

Managing the Global Economy

* CHAPTER ELEVEN *

ON THE THRESHOLD of the twenty-first century, the future of the global economy appears uncertain. During the 1990s, the American economy experienced its longest period of uninterrupted successful and sustained economic growth; income rose for most Americans while inflation and unemployment declined. In Western Europe, on the other hand, economic growth remained sluggish and unemployment was at high levels across the Continent. And Japan was in financial crisis after its "bubble" burst in the early 1990s and it entered a serious recession in the late 1990s. Extricating itself from these difficulties proved exceptionally difficult, but as these lines are written in early summer 1999, there are signs of considerable improvement in the economy. Russia has been in a state of extreme economic distress for nearly a decade. The once-thriving emerging markets of East Asia have struggled with a devastating economic crisis, and Latin America has suffered serious difficulties. Many believe that increasing globalization of the world economy is the culprit behind many, if not most, of these problems.

In the United States, the dominant response to the world's economic troubles and to charges against globalization has been "just follow our example." Most American commentators believe that more open markets and less government intervention will lift the world out of its economic troubles, a belief based on the conviction that American economic success in the 1990s is a product of a recently fashioned New American Economy based on globalization, the computer, and corporate dynamism. Deregulation, privatization, and continuing reduction of the heavy hand of government in the economy have, many argue, paved the way for a streamlined and consequently resurgent American economy. Therefore, Americans believe that the stagnant and troubled economies of the rest of the world should adopt the American system and that free trade, freedom of capital movements, and nonintervention by the state in the economy should be the guiding principles of global capitalism in the twenty-first century.

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However, not all agree that this would produce a "streamlined and resurgent" global economy; indeed, some sources of potential difficulty can be identified. The threat of financial turmoil continues, and the United States and the other major economic powers are far from agreement on ways to prevent future financial crises. The movement toward potentially exclusive regional free-trade areas, especially in Western Europe, is also troubling, and at this writing no international agreement on principles to govern economic regionalization has yet materialized. Furthermore, there is a renewed threat of trade protection and significant erosion of the support for open markets.

CREATING A "NEW FINANCIAL ARCHITECTURE"

In the late summer of 1998, the East Asian economic crisis spilled over into the global economy, setting the stage for what President Clinton declared to be the "worst crisis in 50 years." The Russian government's substantial devaluation of the ruble in August triggered that global crisis. For political reasons the Clinton Administration had bet heavily on "saving" Russia and had pressured the IMF to loan Russia tens of billions of dollars that were subsequently squandered. Investors and governments around the world panicked as they witnessed a major nuclear power renegeing on its agreements and facing economic and political chaos. Worried that other countries would also default, investors began to withdraw their funds in search of safe havens. Declining corporate profits and investor panic accentuated a steady fall of the American and other stock markets; the threat that the Long-Term Capital Management Fund would collapse deepened the crisis.⁸⁸ These events, in turn, set off a serious credit crunch that further slowed global economic growth. In the late fall, some estimated that approximately one-third of the world economy was in recession. Only the United States was still experiencing economic growth. With the depression in East Asia and recession in much of the rest of the world, commodity prices fell considerably, and this caused economic distress in many commodity-exporting sectors, including American agriculture.

American officials had become concerned in the early fall of 1998 that the financial crisis would continue to spread; they focused much of their attention on Brazil. Brazil possessed many characteristics of a developing economy in serious trouble, including a huge budget deficit and sizable international debt. The country's uncertain fiscal situation was causing a heavy capital outflow and putting severe pressure on the Brazilian currency, the real. The Clinton Administration particularly feared that financial collapse in Brazil, a major importer of American products, would seriously damage the American economy and accelerate turmoil throughout the world. As the troubles of the global economy continued to unfold, the Clinton Administration was finally galvanized into action. In a well-publicized speech in mid-September to the Council on Foreign Relations in New York, the President proposed that all the major economic powers stimulate their own economies in order to restore global economic growth; he also proposed that, at the next meeting of the G-7, the major powers should develop a longer-term solution to the problem of global financial instability.

These Clinton initiatives were given a cool reception. Every central bank rejected the suggestion that interest rates be cut so as to stimulate global growth. Subsequently, that autumn, the Federal Reserve, motivated primarily by concerns about the American economy, did cut interest rates three times between September and the end of November; these rate reductions succeeded in reinvigorating the economy. The Clinton proposal for a G-7 meeting had been accepted by other nations, although without enthusiasm; the meeting took place following the annual joint meeting of the IMF and World Bank (WB), held in Washington in October.

Clinton's New Architecture

At the IMF-WB meetings, President Clinton set forth his proposals for a "new international financial architecture" to contain the spreading economic crisis and prevent future crises. The Administration also hoped to forestall efforts by other governments (mainly Western European and Japanese) to impose new restrictions on international capital flows. The President's proposals were considered at the meeting on

October 30 of the major economic powers, and several important decisions were reached. The G-7, assuming that if investors were fully aware of risky situations, they would not repeat the mistakes made in Mexico and East Asia, agreed that much greater transparency of financial conditions in every country was crucial to prevention of future financial crises. To achieve this goal, the G-7 called for much tighter international standards for accounting and for regulation of banks.

The most important G-7 decision was its acceptance of the President's proposal that the IMF should establish a \$90 billion contingency fund to provide countries with emergency financial assistance; the fund would help only those countries already carrying out economic reforms and those whose economic "fundamentals" were basically sound. Thus, the IMF could step in before a crisis actually occurred to shore up the country's financial defense of their currencies by providing adequate liquidity and thereby preventing financial panic. When it made this proposal, the Clinton Administration had Brazil in mind, as Brazil required a huge infusion of foreign capital to keep its economy afloat. Following a bruising but ultimately successful battle in the Congress over replenishment of IMF funds, a large part of which had been squandered on Russia, the IMF offered Brazil a large assistance package of over \$40 billion. A precondition for the financial support was that the Brazilian economy be overhauled in significant ways. Having failed to improve its economic performance, Brazil suffered a major economic crisis in early 1999.

Debate over Regulation of International Finance

As important as the G-7 decisions had been, they failed to quell the intense controversy regarding the reform and regulation of the international financial system. To deal with destabilizing international financial flows, a number of proposals have been set forth that range from creation of a world central bank to imposition of an international tax on money transfers across national boundaries. Some experts believe that self-imposed national restrictions on financial inflows and outflows are necessary; a number of national governments, such as those of Japan, China, and Chile, have maintained controls on financial flows; and in response to the East Asian crisis and global economic turmoil, Malaysia

imposed controls. Moreover, the European Union began consideration of some regionally based capital controls.

Several important proposals for stabilizing international finance have been set forth and debated. A number of economists and others argue that governance of the international financial system should be left entirely up to the market. The Clinton Administration and the IMF favor freedom of capital movements along with greater IMF surveillance over both domestic and international financial matters. A number of countries, including Japan, Germany, and France, believe that stringent international controls over monetary and financial matters are required. Some economists believe that only a "true lender of last resort" will protect the global economy from devastating financial crises.

RELYING ON THE MARKET

A number of economists believe a completely open and unregulated international financial system is the best solution to the problems resulting from international financial flows. They also believe that any other approach necessarily raises the problem of "moral hazard"; that is, if lenders and borrowers believe that the IMF or another official agency will rescue them from their folly, reckless behavior will be encouraged, as happened in the East Asian financial crisis. In an unregulated financial market, the market itself will punish those investors and borrowers who fail to pursue prudent economic behavior. Knowing that no one will rescue them if they get into trouble, international investors will become more cautious. Many proponents of this position regard the term "speculation" as pejorative and argue that what is generally called "financial speculation" is actually the rational attempt by investors to protect their assets from irresponsible government behavior. This position holds that there is no need for international regulation of financial affairs, because truly financially irresponsible lenders and borrowers will be punished by the market and will thereby be deterred from reckless behavior.

Such proponents of this position as Milton Friedman, Walter Wriston, George Schultz, and William Simon argue that the IMF is ineffective as well as obsolete and should be abolished. Friedman considers the role of the IMF in the world economy to be an example of bureaucratic self-aggrandizement. The IMF, Friedman points out, was

originally created to supervise the system of fixed exchange rates that collapsed on August 15, 1971, when President Nixon closed the gold window by refusing to continue the U.S. commitment to buy and sell gold. The IMF then found a new function as an economic consulting agency for countries in trouble, offering money to help them in exchange for promises of reforms. In Friedman's opinion, this interventionism by the IMF encouraged countries to continue pursuing unwise and unsustainable economic policies. Russia's failure to make the hard decisions required to salvage its devastated economy, he believes, was a classic example of IMF culpability for encouragement of irresponsible behavior.

For Friedman and fellow conservatives, the IMF response to the Mexican crisis of 1994–1995 represented a quantum jump in the IMF's counterproductive interventionism. Mexico was bailed out by an aid package of \$50 billion put together by the IMF, the United States, and other countries. Friedman has asserted that the IMF money actually ended up in the hands of such foreign entities as American banks that had foolishly lent money to Mexico, while Mexico itself was left in recession and saddled with higher prices. However, the Mexican crisis had a longer-term and even more serious consequence because it fueled the East Asian crisis by encouraging investors to again make risky investments. Drawn by high returns and assured that the IMF would bail them out if the exchange rate broke down and governments defaulted, investors poured money into the emerging markets of East Asia. In effect, the IMF and its provision of insurance against currency risk subsidized private banks and investors, a clear example of a policy that encouraged undesirable behaviors. Thus, the solution to financial instability must be through elimination of IMF-induced "moral hazard."

The market-oriented position rests on the assumption that investors are rational and will not invest in risky ventures if they know that they will not be bailed out by the IMF and the American government. Therefore, eliminate "moral hazard," and you eliminate the problem of serious international financial crises. That may be correct, but such an approach has never been tried and there is no empirical evidence to support such a daring policy experiment. Indeed, the available evidence leads to the conclusion that investors are *not* consistently rational

but *do* get caught up in euphoria. Indeed, when the speculative bubble bursts, many innocent people will get hurt. For this reason, few governments are willing to risk leaving international financial matters entirely "up to the market," and many governments have installed mechanisms at the domestic level to protect their citizens from financial instability.

STRENGTHENING THE IMF

Others believe that the solution to the problem of international financial instability can be found in strengthening the regulatory role of the IMF. Proponents of this position, especially the United States and increasingly the IMF itself, believe in the freedom of capital movements. However, while agreeing with the market approach about the beneficial nature of free capital flows, they believe that greater supervision of financial matters by the IMF is necessary. Indeed, the IMF has already taken a number of important initiatives to create a regime for international finance. Most important, the IMF charter has been amended to give the IMF greater jurisdiction over financial matters. As IMF's First Deputy Managing Director Stanley Fischer has said, the amendment is intended "to enable the Fund to promote the orderly liberalization of capital movements." He has also noted, however, that achievement of this goal requires continuous and reliable information on the financial conditions in potentially risky economies, development of an effective surveillance system to monitor such economies, and action by the IMF as the lender of last resort.

The following paragraphs indicate some of the difficulties faced by the IMF in its efforts to strengthen its role in preventing financial crises:

1. *Improved Information Gathering.* The 1994–1995 Mexican crisis was indeed deepened by the poor information about Mexican financial conditions supplied by the Mexican government to the IMF and investors. For example, the size of Mexican financial reserves and external debt was kept secret. In 1996, lessons learned from this experience did lead to increased data gathering and its dissemination by the IMF. However, some experts point out that even the improved system of data gathering proved inadequate and clearly did not forestall the 1997 East Asian financial crisis. Although more reliable information on the financial conditions of developing economies would be an important safe-

ard against reckless investing, the fact that governments wish to keep financial data secret in order to increase their leverage with foreign investors raises a major hurdle. The predicament is made worse because governments wish to keep their financial condition secret in order to strengthen their relative position in the intensifying competition for vital imports.

2. *Codes of Conduct and Improved Surveillance.* To increase financial discipline at the international level, the IMF has placed much greater emphasis on developing codes of conduct regarding "good practice" in financial affairs that would require upgrading of the Basle Accords regarding international banking.⁸⁹ In addition, improved surveillance and monitoring of specific economies for such dangers as high budget deficits and high rates of inflation are required. However, even if a country and high rates of inflation are required. However, even if a country warned of impending problems, it may not act to forestall them, and IMF is powerless to force such action; yet it would not be proper for IMF to warn investors of potential problems in a particular country.

3. *Lender of Last Resort.* In a world of increasing capital flows and rising numbers of borrowers, it is inevitable that individual countries occasionally experience serious financial troubles and require international assistance in the form of a large infusion of money to prevent liquidity or even an insolvency problem. When a sound economy has temporary cash-flow problem, that is a liquidity problem; but an economy with severe economic problems will have an insolvency problem.⁹⁰ Even though the most appropriate agency to perform the role of lender of last resort would be the IMF, the IMF is seriously limited in its capacity, because, unlike a true central bank, it cannot create money and its cumbersome governing mechanism prevents it from acting quickly in a crisis. In addition, the IMF's assumption of the role of lender of last resort would raise a serious dilemma because the risk encouraging "moral hazard" increases in proportion to the size of the available resources.

Strengthening the IMF as a means of promoting freedom of capital movements and preventing financial crises has been an important objective for the Clinton Administration. The priority of keeping economies open to international finance reflects the American commitment

to a pro-market ideology; the American financial interests to which the Treasury is highly responsive, and the belief that America has a strong comparative advantage in financial services. However, as the intense 1998 controversy over America's \$18 billion contribution to the IMF illustrates, the Clinton Administration's effort (backed by export interests) to strengthen the IMF's role in preventing financial crises had many opponents, and the controversy raised serious questions about the ability of the United States to lead in fashioning a "new international financial architecture." In order to win congressional approval of IMF funding, the Administration had to accept a number of Congress-mandated changes regarding the IMF, even though Congress did withdraw its demand for a major overhaul of that institution. Although some of the changes may be helpful, others may considerably complicate IMF functioning. Meanwhile, it is certain that U.S. attempts to transform the IMF unilaterally were not pleasing to other governments. The changes proposed by the Congress are listed here with my commentary:

1. IMF agreements with recipient countries and such other IMF activities as reports on various nations must be subject to increased disclosure and transparency. (This proposal responds to charges that the IMF is too elitist and secretive. As many developing countries have resisted disclosure of financial information, this requirement would undoubtedly become a source of friction between the IMF and many countries.)
2. The IMF must impose higher market-based interest rates (about 7 percent) that would encourage faster repayment and greater dependence on the private market. (Many conservatives complain that the IMF competes against the private financial sector and demand that the IMF end its practice of lending to foreign governments at below-market interest rates. If the IMF made this change, it would surely blunt any effort to make it the lender of last resort.)
3. The American government must ensure that IMF loans do not harm the poor or the working class, and labor standards must not be violated. (Obviously, this proposed change was a concession to organized labor and the political left.)

