. Additionally, sudden stops or withdrawals of deposit funds have even been used as punitive measures against "deviant" states — a reality that has amplified the semi-periphery's fear of exclusion.

In the course of the 2000s, the financial markets of the US and UK reached their peak levels in regard to monetary expansion. During the same decade, the

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domestic reserves of semi-peripheral countries followed the same pattern (Obstfeld 2012). Thus, semi-peripheral countries developed a high level of financial dependency on core states, and remained vulnerable to shocks emanating from the core. By the middle of the 2000s, the sub-prime market of the semi-peripheral countries had overflowed with the excess funds of the core. Consequently, the financial core turned its attention to the domestic sub-prime customers, and created sub-prime mortgages. By creating the sub-prime mortgage system, the financial core reached its final limits, and the financial crash became only a matter of time.

The adverse economic effect of capital inflows is not new, at least theoretically. The basic reason for the flow of capital into and out of a country is that country's inadequate internal revenue services. So long as the weaknesses of their internal revenue services exist, semi-peripheral countries will suffer from chronic budget deficits, and these deficits keep the semi-periphery in a state of perpetual need of foreign funds. These endogenous deficiencies also make these countries vulnerable to external capital movements. Another pressure on these countries comes from the backwash effects of capital inflows (Myrdal 1972-1957). These effects, resulting from the unproductive structure in a country, further deepen income inequalities and regional discrepancies in the semi-periphery. One of the most important impacts of capital inflows is that they create a false income effect in semi-peripheral countries which leads people to over-consume. Overconsumption and underinvestment then cause further economic difficulties in these countries. The financial gap between overconsumption and underinvestment strengthens the semi-periphery's dependency on foreign funds.

Conclusion

Persistently inadequate public revenues trigger a chain-reaction in the semi-peripheral countries. Chronic budget deficits are the first phase of this reaction. In the second phase, the deficits create a need for continuous domestic or foreign funding. But foreign funding reveals itself as foreign debts. The combined effect of foreign capital and predatory domestic rule leads to a slower pace of investments.[5] Simultaneously, slow investment and growing capital inflows keep domestic demand and consumption at artificially high levels which, in turn, causes persistent foreign trade deficits. In the last step in a process, these twin deficits establish a dependent economy. Needless to say that widespread corruption and rent-seeking further exacerbate the economic situations in peripheral countries.[6]

Despite appearances, semi-peripheral countries are institutionally weak. Therefore, an institutional-reformist approach to solve the problems of these countries seems credible. However, the institutional weaknesses of semi-peripheral countries are far from coincidental. Institutional weaknesses feed many interest groups, strata, and oligopolies in many countries. But the semi-periphery is generally more vulnerable than the core to the predatory practices of rent-seeking groups. The latest economic crisis only showed that underestimating the power of these groups could be hazardous even for core countries. Therefore, the need for a new financial

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architecture comes to the fore in both types of countries. Another lesson the recent crisis has revealed is the danger of unilateral decision-making that may cause extensive damages. But this lesson is yet to receive the broad recognition it deserves.[7]

Notes

1. A Schumpeterian approach to economic cycles seems still plausible. Joseph A. Schumpeter highlights the importance of capitalists both as a creative and destructive force. Monopolistic capitalism creates two armies. The first is the well-known "reserve army of labor," in Karl Marx's terms. Schumpeter finds a similar pattern within the capitalist class. Monopolistic capitalism also creates a "reserve army of entrepreneurs" who are excluded from the core market by entry barriers. During economic slumps, entry barriers weaken and these businessmen enter the stage with new ideas, innovations, and technologies. This latter army, combined with the advancements of the former, contributes to overcoming the crisis (see Schumpeter [1942] 2008 for further information).
2. Shadow banking consists of non-bank financial strategies. As a barely regulated system, shadow banking can use highly leveraged financial strategies.
3. Banking systems have stuck with the Basel regulations before and after the crisis. However, they have been highly affected by the collapse of their shadow banking entities.
4. The cash in the ATMs cannot be securitized because of its high volatility and immeasurability. Therefore, it stays as is and only the volume changes. If there was even a slight chance of its ever being securitized, the shadow banking system would have already figured out how. International reserves of the semi-peripheral countries suffer from similar problem.
5. Predatory ruling is not the sine qua non part of this chain reaction. In modern democracies, populist or irresponsible governments may also create the same effects.
6. The last crisis in Europe showed that power shifts within the core are also possible. The crisis truly exposed the heretofore hidden core/periphery dichotomies in the European Union. As Germany becomes the new financial core in the Eurozone, the Mediterranean members of the Union have turned into marginalized semi-peripheral associates.
7. Recent developments showed some signs of this recognition. The president and chief executive of the Federal Reserve Bank of New York (FED NY), William C. Dudley, accepted the externalities created by the shadow banking system and the "too big to fail" myth in a speech given on November 15, 2012. Although Dudley admitted the failures of big investment banks, he still has reservations about the benefits of regulated markets. In another study, the International Monetary Fund (IMF) recognized the risks of capital flows. Unlike the FED NY's hesitation to accept regulations, the IMF's attitude is more encouraging, as it would indicate an important paradigm shift. (For more information, see FRB NY 2012 and IMF 2012.)

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