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Here are some op-eds and other items in different places including dot-coms which relate to the Wall Street-Treasury Complex, an idea and phraseology that I developed in my unpredictably influential 1998 article on "The Capital Myth" in Foreign Affairs, after the East Asian financial crisis.

I also enclose a Chapter on the subject from my 2004 Oxford book, In Defense of Globalization, where the idea is developed in greater depth. This book has now sold more than 100,000 copies in English and is in 15 translations (the latest being in German by Pantheon/Random House and in French by Odile Jacob). Many who write on the financial sector have seen it. Here, I also talk of how President Eisenhower (Military-Industrial Complex) and Wright Mills (the Power Elite) and I (the Wall Street-Treasury Complex) are now occasionally called the Columbia Trio.

I then re-used the idea, along with that of "destructive creation" in the financial sector (combining fruitfully 2 novel ideas & phraseology: the phrase "destructive creation" has now come into extensive use also: e.g. Tom Friedman has used it at some length in his New York Times column & so has Gillian Tett in the Financial Times), in my October op ed in the Financial Times. I used these two ideas to explore the causes of the financial crisis and its consequence for some elements of the financial reform, in ways that went beyond the ambit of the Asian Financial Crisis and were far more general in its scope. You may enjoy reading the pieces and especially the quote from Keynes.

Since my idea of the Wall Street-Treasury Complex was borrowed by Simon Johnson who have changed it to the Wall Street Treasury "Corridor," in The Atlantic,

while also vulgarizing it into a "capture" theory, I also attach this article so you can "see for yourself."

The Wall Street-Treasury Complex

1. Bhagwati, Jagdish. "The Capital Myth: The Difference between Trade in Widgets and Dollars." *Foreign Affairs,* May/June 1998.

2. Bhagwati, Jagdish. "Chapter 13: The Perils of Gung-ho International Financial Capitalism." *In Defense of Globalization.* New York: Oxford University Press, 2004.

3. Bhagwati, Jagdish. "We need to guard against destructive creation," *Financial Times,* October 16, 2008.

4. Johnson, Simon. "The Quiet Coup." *The Atlantic,* May 2009

5. On capital flows:
   a. Bhagwati, Jagdish. "IMF does Mea Culpa: Triumph After All." March 9, 2010 (Revised April 15, 2010). World Affairs Journal Blog 8.
   b. Gjelten, Tom. "Global Reality Challenges IMF's Free Market Gospel." March 18, 2010. National Public Radio.

Other Writings on the Financial Crisis

6. Bhagwati, Jagdish. "Culture, Economics and the Financial Crisis," *Kulturaustausch,* December 2008.

7. Bhagwati, Jagdish. "Lessons from the Current Crisis," written in February 2009, appearing in *Qfinance: The Ultimate Resource.* Bloomsbury Publishing, 2009.

The capital myth: The difference between trade in widgets and dollars
Jagdish Bhagwati
Foreign Affairs; May/Jun 1998; 77, 3; ABI/INFORM Global
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The Capital Myth

The Difference between Trade in Widgets and Dollars

Jagdish Bhagwati

In the aftermath of the Asian financial crisis, the mainstream view that dominates policy circles, indeed the prevalent myth, is that despite the striking evidence of the inherently crisis-prone nature of freer capital movements, a world of full capital mobility continues to be inevitable and immensely desirable. Instead of maintaining careful restrictions, we are told, the only sensible course is to continue working toward unfettered capital flows; the favored solution is to turn the IMF even more firmly into an international lender of last resort that dispenses bailout funds to crisis-afflicted countries. The IMF took an important step in this direction at its annual meeting in Hong Kong last September, when the Interim Committee issued a statement virtually endorsing an eventual move to capital account convertibility—which means that you and I, nationals or foreigners, could take capital in and out freely, in any volume and at any time—for IMF members. The obligations originally listed in 1944 in the Articles of Agreement, on the other hand, included only "avoidance of restrictions on payments for current transactions" and did not embrace capital account convertibility as an obligation or even a goal.

This is a seductive idea: freeing up trade is good, why not also let capital move freely across borders? But the claims of enormous benefits from free capital mobility are not persuasive. Substantial gains have been asserted, not demonstrated, and most of the payoff can be obtained by direct equity investment. And even a richer IMF with attendant changes in its methods of operation will probably not rule out crises or reduce their costs significantly. The myth to the contrary has been created by what one might christen the Wall Street–Treasury complex, following in the footsteps of President Eisenhower, who had warned of the military-industrial complex.

CAPITAL MOBILITY IDEOLOGY

Until the Asian crisis sensitized the public to the reality that capital movements could repeatedly generate crises, many assumed that free capital mobility among

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all nations was exactly like free trade in their goods and services, a mutual-gain phenomenon. Hence restricted capital mobility, just like protectionism, was seen to be harmful to economic performance in each country, whether rich or poor. That the gains might be problematic because of the cost of crises was not considered.

However, the Asian crisis cannot be separated from the excessive borrowings of foreign short-term capital as Asian economies loosened up their capital account controls and enabled their banks and firms to borrow abroad. In 1996, total private capital inflows to Indonesia, Malaysia, South Korea, Thailand, and the Philippines were $93 billion, up from $41 billion in 1994. In 1997, that suddenly changed to an outflow of $12 billion. Hence it has become apparent that crises attendant on capital mobility cannot be ignored.

Although it is conceded that this downside exists, many claim that it can be ameliorated, if not eliminated, and that free capital mobility's immense advantages can be enjoyed by all. Conservatives would do this by letting the markets rip, untended by the IMF, which could then be sidelined or even disbanded. Liberals would do it instead by turning the IMF into the world's lender of last resort, dispensing funds during crises with several sorts of conditions, and overseeing, buttressing, and managing the world of free capital mobility.

To understand why neither of these modifications is enough, it is necessary to understand why the original version of the myth, which has steadily propelled the IMF into its complacent and dangerous moves toward the goal of capital account convertibility, was just that. True, economists properly say that there is a correspondence between free trade in goods and services and free capital mobility: interfering with either will produce efficiency losses. But only an untutored economist will argue that, therefore, free trade in widgets and life insurance policies is the same as free capital mobility. Capital flows are characterized, as the economic historian Charles Kindleberger of the Massachusetts Institute of Technology has famously noted, by panics and manias.

Each time a crisis related to capital inflows hits a country, it typically goes through the wringer. The debt crisis of the 1980s cost South America a decade of growth. The Mexicans, who were vastly overexposed through short-term inflows, were devastated in 1994. The Asian economies of Thailand, Indonesia, and South Korea, all heavily burdened with short-term debt, went into a tailspin nearly a year ago, drastically lowering their growth rates. Sure enough, serious economic downturns and crises can arise even when governments are not particularly vulnerable due to short-term borrowing: macroeconomic mismanagement in Japan has restrained its growth rate for nearly seven years now, and Japan is still a net lender of capital. But it is a non sequitur to suggest, as the defenders of free capital mobility do, that this possibility somehow negates the fact that short-term borrowings under free capital mobility will be, and have been, a source of considerable economic difficulty.

DOWNSIZING GAINS

When a crisis hits, the downside of free capital mobility arises. To ensure that capital returns, the country must do everything it can to restore the confidence of those who have taken their money out. This typically means raising interest rates, as the IMF has required of Indonesia. Across Asia this

ARCHIVE PHOTOS

Crisis on line one: Filipino traders react as Manila's stock market tumbles, October 28, 1997

has decimated firms with large amounts of debt. It also means having to sell domestic assets, which are greatly undervalued because of the credit crunch, in a fire sale to foreign buyers with better access to funds. (Economists have usually advised the exact opposite in such depressed circumstances: restricting foreign access to a country's assets when its credit, but not that of others, has dried up.) Thus, Thailand and South Korea have been forced to further open their capital markets, even though the short-term capital inflow played a principal role in their troubles in the first place.

Besides suffering these economic setbacks, these countries have lost the political independence to run their economic policies as they deem fit. That their independence is lost not directly to foreign nations but to an IMF increasingly extending its agenda, at the behest of the U.S. Congress, to invade domestic policies on matters of social policy—as with the 1994 Sanders-Frank Amendment, which seeks to attach labor standards conditions to any increase in bailout funds—is small consolation indeed.

Thus, any nation contemplating the embrace of free capital mobility must reckon with these costs and also consider the probability of running into a crisis. The gains from economic efficiency that would flow from free capital mobility, in a hypothetical crisis-free world, must be set against this loss if a wise decision is to be made.

None of the proponents of free capital mobility have estimated the size of the gains they expect to materialize, even leaving out the losses from crises that can ensue. For free trade, numerous studies have measured the costs of protection. The overwhelming majority of trade economists judge the gains from free trade to be significant, coming down somewhere between Paul Krugman's view that they are too small to be taken seriously and Jeffrey Sachs' view that they are huge and cannot be ignored. But all we have from the proponents of capital mobility is banner-waving, such as that of Bradford De Long, the Berkeley economist and former deputy assistant secretary for economic policy in the Clinton administration:

> So now we have all the benefits of free flows of international capital. These benefits are mammoth: the ability to borrow abroad kept the Reagan deficits from crushing U.S. growth like an egg, and the ability to borrow from abroad has enabled successful emerging market economies to double or triple the speed at which their productivity levels and living standards converge to the industrial core.

And of Roger C. Altman, the investment banker, who served in the Treasury Department under Presidents Clinton and Carter:

> The worldwide elimination of barriers to trade and capital . . . have created the global financial marketplace, which informed observers hailed for bringing private capital to the developing world, encouraging economic growth and democracy.[1]

These assertions assume that free capital mobility is enormously beneficial while simultaneously failing to evaluate its crisis-prone downside. But even a cursory glance at history suggests that these gains may be negligible. After all, China and Japan, different in politics and sociology as well as historical experience, have registered remarkable growth rates without capital account convertibility. Western Europe's return to prosperity was also achieved without capital account convertibility. Except for Switzerland, capital account liberalization was pretty slow at the outset and did not gain strength until the late 1980s, and some European countries, among them Portugal and Ireland, did not implement it until the early 1990s.

Besides, even if one believes that capital flows are greatly productive, there is still an important difference between embracing free portfolio capital mobility and having a policy of attracting direct equity investment. Maybe the amount of direct foreign investment that a country attracts will be reduced somewhat by not having freedom of portfolio capital flows, but there is little evidence for this assertion. Even then such a loss would be a small fraction of the gains from having a pro-foreign investment strategy.

A WALL STREET-TREASURY COMPLEX

That brings us to the myth that crises under capital account convertibility can be eliminated. We have, of course, heard this assertion before as each crisis has been confronted, and then we have been hit by yet another one. Like cats, crises have many lives, and macroeconomists, never a tribe that enjoyed a great reputation for getting things right or for agreeing among themselves, have been kept busy adding to the taxonomy of crises and their explanations. None of the solutions currently propounded can

[1] Bradford De Long, "What's Wrong with Our Bloody Economies?" January 11, 1998, from his World Wide Web page, http://econ161.berkeley.edu/; Roger C. Altman, "The Nuke of the 90's," *The New York Times Magazine*, March 1, 1998, p. 34.

really rid the system of free capital mobility of instability.

Thus, while no one can disagree with Secretary of the Treasury Robert Rubin's contention that reform of banking systems around the world will help, few should agree with him that it will eliminate the crises that unregulated capital flows inherently generate. Nor can the abolition of the IMF and its lender of last resort bailouts be the magic bullet: there were crises before the writer Walter Bagehot invented this function for domestic central banks in the nineteenth century. Nor can making the IMF more powerful kill the crises or give it the nonexistent macroeconomic wisdom to manage them at least cost when they arise.

In short, when we penetrate the fog of implausible assertions that surrounds the case for free capital mobility, we realize that the idea and the ideology of free trade and its benefits—and this extends to the continuing liberalization of trade in goods and financial and other services at the World Trade Organization—have, in effect, been hijacked by the proponents of capital mobility. They have been used to bamboozle us into celebrating the new world of trillions of dollars moving about daily in a borderless world, creating gigantic economic gains, rewarding virtue and punishing profligacy. The pretty face presented to us is, in fact, a mask that hides the warts and wrinkles underneath.

The question, then, is why the world has nonetheless been moving in this direction. The answer, as always, reflects ideology and interests—that is, lobbies. The ideology is clearly that of markets. The steady move away from central planning, overregulation, and general overreach in state intervention toward letting markets function has now reached across many sectors and countries. This is indeed all to the good and promises worldwide prosperity. But this wave has also lulled many economists and policymakers into complacency about the pitfalls that certain markets inherently pose even when they were understood in the classroom. Free capital mobility is just one example of this unwarranted attitude. Indeed, Stanley Fischer, the deputy managing director of the IMF, admitted in a February appearance on the *Charlie Rose* show on PBS that he had underestimated the probability of such crises arising in a world of capital mobility.

But interests have also played a central role. Wall Street's financial firms have obvious self-interest in a world of free capital mobility since it only enlarges the arena in which to make money. It is not surprising, therefore, that Wall Street has put its powerful oar into the turbulent waters of Washington political lobbying to steer in this direction. Thus, when testifying before the Senate Foreign Relations Committee on South Asia in March 1995, right after the Mexican peso crisis, I was witness to the grilling of Undersecretary of Commerce Jeffrey E. Garten on why India's financial system was not fully open to U.S. firms. To his credit, Garten said that this was not exactly a propitious time for the United States to pressure India in this direction.

Then again, Wall Street has exceptional clout with Washington for the simple reason that there is, in the sense of a power elite à la C. Wright Mills, a definite networking of like-minded luminaries among the powerful institutions—Wall Street, the Treasury Department, the State Department, the IMF, and the World Bank most prominent among them. Secretary Rubin comes from Wall Street; Altman went from Wall Street to the Treasury and back; Nicholas Brady, President Bush's Secretary of the Treasury, is back in finance as well; Ernest Stern, who has served as acting president of the World Bank, is now managing director of J.P. Morgan; James Wolfensohn, an investment banker, is now president of the World Bank. One could go on.

This powerful network, which may aptly, if loosely, be called the Wall Street–Treasury complex, is unable to look much beyond the interest of Wall Street, which it equates with the good of the world. Thus the IMF has been relentlessly propelled toward embracing the goal of capital account convertibility. The Mexican bailout of 1994 was presented as necessary, which was true. But so too was the flip side, that the Wall Street investors had to be bailed out as well, which was not. Surely other policy instruments, such as a surcharge, could have been deployed simultaneously to punish Wall Street for its mistakes. Even in the current Asian crisis, particularly in South Korea, U.S. banks could all have been forced to the bargaining table, absorbing far larger losses than they did, but they were cushioned by the IMF acting virtually as a lender of first, rather than last, resort.

And despite the evidence of the inherent risks of free capital flows, the Wall Street-Treasury complex is currently proceeding on the self-serving assumption that the ideal world is indeed one of free capital flows, with the IMF and its bailouts at the apex in a role that guarantees its survival and enhances its status. But the weight of evidence and the force of logic point in the opposite direction, toward restraints on capital flows. It is time to shift the burden of proof from those who oppose to those who favor liberated capital.

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The Perils of Gung-ho International Financial Capitalism

Starting in Thailand in the summer of 1997, the Asian financial crisis swept through Indonesia, Malaysia, and South Korea, turning the region's economic miracle into a debacle. Capital, which had been flowing in, flew out in huge amounts. Where these four economies and the Philippines had attracted inflows of over $65 billion in 1996, the annual outflows during 1997 and 1998 were almost $20 billion, amounting to an annual resource crunch of over $85 billion—a staggering amount indeed! This caused currencies to collapse, stock prices to crash, and economies to go into a tailspin.[1] This was not all. The fear of ruination by contagion sent shock waves worldwide. The Russian ruble went into turmoil in August 1998; the Brazilian real did so in January 1999.

Per capita incomes tumbled to almost one-third their 1996 level in Indonesia, with the other crisis-stricken Asian countries showing declines ranging from a quarter to nearly half of the 1996 levels. The devastation was reminiscent of the Great Crash of 1929, a searing experience that ushered in the New Deal in the United States and led to competitive escalation of tariffs worldwide. Writing about this crisis that had spread ruin within almost a hundred days, I thought of Octavio Paz's famous lines from "Happiness in Herat":

> I met the wind of the hundred days.
> It covered all the nights with sand,
> Badgered my forehead, scorched my lids.[2]

This crisis, precipitated by panic-fueled outflows of capital, was a product of hasty and imprudent financial liberalization, almost always under foreign pressure, allowing free international flows of short-term capital without adequate attention to the potentially potent downside of such globalization. There has been no shortage of excuses and strained explanations scapegoating the victims, suggesting they committed hara-kiri instead of being slaughtered. It is hard not to conclude that the motivation underlying these specious explanations is a desire to continue to maintain ideological positions in favor of a policy of free capital flows or to escape responsibility for playing a central role in pushing for what one might aptly call gung-ho international financial capitalism. Let me consider first the wrong explanations and then the right ones.

The Wrong Explanations

A benign but wrongheaded explanation was that the Asian crisis was a result of these countries' long-standing economic miracle running out of steam. That miracle, it may be recalled, was a result of long-sustained and phenomenally high rates of productive investment at levels that had no precedent in history. But if rapid accumulation of capital through rates of high investment was the source of growth, economists would fear that the growth would slow down because of diminishing returns—that is, as capital accumulated relative to labor, further investment would produce progressively less output. A man with a spade could plow an acre a day, but an extra spade, with the man not given a comrade, would add little to the work done. Economists know that this gloomy scenario can be foiled if there is technical progress that adds to output what diminishing returns subtract from it: instead of an extra spade, imagine that a motor is added to the man's spade. But my Columbia student Allwyn Young had estimated that the Asian countries had no technical change to speak of.

The lay person is bound to wonder how this could possibly be true. After all, these countries had registered huge advances in technology by importing foreign equipment embodying massive advances in technology. Just contrast the images of the hamlets and rickshaws in South Korea at the time of the Korean War, for instance, with the skyscrapers in Seoul, built no doubt with the latest cranes, that filled our screens when Korea advanced to the quarterfinals of the World Cup, to national delirium. Or look at the flood in Western markets of Hyundai cars and Samsung TVs, which cannot have been manufactured except with sophisticated technology.

The way economists calculate productivity change, however, is to attribute to investment the effects of technical change embodied in newer equipment, as in the example of the motorized spade earlier. They virtually assume that new and more productive equipment must be treated

as if investment had increased: that a spade twice as productive is to be treated as if it were two spades. But the consequence is that it is somewhat startling to those who are not economists to say that the region had "no technical change"! So the pessimistic conclusions about diminishing returns are somewhat exaggerated when such equipment-embodied technical change is quite dramatic, as it has been and continues to be in Asia.

But even if the Asian economic miracle had been based on investment rather than technical progress, it is hardly plausible that the miracle would have vanished precipitously. As capital accumulated relative to labor, the future return to capital would decline only slowly, except in the most singular circumstances. But what happened in reality was that the economies *crashed*. Instead of slowly winding down, they went rapidly, within a matter of months, into negative growth rates. If you were to draw a chart of the actual growth rates of per capita incomes in the affected Asian countries, with the growth rates on the vertical axis and the years on the horizontal axis, that chart would go not into a gentle flattening out and then a steady fall, but dramatically into what everyone should remember from their geometry classes as the second quadrant, which plots negative growth rates.

The parallel with the Soviet Union was eerie. There economists had seen per capita income growth rates decline over almost two decades, and the favored explanation was diminishing returns to capital accumulation. But with the arrival of President Gorbachev and his adoption of perestroika (economic restructuring) and glasnost (political reform), the economy went crashing into negative growth rates.

The sharp, discontinuous reversal of fortune was mind-boggling in both cases. In the case of East Asia, the economists who had predicted a decline were happy to claim foresight. But to claim credit for having foreseen a crash when all one had asserted was that a decline would soon set in was not exactly persuasive. The question still remained: why did a financial crisis, and then an economic one, break out when these countries had been doing so well until then?[3]

Yet another argument, albeit a lame one, was that these countries were afflicted by crony capitalism, which led to malfeasance that produced the financial crisis under financial liberalization. As many experts on East Asia remarked, however, crony capitalism had produced the economic miracle earlier; why was it now a cancer that killed the patient? Besides, it is indeed true that many of these leaders had cronies, but which politicians do not? Are President Suharto's entourage "cronies," whereas people at Bechtel and Halliburton are Vice President Dick Cheney's "friends"? Are Barbra Streisand and Steven Spielberg President Clinton's "friends," while President Mahathir's celebrity friends are his "cronies"?

What is the difference? If it is about patronage in exchange for contributions, is it not true that Hollywood has managed to get extraordinary rewards from its lobbying in opening foreign markets for its movies (a matter I discussed in Chapter 9)?

I wrote at the time in Singapore an op-ed essay titled "A Friend in the United States, but a Crony in Asia," which drew attention to the self-serving rhetoric that was coming out of Washington as the ideologues who had pushed for international financial liberalization without adequate safeguards were rushing for cover.[4] This type of talk also fueled the notion that corruption was to be found there, not here. James Wolfensohn, president of the World Bank, took to attacking corruption around the same time, an activity that I warmly welcome, and I noticed that his staff's attention was selectively focused away from the rich countries. So I suggested that if he opened his window in Washington, D.C., and looked out, Wolfensohn would see plenty of the corruption that he and his staff were looking for in the poor countries instead. But I fully understand that it is hard to look in the face the ones whose money you must accept in order to stay in business; morality is more easily thrown at those who borrow than at those who lend.

But if these explanations of the crisis were implausible, then one had a puzzle on one's hands. After all, these economies had excellent fundamentals. Between 1991 and 1996, budgets generally showed surpluses, the investment and growth rates were as impressive as they had been since the 1960s, the inflation rate was in single digits, and current account (i.e., trade) deficits were extremely small as a percentage of national income.[5] In November 1994, when the Mexican peso crisis erupted, requiring extensive rescue efforts by the United States, the fundamentals were unsound, and the turmoil that came was not entirely surprising. East Asia was exemplary; Latin America rarely has been.

Problems with Free Capital Flows

The reason why capital inflows are tricky is simply because when confidence is shaken, the fact that the situation is inherently one of imperfect information implies that the actions of a few can initiate herd action by others.

Economists have amusingly instructive models of herd behavior under imperfect information now. If you do not know which of three restaurants in a mall is good, you could pick one at random and hope for the best. But then you see that two are empty and the third has a table taken by a well-dressed couple. You will think that they know something you don't, and therefore you will go in. The next fellow deciding on which restaurant to pick will now see two tables taken, so he will go in too, occupying a third. And pretty soon, you will have herd behavior benefiting that restaurant generously, even if it is, objectively speaking, not the best one.

This is probably the best explanation of what happened in Asia despite the splendid fundamentals. The huge borrowing of short-term capital was perhaps manageable, objectively speaking, but its sheer size had within it the seeds of panic behavior. Since there was no transparency on how much had been borrowed, the panic spread fast, feeding on itself.

The other problem with the Asian economies was that their institutional practices had not been suitably modified for transition to a regime of free capital flows. In South Korea, for instance, the debt-equity ratios in the industrial enterprises, including the big conglomerates known as *chaebols*, were traditionally twice as high as in the developed countries, where corporations relied for financing far more on equity. If the financing was with debt in wons, a panic-fed crisis could be met by conventional intervention by the central bank extending necessary cash as a lender of last resort. But if the debt was borrowed from abroad and denominated in foreign currency, this meant that there would be a balance-of-payments crisis: dollars to pay the recalled loans cannot be printed in Seoul. This should have been anticipated, and regulations to monitor and prevent massive accumulation of short-term foreign debt to dangerous levels should have been put in place before South Korea was encouraged by the IMF, and required by the OECD as a price of membership, to turn to the free-capital-mobility regime.

At the same time, a lack of banking and financial regulation compounded the problem. Many commercial banks borrowed short-term from abroad, given the new ability to do so as capital flows were freed from control, and lent the borrowed funds long-term to domestic private investors, often in real estate, without adequate safeguards. "In the five . . . economies, short-term borrowing amounted to almost a quarter of bank loans to the private sector in 1996."[6] So when the panic set in and capital began to flow out rather than in, the banks were forced to recall their loans. The central banks also cut the money supply as their foreign exchange reserves shrank due to the capital outflow. Both factors led to closing businesses and, in turn, to collapsing banks.

By contrast, India and China, which had been chalking up high growth rates through the decade prior to the Asian crisis while rejecting the calls for the elimination of capital controls, escaped the crisis altogether. One must therefore ask why the crisis-afflicted countries undertook this shift, which would soon prove expensive, to fulsome integration into the world's financial markets.

The Wall Street–Treasury Complex

The rush to abandon controls on international capital flows—economists call this a policy of capital account convertibility—was hardly a consequence of finance ministers and other policy makers in the developing countries suddenly acknowledging the folly of their ways. It reflected instead external pressures.

These came from both the IMF and the U.S. Treasury (where the leadership was doubtless provided by Treasury secretary Robert Rubin, the most influential financial figure in the Clinton administration). The economists in leadership positions in these institutions were among the most accomplished today. They could not be accused of unfamiliarity with the need for caution and prudence when it came to leaning on countries to free capital flows.

In fact, in 1989, Lawrence Summers (who was deputy to Rubin and succeeded him as Treasury secretary) and his lawyer wife, Victoria, had written a classic article about "excessive speculation," quoting with approbation statements such as:

> The freeing of financial markets to pursue their casino instincts heightens the odds of crises. . . . Because unlike a casino, the financial markets are inextricably linked with the world outside, the real economy pays the price.[7]

and the celebrated words in 1936 of John Maynard Keynes:

> As the organization of investment markets improves, the risk of the predominance of speculation does increase. In one of the greatest investment markets in the world, namely New York, the influence of speculation is enormous. Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes the by-product of the activities of a casino, the job is likely to be ill-done. The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield cannot be claimed as one of the outstanding triumphs of laissez-faire capitalism, which is not surprising if I am right in thinking that the best brains of Wall Street have been in fact directed towards a different object.[8]

If Summers had been eloquent about free capital mobility's downside, Stanley Fischer, who was the main theoretician at the IMF as its first deputy managing director, was surely familiar with the scholarly work on financial and currency crises. So why did they go along optimistically with the notion that the time had come to hasten the elimination of barriers to capital mobility worldwide?

I suspect that this had much to do with the general shift to markets and away from controls that had occurred in the 1970s and 1980s as disillusionment grew with knee-jerk interventions worldwide. They were likely caught in the usual swing of the pendulum—one extreme follows the other. So, I am sure, was Secretary Rubin. But the explanation of his complacency is possibly more complex. His working life had been on Wall Street, with Goldman Sachs. He clearly believed that America's financial markets had brought unusual venture-capital-financed prosperity to the United States. It was natural for him to see that countries practicing capital account inconvertibility, and regulating and inhibiting the inflows of capital, were denying themselves these benefits. It was inevitable that, as with most of us, his outlook was shaped by his experience.

Then again, one must reckon with the energetic lobbying of Wall Street firms to pry open financial markets worldwide. These firms argued that their profits and social good were in sync. If they had any doubts, these were carefully concealed!

The euphoria was widespread. In the exasperated words of the Nobel laureate James Tobin, a great figure in macroeconomics:

> U.S. leadership . . . gives the mobility of capital priority over all other considerations.

And Paul Volcker, the legendary chairman of the Federal Reserve whom Alan Greenspan succeeded, remarked in consternation:

> The visual image of a vast sea of liquid capital strikes me as apt—the big and inevitable storms through which a great liner like the U.S.S. United States of America can safely sail will surely capsize even the sturdiest South Pacific canoe.[9]

It was impossible to puncture the balloon because few with dissenting opinions could penetrate what I have called the Wall Street–Treasury complex.[10] This is the loose but still fairly coherent group of Wall Street firms in New York and the political elite in Washington, the latter embracing not just the Treasury but also the State Department, the IMF, the World Bank, and so on. There is constant to-and-fro between these two groups. For instance, Rubin moved from Wall Street to the Treasury and back; Wolfensohn at the World Bank moved there from his investment firm in New York; Stanley Fischer has moved in the reverse direction from the IMF to Citigroup; Ernest Stern, the senior vice president and acting president of the World Bank, moved to Morgan Stanley; and one could go on.

I think of the Wall Street–Treasury complex not as a conspiracy but very much in the spirit of C. Wright Mills's "power elite."[11] They wear similar suits, not just similar ties; they interact on boards and in clubs;

they wind up sharing the same sentiments, reinforced by one another's wisdom. So on capital mobility, like lemmings, they took other lemmings, and us, merrily down a dangerous path.

The phrase "Wall Street–Treasury complex" has proven popular not just among radical critics or NGOs. Robert Wade, an influential writer on financial crises who teaches at the London School of Economics, has adopted it, calling it the "Wall Street–Treasury–IMF complex."[12] But "Treasury" in my phrasing stood for Washington; adding just the IMF therefore unwittingly narrows, not widens, the meaning. Barry Eichengreen, a noted economic historian and occasional consultant to the IMF, has instead called it diplomatically the "Wall Street complex," but this is to leave out half of the culpable parties![13]

In a lighter vein, remember that Dwight Eisenhower, who surprisingly launched the radical phrase "military-industrial complex," was the president of Columbia University.[14] C. Wright Mills, the author of *The Power Elite*, taught sociology at Columbia. It was at Columbia also that I wrote about the Wall Street–Treasury complex. Consequently many talk now of the "Columbia trio." I suppose this is the next best to being 'N Sync!

The Question of Malaysian Capital Controls

But the Asian crisis called into question not just the wisdom of a rapid freeing of capital flows in countries that still had capital controls. It also raised the somewhat separate question of whether a country that *already* had this freedom would be wise to temporarily abandon it and to adopt capital controls in response to panic-fueled capital flows.

As it happens, Malaysia did just that, imposing selective exchange controls in September 1998.[15] Though the IMF disapproved, Prime Minister Mahathir stuck to his guns, therefore losing IMF support but gaining freedom from its conditionality. Most observers agree that IMF conditionality was in error, requiring deflation when an expansionary response was called for. So the other crisis-afflicted Asian economies went into a deep dive and recovered later, but Malaysia managed to get to the correct, expansionary policies earlier and avoided the gratuitous deepening of the downturn.

Economists have debated whether Malaysian controls played a significant role in allowing Dr. Mahathir to expand when others were contracting under the wrong IMF medicine. That is certainly what theory would say. Just as an import tariff enables you to segment domestic from foreign markets and to raise the domestic price above the foreign price, capital controls segment the domestic capital market from the world market and this can enable you to lower interest rates (to inflate the economy) without fearing further outflows of capital because interest rates are higher abroad. The theory is not far removed from reality, in my view.[16]

Where Do We Stand?

By now, the IMF has abandoned its excessive pre-crisis enthusiasm for free capital mobility.[17] It has learned the role of prudence in opening domestic financial markets to global integration, and the need to strengthen banking structures and practices prior to the opening. It has informally accepted the possible wisdom of measures such as a tax on incoming capital flows (an innovation of Chile) if they get too large. Finally, it has painfully learned the need for diversity of responses and conditionalities should crises erupt despite the prudence and safeguards. In short, while a watchful eye over the Wall Street–Treasury complex remains a necessity, the days of gung-ho international financial capitalism are probably past.

I can do no better than to cite *The Economist*, the most influential opinion magazine today on economics and finance:

> If any cause commands the unswerving support of *The Economist*, it is that of liberal trade. For as long as it has existed, this newspaper has championed freedom of commerce across borders. Liberal trade, we have always argued, advances prosperity, encourages peace among nations and is an indispensable part of individual liberty. It seems natural to suppose that what goes for trade in goods must go for trade in capital, in which case capital controls would offend us as violently as, say, an import quota on bananas. The issues have much in common, but they are not the same. Untidy as it may be, economic liberals should acknowledge that capital controls—of a certain restricted sort, and in certain cases—have a role.[18]

We need to guard against destructive creation

By Jagdish Bhagwati
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It seems clear that thecurrent **financial crisis**, terrifying though it is in its dimensions, will not be allowed to turn into the Great Crash of 2008. However, the larger lessons of the crisis, and its commonalities with previous calamities, must still be learnt if a new financial architecture is to be designed that can reduce the prospect of something similar happening again.

We can be optimistic about the effective handling of this crisis based on several factors. The Great Crash of 1929 has taught everyone lessons in what to do and, more importantly, in what *not* to do. Monetary policy is being loosened, not tightened: we can thank Milton Friedman's influential analyses for that. Fiscal policy will be expansionary, not deflationary: we all live in the age of John Maynard Keynes, whose fiscal prescriptions were unavailable in 1929 and grew out of the mistaken doctrines and policies of that time. The Smoot-Hawley tariff of 1930, which led to "competitive" increases in protectionism by all, accentuated the Crash. No one is willing to repeat that error.

Neither Ben Bernanke, the Federal Reserve chairman, nor Hank Paulson, the Treasury secretary – nor for that matter, President George W. Bush, who must take ultimate responsibility – wants to go down in history as another President Herbert Hoover, who presided over the Great Crash.

Besides, the ideology of the US is a lack of ideology. Where Nicolas Sarkozy, the French president, could not resist being photographed reading Marx's *Das Kapital* and announcing the death of "capitalism", the Americans settled down to fix the problem. They will do everything required to stem the crisis: for evidence of this, witness the **shift** of the $700bn (€515bn, £401bn) bail-out fund from buying toxic assets to recapitalising banks.

When the dust has settled, we must ask the question: why did this crisis occur? There are specifics that are not applicable everywhere. The crisis was, for example, kicked off by highly leveraged lending for uncreditworthy mortgages by the quasi-governmental**Freddie Mac** and **Fannie Mae**. But the problems became huge because "policy innovations" had been racing ahead of comprehension. The securitisation of mortgages was an innovation that led unwittingly to what Wall Street calls "betting the company". Credit-default swaps allowedAIG to bring in huge returns but at high risk if things went wrong, which they did.

The Long Term Capital Management crisis had a similar problem. At its heart were derivatives that no one quite understood. The Asian financial crisis was a result of a different innovation: the spread of capital account convertibility to economies that had registered miraculous growth for three decades, based on trade, but which were felled by their shift to financial convertibility. The downside had not been anticipated.

In each case, the assumption was that financial innovation was like non-financial innovation. When the personal computer was invented, the economy profited without upheaval. The typewriter became obsolete – an example of what Joseph Schumpeter famously called "creative destruction". But with financial innovation, the downside can be lethal – it is "destructive creation". We have to work hard at defining the downside scenarios.

The failure to think about the downside results from what I call the "Wall Street-Treasury Complex". Robert Rubin went from Goldman Sachs to the Treasury and back to Citigroup. Hank Paulson went from Goldman Sachs to the Treasury and will doubtless return also to Wall Street. This network shares the optimistic scenarios that Wall Street spins. Mr Rubin was in charge of the Treasury during the Asian financial crisis, whereas Mr Paulson was among the five major investment banking chief executives who persuaded the Securities and Exchange Commission not to extend prudential reserve requirements to their companies.

We therefore need a truly independent commission of experts to look closely at each financial innovation and work out its potential downside. Keynes once wrote that the inevitable never happens, it is always the unexpected. This commission would be charged with trying to narrow the range of the unexpected. We do not have to be blindsided by downsides just because we lazily surrender to the euphoria of the Complex.

The writer, a university professor at Columbia University and senior fellow at the Council on Foreign Relations, is the author of In Defense of Globalization (Oxford), reissued in 2007 with an afterword

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ECONOMY MAY 2009

The crash has laid bare many unpleasant truths about the United States. One of the most alarming, says a former chief economist of the International Monetary Fund, is that the finance industry has effectively captured our government—a state of affairs that more typically describes emerging markets, and is at the center of many emerging-market crises. If the IMF's staff could speak freely about the U.S., it would tell us what it tells all countries in this situation: recovery will fail unless we break the financial oligarchy that is blocking essential reform. And if we are to prevent a true depression, we're running out of time.

by Simon Johnson

The Quiet Coup

IMAGE CREDIT: JIM BOURG/REUTERS/CORBIS

ONE THING YOU learn rather quickly when working at the International Monetary Fund is that no one is ever very happy to see you. Typically, your "clients" come in only after private capital has abandoned them, after regional trading-bloc partners have been unable to throw a strong enough lifeline, after last-ditch attempts to borrow from powerful friends like China or the European Union have fallen through. You're never at the top of anyone's dance card.

The reason, of course, is that the IMF specializes in telling its clients what they don't want to hear. I should know; I pressed painful changes on many foreign officials during my time there as chief economist in 2007 and 2008. And I felt the effects of IMF pressure, at least indirectly, when I worked with governments in Eastern Europe as they struggled after 1989, and with the private sector in Asia and Latin America during the crises of the late 1990s and early 2000s. Over that time, from every vantage point, I saw firsthand the steady flow of officials—from Ukraine, Russia, Thailand, Indonesia, South Korea, and elsewhere—trudging to the fund when circumstances were dire and all else had failed.

Every crisis is different, of course. Ukraine faced hyperinflation in 1994; Russia desperately needed help when its short-term-debt rollover scheme exploded in the summer of 1998; the Indonesian rupiah plunged in 1997, nearly leveling the corporate economy; that same year, South Korea's 30-year economic miracle ground to a halt when foreign banks suddenly refused to extend new credit.

But I must tell you, to IMF officials, all of these crises looked depressingly similar. Each country, of course, needed a loan, but more than that, each needed to make big changes so that the loan could really work. Almost always, countries in crisis need to learn to live within their means after a period of excess—exports must be increased, and imports cut—and the goal is to do this without the most horrible of recessions. Naturally, the fund's economists spend time figuring out the policies—budget, money supply, and the like—that make sense in this context. Yet the economic solution is seldom very hard to work out.

No, the real concern of the fund's senior staff, and the biggest obstacle to recovery, is almost invariably the politics of countries in crisis.

Typically, these countries are in a desperate economic situation for one simple reason—the powerful elites within them overreached in good times and took too many risks. Emerging-market governments and their private-sector allies commonly form a tight-knit—and, most of the time, genteel—oligarchy, running the country rather like a profit-seeking company in which they are the controlling shareholders. When a country like Indonesia or South Korea or Russia grows, so do the ambitions of its captains of industry. As masters of their mini-universe, these people make some investments that clearly benefit the broader economy, but they also start making bigger and riskier bets. They reckon—correctly, in most cases—that their political connections will allow them to push onto the government any substantial problems that arise.

In Russia, for instance, the private sector is now in serious trouble because, over the past five years or so, it borrowed at least $490 billion from global banks and investors on the assumption that the country's energy sector could support a permanent increase in consumption throughout the economy. As Russia's oligarchs spent this capital, acquiring other companies and embarking on ambitious investment plans that generated jobs, their importance to the political elite increased. Growing political support meant better access to lucrative contracts, tax breaks, and subsidies. And foreign investors could not have been more pleased; all other things being equal, they prefer to lend money to people who have the implicit backing of their national governments, even if that backing gives off the faint whiff of corruption.

But inevitably, emerging-market oligarchs get carried away; they waste money and build massive business empires on a mountain of debt. Local banks, sometimes pressured by the government, become too willing to extend credit to the elite and to those who depend on them. Overborrowing always ends badly, whether for an individual, a company, or a country. Sooner or later, credit conditions become tighter and no one will lend you money on anything close to affordable terms.

The downward spiral that follows is remarkably steep. Enormous companies teeter on the brink of default, and the local banks that have lent to them collapse. Yesterday's "public-private partnerships" are relabeled "crony capitalism." With credit unavailable, economic paralysis ensues, and conditions just get worse and worse. The government is forced to draw down its foreign-currency reserves to pay for imports, service debt, and cover private losses. But these reserves will eventually run out. If the country cannot right itself before that happens, it will default on its sovereign debt and become an economic pariah. The government, in its race to stop the bleeding, will typically need to wipe out some of the national champions—now hemorrhaging cash—and usually restructure a banking system that's gone badly out of balance. It will, in other words, need to squeeze at least some of its oligarchs.

Squeezing the oligarchs, though, is seldom the strategy of choice among emerging-market governments. Quite the contrary: at the outset of the crisis, the oligarchs are usually among the first to get extra help from the government, such as preferential access to foreign currency, or maybe a nice tax break, or—here's a classic Kremlin bailout technique—the assumption of private debt obligations by the government. Under duress, generosity toward old friends takes many innovative forms. Meanwhile, needing to squeeze *someone*, most emerging-market governments look first to ordinary working folk—at least until the riots grow too large.

Eventually, as the oligarchs in Putin's Russia now realize, some within the elite have to lose out before recovery can begin. It's a game of musical chairs: there just aren't enough currency reserves to take care of everyone, and the government cannot afford to take over private-sector debt completely.

So the IMF staff looks into the eyes of the minister of finance and decides whether the government is serious yet. The fund will give even a country like Russia a loan eventually, but first it wants to make sure Prime Minister Putin is ready, willing, and able to be tough on some of his friends. If he is not ready to throw former pals to the wolves, the fund can wait. And when he is ready, the fund is happy to make helpful suggestions—particularly with regard to wresting control of the banking system from the hands of the most incompetent and avaricious "entrepreneurs."

Of course, Putin's ex-friends will fight back. They'll mobilize allies, work the system, and put pressure on other parts of the government to get additional subsidies. In extreme cases, they'll even try subversion—including calling up their contacts in the American foreign-policy establishment, as the Ukrainians did with some success in the late 1990s.

Many IMF programs "go off track" (a euphemism) precisely because the government can't stay tough on erstwhile cronies, and the consequences are massive inflation or other disasters. A program "goes back on track" once the government prevails or powerful oligarchs sort out among themselves who will govern—and thus win or lose—under the IMF-supported plan. The real fight in Thailand and Indonesia in 1997 was about which powerful families would lose their banks. In Thailand, it was handled relatively smoothly. In Indonesia, it led to the fall of President Suharto and economic chaos.

From long years of experience, the IMF staff knows its program will succeed—stabilizing the economy and enabling growth—only if at least some of the powerful oligarchs who did so much to create the underlying problems take a hit. This is the problem of all emerging markets.

Becoming a Banana Republic

In its depth and suddenness, the U.S. economic and financial crisis is shockingly reminiscent of moments we have recently seen in emerging markets (and only in emerging markets): South Korea (1997), Malaysia (1998), Russia and Argentina (time and again). In each of those cases, global investors, afraid that the country or its financial sector wouldn't be able to pay off mountainous debt, suddenly stopped lending. And in each case, that fear became self-fulfilling, as banks that couldn't roll over their debt did, in fact, become unable to pay. This is precisely what drove Lehman Brothers into bankruptcy on September 15, causing all sources of funding to the U.S. financial sector to dry up overnight. Just as in emerging-market crises, the weakness in the banking system has quickly rippled out into the rest of the economy, causing a severe economic contraction and hardship for millions of people.

But there's a deeper and more disturbing similarity: elite business interests—financiers, in the case of the U.S.—played a central role in creating the crisis, making ever-larger gambles, with the implicit backing of the government, until the inevitable collapse. More alarming, they are now using their influence to prevent precisely the sorts of reforms that are needed, and fast, to pull the economy out of its nosedive. The government seems helpless, or unwilling, to act against them.

Top investment bankers and government officials like to lay the blame for the current crisis on the lowering of U.S. interest rates after the dotcom bust or, even better—in a "buck stops somewhere else" sort of way—on the flow of savings out of China. Some on the right like to complain about Fannie Mae or Freddie Mac, or even about longer-standing efforts to promote broader homeownership. And, of course, it is axiomatic to everyone that the regulators responsible for "safety and soundness" were fast asleep at the wheel.

But these various policies—lightweight regulation, cheap money, the unwritten Chinese-American economic alliance, the promotion of homeownership—had something in common. Even though some are traditionally associated with Democrats and some with Republicans, they *all* benefited the financial sector. Policy changes that might have forestalled the crisis but would have limited the financial sector's profits—such as Brooksley Born's now-famous attempts to regulate credit-default swaps at the Commodity Futures Trading Commission, in 1998—were ignored or swept aside.

The financial industry has not always enjoyed such favored treatment. But for the past 25 years or so, finance has boomed, becoming ever more powerful. The boom began with the Reagan years, and it only gained strength with the deregulatory policies of the Clinton and George W. Bush administrations. Several other factors helped fuel the financial industry's ascent. Paul Volcker's monetary policy in the 1980s, and the increased volatility in interest rates that accompanied it, made bond trading much more lucrative. The invention of securitization, interest-rate swaps, and credit-default swaps greatly increased the volume of transactions that bankers could make money on. And an aging and increasingly wealthy population invested more and more money in securities, helped by the invention of the IRA and the 401(k) plan. Together, these developments vastly increased the profit opportunities in financial services.

Not surprisingly, Wall Street ran with these opportunities. From 1973 to 1985, the financial sector never earned more than 16 percent of domestic corporate profits. In 1986, that figure reached 19 percent. In the 1990s, it oscillated between 21 percent and 30 percent, higher than it had ever been in the postwar period. This decade, it reached 41 percent. Pay rose just as dramatically. From 1948 to 1982, average compensation in the financial sector ranged between 99 percent and 108 percent of the average for all domestic private industries. From 1983, it shot upward, reaching 181 percent in 2007.

The great wealth that the financial sector created and concentrated gave bankers enormous political weight—a weight not seen in the U.S. since the era of J.P. Morgan (the man). In that period, the banking panic of 1907 could be stopped only by coordination among private-sector bankers: no government entity was able to offer an effective response. But that first age of banking oligarchs came to an end with the passage of significant banking regulation in response to the Great Depression; the reemergence of an American financial oligarchy is quite recent.

The Wall Street–Washington Corridor

Of course, the U.S. is unique. And just as we have the world's most advanced economy, military, and technology, we also have its most advanced oligarchy.

In a primitive political system, power is transmitted through violence, or the threat of violence: military coups, private militias, and so on. In a less primitive system more typical of emerging markets, power is transmitted via money: bribes, kickbacks, and offshore bank accounts. Although lobbying and campaign contributions certainly play major roles in the American political system, old-fashioned corruption—envelopes stuffed with $100 bills—is probably a sideshow today, Jack Abramoff notwithstanding.

Instead, the American financial industry gained political power by amassing a kind of cultural capital—a belief system. Once, perhaps, what was good for General Motors was good for the country. Over the past decade, the attitude took hold that what was good for Wall Street was good for the country. The banking-and-securities industry has become one of the top contributors to political campaigns, but at the peak of its influence, it did not have to buy favors the way, for example, the tobacco companies or military contractors might have to. Instead, it benefited from the fact that Washington insiders already believed that large financial institutions and free-flowing capital markets were crucial to America's position in the world.

One channel of influence was, of course, the flow of individuals between Wall Street and Washington. Robert Rubin, once the co-chairman of Goldman Sachs, served in Washington as Treasury secretary under Clinton, and later became chairman of Citigroup's executive committee. Henry Paulson, CEO of Goldman Sachs during the long boom, became Treasury secretary under George W.Bush. John Snow, Paulson's predecessor, left to become chairman of Cerberus Capital Management, a large private-equity firm that also counts Dan Quayle among its executives. Alan Greenspan, after leaving the Federal Reserve, became a consultant to Pimco, perhaps the biggest player in international bond markets.

These personal connections were multiplied many times over at the lower levels of the past three presidential administrations, strengthening the ties between Washington and Wall Street. It has become something of a tradition for Goldman Sachs employees to go into public service after they leave the firm. The flow of Goldman alumni—including Jon Corzine, now the governor of New Jersey, along with Rubin and Paulson—not only placed people with Wall Street's worldview in the halls of power; it also helped create an image of Goldman (inside the Beltway, at least) as an institution that was itself almost a form of public service.

Wall Street is a very seductive place, imbued with an air of power. Its executives truly believe that they control the levers that make the world go round. A civil servant from Washington invited into their conference rooms, even if just for a meeting, could be forgiven for falling under their sway. Throughout my time at the IMF, I was struck by the easy access of leading financiers to the highest U.S. government officials, and the interweaving of the two career tracks. I vividly remember a meeting in early 2008—attended by top policy makers from a handful of rich countries—at which the chair casually proclaimed, to the room's general approval, that the best preparation for becoming a central-bank governor was to work first as an investment banker.

A whole generation of policy makers has been mesmerized by Wall Street, always and utterly convinced that whatever the banks said was true. Alan Greenspan's pronouncements in favor of unregulated financial markets are well known. Yet Greenspan was hardly alone. This is what Ben Bernanke, the man who succeeded him, said in 2006: "The management of market risk and credit risk has become increasingly sophisticated. ... Banking organizations of all sizes have made substantial strides over the past two decades in their ability to measure and manage risks."

Of course, this was mostly an illusion. Regulators, legislators, and academics almost all assumed that the managers of these banks knew what they were doing. In retrospect, they didn't. AIG's Financial Products division, for instance, made $2.5 billion in pretax profits in 2005, largely by selling underpriced insurance on complex, poorly understood securities. Often described as "picking up nickels in front of a steamroller," this strategy is profitable in ordinary years, and catastrophic in bad ones. As of last fall, AIG had outstanding insurance on more than $400 billion in securities. To date, the U.S. government, in an effort to rescue the company, has committed about $180 billion in investments and loans to cover losses that AIG's sophisticated risk modeling had said were virtually impossible.

Wall Street's seductive power extended even (or especially) to finance and economics professors, historically confined to the cramped offices of universities and the pursuit of Nobel Prizes. As mathematical finance became more and more essential to practical finance, professors increasingly took positions as consultants or partners at financial institutions. Myron Scholes and Robert Merton, Nobel laureates both, were perhaps the most famous; they took board seats at the hedge fund Long-Term Capital Management in 1994, before the fund famously flamed out at the end of the decade. But many others beat similar paths. This migration gave the stamp of academic legitimacy (and the intimidating aura of intellectual rigor) to the burgeoning world of high finance.

As more and more of the rich made their money in finance, the cult of finance seeped into the culture at large. Works like *Barbarians at the Gate*, *Wall Street*, and *Bonfire of the Vanities*—all intended as cautionary tales—served only to increase Wall Street's mystique. Michael Lewis noted in *Portfolio* last year that when he wrote *Liar's Poker*, an insider's account of the financial industry, in 1989, he had hoped the book might provoke outrage at Wall Street's hubris and excess. Instead, he found himself "knee-deep in letters from students at Ohio State who wanted to know if I had any other secrets to share. ... They'd read my book as a how-to manual." Even Wall Street's criminals, like Michael Milken and Ivan Boesky, became larger than life. In a society that celebrates the idea of making money, it was easy to infer that the interests of the financial sector were the same as the interests of the country—and that the winners in the financial sector knew better what was good for America than did the career civil servants in Washington. Faith in free financial markets grew into conventional wisdom —trumpeted on the editorial pages of *The Wall Street Journal* and on the floor of Congress.

From this confluence of campaign finance, personal connections, and ideology there flowed, in just the past decade, a river of deregulatory policies that is, in hindsight, astonishing:

• insistence on free movement of capital across borders;

• the repeal of Depression-era regulations separating commercial and investment banking;

• a congressional ban on the regulation of credit-default swaps;

• major increases in the amount of leverage allowed to investment banks;

• a light (dare I say *invisible*?) hand at the Securities and Exchange Commission in its regulatory enforcement;

- an international agreement to allow banks to measure their own riskiness;
- and an intentional failure to update regulations so as to keep up with the tremendous pace of financial innovation.

The mood that accompanied these measures in Washington seemed to swing between nonchalance and outright celebration: finance unleashed, it was thought, would continue to propel the economy to greater heights.

America's Oligarchs and the Financial Crisis

The oligarchy and the government policies that aided it did not alone cause the financial crisis that exploded last year. Many other factors contributed, including excessive borrowing by households and lax lending standards out on the fringes of the financial world. But major commercial and investment banks—and the hedge funds that ran alongside them—were the big beneficiaries of the twin housing and equity-market bubbles of this decade, their profits fed by an ever-increasing volume of transactions founded on a relatively small base of actual physical assets. Each time a loan was sold, packaged, securitized, and resold, banks took their transaction fees, and the hedge funds buying those securities reaped ever-larger fees as their holdings grew.

Because everyone was getting richer, and the health of the national economy depended so heavily on growth in real estate and finance, no one in Washington had any incentive to question what was going on. Instead, Fed Chairman Greenspan and President Bush insisted metronomically that the economy was fundamentally sound and that the tremendous growth in complex securities and credit-default swaps was evidence of a healthy economy where risk was distributed safely.

In the summer of 2007, signs of strain started appearing. The boom had produced so much debt that even a small economic stumble could cause major problems, and rising delinquencies in subprime mortgages proved the stumbling block. Ever since, the financial sector and the federal government have been behaving exactly the way one would expect them to, in light of past emerging-market crises.

By now, the princes of the financial world have of course been stripped naked as leaders and strategists—at least in the eyes of most Americans. But as the months have rolled by, financial elites have continued to assume that their position as the economy's favored children is safe, despite the wreckage they have caused.

Stanley O'Neal, the CEO of Merrill Lynch, pushed his firm heavily into the mortgage-backed-securities market at its peak in 2005 and 2006; in October 2007, he acknowledged, "The bottom line is, we—I—got it wrong by being overexposed to subprime, and we suffered as a result of impaired liquidity in that market. No one is more disappointed than I am in that result." O'Neal took home a $14 million bonus in 2006; in 2007, he walked away from Merrill with a severance package worth $162 million, although it is presumably worth much less today.

In October, John Thain, Merrill Lynch's final CEO, reportedly lobbied his board of directors for a bonus of $30 million or more, eventually reducing his demand to $10 million in December; he withdrew the request, under a firestorm of protest, only after it was leaked to *The Wall Street Journal*. Merrill Lynch as a whole was no better: it moved its bonus payments, $4 billion in total, forward to December, presumably to avoid the possibility that they would be reduced by Bank of America, which would own Merrill beginning on January 1. Wall Street paid out $18 billion in year-end bonuses last year to its New York City employees, after the government disbursed $243 billion in emergency assistance to the financial sector.

In a financial panic, the government must respond with both speed and overwhelming force. The root problem is uncertainty—in our case, uncertainty about whether the major banks have sufficient assets to cover their liabilities. Half measures combined with wishful thinking and a wait-and-see attitude cannot overcome this uncertainty. And the longer the response takes, the longer the uncertainty will stymie the flow of credit, sap consumer confidence, and cripple the economy —ultimately making the problem much harder to solve. Yet the principal characteristics of the government's response to the financial crisis have been delay, lack of transparency, and an unwillingness to upset the financial sector.

The response so far is perhaps best described as "policy by deal": when a major financial institution gets into trouble, the Treasury Department and the Federal Reserve engineer a bailout over the weekend and announce on Monday that everything is fine. In March 2008, Bear Stearns was sold to JP Morgan Chase in what looked to many like a gift to JP Morgan. (Jamie Dimon, JP Morgan's CEO, sits on the board of directors of the Federal Reserve Bank of New York, which, along with the Treasury Department, brokered the deal.) In September, we saw the sale of Merrill Lynch to Bank of America, the first bailout of AIG, and the takeover and immediate sale of Washington Mutual to JP Morgan—all of which were brokered by the government. In October, nine large banks were recapitalized on the same day behind closed doors in Washington. This, in turn, was followed by additional bailouts for Citigroup, AIG, Bank of America, Citigroup (again), and AIG (again).

Some of these deals may have been reasonable responses to the immediate situation. But it was never clear (and still isn't) what combination of interests was being served, and how. Treasury and the Fed did not act according to any publicly articulated principles, but just worked out a transaction and claimed it was the best that could be done under the circumstances. This was late-night, backroom dealing, pure and simple.

Throughout the crisis, the government has taken extreme care not to upset the interests of the financial institutions, or to question the basic outlines of the system that got us here. In September 2008, Henry Paulson asked Congress for $700 billion to buy toxic assets from banks, with no strings attached and no judicial review of his purchase decisions. Many observers suspected that the purpose was to overpay for those assets and thereby take the problem off the banks' hands—indeed, that is the only way that buying toxic assets would have helped anything. Perhaps because there was no way to make such a blatant subsidy politically acceptable, that plan was shelved.

Instead, the money was used to recapitalize banks, buying shares in them on terms that were grossly favorable to the banks themselves. As the crisis has deepened and financial institutions have needed more help, the government has gotten more and more creative in figuring out ways to provide banks with subsidies that are too complex for the general public to understand. The first AIG bailout, which was on relatively good terms for the taxpayer, was supplemented by three further bailouts whose terms were more AIG-friendly. The second Citigroup bailout and the Bank of America bailout included complex asset guarantees that provided the banks with insurance at below-market rates. The third Citigroup bailout, in late February, converted government-owned preferred stock to common stock at a price significantly higher than the market price—a subsidy that probably even most *Wall Street Journal* readers would miss on first reading. And the convertible preferred shares that the Treasury will buy under the new Financial Stability Plan give the conversion option (and thus the upside) to the banks, not the government.

This latest plan—which is likely to provide cheap loans to hedge funds and others so that they can buy distressed bank assets at relatively high prices—has been heavily influenced by the financial sector, and Treasury has made no secret of that. As Neel Kashkari, a senior Treasury official under both Henry Paulson and Tim Geithner (and a Goldman alum) told Congress in March, "We had received inbound unsolicited proposals from people in the private sector saying, 'We have capital on the sidelines; we want to go after [distressed bank] assets.'" And the plan lets them do just that: "By marrying government capital—taxpayer capital—with private-sector capital and providing financing, you can enable those investors to then go after those assets at a price that makes sense for the investors and at a price that makes sense for the banks." Kashkari didn't mention anything about what makes sense for the third group involved: the taxpayers.

Even leaving aside fairness to taxpayers, the government's velvet-glove approach with the banks is deeply troubling, for one simple reason: it is inadequate to change the behavior of a financial sector accustomed to doing business on its own terms, at a time when that behavior *must* change. As an unnamed senior bank official said to *The New York Times* last fall, "It doesn't matter how much Hank Paulson gives us, no one is going to lend a nickel until the economy turns." But there's the rub: the economy can't recover until the banks are healthy and willing to lend.

The Way Out

Looking just at the financial crisis (and leaving aside some problems of the larger economy), we face at least two major, interrelated problems. The first is a desperately ill banking sector that threatens to choke off any incipient recovery that the fiscal stimulus might generate. The second is a political balance of power that gives the financial sector a veto over public policy, even as that sector loses popular support.

Big banks, it seems, have only gained political strength since the crisis began. And this is not surprising. With the financial system so fragile, the damage that a major bank failure could cause—Lehman was small relative to Citigroup or Bank of America—is much greater than it would be during ordinary times. The banks have been exploiting this fear as they wring favorable deals out of Washington. Bank of America obtained its second bailout package (in January) after warning the government that it might not be able to go through with the acquisition of Merrill Lynch, a prospect that Treasury did not want to consider.

The challenges the United States faces are familiar territory to the people at the IMF. If you hid the name of the country and just showed them the numbers, there is no doubt what old IMF hands would say: nationalize troubled banks and break them up as necessary.

In some ways, of course, the government has already taken control of the banking system. It has essentially guaranteed the liabilities of the biggest banks, and it is their only plausible source of capital today. Meanwhile, the Federal Reserve has taken on a major role in providing credit to the economy—the function that the private banking sector is supposed to be performing, but isn't. Yet there are limits to what the Fed can do on its own; consumers and businesses are still dependent on banks that lack the balance sheets and the incentives to make the loans the economy needs, and the government has no real control over who runs the banks, or over what they do.

At the root of the banks' problems are the large losses they have undoubtedly taken on their securities and loan portfolios. But they don't want to recognize the full extent of their losses, because that would likely expose them as insolvent. So they talk down the problem, and ask for handouts that aren't enough to make them healthy (again, they can't reveal the size of the handouts that would be necessary for that), but are enough to keep them upright a little longer. This behavior is corrosive: unhealthy banks either don't lend (hoarding money to shore up reserves) or they make desperate gambles on high-risk loans and investments that could pay off big, but probably won't pay off at all. In either case, the economy suffers further, and as it does, bank assets themselves continue to deteriorate—creating a highly destructive vicious cycle.

To break this cycle, the government must force the banks to acknowledge the scale of their problems. As the IMF understands (and as the U.S. government itself has insisted to multiple emerging-market countries in the past), the most direct way to do this is nationalization. Instead, Treasury is trying to negotiate bailouts bank by bank, and behaving as if the banks hold all the cards—contorting the terms of each deal to minimize government ownership while forswearing government influence over bank strategy or operations. Under these conditions, cleaning up bank balance sheets is impossible.

Nationalization would not imply permanent state ownership. The IMF's advice would be, essentially: scale up the standard Federal Deposit Insurance Corporation process. An FDIC "intervention" is basically a government-managed bankruptcy procedure for banks. It would allow the government to wipe out bank shareholders, replace failed management, clean up the balance sheets, and then sell the banks back to the private sector. The main advantage is immediate recognition of the problem so that it can be solved before it grows worse.

The government needs to inspect the balance sheets and identify the banks that cannot survive a severe recession. These banks should face a choice: write down your assets to their true value and raise private capital within 30 days, or be taken over by the government. The government would write down the toxic assets of banks taken into receivership—recognizing reality—and transfer those assets to a separate government entity, which would attempt to salvage whatever value is possible for the taxpayer (as the Resolution Trust Corporation did after the savings-and-loan debacle of the 1980s). The rump banks—cleansed and able to lend safely, and hence trusted again by other lenders and investors—could then be sold off.

Cleaning up the megabanks will be complex. And it will be expensive for the taxpayer; according to the latest IMF numbers, the cleanup of the banking system would probably cost close to $1.5 trillion (or 10 percent of our GDP) in the long term. But only decisive government action—exposing the full extent of the financial rot and restoring some set of banks to publicly verifiable health—can cure the financial sector as a whole.

This may seem like strong medicine. But in fact, while necessary, it is insufficient. The second problem the U.S. faces—the power of the oligarchy—is just as important as the immediate crisis of lending. And the advice from the IMF on this front would again be simple: break the oligarchy.

Oversize institutions disproportionately influence public policy; the major banks we have today draw much of their power from being too big to fail. Nationalization and re-privatization would not change that; while the replacement of the bank executives who got us into this crisis would be just and sensible, ultimately, the swapping-out of one set of powerful managers for another would change only the names of the oligarchs.

Ideally, big banks should be sold in medium-size pieces, divided regionally or by type of business. Where this proves impractical—since we'll want to sell the banks quickly—they could be sold whole, but with the requirement of being broken up within a short time. Banks that remain in private hands should also be subject to size limitations.

This may seem like a crude and arbitrary step, but it is the best way to limit the power of individual institutions in a sector that is essential to the economy as a whole. Of course, some people will complain about the "efficiency costs" of a more fragmented banking system, and these costs are real. But so are the costs when a bank that is too big to fail—a financial weapon of mass self-destruction—explodes. Anything that is too big to fail is too big to exist.

To ensure systematic bank breakup, and to prevent the eventual reemergence of dangerous behemoths, we also need to overhaul our antitrust legislation. Laws put in place more than 100 years ago to combat industrial monopolies were not designed to address the problem we now face. The problem in the financial sector today is not that a given firm might have enough market share to influence prices; it is that one firm or a small set of interconnected firms, by failing, can bring down the economy. The Obama administration's fiscal stimulus evokes FDR, but what we need to imitate here is Teddy Roosevelt's trust-busting.

Caps on executive compensation, while redolent of populism, might help restore the political balance of power and deter the emergence of a new oligarchy. Wall Street's main attraction—to the people who work there and to the government officials who were only too happy to bask in its reflected glory—has been the astounding amount of money that could be made. Limiting that money would reduce the allure of the financial sector and make it more like any other industry.

Still, outright pay caps are clumsy, especially in the long run. And most money is now made in largely unregulated private hedge funds and private-equity firms, so lowering pay would be complicated. Regulation and taxation should be part of the solution. Over time, though, the largest part may involve more transparency and competition, which would bring financial-industry fees down. To those who say this would drive financial activities to other countries, we can now safely say: fine.

Two Paths

To paraphrase Joseph Schumpeter, the early-20th-century economist, everyone has elites; the important thing is to change them from time to time. If the U.S. were just another country, coming to the IMF with hat in hand, I might be fairly optimistic about its future. Most of the emerging-market crises that I've mentioned ended relatively quickly, and gave way, for the most part, to relatively strong recoveries. But this, alas, brings us to the limit of the analogy between the U.S. and emerging markets.

Emerging-market countries have only a precarious hold on wealth, and are weaklings globally. When they get into trouble, they quite literally run out of money—or at least out of foreign currency, without which they cannot survive. They *must* make difficult decisions; ultimately, aggressive action is baked into the cake. But the U.S., of course, is the world's most powerful nation, rich beyond measure, and blessed with the exorbitant privilege of paying its foreign debts in its own currency, which it can print. As a result, it could very well stumble along for years—as Japan did during its lost decade—never summoning the courage to do what it needs to do, and never really recovering. A clean break with the past—involving the takeover and cleanup of major banks—hardly looks like a sure thing right now. Certainly no one at the IMF can force it.

In my view, the U.S. faces two plausible scenarios. The first involves complicated bank-by-bank deals and a continual drumbeat of (repeated) bailouts, like the ones we saw in February with Citigroup and AIG. The administration will try to muddle through, and confusion will reign.

Boris Fyodorov, the late finance minister of Russia, struggled for much of the past 20 years against oligarchs, corruption, and abuse of authority in all its forms. He liked to say that confusion and chaos were very much in the interests of the powerful—letting them take things, legally and illegally, with impunity. When inflation is high, who can say what a piece of property is really worth? When the credit system is supported by byzantine government arrangements and backroom deals, how do you know that you aren't being fleeced?

Our future could be one in which continued tumult feeds the looting of the financial system, and we talk more and more about exactly how our oligarchs became bandits and how the economy just can't seem to get into gear.

The second scenario begins more bleakly, and might end that way too. But it does provide at least some hope that we'll be shaken out of our torpor. It goes like this: the global economy continues to deteriorate, the banking system in east-central Europe collapses, and—because eastern Europe's banks are mostly owned by western European banks—justifiable fears of government insolvency spread throughout the Continent. Creditors take further hits and confidence falls further. The Asian economies that export manufactured goods are devastated, and the commodity producers in Latin America and Africa are not much better off. A dramatic worsening of the global environment forces the U.S. economy, already staggering, down onto both knees. The baseline growth rates used in the administration's current budget are increasingly seen as unrealistic, and the rosy "stress scenario" that the U.S. Treasury is currently using to evaluate banks' balance sheets becomes a source of great embarrassment.

Under this kind of pressure, and faced with the prospect of a national and global collapse, minds may become more concentrated.

The conventional wisdom among the elite is still that the current slump "cannot be as bad as the Great Depression." This view is wrong. What we face now could, in fact, be worse than the Great Depression—because the world is now so much more interconnected and because the banking sector is now so big. We face a synchronized downturn in almost all countries, a weakening of confidence among individuals and firms, and major problems for government finances. If our leadership wakes up to the potential consequences, we may yet see dramatic action on the banking system and a breaking of the old elite. Let us hope it is not then too late.

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Bhagwati

IMF does Mea Culpa: Triumph After All

Bob Davis, the reporter for the Wall Street Journal who writes influential commentary on international economic issues, called me up last week and told me that the IMF had done a mea culpa on capital controls and interviewed me for a story that he wrote with quotes from me in the WSJ (February 19 , 2010).

We discussed also how my heresy in Foreign Affairs (May/June 1998) in an essay titled "The Capital Myth", had been attacked by the IMF in a formal letter to the magazine by their External Affairs director, Shailendra Anjaria ("The Capital Truth: What Works for Commodities Should Work for Cash",November/December 1998). The IMF had now changed that to an admission that capital controls made sense. Triumph had finally come my way, even if it was almost 12 years in the making; though, other major ideas of mine have sometimes taken even longer to get accepted and one must remember that patience is a virtue.

I might add that I had been denounced also by many others at the time, including the eminent economic historian Brad deLong who is such an outspoken and ruthless liberal blogger today that he is sometimes called the Rush Limbaugh on the liberal side. And, while my essay was an important contribution which led to numerous foreign translations of my article, Awards and invitations worldwide, I was never invited to the annual Jackson Hole conferences of the Federal Reserve, whose organizers included the practitioners of the orthodoxy which I had critiqued, not even to participate in their frequent sessions on international trade: heretics such as myself were clearly not welcome at events routinely covered by the major media.

I should also add that my 1998 Foreign Affairs piece also advanced another influential idea, that of the Treasury-Wall Street Complex to explain why the world's smartest economists like Larry Summers and Stanley Fischer had suspended guard about the asymmetry of the case for free trade and the case of free

capital flows. I argued that the symbiotic relationship between Wall Street (whose titans' views about financial flows were excessively rosy) and the Treasury (which I said should include the IMF, World Bank and the State Department), because of constant back-and-forth movements among them --- e.g. Robert Rubin went from Goldman Sachs to the Treasury and back to Citi --- led to shared euphoria and forgetfulness about the downside of free capital flows. This concept has been widely accepted and used by economists as diverse as Robert Wade of London School of Economics and Barry Eichengreen of Berkeley, in various ways. It has been used, but turned into a "capture" theory (which I not not share in its entirety) of the Treasury by Wall Street, by the brilliant MIT economist Simon Johnson who wrote in <u>The Atlantic,</u> but talked of the "corridor" rather than the "complex".

Since President Eisenhower was President of Columbia when he talked about the "military-industrial complex", and Columbia sociologist Wright Mills wrote about the "power elite", and I have been at Columbia since 1980, we are sometimes known as the "Columbia trio". I might say to my distinguished Columbia colleague Joe Stiglitz, who unfortunately encourages ill-read and uninformed populists and is an icon to them: Columbia has had made more respectable, intellectual and radical impact on the world than cheap populism will ever achieve.

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Global Reality Challenges IMF's Free Market Gospel

by Tom Gjelten

March 18, 2010

After six decades of zealously promoting free market economic policies, the International Monetary Fund has traded its dogmatism for pragmatism.

For years, governments that dared to challenge the IMF model found themselves out of favor in Washington and other Western capitals.

But the financial crisis that swept the planet in 2008 prompted a new debate over free market policies and IMF ideology.

Now, in a notable turnaround, the IMF has acknowledged that in some instances, developing countries might benefit from controlling how much foreign capital enters their economies — and how it's used.

The issue goes to the heart of the capitalist system. Free market advocates have long insisted that capital should be allowed to move around the world unimpeded by government regulation, responding to the same supply and demand forces that drive global trade in manufactured goods.

Investors who see opportunities in the labor-rich but capital-poor countries of the developing world, free marketeers argue, should be free to move into those economies whenever they sense a profit to be made — and free to withdraw their money as soon as they lose interest.

They say it's a sure way to economic growth.

That proposition is now being questioned, however, by the very IMF economists who once championed it. Turns out there is such a thing as too much capital flowing into an economy.

When you've got too much money and nothing to do with it, you start doing really foolish things.

- John Ralston Saul, author of 'The Collapse of Globalism'

Challenge To Orthodoxy

The new IMF view is summarized in an official paper published last month, "Capital Inflows: The Role of Controls." After examining the experience of governments that have regulated capital flows, the IMF authors concluded that such policies helped reduce "financial fragility."

Specifically, the IMF now acknowledges that some countries are better prepared than others to handle an influx of foreign capital. Nations with no reason to fear overvaluing their currencies should probably refrain from capital inflow controls, the IMF says.

On the other hand, countries worried about inflation or exchange rates should consider controls, the IMF says. It also advises countries to assess the type of capital coming into their countries, differentiating between risky short-term foreign currency debt and foreign direct investment, which is relatively safer.

Behind the new position is a remarkable story of how critics of gung-ho global capitalism finally succeeded in challenging IMF orthodoxy, in part because the financial crisis of 2008 prompted reconsideration of conventional economic theories.

Roots In The Asian Financial Crisis

The story begins with the financial tremors that swept through East Asian economies in 1997 and 1998. In previous years, foreign capital was flooding Asian financial markets. Investors sensed that the emerging economies of the region were ripe for takeoff, rich in labor and natural resources, and only needed an infusion of capital to jump-start growth.

Lacking the information they often have about incipient industries, however, investors acted impulsively.

The problem starts "when a couple of guys in New York or London, who have far more capital than they know what to do with, simply dump it into a country," economics essayist John Ralston Saul explains.

Other investors then take a cue and mindlessly follow their example — "herd behavior" in action.

As a result, foreign investors in 1996 poured about $65 billion into just four Asian countries: Thailand, Indonesia, Malaysia and South Korea. It was far more than those countries needed, and the result was disastrous.

"When you've got too much money and nothing to do with it, you start doing really foolish things," says Saul, author of *The Collapse of Globalism.*

That includes buying and selling local companies for no particular purpose, Saul says. "You start saying, 'Let's put all those companies together.' And then you say, 'Let's take all those companies apart.' "

Such frenzied investment and speculation drive the local stock prices of those companies, in U.S. dollar terms, sky high. The dollar price of almost all local goods and services rises steeply, because so many dollars have flooded the local currency markets.

Businessmen, homeowners and governments are tempted to borrow even more dollars, because they are cheap. The local currency is soon overvalued; signs of trouble appear.

The Panic Begins

Herd behavior kicks in again. But this time, the herd panics.

When investors see other investors pulling large amounts of money out of a particular country, they begin to wonder if there are underlying factors or other issues that they don't understand, says Eswar Prasad, a former IMF economist now teaching at Cornell University. That uncertainty — and the potential for huge losses — leads them to pull out their money.

This is exactly what happened in Thailand, Indonesia, Malaysia and South Korea. Capital inflows first came to a screeching halt, then went in reverse.

Jagdish Bhagwati, an economist at Columbia University, recalls that investors began leaving those markets "in droves, creating a massive crisis." Those four East Asian countries, according to Bhagwati, experienced a net capital outflow of about $20 billion in 1997 and 1998.

Across the region, economies collapsed. The interest costs on dollar debts soared. Local stock prices plummeted.

Some governments, notably Malaysia, felt burned by foreign investors. The Malaysian government soon imposed limits on capital movements, both in and out.

The Malaysian action set up a confrontation with the IMF, which at the time vigorously opposed all controls on capital flows. The IMF said Malaysia was backtracking on free market reforms.

In Defense Of Controls

Governments that had not yet permitted open capital flows, such as India, remained under IMF pressure to do so, Bhagwati notes.

India dragged its feet on the issue of liberalizing its capital account; in the end, it never did.

That's a position Bhagwati supported. In an essay titled "The Capital Myth: The Difference Between Trade in Widgets and Dollars" that appeared in *Foreign Affairs* in 1998, he disputed the notion that free movements of capital were analogous to free trade in manufactured goods and should therefore be unrestricted.

The IMF was quick to respond. The following issue of the magazine included a letter to the editor from the IMF head of external relations, Shailendra Anjaria. The IMF rejoinder was titled "The Capital Truth: What Works for Commodities Should Work for Cash."

"Those who argue for free trade internationally should also advocate the free flow of capital across national borders," Anjaria wrote.

That was in 1998.

Ten years later, another international financial crisis came along. This time, it hit Eastern Europe the hardest. Like the East Asian governments in the 1990s, Eastern European governments such as Poland and Romania had been allowing foreign capital to flood their economies, in line with IMF preferences. Once again, economies experienced credit crises, and debt-servicing costs went through the roof.

The Turnaround

But this time, the IMF research department took heed. After a thorough comparative analysis of economic developments in countries with and without capital controls, IMF economists came to a provocative conclusion.

Jonathan Ostry, the IMF's deputy research director, says the group's research found that "countries that did have some restrictions on capital inflows tended to come into this crisis with more equity [and] less debt. And this served them well in terms of having less of a credit boom, less of a run-up in asset prices in the good times, and therefore less of a bust in the bad times."

The conclusion was a complete turnaround from the previous IMF position. Ostry was working in the IMF research department at the time the letter was published, but deflected a question about it, noting instead that the IMF line now is "pragmatism, rather than dogmatism."

As the principal author of the new IMF paper, Ostry disputes any notion of a dramatic U-turn in policy, saying the change was "evolutionary."

Bhagwati, the target of the 1998 rejoinder in *Foreign Affairs*, doesn't dispute that the change in IMF thinking unfolded gradually. For his part, he believes the movement of capital around the world, in general, is healthy and boosts the global economy.

But he is thrilled the IMF has finally acknowledged publicly that his previous views were valid.

"Along the way, there were occasional indications [that the IMF had changed positions]," Bhagwati says, "but never so frontally saying, 'Golly, Bhagwati was right,' and now they have."

For: Kulturaustausch

Culture, Economics and the Financial Crisis

By

Jagdish Bhagwati

The author is University Professor, Economics and Law, at Columbia University and a leading economist today. He is the author of In Defense of Globalization, (Oxford, 2004, Paperback edition with an Afterword, 2007), which has recently been translated into German with a Preface by Joschka Fischer and published by Random House/Pantheon.

The role of culture in Economics is often overlooked because culture is often cited as a roadblock to thinking about the role of economics in explaining economic phenomena.

Thus, when I was young, lack of development was occasionally ascribed to the cultural values that attached a low value to economic success. So, the economists turned around to saying and in fact demonstrating in different contexts that there will always be some response to economic opportunity; and that culture defines only the degree and speed of response. As the British saying goes: every man has his price (only the price varies with culture). In fact, some of the early work in development economics was addressed to showing that peasants, who were supposed to be unresponsive to market incentives, were in fact not so.

I must also add that economists found some of the cultural explanations difficult to accept. They seemed to go in all directions. Thus, Confucianism was long supposed to be a drag on development. After the success of East Asia, it was supposed to be conducive to development! A cartoon which I once saw captures well the way economists tend to see cultural explanations: A manager dressed like a Shinto priest is telling his staff: the Protestant ethic does not cut it any more; we are turning to Shinto".

Some economists carry this skepticism of cultural factors too far and therefore miss important ways in which one may explain economic phenomena. Thus, in my book, In Defense of Globalization, I consider the impact of globalization on child labour in the poor countries. I argue that, from a cultural perspective, we can distinguish between wicked and virtuous parents. When incomes improve because of globalization (as happened in Vietnam when trade restrictions were removed and peasants earned about a third more for their rice), the wicked parents will say: ah, we can now earn more from rice so we will take one child away from school and out her to work instead, whereas the virtuous parents will say: we are doing better economically now, so we will take one child away from work and put her in school instead. In Vietnam, and many other studies, parents turn out to be virtuous: maybe, cultural and biological factors explain why parents make virtuous choices. But economists would like to add that economic factors explain the virtuous outcomes as well. How? Because numerous studies show that there are high, private returns to a family from primary education. But poor peasants face "imperfect credit markets", i.e. they cannot borrow money to finance the education, because they do not have collateral. So, if incomes improve, this credit constraint is removed and peasants will then make virtuous choices.

Cultural differences also underlie some key conflicts today between countries. Thus, the general attitude to technical change in genetically-modified foods in the United States is that it solves problems whereas in European culture, it is often that it creates problems. The notion that GM foods are "Frankenstein" foods goes well in Europe; it is generally considered laughable in the United States. And I reproduce a cartoon from The New Yorker where the customer tells the waiter in a restaurant: This broccoli does not taste good; it should be modified genetically for better taste." I say in my Globalization book that the United States is after all a nation where artificially enhanced women (with their endowments amplified by Silicon transplants) are chased by artificially aroused men (on Viagra). [At the cultural level, I might also add that it is odd that sex remains central to relationships even in old age in the United States, in contrast to other cultures. We had a charming Polish secretary who called up her mother in Warsaw. The mother asked her:

Darling, what is this thing called Viagra? So, the daughter explained. The mother, aghast and alarmed, said: Good God, don't tell your father about it!" This story also illustrates a point that many economists make: that culture is not immutable but will often adapt to economic and technical change. The Polish mother obviously thought that her husband would snap out of his Polish-style sexual retirement once Viagra was available.]

So we have had disputes over hormone-fed beef and over GM foods between the United States and Europe. Comparable disputes have arisen over culture and globalization. Americans generally do not see that other nations see that their culture may be undermined by economic globalization. So, the European Union, Canada and others have wanted to impose restrictions such as requiring a minimum proportion of indigenous TV programs. The United States tends to see these as simple protectionism. But it fails to realize that the United States is unique in not seeing why other countries see a need to be supportive of actions to preserve their cultures in the face of globalizing influences. The uniqueness of the US in this regard comes from the fact that, being a nation of immigrants, its experience has been to "import" and assimilate, without feeling threatened, several cultures, much as you can buy a hundred varieties of cheese in the New York stores or see Japanese sushi, central European pastrami and Indian tandoori chicken being sold, Hare Krishnas dancing on Telegraph Avenue outside the University of California at Berkeley. At the same time, on the export side, United States is at the frontier: exporting "low culture" like Coke, McDonalds and pop music, and "high culture" such as ideas on children's rights and women's rights. Of course, protecting your own culture still leaves open the issue as to how best to do it. If you want your own cinema to survive and flourish, having quotas on showing of foreign films is, to begin with, not feasible since people can always buy DVDs. Again, it is surely better to subsidize your own cinema than to restrict the entry of foreign cinema: better to have Renoir compete with Spielberg than to protect Renoir from competition.

The current financial crisis also illustrates well the role of culture in explaining why there has been such a visceral objection to the bailouts that are essential to saving the financial system from collapse. Let me make just two points. First, many people in the United States have been upset by the sight of CEOs cashing in their stock options and getting out of failing firms with large sums of money while the workers lose their jobs and their own stock options (which are frequently the way bonuses were paid in good years) collapse in value. It is not the large sums of money that the CEOs get, and the "inequality" that his implies, that seem to be truly upsetting about this phenomenon. The reaction rather is that what is happening is "unethical". Unlike school children in Asia, Western children are brought up on the notion that, when a ship is sinking, the captain should be on the deck and should go down with the ship while the passengers get away in lifeboats. What the CEOs were doing, on the other hand, was to get out in the lifeboats while the workers were going down with the firm! It really affected people's sense of what ethical behaviour ought to be.

In consequence, the efforts at a bailout by Hank Paulson (Secretary of the Treasury) and Ben Bernanke (Fed Chairman), and the Bush administration, to sell a bailout to the American public, and hence to the US Congress, have encountered strong opposition. Perhaps it might have helped to explain the need for a bailout by using an analogy. Imagine you are in a situation of triage in a lifeboat. One person has to be thrown overboard. If you throw out the sturdy fellow in an expensive suit, you would lose his ability to help you row the boat and take you to a possible rescue. So, you will want to throw the physically less endowed fellow dressed in tatters overboard instead. It seems unfair to save the fellow who is better off; but the triage situation justifies this. So does the bailout of the big banks.

In the end, the pragmatic nature of the Americans is the best guarantor that we will manage to get out of this crisis. When the crisis happened, the French President Sarkozy was in a newspaper, reading Marx's Das Kapital. My reaction was to ridicule him: Surely every decent Frenchman had read Marx, Proust and Voltaire at school. How come Sarkozy had received such bad education that he had to wait until he became the French President to read Marx? By contrast, the Americans got down to fixing the problem. The American ideology is lack of ideology. They remind me of Sir Geoffrey Crowther's reply when, as editor of the magazine The Economist, he was asked: what is the magazine's philosophy: We are in the extreme center!

Viewpoint: Jagdish Bhagwati

Lessons from the Current Crisis

INTRODUCTION

Please provide introductory bio.

The current crisis—or perhaps two crises, one financial or Wall Street, the other macroeconomic or Main Street, both are intertwined—has caused not only panic, but also much anguished thought about its implications for capitalism and globalization. Clear thinking is necessary to prevent both of these principles being undermined in the populist reaction that seems to have emerged.

Market Fundamentalism

The financier George Soros and the economist Joseph Stiglitz, in particular, have gone around saying that the crisis has put an end to "market fundamentalism," and that it represents for capitalism and globalization what the collapse of the Berlin Wall did for communism. Both arguments must be rejected.

The post-war shift to more reliance on markets, greater integration of national economies into the world economy (which we call globalization), and shift away from knee-jerk expansion of public-sector enterprises into activities beyond utilities that are "natural monopolies" was a shift from "anti-market fundamentalism" towards a more pragmatic center. It was not, as these critics claim, a shift from pragmatism to "market fundamentalism."

Besides, the analogy with the collapse of the Berlin Wall is laughable. The Wall's collapse signified the epitaph of a failed communism, which had landed its supporters in authoritarianism and economic wilderness. The current crisis follows instead decades of post-war prosperity, ushered in by the shift to the pragmatic center and away from anti-market fundamentalism. It also follows a steady shift of more of the world's nations to democracy, with economic and political liberalization often reinforcing each other.

Globalization and Financial Innovation

Again, we must avoid the fallacy of aggregation. Globalization, in the shape of freer trade and multinational investments, has been generally a force for good and economic prosperity. But it has also advanced, rather than harmed, social agendas such as gender equality and reduction of child labor, as demonstrated in my 2004 book, *In Defense of Globalization*. But, as every sophisticated economist knows, the financial sector offers asymmetries *vis-à-vis* international trade and, while it provides credit, which is the lifeblood of capitalist (or indeed any) systems, it can also lead to huge downsides and requires monitoring and informed regulation.

In relation to freeing capital flows and capital account convertibility that led to the East Asian financial crisis in the 1980s, I illustrate this asymmetry by using a couple of analogies.

Regarding trade, if I exchanged some of my toothbrushes for some of your toothpaste, and we both remembered to brush our teeth, we would both have white teeth and the probability of our teeth being knocked out in the process would be pretty slim.

However, the analogy for free capital flows is different. It is like fire, which enables me to turn veal into delicious "wiener schnitzel," but it can also burn down my house. The downside is huge, as we discovered at the time of the East Asian crisis.

This insight applies to financial innovation, which underlies recent crises, including the one we are in right now, perfectly. The long-term capital management crisis was precipitated by the financial innovation of derivatives which few understood. The innovation, and its downside when things got rough, had gone beyond comprehension by most, including the regulators. Currently, we have had similarly dangerous financial innovations like the credit default swaps and securitized mortgages. I am afraid few people realized the downside potential of these instruments. Yes, there were some warning voices. But they did not belong to what I have called the Wall Street–Treasury Complex: players who go back and forth, like Treasury Secretary Robert Rubin, between the Treasury and Wall Street (in his case, he went from Goldman Sachs to the Treasury and back to Citigroup). This Complex shared the euphoria about the financial innovations. So, they took us right into what turned into the bonfire.

The point we need to learn is that nonfinancial and financial innovations have important differences. Nonfinancial innovations (such as the innovation of the personal computer) raise the issue of what Schumpeter called "creative destruction" (i.e. smoothing into obsolescence the typewriter). With financial innovations, the problem is that there is a potential downside which can turn it into a "destructive creation." Therefore, we need a high-level "Standing Committee of Experts" whose job would be to look hard at the potential downside of whatever is the latest innovation being created by Wall Street.

Again, an analogy helps. The United States, under the Cheney–Rumsfeld leadership, went to war against Iraq based on the assumption that the war would last six weeks. They did not have a scenario where it would last six years, which it has! They had not worked out the downside scenarios, and the cost of that omission, as with the current financial crisis, has turned out to be enormous. We may not be able to figure out the downside with prescience; after all, Keynes once said, with characteristically brilliant exaggeration: "The inevitable never happens. It is always the unexpected." The task of the "Standing Committee of Experts" which I have proposed would be to reduce the unexpected whenever possible.

Financial Regulation

We therefore need to fix the financial sector and the problems that affect it. In this vein, let me also say that the US Congress was remiss in encouraging home ownership through its quasi-governmental agencies Freddie Mac and Fannie Mae, in effect regardless of adequate collateral, with many mortgages being given to people who could not possibly have qualified under normal commercial criteria. These agencies also "bribed" congressmen from both political parties with political contributions into effectively providing lax oversight. And again the big investment banks, such as Goldman Sachs, pressured the Securities and Exchange Commission into exempting them from the prudential reserve requirements, leading to gross over-leveraging. In turn, politicians like Senator Schumer of New York supported such irresponsible actions by arguing that, if New York imposed prudential requirements on the investment banks, the business would go to London, suggesting that the new financial architecture must seek some basic coordination of regulations so we do not get a dangerous "race to the bottom."

Free Trade, Not Protectionism

The current crisis has also made the critics of free trade more confident. But trade did not cause the crisis, and protectionism will not cure it. The East Asians were smart enough to know that premature capital account convertibility (i.e. freeing of capital flows which is the "financial sector") caused the crash from their remarkable growth for nearly three decades, which was attributable to outward orientation in trade. So, after the crisis, they refused to throw the trade baby out with the financial bath water. Surely, we are not going to be less smart than they were. So, the G20 has been right to urge that protectionism must be kept at bay.

On the other hand, the US has failed to provide the lead in holding the line on protectionism, with the Congress working with the Buy America provisions in its Stimulus Bill. President Sarkozy, in keeping with the French skepticism over free trade, has even gone so far as to suggest that French firms should return to France from Eastern Europe. Apart from that, many leaders face demands to fire legal and illegal workers first, and to hire them last. So, the protectionism and anti-foreigner discrimination is showing incipient signs of breaking out, in trade, in foreign investment, in immigration, and labor markets. Only determined leadership will hold the line; and only time will tell whether it will be forthcoming in the way it should.

Morality in the Financial Sector

One final word is necessary. Many populists have concluded that the current crisis shows that markets are incompatible with morality. This is, of course, an old debate, ever since Adam Smith's time. Let me make just two observations.

First, markets affect our morality less than morality affects how we behave when we work in these markets. Our morality comes from our family, school, church, and even from literature, such as the great Russian novels which explore the ethical dilemmas of its characters. In turn, this affects how we conduct ourselves in the marketplace. Thus, we observe different types of capitalism: the Scandinavian version reflects egalitarianism, for example. In the same industry, again, we find some practicing corporate social responsibility, whereas others do not. It is therefore nothing short of vulgar quasi-Marxism to claim that where and how we work affects our morals.

Second, the corruption that we have seen in the financial sector should to be put down not to greed (which suggests compulsive pursuit of self-interest to the exclusion of other virtues and vices) but often to the mere fact that the financial sector offers such enormous returns to skullduggery that, given the same propensity to cheat, the actual cheating is far greater than it would be without such returns. The greater the temptation, the greater the likelihood that you will succumb to it. So, you observe that, in agriculture, the display of "greed" is less than in the manufacturing sector, and it is the worst in the financial sector.

▸▸ MORE INFO

Books:

Bhagwati, Jagdish. *In Defense of Globalization*. Revised paperback ed. New York: Oxford University Press, 2008.

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