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Dear Friends:

Included below 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 nearly 100,000 copies in English and is in 12 translations: 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 Times column & so has Gillian Tett in the FT), in my October 2008 op ed in the FT. 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 piece and especially the quote from Keynes which a bibliophile friend of mine, Anant Chandavarkar, directed me to.

All the best,

Jagdish



## **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.

## **Other Writings on the Financial Crisis**

4. Bhagwati, Jagdish. "Culture, Economics and the Financial Crisis," *Kulturaustausch*, December 2008.
5. 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*

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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[7]

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



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*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.<sup>1</sup>

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



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<sup>1</sup>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.



## *The Capital Myth*

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.<sup>1</sup> This was not all. The fear of ruin—caused 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.<sup>2</sup>

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 harakiri 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?

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 Barbara Streisand and Steven Spielberg President Clinton's "cronies," 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.<sup>4</sup> 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.<sup>5</sup> 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."<sup>6</sup> 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 approval 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.<sup>9</sup>

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.<sup>8</sup>

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.<sup>7</sup>

It was impossible to puncture the balloon because few with dissenting opinions could penetrate what I have called the Wall Street-treasury complex.<sup>10</sup> 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.”<sup>11</sup> 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."<sup>12</sup> But "Treasury" in my phrasing stood for Washington; adding just the IMF therefore unwittingly narrows, not widens, the meaning. Barry Eichen-green, 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!<sup>13</sup>

In a lighter vein, remember that Dwight Eisenhower, who surprisingly launched the radical phrase "military-industrial complex," was the president of Columbia University.<sup>14</sup> 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.<sup>15</sup> 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.<sup>16</sup>

### Where Do We Stand?

By now, the IMF has abandoned its excessive pre-crisis enthusiasm for free capital mobility.<sup>17</sup> 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 unwavering 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. Untidily as it may be, economic liberals should acknowledge that capital controls—of a certain restricted sort, and in certain cases—have a role.<sup>18</sup>*





## We need to guard against destructive creation

By Jagdish Bhagwati

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It seems clear that the current 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 allowed AIG 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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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 this 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 non-



financial 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

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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 skulduggery 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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