Part I

Policy Options for Advanced Countries to Address Current and Future Global Economic Imbalances

From: New Challenges of Crisis Prevention,
FONDAD, December 2001, www.fondad.org

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FONDAD, December 2001, www.fondad.org

Why Advanced Countries Should Address Global Economic Imbalances

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1 Introduction

In September 2000 the IMF revised its global growth forecast for the year in course upward[1] just as UNCTAD was noting that a downturn in the US economy, and thus for the global economy, in the year was inevitable. A few months later, as UNCTAD completed its drafting on the global prospects chapter of the 2001 *Trade and Development Report*, suggesting that European growth could decline by one to two percentage points from its 2000 average of over 3 percent, the IMF was announcing the opposite trend: improved prospects for growth in the European Union and its prospects to replace the United States as the engine of global demand.

Clearly the 1990s have presented special challenges for those trying to forecast the evolution of the major industrialised economies, and their impact on the developing world. Financial factors that are difficult to model have come to play an increasing role. Nonetheless, it is interesting to note the stark divergence in the positions taken by the IMF and UNCTAD concerning the outlook for global growth.

The increasing economic interdependence of the world's economies creates difficulties for forecasters because both real and financial shocks have more rapid and direct impacts on different geographical regions and different industrial sectors than before. The dominance of the global integration of production and finance over the intensification of trade linkages in industrialised economies also implies that real and financial shocks may have unexpected interreactions and consequences.

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1 At the end of September 2000 the IMF revised its growth estimates upward because: "The global economic expansion has continued to gain strength, with global output growth now projected at 4.7% in 2000, 0.5 percentage points higher than expected in the *May World Economic Outlook* ... Growth is projected to increase in all major regions of the world, led by the continued strength of the US economy; the robust upswing in Europe; the consolidation of the recovery in Asia; and a rebound from last year's slowdowns in emerging markets in Latin America and the Middle East and Europe." *World Economic Outlook*, October, 2000, p. 1.

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It appears that the increased interdependencies provide new sources of international macroeconomic imbalances similar to those that have plagued the stability of the international financial system since the end of the post-war recovery period in the 1960s. If there is a distinguishing feature of the analysis in UNCTAD's *Trade and Development Reports*, it is the emphasis that is placed on the way increased global integration of trade and finance has produced global imbalances in the 1990s.[2]

In particular, the position taken in recent *Trade and Development Reports* has been influenced by the similarity of the current imbalances with those of earlier periods, and the recognition that such imbalances usually have led to substantial disruptions of trade and finance, with serious difficulties in developing countries.

Obviously, if we are to address the question of the policy options facing the advanced countries to deal with current and future global economic imbalances in order to limit the negative consequences for developing countries, we must first identify the forces that determine the interactions of the industrialised and developing economies that have produced the current imbalances and assess whether they will have similar consequences to those in the past.

2 Unanticipated Consequences

The process of recovery from the 1997-98 Asian crisis may serve as a good starting point for a brief review of how economic trends in developing and industrialised economies have interacted. The threat of a wall of cheap exports coming out of Asia, based on sharply undervalued exchange rates, led many forecasters to expect that the aftermath of the Asian crisis would be characterised by a slowdown in the industrialised countries and a risk of global deflation. However, this forecast was quickly disappointed.

The collapse of domestic financial systems and asset prices in the crisis countries made it difficult for their domestic producers to finance the production of increased exports and the imports that were required to produce them. Although foreign balances did improve very quickly, it was initially a downward adjustment in which imports virtually ceased and exports declined, causing overall incomes to fall. Even when increases in export volumes appeared, they were more than offset by falling export prices and rising import prices. The decline in East Asian demand for imports of primary materials, particularly petroleum, compounded the downward trend

2 See in particular *Trade and Development Reports* for 1999 and 2000.

in commodity prices that had already started in 1996, before the crisis. The result was a sharp decline in developing countries' terms of trade. Cheaper exports from developing countries led to a windfall in the purchasing power of developed country consumers. This supported continued expansion in consumer demand in the developed countries and made a substantial contribution to price stability in these countries.

This benign international price environment for industrialised countries, that resulted from the recession in Asia, allowed the Federal Reserve to accept growth rates in the US far in excess of prudent estimates of potential non-inflationary growth. It was felt that there was no need for anticipatory tightening of monetary policy. The result was an increase in the estimates of both the productive potential of the economy, as well as the expected of non-inflationary growth rates. At an average of nearly 5 percent during the period 1997-2000, US growth rates not only exceeded forecasts, but were even double of what had been considered the maximum potential.[3] It is important to note that, combined with the increased competitiveness of Asian exports, this is what finally brought about the rapid recovery of growth in Asia in 1999, not the adjustment programmes or structural reforms in the productive and financial sectors.

Just when it appeared certain that the global economy would avoid the expected post-Asian crisis recession, the firmness of this belief was undermined. The negative consequences of the crisis-induced decline in primary commodity prices became evident in the decline in export revenues in Russia. Since the Russian government was excessively dependent on these revenues for income, and the Central Bank was dependent on them for foreign currency, this led to a sharp reversal in the Russian balance of payments, a default on government debt and a collapse in the ruble exchange rate.[4] Since a large number of developed country financial institutions were exposed either directly or indirectly through their holdings of Russian government debt, the default was quickly transmuted into sharply reduced earnings or even insolvency and bankruptcy for some of the strongest developed country financial institutions, creating a loss of confidence in all

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3 Indeed, the US potential growth rate has now been revised upward from around 2.5% to more than 3.5% in view of what appears to be a stable increase in labour productivity to rates above 2%. Already in 1995 the UNCTAD Secretariat argued that low estimates of potential growth and high estimates of natural rates of unemployment were due to hysteresis, and that industrial economies could grow much faster without an acceleration in inflation and reduce unemployment to levels below the estimates of natural rates if policymakers allowed them to do so: *Trade and Development Report*, 1995, Part Three, chap. III. See also Newsweek, September 1995, pp. 38-9. The *Economic Report of the President*, 2001, p. 72, estimates the potential growth for the US at 3.8%.

4 See Akyüz, Cornford and Kregel, 1999.

but the most highly secure and liquid US government securities. The increased demand for dollar-denominated assets resulted in a sharp appreciation of the dollar. Investors sought to offset liquidity risk, even in the presence of an increasing US current account deficit. The safest, most liquid US government assets became the refuge of risk-averse investors, commanding a large liquidity premium.

The Federal Reserve moved quickly to offset the rising liquidity premium and the risk of a sell-off of private sector financial assets by reducing interest rates, thereby allowing the US economy to continue to function as the engine of growth in the global economy. This provided sustained demand and markets for the recovery of the East Asian economies that in the second half of 1998 had already started to benefit from the reversal of restrictive IMF adjustment policies, finally unleashing the export potential implicit in the large devaluations and excess productive capacity, and producing record current account surpluses.

Thus, a series of unanticipated consequences of the aftermath of the Asian crisis during 1998-1999 served to increase the US contribution to global demand to around a third of global expansion since the crisis (and even around a half if indirect trade effects are also taken into account). This largely offset the loss of the roughly 50 percent contribution to global demand of South East Asia before the crisis and created the belief in a rapid global recovery when it allowed positive growth to return to Asia as a result of improving net exports.

3 Imbalances Between the US, Europe and Japan

Much like Asia before the crisis, rapid US growth led to a sustained inflow of capital into the United States, supported by the liquidity premium on dollar assets and the foreign acquisitions of US companies in the high technology sector. This has produced a combination of rising US current account deficits and an appreciating dollar, reminiscent of the sustained appreciation and overvaluation of the dollar in the early 1980s in the presence of a deteriorating current account. That combination was widely considered to be unsustainable, and resulted in the hard landing of the dollar in 1986-1987.

As in the 1980s, Japan is one of the major multilateral counterparts to the rising US external imbalance, but there are substantial differences that serve to reinforce the imbalance. The first and most obvious is that the United States growth differential vis-à-vis the rest of the world in the 1990s was underpinned by private sector spending and productivity gains; and although household savings rates were negative, US national savings

were positive as the public sector surplus exceeded the rising personal sector savings deficits. On the other hand, despite the excessively high household savings rate, it was Japan that was experiencing deficits and rising national indebtedness. On a purely domestic basis, it was the US that ran the risk of becoming the excess saving economy, paying down its domestic debt, while in Japan national savings were deficient and domestic debt was increasing.

Thus, while increased global financial volatility was increasing the demand for risk-free US government assets, their supply was being reduced by the US fiscal surplus. The resulting downward pressure on US interest rates was enforced by the increasing supply of Japanese government paper and the risk of holding it. The concomitant upward pressure on Japanese interest rates and downward pressure on US interest rates were just the opposite of what would be required to counter the increasing US external deficit and the Japanese surplus. Despite the differences in government budgets a similar self-reinforcing process of a rising dollar and high dollar returns seen in the early 1980s, now supported by the liquidity premium, led to dollar strength even in the presence of a continually rising external deficit (with the addition of the US as a net international debtor) just as in the 1980s. The Plaza and then Louvre Agreements were necessary to reverse this cumulative self-referential process (see Soros, 1987). But in the absence of fiscal policy, adjustment could in the 1980s only be achieved by interest rate policy, which because of the excessive decline of the dollar after 1985 required a reduction in interest rates in Japan relative to the US. This produced the great real estate and equity bubble in Japan, whose reversal at the end of 1989 set the stage for the decade of stagnation in the 1990s and which looks like continuing into the new millennium.

Europe has also been a multilateral counterpart of the rising US external imbalance at the end of the 1990s, but here the situation seems more to resemble the imbalances of the 1960s. In the 1960s the United States argued that its deficit with Europe was simply the counterpart of the high foreign demand for dollar assets, and US expenditures in support of its political commitments to European security. The European counter-argument was that the United States was exporting both unemployment and inflation created by its uncontrollable fiscal deficit. There was no agreement on whether the appropriate policy was the reduction of the United States fiscal deficit (with the anticipated result of lower growth and higher unemployment), or an increase in European demand and growth (with fiscal deficits and feared higher inflation). Unwilling to increase interest rates for fear of stifling growth, and unable to act on exchange rates because of the peculiar position of the dollar in the Bretton Woods System, the United States introduced a wide variety of controls on capital

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flows in an attempt to raise interest rates externally, while keeping them low internally, (including "Operation Twist"). In the end the failure of policy coordination between Europe and the US was resolved by an institutional crisis in which the Bretton Woods system of flexibly fixed exchange rates was abandoned by taking the dollar off gold.

Paradoxically, despite the fact that at the end of the 1990s the US is running an increasing fiscal surplus and the EU is running fiscal deficits, the appropriate policy to reduce the external imbalance would still appear to be tighter fiscal policy in the US to further increase the fiscal surplus, combined with looser policy in Europe. While this might have been acceptable in the era of Keynesian fine-tuning of the 1950s and 1960s, it is no longer politically feasible, as is any use of expansionary fiscal policy by the EU in light of the Stability and Growth Pact. In the absence of capital controls or something like a reverse "operation twist", the response has again been in terms of monetary policy and substantial exchange rate adjustments.

The lack of policy coordination between the US, Europe and Japan in both the 1960s and the 1980s, and the increasing difficulty in employing counter-cyclical fiscal policies, meant that monetary policy became the sole instrument. As a result, policy conflicts emerged in terms of disruptive interest rate differentials and disruptions in exchange rates. In the 1960s, the US attempted to avoid the impact of the required monetary policy on the domestic economy, with the result that eventually exchange rates had to adjust; to do so brought down the post-war exchange rate system. In the 1980s, monetary policy eventually produced interest rate differentials that led to a recession from which Japan and Europe are still attempting to emerge. The same response was used in 1999-2000 with Japan pushing interest rates to zero and the European Central Bank resisting too large a positive US differential.

4 Implications of a US Downturn

The question that determined global prospects in September of 2000 was whether the imbalances that were present in the global economy were sufficiently similar to those of the 1960s and the 1980s to create similar serious disruptions in global growth and in the growth prospects of developing countries. Given the existence of the similar cumulative nature of the three periods of imbalances, and the sustained tightening of US monetary policy, it appeared that not only would the US economy not continue to expand, but that because of the increasing inter-relatedness of the United States in the global economy, the global economy would also slow substantially.

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Since the US has been the major source of global demand, the impact of slower US growth on its external deficit is likely to have a direct impact on global conditions. In Asia, rising net exports provided the financing for expansion despite the sharp contraction of financing by domestic financial institutions attempting to rebuild capital. So any US downturn coupled with expansion of domestic incomes and imports in these recovering Asian economies would in these countries lead to lower current account surpluses, reducing both domestic growth and demand, and the ability of domestic firms to finance continued restructuring.

The extent of the problem can be seen from the more than 20 percent of GDP in Malaysia, Singapore and Hong Kong that is created by exports to the US. The figure for Taiwan and the Philippines is above 10 percent and Korea is only slightly lower at 7 percent. However, these figures probably underestimate the impact since the linkages to the US are most direct in the high-tech sectors of semi-conductors, personal computers and telecommunications equipment. The growth of demand has been strongest in those sectors in the last five years of the US recovery and Asian exports to the US have been strongest in leading their recovery.

In the Western Hemisphere, NAFTA had produced trade integration such that Mexico and Canada now export 25 percent and 30 percent of their GDP respectively to the US. Of the major industrialised economies, Europe and Japan both have low direct dependence on US trade and depend little on each other, although both countries have substantial interests in subsidiaries operating in the US. Thus simply referring to commercial relations would lead to the conclusion that Japan and Europe might be less affected by the performance of the US economy. However, Japan's nascent expansion at the beginning of 2000, based on increasing capital goods exports and rising corporate profits leading to a recovery in investment, was directly dependent on demand coming from South East Asia where the recovery had been determined by increasing sales to the US.

Since most of Europe's trade was within the EU, it was suggested that it was more isolated from global conditions than before the introduction of the euro. However, in the new global environment trade is perhaps the least important linkage between the US and Europe. For example, in 1998 sales of foreign-owned affiliates within the US were close to $2 trillion, nearly double the value of US imports from abroad of a little over $1trillion (see Zeile, 2000), while US companies exported nearly $1 trillion compared to $2.2 trillion of sales by US-owned affiliates operating abroad. If balance of payments accounts were kept by country of ownership of firms rather than by their national location the US deficit in 1998 would have been reduced by roughly half from $198 billion to $99 billion (Lowe,

2001). This suggests that the relation between the external account and the exchange rate is rather different today than it was in the past.

Since European companies have been the major investors in the US, it is no surprise that the major linkage between Europe and the US is no longer in terms of commerce, but in terms of foreign affiliates' sales. For example, sales of German and UK affiliates in the US were roughly five times their exports to the US in 1998[5] and the figure is more than double that for smaller European economies such as the Netherlands. As a result of this globalisation of production and sales, Europe is much more closely linked to the US than its low dependence on trade with the US would suggest.

Of even greater importance is the $500 billion in mergers and acquisitions of US companies by European companies over the last three years, plus substantial portfolio equity and bond flows.[6] These flows are also deceptive in their impact since after 1997 the share of cross border mergers and acquisitions financed by stock swaps increased dramatically. For developed countries as a whole less than 10 percent of mergers and acquisitions were financed by stock swaps in 1997 ($22 billion versus $213 in cash transactions), but the share rose to 31 percent in 1998 ($138 billion versus $307 billion in cash) and reached 40 percent in 1999 ($261 billion versus $384 in cash).[7] For the US it is estimated that roughly half of inward merger and acquisition flows have not involved direct acquisition of dollar assets with foreign currency, but have been financed by means of stock swaps, and that much of the remaining mergers and acquisitions were financed by borrowing in the US. Thus the direct impact on the foreign exchange market of the boom in European mergers and acquisitions of US assets, and any eventual reversal, may have less impact on the behaviour of the exchange rate than commonly expected.[8]

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5 Japan now ranks third, behind Germany and the UK, in terms of gross product produced by owned- affiliates in the US, in part because of the large Japanese presence in Mexico.

6 FDI inflows to the US rose sharply between 1998 and 1999 from $186,316 million to $275,533 million while outflows were virtually constant at $146,052 million and $150,901 million. In contrast inflows to the EU rose about half as much from $248,675 million to $305,058 million, while outflows increased from $425,495 million to $509,824 million. (See *World Investment Report (WIR), 2000*, Annex Tables, B1 and B2). US sales of companies via cross-border mergers and acquisitions in 1998 were 209,548, rising to 233,032 in 1999, against 137,421 and 112,426 of purchases respectively. For the EU purchases were 284,323 in 1998 and 497,709 in 1999 against 187,853 and 344,537 of sales respectively (*WIR*, Annex Tables A.IV.6 and 7). An idea of the flow from the EU to the US is given by the fact that for the US and the EU global cross-border mergers and acquisitions flows account for nearly 80% of total FDI inflows. (*WIR*, Figure IV.9) The share of mergers and acquisitions in investment in foreign affiliates operating in US in 1997 was 87.1% at $60.7 billion, and 89.9% in 1998 at $180.7 billion. (*WIR*, Annex Table A. IV.8).

7 *World Investment Report*, Annex Table A.IV.8.

8 Nonetheless there may be indirect portfolio effects since stock swaps change the currency composition of portfolios, increasing the foreign currency denomination of US portfolios. If

The increasing importance of these financial linkages suggest that caution should be exercised in assessing the ability of the European economy to escape negative consequences of the adjustment to global imbalances. Recent estimates of the elasticity of European growth with respect to US growth are as high as 0.4, suggesting that the recent decline in the US growth rate could bring European growth back to around 2 percent, irrespective of any further impact from a loss of export competitiveness due to strengthening of the euro exchange rate.

5 A New Cyclical Pattern

Global economic performance has been characterised in the past by asynchronous cycles in which downturns in some areas have been counterbalanced by expansion in others, preventing global overheating or recession. However, since the US expansion of the 1990s and the advent of globalisation a new cyclical pattern appears to be forming, in which the negative shocks from the rest of the world create benefits for the US economy that allows it to grow more rapidly, and thus compensate for the negative shock. While these benefits avoid overheating in the US, they create: (a) imbalances in the US external position as US external indebtedness increases; (b) imbalances in the US internal position as private sector indebtedness increases; and (c) a strengthening of the dollar exchange rate as foreign lenders hold their credits on the US in dollar assets.

Since these growing US imbalances are the cause of the improving conditions in the rest of the world, a deterioration in conditions in the US cannot be balanced by an expansion in the rest of the world. Moreover, since these growing US imbalances are unsustainable, a global slowdown is the inevitable result. The decline in growth in the US in the third quarter of 2000 was matched in Europe by a decline in growth from 3.2 percent in the second quarter to 2.8 percent in the third quarter, while Japan experienced a shift from a positive 1 percent to a negative 1 percent growth from the second to the third quarter.[9]

Thus the new cyclical pattern under an increasingly integrated world of trade, production and finance is not synchronous and not symmetric.

US investors were in equilibrium prior to the sale or merger, they should sell the foreign equity they received and if the sale was executed on a foreign exchange, repatriate the proceeds to replace the dollar-denominated securities. This would have the same increase in the demand for dollars as the direct purchase by the acquirer and the reduction in the value of merger and acquisition flows would have a negative impact on the dollar.

9 Of course, the downturn was not limited to developed countries, and most developing countries also experienced a downturn in industrial production around the middle of 2000.

While the US appears to be able to compensate for weakness in the rest of the world, the rest of the world is unable to compensate for weakness in the US. The global economy appears to be facing conditions in which US expansion served to offset weakness in other parts of the world after the Asian crisis, but there seems to be no guarantee of a symmetrical relation that would produce an offset to a decline in the US growth rate. Just as global growth will depend directly on the reaction of the US external balance to a reduction in its growth rate, so will international currency and financial markets.

6 The US Outlook: Keynes, Hayek or Schumpeter?

The analysis of the cyclical performance of the US economy is thus of crucial importance to forecasts of global performance. The sharp drop in economic activity in the US after the second quarter of 2000 raises the question of whether this is a simple cyclical adjustment to excess inventory and capacity build-up that will be quickly reversed by a so-called V-shaped recovery, or whether the "new economy" has been a mirage which has now been dissipated with the collapse of the high-tech stock bubble and heralds a longer period of adjustment that would produce recession (at least two quarters of negative growth) and a return to performance similar to the 1970s.

Judging current conditions is difficult since one of the most striking characteristics of the recent expansion has been the performance of investment. The share of gross fixed investment to GDP has risen in the 1990s to around 18 percent, up markedly from below 14 percent during the recession of 1990-1991.

The build-up of inventories in the second and third quarter of 2000 and the falling capacity utilisation figures support the idea that the US economy is in a traditional Keynesian cyclical downturn, in which excessive optimism over expected future expansion has led to overinvestment in capacity. In this view, as investment is cut back, the multiplier produces further income declines until automatic stabilisers produce a fiscal stimulus or direct policy measures are taken to stimulate investment or increase government spending. This sets a floor under the growth in spending and sales. Eventually, the excess capacity is worked off and the needs for new capacity spurs investment and sets off the recovery.

However, there are a number of factors to suggest that the current expansion and downturn are quite different. The current cycle is much closer, although not exactly equivalent, to the kind of cycle that was described by Friedrich von Hayek in opposition to Keynes. The difference

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between the two explanations of the cycle was not in the existence of excess capacity, but in factors that caused it, and thus the policies required to eliminate it. In Hayek's approach, the excess capacity was caused by excessively easy monetary conditions leading to excessive capital intensity of production, producing the use of techniques that would not be viable in normal monetary conditions. No amount of support to expenditure could remedy this situation; only bankruptcy and elimination of the inappropriate technology would create the conditions for future recovery. This was the basis of the idea of the beneficial "bust" creating the conditions for the new boom to take place – attempting to use fiscal or monetary policy to temper the decline would only prolong the date at which the necessary junking of inappropriate investments would take place and the recovery could commence. Thus, instead of the economy having too much capacity which would eventually become profitable in the recovery, Hayek suggested that the wrong techniques of production were embedded in the capital stock; they would never be profitable at normal interest rates, so recovery would only commence once they had been eliminated and replaced by the appropriate technology.

It is clear that the "new economy" expansion has been driven by new technological advances in the field of computing, telecommunications and information and that investment spending in the sector has played a leading role in recent acceleration in economic growth. Although it remains a fairly small part of the economy – its share of GDP was an estimated 8.3 percent in 2000 (up from 5.8 percent in 1990) – it accounted for almost one-third of all output growth between 1995 and 1999. The annual growth rate of private investment in information technology was 19 percent over the 1990s as a whole and accelerated to 28 percent after 1995. In 1999, business spending on information technology equipment and software was responsible for more than 11 percentage points of the 14 percent real growth in total equipment and software spending by business. It seems clear that it is investment in new technology that was the impetus for the recent exceptional growth and employment performance of the US economy. This means that the kind of excess capacity that is present in the economy may be rather different than that of the traditional Keynesian cycle.

Much of this new investment has been driven by companies financed by venture capital. According to figures provided by the US Council of Economic Advisers total venture capital investment jumped from $14.3 billion in 1998 to $54.5 billion in the first three quarters of 2000 alone.[10] However, industry sources suggest that financing in June 2000 averaged

10 Economic Report of the President, 2001, p. 106.

$350,000 per day[11], and $103 billion in 5,380 companies for the year 2000, compared to $59 billion in 3,967 companies in 1999.[12] Estimates of the total venture capital under management exceed $130 billion. Companies financed by this short-term venture capital were made public via initial public offerings (IPOs), even though they had not yet generated any positive earnings. This created a further massive injection of liquidity into the capital markets, as pension funds, private investors and, above all, foreign investors sought to participate in the new wave of Schumpeterian innovations. In 1999, new IPOs raised over $60 billion in equity and the figure was been matched in 2000 (although the majority was in the first half of the year).

The sudden reversal of expectations concerning the future earnings ability of these companies in the spring of 2000 caused a sharp drop in share prices of high technology stocks (the NASDAQ index which represents the majority of these companies fell from around 5000 to 2500 at the end of the year). The loss in value on stocks initially issued in 1999 and 2000 has been estimated at nearly $300 billion and has brought new issues to a halt by the end of 2000. Thus, in the second half of the year, the new liquidity that had been provided by these issues ceased and, instead, companies have had to meet the financing needs created by their negative cash flows from other sources, causing a drain on liquidity in the market. This has brought investment and expenditures by these new companies to a halt, while the fall in their share prices has made it difficult for them to raise finance from alternative sources. The natural response to a liquidity crisis is to cut employment and investment in an attempt to avoid bankruptcy, but in the presence of negative earnings resulting from the need to establish market share, such a strategy cannot succeed.

These companies produced the so-called high-tech bubble, and the triple-digit price-earnings ratios. But, the flip side of these ratios was an extremely low cost of financing and abundance of liquidity. It is clear that many of the new technology business plans could never have been explored had they been financed by banks at prime rate, just as banks are now unwilling to provide the financing required in the current downturn.

A Hayekian interpretation would find the explanation of the present cycle in the excessive capital intensity of the new techniques due to excessively low borrowing costs as reflected in the extremely high price-earnings ratios. However, in a period of rapid innovation, the full benefits of a new Schumpeterian wave of technological change can only be acquired by allowing the maximum number of alternative applications (see Metcalfe,

11 Data from DeNichilo, 2001.
12 Data from National Venture Capital Association, 2001.

1994), and letting the market evaluate the way the new innovations are incorporated into new business plans. Whenever increasing returns are dominant, as is the case in the area of information technology, the firms that set the industry standard for that product are likely to gain a substantial competitive advantage.

Thus, the benefits in terms of higher productivity depend on a large number of firms being able to compete with alternative business plans. This is what the venture capital funds and the IPO market allowed; the low cost of finance provided by the stock market bubble allowed a plethora of new business plans to be explored and to continue to exist even in the presence of sustained negative earnings. The problem was not their capital intensity, as in Hayek's approach, but that not all of the business plans were valid. As long as the boom continued and cheap financing was available, even the bad plans could attract funding to meet losses. But, as in Hayek's approach, this excess capacity will not eventually be taken up when demand improves. Thus, the cyclical downturn resembles a process by which the market finally exercises its role in selecting from the wide range of possible applications of information technology innovations those that will be viable on a long-term basis, discarding the rest to bankruptcy.

However, there may be collateral effects of this process which extend to other sectors of the economy. Up until the market correction, the only "market test" of a business plan was the takeover of a high-tech start-up by an existing, successful positive earnings company. Many of these companies, aware of the uncertainty of dominating their markets or the ephemeral nature of that dominance in a period of rapid change, adopted a strategy of diversification. Having identified one business plan that allowed them to generate positive earnings, but uncertain of the future direction of the new innovations, they acquired a range of smaller start-up companies employing different technological approaches, either through direct merger or acquisition of stock. Some have even created their own venture capital funds, such as Intel Capital, which had the highest number of venture capital investments in 2000 at 210.[13] As some of these acquired companies face difficulties and sharp declines in stock valuations, the positive real earnings of their acquirers are reduced. Further, a number of more successful companies have also provided a form of venture capital financing to newer start-ups by charging reduced prices, or providing credit through vendor financing or acquisition of stock options. When these smaller companies go bankrupt or meet liquidity difficulties, the parent has to restate sales and take reductions in earnings. In this way, even successful companies will be impacted negatively by the process of selection that is occurring.

13 See DeNichilo, 2001.

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Finally, although the formal banking system has been largely independent of this process of financing new technology companies, the share of business lending in bank portfolios has risen quickly over the last half of the decade. Much of this lending has been to so-called "old economy" or "blue chip" companies with high credit ratings, either in term lending, in back-up credit lines for commercial paper issues or underwriting and supporting bond financing. But, it is precisely these companies that are threatened by the success of the Schumpeterian process of creative destruction that occurs as high-tech companies supplant older producers[14] or provide more productive and profitable alternatives. The way for old economy firms to avoid the creative destruction by firms using business plans based on new technology is to incorporate the new technology by making innovative changes in managerial and productive organisation. One of the reasons for the recent jump in productivity in the US economy is that these changes are now starting to permeate the entire economy.[15]

While the major force in the recent growth of the US economy has been investment, consumption has also expanded strongly, on the back of increased consumer borrowing, as well as the rising share of households holding equity and the rising value of their portfolios. The loss of market values has thus had an impact on household wealth and although consumption spending has not yet started to decline as dramatically, consumer confidence is down sharply suggesting that declining consumer spending will add to the duration of the cycle.

The conclusion is that the current cycle looks much more like a Hayekian cycle in a wave of Schumpeterian innovation, than a simple Keynesian cycle of insufficient aggregate demand. It also suggests that the confidence that has been placed in monetary and fiscal policy in ensuring that the downturn is short may be misplaced. The excess capacity that exists in much of the IT sector is not excess because of insufficient demand, it is excess because it represents investments in non-viable applications of the new technology. Only a process of bankruptcy can eliminate the excess. Further, it is likely that this process will also create financing difficulties for strong companies and balance sheet difficulties for the banking system, reducing investment and liquidity and raising the possibility

14 But, just as IBM was nearly bankrupted by a failure to keep up with the advent of the personal computer market, these changes are usually slow to be introduced. Even established companies like Xerox or ATT, which were considered to have viable business plans meeting the new challenges of IT are experiencing credit rating downgrades on outstanding debt and commercial paper, raising their borrowing costs. See Scherer and Zuckerman, 2000.

15 The *Economic Report of the President*, p. 122, notes that the introduction of neural networks to control various aspects of the process of steel making can reduce labour requirements per ton of steel from six man-hours to one-man hour.

that even some viable business plans may not survive the liquidity crisis. In such conditions the impact of traditional policy instruments of lower interest rates and lower taxes may have a much lower impact on supporting demand and providing a rapid correction of the cyclical downturn. While the likelihood that this will result in a prolonged period of stagnation is low, the expectation of only a one- or two-quarter downturn seems excessively optimistic.

7 Coordination of Macroeconomic Policies by Industrial Countries

As already noted, global imbalances have generally been accompanied by large interest rate differentials and their resolution has generally been produced through a crisis that precipitated exchange rate instability. The interest rate differentials and exchange rate instability generate international speculative or arbitrage flows that have been a major cause of the instability of emerging market financial systems and exchange rates. The International Monetary Fund is still responsible for exchange rate stability, even though the system now permits free capital flows and flexible exchange rates. Flexible exchange rates may be a suitable mechanism for the major developed country blocs since these are large economies with little dependence on international trade and since firms in developed countries have limited exposure to currency risks because they can invoice in their own currencies. By contrast, sharp exchange rate adjustments in the dollar, yen and euro are a major source of disturbance for developing countries. The majority of developing country financial crises have been connected with sharp shifts in exchange rates.[16]

Given the degree of global interdependence, a stable system of exchange rates and external accounts would imply coordination among the macroeconomic policies of major industrial countries. However, the calls for sound economic policies have generally been reserved for developing countries without recognising that sharp movements in the major exchange rates can quickly turn sound policies of these countries into near crises. Just as IMF forecasting does not seem to give sufficient weight to increased economic interdependence, IMF surveillance does not generally involve assessment of such interaction or assess the monetary and exchange rate policies of the United States and other major industrial countries in terms of their coherence with global stability and the impact on developing countries. At the same time, developing countries lack effective fora for redress or dispute settlement regarding the negative impacts that monetary

16 See e.g. UNCTAD, *Trade and Development Report*, 1998.

and exchange rate policies of the major industrial countries produce on their economic performance. In this respect governance in macroeconomic and financial policies lags behind that for international trade, where such mechanisms are part of the WTO regime.

Recent experience suggests that the major developed countries can take action when imbalances become too extreme, as in the Plaza and Louvre agreements and the more recent joint central bank intervention in support of the euro against the dollar. However, if policy adjustments were taken earlier on a coordinated basis the impact would be much greater and the collateral damage on developing countries correspondingly less.

It is often argued that such coordination is impossible, but this view ignores history. The gold standard was an imposed form of coordination in which each country agreed to adjust its domestic policies according to a mechanism that was enforced by the guarantee of free convertibility of domestic currency into gold at a fixed parity. In fact, the coordination was not automatic, but actively overseen by the governors of the central banks of the major developed countries who coordinated their policies in order to preserve the operation of the system (see e.g. Bloomfield, 1959 and De Cecco, 1974).

The difficulty was that this coordination required countries to sacrifice domestic policy goals such as growth and full employment. The Bretton Woods system was supposed to provide a mechanism of coordination that did not require "measures destructive of national or international prosperity".[17] However, the system did not prove capable of that goal and after the Jamaica Agreements of 1976 recognised the de facto existence of a system of flexible exchange rates, almost all coordination was left to the market mechanism, while exchange rate risk was shifted from governments to the private sector. The result was the increase in financial flows and the advent of financial derivatives to insure against that risk. This increased the private costs of exchange rate volatility as well as the public costs of volatile capital flows. These costs were much more easily borne by the large developed countries than by the developing countries. Thus, the costs of the lack of a formal mechanism of policy coordination were unevenly distributed across countries. In particular they have been borne by developing countries involved in the increasingly frequent and virulent financial crises that have occurred since 1976.

The major industrial countries could make a large contribution to the cause of development by coordinating their policies. They should reform the international financial architecture to create incentives for this policy coordination. In this way, their contribution might be larger than any form of aid.

17 Articles of Agreement of the International Monetary Fund, Article I (v).

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From: New Challenges of Crisis Prevention,
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Comment on "Why Advanced Countries Should Address Global Economic Imbalances," by Jan Kregel

Zdeněk Drábek

Introduction

Jan comes up with an interesting and rather original explanation of global cycles and imbalances. If I interpret him correctly, he makes the following points. Following the Asian crisis, full-scale, worldwide recovery has never materialised. The main reason is that global economic growth has been narrowly based with only the US being the bright performer. East Asia's recovery has not taken place as the collapse of financial systems and asset prices made it difficult for Asian firms to finance production and imports. Russia has been overburdened by its external debt (and, one should add, by poor governance and unsuccessful economic policies, and until 1999 by weak oil prices). Japan has been in recession for almost a decade, and its structural weaknesses only reinforce the global imbalances. Europe has been seen as a big hope for global recovery – but its potential role as an engine of global economic growth has not materialised in view of its own linkages to the US economy. Thus, one can observe a "new cyclical pattern" in the global economy. Unlike in the past, a slowdown in one major market/region is no longer offset by an acceleration of growth elsewhere.

How did we get into this situation? Jan puts the blame on several factors. The monetary policy of the US Fed was too loose in 1997-2000, which has led to an unsustainable growth of production capacity. Commodity prices declined in world markets, which has resulted in a deterioration of terms of trade of developing countries. There was also a fundamental change in the structure of savings-investment balances in the US with the dramatic turnaround in the fiscal balance. In contrast, there has not been a desired change in the savings-investment balance in Japan which would be required to stimulate domestic spending. As already noted, the US has become the sole major source of global demand, and the pattern of domestic adjustment has been excessively dependent on monetary policies. Exchange rates, on the other hand, while remaining channels of financial instability, have been far less disruptive in developed countries as compared to developing countries.

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The Changing Nature of Global Imbalances and Policies

In commenting on Jan's paper I would like to make two simple points. The first point is that global economic imbalances and cycles may be taking rather different shapes and patterns than what we observed in the 1970s and 1980s. The second point is that global cycles and imbalances can no longer be treated by macroeconomic policy alone but must be supported by structural reforms. The reason is that international capital movements and economic performance of countries are affected by factors that are of a structural nature, in addition to factors of macroeconomic origin. I shall turn to each of these two points separately.

In the 1970s and 1980s the debate about economic cycles and imbalances was mostly focused on the distribution of current account deficits among the major economies. A current account deficit in, say, the United States was traditionally associated with current account surpluses in Japan and Europe. This meant that the US current account deficits had to be financed by capital inflows into the United States from Japan and Europe (and from some other smaller countries, of course). As the US current account deficits increased, the need for external financing from both Japan and Europe increased. In the 1990s the pattern was similar even though the United States was now also running large current account deficits with China. But that is where the similarities probably also end. Today, the US current account deficits are no longer driven by fiscal deficits – which were dramatically turned into fiscal surpluses – but rather by an equally dramatic decline in the private savings rate.

Japan's current account surpluses, while continuing to be a permanent feature of the country's external position, are no longer driven exclusively by growth of exports. Equally important has been the relative stagnation of Japanese imports due to a prolonged domestic recession. The recession persisted virtually throughout the whole decade of the 1990s. The European economic picture has also changed. Earlier recessions produced double-digit unemployment rates, and despite recent improvements, the unemployment situation continues to be a matter of a considerable concern in Europe. The unemployment crisis is unparalleled in modern European history.

Using the example of these three major markets, it is evident that both the targets of domestic policies as well as the room for policy manoeuvring have been changed. Policymakers in Japan and Europe may now have to target not only external imbalances but also domestic variables. In the United States, the situation appeared for a long time different; the growing current account deficit accompanied a spectacular domestic growth. Moreover, the use of fiscal policy to restrain domestic aggregate demand

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was highly limited in view of the large fiscal surpluses, further increasing the importance of monetary policy. Today, the situation is different. The US current account deficit continues to rise but the economy is on the verge of recession.

Thus, the first big difference in the comparison of today with the past is the distribution of the growth poles in the global economy. Judging from the evidence concerning changes in the US current account, I think that the US has played a major role for the adjustment of particularly South-East Asian countries. The global markets have been driven in the 1990s by the rapid growth of the US economy and, until the financial crisis, by South-East Asia. I was, therefore, rather surprised to read in his paper that Jan kept emphasising the relatively minor role of the US economy as the engine of recovery and adjustment in crisis-stricken countries. He even suggests that the adjustment in South-East Asia was not helped by a rapid recovery of exports to the US. The figures on Asian exports and current account balances do not support this view.

The global economic imbalances can no longer be targeted with macroeconomic tools alone. The reason is, as noted above, the presence of various structural constraints on the performance of domestic markets in Japan and the European Union. This is the second big difference. Structural issues most frequently mentioned in the literature and the debates about Japan's economic performance include, in particular, serious problems of banks, heavy protection of domestic providers of financial services and of agriculture. These issues, together with persistent deflationary expectations of Japanese households, have been frequently stated as the most serious impediments to economic recovery. Similarly in Europe, the main problems are arguably structural rather than macroeconomic.[1] For example, the rigidity of labour markets, the highly restrictive and interventionist Common Agricultural Policy, and the continued lack of convergence of economic growth and policies within the EU are just three examples of structural impediments on European growth.[2]

Unfortunately, these Japan and Europe-specific issues are not discussed in the paper as the paper primarily focuses on the US. This is a rather

1 The problem is more complicated. There is a dynamism between macroeconomic and structural factors and policies. For example, unemployment cannot be blamed on labour market rigidities alone. When labour markets are subject to cyclical downturns, the unemployed may stay out of jobs long enough to lose their skills or may lose interest in new jobs altogether. In other words, a cyclical unemployment can turn into a structural one. For more details, see Blanchard and Wolfers (1999).

2 While most economists have accepted harmonisation of economic policies as a necessary condition for a successful functioning of a monetary union, I am aware of the recent work of Baldwin and Krugman who argue just the opposite with regard to the harmonisation of taxation policies. See Baldwin and Krugman (2001).

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unusual omission in the discussion of global imbalances. While there is no doubt that the US is a major if not the major player, any discussion of global issues should also cover the European and Japanese markets. Clearly, the question is if the growth of the US economy is slowing down, can Japan or Europe step in and take over the role of the engine of global growth? Is the Japanese recession itself not a source of major instability in financial markets? Given the importance of intra-European Union trade, can the EU ever become an engine of global growth on the same scale as the US?

Jan makes a distinction between conventional macroeconomic management, particularly Keynesian management of aggregate demand, and contrasts it with something relatively new – and I think quite interesting – that is, with the idea of a Schumpeterian (driven) economic cycle. He then asks the question what this implies for global and national economic management. He comes out with the answer that conventional macroeconomic management based on monetary and fiscal policies will not be sufficient to address domestic recessions due to the structural nature of the problem. I quite like this answer.

Let me turn to this point in some more detail. Starting from the Schumpeterian analysis of cycles, Jan hypothesises that the recent dramatic slowdown in the performance of the US economy is a reflection of "over-investment", in particular in the sector of information technology. The over-investment has led to what he calls an "information technology bubble". That is an interesting assertion that deserves serious discussion. But what evidence do we have of a significant over-investment? We can approach the answer from two different angles.

The first litmus test is to assess the aggregate rate of savings, which can be done, for example, through international comparisons. Thus, the question is whether the current level of aggregate domestic fixed investment in the US economy of about 18 percent of GDP (quoted in the paper) is a matter of concern by international standards? Is this a rate that, on the surface, would provide evidence suggesting a major imbalance in the US economy? The answer is that we cannot discern any major "investment bubble" from an international comparison. The Japanese economy, for example, has shown investment rates of about double the US rate.

A similar story can be told from historical comparisons. When we compare the US aggregate investment rates over time we find out, once again, that the 18 percent mark is not out of the ordinary, particularly for an economy that has been undergoing a major structural change. One should undoubtedly ask whether all these investments have not been put in the wrong technology. Jan's argument indeed implies that there may be some evidence of it. This, too, I would find surprising. When one considers the

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evidence on the growth of productivity, for example, it is quite clear that the investments in new technology have made a major impact. Also, when one looks at the pattern of bankruptcies in the US, my feeling is that the companies that have gone bankrupt have not so much failed because of the wrong choice of technology but because of poor execution.[3] Moreover, all of that investment has been obviously fully funded. So, from all these perspectives, which are admittedly somewhat superficial, it is difficult to speak of over-investment.

The second litmus test could be to look at the counter-part of investment, that is savings. Thus, in contrast to the over-investment argument there is another argument that should be emphasised, and that is the question of consumption in the US. As much as Jan argues in terms of over-investment, one could equally argue about the presence of over-consumption. There are three current indicators that would worry me if I were Mr. Greenspan. First, the current level of personal savings is negative – household spending has been driven by increased wealth generated by growing stock market values (the "wealth effect"). This reflects the fact that individual households have significantly increased their holdings of equities and stocks in their portfolios. Second, the overall investment financing is now greatly dependent on foreign savings. This, in turn, is due to the low level of private savings in the US. This increasing dependence on foreign savings must be raising the question of sustainability of investment financing in the future. Third, both household and corporate debt have dramatically increased, which makes the private sector highly vulnerable and sensitive to interest rates movements.

There are three other issues that Jan could have raised in his paper. The first one concerns the conduct of US monetary policy. Has US monetary policy been too tight in the 1990s? In retrospect, there are strong reasons to believe that the answer must be affirmative. This is in spite of the efforts by the Fed to inject additional liquidity into the system in the aftermath of the financial crises in Mexico and later in South-East Asia. The interest rate differentials between the US and Europe (let alone Japan) were high and, not surprisingly, they represented a major incentive for foreign investment into US dollar denominated assets. Admittedly, the real returns on investments were also higher in the US than in Europe or Japan. But even if we net out these "growth" effects, the real interest rates were probably far too high for the "old" economy, in view of the heavy burden of large

3 US company Lucent is perhaps a good example even though the company itself has so far avoided bankruptcy. The company has been producing top products in the industry but embarked on highly imprudent and risky practices such as the excessive use of suppliers' credit. The company has also suffered from other managerial problems.

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corporate debt. Moreover, the real interest rates were also beginning to be high in the "new" economy in view of the rapidly declining rates of return in this sector.

The other two issues take us back to structural policies. The first one concerns the conduct of exchange rate policies. There is now growing evidence that the US dollar might be "over-valued". The most direct evidence is the growing current account deficit, which has now reached dangerous levels. At these levels the capital inflows needed to finance the current account deficit may not be sustainable as investors become increasingly nervous about the impact of a strong dollar on US exporters and on the competitiveness of US producers in general.[4]

The third and final aspect that is not discussed by Jan concerns what I would call an "asset bubble". The prices of US dollar denominated assets have increased to such an extent that many respectable commentators have been repeatedly calling for market "corrections".[5] The bubble, too, is due to a number of structural and other non-macroeconomic factors such as the liberalisation of capital markets, the increased role of equities and securities in household portfolios as noted above, psychology and others.[6]

What Policy Options? - Policy Mixes and Super-Supervisor

What policy conclusions can we draw from this discussion?[7] I very much agree with Jan that the first issue on the agenda must be international cooperation. It is inconceivable that global imbalances will be corrected by one single country alone, irrespective of the fact that the country may be quite large. I personally hope that discussions and policy coordination efforts among heads of states and ministers of finance will continue with the present US administration. In the past there has been a recognition of the need to work together, particularly among the G-7 countries, with

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4 See, for example, the alarming public letter written by two Nobel Prize winners M. Modigliani and R. Sollow published as an op-ed article in the *International Herald Tribune* of April 10, 2001.

5 The *Financial Times*, for example, has been arguing for at least two years that the US stock market is greatly over-valued if measured on the basis of price-earning ratios. They continue to make the same point even at the time of writing this note, despite a major correction that took place at the end of 2000 and beginning of 2001. For a more rigorous analysis, based on "Tobin's q", see Smithers and Wright (2000).

6 For a comprehensive review see, for example, Schiller (2000).

7 There is no shortage of recommendations that could be made with respect to a better management of "boom-and- bust" cycles. Most of these have recently been discussed in the context of the new financial architecture. These issues are not covered in my comments, which only refer to the issues raised in Jan Kregel's paper. For an example of broader policy recommendations see Institute for International Economics (1999).

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regard to macroeconomic coordination and exchange rate management. However, the noises that we have heard so far from the US with respect to international cooperation have not been too encouraging. I do not know which way the current US Treasury Secretary will take, but it seems that he is not in favour of such initiatives. On the one hand, the US administration claims to favour a strong US dollar, while at the same time the monetary policy tends to move towards easing. This will either lead to a conflict with the declared objective or it is an "intelligent" way of pushing the dollar down.

Another conclusion that can be drawn from Jan's paper is that nothing will help to address the "information technology bubble" until the adjustment takes place through a process of bankruptcies. If the IT industry has an excess capacity, it must slim down. But the downward adjustment may not be sufficient given the issues that Jan has raised in the paper and that I have raised now. The response should be a mixture of something more, including measures on the macroeconomic front, especially with regard to US monetary policy.[8]

The critical components of global policy "packages" must include measures addressing the prolonged stagnation in Japan. It is evident by now that the impetus to Japanese recovery can hardly lie in further fiscal expansion. There are also limits on the effectiveness of Japanese monetary policy considering the low level of interest rates prevailing in the country for several years. Perhaps the best use Japan can make of monetary policy today would be an attempt to "inflate", with the sole purpose of altering deflationary expectations that seem to have ravaged the consumer spending.[9] However, this could be a rather risky and dangerous path, which probably no politician will take upon himself. Moreover, the policy will not work if the principal cause of the stagnation is structural, such as the balance sheet problem of banks, about which we constantly hear.

Thus, the first important conclusion and recommendation that I would draw from the recent experiences of the largest economies is that domestic recession is unlikely to be reversed by a single policy instrument. Restoration of Japanese growth will most likely require a policy mix that addresses the structural problems noted above, in addition to standard macroeconomic policy tools. Such policy mixes will also be needed in the US and in the EU. Which policies will have to be applied will of course depend on the specific circumstances of each country. But long are the

8 It appears that the policy of monetary easing has already been started at the time of writing this comment.

9 This point has been persistently emphasised by Paul Krugman who has been a strong advocate of policies leading to a moderate inflation.

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times, in my view, that the treatment of global imbalances can be entirely focused on macroeconomic polices.

The treatment of "booms and busts" originating in global imbalances will require yet another step. Like in the case of banks and other financial institutions for which we require a proper supervision to ensure their sound practices, we need to make sure that countries maintain prudent economic policies. Like banks and other financial institutions, countries often function with borrowed and other external funds. When we supervise banks we do so primarily to ensure that depositors and creditors are not exposed to "excessive" risks. The same logic should basically hold in the case of countries. The exposure by countries to excessive risk has enormously increased with the globalisation of capital flows. Thus, the logical conclusion must be that we are in need of a *super-supervisor* that would oversee the creditworthiness and the practices of sovereign countries.

This is clearly a radical proposal. Unlike banks and other financial institutions, to use our earlier comparison, supervision of countries may interfere with countries' sovereignty. The latter could be difficult for countries to accept, and the bigger the country, the more resistance can be expected. The proposal would also have to include detailed recommendations concerning the availability and provision of information, jurisdictions of the super-supervisor, relationship with national authorities, its status and management etc. However, we already have *supra*-national institutions (e.g. IMF, IBRD, WTO), and we already have an institution that performs some of the supervisory functions – the IMF. The mandate of the latter is limited and would have to be considerably widened to fulfil its new tasks. Most importantly, the countries may only be persuaded to move in that direction if they are convinced that the benefits from more stability in global financial markets outweigh the costs of reduced sovereignty over their economic policies.[10]

10 Theoretically, one could conceive an alternative system that would be designed on the basis of self-regulation. The system has been proposed as an improvement of the current system of supervision of banks *within* a country. The proposal has run into a great deal of resistance, and it would be virtually unworkable in the case of a system operating between countries. On the proposal see in particular Calomiris (1998) and American Enterprise Institute (1998).

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Floor Discussion of "Policy Options for Advanced Countries to Address Global Economic Imbalances"

Excessive Spending by the Private Sector and its Lack of Macroeconomic Concern

Manuel Marfán compared the policy problems arising from the combination in the US of a fiscal surplus, a current account deficit and a high rate of economic growth, with the challenges Chilean policymakers – including Marfán himself – were facing in the 1990s.

"We were experiencing an acute policy dilemma because we had a very good fiscal surplus of between two and three percent of GDP and declining inflation, but an increase in the current account deficit. Simple accounting tells you that in a country with an excess of expenditure and a public sector surplus, the main problem is an excess of *private* expenditure. You know that, in the end, your current account becomes unsustainable. Then you are faced with a very weird policy dilemma.

A contractionary monetary policy alone will not reduce private spending because with an open capital account, the private sector will simply substitute domestic financing with foreign financing. So while this policy will not have much of an expenditure reducing effect, it will appreciate your currency and the last thing you want to do is to appreciate your currency even further. The other option is to apply a contractionary fiscal policy and lower your interest rates. That mix will reduce the level of expenditure and change relative prices. However, if you have a fiscal surplus, cutting back on government spending below the level legislated by civil society is politically unfeasible. So what did we do in Chile?

In the beginning, our policy was to increase the international interest rate by means of capital account regulations, which is a way of applying a contractionary monetary policy without the effect of arbitrage with respect to international interest rates. Simply put, you simultaneously raise your domestic interest rate and the cost of borrowing from abroad in order to avoid arbitrage. However, this type of policy does not work eighter from a political economic standpoint because, if you have a successful economy with many good, low-risk investment opportunities and a high expected rate of return, why should you prevent sound financing?

So in the end, you have a rising current account deficit, pressure to

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further increase your fiscal surplus and high interest rates, which appreciate your currency. At some point, this combination of events will explode. In the Chilean case, it exploded by the middle of the 1990s.

Similar things have happened in other economies such as Indonesia, Korea and Malaysia that had a fiscal surplus or balance, a current account deficit and the perception that they were very successful economies. This was also the case of Mexico before the 'Tequila' crisis. In Mexico, the fiscal situation was under control after many years of fiscal deficit; they had a fiscal balance in 1993-1994. However, with the current account deficit rising again, the private sector began expanding very quickly and contractionary monetary policy made Mexico even more vulnerable.

The US had the same ingredients. Its economy was perceived as very successful and there was a combination of a fiscal surplus and an increasing trade deficit. Again, there was a policy dilemma because the textbook policy mix prescribed in that case would have further increased the fiscal surplus in order to accommodate the private sector deficit, and would have reduced interest rates as the concomitant monetary policy to contractionary fiscal policy. Again, it would have been an unsustainable policy from a political economy point of view, especially on the eve of a presidential election.

The corollary of all this is that in the context of globalisation, the degree of freedom to manage the macroeconomic cycle is very small, especially for an economy that is perceived as successful. Although I am unsure what the policy response should be, policymakers should realise that private deficits do matter. However, private deficits are generally not included in the policy agendas, especially not in those of the Bretton Woods institutions who say that central banks should care about inflation, and fiscal policymakers should care about having a balance or a surplus.

In my view, the main problem is that, in general, international capital flows tend to go into the economies that are perceived as successful and less risky. In that sense, from a world perspective, the US trade deficit was not all that expansionary. Well, since it was a trade deficit, there was a surplus somewhere else that was expansionary. But the US was also receiving enormous amounts of capital flows, which was contractionary for the rest of the world. With these capital inflows, the private sector in the US could finance its deficit and increase its private debt, which is a true problem now.

I do not hear any discussion in both the developing and developed countries about how to manage excess private expenditures in the context of a globalised economy. I have not seen any macroeconomic text that has suggested a solution to this imbalance, even though the private sector's behaviour has been the main driving force behind the cycles we have observed since the 1990s."

Stephany Griffith-Jones agreed that excessive spending by the private

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sector lies at the heart of the imbalances that now exist in both the US and the other economies. "This may give some hints as to the policies to be pursued," she said. "One hint that presents itself is the huge expansion of credit. In the US, a lot of the purchases of shares is funded by loans. The last time that this happened was in the 1920s. In the case of the Mexican boom, prior to the crisis, there was a similar huge expansion of consumer credit and of lending to buy real estate. Maybe one of the instruments that has been disregarded is the policy of controlling private credit, both external and domestic, in a counter-cyclical way."

Griffith-Jones argued that more attention should be paid to the issue of expectations. "Since economies are so globalised and privatised, expectations are playing a larger role than before. Currently, in the US, although a significant slowdown has been taking place, people in the markets did not notice the imbalances until recently, and now that they see them, they are concerned – even overly concerned. That their extreme concern is making the situation much more dangerous is not news for those of us who have followed developments in emerging markets because that is how all these crises have occurred. It would be important to know how one could influence these expectations."

Barbara Stallings recalled the winter-spring 1994 exchange in the Financial Times between Alejandro Foley and Pedro Aspe, the then finance ministers of Chile and Mexico. "Their discussion had to do with exactly this point. Alejandro was criticising Pedro for running such a large current account deficit and Pedro said it did not make any difference because there was equilibrium in the fiscal accounts and therefore the private sector would know what to do with the situation. More interestingly, the point I want to follow-up on is the idea that the current account deficit was a temporary phenomenon because it existed in the form of imports of capital goods, the counterpart of the large amount of investment in Latin American economies. The issue was the assumption that 'if you give us a little time, the problem will resolve itself'. So one way – at least in principle – of trying to get out of the dilemma that Manuel portrayed so vividly is to see if there are ways of providing that extra time. Are there mechanisms, some combination of domestic and international policies, that could provide that extra time?"

José Maria Fanelli questioned the need for reducing private deficits. "Our discussion could be called 'how to kill a private deficit'. Yet, I wonder why we should even kill it? Maybe there are good private deficits? If we assume that the private sector allocates resources in the best way, increasing its productivity, why should we care about its deficits? Maybe the problem is not how to kill the private deficit but how to correctly manage and allocate the funds from abroad?"

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Liliana Rojas-Suárez said that when she was still at the Deutsche Bank a few months earlier, they raised the same question: were current account deficits sustainable? "Our basic conclusion was that we were looking at the wrong side of the external sector, that current accounts had a counterpart on the capital account. The question of whether the current account was sustainable or not is really the question of whether the stock of indebtedness was sustainable or not. Basically, that significantly relates to, first, the kind of inflows that are financing the current account and second, the productivity contribution of those flows. When people discuss whether current account deficits are good or bad, the focus is on the wrong part of the balance sheet. If it is financing the right project without distortions from the government, and it is a highly productive project, that project itself can justify a sustainable current account deficit. On the other hand, if it is based on an unsustainable stock of inflows, then you have a problem with the current account deficit."

John Williamson stressed that one should look at both the quality and the size of the current account deficit. "Whether it is financing increased investment or reduced savings, as was actually the case in Mexico, is relevant, but size is relevant too. There are a series of cases where countries have invoked what we in England call the 'Lawson doctrine', which states that the private sector deficit does not matter. The first place I heard this was right here in Chile in 1980-1981 sitting in this very chamber. That is what was being said at that time. Later, we heard it in Britain in the late 1980s and in Mexico in the mid-1990s. Beyond a certain size, one really needs to worry about the current account deficit. I certainly agree that all deficits should not be ruled out. Rather, one should look at how they are financed and what they are financing."

Manuel Marfán deepened the discussion by looking more closely at the private sector's behaviour. "There is no reason why any particular private agent is going to internalise the macroeconomic costs of the private sector's behaviour. It is no wonder that we have observed a currency appreciation in all these economies. The private sector has accounted for a lot of excess foreign currency because they are borrowing heavily from abroad. If you have an exchange rate misalignment from a more structural perspective, there is no private agent that will behave in a way that will correct that because he has no incentive to avoid macroeconomic vulnerability. Avoidance of macroeconomic vulnerability is a public good and that is why you have monetary policy in almost all the countries of the world.

Another disease that can be observed in some of these countries is asset inflation. Again, why should any particular private actor behave in a way so as to counter-effect asset inflation when the profits he makes are precisely the results of asset inflation, and where he tries to flee before the bubble

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explodes? In these types of cycles, there are incentives for the private sector to behave in a way that aggravates the macroeconomic imbalance. When you have an appreciating currency, excess borrowing from abroad becomes even cheaper because when you repay your debt you do it with an appreciated currency. If you are a rational private agent and consider this a misaligned exchange rate, then the rational bet should be 'I should repay my debt before this bubble explodes.' So what do you do? You borrow in the short-term market, which is precisely what should not be done from a macroeconomic standpoint.

The main problem is that while the private sector has good leverage ratios in its own balances, from an aggregate public standpoint the resulting overall economic imbalance may become very dangerous. So there are many public goods that the private sector is not internalising in its behaviour. That is precisely the responsibility of the macroeconomic authorities of the country. However, they usually do not care about private sector deficits."

Stephany Griffith-Jones added: "Referring to what Liliana said, of course it is true that the kind of inflows that are funding the deficit are important, but the problem is that during the debt build-up you are not exactly sure how volatile and reversible these flows are. I was at the Czech Central Bank when it had inflows of 16 percent of GDP. We did not know how reversible these flows were because even the FDI flows tended to have derivative positions and mechanisms to protect the private sector and make it easier to leave, which is good for them but more difficult for the country.

Similarly, in East Asia we all believed that the structure of flows was quite long-term until it changed very quickly at a time when the statistics and perceptions were not fully understood. Transparency of what the financial actors were doing internationally would have helped, but there is this very difficult dilemma. Therefore, I agree with John's point that in the end the size of the deficit always tends to be the bottom line. The expectation that you can somehow get around it does not tend to work. Barbara asked, 'How do you provide for this extra time?' I think that is very close to the nature of the funding. If you are subject to funding that is very easily reversible and subject to expectations, it becomes very difficult and you do not have the extra time."

Zdeněk Drábek disputed Marfán's view that the private sector has little concern for macroeconomic issues. "Why would the private sector not be willing to internalise macroeconomic concerns? When I was working for the Czech government, prime minister Klaus was very proud of saying that the reason why finance minister Balcerowicz in Poland failed was that he never went out to talk to the private sector about the conduct of macroeconomic policy. Klaus was very proud that he spent most of his

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time on the road explaining the government's policies. I think that it would really be in the interest of the private sector to know whether it over-borrows abroad at a time when domestic interest rates are increasing. Why would the private sector not understand that there could be excess borrowing?"

Liliana Rojas-Suárez followed-up: "The private sector is very concerned about the risks it takes. The problem is that the risks have been taken away from the private sector and absorbed by the government. The private sector is willing to become over-indebted because of the deposit insurances, the explicit bailouts and the promises of fixed exchange rates. If they do not have to hedge or save and if they are not properly supervised, why should they care? If these wrong government policies are not addressed, the private sector will remain unaware of the risks it incurs or perceive them as being absent."

Manuel Marfán insisted on the private sector's lack of concern for the macroeconomic soundness of a country. "There are many examples of why the private sector behaves in this apparently non-rational way. During the 1990s, all the international crises began in countries that were exhibiting fiscal surpluses and large current account deficits. The opening up of the capital account implied a race between different private sector holdings over who would have a larger share of the asset properties within the country. When you have that type of competition, in the end, the group that buys the most assets from already existing assets by borrowing abroad is the largest risk seeker. The final equilibrium point of the economy is determined by the least risk adverse participants of the private sector in this type of risk.

I would say that, in general, private investors do not know very much about macroeconomics. They hire people that know, and depend very heavily on their credibility. If an expert says that private sector deficits do not matter, then the investors do not care about private sector deficits. I went to the World Bank meetings in October 1998 in Washington at a time when international investors were panicking and fleeing to safety. The only thing they cared about was how contaminated the Chilean economy was by the Brazilian case. When they made the investment they did not ask that question because Chile was a very popular, safe place to invest and they did not have the time and did not want to spend the money to make a rational, well-informed decision."

US Domination and G-7 Coordination

Amar Bhattacharya brought the discussion back to Jan Kregel's original point that in the end, the issue of global imbalance is dominated by one

country, the US. "That is true and it is also true that in the US the private sector imbalance dominates. However, the interesting question is: what are the policy conflicts that will play out in the US and to what extent do they have symmetrical repercussions in the rest of the world? For example, when the US is put in the position of not only having to deal with a continuing current account deficit but also declining capital inflows at the same time, it creates an exchange rate conundrum. The pressure on the US dollar puts the Fed in a position of having to defend the dollar with high interest rates, when, at the same time, the economy is going into a tailspin. The unwinding of the US deficit has a disproportionate bearing on the global imbalance."

Zdeněk Drábek disagreed with the view that it is only one country that matters. "Other poles of growth centres also matter a great deal. The US has been growing much faster than Europe, which was growing much faster than Japan, which has not been growing. In the global economy, who is the engine? Is there one or are there several? If there has been only one, or one and a half and Japan was out of it, I would be concerned. So far we have been discussing issues of macroeconomic policies, but if the growth of Japan and the European Union also matters, then structural issues need to be considered too. In order to make recommendations about how to deal with boom-and-bust cycles and address global economic imbalances, one also needs to be concerned with the relationship between the macroeconomic policies and the structural constraints that exist in some of these major economies, particularly Japan and the European Union."

José Antonio Ocampo wondered what sort of G-7 coordination would be needed to avoid a world recession and whether Europe would be able to apply counter-cyclical policies. "In order to avoid a world recession or slowdown, should coordination among major economies mean some sort of expansionary policy in Europe or Japan? Japan has been trying to do that for several years with little success. One thing that has struck me about the European cycles is that they are very similar to Latin American cycles. I always think that we in Latin America are highly dependent on US cycles, but why should Europeans follow the same sort of cycle? Does that mean Europe does not have enough policy autonomy? Is Europe unable to undertake counter-cyclical monetary policies because of a dominance or fad in the way of doing monetary policy? The US has practiced some sort of counter-cyclical policy, and, as Jan shows in his paper, the result was extremely pro-cyclical for the US. In 1998, the US lowered interest rates in an effort to avoid a world recession but it unexpectedly turned out to be an extremely pro-cyclical policy for the US, which probably further fed the bubbles. Even if we agree that macroeconomic coordination among major G-7 members is needed, what sort of international

rules have to be designed for that to have effect? In my view, European monetary policies have been extremely pro-cyclical through the 1990s at least."

John Williamson disagreed with Ocampo's suggestion that European monetary policy has been pro-cyclical. "I think there was one pro-cyclical incident in that awkward phase when Europe more or less had a fixed exchange rate, but monetary policy was being fixed by one country, Germany. While monetary policy in 1992 was anti-cyclical from a German standpoint, it created a recession in the rest of the area that did not have the same positive shock coming from German re-unification. While there was a real problem there, I don't think that you can otherwise make that case at all."

José Antonio Ocampo retorted: "It is quite paradoxical that the European business cycle is actually quite similar to the US business cycle. There was a slowdown in 1995, a boom in 1997, a slowdown after that and then a boom in 2000. The pattern is the same as in Latin America. However, the business cycle of Latin America is determined by capital flows and moderate but generally pro-cyclical policies. So my question is: what is happening in Europe? Does it not have enough freedom to isolate itself from these cycles?"

Stephany Griffith-Jones gave her view of Europe's monetary policy. "The things that are driving the European monetary policy have to do partly with the policy of the European Central Bank, which does not have employment growth, for example, as an objective while the Fed does. The other thing is that European monetary policy has been driven by the process of the euro and a certain recessionary bias in the Maastricht criteria, which many people argue is not necessary. There were problems within the European economy that made the macroeconomic response quite restrictive, but it did not really have to be that restrictive."

John Williamson elaborated on the feasibility of G-7 policy coordination. "Should we be thinking of creating a dispute settlement mechanism in the financial regime, as Jan Kregel suggested in his paper? Unfortunately, that is not the way macroeconomic coordination has traditionally been advanced. Any suggestion that macroeconomic coordination meant that country number one, let's not give it a name, should subjugate its national interests to helping other countries was regarded as simply inadmissible. There should be a mutual gain and not an expectation that some countries will change their behaviour so as to advance the interests of other countries. One cannot get an audience for a discussion about this issue unless one starts from that position. I may regret it, but that is the way I tried to formulate my suggestions about macroeconomic policy coordination in the 1980s.

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Suppose that one does start from that position, where does that lead you? The basic thesis in Jan Kregel's paper is that there are some real shocks coming from the developed world in terms of variations in the level of aggregate demand, and exchange and interest rates that have some very adverse repercussions on developing countries. How does one try to address such shocks? In terms of aggregate demand, any suggestion to developed countries that they pump up demand to levels that are too high, inflationary in the present day in age, is going to be unacceptable.

The argument is then made in Jan's paper that Europe and Japan were essentially overestimating their natural rates of unemployment in the 1980s and 1990s when they could have had more demand without having significantly more inflation. Finally, during the US' experiments in the second half of the 1990s, everyone was very pleasantly surprised to find that you could get more growth if you didn't automatically step on the brakes when unemployment hit the latest estimate of the natural rate; in this case you could just ease it down. While this is probably a valid point to criticise macroeconomic policies, I am not sure if one needs to look for a new macroeconomic policy regime.

Regarding exchange rate volatility, the interests of developing countries are not at stake unless they themselves put them at stake. Surely, the East Asians suffered because the dollar appreciated. But why did they suffer? Because they pegged to the dollar instead of to a basket of currencies. The remedy was in their own hands! So here I disagree with Jan. When it comes to interest rates, on the other hand, I tend to agree. There is nothing that developing countries can do to defend themselves against variations in interest rates. As we just heard from Manuel Marfán, Chile tried but had very limited success and eventually ran into the same sorts of problems. However, it was rather interesting that Manuel said that, apart from Singapore and Ireland, the other similar countries all ran into crises, and because Chile did not, it might suggest that there was some value in the maligned capital inflow restrictions after all.

What can one do about it? My suggestion in the 1960s and the 1980s was very similar to Jan's suggestion, which involves an active fiscal policy, which is not very popular nowadays. That argument says that President Bush should have indeed proposed a tax increase although it wouldn't have gone down well with the US Congress."

Rogério Studart pointed at yet another problem of US' domination of global cycles. "I think that the financial problems that the US is facing at the moment are going to strongly affect FDI in developing countries. For countries like Brazil and Mexico, this is going to be a huge financial problem. Why? Because in most of these countries, FDI has been based on mergers and acquisitions of firms, which have been financed through the

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issuing of bonds in highly liquid markets in the US. That liquidity is now shrinking and transnational companies are having a problem of finding other sources of finance.

Nowadays, Brazil is financing a huge part of its balance of payments through FDI. We can make adjustments in the flows, but how can we make adjustments in the stocks? We need to refinance the stocks and if we cannot get it from FDI, where is it going to come from? If there is a decline in FDI this year, which I think is going to happen because of the declining mergers and acquisitions boom, Brazil and Mexico are going to face problems. What kind of policies could be drawn in order to face the huge stock disequilibrium problem that most of the developing countries now have?"

Reply by Jan Kregel

"John Williamson raises a very important point about how a dispute settlement procedure for financial policy conflicts should be viewed. While the WTO represents a dispute settlement mechanism for trade factors, there is currently no such mechanism for settlement of financial policy conflicts. For some time, we at UNCTAD have informally been suggesting some sort of forum in which developing and developed countries could meet and discuss how interest and exchange rate policies in developed countries affect developing countries.

When the Bretton Woods System was set up, the idea of exchange rate management was to eliminate the exchange rate as a commercial policy tool. An institution was set up to stabilise exchange rates so that exchange rate adjustments would respond to the so-called 'fundamental factors', but not be used as an aggressive tool of commercial policy. Interest rates more or less serve in the same category. According to the Fleming-Mundell model, you use interest rates to allow you to run a larger commercial deficit to pursue full employment than you might have done in the past.

Basically, behind the entire Bretton Woods System there is an idea that some sort of framework should be set up to stabilise exchange rates which provides a common benefit for everybody involved. The problem is that after the Jamaica agreements, although this presumption was maintained, there were no formal guidelines set down as to how intervention would occur in order to prevent exchange rates from being used or moved in ways that provided commercial benefit.

This is precisely the case of 'overshooting'. There is nothing that tells us precisely when an exchange rate change gives a country an advantage in commercial policy by overshooting. We raised this issue of a potential WTO arrangement in dispute settlement with the idea that there would be

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some sort of mechanism and principles outlining when intervention should occur on which everybody agreed. Regarding how they should be set up, I have already mentioned John's proposal for pegging exchange rates to real effective exchange rates. If free trade is the best overall system for maximising the benefit of everybody concerned, we need some sort of exchange rate stability that prevents exchange rates from distorting the free trade system. It would be to the benefit of everybody concerned to set down precise regulations, which do not exist in the Jamaica agreements, in order to create a dispute settlement. If a country did not respond to the 'Williamson Rules' then they could be taken to the equivalent of the WTO because they did not adjust their fiscal deficit and caused some damage. There should be the presumption that there is a common benefit to exchange rate stability.

In response to Rogério's question about stocks and flows, I again refer to the Fleming-Mundell model which presumes that you can have all sorts of flows and not pay any attention to the stocks that were built up and the problems they might eventually cause. If there is an ignorance of the stock problem, it comes from this model, which uses interest rates in order to generate flows that allow you to run particular current account positions. However, if you do this over a long period of time, you start building up stocks and, eventually, private financial market participants will recognise these as Keynesian finance schemes. Countries that have to continue borrowing in order to meet their interest payments on the outstanding stock of debt will eventually be cut off from the provision of finance and then you do run into a crisis.

It should be pointed out that the US is the basic economy driving the system and if it moves dramatically for a long period, you will have two particular problems. One is the demand impact, which is going to be very strong and direct. The second is the experience of 1998 when we saw a position that threatened the persistence of the US expansion. In particular, there was a drying up of financing in high-yield markets for a large number of US companies that were driving the expansion. This led to a very sharp run to liquidity and an appreciation, rather than a depreciation, of the dollar. It would be extremely negative for the rest of the world if this happened again."

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