TRADE UNION PROPOSALS FOR REFORMING THE INTERNATIONAL FINANCIAL SYSTEM

BACKGROUND PAPER PRODUCED BY THE

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I. INTRODUCTION

During the last decade of the 20th century and the beginning of the new century, workers around the world were deeply affected by sudden shifts in the global economy. These were caused in large part by the ability of international investors and bankers to move capital around the world and in and out of financial centres instantaneously. They have done so without regard to the social or political consequences of their actions. One of the most dramatic events, and the one that has helped stoke an intense debate about the flow of capital, was the financial crisis that started in Thailand in mid-year of 1997. At this time, investors who had speculated in that export-led, high-growth economy grew concerned about their ability to repatriate profits in dollars, and began pulling their money out. The panic quickly spread to Malaysia, Indonesia, South Korea and other Asian countries with similar economic structures and by 1998 had engulfed Russia.

Those events weakened currencies throughout the developing world, forcing millions of people out of work. The recession led to reduced purchasing power in the crisis hit countries, which eventually also reduced the developed countries, so workers world-wide were affected. . While investors in the so-called emerging markets protected their profits by pulling their money out, the workers they left behind faced unemployment, reduced social services and instability.

In the midst of the Asian financial crisis, the International Monetary Fund (IMF) stepped in with billions of dollars in bailout money that, via the developing country governments that received it, quickly began to flow to the banks and investors who had supplied the capital during the high-growth era of Asian development. In return, the IMF demanded that the recipient governments begin large-scale restructuring of their economies to bring their investment regimes into line with the free-market policies of the large industrial powers. This meant lifting controls and restrictions on direct foreign investment, rapid privatization of government-run companies and drastic corporate restructuring. The Fund also demanded that governments apply drastic austerity measures in order to avoid running up public-sector deficits. In the aftermath of the IMF "rescue," dozens of buyout companies and investment banks descended on the region to buy up the leftover assets at bargain prices.

Since that time, trade unions and other organizations seeking to stabilize economic growth, protect employment and gain a fairer sharing of economic costs and benefits have been on the defensive against a corporate-led push to quicken the pace of unregulated globalization. The corporate forces behind this unregulated free-market globalization are backed by banks and financial institutions, which hold enormous power over national economic policies and dominate the decision-making process at the IMF.

Bucking the System

Some governments and political parties around the world that see foreign capital as critical to national development, but understand the danger and volatility of capital flows, have tried to take steps to curb the excesses they witnessed during recent crises. But the political powers in those countries, which include countries in Asia and in Latin America, have been forced, sometimes under enormous financial pressure from the multilateral lending institutions, to back down and reverse direction.

For example, in the wake of the financial crisis of 1997, the government of Malaysia, hoping to shield itself from the currency fluctuations jolting the region, imposed selective controls of capital coming in and going out of the country in September 1998. The steps included exchange controls, such as declaring all Malaysian notes (the ringgit) held outside the country worthless if not brought home within one month, and imposing a one-year freeze on the repatriation of profits from sales of equities by foreigners.

The government of Mahathir Mohamad restricted the amount of local currency that could be carried in and out of the country or used to buy and sell goods in foreign currencies. Taking those steps, the government — which welcomes multinational corporations and restricts the rights of labour unions to organize in foreign-owned plants - was severely criticized by the IMF and many free-market economists, who accused the country of trying to isolate its economy from the rest of the world. Mahathir's reply, which appeared in Time Magazine, was that "Malaysia has chosen to be a heretic. [...] If the international community cannot change, then Malaysia must undertake its own reform. We are going to do our damnedest to succeed, even if all the forces of the rich and the powerful are aligned against us."

Mahathir's gambit seems to have worked. After some hesitation, foreign investors returned to Malaysia in force; the country attracted record levels of investment in 1999 and 2000. This happened, even though private capital flows to most of the East Asian "crisis countries" had not recovered to previous levels, even five years after the crisis.

Or take the case of Argentina, which in December 2001 declared the largest debt repayment default in history after the IMF withheld disbursements on a loan the country had been granted less than four months earlier. In August 2001 Argentina had received an $8 billion rescue package from the IMF to keep its economy afloat just eight months after receiving a massive $40 billion bailout arranged by the IMF.

Many economists in the labour movement trace the country's problems back to 1991 when, with the strong backing of the IMF, Argentina adopted a Convertibility Law that froze the peso/dollar exchange rate by backing every peso in circulation with a dollar in reserve. A currency board was established to maintain the peso-dollar peg. To attract foreign direct and portfolio investment, the law lifted all exchange controls, making the peso freely convertible into dollars in all foreign and domestic transactions. With that in place, inflation dropped to nearly zero, bringing some stability to the economy. But the other part of the "reforms" included a massive programme of privatization, which forced many public sector workers out of work.

The currency system also began to wreak havoc in the latter part of the 1990s. By linking the peso to the dollar, Argentina became vulnerable to currency decisions made by the US Federal Reserve in Washington. During the late 1990s, the Federal Reserve began holding the dollar in short supply to curb what it believed to be excessive growth in the stock market – or "irrational exuberance," in the words of Fed Chairman Alan Greenspan. As a result, the Argentine economy was squeezed as interest rates were increased in order to preserve the parity of the peso with the dollar. Export-oriented industries were particularly hard hit as the overvalued currency priced Argentine goods and services out of the country's most important export markets, notably Brazil and the European Union. As the economy shrank, Argentina's dollar-denominated debt became an unbearable burden.

A new government took office in December 1999 with the economy in recession, 14% unemployment, strongly rising income inequality, and a third of the population living below the poverty line. In December 2000, the IMF put forward the $39.7 billion bailout that required the government to adopt IMF demands to cut spending – which they did by cutting back on the state-run pension system, rolling back the union-run health system and freezing government spending for five years. Unemployment quickly rose to 16%, setting off anti-government demonstrations and stiffening congressional resistance to the government's efforts to carry out the IMF policy demands. In order to qualify for a second IMF bailout plan in August

2001, the government drastically reduced government spending even further and cut pensions and public sector wages by up to 13%.

By the end of the year, Argentina was unable to pay its $132 billion debt and declared default. It also froze bank accounts and announced further government austerity measures, actions that set of widespread rioting that left 27 people dead. The political turmoil that followed the riots resulted in the presidency changing hands four times in less than two weeks, as designated successors resigned in the face of the tremendous challenges they faced. In January 2002 newly installed president Eduardo Duhalde decreed an end to peso-dollar convertibility and set about to design a plan for recovery of an economy which, by now, was in full-scale depression, with unemployment having reached more than 20% and many people incapable of meeting their obligations because bank accounts were still frozen.

The government counted on renewed IMF lending in order to be able to lift the banking restrictions, but, as of mid-2002, the Fund's assistance was not yet forthcoming. The IMF continued to demand that the new Argentine government apply the kind of draconian austerity measures that had led to the collapse of the previous governments. Also by mid-2002, Argentina's financial problems were spreading to other South American countries, in spite of the IMF's claims that that measures adopted by other countries and based on IMF recommendations had succeeded is preventing a "contagion" effect. In August 2002 the IMF quickly came up with new bailout packages for two of Argentina's neighbours, Brazil and Uruguay. The Fund's $30 billion emergency loan to Brazil represented the biggest loan ever granted by the institution.

IMF: Market Confidence above Equitable Sharing of Costs

To a large extent, retaining the confidence of volatile financial markets has displaced equitable sharing of economic costs and benefits as the primary consideration shaping global macroeconomic policy. Financial globalization has been facilitating a broader drive to replace the social welfare and full employment orientation of the early years after World War II. Governments have gone back to the unregulated free-market policies of an earlier era, as expressed most forcefully in the "trickle-down economics" advocated by the US and British governments during the Reagan and Thatcher years of the 1980s.

At the same time, it is clear that there has been a crisis of confidence among the advocates of financial liberalization in the United States, Europe and elsewhere. This has come about as a result of the many currency crises of the last several years, the huge amounts of public funds devoted by the major financial powers to contain threats to the financial system, and growing calls from heavily indebted countries to change the rules of the game.

Many academic economists, trade unionists and non-governmental organizations have come to view liberated financial markets as inherently inefficient and prone to excessive volatility. Many voices are now calling for some return to capital controls as practised before the capital market liberalization of the 1980s. Others argue that the increasing frequency and severity of financial crises during the 1990s must be blamed on the use of publicly funded "bailouts" to contain the crises. Such bailouts, they say, increase "moral hazard," an insurance industry notion that insuring against loss from risky behaviour diminishes the insured party's incentive to behave prudently. If instead, it is argued, the commercial banks were obliged to accept an appropriate share of the costs of a financial crisis, they would be less likely to make risky loans.

As trade unions, environmental organizations and human rights groups have pushed from below to criticize the financial policies of the IMF, the United States government and some mainstream economists have joined in with the moral hazard argument. All of this pressure has forced the officials who run the international financial institutions to reassess their views. There is now virtually unanimous rhetorical agreement among central banks, finance ministries, and institutions such as the IMF and the World Bank on the need to reform "the global financial architecture" in order to bring greater stability to international capital flows.

Thus far, however, only a few concrete actions have emerged from the official deliberations on archi-

tectural reform, and most reform proposals from the academic critics have been kept off the official agenda. This publication is an attempt to correct that trend and give information to trade unionists that they can use to argue at the highest levels of government for new programmes that will support equitable development based on universally accepted standards for human and worker rights.

What's Wrong with the Current System?

For many years, the IMF and those who defend its policies have argued that even the mildest forms of capital controls would destabilize the global financial system. In fact, the system established by the IMF is itself unstable and inefficient.

The past two decades have been marked by a rising frequency of national banking and currency crises, with some spilling over into international crises. Nearly three-quarters of the 184 members of the IMF, including a substantial number of industrialized countries, suffered one or more bouts of banking crises or "significant banking problems" during the period from 1980 to 1995, that is, even before the Asian financial crisis of the late 1990s. Full-fledged banking crises, defined by the IMF as "cases where there were runs or other substantial portfolio shifts, collapses of financial firms, or massive government intervention," afflicted 36 countries from 1980 to 1995.

The crisis in Asia raised these numbers significantly. An analysis of 26 developing and industrialized countries suffering banking and currency crises during 1980-95, found that financial sector liberalization within the five years preceding the crisis accurately predicted 67% of the banking crises and 71% of the currency crises. Liberalization, by broadening access to foreign funds, had encouraged domestic banks and companies to raise their liability leveraging to crisis levels.

The most important financial crises of the past decade having international consequences include:

- The Mexican peso crisis of 1995
- The Thai currency crisis of 1997
- The East Asian financial crisis of 1997 and 1998
- The Russian financial crisis of 1998
- Japan's banking crisis over the past decade
- Currency crises beginning in late 2000 in Turkey and Argentina
- Financial crises in Brazil and Uruguay in mid-2002

The social and economic costs of these crises have been substantial. A World Bank study of a sample of developing country banking crises estimated that Gross Domestic Product (GDP) declined 14.6% during the periods of crisis. Significantly, the study argued that banking crises have become intertwined with currency crises due to "surges of international capital inflows — especially private-to-private flows — to developing countries and the growing integration of these economies with world financial markets."

Equally destabilizing has been the IMF's response. Measures imposed by the IMF on national governments have included reductions in government subsidies for transport and health services used primarily by workers and the poor. They have included demands for privatization that have slashed jobs without creating a safety net, and other economic hardships.

Our job as trade unionists concerned about the general welfare of workers is to show that our solutions, and those of allied organizations that support more equitable development, would alleviate those hardships and impose the efficiencies and stability so badly needed in financial markets today. Briefly, our response should include elements of the following, which are described in detail in this report:

- **A small globally uniform tax on all private foreign exchange transactions, also known and**

popularized as the Tobin tax. The currency transactions tax would reduce some of the speculation in financial markets today and raise capital that could be used to assist countries caught up in financial crises and for other social purposes.

- **A fair international debt arbitration and bankruptcy process**. Developing and transition countries should be able to operate a temporary debt standstill when circumstances require, with a mandatory role for the private sector in comprehensive debt restructuring programmes. An effective sovereign debt restructuring mechanism is urgently needed, which could allow for a repayment moratorium while negotiations between the debtor country and foreign creditors for orderly restructuring of the debt take place.

- **Closer co-ordination of major currencies**. Improved fiscal and monetary policy coordination should be implemented between the currency blocks of the dollar, euro and yen so as to generate more stable parities.

- **Tougher requirements for banks.** The Bank for International Settlements requires banks to maintain a ratio of capital to total loans (capital adequacy ratio) of at least 8%. But maintaining this ratio doesn't always prevent bank failures. Instability also arises when lenders and investors acquire assets without proper regard to risk. One possible solution could be an asset-based revenue requirement, that would force financial firms to hold their reserves against each class of asset, with the regulatory authority setting reserve requirements on the basis of its concerns with specific classes of assets.

- **"Speed bumps".** These are a form of temporary capital controls aimed at discouraging inflows of short-term capital and were employed in Chile for a period in the early 1990s. In most cases, these regulations require that capital in-flows remain in the target country for a specific time; in Chile's case it was 12 months.

- **Incorporating labour and human rights and social protection within IMF/World Bank policies.** Labour and human rights should be at the core, not only of trade agreements, but debt relief and bailouts as well. This could help provide the safety net so badly needed when the IMF imposes cuts in government budgets and other steps that lead to mass unemployment. The welfare of working women and men and the poor should be the primary preoccupation when the international financial institutions define specific assistance programmes.

- **Seeking diversification of economic activity based on domestic demand.** The IMF and World Bank have long promoted to developing countries the model of export-led industrialization, where foreign and domestic investors build manufacturing plants (or agribusiness) where a primary competitive tool is low wages. A more stable global economic system would entail de-emphasizing export-led development in favour of a balanced development strategy including also domestic-demand driven growth, and regional integration and cooperation.

- **Strengthening capital controls**. Domestic governments around the globe should strengthen their own regulatory procedures to enforce laws against corruption or illegal speculation, and introduce limits to short-term foreign currency exposure, and controls and certification of derivatives trading and other forms of highly leveraged investment. Stronger regulation is needed even in advanced economies such as the United States. This was made abundantly clear by the collapse of New York's Long Term Capital Management in 1998, triggered by heavily leveraged bond trading, and by the series of corporate scandals beginning with Enron in late 2001, in which large multinational banks were often willing accomplices.

II. THE ORIGINS OF THE BRETTON WOODS SYSTEM AND HOW IT BROKE DOWN

The IMF and the World Bank were founded in 1944 at a conference at Bretton Woods, New Hampshire, following 15 years of global depression and world war. The Great Depression of the 1930s had begun with the collapse of the US stock market in 1929 and lasted for nearly a decade. It was caused by a combination of factors, including a vastly unequal distribution of wealth and extensive speculation in the stock market in the late 1920s that kept stock prices artificially high. The Wall Street crash led to a national economic collapse in the United States and the resulting depression quickly spread throughout the industrialized world. Although the US and other governments took strong steps to end the depression and put millions of jobless workers back to work, the slump never really ended until the outbreak of World War II restored industrial production.

Towards the end of the war, the United States hosted a conference of finance ministers from around the world, chaired by Harry Dexter White of the US Treasury and John Maynard Keynes of Great Britain. Their primary task was to restore global capitalism and the free trade of goods. The Articles of Agreement which established the IMF and the World Bank represented a collective effort to restore stable exchange rates and convertible currencies in order to facilitate the revival of multilateral trade and investment, while leaving to each member ample room to pursue independent employment and social welfare policies. The agreements reflected the policy positions of mainstream US and British economists, who favoured restrictions on capital mobility on equity grounds. As Harry Dexter White explained:

> *"Englishmen have not forgotten that in the [pound] sterling crisis of 1931, social services were cut in the attempt to maintain the fixed sterling parity [with gold]. To use international monetary arrangements as a cloak for the enforcement of unpopular policies, whose merits or demerits rest not on international monetary considerations as such but on the whole economic programme and philosophy of the country concerned, would poison the atmosphere of international financial stability."*

The Bretton Woods agreement provided the necessary room by allowing member countries to adjust their foreign exchange rates and restrict movements of capital when they severely impeded the maintenance of national output and employment. The IMF was assigned the tasks of monitoring member compliance with the Articles of Agreement, and providing short-term liquidity to members experiencing balance of payments difficulty. Under Article VI, which authorizes member countries to use capital controls as needed, the IMF was also obligated to cut off its credits when used to facilitate capital flight.

Despite the IMF's recognition in principle of the primacy of national policies that promote full employment and the economic welfare of the population, in practice the Fund's interventions soon demonstrated other priorities. Joseph Stiglitz, former chief economist of the World Bank, summarized the IMF's transformation this way:

> *"In its original conception [...], the IMF was based on a recognition that markets often did not work well — that they could result in massive unemployment and might fail to make needed funds available to countries to help them restore their economies. [...] Over the years since its inception, the IMF has changed markedly. Founded on the belief that markets often worked badly, it now champions market supremacy with ideological fervour. [...]Today the IMF typically provides funds only if countries engage in policies like cutting deficits, raising taxes, or raising interest rates that lead to a contraction of the economy. [Stiglitz 2002; p.12-13].*

As is described in further sections of this report, the Bretton Woods system, as it was eventually applied, came to operate in favour of entirely different priorities from those conceived by the founders of the IMF and World Bank.

Conservative Attacks on the Bretton Woods System

The first attacks on the Bretton Woods system came from the right and from conservative economists. One of the most vociferous of the early critics was Milton Friedman of the University of Chicago. Friedman later became well known in Latin America for championing free market economics in Chile after the coup d'état of Augusto Pinochet in September 1973 began 17 years of military dictatorship. In a polemical essay that took aim at Keynes, the chief architect of Bretton Woods, Friedman argued that floating exchange rates plus free capital mobility offered the advantages of insulating each economy from external real or monetary shocks, freeing them to implement the macro-economic policies they wished. Friedman also argued that currency speculators would bring the movement of nominal exchange rates into equilibrium, forestalling the development of massive hot money flows. In the end, he said, long-term capital flows would bring about a global convergence of real interest rates, thereby maximizing the global efficiency of investment in allocating resources.

But contrary to Friedman's prediction, rapidly rising short-term capital movements were accompanied by rising exchange rate volatility. By the early 1980s, it was evident that short-term capital movements were far outstripping the flows needed to finance international trade in goods and in non-financial services, such as shipping, international travel and tourism. These movements were having an impact on exchange rates completely independently of trade flows. Movements in the United States dollar have provided an especially glaring example. The dollar exchange rate kept rising rapidly in the first half of the 1980s despite a rapidly worsening trade deficit, because it was being driven upward by massive inflows of foreign capital. A similar movement of the US dollar took place in the late 1990s and into 2001.

Defenders of the Friedman position then shifted the focus of their explanation of exchange rate movements from trade to financial market dynamics. They argued that easing of capital controls, and improvements in electronic data processing that facilitated the explosive growth of financial flows, were also hastening the realization of a globally efficient allocation of resources.

Bretton Woods vs. post-Bretton Woods Trends in the Global Economy

The Bretton Woods system of pegging member exchange rates to the gold-convertible US dollar was dismantled soon after 1971, when the US decided it could no longer meet its gold-convertibility commitment.

Replacing it has been an evolving assortment of managed and unmanaged floating exchange rates, as well as various forms of pegged rates. Among developing countries, the trend has been toward floating currencies. Those countries with some type of pegged rate declined from 87% of the group in 1975 to 40% in 1997, according to the IMF. Among the industrialized countries, central banks intervened occasionally in otherwise market-determined exchange rates. The European Union countries systematized the interventions between their own currencies by setting up the European exchange rate mechanism, a cooperative arrangement for limiting intra-EU exchange rate movements, which was superseded in 1999 by the adoption by twelve countries of a single EU currency, the euro.

However, the confusing evolution of arrangements has been accompanied by sustained movements toward trade and capital market liberalization in both the industrialized and developing countries. "Indeed, the integration of global financial markets has proceeded much more rapidly than that of the goods markets," the IMF said in 1991.

Nevertheless, the globalizing of free movement of capital is not complete. By the mid-1980s the industrialized countries had finished abolishing the capital controls which had been retained during the Bretton Woods era to help achieve macroeconomic stability. But among developing countries, capital decontrol was then just gaining momentum, and despite prodding by the IMF and World Bank, the majority still retain some controls to maintain stability.

Post-Bretton Woods Financial Trends

The lifting of restrictions on cross-border financial flows reached critical mass by the early 1980s. Funds could now be moved freely between banks and security markets domiciled in different industrialized countries and offshore tax havens. By the early 1990s the cross-border integration of national financial markets also encompassed a growing number of the developing countries, sparking an explosive growth of currency transactions.

Those who defended the dismantling of controls on international capital flows claimed that freer movements of capital would mean that balance of payments problems would correct themselves quickly and painlessly. According to their predictions, the shift from the pegged exchange rates and capital controls of the Bretton Woods era to floating exchange rates and capital decontrol of the post-Bretton Woods era would bring about more rapid and smoother adjustment of trade imbalances.

In the 1970s, the claim could still be plausibly defended by blaming the rising volatility of financial flows on an unusually severe series of exogenous trade shocks, notably the OPEC-led surges in oil prices in 1973-74 and 1979-80. But, as global financial transactions rose from 3.5 times global exports in 1977 to 34 times global exports in 1986, it became obvious that exchange rate movements among the industrialized countries, which were even more volatile in the 1980s, were being driven primarily by financial dynamics. And it also become evident that the payoff expectations motivating the financial movements were pushing exchange rates far out of line from the rates needed to create equilibrium between exports and imports.

Interest and Exchange Rates and the Multinationals

The dramatic rise of real interest rates and the high volatility of real exchange rates since the demise of Bretton Woods has slowed export growth in many countries and tilted both domestic and foreign investment toward financial assets. More and more, the "paper" economy is displacing the real economy as the object of financial transactions.

Strategies to "grow" companies have turned from building new capacity to acquiring existing capacity through mergers and acquisitions. The successful political and ideological push to privatize state-owned assets has further enlarged domestic and international opportunities to acquire existing capacity. Yet the sharp drop in productivity growth overall suggests that the net contribution to increased productivity from more efficient management of the acquired capacity has been modest at best. The tilt toward mergers and acquisitions, however, helps account for a slower growth of real investment and output growth.

Capital decontrol has also encouraged the transformation of the financial divisions of multinational corporations into major profit centres, pursuing intricate liability and portfolio management strategies. The Bank for International Settlements, in a post-mortem investigation of the 1992 currency crisis that had weakened the European Union's exchange rate mechanism, found that multinational corporations were more important than hedge funds in mounting the speculative currency attacks that set off the crisis.

By borrowing in the currency of the recipient country, and by foreign exchange option strategies, multinational corporations have been able to avoid much of the foreign exchange and political risks of acquiring foreign assets, by effectively remaining in their home currency. Thus, contrary to the prediction of textbook neoclassical trade theory, the upsurge of foreign direct investment has resulted in smaller net transfers of real resources to the recipient countries than appear at face value.

> *"The vast majority of the capital stock of the foreign subsidiaries of US multinational corporations does not come from the United States but is accumulated or raised locally by the subsidiary. [...] Informal inquiry with corporations and banks suggests that the obligations incurred by subsidiaries are generally kept in local currency, while the obligations incurred when the parent borrows abroad for use at home is generally hedged back to the home currency. [...] Since the subsidiary's borrowed funds are used locally, there is no cross-border transfer of capital" [Feldstein, 1994; p.690].*

The international portfolio investing of insurance, pension and mutual funds, which has expanded rapidly since the1980s, has also been largely hedged against foreign exchange and political risks by foreign exchange options [Feldstein, 1994; p.685]. The hedging has minimized the net transfer of real resources from portfolio investments as well.

Global Financial Markets as Enforcers of Policy and Producers of Crises

The ballooning of financial flows has greatly increased the power of the financial markets to "discipline" national policy-making around the globe. The rise of the dollar value of daily foreign exchange trades has vastly overtaken the rise of official reserves. In 1977 global official reserves equalled 16.2 days of foreign exchange trading, whereas in 1998 they barely equalled one day's global turnover. This precipitous decline of relative "firepower" has greatly reduced the ability of central banks to intervene in the foreign exchange markets to restrain volatility, or to stabilize the real exchange rate.

The success of the 1985 Plaza agreement between the US, Japan, West Germany, the U.K. and France, to collectively knock down an overvalued dollar, was short-lived. Follow-up collective and individual attempts by the central banks of these countries to stabilize the dollar-yen and dollar-mark exchange rates were soon overridden by the financial markets. Several attempts by the European, US and Japanese central banks in the late 1990s and early in the new century to drive down the dollar relative to the euro failed, despite an ever-increasing trade deficit in the US. Short of ammunition for effectively countering unwanted exchange rate movements, central banks have turned to appeasing the markets. Raising interest rates has become the weapon of choice against runs on the currency, which is essentially rewarding financial capital for not fleeing.

Since 1984 the real interest rate on 10-year government bonds, often dubbed "riskless", has averaged much higher than the real GDP growth rate in all the G-7 countries except Japan. During the Bretton Woods era, by contrast, the average real interest rate was considerably below the real GDP growth rate, and merely equalled it during the pre-World War I gold standard era. Only during the inter-war decades did the ratio of the interest rate to GDP growth, elevated by the collapse of GDP during the 1930s, rise to approximate the current ratios.

Higher real interest rates should, in textbook theory, raise the cost of capital and depress equity values. Yet while the growth of physical investment did slacken, bond financing and equity market capitalization boomed. From 1982 until 2000 the global value of bonds listed on the organized bond markets grew two-thirds faster, and the capitalization of the global equity markets grew twice as fast, as nominal GDP. Together with the rising real interest to GDP ratios, the data imply that the share of global income accruing to owners of financial assets, debt leveraging, and asset inflation, were all increasing at rates that could not persist indefinitely. Sure enough, economic growth in the major industrialized countries ground to a halt in early 2001, well before the destabilizing effects of the September 11 terrorist attacks in the United States, which made the economic situation even worse.

Interest Rates and Capital Controls

The sharp rise in long-term real interest rates since the end of the 1970s was not caused by an accelerating demand for loans to finance long-term investment projects, since investment growth slowed substantially from the Bretton Woods rates of growth.

Since interest rates are a major part of the cost of capital for investment projects, the causality more likely ran from higher interest rates to reduced investment growth, than the reverse. Was it a fear of inflation that caused lending institutions to raise the risk premium on long term lending? That doesn't fit the evidence well. Inflation increased in the 1970s in the industrialized countries, when their real long-term rates of interest declined below the Bretton Woods average rate. Inflation has been on the decline since the early 1980s, yet real interest rates have been averaging double the Bretton Woods rates. Another weak causal candidate is fiscal deficits; they have been on the decline in most industrialized countries since the early to mid-1980s.

By contrast, capital decontrol is a much stronger causal candidate. An OECD econometric study has calculated that about half the rise of real long-term interest rates in the industrial countries in the 1980s was due to capital decontrol [Orr et al., 1995]. What might have been the causal connection?

Prior to capital decontrol, when the monetary authorities lowered short-term interest rates to stimulate the economy, the major holders of long-term bonds, notably insurance companies and private pension funds, anticipated, wrongly or rightly, inflationary consequences. Since fiduciary restrictions blocked them from holding stocks, they could merely move funds from longer to shorter-maturity bonds. But capital decontrol, however, gave them the opportunity to move funds instead between home and foreign bond markets in pursuit of higher yields.

In this manner, capital decontrol pushed up long-term interest rates, and to a lesser degree, short-term rates as well, and undermined the effort to stimulate the economy by monetary easing. Fearful of capital outflows, governments also began shifting their primary focus from achieving high levels of output and employment to stabilizing the price level, which has helped to support the higher levels of real interest rates of the past two decades.

In effect, by lifting capital controls governments gave up most of the ability to adjust real interest rates for objectives other than comforting the bond markets. This was a major cause of the Asian financial crisis. When foreign investors suddenly pulled massive amounts of capital from several Asian economies, the monetary authorities reacted by pushing up interest rates in the hope of retaining the funds. By doing so, they drove the economy into recession when credit became too costly for most consumers and investors. The governments of these countries further accentuated their economic problems by drastically cutting government expenditures in order to prevent the deficit from growing, as the IMF pressured them to do.

Basel Committee on Banking Supervision

The Basel Committee on Banking Supervision, a consortium of bank regulators from twelve leading economies, has been engaged since the mid-1970s in cleaning up successive financial crises produced by banks feeding on new opportunities created by financial globalization. In the late 1990s, it began revising the 1988 Capital Adequacy Accord, rendered inadequate because of financial innovations and "regulatory arbitraging" by the banks. The background is as follows.

The 1988 Accord was a response to the over-lending by leading US and British banks to Latin American banks and governments, which helped produce the Latin American debt crisis of the early 1980s. The lenders had protected themselves against exchange rate and interest rate risks by denominating the loans in foreign currency — chiefly dollars — and requiring the interest rate to be adjusted to changes in LIBOR (the London Inter-Bank Offer Rate), the lending banks' cost of funds benchmark.

Comforted by these measures, the banks had begun offering loans of up to seven years maturity.

Indeed, the banks pushed developing countries to take more loans so that they could to fill their lending portfolios. In doing so, they overlooked default and liquidity risk. By the early 1980s, threats of default had begun, most noticeably by Mexico in 1982. As a result, the major international banks, which were heavily leveraged on their equity capital, found themselves with non-performing Latin American loans which greatly exceeded their equity capital.

Since the defaulted loans could only be sold to bottom-fishing speculators at a fraction of face value, some leading US banks had become technically insolvent, and others nearly so. For example, Citibank, whose capital to asset ratio was then 4%, had 12% of its portfolio in Latin American loans. Had the liquidation value of those loans fallen to one-third or less of their book value, Citibank would have been insolvent.

In addition, the troubled banks were major foreign exchange dealers and they held large deposits from domestic and foreign correspondent banks. To add to the insolvency threat, massive deposit withdrawals by nervous correspondent banks could have produced with lightning speed a liquidity crisis of international proportions.

Emergency interventions by a consortium of the monetary authorities of the major creditor countries, the IMF, and the lead lending banks averted successive crises with emergency loans to sustain debt servicing by the heavily indebted countries. As part of the rescue packages, debtor governments were in turn forced to accept bank debt paper at or near face value as payment for assets, often consisting of privatized government-owned real estate. This enabled the lending banks to sell their bonds at less heavily discounted rates and reduce their losses on loans to Latin America, at the same time as public assets were privatised on a massive scale.

From this experience the Basel Committee on Banking Supervision decided that the key to preventing a recurrence of the 1982 crisis was to prevent the banks from incurring excessive credit risk. The 1988 Accord tried to do this by classifying bank assets in risk classes, with higher capital/asset ratios assigned to riskier assets. The Accord also required that the bank's overall capital/asset ratio — a weighted average of the capital/asset ratio of each class multiplied by the percentage of total assets in that class — be equal to or exceed 8%.

But once the Accord went into effect in the early 1990s, the banks began regulatory arbitraging — that is, searching for loopholes that would allow them to stretch their capital over larger quantities of assets. They found a key loophole in the risk-weighting scheme, which set the capital/asset ratio for inter-bank loans of less than a year at 20% of the ratio assigned to loans to private non-banking firms. This induced the international banks to start short-term lending on a large scale to banks in Asia, Latin America and the former communist countries, which then lent the funds at large spreads to domestic borrowers.

III. THE ASIAN CRISIS AND THE COLLAPSE OF ARGENTINA

Asia and Export-Led Development

In explaining the roots of the East Asian crisis beginning in 1997, the IMF and the finance ministers of leading industrialized countries focused primarily on the structural problems caused by so-called "crony capitalism." Lawrence Summers, the former United States Treasury Secretary, once expressed the opinion that the East Asian countries had erred by following what he called the Japanese model of economic development. In a speech delivered in 2000, Summers stated that the Asian countries had "favoured centralized coordination of activity over decentralized market incentives. Governments targeted particular industries, promoted selected exports, and protected domestic industry. There was a reliance on debt rather than equity, relationship-driven finance not capital markets, and informal rather than formal enforcement mechanisms." Ultimately, this style of capital formation led to bad business decisions, or, in Summers' words, "money borrowed in excess and used badly".

Indeed, "crony capitalism" and other forms of official corruption did create serious impediments to sustainable development in Asia, a point which is often made by Asian trade unions and other civil society organizations. But it is just one piece of the total picture.

By any standard, Asian growth rates from the early 1960s to the late 1990s were impressive and raised living standards for millions of people. But the pattern of Asian development since World War II has closely followed two developments. One was the export-led economic agenda pushed by the international financial institutions and the United States, and adopted by South Korea and other East Asian countries during the Cold War years. The other important development was the rapid deregulation of capital markets in the 1990s.

Export-led development followed a simple formula: countries pegged growth to selling manufactured goods, agricultural products and natural resources overseas. Capital was siphoned into industries chosen by state economic planners and businessmen. In nearly every country where this pattern was followed, the policies were guided by authoritarian governments that favoured certain business groups. They maintained low wages by stifling labour unions and independent political organizing.

That was the case in South Korea, which was under military dictatorship from 1961 to 1987, and in Indonesia, where General Suharto and a military-dominated government ruled from 1965 to 1998. The first phase of export-led industrialization was primarily financed by Japanese corporations and banks, which began investing heavily in Korea and Southeast Asia during the 1960s and 1970s.

The spread of export-led capitalism was also accompanied by policies, pushed by the IMF and leading industrialized countries, most notably the US, to lift barriers to the flow of private capital around the world. After the Latin American debt crisis of the 1980s, private bond and investment markets replaced the international financial institutions and government development funds as the primary suppliers of capital to foreign countries and corporations. According to the IMF and World Bank, private capital flows to the developing world jumped from $44.4 billion in 1990 to $234.2 billion in 1996, making up 85% of total investment in those countries.

But Japanese capital investments in Asia slowed in the 1990s as a result of the collapse of Japan's "bubble economy," which was based largely on speculative investments in land and real estate. To attract investments from other countries, many Asian governments raised interest rates and pegged their currencies to the dollar. The policies worked, bringing billions of dollars from foreign investors into the region. Between 1985 and 1995, GNP in Southeast Asia grew between 6% and 10% a year. The result of such high economic growth was that by 1996, Asia was buying more than 30% of all US exports.

Source of the Asian Financial Crisis

The problems that engulfed the region were sparked by the misallocation of these enormous flows of capital. In Thailand and Indonesia, much of the investment was funnelled into high-profit projects with a quick turnaround time, primarily stocks, consumer financing and real estate. In South Korea, government-supported banks directed the loans to conglomerates competing with each other to expand capacity in automobiles, semiconductors and other industries. The crisis developed when banks began to pile up bad debts as a result of a glut in real estate and a slowdown in manufactured exports. That, combined with a wave of currency devaluations, triggered the panic by foreign investors who quickly sold off their stocks and bonds, sparking the intervention of the IMF.

But the results of the IMF's $150 billion interventions in Thailand, South Korea and Indonesia failed to turn around those economies. The primary focus of the bailout was to prevent foreign debt default by providing short-term credits. These were tied to the adoption of austerity measures and policy reforms intended to entice an early return of foreign capital by rebuilding investor confidence and expected profitability.

But the austerity measures — sharply higher domestic interest rates to slow capital flight, and reduced fiscal outlays to keep fiscal deficits from "crowding out" private sector financing — were ill-timed, to say the least. Higher interest rates and depressed home demand set off waves of bankruptcies, major banking crises, and the drying up of domestic bank lending. Output and employment plummeted while popular discontent rose. Belatedly, the IMF tried to reverse course, increasing its credits and easing its restrictions on deficit spending.

Joseph Stiglitz, who was the chief economist for the World Bank during the crisis, was ostracized by the IMF for publicly criticizing their policies in Asia. In a public appearance in Washington after winning the 2001 Nobel Prize for economics, Stiglitz described the IMF interventions in Asia (and, later, in Russia and Brazil) as a new form of "corporate welfare" because it bailed out the investors at the expense of workers and the poor. "This was corporate welfare paid for by taxpayers in Russia, Brazil and the affected countries in Asia," he said at an October 2001 press conference. "The poor people ended up paying the bills to bail out the people doing the bad lending." The IMF, he concluded, "created a depression" in Asia. In a book published later he elaborated further on the effect of IMF policies in East Asia in the late 1990s:

> "Contractionary fiscal and monetary policies combined with misguided financial policies led to massive economic downturns, cutting incomes, which reduced imports and led to huge trade surpluses, giving the countries the resources to pay back foreign creditors. If one's objective was to increase the size of reserves, the policy was a success. But at what expense to the people in the country and their neighbours!" [Stiglitz, 2002; p.108].

Even at the beginning of the new century, the repercussions from the crisis were still preventing a sustained economic recovery in Asia and the return of foreign capital. This contrasts with Malaysia which, though also severely hit by the region's capital flight, rejected IMF assistance and resorted instead to an expansionary monetary and fiscal policy, which it protected with capital controls. Spared a bankruptcy wave and a systemic banking crisis, the Malaysian economy recovered more quickly than its neighbours, as did also, ironically, its inflow of foreign direct investment. The contrasting experience, which has not gone unnoticed among Malaysia's neighbours, is further fuelling opposition to the IMF's policy demands.

Contrast Between Pre- and Post-1997 Analyses

The IMF and World Bank's policy dilemma is compounded by the embarrassing contrast between their pre-and post-1997 analyses of the East-Asian economies. Most of these economies had enjoyed two decades of rapid economic growth, low inflation, relatively stable dollar exchange rates, high export and investment growth rates, balanced fiscal budgets, high private savings rates, and moderate and stable income inequality. In a widely disseminated policy report the World Bank dubbed it "the East Asian Miracle,".and intended to use it as a "blueprint" development model for other developing countries. The report also clo-

sely reflected the views of the IMF.

One major lesson, according to that World Bank report, was that "market friendly" policies that promoted private initiative in liberated markets and confined government intervention to "well-defined limits," rather than Japanese style official industrial planning and subsidies, accounted for the rapid industrialization of East Asia. This lesson was soon attacked by Asian development experts as an ideologically motivated and factually incorrect downplaying of the importance of activist industrial promotion measures in Korea, Indonesia, Taiwan, Malaysia and Singapore, as well as in Japan.

A second lesson of the World Bank report was that by liberating their financial sectors and lifting capital controls, the East Asians were effectively exploiting the new opportunities provided by financial globalization. This view, which was also emphasized in the laudatory pre-crisis IMF reports, looks quite lame, to put it mildly, in the wake of 1997.

So also does a third lesson, which was that "technocratic insulation, [...] the ability of economic technocrats to formulate and implement policies in keeping with politically formulated national goals with a minimum of lobbying for special favours from politicians and interest groups had facilitated the successful policy making". This was a left-handed compliment to the authoritarian governments then dominating the region.

The IMF's post-1997 explanations of the Asian crises, by contrast, single out major flaws in the financial liberalization process that had passed unnoticed in its pre-1997 reports. For example, they criticized, in hindsight, practices such as allowing undercapitalized domestic banks to become overly dependent on volatile short-term foreign loans, which they re-lent to over-leveraged domestic firms, and to finance real estate and stock market bubbles. They have also transmogrified the World Bank's positive "technocratic insulation" into negative "crony capitalism," to which the IMF now assigns much of the responsibility for the loose financial practices that brought on the crises. The IMF now uses "crony capitalism" to buttress its case that privatizing state functions and more market decontrol should be the primary focus of the structural reforms needed to avert future crises.

But while in financial transactions it takes at least two to tango, the IMF has been slow to assign any core responsibility to the international banks and capital markets. In the 1995 Mexican financial and currency crisis, which spilled over to other Latin American countries, the IMF attributed the skittish behaviour of foreign banks and investors to the region's inadequate official data and weak corporate accounting standards. The inadequate data, according to the Fund, had prevented the banks and portfolio investors from accurately assessing their risk/return ratios. As an initial step toward reforming the global financial architecture, the IMF, therefore, sought and received authorization to improve the timeliness and "transparency" of the data provided to the international financial markets by developing country borrowers. The reform proved to be a damp squib, for reasons to be discussed later on.

In any event, it didn't prevent skittish behaviour by those same markets from spreading the 1997-98 crises to a much wider group of countries. More recently, as part of the architectural reform effort, the IMF has been collaborating with the Basel Committee on Banking Supervision to improve the prudential regulation of international banks by strengthening their required capital/loan ratios and risk management procedures.

In seeking agreement from the international banks on the prudential reforms, the Basel Committee has encountered heavy weather. Preliminary agreement has finally been reached on the general structure of the proposed reforms, though the details have still to be negotiated with the banks. Nevertheless, the IMF's collaboration is a tacit admittance that it now accepts that the skittish behaviour of the international banks has deeper roots than inadequate data from the debtor countries.

When the Bush presidency came to office in the United States in January 2001, cabinet appointees expressed commitments not to repeat some of the mistakes of the past, particularly the bailouts for wealthy investors. But subsequent events in Argentina and several other countries made it difficult to keep that promise.

The case of Argentina

IMF bailouts made in late 2000 — a $7.5 billion bailout for Turkey and a $40 billion bailout for Argentina — indicated that the IMF had learned little from its experience in Asia. As before, the plans did not require foreign creditor banks and bondholders to come up with more cash. Instead, the hope was that the large injection of liquidity, along with adoption of the IMF's demands for austerity policies, would revive foreign creditor confidence and induce foreign investors to finance Argentina's foreign debt with lower interest rates and longer maturities. In the case of Argentina, the policies included phasing out substantial parts of what was left of the state-run pension system, rolling back the union-run health system, and freezing the government expenditure level for five years.

The Argentine bailout purported to avoid past flaws. It provided larger short-term liquidity and gave the government somewhat more slack for deficit financing, allowing it to spend $20 billion over the next five years on public works. In a December 2000 interview, the IMF's second-in-command, Stanley Fischer, admitted that the earlier policy demands had worsened matters, but added that in advance "it is very hard to know how it is going to turn out". In any event, "what the current programme is, is a recognition that growth is an essential issue in Argentina". And "if Argentina is to grow," Fischer went on, the impetus would have to come from higher export growth.

However the new bailout was incapable of overcoming the policy contradictions that plagued Argentina's decade-long effort to achieve stable economic growth. To curb high inflation, Argentina's 1991 Convertibility Law had frozen the peso-dollar exchange rate, and tied the central bank's monetary emissions tightly to its dollar reserves. And to attract foreign direct and portfolio investment, the law also lifted all exchange controls, making the peso freely convertible into dollars in all foreign and domestic transactions.

The Convertibility Law brought down inflation, but in the transition to a stable price level, the exchange rate became badly overvalued, and the dollar became the preferred domestic store of value as well as unit of account for larger domestic transactions. Without a devaluation, Argentina was therefore at a serious cost disadvantage in trying to expand exports faster. As the dollar gained value in the late 1990s relative to currencies such as the Brazilian *real* and the euro, which were the currencies of its major foreign markets, Argentine goods were effectively priced out of international markets.

But repealing the Convertibility Law and devaluing the peso could have set off a massive flight to the dollar that would quickly drain the central bank of the dollars it needed to supply pesos and to service the foreign debt. Only by introducing and effectively applying the bêtes noires of the IMF and World Bank, exchange and import controls, could the government have hoped to stem such an outflow.

The IMF advised sticking with the Convertibility Law, which meant neither devaluation nor exchange and import controls. But this required pushing wage/price deflation into negative territory by tighter wage-cutting measures and credit restrictions as the chief means for offsetting the export cost disadvantage imposed by the overvalued but frozen exchange rate.

In August 2001, less than nine months after the $40 billion bailout, the economy once again appeared to be on the edge of financial collapse, with exports continuing to decline, the economy contracting further, and the government's deficit growing because fiscal revenues were far below target. After much wrangling, the IMF came up with a further $8 billion emergency loan package, but accompanied by even stricter conditions regarding the level of the deficit. In order to acquire the latest loan, Argentina announced a further round of spending cutbacks, the most important being to slash the salaries of public sector workers and the pension benefits to all Argentine retirees.

The drastic new budget cutbacks only seemed to feed the downward spiral of the Argentine economy. In December 2001 the IMF announced that it was suspending payments on the August emergency loan because the deficit target had not been met. Tax revenues were once again substantially below target. Immediately the Argentine government declared a partial default on debt payments and, in order to avoid a public sector liquidity crisis, seized $3.5 billion in private pension fund assets.

By December 2001 the IMF was admitting that the Convertibility Law, which decreed the fixed peso-dollar exchange rate, was no longer viable. The IMF informed the Argentine government that one of the

conditions of further lending would be for the country to choose between a devaluation of the peso or full dollarization, i.e. replacing the peso with the US dollar as the country's currency.

In January 2002, the new government of Eduardo Duhalde decreed a devaluation and then a free-floating peso. By August 2002 the peso was exchanging at 3.60 to the dollar, meaning that it had lost 72% of its value since January. But the IMF also demanded that the government undertake a major fiscal reform, including additional large public expenditure reductions, as conditions for restarting lending. The IMF particularly wanted to see the central government rein in spending by the provinces, which devote a large part of their spending on government entities responsible for health and education programmes.

The Fund was imposing these conditions for additional public spending cutbacks even as the Argentine economy was in full-fledged depression. By August 2002 nearly one in four Argentines was officially considered unemployed and the IMF predicted that the GDP would contract by 15% in 2002.

IMF insistence that the government adopt drastic new austerity measures while undergoing economic collapse was likened by some commentators to the discredited pro-cyclical economic policies applied in the early years Great Depression of the 1930s in the United States. Columbia University economist Jeffrey Sachs was quoted as follows by the New York Times: "They [IMF officials] are telling Argentina to take a depression as a given and, since tax revenues aren't being collected anymore, to adjust their spending down to that level. They are not thinking straight at all. That's Herbert Hoover economics." The IMF's attitude towards Argentina in 2002 gave little indication that the Fund had learned from the mistakes it had made in response to the 1997 crisis in East Asia.

Lessons Learned?

If ever a country has faithfully followed the policy prescriptions of the IMF and World Bank, it was Argentina. After pegging its currency to the US dollar in 1991 at the behest of the IMF in order to eliminate inflation and assure financial stability, Argentina embarked on a policy of radical privatization. Virtually no public service, up to and including the post office, was left untouched by the privatization programme recommended by the international financial institutions. In the mid-1990s the government accepted the World Bank's advice to dismantle the comprehensive public pension programme in favour of a largely privatized scheme. In light of the December 2001 state seizure of pension fund assets, it is somewhat ironic to note that the World Bank's experts argued at the time that privatized pension funds would offer more security for workers' pensions than a public programme.

The spectacular failure of the policies of the international financial institutions in Argentina has at least led to some introspection on the part of the institutions. During the meetings of the IMF and World Bank held in Ottawa in November 2001, member countries expressed much concern about the situation in Argentina. One major preoccupation was the fact that the country was visibly heading toward the biggest debt default in world history without the IMF having the slightest mechanism for organizing negotiations between Argentina and its creditors. In fact, the Fund had repeatedly resisted calls to allow for a standstill, or moratorium on debt repayments, which could be decreed in cases where countries are in technical default, so that an orderly debt restructuring can be negotiated with creditors, both private and public.

A few weeks after the Ottawa meetings, the IMF indicated that it was prepared to make a radical about-face in Fund policy. The new second-in-command Anne Krueger announced that the Fund was ready to support a mechanism similar to "bankruptcy protection" for countries incapable of meeting loan payments, during a period of debtor-creditor negotiations. Krueger cautioned that it might take a few years for such a mechanism to be operational and that those countries already in crisis situations, such as Argentina, could not expect to use it. However, for the IMF to voice support for such a mechanism, which it previously considered totally anathema to the efficient functioning of international capital markets, is a major development.

There are other recent glimmers of greater IMF policy flexibility. While there is little indication of the Fund easing its overall austerity demands, the IMF is at least evincing an interest in more equitable sharing

of the austerity. This change has developed since the Fund's declaration, in September 1999, that poverty reduction would be the institution's "overarching goal". The Fund now urges expenditure on poverty relief by debtor governments, provided that it is "closely targeted" to minimize the impact on the fiscal deficit. It has also begun pressuring client governments to attack tax evasion and other corrupt behaviour more vigorously.

The IMF has also stopped its campaign of the late 1990s to amend its charter — the Bretton Woods Articles of Agreement — to require that to qualify for IMF emergency credits, members must pledge to abolish all capital controls within a mutually agreed upon time period. That campaign had been set to culminate with formal approval at the September 1997 meeting of the IMF Board of Governors in Hong Kong, but the currency crises enveloping the neighbourhood made it unwise to pursue the matter.

The Fund has also stated that countries may justifiably apply short-term capital controls in some emergency situations, although it has never explicitly recommended that a government introduce such controls.

These modifications in IMF policy, whether tactical or permanent, are, however, limited by the Fund's abiding commitment to global capital market liberalization, which it justifies by appeals to economic theory and historic experience. Its conviction that liberated global capital markets can become stable and efficient mechanisms for allocating economic resources is, it contends, firmly grounded in basic economic theory. Excessive volatility of capital flows and other malfunctions are therefore transitional phenomena, according to the Fund; just part of a learning process by which the markets correct mistakes and eventually get it right.

But given the number of crises in recent years, from East Asia to Russia, and from Turkey to the spectacular failure of Argentina, subsequently spreading to neighbouring countries such as Brazil and Uruguay, the IMF's claims sound increasingly ludicrous. As equally disturbing as the inherent instability of the international financial system in its current form, is the fact that the system has utterly failed to ensure a steady flow of much-needed capital for developing countries' growth. The frequent financial crises of recent years have harmed economic growth throughout the world, but they have harmed developing countries in particular.

As mentioned above, the lifting of barriers to capital flows during the 1990s initially appeared to benefit developing countries, as private capital flows to the countries as a group increased more than fivefold between 1990 and 1996. However, in the wake of the East Asian crisis, these flows declined precipitously, from $234.2 billion in 1996 to $7.7 billion in 2000, a drop of almost 97%. Although there was a slight improvement in 2001, to $31.3 billion, they are still at only 13% of the level reached in 1996 and lower than at any year of the 1990s.

The plunge in private capital flows was particularly severe in the "crisis countries" of East Asia (Indonesia, Korea, Malaysia, the Philippines and Thailand), where private capital flows were negative in 1997 and remained so at least until 2001. However, every developing region, as well as the transition countries of Europe and Asia, suffered a drop-off of capital inflows after the 1997-1998 crises.

The current international financial system has failed to deliver the stability that all countries of the world require to develop and prosper. The system has particularly failed in helping the developing regions obtain access to the private capital which, according to the market-based approaches of the IMF and World Bank, are supposed to be the keys to achieving their objectives of sustainable growth and poverty eradication. It is obvious that substantial changes to the system are needed.

IV. CHANGES NEEDED IN THE GLOBAL FINANCIAL ARCHITECTURE

Clearly, a new Bretton Woods architectural arrangement, respectful of the original objectives of the agreement, would open up more policy space for countries to adjust their exchange rates and interest rates to meet domestic economic and social needs than does the free market approach. Indeed, the arrangement enshrined in the 1944 Articles of Agreement should have done exactly that. It remains the IMF's charter, and defines the obligations of the IMF member countries, though now "honoured more in the breach than in the observance". Financial economist Martin Mayer concludes a critique of the risk reduction claims of the official architectural reforms with this trenchant observation, made in 1999:

> *All countries have signed off on Article IV of the Articles of Agreement of the International Monetary Fund, requiring that "each member shall: (1) endeavour to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability…[and] (2) seek to promote stability by fostering orderly underlying economic and financial conditions, and a monetary system that does not tend to produce erratic disruptions." These, not the facilitation of trading opportunities or capital movements per se, are the relevant objectives. It's the economy, stupid, not the market for paper [Mayer, 1999].*

For many years, the IMF has disregarded the intent of Article IV as well as of Article VI, which authorizes member countries to use capital controls, and instructs the IMF to deny its credits to members using them to finance capital outflows. This disregard went largely unchallenged while the Fund's dubious economic justification, that market reforms were a superior way of fulfilling Article IV's objectives, held sway. That the disregard persists, despite growing awareness that the justification is fundamentally flawed on both theoretical and empirical grounds, illustrates the fact that infusing the architectural reform effort with a real Bretton Woods perspective requires winning political as well as analytic battles.

The Necessary Reforms

The following package proposing reform of the international financial architecture includes some items that are already on the official reform agenda, along with others that have been struggling, thus far unsuccessfully, to force themselves onto that agenda. Combined, they are an updating of the original Bretton Woods architecture commensurate with the changed economic and political environment of today.

The proposals, if put in place, would contribute to restoring some of the stable and equitable economic growth of past years. They would particularly help the developing and transition countries to gain greater control of their economies and pursue strategies of combating poverty and creating decent employment. The proposals would also provide institutional building blocks for erecting a genuinely integrated global economy of the future, which would allow pursuit of goals of full employment, poverty eradication, and more equal distribution of income world-wide. The package is directed at crisis-prevention, at weakening the power of the international financial markets over domestic macroeconomic policies, and at reducing the inequalities in the world economy induced by the current international financial architecture.

1) A Currency Transactions Tax

The currency transactions tax is best known as the "Tobin Tax". It was named after Nobel Laureate economist James Tobin, who proposed it soon after the breakup of the Bretton Woods exchange rate system in the early 1970s. The tax is a "market-friendly" alternative to direct capital controls.

In effect, the tax allows the market to screen out hot money from longer-term financial flows. Around 80% of the $380 trillion annual global foreign exchange transactions in 1998 (see Table 5) involved round trips of a week or less. Most of the transactions were related to interest rate arbitraging and open spe-

culation by banks, investment houses, hedge funds and multinational corporations, taking very large short-term positions to exploit transitory and usually small profit margins.

Covered interest rate arbitraging, in which financial operators like banks move huge sums between currencies to exploit tiny profit margins, would be squeezed the most by a small currency transactions tax. To illustrate, an interest rate difference of 1% between US and U.K treasury notes, minus the cost of carrying out the various steps in the operation, leaves a weekly net return of, say, 0.2%. If the operation involves a weekly round trip, and is repeated weekly with various currencies, the annual net return on the outlay is 10.4% (0.2% x 52). Since a 0.1% Tobin tax on each leg of the round trip would wipe out that return, an interest rate difference of 1.2% would be needed to restore the after-tax return to its previous level.

Speculating on future exchange rate movements might be less affected (since they have higher expected returns as they are riskier), but since the tax reduces the expected returns from such operations, it would reduce their volume as well. And, of course, the higher the tax rate were set, the more it would discourage and reduce short-term flows, and the more autonomy it would grant countries over their interest rate policy.

On the other hand, a small tax would bite minimally into the much larger profit margins of extended and economically justified round trip activities, such as exporting and importing. Indeed, there is an offsetting benefit; to the extent the tax reduces exchange rate volatility, it reduces exchange rate risk and the need to incur hedging costs.

The annual tax revenue could be substantial. Preliminary estimates by professors David Felix and Ranjit Sau are that a 0.1% tax, applied to the 1995 global foreign exchange turnover of $307 trillion, using a range of elasticity assumptions and other adjustments, could have generated annual revenue of between $148 billion and $180 billion. They also estimated that the turnover volume would have declined between 20% and 30% as a result of the tax. Applying the same assumptions to the higher 1998 global foreign exchange turnover would raise the revenue figures by 24%.

The technical problems of enforcing the tax are intricate, but not insuperable. The tax collecting could be done by the existing taxing agencies of each participating country, with the revenue pooled and administered by a central authority created for that purpose, or by a reformed IMF. Participation in the currency transactions tax could be globalized by making it an additional requirement for remaining an IMF member in good standing.

To prevent curbing tax evasion by moving the foreign exchange transactions to tax-free havens, it has been proposed to use SWIFT, the world-wide inter-bank electronic payment system, plus the national electronic equivalents, to collect the tax. These systems are used for large value financial transactions between foreign exchange trading banks that collectively make up the so-called “wholesale” foreign exchange market. The orders and settlement of trades in these electronic systems are closely supervised by central banks, which under this proposal would collect the tax. Dealers would presumably pass the tax to their non-financial “retail” customers by widening the bid-ask spread [Schmidt, 2001].

How to ensure that the different types of cross-currency trades, from spot transactions to complicated over-the-counter derivative transactions, are taxed equitably has also elicited a variety of plausible suggestions. In other words, as regards the technical feasibility of the currency transactions tax, the positive indications are strong enough to warrant adding the tax to the official reform agenda for more in depth investigation.

Getting the currency transactions tax on the official agenda would bring to the fore other political problems, related to the fact that almost all the foreign exchange transactions subject to tax take place in a few financial centre countries. The foreign exchange markets of Britain, the US and Japan handled 56% of all global foreign exchange transactions in 1995, with Britain alone handling 30%. Adding Singapore and Hong Kong (13%), and Switzerland, Germany and France (14%), brings the total to 83% of all global transactions handled in the foreign exchange markets of eight countries. Ten smaller industrialized countries handled all but 2% of the remaining transactions.

This highly skewed tax collecting means that agreement between the G-7, Switzerland and China,

could make the currency transactions tax happen, but they would also dominate the setting of its terms, such as the minimum global tax rate, and the distribution of the tax revenue. Convincing the major countries of the case for a currency transactions tax is essential for getting the tax adopted on terms that advance the social goals for the global economy of its current supporters. This is a daunting task, though the increasing frequency of financial crises has brought pragmatic segments of the economic and political élites in many countries on board, increasing support for the tax.

2) A Fair and Transparent International Debt Arbitration and Bankruptcy Process

In the absence of bankruptcy laws, the incentive is strong for each creditor to rush to seize debtor assets before the others can, when the debtor firm encounters repayment difficulties. The rush results in the dismantling of firms which are experiencing merely liquidity problems that could be overcome if given time, and therefore leads to a larger aggregate loss to creditors as well as a haphazard distribution of the losses. Creditors as well as debtors thus have a joint interest in governmental mechanisms that would overcome the "free rider" problem and allow more orderly and rational debt workouts.

Over the decades this led in many economies to the buildup of bankruptcy laws and bankruptcy courts with the power to oversee such workouts. When creditors cannot all agree on the terms, the courts can enforce "standstill agreements" on creditors. These allow debtors to suspend part or all debt servicing for a period, during which creditors are required to keep rolling over their existing loans. The courts may also press for agreements that require creditors to take "haircuts," that is, agree to forgive some of the debt and share the losses. One of the many reasons the global economy is at a primitive and dangerous stage of development is that it lacks such global institutions for orderly, equitable workouts of international debts.

Instead what exist are partial ad hoc arrangements. Those handling intergovernmental debts in arrears could be considered relatively equitable and farsighted, compared to those dealing with debts incurred in the global financial markets. The Paris Club, a consortium of creditor governments set up to deal with arrears on government loans to developing countries, has generally been willing to extend maturities and adjust interest payments on such loans (although often on condition of adherence to IMF/World Bank programmes).

The Jubilee 2000 movement, which the ICFTU supported, managed to extract partial (although still inadequate) forgiveness of the foreign debts of some two dozen poor indebted countries, mostly in Africa, because the debts involved were all owed to foreign governments, the World Bank, and the IMF. The Heavily Indebted Poor Countries (HIPC) Initiative, through which the debt relief has been granted, is committed to granting debt reductions to a dozen more countries undergoing internal strife, once the situations in those countries are more stable.

On the other hand, the IMF-led bailouts of countries with commercial debt, the chief arrangement for adjudicating payment crises of those developing countries, have been focused on minimizing losses to the creditor banks and bondholders.

More recent IMF bailouts have, however, evoked an array of unofficial proposals for "bailing in" private creditors. Most of the proposals focus on two main themes: temporary debt "standstills" for developing countries in payment difficulties, and comprehensive rescheduling of debts to private lenders on the lines of the Paris Club programmes for intergovernmental debt. The ICFTU has supported both types of workout proposals.

The IMF has recently taken tentative steps in support. It has come out in favour of "collective action" clauses in bond contracts, which would allow holders of a majority of a bond issue to act on behalf of all the bondholders in negotiating workouts. In the payment arrears of Ecuador, Pakistan, and Ukraine, the IMF deliberately kept its bailout funds too low to cover full debt service in order to pressure the private creditors to come up with more funds. However, it remains to be seen if the features of these bailout packages, a shot across the bow of the bond markets, herald a full scale follow-through in the event of defaults by large debtors.

More significant has been the IMF's endorsement in principle of a form of "bankruptcy protection", involving a temporary moratorium on debt payments as debt restructuring agreements are worked out. The gradual financial collapse of Argentina in 2001, giving way to the largest debt default in history, demonstrated the urgency of such a mechanism. In late 2001 the proposal received support from two key quarters. First was a report of a large group of former developing country finance ministers, and then later the Treasury Secretary of the United States. After this, the IMF voiced its support for a Sovereign Debt Restructuring Mechanism (SDRM), providing for orderly negotiation to reduce or reschedule foreign debts while applying a standstill. For years, the IMF had previously dismissed such a measure.

The IMF's SDRM proposal, as well as earlier proposals put forward by trade unions and NGOs, all recognize that for the debt workouts to be orderly rather than disruptive, participation of the private creditors would have to be mandatory. This is because unilateral action by a single important developing country would probably produce panic in the bond markets and an across-the-board shutoff of new lending to other developing countries [Group of 22, 1998].

However the battle to put in place a debt restructuring arrangement is by no means won. Although the US Treasury Secretary voiced initial approval for an SDRM, other US government spokespersons later appeared to be backing off from this support; especially after several US private investment banks voiced their opposition.

In addition, many details of the IMF's proposal still have to be worked out. The ICFTU, along with some non-governmental organizations, have welcomed the fact that the IMF has at least opened a debate on the SDRM, but have been critical of some aspects of their proposed mechanism. Criticisms include the lack of transparency and opportunity for other "stakeholders" to intervene in the process and the long delay (up to three years) that the IMF states it will take to put this in place.

There has also been much criticism of the IMF's proposal, as enunciated in the Fund's first expressions of support for an SDRM in November 2001, to act as arbiter in administering the mechanism at the same time as usually being an important creditor. Among other things, the Fund would be empowered to set the conditions for debtors in arrears to merit favourable treatment. Unless the IMF changes its basic policies, its conditions are likely to run contrary to key components of this plan. However, in response to the criticism, later publications released by the Fund in April 2002 presented alternative approaches in which the IMF would play a more limited role in the operation of the mechanism.

3) Closer Co-ordination of Major Currencies and Target Zoning

Limiting fluctuations between the dollar, euro and yen exchange rates could be a loose equivalent to the fixed dollar price of gold that had anchored the Bretton Woods exchange rate regime. The three currencies are the dominant "vehicle" currencies today. Prices of many internationally traded commodities are quoted in one of the three, international financial settlements are via one of the three, and official foreign exchange reserves are held in one or more of the three. Limiting the volatility of the Big Three exchange rates would substantially reduce the exchange rate risk that haunts international trade and finance.

To achieve this, the monetary authorities of the US, Europe, and Japan would have to agree on exchange rate midpoints and on upper and lower limits to fluctuations of the market rates around the midpoints. Enforcement would require the Big Three central banks to coordinate their buying and selling of the three currencies in the foreign exchange market to keep fluctuations within the chosen limits. To provide more flexibility, the arrangement would need to include a mechanism for adjusting the midpoint rates when confronted with major alterations in trading or other economic conditions. This also follows the Bretton Woods model, which permitted countries to move to a new fixed exchange rate when confronted with a "fundamental disequilibrium".

Political and economic tradeoffs are involved. Setting narrower limits would demand closer coordination of domestic interest rates by the Big Three. Setting wider limits reduces the interest rate coordination requirements, but allows more currency speculation and exchange rate risk to persist. If implemented together with a coordinated currency transactions tax, that would make narrow limits more economically as well

as politically feasible. The tax would make currency speculation more costly, and the accumulated tax revenue could be devoted in part to reinforce the market interventions of the Big Three central banks to keep exchange rate fluctuations within the desired limits. And as illustrated previously, the tax would also ease the interest rate coordination required to protect the limits.

Currently, there are more overt indicators of support at the G-7 level for a target zone than for the Tobin tax. At certain meetings of the G-7 finance ministers, the French, German, and Japanese ministers apparently sought to put target zoning on the agenda. However the United States has not agreed to open a discussion on exchange rate coordination.

Nevertheless, ad hoc collective interventions in the currency markets have been occurring with US participation. And the demand from the non-financial business sector for more stable real exchange rates, which motivates such intervention, could become a powerful political force for target zoning. The large swings in real exchange rates shown in Table 6 have been generating large swings in the profits and competitive positions of exporters, importers, and import-competing firms. Even multinational corporations that produce and outsource in various currency locales have not been exempt from adverse effects of such swings.

A major factor in the upsurge of foreign direct investment in the past two decades has been multinationals slicing up the production chain and outsourcing segments around the world where costs — primarily labour costs — are cheapest. But unexpected mid-term swings of the real exchange rates, which also alter relative labour costs between different locales unexpectedly, confound investment decisions. That helped generate the global excess capacity problems that have afflicted the automotive, micro-chip and other industries dominated by multinational corporations. Rising interest in target zoning could also arouse non-financial business interest in the currency transactions tax as a facilitating mechanism.

4) Stabilizing Finance: Tougher Reserve Requirements for Banks

During the 1990s, recurring bouts of global instability prompted repeated calls for a new architecture of international finance. However the debate over new architecture has focused almost exclusively on the structural deficiencies of developing-country capital markets and on international financial transactions with these countries. As a result, three crucial and somewhat self-evident points tend to be overlooked.

- Financial markets in industrialized countries provide the resources that fuel the global system. Instability in these enormous markets poses the greatest potential threat to systemic soundness. And developed country markets have grown increasingly fragile as a consequence of widespread financial innovation and relentless deregulation.

- Measures that improve developing-country financial systems are desirable on their own terms and may very well render the global system somewhat more sound. But they cannot address the dangers posed by turmoil in industrialized country financial markets.

- Restoring global soundness requires the reconstruction of a coherent, comprehensive regulatory framework for these highly advanced and vulnerable markets.

The concept of asset-based reserve requirements (ABRR) could provide a possible tool in such a framework. Ultimately, financial instability arises when lenders and investors acquire assets without proper regard to risk. By varying the level of reserve requirements on asset categories, monetary authorities could adjust the relative attractiveness of various holdings, thereby discouraging unduly risky portfolio choices.

Central banks could apply this framework to **all** financial intermediaries on the basis of the assets they hold, rather than having different requirements for different corporate forms (e.g. banks, securities firms, finance companies). This would create a level playing field and remove incentives for customers to shift business from one intermediary to another — or for intermediaries to shuffle activities among their affiliates — simply to evade regulatory costs.

Equally important, a system of ABRR could provide central banks with additional tools at a time when financial innovation and the relative shrinkage of the banking sector are blunting the power of monetary poli-

cy. In an era when monetary authorities are being asked to do more with less in terms of ensuring stability and prosperity, ABRR could make crucial contributions to the conduct of macro-economic policy.

In the domestic context, a system of ABRR has both macroeconomic and microeconomic advantages. At the macroeconomic level, it can provide central bankers with additional policy instruments to contend effectively with phenomena like asset price inflation. At the microeconomic level, it possesses important stability properties that can remedy sectoral imbalances as they begin to emerge. Moreover, levying reserve requirements on domestic financial firms' international investments can also contribute to greater global financial stability.

In the process of levelling up the regulatory playing field, a system of ABRR could strengthen oversight of the asset side of financial firms' balance sheets. Under the existing system, prudential supervisors continuously monitor credit quality, frequently encourage regulated firms to maintain strong internal controls and sometimes berate or discipline banks when troublesome lending patterns emerge. However, these actions are firm-specific rather than economy-wide, restricted to regulated entities and typically focused on problems that have already emerged.

By contrast, a system of ABRR could apply to the entire financial sector and could prevent asset allocation problems before they gather steam. These new rules would confront the fact that excessive concentrations of balance sheet risk constitute the real source of financial fragility today. With deposit insurance, as is used currently, runs on financial systems no longer result from herd behaviour by scared depositors, but instead reflect investor beliefs about the inadequacy of the systems' underlying assets.

An ABRR system requires financial firms to hold reserves against each class of asset, with the regulatory authority setting reserve requirements on the basis of its concerns with each asset class. One concern may be that the asset class is too risky; another may be that the asset class is expanding too fast and producing inflated asset prices. By forcing financial firms to hold reserves, the system requires that they retain some of their funds in the form of non-interest-bearing deposits with the central bank. The implicit cost of foregone interest must be charged against investing in a particular asset category, and it reduces the marginal revenue from that asset type. As a result, financial firms reduce their holdings of the relatively less-profitable asset type and shift funds into other asset categories that have become relatively more profitable.

5) Chilean Style "Speed Bumps"

In the wake of recent financial crises, there has been a surge of interest in how to stabilize global financial markets. One policy suggestion that has been received with increasing attention is that of establishing Chilean-style "speed bumps." Paradoxically, Chile committed itself to eliminating these controls just when interest in the international community increased to the point of viewing them as a valuable institution for tempering inflows of volatile short-term capital. Chile's decision to remove the controls came after years of pressure from the IMF and from industrialized countries, in particular during trade negotiations.

The Chilean "speed bumps" are a form of temporary capital controls aimed at discouraging inflows of short-term capital. They were employed in Chile for a period in the early 1990s. In most cases, these regulations require the capital inflows to remain in the target country for a specific time; in Chile's case it was 12 months. They can be contrasted with traditional capital controls, such as those imposed by Malaysia in 1998, which are aimed at preventing outflows of capital. The "speed bumps" can embody a number of different features, including:

- A requirement that capital in-flows stay for a given duration;
- Placement of a temporary, non-interest bearing, reserve requirement on all capital inflows, that is refunded after a specified period;
- Payment of a penalty in the event that a capital inflow reverses within a given period.

The purpose of these kinds of measures is to discourage short-term speculative investment that can have a destabilizing effect on the national economy. At the same time, these measures do not hinder longer-term

investment in productive capacity.

6) Core Labour Standards and Social Protection in the Operations of the IMF and World Bank

The World Bank's World Development Report 2000/2001 contends that real sustained achievements in poverty reduction require the empowerment of the poor, including the creation of strong civil society organizations, the building of alliances between the poor and the non-poor, and genuine participatory democracy. This recognition has led to the requirement (not always implemented, unfortunately) that Bank- and IMF-sponsored poverty reduction strategy papers (PRSPs) — which all member countries receiving debt relief or concessionary loans must prepare — must be based on civil society consultation [ICFTU, 2001].

An obvious pre-requisite for all of these necessary steps towards poverty reduction is the right for the poor and underprivileged to organize themselves. That is why freedom of association and the right to collective bargaining, which both institutions have endorsed in principle, are key elements for successful poverty reduction strategies. The IMF and World Bank must promote these rights regularly and consistently in all of their operations.

Trade unions have welcomed pronouncements from the IMF and World Bank endorsing core labour standards, that is, the prohibition of forced labour and discrimination, the elimination of child labour, and respect of freedom of association and right to collective bargaining. The institutions have done so in order to be consistent with their poverty-reduction mandates, acknowledging that labour is often poor people's main or only asset, and that respect for fundamental labour rights is key to allowing the poor to benefit more fully form this asset.

Despite these positive pronouncements in favour of the core labour standards, conditions on loans or country-level policy advice proffered by the IMF and World Bank frequently include elements that, in effect, demand that countries violate the core labour standards. For example, IMF policy advice often includes recommendations that governments should act to lower wage levels, even in low-wage countries, an action than can contribute to the proliferation of child labour (when adult wages don't provide the means for a family to survive on). Both the IMF and World Bank often advise governments to introduce measures to enhance "labour market flexibility" by restricting the scope of collective bargaining. Both examples constitute violations of the core labour standards.

If the endorsement of the core labour standards by the IMF and World Bank is to mean anything, both institutions must ensure that their interventions are consistent with this endorsement. Both institutions have recognized that respect of the core labour standards is an essential part of the poverty reduction process. In addition, cross-country comparisons show that respect of core labour standards correlate strongly with financial stability [Palley, 2001]. Promotion of core labour standards is therefore perfectly consistent with one of the IMF's fundamental missions, which is to promote financial stability. Likewise, respect of core labour standards must become part of all World Bank operations, as mandatory elements of the Bank's standard bidding document and as part of other contractual documentation.

Another important element in achieving stable growth and long-term poverty reduction is the establishment of social safety nets that provide a basic income and maintain access to essential services when workers lose their jobs. IMF-imposed austerity programmes often require that, in order to achieve specified fiscal targets, countries in economic difficulty slash spending on social protection precisely when it is needed most. The IMF and World Bank should ensure that adequate social protection measures are put in place before crises occur, and that funding for the programmes is maintained even if, because of economic difficulties, countries are obliged to incur temporary budget overruns.

7) Seeking Diversification of Economic Activity Based on Domestic Demand

For decades, the IMF and World Bank and major industrialized country governments have promoted to developing countries the model of export-led industrialization, whereby foreign and domestic investors build manufacturing plants or agribusiness enterprises where one of the primary competitive tools is low labour costs. Instead of such a crude export strategy, countries should seek a greater diversification of national economic activity based on domestic demand. Such a pattern of demand-led growth entails allowing workers to win the wages necessary to fuel such demand. Labour standards and social safety nets have a vital role in promoting faster, more stable growth.

The push towards export-led growth has particularly intensified since the early 1980s, when this model became a key component of structural adjustment policies pushed by both the IMF and World Bank. Though developing country economies have grown as a whole, many have grown slowly and others not at all, particularly when economies have specialized in the production and export of commodities whose prices have declined. Indeed, the UNDP has said that 66 developing countries ended the 1990s poorer than when they began.

Export-led growth has created a dependence on markets in the developed world that replicates many of the problems of the earlier "plantation" model of development in the Asian and African colonies of the European powers. By forcing countries to shift ever more of their output onto global markets, the export-led growth model aggravates the long-standing trend deterioration in developing country terms of trade. There is even a vicious circle dimension to this problem, with declining terms of trade exacerbating the underlying problem of export-led growth. Thus, falling prices compel developing countries to export even more, thereby compounding the problem of falling prices. This vicious circle has long been visible for producers of primary products. Now, as a result of the transfer of manufacturing capacity to developing countries that lack the capacity to buy their own output, it may also be present in all but highest-end manufacturing.

This vicious circle also interacts with developing countries' debt service and repayment problems. These countries borrow in hard currency, and deteriorating terms of trade make it even harder for them to earn the currency needed to service their debts. This in turn forces them to export even more, thereby aggravating the underlying terms of trade problems.

Side by side with these negative effects, the export-led growth model has also had negative impacts in the developing economies by causing job loss and wage competition. The addition of developing country capacity to existing global supply, without any commensurate increase in demand, inevitably leads to a situation of demand shortage and excess capacity. This inevitably generates pressures to cut wages and benefits in other labour markets, particularly those of other developing countries, as a means of competing.

These features of export-led growth suggest that it risks imparting a deflationary bias to the global economy. A sustainability problem arises because, by definition, one country's exports are another's imports. Thus, whereas one country can successfully pursue an export-led strategy (as Japan did in the period 1950 to 1980), all cannot because all countries cannot run trade surpluses. If all try to do so, the inevitable outcome is a global shortage of demand, and such a condition is a reasonable characterization of the recent global economic environment in which much of the world has been either in recession or growing below potential.

The global demand problematic associated with export-led growth has strong implications for the stability of global financial markets. For the near future, developing countries will continue to be net borrowers on global capital markets as they seek to industrialize. Yet a global regime of export-led growth implies that sufficiency of demand will continue to be a problem, which implies that balance of payments and currency crises will remain a persistent danger. In such an environment, countries that find themselves short of demand will have an incentive to resort to currency depreciation as a means of gaining international competitive advantage. This threatens to revive the dangerous process of competitive devaluation that was so destructive in the 1930s.

The contradictions inherent in a global export-led growth regime compel a need to shift the stance

of development towards a path incorporating domestic demand-led growth. Regional integration and cooperation agreements between countries can certainly be consistent with such a strategy. The strategy requires rising wages and a less unequal distribution of national income to support domestic consumption. However, it is exactly this outcome that is blocked by the model of globalization promoted by the IMF and World Bank.

To embark on a new path, a "levelling" of the economic playing field between business and labour is needed, for in the absence of such a levelling, labour will be unable to win the wages necessary to support domestic demand-led growth. Part of the remedy lies in respect of the core labour standards, which, by allowing for the formation of genuine trade unions that bargain collectively with employers, can contribute to a more equitable system of income distribution in the country.

8) Strengthening Capital Controls

An efficiently functioning global economy needs a system that allows exchange rates to alter when justified by fundamental economic changes, while limiting capital mobility. The form of floating exchange rate system applied in the 1970s worked in just such a way. But it was discontinued due to the particular problems of that decade, including generalized high inflation and extreme exchange rate volatility. However, these problems were more the result of the OPEC oil crisis and other factors rather than the exchange rate system.

Foreign exchange market speculation and volatility is not the result of flexible exchange rates. Rather, it is the result of excessive capital mobility, which has allowed financial capital to flow around the world in search of quick speculative gains. This has transformed foreign exchange markets into financial asset markets, so that exchange rates are no longer driven by the needs of trade finance.

Similarly, the incentive for governments to pursue contractionary policies is not driven by flexible exchange rates. Once again, excessive capital mobility is the problem since it exposes governments that pursue expansionary policies to the risk of being chastized by capital flight and facing a sell off in bond and foreign exchange markets.

Restoring controls on financial capital mobility would put an end to many of these problems, which some countries have attempted to respond to by maintained fixed exchange rates. At the same time, retaining flexible exchange rates would mean that there is an automatic system for correcting trade imbalances. This adjustment mechanism would not be contractionary, because it would merely involve a change in the price at which one currency is exchanged for another. Moreover, governments could pursue expansionary policies without risking punishment by capital flight.

The dominance of economic thinking in which unfettered free markets are considered to be the only legitimate policy objective has misguided many people to believe that capital controls are wrong and unnatural. But the abolition of these controls has not created efficient international financial markets; it has merely created markets in which financial capital is dominant. Some have argued that capital controls cannot be implemented in today's global economy. But financial capital moves through the banking system, and wherever it moves, it leaves a footprint in the form of a transactions record. Consequently, capital controls are not only desirable but feasible. The following are policy proposals which governments can apply on a national level:

- Domestic governments around the globe should strengthen their own regulatory procedures to enforce laws against corruption or illegal speculation, and introduce limits to short-term foreign currency exposure, and controls and certification of derivatives trading and other forms of highly leveraged investment.
- The destabilizing influence of foreign inflows of hot money could be neutralized by imposing a minimum required stay.
- Rapid devaluations of currency are often provoked by the sale of large amounts of currency by individuals and corporations in the expectation that the value will fall, a practice know as "short

selling". Short sales of currency could be subject to a requirement that they be accompanied by a non-interest-bearing deposit with the central bank equal to 50 percent of the short sale. Having sellers make a non-interest bearing deposit would raise the cost of speculating against a currency and therefore discourage the practice. This regulation would apply to foreign subsidiaries located in a country as well as to subsidiaries and affiliates of corporate nationals located abroad.

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Annex: Tables

Table 1

Global Growth of GDP: Floating Rates and Capital Decontrol Decades Compared to 1960-1971

	1972-81		1982-91		1992-98	
Total sample of countries	Number of countries	%	Number of countries	%	Number of countries	%
Growth higher than 1960-71	17	32.1	5	9.4	10	18.9
“ lower “ “	36	67.9	48	90.6	43	81.1
Less oil-exporting countries						
Growth higher than 1960-71	11	25.0	4	9.1	10	22.7
“ lower “ “	33	75.0	40	90.9	34	77.3

[a] Oil Exporters : Algeria, Ecuador, Egypt, Indonesia, Mexico, Nigeria, Norway, United Kingdom, Venezuela

Source: World Bank, World Tables.

Table 2

Annual Growth of Gross Fixed Investment at Constant Prices, 1959-97

(Percentages)

	G-7 Countries	OECD Countries
1959-71	6.1	6.0
1972-84	2.5	2.3
1985-97	3.6	3.7

Source: OECD. Economic Outlook Annex Tables, various issues.

Table 3

Annual Growth of Exports of Goods and Services at Constant Prices, and Ratios of Export to GDP Growth, 1959-97

A. Average Annual Export Growth[a]

	G-7 Countries	OECD Countries	World
		(Percentages)	
1959-71	7.8	8.5	8.2
1972-84	6.2	6.3	7.6
1985-97	6.6	6.7	5.9

B. Ratio of Export to GDP Growth[a]

	G-7 Countries	OECD Countries
1959-71	1.7	1.8
1972-84	2.1	2.3
1985-97	2.5	2.5

[a]G-7 and OECD data are weighted averages, using relative GDP as weights. World Exports for 1959-74 are deflated by the average of U.S. imports and export price indices, for 1975-97 by the IMF unit export value index.

Source: OECD Economic Outlook Annex Tables, various issues, and IMF International Financial Statistics, various issues.

Table 4

Annual Productivity Growth of the OECD Business Sector, 1960-97

	Labor Productivity			Total Factor Productivity		
	1960-73	1973-79	1979-97	1960-73	1973-79	1979-97
	(percentages)					
G-7 Countries	4.5	1.6	1.4	3.1	0.7	0.8
Other OECD Countries	5.0	3.1	2.6	2.9	1.2	1.4
All OECD Countries	4.6	1.8	1.6	3.0	0.8	0.9

Source: OECD, Economic Outlook, June, 1999, Annex Table 59.

Table 5

Ratios of Annual Global Foreign Exchange Turnover to Global Exports and Official Reserves[a], 1977-1998

	Annual Forex Turnover	Forex/Exports	Global Reserves/Exports	Reserves to Daily Forex Turnover
	(US$ trillions)	(Ratios)	(Ratios)	(Ratios)
1998	380.2	67.8	0.29	1.0
1986	67.5	33.9	0.28	2.0
1977	4.6	3.5	0.23	16.2

Memorandum Item	1961-65	1966-70
1. Global Reserves/exports	0.43	0.32

[a]Reserves include official gold holdings.

Sources

Bank for International Settlements, Central Bank Survey of Foreign Exchange Activities, triannual surveys, 1986-1998. Daily turnover data multiplied by 250 trading days.

U.S. Federal Reserve Bank of New York, Summary of Results of the U.S. Foreign Exchange Market Turnover, (New York, September, 1992), U.S. 1977 estimate divided by 0.17, the average U.S. share of global turnover computed from the BIS surveys.

International Monetary Fund, International Financial Statistics, various issues.

Table 6

Decade Variation and Annual Volatility of Real Exchange Rates, since 1970(1) by Developed and Developing Country Groups

(1970-1979 mean rates=100)

	1970-1979			1980-1989			1990-1999		
	Mean	Range	Coef. Of Var.	Mean	Range	Coef. Of Var.	Mean	Range	Coef. Of Var.
I. Developed Countries									
1. United States	100.00	0.2153	0.0742	107.66	0.3478	0.1205	100.47	0.1836	0.0628
2. U.S., Germany, Japan	100.00	0.1716	0.0577	102.76	0.2659	0.0930	105.32	0.1844	0.0635
3. Euroland (2)	100.00	0.2184	0.0738	93.91	0.1794	0.0719	96.64	0.1487	0.0486
4. Others(3)	100.00	0.1845	0.0628	104.28	0.1811	0.0559	110.55	0.1814	0.0506
5. Overall Average	100.00	0.1975	0.0671	102.15	0.2436	0.0859	103.24	0.1745	0.0564
II. Developing Countries									
1. Asia(4)	100.00	0.3375	0.1178	94.13	0.3515	0.1785	78.59	0.2876	0.1123
2. Latin America(5)	100.00	0.2424	0.0786	97.91	0.6043	0.2888	94.93	0.3325	0.1329
3. Middle East-Africa(6)	100.00	0.7053	0.2535	125.67	0.5389	0.3171	109.62	0.5173	0.2904
4. Overall Average	100.00	0.4284	0.1500	105.90	0.4982	0.2673	94.38	0.3791	0.1882

Footnotes:

(1) Tradeweighted Indices

(2) Euroland: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Spain

(3) Others: Australia, Canada, Denmark, New Zealand, Norway, Sweden, Switzerland, United Kingdom

(4) Asia: Hong Kong, India, Indonesia, Korea, Malaysa, Pakistan, Philippines, Singapore, Taiwan, Thailand

(5) Latin America: Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Venezuela

(6) Middle East-Africa: Kuwait, Morocco, Nigeria, Saudi Arabia, South Africa, Turkey

Source: Morgan Guarantee Trust Co., World Financial Markets

Table 7

Real Long Term Interest Rates[1] Divided by Real GDP Growth Rates of the G-7 Countries: Thirteen Year Averages, 1959-97

	Canada	France	Germany	Italy	Japan	U.K.	U.S	G-7 Average
1959-1971	0.65	0.22	0.88	0.49	n.a.	0.71	0.59	0.55
1972-1984	0.63	0.80	1.42	-0.24	0.29	-0.11	0.52	0.47
1985-1997	3.26	2.86	2.35	3.75	0.90	1.63	1.67	2.34

Memorandum: Pre-1959 G-7 Average Ratios

1881-1913	0.97
1919-1939	2.40
1946-1958	0.36

[1]Annual interest rates on 10 year government bonds deflated by national CPI.

Sources: Interest rates and CPIs from IMF, International Financial Statistics. Real GDP growth rates from OECD, Economic Outlook Annex tables. Pre-1959 data from Michael Bordo, "The Bretton Woods International Monetary System: An Historical Overview," Table 1, in Michael Bordo and Barry Eichengreen eds. A Retrospective on the Bretton Woods System, (University of Chicago Press, 1993). With the Real GDP per capita growth rates in that table multiplied by population growth rates.

Table 8

Annual Rates of Unemployment and the Growth of Real Wages and GDP per Capita in the United States and the European Union, 1960-2000

	Unemployment Rate		Real Wage Growth (percentages)		GDP per Capita Growth	
	U.S.	E.U.	U.S.	E.U.	U.S	E.U.
1960-73	4.81	2.35	1.45	2.09	2.72	4.76
1974-79	6.68	4.57	0.03	5.30	1.62	2.52
1980-89	7.16	9.23	-0.85	3.32	1.49	2.23
1990-95	6.32	9.85	-0.68	1.07	0.85	1.55
1996-2000	4.62	9.82	1.60	1.02	2.48	2.05

Sources: Sheldon Friedman and Christian Weller “One More Time: Labor Market
Flexibility, Aggregate Demand and Comparative Employment Growth in the U.S. and Europe, Economic Policy Papeer E011, Afl-CIO Public Policy Department, Washington, D.C. 1998,. Tables 1,8,10. O.E.C.D. Economic Outlook June, 2000, Tables 1,12,16,21.

Table 9

Trends in Wage Earnings Inequality in the U.S. and Europe, 1980-95*

	Early 1980s		Mid-1990s		Change 1980-1995	
	50/10	90/50	50/10	90/50	50/10	90/50
France	1.67	1.94	1.65	1.99	-2	+5
Germany	1.65	1.63	1.44	1.61	-21	-2
Italy	1.96	1.50	1.75	1.60	-21	-10
Sweden	1.30	1.57	1.34	1.59	+4	+2
United Kingdom	1.69	1.65	1.81	1.87	+12	+22
United States	1.78	1.96	2.00	2.21	+22	+25

*Measured as the ratio of the earnings of the 50th percentile worker to those of the 10th percentile worker (50/10), and of the earnings of the 90th percentile worker to those of the 50th percentile worker.(90/50).

Source:Lawrence Mishel, Jared Bernstein, and John Schmitt, The State of Working America, 1996-97 Economic Policy Institute, Armonk, N.Y., M.E, Sharpe, 1998. Table 8.10.