Development DESTIN Studies Institute

Working Paper Series

ISSN 1470-2320

2002

No. 02-24

OUT OF THE BOX: RETHINKING THE GOVERNANCE OF INTERNATIONAL FINANCIAL MARKETS

Prof. Robert Wade

Published: February 2002

Development Studies Institute

London School of Economics and Political Science

Houghton Street

London

WC2A 2AE UK

Tel: +44 (020) 7955-7425

Fax: +44 (020) 7955-6844

Email: d.daley@lse.ac.uk

Web site: www.lse.ac.uk/depts/destin

31 Sep 99 In *Journal of Human Development* , vol. 1, n.1, 2000, UNDP. "worldfinancialarchitecture"

OUT OF THE BOX: RETHINKING THE GOVERNANCE OF INTERNATIONAL FINANCIAL MARKETS

Robert Wade[1]

The emerging market crises of 1997-99, in Asia, Russia and Brazil have prompted an outpouring of discussion about a new, improved "international financial architecture". "Architecture" suggests a redesign of institutions and rules. But the governments of the major industrial countries and the staff of the major international financial organizations have narrowly focussed the discussion on the rules and regulation of financial markets themselves. Even analysts of more free-thinking disposition have tended to accept the assumption that the causes of these financial crises are to be found in the governance of financial markets--the international financial markets and especially the domestic financial markets of the crisis-affected countries; and that better rules and regulations of finance can substantially cut the risks of repetition.[2]

This is questionable. The emerging market crises are only one part of the world economy's deteriorating economic performance in the 1990s, and their frequency and severity is bound up with the other parts of the larger deterioration. Improved world economic performance, including lower risks of emerging market crises, requires action by the governments of the major industrial countries to coordinate their macroeconomic policies around an *expansionary* agenda. The whole area of macroeconomic policy coordination is missing from the current debate about a new international financial architecture. The changes needed in the current international financial architecture have to include those necessary to encourage, not penalize, macroeconomic policy coordination.

The architects of Bretton Woods understood this very well. They sought to design a set of institutions and rules that would achieve several

---

[1] Professor of Political Science and International Political Economy, Brown University, and professor-designate of Political Economy and Development, LSE.

[2] For examples of new international financial architecture discussions which accept this narrow constraint, see Stephany Griffith-Jones, "Towards a better financial architecture", paper for First Global Forum on Human Development, UNDP, New York, 31 July 1999; "Reinventing global governance—for humanity and equity", chapter 5, *Human Development Report 1999*, UNDP, Oxford University Press, 1999, especially p.102; *Towards a New International Financial Architecture*: *A Practical Post-Asia Agenda*, Barry Eichengreen, Institute for International Economics, Washington DC, 1999.

objectives at the same time. The new system would expand international trade and investment, while also enlarging the capacity of national governments to pursue countercyclical macroeconomic policy and thereby protect societies from the instabilities of free markets. It would also create institutions at the world level, one (the IMF) to assist countries facing temporary balance of payments difficulties and pre-empt a protectionist response, the other (the World Bank) to redistribute resources to countries that were missing out in free market allocations and protect the legitimacy of the system. The architects—Keynes in particular—recognized that for international trade and investment to expand at the same time as governments maintain policy autonomy would require governments to coordinate among themselves to impose limits on international financial flows and on exchange rate movements in the face of different macroeconomic conditions in different countries. For Keynes, nothing was more damaging of national economic performance than the free movement of speculative capital; and he considered it a major triumph that the plan for the IMF "accords to every member Government the explicit right to control all capital movements. What used to be heresy is now endorsed as orthodox….our right to control the domestic capital market is secured on firmer foundations than ever before, and is formally accepted as a proper part of agreed international arrangements".[3]

The years from the Second World War to the early 1970s saw unprecedentedly fast and stable growth in much of the world, including both developed and developing countries, and an important part of this performance can be attributed to the Bretton Woods architecture.

But the system was undermined in the late 1960s and the early 1970s by several forces, most importantly the growth of international finance. Since then financial globalization has weakened the capacity of national governments to protect their societies in at least two ways. First, it imparts a deflationary bias to policy, and makes national-level countercylical macro policy more difficult. If one government undertakes unilateral expansion by loosening monetary policy and lowering interest rates, capital moves abroad as investors and speculators seek higher returns and lower inflation. The government must either let the exchange rate depreciate (which may trigger inflation and further depreciation), or raise interest rates. Either way it cuts off the unilateral expansion.

Second, financial globalization contributes to the outbreak and severity of financial crises. Financial markets have an inherent (or

---

[3] Louis Pauly, *Who Elected The Bankers?*, Cornell University Press, 1997, p.94.

endogenous) tendency to become fragile and then unstable, a tendency which globalization greatly reinforces. Banks and firms everywhere tend, as a boom continues, to see less risk ahead and therefore to *reduce* their cushion of liquid assets against a downturn. Then when a shock hits the system banks and firms attempt to call in loans and sell assets all at once, precipitating economy-wide crisis. This can happen even in a closed economy, but when the economy is open to international financial markets and those markets are very large, it is more likely. Prudential regulation of banks and debt to equity limits on firms are of only moderate help in offsetting the tendency towards financial instability.

The tendency is compounded by the incentive system of the institutional investors who move the money. They are penalized for missing out on business that their competitors are getting, but not penalized for making losses when their competitors are making losses. And provided they are not penalized they can earn within a few years enough in bonuses to retire on. This incentive system generates pronounced herd behavior, leading to capital surges in and out of countries. The Asian crisis is testimony to the destructive potential of these surges.

The Economic Deterioration of the 1990s

During the 1990s, as financial globalization accelerated, the major industrial economies experienced a worse economic performance than in the 1980s. Most indicators of economic performance deteriorated. For the group of seven major industrial economies (the G7), growth of GDP per head fell by *one third*, from 2.1 percent over the 1980s to only 1.4 percent in the 1990s. Unemployment remained high in both decades, averaging nearly 7 percent. Income inequality widened in most economies, especially in the countries of English-speaking settlement where market liberalization has been pushed furthest.

The 1990s have also seen wild exchange rate movements, the biggest since the Second World War, especially between the three major currencies, the US dollar, the yen, and the mark. Between the spring of 1995 and 1998 the dollar appreciated by 20 percent against the mark and by 50 percent against the yen. In early October 1998 the US dollar dropped 17 percent against the yen in 48 hours, a movement attributed to rumors of possible expansionary policy actions by the Japanese government. A system of monetary relations that produces such volatility is not much of a system.[4]

---

[4] Benoit Mandelbrot, "A multifractal walk down Wall Street", *Scientific American*, February 1999, 70-73.

Of the standard indicators of economic health, only inflation and fiscal deficits have improved. Consumer price inflation fell in the G7 from 5.5 percent in the 1980s to 2.7 percent in the 1990s. Fiscal deficits actually rose from 2.9 percent of GDP in 1981-91 to 3.4 percent in 1992-95, but then fell to only 1.4 percent in 1997-98.

The 1990s have also seen an accelerating series of financial crises involving *both* industrial and "emerging market" economies: the Japanese crash in 1990, from which Japan has been unable to recover for a decade; the Scandanavian crash of 1991-2; the European Exchange Rate Mechanism crisis in 1992 (that resulted in the British pound and the Italian lira being forced to devalue and exit the system); the Mexican crisis of 1994-5; the Asian crisis of 1997-99; the Russian crisis of 1998; the Brazilian crisis of 1999; and others pending in Argentina, Mexico, China, and elsewhere.

The emerging markets financial crises of 1997-99, which prompted the calls for rethinking international financial architecture, are therefore only a sub-set of poor world economic performance in the 1990s. Changes in financial rules and institutions need to address this larger picture.

The Solution of the G7 and the IMF

The G7 finance ministers have met every three or four months since 1986 to review the state of their economies and decide on common action. Naturally they have been concerned to reduce unemployment and exchange rate volatility, to reduce the likelihood of more emerging market crises, to raise growth rates, and to spread the benefits of international trade and investment more evenly across countries.

They have insisted in their communiques during the 1990s (more emphatically than in those of the 1980s) that the solutions to these various problems lie in making markets work better and preventing market failures.[5] At the level of macroeconomic policy, they call for all countries to adopt sound monetary and fiscal policies, where "sound" is code for "tight enough to keep both inflation and fiscal deficits at very low levels". At the level of microeconomic policy, they call for market liberalization. So their solution to the problem of exchange rate volatility is general adoption of "sound" macro policies, which will then eliminate the sort of macroeconomic imbalances that are, they say, the underlying cause of exchange rate volatility. Their solution to high unemployment is to deregulate labor

[5] Michael Webb, "The Group of Seven and political management of the global economy", paper for International Studies Association Convention, Washington DC, 17-21 February 1999. I am indebted to this paper for much of the following discussion of G7 macroeconomic relations.

markets so as to make labor markets more flexible in terms of hiring and firing, wages, working time, and work organization. Their solution to financial fragility and instability is more transparency, stricter IMF surveillance, tighter prudential regulation of borrowing banks, higher capital adequacy standards, contingent lines of credit, and the like.

Since the G7 are the most powerful members of the IMF their views are taken up as the IMF's views and projected into the IMF's client countries, reinforcing the consensus about the way ahead. In words that might have come from a G7 finance ministers' communique, the managing director of the International Monetary Fund, Michel Camdessus, recently declared that emerging market countries must undergo reform,

> "based on a mature partnership between governments and market players, and a higher sense of responsibilities for the international common good. In normal times, it means establishing an arm's length relationship between governments and markets, neither too close nor too distant. It is a partnership that demands good governance, transparency, and disclosure of information, and a respect for standards and codes of good practice that are consistent across countries".

He further declared, "There is a strong consensus for making transparency the 'golden rule' of the new international financial system".[6]

In short, the G7/IMF solution calls for government policies to be made more consistent with the preferences of private markets—of financial organizations and of employers. US academic economists and emerging market economists trained in the US also tend to endorse this broad line of solution.

Indeed, most of what the G7 and IMF and allied bodies have acted on so far—as distinct from merely talked about—are related to subjecting the governments, banks and firms of emerging market countries to the tighter discipline wanted by private international capital markets, rather than subjecting those international capital markets or the G7 countries to tighter discipline. As one analyst puts it in the context of improved information, "Much useful progress has … been made on improving information on developing countries, which hopefully will help markets and policy-makers take better decisions…. More limited progress has till now been made on the equally important issue of improving information on international financial

[6] Michel Camdessus, "Governments and economic development in a globalized world", speech to 32nd International General Meeting of Pacific Basin Economic Council, Hong Kong, May 17, 1999.

markets."[7] The IMF's increased surveillance capacity is for surveillance of its potential borrowing countries, not of the G7 countries.[8]

Transparency for them, not us: the case of US regulation of derivatives

The US government's stance on the regulation of over-the-counter (OTC) derivatives contracts is a case-in-point of asymetrical demands for transparency and regulation. The OTC market in swaps and options has grown at an astonishing rate, from $8,000 billion of OTC derivatives outstanding in 1993 to over $50,000 billion in 1998.[9] A large part of these derivatives are booked in the US. Very little is known about their net impact on the stability of financial markets, because unlike derivatives which are traded on commodity exchanges OTC derivatives are traded privately, with no reporting requirement. But it became clear after the Mexican crisis that "Inadequate disclosure by banks, together with the failure of the official statistics to capture these [OTC] transactions, mean that foreign currency exposures in Mexico turned out to be far greater than anyone realized when the crisis first erupted. So the derivatives industry [that had marketed complex derivatives to Mexican banks before the crisis to allow them to overcome constraints on foreign exchange positions and controls against investing on margin] exacerbated Mexico's plight".[10] The derivatives industry almost certainly exacerbated East Asia's plight in the same way.

A strong argument can be made that the OTC derivatives market, that is presently unregulated and completely opaque, constitutes a major source of risk for the world economy. Only by bringing OTC derivatives within a regulatory regime would we even know enough about them to assess their net effects on risk. And that regime has to extend not only to firm-by-firm regulation, but to the regulation of entire classes of transactions. Otherwise it can easily happen—and did happen in the case of lenders to Long Term Capital Management, the American hedge fund that collapsed in September 1998 under the weight of its derivative contracts—that each entity considered on its own meets the regulatory requirements but when added together the market is dangerously exposed.

---

[7] Stephany Griffiths-Jones, "Towards a better financial architecture", p.45.

[8] The IMF Board is considering a report that urges the surveillance process to be strengthened and extended to greater focus on regions of the world, rather than individual economies, in recognition of contagion effects. *The Financial Editorial* editorializes that the IMF should "[cut] down on surveillance of the developed world" on the grounds that the developed world is already well enough surveilled by the OECD and private-sector bodies ("A watchful eye", 3 August 1999).

[9] John Plender, "The bankers' black hole", *Financial Times*, 22 July 1999.

[10] John Plender, "The bankers' black hole". Frank Partnoy, *F.I.A.S.C.O.: Blood in the Water On Wall Street*, Norton, 1997.

However, when the US Commodity Futures Trading Commission (CFTC), the body that regulates commodity futures trading, proposed to extend its remit into the area of regulating OTC derivatives, Treasury Secretary Rubin, Federal Reserve Chairman Alan Greenspan, and Securities and Exchange Commission Chairman Arthur Levitt all attacked the idea in the strongest terms. This was not a turf battle. The latter three were not saying that they rather than the CFTC should do the regulation; they were saying that the OTC derivative market did not need regulation, and that in any case regulation in the US would only drive the business to other financial centers, at serious loss to Wall Street. So alarmed were Mssrs. Rubin, Greenspan and Levitt at the CFTC's proposal to regulate these markets that Secretary Rubin discreetly obtained presidential authorization to fire the head of the CFTC, who officially resigned in January 1999.[11] This is an example of how the proposals for more transparency and tighter prudential regulation bear mostly on emerging markets rather than on source countries.

The G7/IMF solution is not working

The priority given to very low budget deficits and very low inflation (around 0 to 3 percent) imparts a deflationary bias to the world economy. But the G7 go on affirming the recipe on the argument that macroeconomic stability plus "well-informed and well-functioning financial markets"[12] plus labor market flexibility will eventually lead to a growth recovery—one that is sustainable because based on sound "fundamentals".

Yet the G7 countries have already achieved very low inflation and low budget deficits. Indeed, they have never been so convergent in these respects since the Second World War. On the other hand, economic performance remains poor, as noted: unemployment high, exchange rate volatility very high, growth slow, and several serious financial crises. The formula is not working, yet the G7/IMF repeat it as the only alternative. Each new communique reads more like Alice in Wonderland.

So too do the IMF's statements about the lessons to be drawn from the Asian crisis. In January 1999, one and a half years after the crisis began, still with no sign of recovery in Asian economies, the Fund continued to say that the "structural reforms [included in Fund conditionality] … were

[11] The proposal to regulate the OTC market was admittedly only one reason for the firing of Brooksley Born, head of the CFTC, but probably the principal one.
[12] Group of Seven, "The Halifax summit review of international financial institutions: background document", June 15-17, 1995, quoted in Webb, "The Group of Seven".

needed to address the root causes of the crises, restore market confidence, and set the stage for a sustainable resumption of growth".[13] The structural reforms included opening the capital account even further, closing insolvent banks and enforcing capital adequacy standards, breaking up conglomerates, and (in Korea) deregulating labor markets. And the Fund also continued to say that high real interest rates, on which it insisted as another condition of its bail-out funds, were necessary to attract back scared domestic and foreign investors, and that there was no other way to stop the currency from falling. The Fund's conditions are in line with the thinking of the G7 about the policy prescription for their own economies, and this may be why the Fund keeps saying that they were right.

But the balance of plausibility goes the other way. High real interest rates hurt the balance sheets of firms, which in most of the countries had high debt-to-equity ratios; and the resulting rise in domestic bad debts worsened the external loss of confidence in the currency. We see this effect in the long period of time—at least 12 months—during which real interest rates remained far above pre-crisis levels while the exchange rate remained far below pre-crisis levels.

As for the need to undertake major structural reforms in the midst of a crisis as a condition for receiving emergency funding, the comparison with Mexico in 1994-95 is telling. The Mexican currency crisis began with the forced devaluation of December 20, 1994. By January 31, 1995, a massive and credible international rescue package of $50 billion dollars was assembled, with almost no conditionality and certainly no requirement for large-scale structural reforms. (The government announced a reform program only in March 1995.) The panic and contagion subsided soon after the initial announcement, and the crisis as a whole was relatively short-lived. In Asia the governments had to agree to a long conditionality list as a condition of the initial agreement to provide funds; the pledged funds were relatively smaller and came in phased tranches which were much smaller than the pledges. The panic and contagion lasted far longer than in Mexico, and what began as an external currency crisis in Thailand developed into a combined external currency and domestic banking crisis throughout the region—as did not happen in Mexico.

Had the US and the IMF insisted on structural reforms and tranched disbursements in Mexico, the Mexican crisis might have become as severe and protracted as the Asian one. But the US national interest was overwhelmingly to effect a speedy recovery on its southern border, while

[13] IMF, *IMF-Supported Programs in Indonesia, Korea, and Thailand: A Preliminary Assessment*, January 1999.

the US national interest in Asia was to open the economies and liberate markets. Hence the US Treasury shot down the Japanese proposal for an Asian Monetary Fund, which would have made Mexico-scale resources available on a quick disbursing basis, because the Treasury was afraid that countries would use assistance from the Asian Monetary Fund to wiggle out of G7/IMF reform commitments. In short, the IMF's assertion that there was no alternative to its imposition of high real interest rates and major market-liberalizing reforms in Asia is belied by the experience of Mexico, which received a very different prescription because the US really did place priority on a speedy recovery.

These several points suggest that the G7/IMF's solutions are not working to fix the economic problems to which they are directed. But the problems are not only economic. Governments of the mature democracies have been loosing the confidence of their citizens, as shown by poll results which show steady decline in the esteem in which people hold politicans and in the trust they vest in parliament, the judiciary, the civil service, and the police. The declines began in the late 1960s and 1970s, but have continued during the 1990s. In the United States, for example, when asked to agree or disagree with the statement that "the government is pretty much run by a few big interests looking after themselves", only 29 percent of the electorate agreed in 1964; by 1984 the figure had risen to 55 percent, and by 1998, to 63 percent, or two out of three.[14] Yet citizens continue to hold the government of their own country responsible for overall economic prosperity. The gap between their expectations and the governments' protestations that their job is properly limited to low inflation and safeguarding the framework of markets—or that this is all that globalization will allow them to do—may help to explain the anti-government malaise affecting most of the mature democracies.

The need for macroeconomic coordination

At the core of the list of G7 and emerging market economic problems is a crisis of over-investment. The world has the capacity to produce far more than it currently consumes. This is especially true in manufacturing. In automobiles, for example, world capacity is about 60 million vehicles annually, and world purchase is 45 million. The result is that less than a third of the world's 40 largest car producers have a positive cashflow. Across

---

[14] Robert Putnam, Susan Pharr, Russell Dalton, *What Is Troubling the Trilateral Democracies?*, Princeton University Press, 1999, summarized in "Is there a crisis?", *The Economist*, July 17, 1999, p.49-50.

manufacturing the excess capacity squeezes prices and profits, making firms financially vulnerable. [15]

Excess capacity is itself due to a rate of growth of demand substantially lower than the rate of growth of supply. Several factors, such as increasing ease of entry to most manufacturing branches, put a floor on the growth of supply, so that supply capacity does not fall to adjust to the slower rate of growth of demand. On the demand side, slow growth is due to the G7 policy consensus around austerity, together with rapidly widening income inequality on a world scale.

To address these problems seriously the G7 governments have to pursue more expansionary policies. At a minimum they should cooperate to the point of restoring the autonomy of *national* governments to exercise effective macroeconomic policy. This would require coordinated intervention in exchange markets to stabilize the exchange rates of the major currencies, and coordinated intervention in capital markets to limit short-term capital flows. With these in place individual governments could run expansionary policies with less risk of capital outflow and exchange rate collapse. This was the sort of limited cooperation envisaged in the Bretton Woods system. It would help not only to stabilize economies but also to offset the tendency of financial globalization to undermine the overlap between those who are affected by a government's decisions and those who can influence the government; and so help to check the erosion of governmental legitimacy.

More ambitiously, they could practice what has been called "international Keynesianism", that is, coordinate their monetary and fiscal policies around a joint expansion so that when one country expanded it would not run large trade deficits due to others not expanding. Unbalanced expansion is of course just what has been happening during the 1990s, with the US expanding unilaterally and running the biggest current account deficit to GDP of the 20th century. The US current account deficit has only been sustained for as long as it has because the US dollar is the main world reserve currency, so that foreign holders are willing to go on holding an increasing stock of US dollars, for now.

Macroeconomic coordination and emerging market crises

The close link between emerging market crises and G7 macroeconomic conditions can be seen clearly in the present recovery phase

[15] Robert Brenner, "The economics of global turbulence: a special report on the world economy, 1950-98, *New Left Review*, 229, May/June.

of the Asian crisis. The crisis-affected countries experienced a very sharp contraction of imports in 1997-98, which together with the domestic credit squeeze prevented them from taking advantage of the sharp falls in their exchange rates to boost exports. Thailand, for example, experienced a 33 percent fall in its exchange rate between June 1997 and the end of 1998; a 9-10 percent fall in GDP during 1998; a 34 percent fall in imports in US dollars in 1998; and a 7 percent fall in exports in US dollars. As of mid 1999, Thai imports are growing very fast (23 percent year-on-year in June 1999), and recapitalized banks are beginning to lend normally. With exchange rates still well below pre-crisis levels, exports, though still sluggish, are likely to grow fast as the import surge brings in components. Asia is under compulsion to export in order to repay its mountain of foreign debt.

As the Asian export machine shifts into high gear, what happens next depends heavily on G7 macroeconomic conditions. If the G7 could coordinate around an expansionary set of policies the coming Asian export surge could be absorbed without displacing exports from other emerging markets. If they do not raise their growth—if they remain wedded to the low inflation/low budget deficits/deregulation agenda—super-competitive Asian exports are likely to pose a serious challenge to rival producers in countries such as Poland, Mexico, Argentina, Brazil and China. Many emerging market economies are already in fragile condition because of the contraction in demand from Asia and Japan, which caused falls in the prices of manufactured and base commodity exports. If the G7 continue to grow slowly (and especially if the US economy slows, as is likely), these countries become candidates for the next emerging market crisis as Asia ramps up its exports.

Macroeconomic coordination is feasible

The G7 and affiliated organizations like the IMF, together with the large majority of US-trained academic economists, claim that an expansionary agenda is infeasible because of financial globalization.

Yet there have been isolated cases of coordinated macro expansion between the G7. One was set in motion by the Louvre Accord of February 1987, and given urgency by the stock market crash of October 1987. The coordination broke down after a year and a half or so, however, with the Germans claiming that the US had not carried out its side of the bargain--it had used the expansion in Europe and Japan to avoid cutting its own budget deficits, as it had agreed. Notice that the accord broke down because of a

perception that the US could not be trusted, not because coordinated macro expansion was rendered infeasible by globalization. Similarly, there have been some cases of successful coordinated exchange rate intervention, to bring up the dollar (in 1995) and to bring down the yen (in 1998). And the global expansionary effect of the US's unilateral Keynesianism during the 1990s (though never officially described as such) shows that demand stimulus can still be effective.

Why do the G7 not coordinate a macroeconomic expansion?

The G7 attempt to convince their publics of the *inevitability* of the low inflation/low budget deficits agenda, with its deflationary effects, not because the evidence shows that in a globalized financial system there is no alternative, but because most of the time this represents the only agenda they can all agree on. The reasons for the weakness of G7 action are in this sense more political than economic. In the US, budget battles between Congress and the administrations of presidents Bush and Clinton have paralysed fiscal policy, and made it difficult for US administrations to meet their G7 commitments to reduce budget deficits. In Germany reunification and the Maastricht criteria have reduced fiscal flexibility, and Japan through the first half of the 1990s was unable to mount deficit spending to end the recession because of political and bureaucratic opposition. And beyond these specific factors in each G7 country is the overall ascendancy of international finance, whose interests are increasingly shaping the direction of public policy wherever international finance wishes to operate. These interests want very low inflation, low taxation, and light regulation.

In response to the emerging market crises of 1997-99 the G7 reluctantly considered coordinated reflation to ward off the risk of a world recession. The US Federal Reserve cut interest rates, even though the US economy (alone amongst the G7) was growing fast, so as not to worsen the capital outflow from Asia. The Japanese government also raised its fiscal stimulus, having already lowered interest rates almost to zero. But the Bundesbank declined to have a coordinated monetary expansion, saying that the European Union had survived the Asian crash and would be further protected from emerging market crises by the introduction of the single currency, the euro. So the G7 finance ministers could agree to no coordinated macroeconomic policy measures at their meetings in September-October 1998, at the height of concern about a world crisis; while at the same time they issued warnings to emerging market governments of the dangers of restricting capital flows. The case of the G7

response to the emerging markets crises of 1997-99 is a microcosm of the more general weakness of G7 action during the 1990s.

An International Clearing Agency

Coordination of macroeconomic policies is one line of solution. In the longer run we need to consider another idea which is complementary but much more radical: remove a basic constraint on the growth of world demand by abolishing foreign exchange markets. Our current system is biased towards deflation not only because of the lack of macroeconomic coordination, but also because foreign borrowing is denominated in foreign currencies (mainly the US dollar), and countries that borrow must export in order to earn the foreign currency with which to repay the debt. Indeed, not only foreign borrowing but also foreign portfolio investment and foreign direct investment puts obligations on the central bank to maintain sufficient reserves to cover demands to convert local currency into foreign currency. The imperative of “export-in-order-to-service-debt-and-meet-contingent-obligations-associated-with-foreign-investment ” leads governments of debtor countries to try to lower wage and other costs in the interests of gaining competitiveness vis-à-vis producers of similar products. This strengthens tendencies towards deflation and world excess capacity; and specifically tendencies towards large US trade deficits, since countries tend to sell to the more open US market in order to earn the principal hard currency, and the vast US consumer credit system makes it unusually easy for US residents to buy foreign goods.

A new system would allow each country to pay for cross-border transactions in its *own* currency. The pivot would be an international clearing agency (ICA).[16] The ICA would hold debt securities of its member nations as assets (such as central bank bonds and other securities, or Treasury bills in the case of the US); and would hold their international reserves as liabilities, denominated in a weighted basket of member country currencies. (The international unit of account might be called BANCOR, following Keynes’ suggestion.) With these assets and liabilities the ICA would clear payments between countries internally, between one account to another, without the payments having to go through an open foreign exchange market.

---

[16] I am indebted to Jane D’Arista for discussions of the International Clearing Agency. See Jane D’Arista and Tom Schlesinger, “Reforming the privatized international monetary system”, *Fomcalert*, publication of the Financial Markets Center, Philamont, VA, December 22, 1998. An expanded version is due to appear from the same organization in fall 1999.

Take the case of an exporter in country A who sells to a buyer in country B. The B buyer sends a cheque to the A exporter, denominated in B currency. The A exporter takes the B cheque to a commercial bank in country A. The commercial bank creates a deposit for the exporter in A currency, using the current exchange rate between A currency and BANCOR; so the exporter is paid off. The commercial bank is required to hand the cheque to the A central bank. The A central bank creates a reserve account (or central bank deposit) for the commercial bank to support the exporter's deposit, in A currency; so the commercial bank is paid off. The central bank of A then deposits the B currency cheque at the ICA. The same process is repeated. The ICA makes a deposit into country A's reserve account, denominated in BANCOR and equivalent to the value of the B currency cheque. It passes the cheque to the central bank of B, and is paid for the cheque by deducting its value from B central bank's reserve account at the ICA. B central bank passes the cheque back to the commercial bank of the buyer. The commercial bank debits the buyer's account for the value of the cheque in B currency, and the sequence is completed.

The exchange rates would be adjusted periodically in response to changes in the levels of reserves held at the ICA. Countries running persistent surpluses would face an appreciation, countries running deficits, a depreciation. But the changes would reflect changes in relative costs of production, not the speculation on future movements which has come to dominate the process today. Changes would be made at predetermined intervals (for example, once a month). Of course, panicky capital outflow could theoretically still occur in this system, if foreign investors feared a stock market collapse or an impending devaluation. But the ICA could offset large capital outflows by buying the beleagured government's securities and adding to its reserves, while eliminating the sort of precipitous fall in currency values that caused the explosion of external debt in the Asian crisis. The system would do away with or at least moderate the need for national-level capital controls, because the ICA could quickly add to a country's reserves.

Through its decisions on reserves and exchange rates the ICA would hold the wealth of nations in its hands. Its governance would not be unproblematic. It would need to operate with a voting mechanism that reflected both population and economic output. Contributions to its capital base would be tied to the economic output of its member states, as a measure of relative ability to pay. It would cover its operating costs by a small spread on its transactions.

There are further questions about how far it moves in the direction of open market operations and lender of last resort. But the basic point is that it illustrates one way to institutionalize a lifting of one source of deflationary pressure in the world economy--the need to earn foreign currency in order to service debt, when the foreign currency markets are subject to huge volatility driven by speculation rather than real transactions. If it sounds utopian, recall that it is not unprecedented. The European Payments Union of the 1950s operated in much the same way. And the UN's Global Environmental Facility has now had several years of experience with a double voting criterion combining population and economic output.[17]

Conclusion

Serious world problems of instability, imbalance, unemployment, and financial crisis remain. Countercyclical national-level macroeconomic management continues to be ineffective, but no international mechanisms are being developed to fill the gap. The G7 sits on its hands, saying that we must all adjust to the reality of financial globalization. Finance ministers of emerging market countries tend to agree. They all tend to reject, implicitly or explicitly, the macroeconomic coordination agendas described earlier, including joint macroeconomic expansion, exchange rate coordination, and most limits on capital mobility beyond taxes on short-term inflows. They talk, rather, of how to make financial markets work better, how to protect the markets from themselves, how to recover faster when crises do occur, and how to align government policy more closely with the preferences of private international financial firms.

With most centers of power in the world accepting the narrow definition of the G7, the hope rests with non-governmental organizations, trade unions, other civil society groups, and perhaps even the United Nations to force a widening of the debate. Failing that, hope lies in another series of financial crises that threaten material interests sufficiently close to the G7 to force their governments to widen the agenda for the sake of their own preservation.

END

[17] European Payments Union [Sally Dore 44-117-942-2620], Alec Cairncross, Economic Policy Since the War…. GEF reference?