

INTERNATIONAL FINANCIAL REFORM:

What's Needed and What's Possible

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Guest Lecture

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World post 1973 features greater capital mobility, greater goods mobility, but limited labour mobility (except for high skilled labour). This combination has led to greater income inequality, greater instability, and less national control over economic policy and outcomes. What if anything can be done to return to a world more like 1945-70 (the Golden Age) of greater stability and growth, and more equitable income distribution?

Introduction

- We are in the throes of another financial crisis; previous crises since 1970 having erupted in 1997-99 (E. Asia/Russia/Brazil/Turkey/Argentina); 1994-5 (Mexico/Latin America); 1992 (Europe); 1980s (Middle-Income debtors, mostly LA); 1970s (breakdown of BW system)
- This may not be “just another” financial crisis but “the big one” focused on the USA (“mother of all meltdowns”—M.Wolf, FT, Feb.19)—Nouriel Roubini in today’s FT—total losses over \$3 trillion in the financial sector alone related to sub-prime mortgages etc., plus \$6 trillion in equity losses by homeowners, \$5.6 trillion in losses on stocks+losses on commercial property, total wealth loss=annual US GDP (around \$14 trillion). M. Wolf: if this is right, “more than the biggest financial crisis since the 1930s”. US authorities have two choices—continued asset deflation or inflation to pump up incomes and the economy.
- since it is focused on the USA—the centre of the current international system—not the “periphery”
- Past crises have been handled by disciplining the victims at the periphery (reducing vulnerability to shocks in crisis-affected countries via structural adjustment) rather than the perpetrators (ungoverned financial markets and the policies of the countries at the centre, particularly the USA)
- To understand what reforms “are needed” it is necessary to understand why financial crises happen or more generally why the international financial system is fragile and unstable

- We start with an excursion into international economic theory and the domestic roots of financial markets, then look at the policy and institutional reform implications including what is needed, and conclude by considering what is possible

Capital Mobility, the Mundell-Fleming Trilemma, Domestic Roots of Crisis

- Some elementary economics is useful to understand how the world went from the postwar “Golden Age” to a world of financial instability and periodic international crises
- The breakdown of the Bretton Woods fixed exchange rate system in the 1970s was accompanied, even precipitated, by increased international capital mobility
- In papers published in the 1960s, Robert Mundell and J. Marcus Fleming showed that capital mobility presented national governments with a “trilemma”:
 - It is not possible for national governments to maintain all three of fixed exchange rates, autonomous monetary policy, and international capital mobility
 - If international capital mobility is permitted, governments would have to sacrifice either autonomous monetary policy or fixed exchange rates
 - Suppose that a government tried both to fix its exchange rate and have an autonomous monetary policy. If interest rates are lower than in key trading partner countries (the US), capital would flow out, putting downward pressure on the domestic currency (it would depreciate) as traders sold domestic for foreign currency to invest abroad. The government could try to sell foreign currency (buy the domestic currency and defend the fixed exchange rate) until its foreign reserves run out, but then it would have to increase interest rates to international levels to stop the outflow. In this case, monetary policy autonomy is sacrificed (leading to lower investment, growth, and employment).
 - Suppose instead the government wished to retain a lower interest rate to stimulate the economy no matter what. As capital flows out and reserves are being depleted, the government would cease defending the exchange rate by depreciating the currency (selling less foreign currency per unit of domestic currency bought). This will deter traders from exporting capital since it is more expensive in terms of domestic currency and stop the outflows if the depreciation is deep enough. In this case, the fixed exchange rate has been sacrificed (leading to higher import costs and possibly inflation).

- The 19th-century gold standard and the interwar gold exchange standard featured international capital mobility and fixed exchange rates (to the price of gold), but little monetary policy autonomy.
- The Bretton Woods system (1944-1973) featured fixed exchange rates and autonomous monetary policy but restrictions on capital mobility. This system was designed by Keynes and others based on the experience of the Great Depression when there were “competitive devaluations” which undermined trade, widespread defaults on international loans (a result of international capital mobility during the 1920s and earlier) and high unemployment.
- Although the Mundell-Fleming trilemma had not yet been articulated, the BW architects wanted to create a system to encourage trade (through fixed or stable exchange rates) and also provide governments with the domestic macroeconomic tools to fight unemployment, including independent monetary policy to stimulate economic activity.
- Accordingly capital mobility was subordinated in the BW system to achieve fixed exchange rates and autonomous monetary policy (Keynes was also deeply suspicious that international loans were a source of instability).
- Indeed Article VI, Section 3 of the IMF’s Articles of Agreement states:
 - “Members may exercise such controls as are necessary to regulate international capital movements...”
 - This feature came under pressure in the late 1990s from those who sought capital account liberalization via an amendment of the Articles, but as the Asian and subsequent financial crises broke out after 1997, proponents backed off.
- Members of the IMF are required under Article VIII to avoid restrictions on current payments (for trade), i.e. to stand ready to convert their currency into any other currency at the official fixed exchange rate. However, Article XIV allows temporary exchange controls but to remove them when they are satisfied they are able to settle their balance of payments. So the BW system went to some length to preserve exchange rate stability to underpin the fixed exchange rate regime.
- Domestic roots of financial fragility: a footnote
 - Markets are not always “efficient” (leave aside equitable)—there is occasionally/often price overshooting, excess demand or supply not automatically self-correcting (Keynes)
 - Even though markets may eventually reach equilibrium, there can be “manias, panics and crashes” (Kindleberger) that create a lot of damage along the way
 - Financial markets (loans or equity to finance real transactions) are especially unstable, fragile and prone to crisis because of uncertainty

about the future, informational asymmetry between lenders and borrowers, and moral hazard (banks will always be bailed out). Speculation is a driving force (Hyman Minsky—acknowledged by M. Wolf in FT Jan.22)

- Minsky's model of financial instability and crisis is essentially domestic and it applies perfectly to the current subprime mortgage/ABCP/CDO/banking/hedge fund crisis in the USA (also dot-com boom and bust)...manic overborrowing and lending, overinvestment leading to unsustainable prices unrelated to underlying values leading to panic selling, bankruptcies and failures, asset price deflation
- Three other features worth noting:
 - Financial innovation by banks/lenders/investors is continuous in a capitalist economy
 - Domestic authorities (central banks, financial regulators—Finance Depts., OSFI in Canada) are typically playing catch-up to try to understand the markets and ensure the right balance between providing opportunities and controlling threats. But the prevailing stance since 1980 has been increased liberalization and deregulation
 - Most important is the spectacular growth of the financial sector compared to the rest of the economy. In the U.S., after-tax profits of financial companies jumped from 5 percent of total corporate profits in 1982 to 41 percent in 2007, although their share of corporate value added only rose from 8 to 16 percent
- When financial/capital markets become international, the possibilities for speculation, manias, panics and crashes multiply, and the possibilities of governing them become more economically complex and much more difficult politically
- Bhagwati's 1998 *Foreign Affairs* article, "The Difference between Trade in Widgets and Dollars". The paper made the point that free trade in goods was qualitatively different from free trade in capital flows for the simple reason that the latter can, because of being driven occasionally by "panics and manias," be destabilizing and costly. "If you were for free trade," he wryly remarks, that did not mean that you had to be for "free capital flows, free immigration, free love, free whatever."

Policy and Institutional Implications

- International capital mobility was never *prohibited* or even discouraged by the BW system; but restrictions on capital mobility were allowed
- The BW system actually started to break down in the 1960s, as postwar conditions suggested a reversion to normalcy and optimism was fed by growth,

- low unemployment, and to some degree decolonization, all leading to increased capital mobility
- Europe relaxed postwar controls on capital movements, the US started to invest in Europe and elsewhere as well as running large dollar deficits, which fed international growth but also began to undermine confidence in the dollar's convertibility to gold
 - Demise of the BW system: US dollar, by 1970s the world's key reserve currency, suspended gold convertibility, valued at \$35/oz., so the basis of the fixed exchange rate system fell away.
 - Attempts at restoring the fixed exchange rate system in the 1970s failed. The era of flexible/floating exchange rates had arrived.
 - The IMF's fundamental rationale—to support the fixed exchange rate system by providing short-term liquidity to countries facing BOP difficulties—also fell away
 - IMF conditionality for BOP support comprised mainly aggregate demand management—i.e. fiscal and monetary constraint to remedy deficits—although this was not consistent with its original conception
 - Akyuz paper good on this
 - Rationale changed from “system of stable exchange rates” to “stable system of exchange rates”
 - By the 1980s the IMF found a new calling—to be the lead coordinator in managing international economic and financial crises. These were all in developing countries because, by 1980, industrial countries had stopped borrowing from the IMF
 - Lines between the IMF and World Bank, created exclusively to lend to the developing countries, became very fuzzy
 - Both became purveyors of structural adjustment, with much more intrusive conditionality i.e. expenditure priorities, economic policy choices including issues such as privatization, trade liberalization, and increasingly capital market liberalization (“mission creep” driven by G7 stakeholder countries).
 - Vested interests of principal creditors important in understanding bailouts rather than workouts
 - The IMF gradually became a chronic lender to poor countries (a development agency) using concessional finance from donors rather than revolving funds in its General Account
 - This led to a growth in the Fund supported by its new lending operations
 - A watershed was the “Asian” crisis which led to the most intrusive conditionality ever, in a region of the world unused to this.
 - Borrowers have “voted with their feet” and stopped going to the IMF in the current decade, just as industrial countries three decades ago

- Ironically this has led to structural adjustment at the IMF to remedy its operating deficit (10 percent reduction in staff)
- Another sea-change following the Asian crisis has been the dramatic rise in foreign reserves, particularly but not exclusively in Asia
 - Medhora, (*World Economics* October 2007, “The Uneven Build-up of Reserves: Ways Forward”) partly due to structural imbalances between US BOP deficits and Asian trade surpluses, but more because of the need to “self-insure” against future financial crises and not have to go to IMF
 - Nine-fold increase in reserves by developing countries 1990-2005, from \$200 billion to almost \$2 trillion (including Africa; but China most dramatic: 25-fold increase)
 - Reserve cover way beyond “prudent” norms—one year’s imports (China and Korea); India—a year and a half; Japan—two years.

What is Needed to Prevent or Manage Crisis

- There is no evidence to support the contention that financial globalization has increased investment or led to higher growth in developing countries. Countries that have grown most rapidly have been those that rely least on capital inflows.
- On the contrary there is evidence to support the argument that large, volatile cross-border capital flows (“downhill” as during the 1980s/90s or “uphill” during the current decade) are destabilizing and reduce growth.
 - The desirable place to be on the Mundell-Fleming triangle is the base, i.e. to simulate a Bretton Woods-like world of fixed or very stable exchange rates and autonomous monetary policies, with greater national ownership, and higher levels of growth and greater stability. But how to get there?
- There are three layers to resolving the problem of international financial instability. Seen this way the prospects for reform are more tractable:
 - At the *national* level, much tighter regulation and supervision over finance to reduce speculation and excessive risk-taking by financial institutions particularly in the developed countries (OECD)
 - This calls for much greater transparency of hedge funds, rating agencies and other market players, e.g. bond rating agencies that are owned by the banks but should be independent (micro-prudential regulation)
 - Also the need to broaden the scope of central bank intervention beyond the commercial banks which are privileged in central banks’ operations (cf. the current US bailout; see www.thomaspalley.com who argues that the Fed needs to extend its

support to non-deposit taking financial intermediaries such as mortgage companies).

- In addition, as experts such as Goodhart of LSE, and Bill White of the BIS, there is need for “macro-prudential regulation”—more counter-cyclical capital requirements, tighter monetary and fiscal policy during upswings to build up cushions for downswings (Greenspan as a “serial bubble blower”—tackling the 2000 and 2001 crises by keeping interest rates low and pumping more liquidity into the economy). In other words: a reversion to Keynesian counter-cyclical policy.
 - Warning! National financial/monetary policy is very closed, restricted to key players (Central Banks, Finance Departments, some members of the private financial sector) and resistant to more open discourse
 - In developing economies the trend toward self-insurance via growing accumulation of reserves will continue, notwithstanding the opportunity costs. This will give greater independence from the IMF, policy ownership, and defence against volatility and financial shocks.
- At the *regional level* there is scope for greater cooperation via reserve pooling (Asia’s Chiang Mai initiative—swap arrangements of over \$70 billion; also Latin American examples (see R. Culpeper in Ocampo, ed., *Regional Financial Cooperation*, Brookings 2006, also local currency bonds in Asia)—this is a broader application of the principle of self-insurance but pooling risks more widely.
 - The EU is an obvious example of what can be achieved through regional cooperation, although this went far beyond financial cooperation and eventually monetary union. However, it took half a century to achieve and still is a work in progress.
 - The strengths of regional financial cooperation include complementarity with other cooperation efforts, eg. Regional trade or integration agreements, greater understanding of shared problems among neighbours and less inclination to apply intrusive conditionality
 - Weaknesses include being subject to the same shocks at the same time, or not having strong regional members with deep resources (esp. SSA)
 - This brings us to the *global level* and to the reform of the IFIs including the IMF and the World Bank. But it also relates to the “international rules of the game”.
 - The most important rule relates to controls on international capital flows, i.e. the apex of the M-F triangle. The debate of the 1990s was won by those favouring retention of the existing rules;

nonetheless the prevailing advice is still “loosen restrictions on capital flows in due course and don’t look back”

- Other rules relate to exchange rate misalignments—i.e. the left corner of the triangle. Even under BW, there were “fundamental disequilibria”—the official exchange rate was out of line with equilibrium, and in the longer term BW accept the need for shifts in exchange rates. Today, there is a need for surplus countries (esp. China) to revalue their currencies to help reduce global imbalances. But this has always been a weakness of the international system—it is far easier to get deficit countries to act (by devaluing) than surplus countries
 - This brings us to the institutions themselves—the IFIs. Most of the IMF reform proposals suggested by Akyuz, Wade and others make sense but run into the problem of asymmetry noted above, based on *realpolitik*. Another good idea—touted by Medhora in his recent article—is a revival of the Substitution Account at the IMF, which would substitute SDRs for foreign exchange reserves as principal international reserve asset over time.
 - But there is little reason to suppose that the IMF has any clout whatsoever over the USA, other G8 countries, China or India or any “non-program” countries. Or that a new global institution or set of them would not reflect the priorities and geostrategic interests of the most powerful countries, just as the BWIs have.
 - There is a possibility that with the rise of China and India the balance of power in the IFIs will change and loosen the stranglehold of the G7 members. (e.g. leading to more appropriate distribution of voting power, selection of the Heads). However, this would not necessarily mean that the IMF would have any more suasion over any members of the expanded G-club or that China and/or India would act in the interests of the world community rather than themselves.
- But reforming the international financial system does not have to depend on a “fix” on the global level. Three reasons to be hopeful:
 - The rediscovery of the importance and power of (Keynesian) counter-cyclical national macro-economic policy
 - The possibility of national and regional actions to self-insure against instability
 - The emergence of China and India as economic powers to challenge the hegemony of the USA. Geopolitical competition, as long as it remains peaceful, can be a good thing.