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## A POLITICAL ECONOMY THEORY OF FINANCIAL CRISES: ABSTRACT

The last two decades of the twentieth century have seen burgeoning financial crises, afflicting a wide range of developing countries such as Argentina, Brazil, Indonesia, Malaysia, Mexico, Russia, South Korea, Thailand and Turkey. After each episode the IMF—and the mainstream press—has concluded that the causes were ‘primarily internal’ to the countries under question and that the solution was to strengthen the national policy process—increased transparency, prudential regulations, surveillance, etc.—and to create and sustain macroeconomic stability. The IMF’s conclusions and prescriptions could work in theory, but in real world one needs to critically assess the plausibility of such claims since accepting them uncritically would mean taking new and greater risks. But in order to assess the credibility of the mainstream claims, one must first examine the theoretical underpinnings of the neoclassical argument.

The first thing is to understand that the mainstream conclusions follow logically and inevitably from the a priori assumption—which is consistently made either implicitly or explicitly by the IMF and its ‘soul mates’—that international mobility of capital is both highly desirable and inevitable. Once made, this assumption limits the availability of policy options such as capital controls, not to mention more egalitarian policy solutions like social investment and community entrepreneurship.

Thus, the canons of neoclassical argument, desirability and inevitability of capital mobility are the new boundaries within which the public policies are conceived. Accordingly any crises will, therefore, appear as the fault of incompetent, venal policy makers due to (a) their inability to operate within the constraints determined by capital mobility desirability); and (b) their inability to install a market-friendly legal-institutional framework that is tailored to the new realities of globally flexible financial system. Of course the plausibility of this argument rests on the assumption that stable and sustainable growth in output and welfare can be attained within those constraints, irrespective of the political, social or institutional peculiarities of the country in question. And this is not self-evident. Indeed a growing chorus of critics challenging this claim as the world embarks on capitalism’s new century.

This paper examines the theoretical underpinnings of the mainstream argument, outlining how the basic neoclassical model pictures a world in which the room for policy maneuvers is very limited. In this world, rational policy makers who pursue ‘sound policies’ run governments, they, by design and definition, have acknowledged and accepted the canons of neoclassical view. Again, in this world investors or ‘market participants’ too are ‘rational’ and behave in accordance with the logic of the marketplace. In a world defined as such, market outcomes are ‘optimal’ and ‘efficient.’ (Of course, the ‘positive’ aspects of such a world is limited to optimal and efficient allocation, whereas the distribution of economic welfare remains indeterminate—which is itself a very important public policy *problématique*.) However, all of this changes quite dramatically if one allows for the possibility of ‘pervasive’ irrationality in the behaviour of such market participants; and inherent tendencies for disequilibria and instability of such markets due to information asymmetries, herd behaviour and adverse selection et cetera. At this point liberalization of markets and excessive international integration could lead to the large-scale misallocation of resources, destructive and ‘irrational’ volatility and sub-optimal use

of resources due to excessively destructive financial crises and resulting social processes of increasing polarization, radicalization and various forms of fundamentalism.