TOWARD A NEW INTERNATIONAL ECONOMIC ORDER: GOODBYE WASHINGTON CONSENSUS, HELLO WASHINGTON ALTERNATIVE

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The financial crisis which started in east Asia in mid-1997 has continued to spread throughout 1998. Russia has undergone a financial collapse. Brazil has been hit by the financial wobbles, and has had to raise interest rates to a level which will ensure a 1999 recession there and in the rest of Latin America. The same also holds for South Africa, which is Africa's largest economy.

At the beginning of this year east Asia's woes were viewed by many as having little consequence for the U.S. economy. Indeed, Chairman Greenspan even mused that it might be "salutary" in that it would slightly restrain economic activity, thereby avoiding the need for the Federal Reserve to raise interest rates. This Panglossian view has now dissipated, and with recent moves by the Fed to cut the federal funds rate by three quarters of a percent has come official recognition that the troubles sparked by east Asia's financial collapse pose a real danger to U.S. economic well-being.

The crisis and its subsequent spread have raised two distinct sets of issues. One set of issues has concerned how to react immediately to the crisis and prevent it from deepening. Here, the focus has been on the appropriateness of the IMF's policy recommendations for east Asia and the need for global reflation. The IMF initially recommended a dose of fiscal and monetary austerity in the afflicted economies (Thailand, South Korea, and Indonesia), while the Federal Reserve viewed the crisis as exclusively regional in impact. The IMF's policies threatened to worsen east Asia's deflation, and it has now been grudgingly compelled to allow east Asian governments to run deficits, and interest rates have also been lowered somewhat. Meanwhile, the Fed has grudgingly come to recognize the U.S. economy's own exposure to east Asia's misfortune, and it has cut interest rates. However, there is a real danger of Federal Reserve policy being a matter of "too little, too late." In particular, the Fed continues to claim that rates cut have been needed to calm financial markets which indicates it may not yet have recognized the scale of weakening global demand.

A second set of issues concerns the structure of the international economic order. Here, the question is to what extent are fundamental flaws in the structure responsible for the crisis, and to what extent are they responsible for the trend slow down in economic development and worsening of global income distribution.

This second set of issues is at the heart of the debate over the international financial architecture, and its resolution will critically determine the path of future prosperity. Though IMF policy in east Asia and Federal Reserve interest rate policy have both shifted in a more expansionary direction, this advance risks being short lived unless accompanied by recognition of the fundamentally flawed character of the existing global economic order. This is because the thinking that gave rise to the IMF's initial mistaken diagnosis of and prescription for east Asia's collapse is the same thinking that has guided the construction of the existing order.

Absent a rejection of this thinking, the world economy will remain brutally exposed to unstable deflationary forces, while policy makers will ineluctably be drawn back toward policies of contraction. Indeed, this is already evident in Brazil, where IMF sponsored high interest rates and fiscal austerity may manage to save the Brazilian currency, but only at the cost of deep recession. Moreover, this in turn threatens to pull down the Argentine economy. The lesson is clear: applied to enough countries, IMF contractionary policies will trigger a global recession.

The differences in thinking regarding the validity of the existing global economic order are reflected in disagreements over the interpretation of the current crisis. On one hand, there is the IMF-Treasury view which interprets it as a narrow crisis of international financial markets: hence, Treasury Secretary Rubin's call to "modernize the architecture of the international financial markets." On the other hand there is a view that reads the situation as a full-fledged crisis of globalization that has revealed deep flaws in the design of the existing global economic order.

The narrow financial markets crisis view is promoted by supporters of the "Washington Consensus" which has dominated economic policy making for the last twenty years. It maintains that global economic growth is best furthered by more open trade, export-led growth, greater deregulation, and more liberalized financial markets. It is epitomized by the IMF, which has sought to characterize the crisis as resulting from inadequate financial transparency, and in the aftermath of the crisis the IMF has actually called for greater liberalization of international financial capital flows. All that is required is a minor tune-up of the international financial system, combined with some learning from experience. Thus, "sequencing of reforms" has become a hot new issue, the argument being that countries like South Korea engaged in wrong sequencing whereby they mistakenly liberalized short term capital flows before long term flows. Learning means that policy makers will not make this mistake next time, but meanwhile the underlying recommendations of the Washington consensus remain correct.

The Treasury view is a blood cousin of that of the IMF. Both the Treasury and the IMF were slow to recognize that east Asia's troubles were triggered by a bank run that had foreign investors rushing to repatriate funds. They therefore both initially supported mistaken policies of economic austerity predicated upon high interest rates, government spending cuts and higher taxes. Since then, both have reversed these policy prescriptions to a significant degree. However, they continue to see the long run solution in terms of limited financial market reforms. Thus, Secretary Rubin's claim that "(T)hese reform programs have at their core strengthening financial systems, improving transparency and supervision, eliminating the inter-relationships between banks, the government, and commercial entities, opening capital markets, and appropriate monetary and fiscal policies."

A view that straddles the debate is that of Jeffrey Sachs. Sachs was one of the early architects of Washington consensus "shock" therapy in eastern Europe, the premise of which was that the old command style economies had to be opened to the bracing wind of the market by rapid privatization and deregulation. However, he has broken with the Washington Consensus over east Asia's crisis, and was one of the first to point out that austerity was the wrong response to a bank run.

A key difference between the IMF-Treasury view and Sachs concerns the relationship between stabilization and growth. All are for growth. However, the IMF-Treasury view maintains that stabilization must come first, and only then will growth be possible; hence, the inclination to high interest rates and fiscal austerity to placate financial markets. Sachs implicitly argues that stabilization is not possible without growth. Policy makers must therefore focus on jump starting the world economy through a variety of initiatives from coordinated interest rate cuts to debt relief and development assistance.

This growth versus stabilization difference is important, but in all other regards Sachs shares the Washington consensus. In particular, he is committed to "fast track" style free trade which fosters an international race to the bottom. International wage competition and shifting of jobs in response to cross-country differences in work place and environmental standards are legitimate dimensions of free trade. At the macroeconomic level, export-led growth which has countries relying on foreign demand to ensure full employment, is also legitimate. Moreover, this is so even if exports are achieved through reliance on depreciated currencies.

Whereas proponents of the Washington consensus think that the existing model of globalization merely needs a tune-up, there is a "Washington alternative" which thinks the model fundamentally unsound. The issue is not one of recalibrating the model, but rather one of designing a new model that is stable, equitable, and pro-growth. For the last fifteen years, the Washington consensus approach has dominated, yet global economic growth has been slower and inequality has risen. In industrialized countries, wages have stagnated, workers are working longer hours, and there has been an increase in job insecurity. Rather than being an isolated event, east Asia's financial crisis represents one more in a succession of crises. As World Bank chief economist Joseph Stiglitz puts it, the world economy has been having "a boom in busts."

At the most abstract level, the Washington alternative challenges the notion that markets and the process of globalization are natural phenomena that are to be fatalistically accepted. Thus, John Sweeney, President of the AFL-CIO, has said "The global economy is not a natural outgrowth of the workings of an invisible hand. It is an act of man, not of god." All markets and all economies operate on rules, and this applies as much to the markets that have been fashioned by the Washington consensus as it did to markets fashioned under the New Deal. The problem is that the new global economy has been made to benefit some at the expense of others. Thus, President Sweeney notes that it has been "created by government muscle, welded behind closed doors, largely on behalf of the most powerful corporate and financial interests."

The Washington alternative also seeks to modernize the financial architecture, and it also sees the restoration of expansionary demand conditions as critical to restoring stability and growth. In this, it shares elements with both the Treasury - IMF and the Sachs views. However, that said, it maintains that these measures are nothing near enough. Instead, they are but part of a more fundamental reconfiguration of the international economic order. The conversation cannot be narrowly restricted to discussion of financial markets. Trade, finance, economic growth, and income distribution are all intimately connected, and this means much more must be on the table.

Though notionally agreeing on the need for a new financial architecture, discussion of specifics quickly reveals fundamental differences. The Washington consensus seeks more capital liberalization, more financial transparency and disclosure, and more IMF market surveillance: the claim is that more daylight and more market openness will ensure that market discipline produces efficiency and stability. The Washington alternative says that more financial transparency and disclosure are indeed needed, but there is also a need to reduce speculation and get investors to invest with an eye to the long term and with proper regard to risk. Measures such as Tobin taxes (which tax buying and selling in currency markets) that reduce currency speculation, and Chilean style speed bumps that oblige investors to commit for a minimum time period, are also needed. To the Washington consensus these are interventions that distort the market's natural rythms: to the Washington alternative these are rules that harness the strengths of markets for the benefits of all.

There is also notional agreement on the need to strengthen demand conditions to foster growth, but again there is fundamental disagreement on the specifics. Thus, whereas the Washington consensus sees export-led growth as a solution to each country's demand problem, the Washington alternative sees it as a source of deflation. Export-led growth must be replaced with domestic demand-led growth. One country's exports are another country's imports which means that all can not rely on export-led growth. Attempts to do so result in a beggar-thy-neighbour world that risks plunging the global economy into a deflationary spiral. The way out is domestic demand-led growth. This is a strategy that lifts all boats since demand growth in one country pulls in exports from others, so that all grow together.

Achieving domestic demand-led growth in turn requires strengthening domestic demand, and this brings to the fore even deeper divisions between the Washington consensus and the Washington alternative. Growing domestic demand calls for rising wages to support domestic consumption, and achieving this will require restoring the balance of power between capital and labor. Core labor standards that give workers rights of free association allowing them to form unions and bargain collectively are essential. Rather than being a market distortion, independent trade unions are the private sector solution to the imbalance of power created by capital's new found ability to roam the globe in search of the cheapest most exploitable workers.

The intelligence and humanity that mark Treasury Secretary Rubin have placed him on record as supporting such core labor standards and human rights for ethical reasons, but the problem is that this issue remains peripheral in the Treasury's economic construction of the current crisis. The reality is that it is central: escaping the trap of export-led growth and making globalization work for all can only happen if the playing field between workers and capital is levelled.

Moreover, there is another reason why human rights, labor rights, and strong independent trade unions are vital. The IMF has emphasized the problem of political corruption and economic cronyism which has given rise to misallocation of borrowed resources. It has proposed solving this problem through increased market discipline imposed by increased financial transparency and increased financial liberalization. The argument is that market competition will compete cronyism away. This belief is mistaken. The reality is that these behaviors are politically sponsored, and changing them requires political reform. This in turn requires putting in place countervailing forces that can block such behavior. Human and labor rights that give workers the right of free association and confer the ability to organize independent trade unions, are the foundation of such reforms. Strong well-functioning democracy is needed to prevent economic cronyism, and unions are an essential ingredient for such an outcome.

Debt relief for developing countries is another measure that can help shift the world economy toward a path of domestic demand-led growth. Debt service burdens now hinder much of the developing world from following an equitable pro-growth agenda. They also force the third world to focus on export-led growth, which has contributed to deteriorating terms of trade, as well as causing job loss in developed countries. Debt relief is a means out of this box.

What is true for workers also holds for governments. Just as footloose capital is able to threaten workers, so too it can threaten governments. As a result of their increased mobility, corporations are increasingly able to win tax exemptions by threatening to move jobs overseas. This has contributed to shifting the tax burden on to working households. The same process threatens to undermine environmental and work place safety standards. Thus, with business perceiving these measures as a cost, the threat of relocation will be used to get such standards repealed. This is the hallmark of race to the bottom that has been unleashed by globalization Washington consensus style.

The Washington alternative seeks to remake the globalization process in a way that addresses these problems. Opponents call it interventionist and protectionist. The reality is that it embraces open markets when the rules have been designed such that there is a level playing field between workers and capital, and when business cannot engage in competition that puts work place and environmental standards in play.

East Asia's crisis has provided an opportunity to break with the Washington consensus and replace it with the Washington alternative. This alternative can shift the global economy away from its current path of deflation and rising inequality, back on to an earlier path of equitable growth with full employment. It is time to say goodbye Washington, hello Washington alternative.