Dealing With Debt

How to Reform the Global Financial System

Something is wrong with the global financial system. One might think the system would shift money from rich countries, where capital is in abundance, to those where it is scarce, while transferring risk from poor countries to rich ones, which are most able to bear it. A well-functioning global financial system would provide money to countries in their times of need, thereby contributing to global economic stability. Through an orderly bankruptcy procedure, a

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well-functioning global financial system would grant a fresh start to those who cannot meet their debt obligations, giving creditors an incentive to pursue good lending practices, while ensuring that borrowers able to repay loans do so.

The current global financial system does none of these things. As a result, international financial crises or near-crises have become regular events. The question is not whether there will be another crisis, but where it will be. Mexico, Korea, Indonesia, Thailand, Russia, Brazil, Argentina, and Turkey have each endured a major crisis or near-crisis, bringing the global average for the past eight years to about one crisis per year. This list does not even include the smaller countries, such as Ecuador and Uruguay, whose crises devastated their countries but made less of a dent on Wall Street. But this is only the tip of the iceberg. It is becoming rarer for a country not to have a crisis than to have one, and by some reckonings, there have been 100 crises in the past 35 years. This much seems clear: the International Monetary Fund (IMF), whose responsibility it is to ensure the stability of the global financial system, has failed miserably in its mission to stabilize international financial flows, arguably making matters worse.

Meanwhile, instead of channeling funds from rich countries to poor ones, the global financial system has allowed the United States to become the largest borrower in the world, absorbing about US$40 billion per month to finance a consumption binge amidst declining investment and savings and a decades-old trade deficit that is close to five percent of gross domestic product (GDP).

Observers in the early 1990s, however, lauded the huge flows of private capital—at one point exceeding US$300 billion—from developed to developing countries, heralding a new era in which the private sector would supplant the need for public assistance. But this was a hollow boast. Even then, it was clear that most of the money went to a few countries, most notably China, and virtually none to the countries that needed it most, such as those in sub-Saharan Africa. Nor was the money spent in desperately needed sectors like healthcare, education, and the environment. Developing countries could attract firms to extract their natural wealth—provided they gave it away cheaply enough. There was far less success in attracting investments that would create new jobs. Worse still, much of the money was speculative—hot money—coming in while the going was good, but fleeing the moment matters looked less rosy. The countries did grow a little faster while the money was flowing in, but the damage that ensued when it flowed out more than offset the initial gains.

Economists studying capital flows have long recognized that, especially in developing countries, they are procyclical, coming in good times and leaving in bad thus making the booms more intense and the busts worse.

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Capital flows are among the primary causes of economic fluctuations and have less to do with what is going on in a particular country than with what is happening elsewhere. Bankers and speculators have given new meaning to the old adage that bankers lend to people who do not need money and refuse to lend in times of need.

These bankers should not be vilified; their vocation, after all, is business, not charity. Instead, the blame lies with the IMF and US Treasury for assuring developing countries that opening their markets to these short term speculative flows would lead to greater stability. There is overwhelming evidence that such capital market liberalization exposes developing countries to high levels of risk beyond their economic capacity without enhancing their economic growth. During the administration of US President Bill Clinton, the US Council of Economic Advisers repeatedly argued this point with the US Treasury, but without success.

But even when foreign banks did not yank money out of developing countries during times of need, they forced the developing countries to bear the brunt of interest and exchange rate fluctuations. The volatility in interest and exchange rates has time after time precipitated crises and debt levels beyond the country's capacity. Countries struggling to meet their obligations cut their already low levels of education and healthcare spending, but often to no avail. Eventually, they are forced into default. This occurred in Latin America during the early 1980s, when the US Federal Reserve Board's unprecedented high interest rate levels suddenly rendered their debt unsustainable. Latin America's problems were not caused by a change in their own policy, but by a change in US policy, yet Latin American states were left to bear the costs. Since there is no adequate international bankruptcy procedure, those countries struggled on, losing a decade of growth and gaining poverty and unemployment.

Another telling example is Moldova, a desperately poor country that has seen its income decline 70 percent during its transition from communism to capitalism—a transition that was supposed to bring unprecedented prosperity. In 2002, almost 75 percent of Moldova's dwindling government budget went to service the foreign debt, which had grown to unmanageable levels because Moldova had to match Russia's currency devaluation. Forced to bear the risk of these exchange rate changes, Moldova saw its moderately high debt, denominated in hard currencies, soar to astronomical levels.

Global Market Failures

Underlying these systemic market failures are numerous problems, and it was the responsibility of the international economic institutions to address these issues. Unfortunately, the IMF was so busy preaching the wonders of the market and espousing its version of market fundamentalism—in which markets are intended to solve almost

In the aftermath of an IMF bailout, a protestor urges South Koreans to shun imports in order to salvage the country's economy.

Photo Courtesy AFP Photo

all problems—that it had little time to address the market failures that provided the rationale for its creation.

Economist John Maynard Keynes, the intellectual godfather of the IMF who worried about the massive unemployment during the Great Depression, knew that when countries face a downturn, monetary policy often would not suffice to restore the economy to full employment—something the United States has witnessed in the last two years. Keynes argued that governments should increase expenditures (or cut taxes), but he also recognized that due to capital market imperfections, some countries would have difficulty getting access to the funds needed to finance such an expansionary fiscal policy. Because what happened in one country has effects on its neighbors—a slowdown in one can bring on a downturn in others—good macromanagement is an issue of global concern. That is why there needs to be an international fund to provide money to countries facing a downturn.

As I explained in my book, *Globalization and its Discontents*, Keynes would be turning over in his grave if he were to see what has happened to his creation. Rather than enabling countries to pursue expansionary policies to resolve economic crises, the IMF has instead forced countries into contractionary policies, which has only exacerbated economic downturns, just as economic theory predicted—predictions which have been confirmed by the cases of East Asia and Argentina. Note the contrast between what the IMF and the US Treasury insist on abroad, and what almost everyone thinks is the right US domestic policy —in the recession of 2001, both US parties agreed that there was a need for economic stimulus. Of course, the United States can easily borrow to finance the needed stimulus, but that is exactly the point: the IMF was supposed to provide the needed funds.

There were other market failures the IMF should have addressed to enhance global economic stability, such as the market failures associated with risk which results in poor countries bearing the brunt of exchange rate and interest rate fluctuations. There are a variety of ways this can be resolved, but the IMF does not even seem to recognize the problem, let alone address it. Meanwhile, it has pushed policies like capital market liberalization, actually increasing the risk to which developing countries are exposed.

The Global Reserve System

At the center of the failures of the global financial system is the global reserve system. Every year, countries around the world have to set aside substantial amounts of money into reserves against a variety of contingencies such as decreases in foreign investor confidence, or dropoffs in international demand for the country's exports. Substantial amounts of global income are thus not translated into global aggregate demand. There are roughly US$2.4 trillion held in reserves around the world. Countries like to keep reserves growing in tandem with imports and foreign denominated liabilities. If these grow at 10 percent per year, then countries need to set aside US$160 billion every year. Today, states hold these reserves in a variety of forms, including gold and US Treasury bills. While the United States may benefit from the resulting increased demand for US Treasury bills, the cost to the developing countries is high. Today they receive a return of 1.25 percent—a negative real return rate—even though investments yield high returns within their own counties. This is the price developing states have to pay to insure against unpredictable market events.

To see what this implies, consider a poor country in which a firm borrows US$100 million from a US bank, paying 18 percent interest. Prudent reserve policy requires that country to set aside US$100 million in reserves, normally held as US Treasury bills. In effect, it must increase its low interest loans to the United States. The country is both borrowing and lending the same US$100 million from the United States—a complete wash, except that when it borrows, it pays US$18 million a year, and when it lends, it receives US$1.25 million a year, for a net transfer from the poor country to the United States of US$16.75 million. This is great for the United States and the US Treasury, but it is hard to see how this promotes growth in the developing country.

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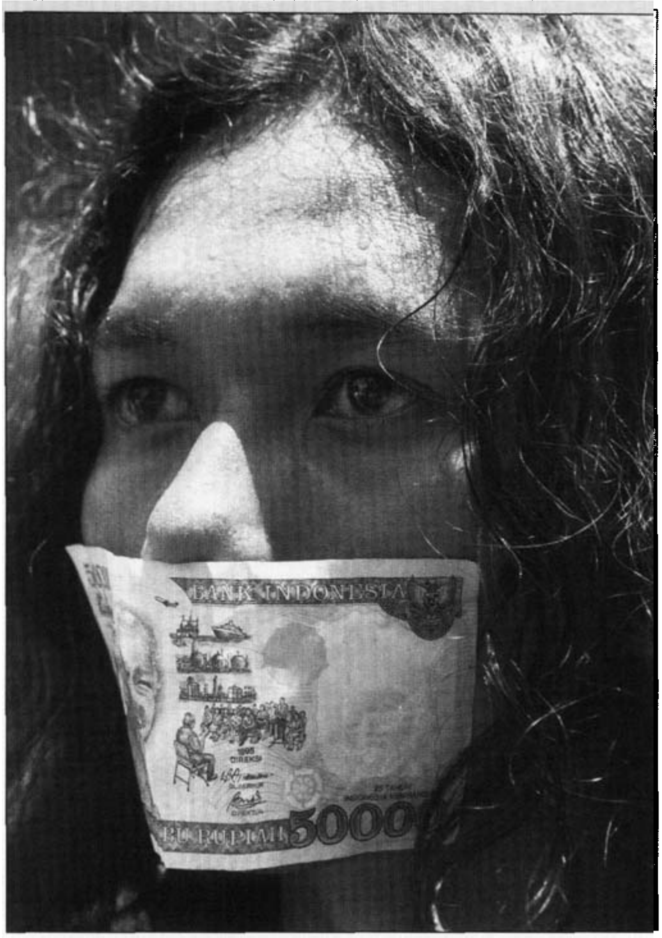
The high costs of the global reserve system to developing countries can be seen in another way. For instance, a country with an import-GDP ratio of 30 percent that holds reserves equal to the cost of six months of imports has to hold reserves equal to 15 percent of GDP. If it holds these in the form of US treasury bills, yielding a real two percent return when the return on the marginal investment inside the country is 12 percent, then the opportunity cost to the country is 1.5 percent of GDP. For many developing countries this is an annual amount substantially greater than the entire amount of foreign assistance received.

But matters are even worse. The arithmetic of global trade implies that the sum of all trade deficits equals the sum of all trade surpluses. This means that one country's deficit is another country's surplus. If some countries, like Japan and China, insist on running surpluses, then other countries must run deficits. Thus deficits are as much the fault of surplus countries as they are of deficit countries. These deficits are like hot potatoes: if one country manages to get rid of its deficit, it must show up elsewhere. That is one of the reasons why the world, under current arrangements, has faced a succession of crises. When Korea suffered a crisis and converted from a deficit to a large surplus, other countries around the world wound up with larger deficits.

The global economic system has been able to work only because the United States has acted as a "deficit of last resort"—meaning that the richest country in the world is the only one able to spend well beyond its means. The global financial system ought to channel global savings to the poorest countries so they can use it to invest and grow; instead, it is channeling global savings to the richest country, so that its citizens, whose living standard is already beyond the wildest dreams of those in the developing world, can consume even more. But the world's willingness to lend to the United States as it finances these deficits may be limited, even given foreign countries' desire to hold US dollars as reserves. If every country tried simultaneously to cut back on their trade deficits, but no pressures were imposed on the surplus countries, earlier fears of a deflationary bias in the global economy would be realized.

There is, however, an alternative. Keynes, during the founding of the IMF, envisaged the issuance of "global greenbacks," more familiarly known as special drawing rights (SDR). The international community has already recognized that it can provide liquidity to a country in the form of SDRs, which effectively give a country purchasing power. They are, in a sense, a form of international money, exchangeable for hard currencies that can be used to purchase goods and services.

A university student wears a rupiah note over his mouth at a protest against the IMF in Jakarta, Indonesia.



Global greenbacks could be used to finance global public goods, such as improving the environment, preventing the spread of diseases like AIDS, increasing literacy in the developing world, and providing humanitarian and broader development assistance. For countries that receive less than the amount they put into reserves, the new "global money" would supplement reserves, freeing up money that otherwise would have been set aside. Countries that receive more than they put aside for reserves could exchange the new money for conventional currencies. Eventually, of course, all the new money wends its way into reserves. In effect, these reserves are a commitment of the countries of the world to help each other in times of difficulty. A country with the reserves of this new global money could exchange it for hard currencies, with which it could, for instance, sustain needed food imports. This policy would end the logic of instability that is built into the current system, for it would allow some deficits without inevitable crisis. Even if a developing country runs a trade deficit, its financial position can be stabilized by assistance from the international community through a grant of the new global money.

This scheme would not be inflationary; rather, it would offset the inherent downward bias of the current regime. Relative to global income—some US$40 trillion—the magnitudes of monetary emissions would be miniscule. But relative to present spending on global public goods or official development assistance, the amounts are enormous. The scheme would allow for the support of vital global public goods in a way that is not subject to political vicissitudes in major developed countries. Furthermore, this global system can be implemented even without the unanimous support of developed countries, some of whom might resist a greenback scheme that would undermine the advantages they

Photo Courtesy AFP Photo/M. Vidon

receive from current arrangements. Instead, this policy requires only that most advanced industrial countries agree to recognize the new SDR as a form of global money. These countries could pressure any hold-outs by agreeing to limit their holdings of non-participant currencies and treasury bills in their reserves. There are, of course, innumerable details that would have to be worked out before such a system could be put into practice, but I am confident that this could be done.

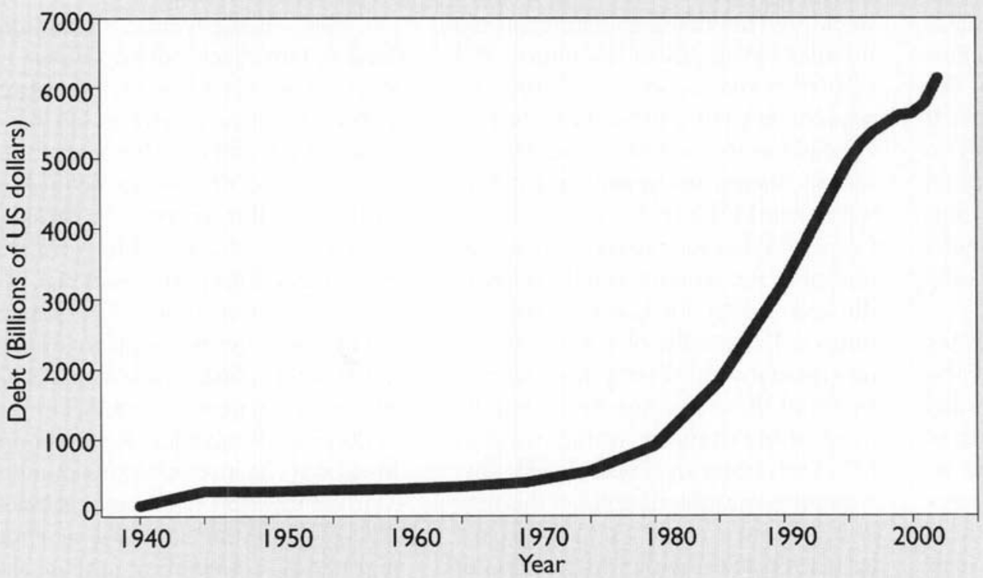
A Bankruptcy Regime

With the collapse of Argentina following on what are widely viewed as failures of big bail-outs in Brazil, Russia, Korea, Thailand, and Indonesia, there is a growing recognition, even in the IMF, that there is a need for an alternative policy response to these crises. The most widely discussed alternative involves a form of bankruptcy or standstill procedure. During the East Asia crisis, it was only with the standstill that Korea's exchange rate stabilized. Indeed, it is often desirable to impose capital controls to stop economic hemorrhaging during a crisis, just as it may be desirable to impose capital controls to stop an excess inflow of capital into a country during a boom. The rush of capital into and out of a country imposes high costs on others, called externalities. Like other forms of externalities (such as pollution), government intervention is likely to be a desirable solution. Chile and Malaysia have shown that such interventions in inflows and outflows are not only feasible, but can also be conducted without significant adverse ancillary side effects—leading to significant benefits in both cases. Given the proclivity of markets to excessive overreaction, well-implemented standstills can be important instruments for stabilizing markets in the case of a country facing a crisis.

In any proposed bankruptcy procedure, it is first important to distinguish between private and public indebtedness. Private debts should not be converted into public debts—a mistake that was made in many instances as a result of pressure from Western banks and governments. There is a need for expedited financial restructuring of private debts in the event of a macroeconomic disturbance—a global version of US Chapter 11 regulations which provide for relatively quick corporate reorganization, allowing the firm to continue producing. But bankruptcy, even under Chapter 11, can be a slow process. When only a few firms in a country face bankruptcy, delay is costly to the shareholders and workers, but not to the economy as a whole. But when 50 percent of the firms in a country face bankruptcy, as in Korea, or 75 percent, as in Indonesia, then delay is very costly and causes macroeconomic consequences that go well beyond the workers and shareholders of the particular firms striving to resolve the companies' difficulties.

BURGEONING DEBT

US Federal Debt



The graph at left shows the history of the increase in the US federal government's accumulated debt during the last 60 years. Large deficit spending in the 1980s began a trend of debt accumulation that was reversed during the late 1990s due to surpluses in the federal budget. Though the level of federal debt stabilized during this period, it has recently risen as a result of a return to deficit spending.

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In designing bankruptcy laws, it is necessary to balance creditor and debtor interests, which is why bankruptcy legislation is so political. The IMF has tried to push a particular approach to bankruptcy, but given its close connection to creditor institutions, its advice has to be viewed with suspicion. In any case, its usual approach of one-size-fits-all advice works particularly poorly in this arena. A bankruptcy law that might work well in the United States could be a disaster in Russia or Thailand. The excuse that the problem is not with the law but with how it is implemented misses the central point. Courts are needed to implement bankruptcy laws, and their interpretation of the law will be based on the mores and perspectives of that particular country.

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Sovereign Debt

The second major set of issues concerns sovereign debt (debt of a government), and here there is need for an international bankruptcy regime based more on Chapter 9 of the US bankruptcy code, which pertains to the inability of municipalities to fulfill their debt obligations. The critical distinction is that Chapter 9 recognizes the importance of the basic functions of government. In the aftermath of a public "default," creditors—domestic and foreign—should be at the table along with all the other stakeholders, such as social security claimants and those who depend on the state for education and health services. Indeed, Chapter 9 recognizes the central importance of maintaining governmental functions.

The administration of the international bankruptcy regime needs to be put in impartial hands. The IMF simply cannot play a pivotal role beyond that of another claimant. The IMF is a major creditor, and is controlled by the major creditor countries. It thus represents a particular set of vested interests. One option is the creation of voluntary creditor and debtor committees to develop efficient and equitable bankruptcy plans. Such a voluntary approach has the major advantage of being able to be set up rather quickly. But there may be incentives on either side to delay resolution, resulting in extreme social and economic costs. Accordingly, there is a need to go beyond voluntary measures, perhaps by establishing a World Bankruptcy Organization or creating a special court within the International Court of Justice for administering bankruptcies. In the short run, debt contracts can be rewritten to include so-called collective action clauses, which encourage bondholders to resolve problems collectively. But this is only a partial solution because even countries with such clauses have had to use Court procedures to resolve bankruptcy. While it is true that these revisions in the international bankruptcy regime may lead to higher interest costs, these higher rates will serve to circumscribe the excessive indebtedness of both private and public borrowers which ultimately hurts virtually everyone within society, not just those who are engaged in international lending.

So far, US citizens have not felt the full costs of the deficiencies in the global financial system. The United States is pivotal in setting interest rates and borrows mostly in US dollars. Thus the problems of exchange rate and interest rate risk, which are central to developing countries, are of little concern to US citizens. In fact, the United States has in some ways benefited. The global financial crisis and the way it was mismanaged by the IMF imposed enormous costs on East Asia, while in the United States, the lower commodity prices decreased inflationary pressures, led to lower interest rates, and fed the late 1990s boom. The global reserve system has led others, including poor countries, to lend to the United States even when its interest rates are low, helping the United States borrow huge amounts abroad.

The events of September 11, 2001, have made clear that in today's globalized world, what happens in one part of the world has profound effects on others. Ultimately, the United States will bear some of the consequences of a global economic system that often leads to crises, unemployment immiseration, insecurity, and despair.

Even the US economy is at risk. How long will the world be willing to lend to the United States, especially if analysts note that the United States has moved from being the world's largest creditor to the world's largest debtor? The evaporation of the staggering US$3 trillion 10-year surplus into a US$2 trillion deficit—combined with deficit-increasing tax cut proposals and a multitude of corporate accounting scandals—fuels fears over US fiscal management. It may be possible for the United States to muddle through this crisis, ignoring the fundamental flaws in the global financial system and the growing discontent with globalization. But it makes much more sense for the United States to use its position of leadership and dominance in the global economy to work for reforms in the global financial system—reforms that, as they enhance global economic justice and make globalization work better for those in developing countries, will at the same time increase economic stability and security for the United States and the world.