

## ON FINANCIAL CRISIS AS A DISCIPLINARY DEVICE OF EMPIRE: EMERGENCE AND CRISIS OF THE CRISIS

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In early August of this year the government of Brazil received a thirty billion dollar bailout from the International Monetary Fund. Not only was this the Fund's largest loan ever, it also quite spectacularly reversed the previously announced policy stance of the Bush administration. What arguably triggered the Bush/IMF about-face was the reiteration, on a Sunday news program (Fox News Sunday, 28 July), of the administration's refusal to back bailouts. Paul O'Neill's comment, that bailout money would end up in Swiss bank accounts, triggered—the very next day—the largest single-day drop of Brazil's currency. Ten days later, with U.S. blessing, a thirty billion dollar bailout was made available.

The Bush administration's argument had been that bailing out countries in currency crises (as had been done by the Clinton administration) creates "moral hazard," that is, it induces the reckless behavior that leads to crisis by ameliorating the pain of the consequences of bad behavior. The theory was that the threat of crisis and its full consequences should make otherwise irresponsible national governments choose to apply good sustainable policy. Refusing to bail countries out would make governments think twice before running up fiscal deficits that could lead to speculative attacks on their currency. The threat of crisis—made possible because of capital account liberalization—would discipline governments. That discipline was supposed to be one of the great benefits of capital account liberalization.

The disciplinary argument for capital account liberalization—that it imposes salutary and necessary discipline upon national governments—has a long history. Economists have long been interested in institutional structures that motivate "efficient" outcomes. The high point of optimism about capital account liberalization was probably the 1997 Annual Meetings of the IMF and the World Bank in Hong Kong, when the IMF approved a plan to amend its charter, the Articles of Agreement, and give itself jurisdiction over the capital accounts of member countries. In his opening address advocating the amendment (only the fourth such amendment since the IMF's creation in 1944), Michel Camdessus, Executive Director, summed up the argument: "Countries cannot compete for the blessings of global markets and refuse their disciplines."<sup>1</sup>

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<sup>1</sup> Michel Camdessus, "Managing Director's Opening Address: Camdessus Calls for Responsibility and Solidarity in Dealing with the Challenges of Globalization," *IMF Survey*, volume 26, no. 18, 6 October 1997, p. 292. Later in the same speech (p. 293) Camdessus adds: "The point is not to encourage countries to remove capital controls prematurely or prevent them from using capital controls on a temporary basis, when justified. The objective is rather to foster the smooth operation of international capital markets and encourage countries to remove controls in a way that supports the drive toward sustainable macroeconomic policies, strong monetary and financial sectors, and lasting liberalization."

Yet the most recent cases of Argentina and Brazil seem to indicate that the threat of crisis and, more tellingly, crisis itself, is no longer sufficient to produce the desired behaviors. As one commentator has noted: “The mantra of the no-bailout people—that a crisis is the medicine that will cure bad policies—may sometimes be exactly wrong. Crises can be the poison that brings on even worse policies...”<sup>2</sup>

This paper will review the recent crisis of financial crisis as a disciplinary device. I will first review the rise and spread of capital account liberalization in the 1980s and the justifications given for this liberalization. I will analyze capital account liberalization as a disciplinary strategy at the global level and then discuss how and why the strategy has failed. The key issue is why did financial crisis go into crisis? Why does the discipline and constraint that capital account liberalizations impose on national governments no longer obtain? Why is there today confusion and disarray—even open recriminations—in capitalist policy making circles with regard to capital account liberalization? Joseph Stiglitz for example, himself recipient of a Nobel prize in economics and former World Bank chief economist, states, when reviewing the Asian financial crisis:

The countries in East Asia had no need for additional capital, given their high savings rate, but still capital account liberalization was pushed on these countries in the late eighties and early nineties. I believe that capital account liberalization was the single most important factor leading to the crisis. I come to this conclusion not just by carefully looking at what happened in the region, but by looking at what happened in the almost one hundred other economic crises of the last quarter century [emphasis in the original].<sup>3</sup>

Beginning with the Mexican crisis and the subsequent unprecedented U.S.-led bailout of Mexico in 1993-94 and accelerating with the Asian crisis of 1997-98, there has been a wide-ranging debate among economists and policymakers with regard to what Robert Rubin called the “international financial architecture.”<sup>4</sup> The debate is about policy rather than theory; it is about how to institutionalize the capital account liberalization strategy. Despite numerous incremental changes at the international level, there is as yet—nine years later—not even the beginning of a consensus over how to restructure international monetary affairs in order to make the theory work, that is, in order for capital to reap the benefits of capital account liberalization. In a final section I speculate on a possible strategy that capital may seek to employ next, after the failure of capital account liberalization.

## THE ASSUMPTIONS OF BRETTON WOODS

The heart and essence of what we call “globalization” has been the removal of controls on the international movement of capital, that is, what economists and the IMF call the liberalization of capital accounts. Unlike trade liberalization or the globalization of production, which were both ongoing gradual developments, capital account liberalization was the quantum

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<sup>2</sup> Stephen Mallaby, “Between a Rock and a Bailout,” *Washington Post*, 1 July 2002.

<sup>3</sup> Joseph E. Stiglitz, *Globalization and Its Discontents* (New York: W. W. Norton, 2002), p. 99.

<sup>4</sup> The best overviews of this debate are: J. Bradford DeLong and Barry Eichengreen, “Between Meltdown and Moral Hazard: The International Financial Policies of the Clinton Administration,” Paper presented at the Kennedy School Conference on the Economic Policies of the Clinton Administration, Harvard University, Cambridge, MA, June 2001; Peter B. Kenen, *The International Financial Architecture: What’s New? What’s Missing?* (Washington D.C.: Institute for International Economics, November 2001). The term “international financial architecture” was first proposed by Robert Rubin in 1998: Robert E. Rubin, “Strengthening the Architecture of the International Financial System: Remarks at the Brookings Institution (14 April 1998),” Washington D.C.: U.S. Department of the Treasury, 1998.

leap that ushered in a new phase in the international monetary order.<sup>5</sup> Prior to the current regime of liberalized capital movements—several decades ago—the international norm was to restrict the mobility of capital. While the Bretton Woods agreements sought to create a liberal *trade* regime, they were also a decided rejection of the pre-Great Depression liberal *financial* regime. A key sinew of the Keynesian State was, in fact, the institutionalization of capital controls. Section 3 of Article 6 of the *Articles of Agreement of the International Monetary Fund* (22 July 1944) stated: “Members may exercise such controls as are necessary to regulate international capital movements...”<sup>6</sup> As Keynes would state, the control of capital movements was to be seen “not merely as a feature of the transition, but as a permanent arrangement.”<sup>7</sup> While actual practice in the Bretton Woods era diverged in important ways from the original framework—in particular, the U.S. kept its capital market open and capital constantly sought ways to overcome government controls<sup>8</sup>—in practice all major Western countries maintained some form of control on capital movements.

There were two main reasons why the Bretton Woods system called for controls on the movement of capital. First, because the domestic interest rate needed to be unlinked from global market forces in order to make it available as a domestic policy tool, and second, because the inter-war experience had demonstrated that free capital mobility would result in a systemically harmful level of volatility and instability. Both of these issues were addressed in a letter Keynes wrote responding to a memorandum from Roy Harrod which had called for the abolition of controls on capital. With regard to the first reason, Keynes wrote:

You overlook the most fundamental long-run theoretical reason [for the control of capital movements]. Freedom of capital movements is an essential part of the old *laissez-faire* system and assumes that it is right and desirable to have an equalisation of interest rates in all parts of the world. It assumes, that is to say, that if the rate of interest which promotes full employment in Great Britain is lower than the appropriate rate in Australia, there is no reason why this should not lead to a situation in which the whole of British savings are invested in Australia, subject only to different estimations of risk, until the equilibrium rate in Australia has been brought down to the British rate. In my view the whole management of the domestic economy depends upon being

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<sup>5</sup> Such would be the assertion, for example, of Anne O. Krueger. See: Takatoshi Ito and Anne O. Krueger, “Introduction,” in: Takatoshi Ito and Anne O. Krueger, editors, *Regional and Global Capital Flows: Macroeconomic Causes and Consequences* (Chicago and London: University of Chicago Press, 2001), pp. 1-10.

<sup>6</sup> *Articles of Agreement of the International Monetary Fund (July 22, 1944)* in: J. Keith Horsefield, editor, *The International Monetary Fund 1945-1965: Twenty Years of International Monetary Cooperation*, Volume III: *Documents* (Washington, D.C.: International Monetary Fund, 1969), p. 194. In its entirety, Section 3 states: “Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise those controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments, except as provided in Article VII, Section 3 (b), and in Article XIV, Section 2.”

<sup>7</sup> John Maynard Keynes at the House of Lords, 23 May 1944, in: *The Collected Writings of John Maynard Keynes*, Vol. 26: *Activities 1941-1946: Shaping the Post-War World, Bretton Woods and Reparations*, edited by Donald Moggridge (Cambridge: Cambridge University Press, 1980), p. 17. Keynes states: “Not merely as a feature of the transition, but as a permanent arrangement, the plan accords to every member government the explicit right to control all capital movements. What used to be a heresy is now endorsed as orthodox. In my own judgment, countries which avail themselves of this right may find it necessary to scrutinise all transactions, as to prevent the evasion of capital regulations. Provided that the innocent, current transactions are let through, there is nothing in the plan to prevent this. In fact, it is encouraged. It follows that our right to control the domestic capital market is secured on firmer foundations than ever before, and is formally accepted as a proper part of agreed international arrangements.”

<sup>8</sup> McKinnon provides a concise overview of the differences between the set of rules agreed to at Bretton Woods and the actual practice. Ronald I. McKinnon, “The Rules of the Game: International Money in Historical Perspective,” *Journal of Economic Literature*, vol. 31, no.1, March 1993, pp. 1-44.

free to have the appropriate rate of interest without reference to the rates prevailing elsewhere in the world. Capital control is corollary to this.<sup>9</sup>

Keynes's example assumes a fixed exchange rate, yet illustrates the issue well. Policymakers face a "trilemma." With capital mobility, policymakers cannot simultaneously control both the domestic interest rate and the exchange rate. If the exchange rate is fixed, then the domestic interest rate must be used to maintain the exchange rate. Likewise, if the interest rate is fixed, then the exchange rate must be subordinated to maintaining the domestic interest rate. Only if a country closes off cross-border financial transactions can it use both the exchange rate and its interest rate as policy tools. That is, capital controls were necessary for a government to have sovereignty over its domestic economy.

With regard to the second reason—the tendency of an uncontrolled international capital market to produce instability and volatility—Keynes stated in the same letter:

I see no reason to feel confidence that the more stable conditions, e.g. the partial remedy of the trade cycle and the prevention of sharp movements in exchange rates, will remove the more dangerous movements [of capital]. These are likely to be caused by political issues. Surely in the post-war years there is hardly a country in which we ought not to expect keen political discussions affecting the position of the wealthier classes and the treatment of private property. If so, there will be a number of people constantly taking fright because they think that the degree of leftism in one country looks for the time being likely to be greater than somewhere else.<sup>10</sup>

Keynes is stating that even relative macroeconomic health—good economic fundamentals—would not be sufficient to prevent the "more dangerous" destabilizing movements of capital seeking safe-haven from perceived political threats. Capital controls were therefore called for as a means of containing the effects of shifts in the domestic balance of class forces. Keynes and the participants in the Bretton Woods meetings drew upon the experience of widespread exchange rate instability in the interwar years. A key document that provided some of the empirical and theoretical justification for the Bretton Woods monetary system was a 1944 study by Ragnar Nurkse written for the League of Nations. The document, *International Currency Experience: Lessons of the Inter-War Period*, pointed to the experience of the inter-war French franc as a prototypical example of the destabilizing effects of free capital mobility.<sup>11</sup> The document's conclusion stated:

Any considerable or continuous movement of the exchange rate is liable to generate anticipations of a further movement in the same direction, thus giving rise to speculative capital transfers of a disequilibrating kind tending greatly to accentuate any change that may be required

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<sup>9</sup> John Maynard Keynes, Letter to Roy F. Harrod, 19 April 1942, in: *The Collected Writings of John Maynard Keynes*, Vol. 25: *Activities 1940-1944: Shaping the Post-War World: The Clearing Union*, edited by Donald Moggridge (Cambridge: Cambridge University Press, 1980), p. 149.

<sup>10</sup> John Maynard Keynes, Letter to Roy F. Harrod, 19 April 1942, in: *The Collected Writings of John Maynard Keynes*, Vol. 25: *Activities 1940-1944: Shaping the Post-War World: The Clearing Union*, edited by Donald Moggridge (Cambridge: Cambridge University Press, 1980), p. 149.

<sup>11</sup> League of Nations, *International Currency Experience: Lessons of the Inter-War Period* (Geneva: League of Nations, 1944). The case of the French franc is presented on pages 117-122. The best overview of the inter-war franc is: Eleanor Lansing Dulles, *The French Franc 1914-1928: The Facts and Their Interpretation* (New York: Macmillan Company, 1929). For a recent overview and discussion see: Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System* (Princeton, New Jersey: Princeton University Press, 1996), pp. 51-57.

for the balancing of normal transactions. Moreover, the normal transactions also may come to be affected by speculative anticipations: a fall in the exchange value of a country's currency may lead to a rise in imports and a decline in exports if traders at home expect the prices of foreign goods to be still higher in the future and if foreign buyers hold off in anticipation of still lower prices as a result of an expected further decline in the exchange. Self-aggravating movements of this kind, instead of promoting adjustment in the balance of payments, are apt to intensify any initial disequilibrium and to produce what may be termed "explosive" conditions of instability. We have observed such forces at work in several cases...<sup>12</sup>

An axiomatic component of the Keynesian/Bretton Woods approach was the argument that the speculative activities of financial capital were not a functional element of capitalism and they should be minimized or contained.<sup>13</sup> In the years leading to the Bretton Woods conference, speculators were frequently blamed for widespread instability and excess. President Roosevelt had excoriated speculators in his 1933 inaugural address and Roosevelt's Treasury Secretary Henry Morgenthau had stated at the conclusion of the Bretton Woods conference that he hoped the agreements reached would "drive...the usurious money lenders from the temple of international finance."<sup>14</sup> In contrast, the economic theory behind the current period of capital account liberalization and globalization is built upon the premise that speculation, in particular the international currency speculation of financial capital, is a functional element of capitalism that provides essential information to policymakers and investors alike. The transition from the first view to the second began with Milton Friedman's<sup>15</sup> response to Nurkse. Friedman's argument that speculation is stabilizing, rather than destabilizing (because destabilizing speculators would lose money) spawned a substantial literature in the 1970s that lay important elements of the groundwork for current policy.<sup>16</sup>

The debate between Nurkse and Friedman is old, but its substance eerily presages the current continuing debates over global financial instability. At issue is whether international currency crises are ultimately caused by monetary and fiscal policy or if they are exogenous to domestic policy and reflect an autonomous dynamic in the currency markets. The mainstream literature on this issue is large and inconclusive.

## THE STRATEGY OF CAPITAL ACCOUNT LIBERALIZATION

Today, international capital movements are no longer controlled by states, on the contrary, beginning with Margaret Thatcher's removal of controls on capital movements in 1979, there began a steady march toward removing all restrictions on the ability of capital to move. This was a major and relatively rapid structural transition at the global level, and it marks the

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<sup>12</sup> League of Nations, *International Currency Experience: Lessons of the Inter-War Period* (Geneva: League of Nations, 1944), pp. 210-211.

<sup>13</sup> Interestingly, Dudley Dillard traces this aspect of Keynes's thought to Proudhon. Keynes credits Silvio Gesell, who in turn saw himself as a follower of Proudhon. See: Dudley Dillard, "Keynes and Proudhon," *Journal of Economic History*, vol. 2, issue 1, May 1942, pp. 63-76.

<sup>14</sup> Henry Morgenthau, Closing Address to the Bretton Woods Conference, July 22, 1944. Cited in: David F. De Roosa, *In Defense of Free Capital Markets: The Case Against a New International Financial Architecture* (Princeton, NJ: Bloomberg Press, 2001), p. 19.

<sup>15</sup> Milton Friedman, "The Case for Flexible Exchange Rates," in: *Essays in Positive Economics* (Chicago: University of Chicago Press, 1953), pp. 157-203, especially pp. 174-177.

<sup>16</sup> For example: Harry G. Johnson, "Destabilizing Speculation: A General Equilibrium Approach," *Journal of Political Economy*, vol. 84, no. 1, February 1976, pp. 101-108.



beginning of the current era of globalization. The process was largely complete by the early 1990s and it was accompanied by a concomitant escalation in cross-border capital movements and currency speculation. By 1992, in the midst of the crisis of the European Monetary System, the *New York Times* could report that trading among currency speculators had reached an estimated trillion dollars a day, far overwhelming the ability of the world's central banks to defend their own currencies against the opportunistic speculators. Collectively, all the major central banks held in reserves only little more than a trillion dollars, the total amount of turnover in a single day of currency trading.<sup>17</sup>

The main benefit that capitalists obtain from capital account liberalization is that it disciplines national governments. Maurice Obstfeld, a leading theorist in international economics, states:

Economic theory leaves no doubt about the potential advantages of global financial trading. ...At the global level, the international capital market channels world savings to its most productive uses, irrespective of location. ...The other main potential positive role of international capital markets is to discipline policymakers who might be tempted to exploit a captive domestic capital market. Unsound policies—for example, excessive government borrowing or inadequate bank regulation—would spark speculative capital outflows and higher domestic interest rates. In theory, a government's fear of these effects should make rash behavior less attractive.<sup>18</sup>

The IMF, in a staff paper studying when and how market discipline can be made most effective, goes further in specifying the conditions necessary for capital account liberalization to produce its desired effects. The paper states: “the risk of crisis is the spur of market discipline. Thus, crises can have a necessary, even salutary, role in forcing governments to follow sustainable policies...”<sup>19</sup> For the threat of crisis to have its full effect, the paper concludes, four conditions must exist: “open capital markets; good information about a borrower's existing liabilities; no prospect of a bailout; and a borrower's responsiveness to market signals.”

The insight that global market forces, particularly capital mobility, could serve as a disciplinary device over national governments is not new, indeed, it can be found even in Adam Smith.<sup>20</sup> The current cycle of research on the effects of capital mobility upon government behavior was probably opened in 1963 by Robert A. Mundell, a Canadian then at the University

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<sup>17</sup> Allen R. Myerson, “Currency Markets Resisting Powers of Central Banks,” *New York Times*, 25 September 1992, pp. A1 and C15.

<sup>18</sup> Maurice Obstfeld, “The Global Capital Market: Benefactor or Menace?” *Journal of Economic Perspectives*, vol. 12, no. 4, Fall 1998, p. 10.

<sup>19</sup> Timothy D. Lane, “Market Discipline,” *IMF Staff Papers*, vol. 40, no. 1, March 1993.

<sup>20</sup> Adam Smith discussed the constraints that capital mobility imposed upon the national governments' ability to tax capital stock: “There are...circumstances which render the interest of money a much less proper subject of direct taxation than the rent of land. ...land is a subject which cannot be removed, whereas stock easily may. The proprietor of land is necessarily a citizen of the particular country where his estate lies. The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune more at ease. By removing his stock he would put an end to all the industry which it had maintained in the country which he left. ...A tax which tended to drive away stock from any particular country, would so far tend to dry up every source of revenue, both to the sovereign and the society.” Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (New York: Modern Library, 1937), p. 800.

of Chicago, who began analyzing the policy implications of increased capital mobility in series of foundational papers. Implicitly, he was analyzing the situation of Canada, which could not control the movement of capital across the border with the U.S. He demonstrated that monetary policy could not control the interest rate in a small economy with a fixed exchange rate and open capital markets.<sup>21</sup> By 1971, Laurence Krause was discussing how capital mobility would reduce governmental discretion: "Private capital flows can have a great influence on domestic economic conditions and the balance-of-payments positions of countries, possibly undermining governmental policies." Indeed, he was already well aware of how some sectors of the capitalist class could see such an encroachment on government power as potentially beneficial: "...the private sector has encroached on governmental sovereignty in financial markets. This conclusion can be either applauded or decried depending on one's view of the wisdom of governmental policy and the desirability of integration."<sup>22</sup> By 1972, after the collapse of Bretton Woods, a die-hard Keynesian, James Tobin, was calling for his now famous tax, the Tobin tax (a small tax on international currency transactions) in order to reduce capital mobility and restore some governmental sovereignty over macroeconomic policy.<sup>23</sup>

But *why* has there been this turn toward capital account liberalization as a disciplinary device against national governments? Keynesianism and the Keynesian State went into crisis in many countries in the 1970s because the growing power and mass insurgency of a variety of movements and sectors of the working class which overwhelmed the ability of the state to manage and control those demands. Many of those demands involved rising levels of social expenditures by national governments. This was the "crisis of the welfare state" or the "fiscal crisis of the state" that was variously described by analysts of the left and right. In Samuel Huntington's often cited phrase, "too much democracy" resulted in increased government expenditure, accompanied by a wage growth that exceeded the rate of growth of productivity, producing falls in the rate of profit, investment, and growth.<sup>24</sup> The key point is that by the mid to late 1970s national governments had demonstrated that they had become incapable of managing their sectors of the working class in the manner that had been presupposed by the Bretton Woods agreements. Part of the response was to attack working class gains at the national level (Thatcher/Reagan), another part of the response, a response at the international level, was to use the marketplace to discipline national governments through capital account liberalization.

Liberalizing capital accounts was a powerful but quiet way of responding to the crisis of the Keynesian state. In a discussion contrasting financial liberalization to trade liberalization, Eric Helleiner explains why it was possible to complete a transition to liberalized finance both relatively quickly and with relatively little resistance. First is the fact that capital account

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<sup>21</sup> Robert A. Mundell, "Capital Mobility and Stabilization Policy under Fixed and Flexible Exchange Rates," *Canadian Journal of Economics and Political Science*, vol. 29, no. 4, November 1963, pp. 475-485. The Mundell-Fleming model of the influence of capital flows on macroeconomic policy became the standard fare of intermediate and advanced macroeconomics textbooks of the 1970s and 80s. An excellent overview of Mundell's contributions is: Robert E. Prasch, "The Economic Contributions of Robert A. Mundell," *Review of Political Economy*, Vol. 13, no. 1, 2001, pp. 41-58.

<sup>22</sup> Lawrence Krause, "Private International Finance," *International Organization*, vol. 25, no. 3, Summer 1971, pp. 524, 527.

<sup>23</sup> The Tobin tax was first proposed in a lecture at Princeton in 1972. The lecture was published in 1974. James Tobin, "A Proposal for International Monetary Reform," *Eastern Economic Journal*, vol. 4, no. 3-4, July-October 1978, pp. 153-159. See also: Mahbub ul Haq, Inge Kaul and Isabelle Grunberg, editors, *The Tobin Tax: Coping with Financial Instability* (New York: Oxford University Press, 1996).

<sup>24</sup> Samuel P. Huntington, "The United States," in: Michael Crozier, Samuel P. Huntington, and Joji Watanuki, *The Crisis of Democracy: Report on the Governability of Democracies to the Trilateral Commission* (New York: New York University Press, 1975).

liberalization has a low political visibility. The transition to the current liberalized regime was completed with little public debate or scrutiny. Usually what was involved was the quiet abrogation of a few arcane government regulations. In England, the process consisted of the non-renewal of “emergency measures” instituted during World War II. In her memoirs, Margaret Thatcher states that of all her activities in 1979, she “took greatest personal pleasure in the removal of exchange controls.” While it is possible to read into her words more than was meant, it also appears that she was well aware of how that act would change the world:

But not every capitalist had my confidence in capitalism. I remember a meeting in Opposition with City experts who were clearly taken aback at my desire to free their market. “Steady on!”, I was told. Clearly, a world without exchange controls in which markets rather than governments determined the movement of capital left them distinctly uneasy.<sup>25</sup>

Added to this low visibility is the credible deniability of government responsibility. Liberalized capital movements are frequently presented as the result of autonomous technological changes and irresistible market forces, over which the government has no control and to which it must acquiesce. Several excellent studies have challenged this interpretation. Helleiner’s history of the process of financial liberalization, *States and the Emergence of Global Finance: From Bretton Woods to the 1990’s*, shows how the decisions and actions of policymakers in the United States and England have played the key role at every juncture.<sup>26</sup>

Unlike trade liberalization, financial liberalization does not present the same coordination or collective action problems that are inherent in trade liberalizations. A country that liberalizes trade before others will be swamped with imports, destroying its domestic industry, and be unable to raise exports because other countries are retaining protectionist barriers. Historically, trade liberalizations have been complex protracted procedures requiring all countries to liberalize simultaneously so as to spread the costs of trade liberalization, and presumably reap its benefits. On the other hand, unlike trade liberalization, a single country can liberalize capital movements and reap its benefits by attracting business away from other locations that still control capital movements. Capital account liberalization becomes an imperative upon all other nation-states as soon as one or a few major states liberalize unilaterally.<sup>27</sup> As Helleiner concludes: “The collective action problems of finance [are] the opposite of those in trade. They concern the maintenance of a closed financial order rather than the creation of an open one.”<sup>28</sup>

Unlike trade liberalization, where the losers are concentrated and therefore can more easily organize and mobilize themselves, the losers from capital account liberalization are not concentrated in single industries or sectors. On the other hand, the immediate beneficiaries, the bankers and financiers that profit from the unleashing of speculative flows, what Jagdish

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<sup>25</sup> Margaret Thatcher, *The Downing Street Years* (New York: HarperCollins Publishers, 1993), p. 44. Recall that the United States removed all its controls on capital movements in 1971. My sense is that the U.S. liberalization belongs to an earlier phase in history, while the Thatcher liberalization is followed by a wave of liberalizations across Europe and Japan. See: John B. Goodman and Louis Pauly, “The Obsolescence of Capital Controls? Economic Management in an Age of Global Markets,” *World Politics*, vol. 46, issue 1, October 1993, pp. 50-82.

<sup>26</sup> Eric Helleiner, *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s* (Ithaca: Cornell University Press, 1994).

<sup>27</sup> For a wider application of this argument claiming that the abandonment of social democracy by one government forces others to necessarily follow, see: George DeMartino, “Global Neoliberalism, Policy Autonomy, and International Competitive Dynamics,” *Journal of Economic Issues*, vol. 33, no. 2, June 1999, pp. 343-349.

<sup>28</sup> Eric Helleiner, *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s* (Ithaca: Cornell University Press, 1994), p. 197.



Bhagwati called the “Wall Street-Treasury complex,”<sup>29</sup> are both few and powerful. Thus, capital account liberalization does not create the same domestic political confrontations that are created by trade liberalization, making it a quiet, effective strategy to respond to the crisis of the Keynesian state and shift the balance of power back toward capital.

## BUT HAS IT WORKED?

But has this new strategy worked? Has it in fact produced the good behavior that was sought? Let us first note the inherent risks of this strategy. Unlike what was promised by the followers of Friedman’s argument that speculation would be stabilizing, we have instead seen a return of the periodic instability and crisis that characterized the pre-Keynesian era. The crisis of the European Monetary System in 1992-93, the Mexican crisis of 1994-95, the Asian crisis of 1997-98 that subsequently became the Russian, Long Term Capital Management, and Brazilian crisis, and now the crisis of Argentina, Uruguay, and Brazil, all have liberalized capital movements as their common denominator. Economic historian J. Bradford DeLong reviews the past and contemporary history and concludes: “A look back at history shows no easy way of controlling the macroeconomic instability that large-scale capital flows create.”<sup>30</sup>

The prospect of a return to the pre-Keynesian chronic instability described by Kindleberger in *Manias, Panics and Crashes*<sup>31</sup> is, at least in part, what fuels the continuing debate over the “international financial architecture.” The debate has become increasingly strident and has led to public quarrels between those wanting to further strengthen the capital liberalization strategy (conservatives) and those calling for incremental adjustments designed to strengthen the existing architecture and decrease the depth and frequency of financial crisis (liberals). Conservative economists have argued that the Clinton-era bailouts have undermined the strategy, leading to perverse results. (Recall that according to the IMF published study, one of the conditions required for the threat of crisis to have its full effect is “no prospect of a bailout.”) Their argument is that the examples of the Mexican and Asian bailouts have induced excessive risk-taking in expectation of a bailout, thus increasing the probability of further crises. Hence, the Bush administration’s early insistence on approving no further bailouts. In the extreme, they call for the elimination of the IMF, leaving national governments entirely at the mercy of the market.<sup>32</sup> Liberal economists, in contrast, have decried the strategy for imposing too much discipline, often too late, and generally call for a variety of measures such as strengthening domestic financial systems, increased transparency, better standards and codes, and increased private-sector involvement in the resolution of crises. Both conservatives and liberals are therefore motivated to call for a restructuring of the international financial architecture and have

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<sup>29</sup> Jagdish Bhagwati, “The Capital Myth: The Difference between Trade in Widgets and Dollars,” *Foreign Affairs*, vol. 77, no. 3, May/June 1998, pp. 7-12.

<sup>30</sup> J. Bradford DeLong, “Financial Crises in the 1890s and 1990s: Must History Repeat?” *Brookings Papers on Economic Activity*, Part 2, 1999, p. 279.

<sup>31</sup> Charles P. Kindleberger, *Manias, Panics and Crashes: A History of Financial Crises* (New York, Basic Books, 1978).

<sup>32</sup> An example of the extreme conservative view, arguing that the current instability is due to the remaining elements of government intervention in the market, is that of Kevin Dowd. He presents a model of what a true laissez-faire financial system would look like: “Laissez faire would mean no central banks, no financial regulatory agencies, and no other government intervention in the financial system anywhere in the world. There would be no international quasigovernmental financial agencies: no IMF, no World Bank, no Bank for International Settlements, and so forth.” Kevin Dowd, “Are Free Markets the Cause of Financial Instability?” *Critical Review: An Interdisciplinary Journal of Politics and Society*, Vol. 14, no. 1, Winter 2000, pp. 57-67.

put forth a large number of proposals to that effect. Neither side, however, questions the strategy. All of them want to find a way to make the market discipline national governments.

The case of Argentina may become an important turning point. Argentina illustrates how market discipline is now becoming increasingly insufficient to overcome working class pressure for growing expenditures, that is, increased fiscal outlays. What may become evident to capital is that the necessary discipline may need to be applied directly, rather than through the compulsion of market forces.

Throughout the 1990s, Argentine policy was under the close and continual scrutiny of the IMF. The former director of the IMF Research Department in the nineties, Michael Mussa, is particularly trenchant in his denunciation of the Argentine case as evidence of a “deep-seated” failure:

...the economic issues that Argentina needed to confront were primarily in the areas of fiscal, monetary, and exchange rate policy—the traditional bread and butter of Fund policy concerns. Thus, to the extent that the Fund got it wrong, or failed to get it right, in Argentina, this is likely to be revealing of particularly deep-seated deficiencies.<sup>33</sup>

Like several other economists,<sup>34</sup> Mussa finds that the core of the Argentine crisis is a fiscal crisis, that is, a crisis caused by an excess of government spending. He states:

...enumerating the many things that contributed to Argentina’s tragedy, however, should not obscure the critical, avoidable failure of Argentine economic policy that was the fundamental cause of disaster—namely, the chronic inability of the Argentine authorities to maintain a responsible fiscal policy.<sup>35</sup>

This of course, is exactly what the market discipline unleashed by capital account liberalization strategy was supposed to address. Clearly, it failed. But *why* were Argentine authorities unable to maintain a responsible fiscal policy?

In 1991, in an effort to eliminate government control over monetary policy altogether, that is, eliminate the government’s discretionary control over the issuance of money, Domingo Cavallo, a Harvard-trained Minister of Economics, borrowed from Argentina’s nineteenth century economic history and instituted a currency board. The currency board could only issue national currency, the peso, if it was backed one-to-one by an American dollar held in reserve. This “hard peg” of the local currency would work like the nineteenth century gold standard. Money could only be issued when backed by a hard asset, and the adjustment to any shocks or fluctuations in the real economy would have to be carried out by adjusting prices. In the Argentine case, as in all

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<sup>33</sup> Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy* (Washington, D.C.: The Institute for International Economics, July 2002), p. 3.

<sup>34</sup> For example: Andrew Powell, “Argentina’s Avoidable Crisis: Bad Luck, Bad Economics, Bad Politics, Bad Advice,” Paper presented at the Brookings Trade Conference, Brookings Institution, Washington D.C., 2 May 2002 (forthcoming in: Susan M. Collins and Dani Rodrik, editors, *Brooking Trade Forum*, 2002); Mario Teijeiro, “Una vez mas, la política fiscal,” Centro de Estudios Públicos, 15 June 2001 (available at: [www.cep.org.ar](http://www.cep.org.ar)).

<sup>35</sup> Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy* (Washington, D.C.: The Institute for International Economics, July 2002), p. 10.

other hard pegs, the important price that needed to adjust flexibly was the wage. If the wage were, in the Keynesian phrase, “sticky downward,” then adjustment to any shock such as a fall in export revenue would have to occur through a rise in unemployment. A vast number of unemployed were in fact created by this framework, particularly after the external shock of the Mexican crisis of 1994. By May of 2001, there were 4.4 million unemployed and underemployed accounting for over 31% of the labor force.<sup>36</sup>

The currency board did end the hyperinflation of the Alfonsín regime. But it did not end the pressure for increased government expenditures. The Menem regime was able to partially hide its poor fiscal performance in the years of rapid growth in the early 1990s because of the nonrecurring proceeds of privatization and the back-loading of interest payments on the Brady bonds that had resolved the debt crisis of the 1980s. But thereafter growing expenditures were financed by borrowing money. Some have argued that the hard peg of the currency board in fact increased the government’s access to international finance, thus allowing for a more rapid accumulation of debt than otherwise. External debt and internal debt, some of it in the form of provincial and national bonds that circulated as quasi-currencies, became the expression of the government’s inability to manage the various demands for government expenditure, that is, the inability to successfully manage the class relation. Total public debt as a percentage of GDP steadily grew from 29.2% in 1993 to 41.4% in 1998.

The IMF and mainstream commentators will give the blame for this poor fiscal performance to Argentine politicians. In Argentina, the middle class is rallying behind a campaign to “get rid of them all,” meaning all the politicians, who are seen as self-serving and irresponsible. But is the malfeasance of politicians the most important explanatory variable in this case? I think not. On the contrary, what explains the inability of politicians to control expenditures is a massive upsurge of a variety of insurgencies throughout Argentina in the decade of the nineties, that is, a recomposition of working class power.

Most enumerations of the cycle of struggle of the nineties in Argentina will begin with the “*Santiagoñazo*” of 1993. Thereafter, a growing number of confrontations will steadily increase in size, frequency, and intensity throughout the nineties as described, for example, by Laufer and Spiguel<sup>37</sup> and in the collection edited by Giarracca, et al.<sup>38</sup> The unemployed, the retired, public servants, students, and the employed organized and presented their demands. These confrontations placed increasing pressure upon provincial and central governments, and therefore upon politicians, to increase or maintain expenditures.<sup>39</sup> The threat of financial crisis, of which the authorities were always aware, was not sufficient to discipline the government.

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<sup>36</sup> INDEC (*Instituto Nacional de Estadística y Censos*). Argentine unemployment and underemployment statistics are reported twice a year and are for the 28 major urban areas. The most recent figures at the time of this writing, corresponding to May of 2002, are: unemployment 21.5%; underemployment 18.6%; for a total of 40.1% of the labor force. INDEC statistics are available at: [www.indec.mecon.ar](http://www.indec.mecon.ar).

<sup>37</sup> Rubén Laufer and Claudio Spiguel, “Las ‘puebladas’ argentinas a partir del ‘santiagoñazo’ de 1993: Tradición histórica y nuevas formas de lucha,” in : Margarita López Maya, editor, *Lucha popular, democracia, neoliberalismo: protesta popular en América Latina en los años de ajuste* (Caracas: Editorial Nueva Sociedad, 1999), pp. 15-43. Also relevant to our discussion, in the same text, is: Adrián Scribano, “Argentina ‘cortada:’ Cortes de ruta y visibilidad social en el contexto del ajuste,” pp. 45-71.

<sup>38</sup> Norma Giarracca, et al., *La protesta social en Argentina: Transformaciones económicas y crisis social en el interior del país* (Buenos Aires: Alianza Editorial, 2001).

<sup>39</sup> See, for example: Conrad M. Herold, “Argentina: The Unemployed Against Empire,” *Freespace Quarterly: A Long Island Journal of Art, Activism, and Independent Media*, July-September 2002, pp. 5-7.

The Argentine case is symptomatic. Neither the currency board nor the liberalization of capital flows were sufficient to discipline the government and correct fiscal excesses. Neither has the crisis itself yet resulted, nine months later, in any policy proposals acceptable to the IMF. In March of 2001 Rudiger Dornbusch and Ricardo Caballero of MIT proposed a new strategy to deal with situations such as those of Argentina.<sup>40</sup> They advocated putting Argentine economic policymaking under the direct control of a panel of foreign experts, to whom Argentina should surrender all economic sovereignty. Their proposal sounds to some, especially in Argentina, like a return to outright direct colonial control. This may need to be capital's next strategy.

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<sup>40</sup> Ricardo Caballero and Rudiger Dornbusch, "Argentina Cannot Be Trusted," *Financial Times*, 8 March 2002.

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