



IMF: Case of a Dead Theory Walking

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The Asian financial crisis has eased, but its reverberations have enmeshed the International Monetary Fund (IMF) in a major legitimacy crisis over its recently assumed mission and its ability to implement it. That new mission—promoting free capital mobility around the globe—parallels U.S. policy, though deviating sharply from the IMF's original function. The IMF's crisis is thus also a U.S. policy crisis.

Under the Bretton Woods Agreement, reached by the major capitalist powers toward the end of WW II, the World Bank was to provide reconstruction financing, while the IMF was to provide short-term financing to stabilize exchange rates. The basic objective of the agreement, whose terms still serve as the IMF's charter, was to establish an economic order in which multilateral trade and investment (together with stable, convertible exchange rates) would be compatible with full employment, progressive taxation, and other components of welfare capitalism.

Controlling international capital flows was judged essential for these goals to be mutually sustainable. Hence Article VI authorizes member countries "to exercise such controls as are necessary to regulate international capital movements" and empowers the IMF to request tighter controls and to deny emergency credits when used "to meet a large or sustained outflow of capital." In practice, the IMF has neither requested borrowing countries to tighten capital controls nor denied credits when they were used to finance capital flight.

Key Points

- The IMF has been transformed into an instrument for forcing open third world markets to foreign capital and for collecting foreign debts.
- This transformation, which violates the IMF's charter both in spirit and substance, has increased socioeconomic costs to countries requesting IMF financial aid.
- The IMF's crisis stems from growing debtor resistance to its demands, the soaring fiscal costs of frequent IMF-led bailouts, and mounting evidence of IMF policy failures.

However, during the first three post-war decades, the IMF as a major source of emergency credits to developing countries, was largely sidelined by bilateral foreign aid driven by cold war politics and, in the 1970's, as "foreign aid fatigue" set in, by private bank loans. Beginning in the late 1970s, however, the U.S. found the IMF increasingly useful for handling debt crises in the developing world and opening developing country asset markets to international capital. From a minor lender of last resort, the IMF became a major enforcer of foreign debt service and a leading advocate of removing all obstacles to the entry of foreign capital. In pursuing these functions, the IMF has attacked capital controls throughout the developing world, thus moving from neglect to active violation of Article VI.

As the IMF has pursued its campaign to rid developing countries of capital controls, it has steadily expanded the set of policy changes it demands from countries seeking its credits. Prior to the 1980s, the IMF

advocated policies intended largely to relieve foreign exchange crises at moderate socioeconomic cost to the borrowing economies. The IMF insisted on monetary-fiscal tightening and devaluation but did not demand that capital controls be removed.

By 1980, however, its primary goal became resolving balance-of-payments crises by attracting foreign private capital. The IMF's policy demands now included measures that cut deeply into the socioeconomic structures of the borrowing countries and increased their adjustment costs. It required countries to ease capital controls and to rely on raising interest rates to halt capital outflows and attract inflows. By intensifying domestic bankruptcies, banking crises, and credit crunches, this strategy often deepened declines of output and employment. To attract equity investment, the IMF also pressured borrowers to privatize state assets, reduce social expenditures, and repeal measures that protected wages and favored domestic firms over foreign competition.

These tougher IMF conditions and increased IMF meddling sparked popular unrest and political crises. Fearing popular reaction, many borrowing countries took IMF funds without fully implementing associated IMF demands. Mounting resistance to its austerity conditions and political meddling has contributed to the crisis currently enveloping the IMF.

The IMF is also under attack for its failure to provide adequate debt relief. In the past, when bilateral government loans constituted most developing country foreign debt, the IMF could ease the debt-servicing burden by persuading lender governments to stretch out repayment schedules. More recently, eager to keep private capital flowing and to promote increased global financial integration, the IMF has emphasized sustaining the full servicing of private loans as a core principle. Indeed, to assuage panicky creditors the IMF even required borrower governments to rewrite private debt contracts. In the early 1980s, the IMF encouraged debtor governments in Latin America to guarantee the foreign liabilities of their domestic private banks, whose copious borrowing had helped bring on the crisis. To obtain bailout funds to mitigate its 1995 crisis, Mexico was required to pay out dollars to holders of its *tesebonos*, though contractually these treasury notes merely required repayment in pesos.

In compensation for such government guarantees, the IMF has been enlarging emergency credits. But as currency/banking crises have become more frequent and severe, there is mounting legislative resistance in the U.S. and other creditor countries to the rising fiscal burden of replenishing IMF coffers and providing supplemental bailout funding. The \$50-billion Mexican bailout of 1995 dwarfed previous packets, yet it was nearly quadrupled by the sum of the Asian-Russian-Brazilian bailout packets of 1997-98. Since 1995 the international bailout packets have amounted to over \$250 billion, with around 35% supplied by the IMF. Its coffers nearly emptied, the IMF has been campaigning for enlarged replenishment quotas from its members to enable it to respond more expansively to future crises. The campaign is falling flat.

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The IMF is being buffeted as well by growing criticism that its "sound" crisis policies have had a low success rate and that the substance of what it dubs "sound" has evaporated in a fog of *ad hocism*. Typically, the IMF's pre-crisis assessments failed to foresee the impending crises. Its "sound" crisis remedies concentrated the adjustment costs on the borrowers while protecting the lenders. The IMF tried to obscure overt failures by *ad hoc* modifications of

its remedies. In the process, the optimistic performance targets of the initial IMF policy package fade from view, along with clarity as to which fiscal, monetary, and exchange rate policies are indeed "sound." Accordingly, mainstream economists have been defecting from the theoretical perspective on financial market behavior that has underpinned the IMF's current mission—compounding the IMF's legitimacy crisis.

Problems With Current U.S. Policy

The Bretton Woods Articles of Agreement were shaped by the Keynesian view—widely shared at the time—that unconstrained financial markets are prone to excessive volatility and speculative mispricing of assets, with adverse repercussions on production and trade. The recent IMF (and U.S.) drive to promote free capital mobility around the globe stands the Bretton Woods perspective on its head. It is argued that if financial markets are allowed to operate freely, these markets will price assets efficiently and optimally. Interventionist policies that distort the markets—and not markets themselves—are deemed the root causes of financial disorder. The corollary of this theory is that lifting capital controls globally advances rather than undermines the basic Bretton Woods goals.

This theory holds that free capital mobility produces an international converging of real interest rates and a more accurate global pricing of capital assets, thus elevating the returns on global capital and the efficiency with which global resources are allocated. In addition, it is claimed that by rewarding "sound" policies with capital inflows and punishing "unsound" ones with capital outflows, the globalized financial markets will also improve domestic policymaking. All this is supposed to accelerate productivity and output growth—especially in the capital-short, technology-dependent developing world, where the return on capital should be highest. Hence, the increased socioeconomic costs of IMF policy demands merely swap short-term pain for greater long-term gain.

Such theorizing, however, builds on an assertion about the innate efficiency of financial markets that has negligible backing from economic theory and is refuted by actual trends after the 1960s. Lifting capital controls has opened the gates to an accelerating volume of international financial flows. But these have been accompanied in most of the developing and industrialized world by slackened growth of investment, savings, output, trade volume, and productivity, compared to the Bretton Woods decades.

Increased capital mobility has caused global growth to slacken for two main reasons: 1) heightened volatility of both nominal and real exchange rates, and 2) much higher real interest rates generated by the explosive growth of cross-currency financial flows. Higher volatility raises the risks of investing long-term, while higher real interest rates raise the cost of capital. Combined, they have tilted private investment after the 1960s toward projects with quicker payoffs, which have contributed less to productivity growth than did the long-term investments characterizing the less volatile Bretton Woods decades.

Since the 1970s there has been an upsurge in investments in mergers and in speculative investments—adding nothing to productive capacity. Over 80% of global foreign exchange (forex) turnover—which exceeded \$375 trillion in 1998 compared to \$4.6 trillion in 1977—involves round trips of a week or less. Only 3% directly finances trade in commodities and

nonfinancial services, compared to 30% in the 1970s. The other 97% represent financial transactions that exploit discrepancies between inter-country interest rates and corresponding exchange rates, speculate on movements of bonds and equities in different markets, and hedge against or speculate on exchange rate changes. The short-term focus of these flows makes them highly skittish. Hence, as their volume has increased, so has the frequency and extent of disruptive flow reversals. Since 1980 around 80% of IMF member countries, industrialized as well as developing, have suffered one or more bouts of currency/banking crises or near crises. In contrast to the localized crises of the Bretton Woods era, the reactions of the globalized financial markets have rendered subsequent crises far more contagious.

The changing economies of the industrialized countries contribute to the rising financial fragility. Since the mid-1950s, each of the G-7 countries has experienced rising shares of gross domestic product (GDP) devoted to finance, insurance, and real estate (FIRE)—activities that facilitate asset trading and risk transfer. Rising FIRE/GDP ratios were associated until the mid-1970s with faster output growth of goods and nonfinancial services in each of the G-7 countries. But the correlation turned negative thereafter, indicating that the surging financial activities since the demise of Bretton Woods have been crowding out production of goods and nonfinancial services.

The rise since 1980 of real interest rates to double real GDP growth rates in the G-7 countries is also indicative of increasing financial fragility. Reinforced by increased debt leveraging, the holders of financial assets—mostly the wealthy elite—have been garnering rising shares of national income and wealth. Over the past 115 years, only the inter-war decades experienced such a prolonged rise, and then mainly because real GDP collapsed in the deflationary 1930s. The massive booms in shares and real estate prices of the 1980s and 1990s, despite the slow growth and high real interest rates, also imply an excessive reduction of investor risk perceptions, resembling the Roaring Twenties that preceded the Great Depression.

Key Problems

- The current IMF mission, imposed by the U.S., is based on flawed theorizing about the efficiency of unconstrained financial markets, which are innately prone to the destabilizing mispricing of capital assets.
 - The international decontrol of financial markets has encouraged hot money flows, that have increased exchange rate volatility and the frequency of contagious currency crises, thus retarding global growth of output, trade, and productivity.
 - Debt leveraging, rising real interest rates, and booms of asset prices have fueled prolonged trend toward income and wealth concentration reminiscent of the 1920s.
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Toward a New Foreign Policy

Washington has been crusading simultaneously for worldwide free trade and free capital mobility. But the architects of Bretton Woods were right. These two goals conflict in both theory and practice. If economies are unable to directly restrain destabilizing capital flows, they will be tempted to do so indirectly by imposing trade restrictions. The mission crises of the IMF and the World Trade Organization (WTO) are thus causally linked. Curbing hot money flows is essential for reducing exchange rate volatility and contagious currency crises. Controlling short-term flows is also essential for allowing countries more scope to implement monetary and fiscal policies and to initiate environmental and other programs that complement their

Key Recommendations

- A small uniform tax on global foreign exchange transactions, would assist joint-Big Three efforts to stabilize their exchange rates.
- By weakening the veto power of financial markets, the Tobin tax would also facilitate a return to the more equitable and stable welfare capitalism of the Bretton Woods era.
- Increased grassroots pressure is needed to overcome the resistance of the financial elite to measures that constrain capital mobility.

socioeconomic structures and social welfare objectives.

Discussions now under way among the G-7 leaders and at the IMF aim to curb exchange rate volatility and contagious currency crises by "reforming the global financial architecture." But the reforms under active consideration still target government policies, not market failures, as the root cause of financial disorders. They stress greater "transparency" from governments, calling for governments to provide more timely and comprehen-

sive information to the financial markets on domestic economic conditions and impending regulatory and policy changes. Proposed reforms aim to further reassure foreign investors by pressing developing and "transitional" economies to model their banking and capital market institutions and bankruptcy laws on those of the advanced economies.

Underlying these official discussions about financial architecture reform is a mounting tension. While there is a continual reaffirmation that capital decontrol for all IMF members remains the long-term goal, there is rising anxiety that the polarizing distribution of income and wealth accompanying the free market globalization is threatening the effort. Also haunting the discussions is a growing awareness that new demands for increased transparency can't fulfill the lack of information about the future, condemning mortals who invest competitively to form imperfect expectations about future returns from their capital assets. It cannot, therefore, prevent recurrences of the sudden reversals of financial flows that afflicted the European Union in 1992, Latin America in 1982 and 1995, and East Asia (as well as Russia and other former Soviet Union republics) in 1997-98.

Given this shortcoming, is it politically wise to increase the pressure on widely diverse countries to reshape their central institutions primarily to comfort opportunistic foreign investors? From a Bretton Woods perspective, the official architectural reform agenda is short on proposals to deal with market failure. The official agenda, therefore, is dangerously one-sided in demanding that developing countries reform to accommodate the needs of the financial markets of the creditor countries, while devoting little attention to taming the volatility of these markets.

But Bretton Woods-like proposals that would redress the global financial balance have been kept off the official agenda. A prime example is James Tobin's well-known proposal to impose a small

globally uniform tax on all foreign exchange (forex) transactions. The tax, a "market friendly" substitute for direct capital controls, reduces hot money flows by squeezing the profitability of large-volume, quick round-trips (maneuvers that exploit interest rate differences across currencies and speculate on exchange rates) while barely affecting returns from the longer round-trips related to foreign trade and direct investment. Exploratory guestimates suggest that a 0.1% tax might cut forex turnover by up to 50% and generate annual tax revenues of perhaps \$200 billion.

Such a move would facilitate another Bretton Woods objective, stabilizing key exchange rates. Since 1985 the financial powers have intermittently sought to realign their exchange rates within target zones that set bounds to rate movements. But these efforts broke down, because large speculative flows dwarfed the capacity of central banks to use their forex reserves to counter opportunistic attacks on exchange rates. This is not surprising, since official worldwide forex reserves had shrunk from 17 days of global forex turnover in 1977 to a one-day turnover by 1992. By shrinking private flows, the Tobin tax would improve prospects for jointly curbing dollar, euro, and yen fluctuations. This would enable the Big Three currencies to replicate the dollar's stabilizing role during the Bretton Woods era, when the greenback served as a relatively reliable anchor for the lesser currencies.

The tax would also reduce the power of financial markets to coerce domestic policies. A 0.1% tax allows country A's interest rate on 30-day notes to diverge from B's by an additional 2.5% before triggering profitable arbitrage and speculative capital outflows, thus strengthening the economic feasibility of socioeconomic measures that take time to bear fruit. And the annual tax revenue—collectively administered, perhaps by a reformed IMF—could be an important building block of the international architectural structure needed for more stable worldwide financial integration and a more equitable sharing of the costs and benefits of globalization.

Led by the U.S., both the G-7 and the IMF have blocked consideration of the Tobin tax. In 1996 the U.S. forced the UN Development Programme to cease promoting a volume of expert papers assessing the tax. In 1999 the U.S. Treasury forced the World Bank to fire its chief economist, Joseph Stiglitz, for inducing the bank to take too critical a stance regarding capital decontrol and the distributional inequities of free market globalization.

Defecting mainstream economists offer diverse hypotheses to explain the tenacious U.S. commitment to globalizing capital decontrol, notwithstanding its collapsing theoretical and empirical support. Many emphasize that the risk/reward structure biases financial bureaucrats toward status quo positions—some asserting that the frequent interchange of personnel has formed a Wall Street-Treasury complex. Others stress ideological antipathy toward reinvigorating welfare capitalism or toward subordinating U.S. sovereignty to strengthened international institutions.

The hypotheses imply that for such Bretton Woods-like reforms to be adopted, they must first be made politically feasible by grassroots support that is strong enough to change the political climate and bureaucratic risk/reward parameters. For this to happen before the next crisis hits, unions, environmentalists, and social welfare advocates here and abroad must step up their demands for real reform of the international financial architecture. Taming global financial markets is essential if social reformers are to achieve their broader objective of a more stable and equitable world economy.

Sources for More Information

Organizations

Bretton Woods Project

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Focus on the Global South

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Friends of the Earth

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Third World Network

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