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International Finance and Global Deflation: There is an Alternative

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Introduction

It is often said that geologists learn most about the earth's crust from extreme events such as earthquakes and volcanoes. A similar principle likely applies for economists, and it is illustrated by the financial crisis which erupted in east Asia in mid-1997.

The crisis and the IMF's initial response revealed two important things. First, the new international economic order is unstable and susceptible to financial crashes that carry the risk of global deflation. Second, the IMF is deeply imbued with an economic philosophy that impedes achieving international financial stability and widely shared economic prosperity. This philosophy has given rise to an economic outlook that recommends fiscal austerity, financial liberalization, and export-led growth irrespective of circumstance. Over time, such a policy configuration stands to aggravate the problem of financial instability and trigger global deflation.

The revealed instability of the international financial system and the IMF's unduly austere initial response in turn reveal two clear needs. One is to remedy the underlying structural weaknesses that afflict the international financial system. The other is to reform the IMF.

At the systemic level, the fundamental problem concerns speculative "hot" money that chases yield and capital appreciation without regard to risk. The task is to make this money "cold", in the sense of getting investors to invest on the basis of economic fundamentals. Bail out critics argue that the only reliable mechanism is market discipline. Investors must eat their losses: bail outs merely encourage more risk taking by encouraging investors in the belief that they will be bailed out when they get into trouble.

There is logic to this argument, and bail outs that leave the system unchanged will produce this outcome. However, we can do better. Appropriately crafted market rules can turn hot money into cold money, while avoiding the periodic economic crashes that are the inevitable accompaniment of market discipline.

The other need is to reform the IMF. Though the IMF was forced to dilute its demands for austerity in east Asia, its initial response revealed the true color of its spots. Without fundamental reform of the IMF, there can be no confidence that the it will not resort to the same policies in subsequent crises. Moreover, next time the political leverage provided by the IMF's request for increased capital may not be available to get it to reverse course. The IMF remains committed to a policy of financial liberalization and expanded capital mobility. In pursuing this policy it has been driven by the myth of a "natural" market that can be achieved by abolishing controls on capital movements. However, rather than creating a natural market, this policy has merely created an unstable market that needlessly endangers livelihoods and prosperity. IMF reform is therefore needed if the existing policy dynamic is to be turned around.

The origins of the east Asian crisis

Though the IMF sought to place the blame for the crisis on excessive east Asian government intervention, the real cause lies in international capital markets. These markets permitted excessive short term foreign currency denominated lending, and they also encouraged extensive foreign portfolio investment. In combination with uncontrolled international capital mobility, this produced a combustible mix.

Globalization of finance has encouraged a taste for "emerging markets". In the early 1990s, this new taste was rewarded with spectacular returns, which attracted even larger flows of funds and produced a herd driven move by investors and banks into east Asia. Moreover, this development was actively promoted by the IMF, which encouraged governments to eliminate controls, remove domestic ownership restrictions, and open domestic financial markets.

Portfolio investors hold equities denominated in local currencies, and are therefore concerned with the exchange rate since it determines the dollar value of their investments. Believing that the exchange rate was about to fall, equity investors in east Asia sought to protect their funds by selling out and repatriating them back home. However, this selling then drove the exchange rate down. In doing so, it increased the burden of foreign debts which are denominated in foreign currency, thereby pushing east Asia toward insolvency. Since much of east Asia's debts was of a short term nature, with the prospect of repayment not far off, this gave portfolio investors additional reason to sell. In this fashion, east Asia found itself locked in a spiral of exchange rate depreciation.

Having created an east Asian asset price bubble in the first half of the 1990s, international capital markets created a debt-deflation when they reversed themselves. The region had borrowed billions of dollars, and the decline in exchange rates increased the burden of these debts. The prospect of corporate bankruptcies then prompted foreign investors to continue bailing out. Given the increase in burden of debts, the supply of credit evaporated, thereby disastrously reducing economic activity and providing additional reasons to exit. In this fashion, the rush for the exits created a vicious cycle. Declining exchange rates worsened countries debt burdens and lowered credit ratings,

which in turn reduced credit availability, raised interest rates and lowered economic activity, which gave investors additional "fundamental" reasons to exit.

Globalization and the new danger of global deflation

The hallmark of globalization is increased international trade and financial flows. These flows have in turn produced an increase in economic interdependence. The east Asian crisis of 1997 revealed that entire regions can be now be pulled down, but it is also possible that world economic interdependence is sufficiently advanced that regional downturns have acquired the potential to threaten all regions through an expanded global transmission mechanism.

There are a number of channels to this expanded transmission mechanism. One channel is international trade. Here the effects work though a combination of exchange rate depreciation and economic recession which together impact exports and imports, thereby transmitting shocks across countries. The international trade channel has always been present, but globalization has increased its relative significance by increasing exports and imports as a share of GDP. This is illustrated in table 1 which shows how countries have become significantly more "open" over the last thirty years, as measured by exports and imports as a share of GDP.

This international trade transmission mechanism may have been further strengthened by the development of regional trading blocs which have accompanied globalization. When crisis strikes, entire regions can now be pulled down and this potentially amplifies disturbances through a cascade effect. Thus, an economic disruption in country A pulls down neighboring country B, and the combined disruption is then sufficient to pull down

country C which is located in another region. The potential for such a cascade effect is illustrated by the U.S. economy: in 1997 almost 30% of U.S. exports were directed to the east Asia region (Japan, China, Singapore, Taiwan, Hong Kong, South Korea, Thailand, Indonesia, Malaysia and the Philippines).

A second transmission channel is global commodity markets. Here the mechanism is commodity price deflation which reduces incomes of commodity producing countries, thereby lowering their demand for exports from the industrialized world. Commodity price developments in late 1997 and early 1998 suggest that regionalization may have also strengthened this channel. Thus, markets recognized that east Asia is a major industrial basin and large consumer of primary commodities, and the implications of recession were therefore quickly reflected in lower prices for key commodities such as nickel, copper, and oil. However, balancing this deflationary effect is the fact that consumers in industrialized countries benefit from lower commodity prices which serves to increase their domestic spending power.

Even more important than the export demand effect of commodity markets is the potential for these markets to spread financial contagion. As commodity prices fall, commodity export earnings also fall. Since many commodity exporting countries are hard currency debtors, these countries could start to face debt repayment problems that generate their own east Asian style currency runs. Examples of indebted countries that are vulnerable to such an outcome are Chile which is exposed to the price of copper, and Mexico and Russia which are both exposed to the price of oil.

The international trade channel also has the potential for spreading financial contagion. Over the last decade, developing countries have been encouraged to adopt export-led

growth policies. Such policies have set up a dangerous rivalry whereby countries compete for demand in industrialized countries, and it may have inadvertently recreated the problem of competitive devaluation that afflicted the world economy in the 1930s. Thus, when one country suffers an extensive depreciation, financial markets soon shift their pressure on to the currencies of export rivals realizing that those rivals now face difficulty maintaining their export competitiveness. In this fashion, future spirals of competitive devaluation could easily develop.[1]

Production shifting is a fourth channel now operating to transmit economic disturbances. Opening of international markets and increased mobility of capital have contributed to increased foreign direct investment flows. As a result, firms can increasingly engage in production shifting and investment diversion in response to large scale currency realignments. This production shifting channel is a new supply-side feature of globalization, and it stands to amplify the future effects of financial crises.

Related to this production shifting channel is the fact that industrialized country domestic labor markets are probably more fragile as a result of globalization. This is particularly true of the U.S. economy in which nominal wages are more flexible owing to the decline in trade union membership, a phenomenon which is itself significantly attributable to globalization. Thus, declining transactions costs and increased mobility of physical and financial capital have enabled U.S. business to shift unionized manufacturing jobs overseas or to "sun belt" states where labor laws make union organizing difficult. This development has increased worker economic insecurity, shifted bargaining power toward business, and made nominal wages more flexible.

The increase in nominal wage flexibility takes on significance when it is linked with increased household indebtedness (another feature that is particularly evident in the U.S. economy). Wages are now more likely to fall in recessions, and household nominal income is also more volatile because a greater share of compensation derives from overtime hours and profit sharing plans. The combination of downward flexibility of household nominal income and increased household indebtedness means that industrialized economies may have become more vulnerable to their own debt - deflation traps. The mechanism is as follows: falling household income renders heavily leveraged households increasingly insolvent, thereby worsening the problem of aggregate demand, destabilizing the banking sector, and cutting off the creation of credit. There are hints that the U.S. recession of 1990 partook of such a process.

The expanded trade channel also interacts with the emergence of increased financial fragility within industrialized countries. The initial impact of the trade channel operates on the manufacturing sector, and especially export-oriented and import-competing sectors. Given increased export involvement, manufacturing sector profitability is more vulnerable to foreign disturbances, and falling profitability can cause a cut back in investment spending that spreads economic contraction more widely.

Declining profitability also has the potential to trigger a stock market decline. In industrialized countries, particularly the U.S., more households are now invested in the stock market and stocks are also more highly valued. Households are therefore more exposed to stock market fluctuations, and this has likely increased the magnitude of the stock market wealth effect on consumption spending. Consequently, future stock market downturns can be expected to have larger macroeconomic effects than in the past.

In sum, globalization has expanded the conventional international trade transmission mechanism. It has also promoted a restoration of *laissez-faire* price flexibility in commodity markets, product markets and labor markets. When linked with increased household indebtedness and increased household exposure to stock markets, these developments suggest that the world economy may have become more vulnerable to debt - deflations triggered by financial market crashes.

Capital mobility and the new problem of capital account governance

The above discussion of the international transmission mechanism reveals how globalization has widened the international propagation of financial shocks and made domestic economies more susceptible to deflation. This means minimizing the frequency and containing the scale of such shocks has become an urgent task.

Rather than being read in isolation, the east Asian crisis should be read as part of an on-going history of economic dislocation emerging out of international money markets. In 1994, Mexico was subject to a financial crisis rooted in unsustainable macroeconomic policies which international capital markets had bankrolled. In 1992, the British pound and Swedish Krone were both subjected to speculative attack. The U.K. was forced to leave the European exchange rate mechanism, while Sweden was forced to raise interest rates thereby initiating a period of permanently higher unemployment. In the mid-1980s the U.S. dollar was significantly over-valued, leading to a major deindustrialization of the American economy. A similar problem afflicted the British economy in the early 1980s. For the last fifteen years, France has defensively tied its interest rates to German rates in order to protect against currency disorder and imported inflation, but the result has been

massive unemployment. Finally, in 1982 there was an international debt crisis amongst developing countries.

International financial markets are deeply implicated in each of these crises. With regard to east Asia and Mexico, they allowed excessive short term foreign currency denominated lending. In the case of the Reagan dollar and Thatcher sterling over-valuations, portfolio flows responded to tight domestic monetary policy in a fashion that appreciated the exchange rate and caused de-industrialization. In the case of France, the government had to capitulate to the threat of an exit of financial capital and raise interest rates. International financial flows have either directly contributed to the making of instability, or they have acted in a way that has frustrated the conduct of domestic monetary policy.

In the post-Bretton Woods globalized economy, capital account governance rather than exchange rate management has become the critical problem. This marks a change from the Bretton Woods era when capital controls and relatively unintegrated financial markets meant that exchange rate management was the issue. Back then the problem was how to facilitate exchange rate realignments in response to balance of payments difficulties engendered by underlying country differences in productivity growth and inflation rates. Those problems are now taken care of by flexible exchanges rates, but capital mobility threatens to undermine countries abilities to conduct domestic monetary policy and developing countries abilities to grow. Though exchange rate fluctuations remain the most visible sign of crisis, they are the symptom of underlying deficiencies in the system of capital account governance. It is to this issue that policy makers must therefore direct their attentions.

However, any redesign of the international financial architecture must also preserve the benefits of capital mobility. Just as national capital markets bring benefits of improved allocation of scarce capital, so too do international capital markets. Lender nations are made better off by being given access to the globally highest rate of return, while borrower countries are also made better off by getting access to lower cost foreign capital which enables them to undertake more investment. Portfolio holders are also given increased opportunities for portfolio diversification. The ensuing reduction in risk then enables them to adopt more high return - high risk projects, and this rebalancing of portfolios raises total rates of return (Obstfeld, 1994). These are real benefits that stem from voluntary exchange in expanded capital markets, and they must be preserved.

Finally, though crisis may provide the opening for reform, crisis must not be the exclusive focus of reform. The new financial architecture should certainly be designed to prevent the emergence of crisis, but equally important is that it work to promote a pro-growth full employment environment through the provision of widely accessible credit that is available on reasonable terms. In sum, the goal is the prevention of crisis, the preservation of the benefits of capital mobility, and the promotion of a pro-growth global economic environment.

Changing lender behavior: Tobin taxes, speed bumps and hedging

The revealed instability of the international financial system and its proclivity to frustrate expansionary domestic economic policy mean that there is a need to fix the system. One dimension of the problem concerns lender behavior. Though the IMF has sought to blame the east Asia crisis on excessive and unwise foreign borrowing, the

reality is that the fault lies with lenders whose chase for yield resulted in an over-extension of credit. One accepted fact in economics is that borrowers have a proclivity to over borrow, and well functioning credit markets therefore place the onus of control exclusively in the hands of lenders. When credit markets fail, the *prima facie* case is always against lenders. The only time when lenders are excused is when there has been major fraud that could not have reasonably been detected. This is not the case for east Asia where countries' policies and procedures have been long established.

The chase for yield by both banks and portfolio investors is the root of the problem. Additional dimensions of the problem concern destabilizing exchange rate fluctuations and uncovered foreign currency denominated lending. All three dimensions need to be addressed.

East Asia's crisis has shown that the IMF's existing model of financial liberalization, predicated upon free capital flows, foreign portfolio investment and short term foreign currency denominated borrowing, is unstable and vulnerable to movements in the exchange rate. Such movements can be initiated either for reasons associated with economic fundamentals, or for completely speculative reasons. Whereas the former are desirable since they contribute to economic balance, the latter are undesirable and can cause the system to collapse precipitously. The reason is that speculatively induced expectations of a declining exchange rate provide a rational reason for individual portfolio investors to sell out. By selling out they protect the dollar value of their investment, but when they sell out this initiates a further fall in the exchange rate, thereby generating a vicious spiral.

A new mechanism is therefore needed to prevent such speculatively induced collapses. The natural candidate is the Tobin tax (Tobin, 1978), whereby a small tax (perhaps 0.1%) is placed on all foreign exchange (FX) dealings. Such a tax would be sufficiently large to discourage speculative FX trading, but would not be large enough to discourage investors who are acting on the basis of economic fundamentals. Reducing speculative trading in this fashion would take a lot of noise out of the system, thereby reducing the likelihood of a speculatively induced rush for the exit such as has occurred in east Asia.

The crisis has also shown that foreign portfolio investment is extremely sensitive to exchange rate movements, be they driven by speculation or fundamentals. Investors are concerned with rate of return, and this is affected by the exchange rate. Once foreign portfolio investors begin to believe that the exchange rate will fall, they have good reason to sell. This then pushes the exchange rate further down, so that their actions become self-reinforcing. This same self-reinforcing tendency also holds with the development of asset price bubbles, when portfolio investors rush in and bid up asset prices and the exchange rate, thereby generating extravagant returns that attract the herd. New mechanisms are therefore needed to stop ill-considered financial inflows and sudden financial outflows.

The natural mechanism to stop such flows are "speed bumps" such as those that have been used to good effect by the Chilean monetary authorities. Such speed bumps work by having investors commit to a minimum stay (perhaps 12 months) when they bring money in. Attention has been focused on how speed bumps protect from sudden outflows because investors cannot withdraw their money at will. However, speed bumps have additional constructive incentive effects. Knowing that there are speed bumps, investors

will think carefully before committing their funds. Instead of simply chasing yield, investors will take account of the risk that they might find themselves stuck in the midst of a crisis, unable to withdraw their funds.

Just as there are beneficial incentive effects on investors, so too there are beneficial incentive effects on policy makers. Given the presence of speed bumps, investors will demand risk premiums from countries where policy is unstable. Consequently, countries that want to obtain low cost credit will have an incentive to put in place stable policies so as to lower the risk premium they are charged.

A third element of lender failure concerns the existence of uncovered foreign currency denominated loans. The U.S. is not exposed to this problem because it borrows in dollars. However, developing countries cannot borrow in their own currency, and are therefore exposed to increases in debt burdens resulting from foreign exchange fluctuations. Traditionally, the responsibility for protecting against such effects has lain with borrowers. However, hedging is expensive, and borrowers therefore have an incentive not to do so because creditors eat the loss in the event of default: once again, the fundamental economics of credit markets asserts itself. Unfortunately, the scale of international lending is now so large that the system is afflicted by a "too big to fail" problem whereby taxpayers are being forced (indirectly through IMF bail outs) to eat the losses. Creditors are therefore passing on their losses, and this has given rise to yield chasing and an explosion of uncovered risk that threatens to get ever larger.

A mechanism for ending this dire situation is therefore needed. The economics of credit markets suggests that, rather than relying on debtors to hedge their borrowings, monetary authorities must instead insist that lenders hedge their loans on behalf of

borrowers. As noted above, hedging is expensive and this will cause the cost of credit to rise. However, the risk is there, and it therefore needs to be priced in. Credit should not be subsidized as it now is through the provision of a bail out safety net paid for by taxpayers. These new hedging regulations would apply to both bank loans and bond issues. Thus, when bonds are issued, they would also be required to be fully hedged as part of the terms of issue.

Changing borrower behavior: transparency, openness and labor rights

Reforming lender behavior is one part of fixing the system. However, borrower behavior also matters. The IMF has emphasized the problem of political corruption and economic cronyism which has given rise to misallocation of borrowed resources. It has advanced two solutions. One is to increase market transparency by requiring improved accounting and reporting standards. The second is to increase the extent of financial liberalization by giving foreign companies increased domestic market access. 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. All future bail outs (as well as the existing IMF programs in over 70 developing countries) should therefore require that governments abide by internationally recognized human and labor rights. This is the ethically right course, but there is also a profound economic argument.

Ending cronyism and political corruption demands political reform that puts in place the countervailing forces needed to block such behavior. Human and labor rights are the foundation of such reforms. Crony capitalism distorts the behaviors of borrowers: it also

distorts the actions of lenders, who all too easily get sucked into its malpractices. It is this logic that has prompted the OECD to adopt the Convention on Combatting Bribery (1997). Bribery distorts economic outcomes and reduces welfare, and hence the push to outlaw it. Political cronyism has the same effect, but the only way to end it is by establishing well-functioning democracies predicated on human and labor rights.

Fair and free markets cannot function in a corrupt and unconstrained polity. Under the 1994 Frank-Sanders law, U.S. executive directors to the World Bank and IMF are already required to use the voice and vote of the U.S. to urge their respective institutions to adopt policies that encourage borrowing countries to guarantee internationally recognized worker rights. It is now a matter of urgent public policy that the Frank-Sanders provision become part of standard IMF conditionality. The problems in east Asia have clearly revealed that this is a necessary ingredient for well functioning international capital markets.

Another economic advantage of insisting on human and labor rights concerns economic growth and wages. Palley (1998a) documents how countries that have instituted improved rights of free association have grown significantly faster in the ensuing five year period. Rodrik (1998) documents how greater democracy goes hand-in-hand with higher wages. This can help transform developing economies from being export dependent into mature economies in which their own citizens are the principal consumers. The current emphasis on export led growth has given rise to a situation in which a few countries run large trade surpluses, and drain demand from the global economy. This chase for exports is contributing to global deflation. Having wages rise in newly industrialized countries would remedy this by creating the conditions whereby

these countries could grow their industrial capacities on the basis of their own domestic demand.

Reasserting domestic monetary control: Asset based reserve requirements, requirements on foreign currency short sales, and Tobin taxes

A key consequence of increased capital mobility and the globalization of financial markets has been a tendency for domestic monetary authorities to lose control over interest rates. This loss of control is evident in France's adoption of the *Franc fort* policy, and in Sweden's forced adoption of higher interest rates in 1992 to defend the Krone. Capital mobility allows financial capital to vote with its feet and veto policy it does not like. In general, financial interests prefer mildly deflationary policies as this preserves the value of financial assets. As a result, rather than lowering global interest rates, capital mobility may have contributed to institutionalizing deflationary monetary policy.

One policy for restoring domestic monetary control is the adoption of asset based reserve requirements (ABRR). Existing reserve requirement regimes focus on the liability side (LBRR), and are an out growth of earlier concerns with depositor bank runs. Deposit insurance and the lender of last resort function have now taken care of this problem, rendering LBRR obsolete. The new policy problem is how to regain control over interest rates for purposes of managing the domestic economy.

ABRR give monetary authorities a means of differentially affecting the cost of credit across sectors (Palley, 1997), thereby allowing them to cool individual sectors without cooling the entire economy. More importantly, the borrower cost of credit can be raised (by increasing reserve requirements) without raising money market interest rates. Thus,

tighter monetary policy need not be accompanied by an inflow of foreign capital and exchange rate appreciation, such as happened in the U.S. in the 1980s.

A second proposal (Eichengreen and Wyploz, 1993) is that short sales of currency by individuals and corporate nationals be accompanied by placement of a non-interest bearing deposit with the central bank equal to 50% of their value. The regulation would also apply against foreign subsidiaries operating in the monetary authorities' jurisdiction, and against foreign subsidiaries and affiliates of all corporate nationals. This would reduce currency speculation by raising its cost, and it is workable because there are good reasons to believe that most FX short sales come from domestic nationals since their income flows are denominated in the currency they are selling which significantly reduces their exchange risk.

The move to risk based equity requirements also needs to be carefully reconsidered. This move has been prompted by a desire to minimize yield chasing. However, it risks destabilizing the system. This is because financial institutions suffer loan losses in bad times, which wipes out equity. Loan quality also deteriorates then. Consequently, financial institutions will have to raise more equity in bad times, but this is exactly when it is most difficult to do so. As a result, risk based capital requirements could unleash a destabilizing dynamic, that squeezes the financial sector in bad times, thereby worsening asset price deflation and exacerbating credit contraction. This could transform shallow recessions into a deep recessions.

In this regard, ABRR are a better instrument of control. These requirements can be calibrated according to the riskiness of assets, thereby addressing the moral hazard problem. However, when loans default, the reserve requirements on them are released,

which mitigates any liquidity pressure financial institutions may be feeling. This helps preserve asset values and prevents unnecessary credit contraction.

Finally, not only are Tobin taxes good for mitigating currency speculation, they are also good for reasserting domestic monetary control. The Keynesian problem of loss of control over interest rates arises because of interest rate arbitrage, which has funds flowing from low rate centers to high rate centers. Tobin taxes introduce a small wedge that prevents complete arbitrage, and this creates a space for differences in cross-country interest rates.

Changing IMF policy: restoring an equitable pro-growth agenda

The final piece of the policy puzzle concerns IMF policy. The crisis in east Asia has revealed that the IMF is deeply imbued with an economic mentality that impedes achieving financial stability and widely shared prosperity. This mentality is predicated upon the economics of fiscal austerity, financial liberalization, and export-led growth: it risks exacerbating the problems of financial instability and global deflation.

The danger posed by the IMF's current stance is illustrated by its initial response to the east Asian crisis (Palley, 1998b). Despite the fact that both South Korea and Thailand had consistently displayed fiscal responsibility, and even run sustained budget surpluses, the IMF arrived on the scene and immediately demanded government spending cuts and higher taxes. Coming on top of an already dire collapse in economic activity, such a recipe would inevitably have deepened east Asia's recession. Concerted opposition by the IMF's critics forced it to back track on fiscal austerity, but the IMF's plan still requires countries to aim for large trade surpluses that threaten to export deflation. One countries'

surplus is another's deficit, and this means that all countries cannot engage in export-led growth. Rather, countries must seek to develop their own domestic markets. However, as a country grows and sucks in imports, others must grow and take its imports or else it will become balance of payments constrained. Hence the need for an expansionary global regime.

The bottom line is that the IMF's policy combination of fiscal austerity plus devaluation engenders world wide wage competition and deflation as countries seek to export their way out of problems. Side-by-side, the IMF's continued push for financial liberalization, unaccompanied by appropriate systemic reform to the domestic and international financial system, promotes financial fragility and entrenches moral hazard.

Reforming the IMF is therefore critical for two reasons. First, because current IMF policies are counter-productive: second, because the IMF's institutional standing means that it can importantly influence whether and how the international financial order is reformed.

Sachs (1997) recently documented how the IMF has stabilization programs in 75 countries. These countries comprise half the developing world. South Korea, the world's eleventh largest economy, has now been added to this list. The IMF has actively promoted the existing international financial order, but rather than seeing the proliferation of stabilization programs as evidence of design failure, the IMF sees it as vindicating its own existence.

The IMF's intellectual framework promotes financial instability, but there is no means to get it to change. The incentives are wrong. The east Asian bail out involves more than $100 billion, and its massive scale contributes to further growth in the size and import of

the IMF. It is not the institution of the IMF that is wrong. An institution such as the IMF will always be needed to provide liquidity to the international financial system in times of financial crisis. Moreover, it should be remembered that the IMF was created under the Bretton Woods agreement which was the product of an era of progressive economic policy. Rather, it is the IMF's policies of economic austerity and inappropriately designed financial liberalization that are wrong. In the case of South Korea, the IMF persistently encouraged the South Koreans to open their economy. The Koreans did this, and in doing so they made themselves vulnerable to the type of bank run which they are now suffering. The lesson is clear. If countries are to engage in financial opening, then these moves must be accompanied by international reforms that render "cold" international capital flows. In the absence of such reforms, such openings can prove highly dangerous. The IMF has completely failed to appreciate this.

Overcoming these obstacles requires institutional reform. Just as the IMF has insisted on increased transparency in government and in financial markets, so too its decision making should be made transparent. The IMF also needs to engage in self-conscious institutional reform. There is too little diversity of economic opinion within the IMF, and this has promoted a closed state of mind. The consequences of this were evident in the wrong-headed call for fiscal austerity in South Korea and Thailand.

Though the IMF retreated on these policies, its original response revealed the true color of its spots. This time round, critics were able to get it to change its policies because the IMF needed political support for increasing its capitalization. In the absence of this, it is unlikely it would have changed its stance, and such leverage may not be available in future. Internal and external institutional reform is therefore essential: there must be

greater intellectual diversity within the IMF, and the IMF must be subjected to regular open external monitoring by participant governments.

Finally, as one of the developing world's largest creditors, the IMF must consider the matter of debt relief. 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 of getting out of this box.

Paying for such debt relief is a third way in which Tobin taxes can help since they would raise billions of dollars, some of which could be used to finance a Marshall Plan for the third world.

Conclusion: rediscovering imaginative regulation

The inter-war years were a period of economic depression and competitive devaluation. In the immediate post-war era, the Bretton Woods system prevented competitive devaluation, while governments pursued Keynesian demand management policies that ensured full employment. However, in 1973 the Bretton Woods system broke down because of its inability to deal with repeated instances of balance of payments disequilibrium.

The system of flexible exchange rates that replaced Bretton Woods addressed the problem of balance of payments disequilibrium. However, this system has itself fallen prey to the emergence of unrestrained international capital mobility which has introduced a new set of capital account management problems. Governments can no longer conduct effective stabilization policy because financial markets veto policies they do not like.

Side-by-side, the scourge of competitive devaluation has re-emerged owing to speculative herd driven investor behavior in financial markets. Such behavior generates asset price bubbles that are financed by international capital inflows. However, once the bubble bursts, countries are forced to undergo massive devaluations to generate the foreign currency earnings needed to repay earlier borrowing, thereby triggering the competitive devaluation process.

Reform of international money markets has become an urgent priority. Such reform must aim to change both lender and borrower behavior while preserving capital markets' abilities to efficiently allocate scarce capital. It must also aim to restore control to domestic monetary authorities and promote a pro-growth economic environment.

Unfortunately, there has been a colossal failure of imagination amongst policy makers that has prevented this from happening. This failure is illustrated by Chairman Greenspan's speech to the Economic Club of New York which reiterated the IMF mantra that the only thing policy makers can do is push for fiscal austerity and more financial liberalization.[2] This is economic fatalism, whereby the right to control economic destiny is rendered subservient to the dictates of global capital markets.

Regulation is difficult, and it requires imagination. Moreover, regulation needs to be updated. Effective regulation places constraints on profit maximizing firms and prevents them from doing what they would like to do. They therefore have an incentive to seek out ways to evade regulation, and over time they inevitably succeed in doing so. In effect, good regulation always sows the seeds of its own destruction. This is the Rosetta stone of all good regulators.

Over time, financial markets will undoubtedly innovate in ways that evade the above package of regulations. This in no way invalidates the package; instead, it merely affirms that regulation is an on-going process that needs to be continually updated. Sometimes regulators are lucky enough to get ahead of their market rivals, as illustrated by the successful financial regulations of the New Deal. Sometimes, regulators merely manage to keep abreast of the game. However, there is never an excuse for capitulating and surrendering the public interest to the dictates of the market.

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	1966	1995	Change 1966 - 1995
United States	9.9%	23.6%	138%
Canada	39.1%	72.3%	95%
Japan	19.4%	16.8%*	-13%
Germany	51.1%+	63.4%*	24%
United Kingdom	37.8%	57.3%	52%
France	25.0%	44.5%	78%
Italy	28.1%	43.2%*	54%
Austria	51.4%	76.2%	48%
Belgium	73.5%	137.2%*	87%
Denmark	58.5%	63.3%	8%
Finland	41.3%	67.5%	63%
Netherlands	89.8%	100.0%	11%
Norway	83.2%	70.6%	-15%
Portugal	54.1%	61.0%*	13%
Spain	20.2%	47.3%	134%
Sweden	43.8%	75.3%	72%
Switzerland	58.7%	66.9%	14%
G-7	30.1%	45.9%	53%
Europe	51.2%	69.6%	36%

Table 1 Openness of OECD countries, 1966 - 1995. Openness = [Exports + Imports]/GDP. Source: Author's calculations using IMF statistics. G-7 and Europe computed as simple average. * = 1994 data. + = 1979 data.

1.. It is easy to create a counter-factual scenario whereby the depreciations which have afflicted east Asia spread to other countries as they try to maintain export competitiveness. China and Hong Kong face the prospect of reduced international competitiveness, and Brazil which is Latin America's industrial giant faces similar

problems. Once landed in Latin America, Argentina and Mexico could then readily become victims of a competitive devaluation spiral. Chile is also vulnerable since 40% of its exports go to east Asia, and copper which is its major export has fallen in price.

2. Speech to the economic Club of New York, December 2, 1997.