Global Imbalances, Power Shifts and the Future of Multilateralism

Event Transcript

April 12, 2007

With Joseph Stiglitz, Josè Antonio Ocampo and Mark Weisbrot

Mr. ANDREWS: Good morning. My name is Ed Andrews. I am an economics correspondent with the *New York Times* here in Washington. It has been my pleasure for the last several years to report on both international economics and domestic monetary policy. Before that, I spent six years in Europe as the European economics correspondent for the *Times*, which happened to coincide with, sort of, the run up and completion of the launch of the Euro as the single currency for most of Europe. So I am very excited to be participating in this roundtable this morning. I expect we will have quite a very lively discussion about global imbalances.

Just to start this off before introducing our guests, I thought I'd make a couple of comments. When I was in Germany in 1999, just before the European Union was about to complete its final agreements on setting up the Euro, I had a lengthy interview with a very senior member of the German Bundesbank. And at that time, there was a lot of concern -- there was some concern that the European currencies were, sort of, perennially undervalued and that the Deutschmark couldn't, sort of, regain its footing against the dollar. The dollar seemed to be unrelentingly strong. I raised that question with the banker because it obviously had big implications for the strength and competence of the Euro, and establishing credibility for the Euro was going to be their first and top priority, obviously. And he had a lot of answers about why he was confident about the D-mark and the Euro. But then he leaned over to me and sort of confidentially looked at me and said, "You know, there is something else going on here that will change all of this." And I said, "What?" And he goes, "Well, just between you and me, you know, the U.S. current account deficit, it's just soaring, and that is really going to take a toll." At that time, of course, the U.S. current account deficit was somewhere in the neighborhood of, I think it was less than $400 billion a year and somewhere around 3% of GDP perhaps, and today it is, in 2006 it was $856 billion and 6.5% of GDP. It might be edging back a little bit now, but it's huge. So the imbalances that seemed to be startling to the German Central bankers back then obviously have continued to widen and grow remarkably since then. And, yet, there hasn't, to date, been the kind of payback that, at least lay people like myself, might have expected. Despite all the run up in U.S. indebtedness, the U.S. economy keeps chugging along pretty well.

And, in fact, what we've seen in the last couple of years has been even more remarkable. We've seen a reverse capital flow, money from poor countries to developed countries, particularly the United States. In other words, many of the seemingly poor countries have become big net lenders to the United States, and this had something, we don't know how much of it, it clearly has something to do with the situation we have now where our long term interest rates remain very low, our yield curve is flat, or negative, and despite the fact that the Federal Reserve has raised short- term interest rates dramatically since 2004, our long-term rates are almost as low as they were back then. And that has to do with the fact that we've got all this money that keeps flowing in from the rest of the world.

So, clearly, we've got these huge global imbalances. People have been worrying about it, fretting about it, theorizing about it for years now, and there is a lot we don't understand. It does seem clear that the global economy is changing in big ways and that this is partly driven by China and Asia, but probably many, many more things beyond that. As Mark Weisbrot is likely to talk about, maybe you know this as well, we'll see a lot of ripple effects of the changes in the global economy, the impact of these imbalances that are maybe not so obvious at first glance. One of them that Mark has been talking about for a while is the possible growing irrelevance of the IMF and other multilateral institutions and by extension, to some extent, the so-called Washington Consensus on what developing countries ought to be doing.

The fact is, there are fewer and fewer countries that seem to be looking for money from these institutions. So they don't have the policy influence and clout that they once did. Many countries are just, sort of, turning away from the IMF, either because they have lots of money, they have actually got lots of savings that they are building up, or because they can get the money from other places, Venezuela, Asian countries, OPEC countries. Who knows?

So there is a lot going on here. I look forward to the comments that all of our members are going to make. I'm tempted to subtitle this talk as: "Global Imbalances Threat or Menace?", but I think they are part of our life. Let's see if we can make some progress here.

Let me introduce our speakers. Mark Weisbrot is co-director of the Center for Economic and Policy Research here in Washington. He has a Ph.D. in Economics from the University of Michigan and is co-author with Dean Baker, his long-time associate at the Center, of the book, *Social Security, the Phony Crisis*. Mark has been a long time commentator and analyst about global finance, global international trade issues, has studied closely the trends, trials and tribulations of crises in Latin America and the role of the IMF, the World Bank, and the United States in either alleviating or contributing to those problems.

Joseph Stiglitz really needs no introduction at all. Professor at Columbia University in New York and chairman of Columbia's Committee on Global Thought, he won the Nobel Prize in Economics in 2001 for his analyses of markets with asymmetric information. He is well remembered as the Chairman of the Council of Economic Advisors under President Clinton, and then as Senior Vice President of the World Bank from '97 to 2000. He is a prolific author. I'm sure almost everybody in this room is familiar with *Globalization and Its Discontents*, a book that I'm reading here that's been translated into 35 languages. That's pretty good. You may actually be making some money on this book. I think your most recent book is, *Making Globalization Work*. To be bought at the back of the room. You'll get a good price.

José Antonio Ocampo is the former Executive Secretary of the U.N. Economic Commission for Latin America, a former finance minister from Colombia. He is now, am I correct, this is now, correct?

MR. OCAMPO: Yes.

MR. ANDREWS: You are now the head of the U.N. Department on Economic and Social Affairs, which is responsible for the follow-up to the major U.N. summits and conferences. He has also been a prolific academic and author. He is well known as almost all of the -- or many of the major universities, both here and in Europe, and has received many honors over his long career.

So, with that, shall we get started?

MR. STIGLITZ: It's a real pleasure to be here. Let me just begin by trying to put a little bit of perspective on how I want to approach these issues, and that is to see issues of global finance, global financial architecture as a means to an end, not an end in itself. We sometimes forget this confusion between ends and means. I've been very critical of the Washington Consensus as often confusing ends and means.

Two examples of that are discussed in two of the books that the Initiative for Policy Dialogue has put out recently, one that was co-authored between José Antonio Ocampo and myself, is called, *Stability With Growth*. And it argues that the kinds of stabilization policies that the IMF has pursued focusing on price stability have actually not resulted in real stability, and we ought to be focusing on real stability, but, in fact, have not only not accomplished real stability, have actually, in doing that, compromised long-term economic growth. And those are the things we ought to be focusing on, real stability and real growth.

The other one is a book called, *Fair Trade for All*. I'm going to be focusing on financial issues, but because trade is such a big issue, and during the question period we can try to talk about that, what it tries to argue is the so-called development round of trade negotiations doesn't deserve that name. It was an attempt to put old wine in new bottles, and it's totally different from what, if you would put development economists from around the world and said, "What would be a trade regime that would promote economic development?" it would be totally different from what has been on the agenda and what is likely to emerge, if anything emerges, from the current set of negotiations. So, again, it is not trade globalization as an end in itself, but trade globalization as an instrument for long-term economic growth, and that the current proposals do not accomplish that.

We are celebrating this year, if I can use that word, the tenth anniversary of the East Asian crisis. It is hard now to remember what things were like ten years ago. The crisis began on July 2nd, 1997 with the Thai Baht collapsing through the floor, and it then spread in October to Indonesia, and then in December to Korea, and embraced most of the countries. And when markets are declining, exchange rates are declining, economies are going into recession, you don't know where the bottom is. And it is exactly that that causes problems. You know that there is eventually going to be a bottom, but you don't know how far you are going to drop before you reach that, and that is a major source of anxiety.

The East Asian crisis eventually spread and became the global financial crisis of 1998, and in the summer and fall of 1998, concerns got so great that the Fed, which almost never responds to global financial, it always focuses on things domestically, inflation and growth in the United States, actually cut the interest rates in an attempt to, it thought, avert a global financial crisis.

So one has to, you know, as we think about what happened then, where we are today, one has to try to put oneself back in the mood of ten years ago and realize the state of anxiety that prevailed then, I think deservedly so, because it wasn't clear how bad things would get. And for the people in many of the countries, they did get very bad. Estimates are that on the island of Java, for instance, eventually unemployment rates got up to 40 percent. In these countries, these events were as big as the Great Depression which has left such a telling effect in the United States and the U.K. As we look back on that, it is also useful to remember both the kinds of policies that were put forward, the models that underlie those policies, and several of the very strongly held views that were described as consensus views, consensus mainly between the U.S. Treasury and the IMF, and consensus that is easy to achieve when you are the boss of one institution. So that is to say, the U.S. Treasury was giving orders to the IMF. So the consensus maybe is a little bit artificial.

Among the views that were put forward then, for instance, were the two pole views of exchange rates: either you ought to have perfectly flexible exchange rates or you should have perfectly rigid exchange rates. For those of you who are young enough not to have gone through that discussion, you say, "That's absurd." And what was interesting was that almost at the same time of this, the Ford Foundation convened an Eminent Persons Group which came to the consensus among a group of eminent economists, mainly from the developing countries, but people with long experiences, that the correct problem was neither of these two poles but something in the center. The IMF abandoned one of those two poles after the Argentine crisis.

The second proposition that was very widely held at the time was that capital market liberalization was unambiguously a good thing. In fact, at the meeting ten years ago, not now, but ten years ago in September, the annual meeting, they tried to change their charter to force countries to liberalize their capital markets. I had just come to the World Bank. Perhaps I had too recent experience of being in academia. So I asked a question, "Where is the evidence that this is good for economic growth?" And, as it was a little bit naive, the response was, "We don't need evidence. We know the truth. And how do we know it? Because everybody we talk to says the same thing." And of course if you only talk to people who agree with you, you will get a consensus among that small group.

So there wasn't any evidence. It was really remarkable. They tried to change the charter, the architecture of the global economy without any evidence that it was good for growth of the developing countries. The World Bank had actually, by that point, already amassed plenty of evidence that it was bad for stability. Capital comes in, capital comes out. And we were about to amass more evidence on capital market liberalization because the East Asia crisis, I think now most people realize, at least one of the most important contributing factors were these massive flows of speculative capital coming in and out of countries.

Well, the third pillar, the strategies of the IMF at the time were very much: raise interest rates, cut back expenditures, raise taxes, in other words, contractionary fiscal monetary policies in response to an economic downturn, just the opposite of what is taught in virtually every course -- undergraduate and graduate course -- around the world. And again, I mean, it was quite startling, and I was startled, coming from academia, that these countries were being told to do the opposite of what, as I say, everybody is taught in graduate school and undergraduate.

Well, as I've said many times, the good news was that we didn't have to revise our textbooks. The standard wisdom turned out to be right. These countries, contractionary monetary fiscal policies did have the predicted effects of depressing their economies. The downturns turned into recessions and depressions. There was an attempt by the U.S. Treasury to suppress, to even suppress the use of what they called the "D" and "R" words. They said, you know, it would be depressing if we mention "Depressions." So they told us not to use those words. GNP going down 12 or 15 percent, we'll call it a “market correction.”

(Laughter)

MR. STIGLITZ: There are some major changes that have happened since then, but in the midst of that crisis there was a call for a change in global governance and a change in the global financial architecture, and neither of these have happened. And I think the wisdom at the time was if they didn't happen in the moment of crisis, they would not happen after the crisis. And I think that was right.

But, in fact, those who were controlling the processes didn't want them to happen. So what they did is, they put together a number of palliatives to, sort of, give the impression of something happening, but nothing really happening, no real fundamental changes.

One of the positive things that did happen was that the IMF eventually began to do research on the question of what were the effects of capital market liberalization -- a little late -- but better late than never. And finally, in 2003 they came out with a report, the chief economist and a number of his colleagues came out with a report, and it came to the only conclusion that it could have, which was that capital market liberalization does not have positive effects on growth and has negative effects on stability, at least in many countries. In other words, it didn't have the effects that they had asserted.

They were surprised, and this in itself tells a great deal about the mindset, they were surprised because they said it was inconsistent with economic theory. What that is useful for is reminding us [that] all of us have theories in our mind, all of us walk around with a theoretical structure, otherwise, we couldn't understand anything. Keynes put it very forcibly. We said a lot of what we think of, you know, practical men, are theories of 50 years ago that eventually come and got embedded in our mind. Unfortunately, sometimes the theories that are embedded in our minds are theories that have since then been discarded.

So when they said it was against economic theory, what theory did they have in mind? They had a theory based on people who live infinitely long, in a world of perfect information and perfect capital markets. Now, I don't know about you, but I live in worlds where people live a finite length of time, and as I get older, one realizes that more and more, and that people live in a world with imperfect information and imperfect risk markets. So that the underlying assumptions were just fundamentally wrong, and if you have a wrong model, if you go through life saying, "this is the world," then you're going to have problems, and that is essentially what happened. A theoretical analysis showing that dropping these assumptions, any one of them, even perfect information, but finitely lived individuals, capital market liberalization could lead to more instability. Imperfect information can lead to more instability.

In fact, the interesting thing is, had they come to the result that it was stabilizing, they would have had even a greater challenge because we know that many times capital flows are pro-cyclical. So how in the world can it be that capital market liberalization leads to stabilization when capital flows are pro-cyclical?

I just want to emphasize this, because it does illustrate some of the problems that we have. There are some very strong ideologies. They are almost religions, they are not challenged by the facts. When the facts come, they say -- you know, in 2006, they came out with another paper saying, "Well, we know capital market liberalization has to be good for growth. We just haven't seen it in the data. And it comes through these other processes, like good governance and things like that, but we still haven't been able to detect it."

So what is remarkable is that it has all the indicia of what we would call, you know, a religion and ideology that when evidence comes to you that says something is wrong, rather than saying, "Let's revise our understanding of the world," it says, "Let's make sure we can get the world to conform to our beliefs."

So the second thing that I think is a major change that has happened is that the IMF has realized that its legitimacy is in question. That becomes particularly important because one of the main agenda that they talk about now is governance. You thought that they were supposed to be concerned with financial markets. But one of the reasons that they say that growth, that capital market liberalization is basically good for growth and stability is because capital market liberalization now they say is important because it leads to good governance. Good governance is the mantra of the day, and everything has to be linked to good governance. And good governance leads to higher growth and stability.

But then the response from many countries is, "Well, if good governance is so important, why don't you have good governance?" And that is a question that has been increasingly asked of its sister institution, the World Bank, where issues of -- you know, it has put corruption at the center of the agenda. Everybody is against corruption. That's not the issue. The question is, "Is there corruption in the corruption agenda? Is there due process?" As democracies, we think due process is important. And, "Is there due process of bringing charges of corruption?" And, most importantly, "Is there a comprehensive effective anti-corruption agenda?" It's not just a speech, it's not just -- it depends on things like good procurement processes, and the World Bank actually has very good procurement processes, competitive procurement practices that the Defense Department, in the last six years, have often short circuited with disastrous results.

So the issue of global governance becomes one of legitimacy, political legitimacy, and the institution becomes important as it, itself, focuses on the issues of governance. And the issues there have to do with how the heads of these institutions are chosen, the distribution of voting rights, voice, representation, and so forth.

The good side is, it has recognized that problem, it has changed the voting rights a little bit, but not in ways that have a fundamental effect on outcomes. Africa, which is the main source of one of the main areas of lending, a major area in which there is poverty, has under four percent of the votes. And that means that in trying to reach a coalition about what good policies are, it is just not worth paying any attention to Africa. Some people would say, "Well, the lenders are providing the money. Shouldn't their voice be larger?" But, actually, one of the interesting things under the reforms that occurred in the eighties, the real support of the IMF comes not from the lenders but from the borrowers. The lenders are getting a return on their money. The borrowers are financing the institution through a spread on the money that they borrow. And right now, one of the problems is that people don't want to borrow from the IMF. Usually banks try to be friendly to their customers, and the history here has not been stellar in customer relations. So it's not as surprising that one country accounts now for over half of the outstanding loans of the IMF, and therefore, effectively, supports the IMF. I tease my friends from that country about, "Did you really make the decision that you want to provide the support for this institution?"

One of the real problems, a broader problem of global governance, is how the international community makes decisions. There are a variety of institutions, formal and informal, and I think some of the informal institutions do play a very important role, and one of them is the G8. And what should be increasingly clear is that the G8 did not provide an appropriate forum for addressing global issues like global financial issues. The G8, for instance, this year has been talking about global imbalances. But one of the themes is that one of the problems is China. But China is not a member of the G8. So they are saying that China is so important, that it is a major factor in global imbalances, but you can only come to lunch. You can't be a real member of the club. That, obviously, is one of the things that needs to get reformed.

We convened the Initiative for Policy Dialogue -- in conjunction with some German Foundations -- convened a meeting of what we call the Shadow G8, a group of people from a large number of countries not limited to eight. We had China, India, we had a large number of countries who called it the GM, and I think our table at the back is a summary of our conclusions. We try to talk about what the G8 should talk about, a little bit what they should conclude after they talked about these issues. And one of the points of consensus was that G8 should be changed to the GM. And I think, when we think about global imbalances, that is one of the things that ought to be clearly on the agenda.

I want to very quickly talk now about the substance of the global imbalance, which you described as being very large. And the question is, "Should they be of concern?" There is one view is, "No." You have markets, market equilibrium, demand and supply in any configuration. Some countries are borrowing from others. Economic theory doesn't say what is a reasonable amount of borrowing.

So this is just the equilibrium that we are in today. So why worry? It is a market equilibrium. Well, I think there are reasons to worry, and the most obvious reason that one suspects something is peculiar about this is -- there are actually several. One of them is, this is a very strange -- it is not what you would expect from a reasonable, well-behaved economy. For instance, the United States, looking at it from America's perspective, is borrowing abroad $850 billion. Well, America is going through a process of aging baby- boomers. I'm in the baby boomer generation, and eventually we will retire. And what that means is that this is part of the demographic pattern where we should be saving, not borrowing. And then later on, we should go on and dis-save. So we are just doing the opposite. We are in the process of dis-saving when we should be saving. Very strange and not consistent with, certainly, infinitely lived utility maximization.

Anyway, the second problem has to do with the developing countries. You should think that money should be flowing from rich countries to poor countries, and that flow of money should support the growth of poor countries where there is capital scarcity. A rich country is supposed to be capital abundance, and that's the direction, you know, just like water should flow downhill. If you saw water flowing uphill, you'd say, "Something is wrong." Antigravity. Anyway, the same thing with money now, in the world. Something is peculiar. Money is flowing from poor countries to rich countries.

What all of this leads up to is that things will grow eventually from being wrong to more right, and that is, that there will be a disorderly unwinding of the imbalances. Disorderly unwinding means large changes in asset prices, maybe a crisis, and that will have global implications for the real economy, which is what we are really interested in.

So that is the source of concern, and I think it is a legitimate source of concern. So the question is, what is the source of the problem? Now, when the finance ministers get together this week, they will almost surely repeat the standard mantra. The standard mantra, if you get together a meeting, you say, "We are all to blame. We all have to work harder," and the general shared blame is Europe should grow faster, as if Europe is deliberately not growing as fast as it could.

The second one is that China should re-value its exchange rate up, not down, and usually float, going back to the pre-market hypothesis. And the third is that the U.S. should do something about its deficits.

Now, there may be a grain of truth in all three of these, but I think one has to look at this from a perspective of proportionate blame. And I can't go through all of it in the limited time, but let me just hint at what I mean by that. China's deficit -- surplus, I'm sorry -- China's multilateral surplus is $150 billion, roughly. It's not clear whether that is an accurate number. Many people believe that the true number is substantially less than that because of over-invoicing of exports and under-invoicing of imports. In a world of capital controls there are strong reasons for engaging in this. But think for a moment, what would happen if China succeeded in getting rid of its surplus and brought it down to zero and, in doing that, dollar for dollar was translated into a reduction of the U.S. multilateral trade deficit. The U.S. trade deficit would go from $850 billion to $700 billion, a huge number, more than $2 billion a day. So the basic point is that correcting China's problem doesn't solve the global imbalance problem. Only one thing will, and that's the United States.

MR. ANDREWS: Can I interrupt you right there? This looks like a really good point to jump off to José, who has been wrestling with exactly these kinds of issues that you are beginning to raise right here. Why are we concerned, what's the worry here? And your arguments are going to get at that there is no simple solution to this, but you've raised concerns about both a system that is, sort of, based on one reserve currency, like the U.S. dollar, as well as concerns about a system based on many currencies.

Do you want to jump in and pick up from here?

MR. STIGLITZ: Can I just say maybe two sentences that will -- or maybe three sentences. The first is that in fact if you think about what would happen if China revalued its exchange rate, it actually would risk increasing and if that were the only thing that were done, it would actually risk exacerbating global instability. And that's why other things of the kind that both José Antonio and I agree have to be done. The reason is very simple. Assume that China revalued. Does that mean that the United States is going to start producing apparel or textiles that it was importing from China? No. It would mean it will import it from Bangladesh and Cambodia, that the U.S. trade deficit would probably not change in any significant degree, but there is a law of conservation, and what was a surplus with China will show up in other places and, in particular, those other places will be less willing than China has been to finance the huge U.S. deficits. The difficulties of financing the deficit will contribute then to part of the unraveling of the instability -- the instability of the global system.

The second point I want to make is that we have to look more deeply at what are endogenous versus what are exogenous variables, what are the drivers in the whole system. And in my mind, the most important driver of the system right now is the global reserve system. The global reserve system, where people are demanding dollars or have been as a result of running a buffer against the huge instability of the global financial markets and not wanting the IMF to come in to rescue them, because they saw what happens when the IMF came in to rescue them. So they've accumulated these, literally, trillions of dollars of reserves. That is one of the forces that are contributing to these global imbalances, and if that analysis is correct, the solution requires coming up with an alternative global reserve system. The current global reserve system is not only unstable, deflationary, but also inequitable because it involves developing countries lending to the U.S. at low interest rates and borrowing from the U.S. at high interest rates, an effective form of foreign aid that is greater than all of the foreign aid that the United States gives.

Then, in my book, *Making Globalization Work*, I describe an alternative global reserve system that is, I would argue, both more stable, more growth oriented, and more equitable.

MR. ANDREWS: That sounds like a perfect segue.

MR. OCAMPO: Thank you. I actually will follow exactly, you know, along those lines. The first point that I want to make was a point that Professor Robert Triffin, then at Yale University, made around 1960 actually, and he said a global reserve system based on a national currency is inherently unstable. You can say that the previous international system, which was a gold standard, had other features that make it also unstable for different reasons, at least for developing countries, which is a point that he also made. But in the system, he said, the problem with a system based on a national currency, is that the only way to provide liquidity to the world is by running deficits. But then that weakens the confidence in that currency. So it is bound to have cycles of confidence and loss of confidence in that specific currency. And that is the history of the international reserve system of the recent decades. We are experiencing the third cycle of that sort now. So that's the point.

You know, you could say now maybe we are moving toward multiple reserves, now that the Euro is rising as a reserve currency. The Yen did not quite make it, but maybe Asia, for instance, through it's Chang Mai Initiative, could actually evolve into a multilaterally backed Asian reserve currency. I'm saying I'm not totally sure that system would be more stable, because actually shifts among currencies may generate another instability. As the discussions about maybe Central Banks from Asia and the Arab world shifting from buying U.S. bonds to buying Euro bonds has made clear that that could be an additional source of instability. So actually a system of multiple currencies would have to evolve into a new Bretton Woods. I mean, that would be my bet because, otherwise, it would be very unstable.

The second issue is that this is really being compounded by the rapid growth of unregulated financial activities. I was struck actually in a recent debate that we had celebrating the 60th anniversary of the United Nations Statistical Commission by a person from the private sector from one of the major investment banks of New York who actually said, "Well, I must say that one of the major points that we have today is that we don't have good measurement of the new financial activities. Nobody knows what is the amount of risk involved in this world."

I must say we have seen recently two episodes of more risky financial markets. We saw one last year and we saw one in late February, early March in the world. I would say, to be sincere, they both have gone through just a period of turbulence and then the markets have reacted positively. But we do not know when there is, for instance, a major correction of the U.S. dollar due to this global imbalance, how many derivative positions will be involved in generating great losses even for major financial institutions. So there is a big question mark about how this system is made even more risky due to this fact and to the reluctance, I must say, despite even the call by major regulators to move in the direction of some form of regulation for these financial innovations.

The third point is a point that Joe already made also, which is the point that the global reserve system is also inequitable. It is inequitable because not all countries are forced to accumulate international reserves. It is only developing countries that, due to the inherent weaknesses, the fact that they cannot issue an international currency, those countries are forced to accumulate international reserves. So it has generated at the end, due to the fact that I will mention a bit later, it has generated a system in which there is a transfer of resources from developing countries to industrial countries, particularly to the U.S., you know, water flowing uphill in the international system.

But it is also inequitable because due to this feature, this feature that we have seen recently, we can call it self-insurance of developing countries to financial risk, the financial risk that they already experienced in the late 1990's and previously in the 1980's -- you go back in history, the 1930's, back in history you have several other crises in which developing countries were forced to make major adjustments because of the fact that they face strictly pro-cyclical capital flows. Capital flows move pro-cyclically, move in periods of abundance towards countries and then fly during periods of crisis.

So the basic claim for capital market liberalization is actually the financial markets are stabilized. People are willing to diversify their risk, and that will lead to stabilization in various counter-cyclical capital flows.

As we know, the developing world generally experiences pro-cyclical capital flows. I mean, we are flooded now with capital, but ten years ago we had a major run of capital, and then you can go back in history, prior to that we had boom capital. I mean, the current conditions are not very different from those in early 1977 when I was in the Colombian government. It is a very similar situation in terms of the capital markets. But then we have had the experience of the 1980's. So this is an inherent feature of the way of capital markets.

I must say it is not only true for developing countries, it is also true for all risky borrowers, like what we have seen in the mortgage markets in the U.S. It's exactly that. It's a pro-cyclical performance of certain mortgage lending to poor citizens. It is true of lending to small and medium sized enterprises worldwide, because they are seen as risky borrowers. So any risky borrower has the future that markets behave in a pro-cyclical fashion. So they destabilize. They don't stabilize. That's another inherent inequity in the system.

This leads to a series of responses. You say, well, is this an illogical way? What do developing countries do in the face of this performance of the global financial markets and the characteristics of the global financial markets? Well, this is what some of us have been calling for a long time self-insurance. In a world where you don't have a real insurer, the only way is to insure yourself. You know, you can think of a global insurer, the IMF should play that role if it worked properly. You could think of regional insurances. For instance, in the Andean region, we have the Andean or now Latin American Reserve Fund, which provides a little bit of self-insurance. But the Chiang Mai Initiative in East Asia is another way to create some regional self-insurance.

But so far, in the system that we have, we only have national self-insurance. And the way, you don't want to run risks, you have to accumulate huge amounts of international reserves. OK. That is what we have seen after the Asian crisis. That was, in a sense, a rational response to what happened in the Asian crisis on behalf of developing countries. Now I must say that that is also rational from many other perspectives. Let me say, for instance, when you are experiencing a terms of trade boom, all commodity exporting countries now are experiencing a terms of trade boom, it is rational to save the money rather than to spend it now, because you know that the prices are going to be down sometime.

If your source of capital, your source of pressure on your exchange rate market are capital in-flows, because they behave in a pro-cyclical fashion, it is actually also a logical response to accumulate international reserves to back the eventual flight of capital. Although, I would say it is even more rational to control capital, of course, under those circumstances rather than accumulate international reserves.

In cases when you are actually in a structurally strong trade surplus, such as China, it may actually be better, more rational to accumulate international reserves rather than appreciate your currency, which is what China is being asked to do. Why is that? I would say essentially because we know from experience in the world, which was the Japanese experience, of a strong appreciation when they had huge structural current account surpluses. And they say the Plaza Accord of the 1980's actually forced Japan into deflation. I think the worse thing that can happen for the world economy today is to force China into deflation. I think it would be spectacularly bad for developing countries, because actually China is [the] second engine of the world economy now. So that it would be a wrong procedure. That is why in a sense reserve accumulation has become the only logical response by many developing countries for different circumstances, either because they have capital account booms, because they have trade, commodity price booms, or because they have a structural trade surplus. It is actually rational to accumulate national reserves in a system that does not provide you with anything but pro-cyclical capital flows.

This would be my fourth point. One bigger problem is when you accumulate, at the same time, reserves in many developing countries, because it is rational for each country to do so, you generate what we in economics call the fallacy of composition. If everybody does that, then you have a major problem, which is part of the global imbalances because you need to have someone who is running a deficit, because otherwise you cannot accommodate those responses. So the global reserve system, curiously enough, is forcing developing countries to accumulate a national reserve and, in a sense, it is forcing the U.S. to have a deficit in order to accommodate that situation of the rest of the world.

This is the equilibrium that we have and, in a sense, it reflects really major structural problems in the design of the global reserve system.

So what are the responses? I would say there is probably no single answer, but I will suggest three points.

The first one is a point that actually Lord Keynes made in the design of the Bretton Woods system, and then the French and the developing countries made again in the 1960's, is that at the end of the day you need a global currency. And Joe, in his most recent book, has made the case again for that. You need a global reserve currency. I mean, you have to develop a system based on the political global reserve currency which would be, of course, a different system from the gold standard, but the gold standard had the advantage that you had a truly global reserve currency that we don't have today. Now I don't see any immediate hope for that, I must say. The power balance in the world, it will not be to that solution unless –

MR. STIGLITZ: Even though there is agreement on this table?

(Laughter)

MR. OCAMPO: The second point is that you need a better mechanism to coordinate or to have dialogue among the major players. We had that discussion, actually, in the Shadow G8. My position is, it's better to do it through a multilateral organization. So I really prefer a reformed IMF to a G10, 20, 25, whatever G, or a G4. Some people have suggested a G4, just, you know, the U.S., European Union, Japan and China. So you can think of any G. The G's, I guess, viewed from the point of view of the organization for which I work, is inherently an illegitimate organization. Any G is illegitimate. It is legitimate in terms of expressing points of view of a limited number of countries. But at the end of the day, it's legitimacy is derived from trying to play into a broader, multilateral framework in which all are represented because it's a system that inherently eliminates -- now, you know, the IMF, Joe said, only five percent is a vote of the Africans, but in this system they have no vote. So in a G, or one country which may represent or not represent Africa, or two Latin America, which may represent Latin American or may not represent Latin America. So since I am from a middle-sized country, I would say I don't like the system. I prefer a system in which the medium-sized and the small countries have the possibility to have some voice. So that's why a multilateral framework, I think, is better. So a reformed IMF is better to the G8, G10, G20, or the new Plaza Accord.

Again, I think there is some beginning, I mean, there is a lot of discussion about this multilateral surveillance that was approved by the IMF last year and how it has worked. We'll see some analysis of that during the meetings that follow.

And the third point that I would make is that rebalancing should focus more, in the judgment of economists, on quantities rather than prices. What do I mean by that? I think the real issue is not exchange rate adjustments. It is really to try to see how the imbalance between savings and investments of different countries are solved. For that reason, let me say again, that the Chinese position on its own imbalances is actually more rational than is usually for trade in the U.S. price. Because I really think that it makes sense for China -- I mean, the position of China is we are going to inflate, we are going to consume more. I think that is likely to generate a much faster correction of the Chinese trade surplus than forcing it to revalue which runs the risk of a price inflation. So I really think that the Chinese have a clearer idea about what to do with their economy than is portrayed in the debates in the United States.

Now, I will say I will finish with this. One of the big question marks is that we don't know what is the real effect of exchange rate adjustments in integrated production systems. I mean, when we consume something in the United States of America, that good has inputs from I don't know how many countries. The U.S. multinationals are moving elsewhere to produce those goods or to contract those goods. The Europeans and the Asians, everyone is moving into the U.S. to do exactly the same. So what is an integrated production system, the effects on trade of exchange rate adjustments? Who at the end -- for instance, suppose China appreciates. China becomes less competitive. Is that going to move production to the U.S.? I would say we don't know. Maybe it will move to Vietnam, to Bangladesh. So it is unclear what is the effect, and it is probably not going to be on one country. It is going to be a set of countries, depending on the specialization that they have in tasks within product exchange.

So one thing that we don't understand, we continue thinking of exchange rate in a world in which goods are totally produced by countries. But in a world in which most trade is actually in intermediate goods, it is unclear what are the effects of exchange rate adjustments. Thank you.

MR. ANDREWS: I'm just going to toss in a question, I don't want it answered right now, but one question that occurs to me as I listen to both of you so far, and maybe, Mark, you want to chime in on this, is at a very basic level there has been a lot of talk about the reserve system and the global trading system is unstable, that there is too much instability. But instability is not necessarily a bad thing. We hope that markets do a lot of self correction. I guess there is sort of a rhetorical distinction: at some point, what becomes a healthy self correction is an unhealthy dose of instability. I just would like people to maybe reflect on that because instability is not necessarily bad. It may mean that the system is not bad just because it is unstable.

Mark?

MR. WEISBROT: Thanks. I want to thank everybody for coming and for these excellent presentations so far. I won't cover any of the same ground, and we will probably still have to go over a little bit.

We have done papers on a number of these topics. We did a paper, that CEPR has -- it's all at cepr.net -- we did a paper that was actually called, "When Rivers Flow Upstream," about the transfer of the flow of capital from south to north. Another one on the costs to developing countries of holding increased amounts of reserves in recent decades, and another one, looking at the projections for imports in the United States assuming, and I actually do believe, that some adjustment is going to take place in currencies, including the dollar. And one of the implications of that is that the U.S. import market, looking forward over the next decade, will probably shrink, at least measured in non-dollar terms, for countries that want to export to the United States. Anyway, those are just some of the things we looked at.

We also, you know, my co-director, Dean Baker, was the first economist and practically the only one in the United States to do the actual arithmetic of the stock market bubble of the late nineties and show mathematically that it actually had to burst, and the housing bubble as well. We were the first to go after that as well.

We are very interested in these issues, but I think they have been well discussed. So rather than go into those, I want to start at another point as part of this forum, which is also about power shifts and the future of multilateralism. You know, we have been working on these issues for, I have at least, 10 years, and I know people in this town have been working on the reform of the international financial institutions for more than 20 years. All along there has always been a debate, because we all looked around and we saw the same thing on something that Joe described already, a creditors' cartel. That's where the IMF's power came from, and it was not the money that they loaned but actually the fact that if you don't sign an agreement, many times if you are a government, with the IMF, or you don't meet their conditions, you don't get money from the World Bank, regional banks like the Inter-American Development Bank, the G7 governments, and sometimes even the private sector. That was a very enormous power. Nobody up here is naive to think that that was the whole driving force of the Washington Consensus, but it was a very powerful one, and it was by far the most important avenue of influence that the United States and the Washington Consensus, the neo-liberal reforms, whatever you want to call them, had over the last 30 years. In fact, and of course Joe mentioned already that Treasury is on top of this thing.

I remember a few years ago at a meeting here in Washington when, in a moment of candor, the research director of the IMF said he was tired of all these NGO's complaining that the IMF is not accountable. He said, "Because we don't do anything without checking with the Treasury Department."

(Laughter)

MR. WEISBROT: Now this, more than 180 countries are part of this organization which could be described as a G1, if we are talking about G's. And I don't think it has changed very much. So in this debate we had, people said, "You know, we can't really bust up this cartel. Let's just try and reform it." I said, "Fine. We're reformists. We like reform from the bottom up and the top down, any kind you want." But we were a little skeptical, and that skepticism, I think, has turned out to be true. The reforms we have now after 20 years, China is going to get a three-quarters of a percent increase, I think, from something like 2.98 to 3.74 percent, Mexico will get two-tenths of a percent more, South Korea will get a tiny amount. And who is the fourth one, a country that you didn't mention that owns half of the IMF's portfolio, Turkey. And that's it for reform so far after 20 years. So, at this pace, I think somewhere in the 22nd, 23rd century, we will have a somewhat more accountable institution.

So what we said back then was the way change is going to take place is that this cartel is going to lose its power in the world. And that is really what has happened over the last decade. Joe mentioned the first step, and that was the East Asian financial crisis, and Jose Antonio said yes, you know, it was a rational response after the terrible experience that they had with the Fund, all their mistakes on these issues on exchange rates and capital account liberalization, pro-cyclical policies. They decided to pile up reserves. That took a big bunch of middle income countries out of the IMF orbit. The second stage -- of course, there were other countries, too. Russia abandoned the last element of its IMF program in '98 when its exchange rate collapsed, and it's been growing quite rapidly ever since.

The other major change was the IMF's confrontation with Argentina, where for the first time in the world, history, a middle income country stood up to the IMF and won. And I'm going to talk about that with the economy minister from Argentina at 2:30. That's at the New America Foundation on Connecticut. So I won't go into that too much here, but just to say that, again, this question, this dogma that they had where exchange rates had to be fixed or flexible, well, obviously, the fixed exchange rate was one of the main causes of the disaster that befell Argentina between 1998 and 2002 and ended in the collapse of that exchange rate and the world's largest debt default.

But the story does have a happy ending because their central bank and their government decided to question this dogma, and they pursued a policy which is called a stable and competitive real exchange rate which, according to IMF dogma, was not something that could be really done. It was not the fixed or the flexible one that the IMF recommended after the collapse of the fixed exchange rate, and it has worked quite well. Over the last five years, Argentina has grown 47 percent in real GDP, pulled 9 million people -- out of a country of 36 million -- over the poverty line and has been the fastest growing economy in the Western Hemisphere despite the IMF's projections and a lot of nay saying in the business press. So again, we'll talk about that later.

But this, I think, is just one example of what the collapse of this cartel has enabled. I think there is quite a bit more going on. In fact, I would argue that even though it is not talked about much in Washington, I think it is probably because this whole creditors' cartel all these years has kind of been an open secret. I mean everybody knows it. It's been in the New York Times. But it is not something that people have really talked about because of the question of legitimacy. It's bad enough that this institution gives, you know, more votes to the United States with less than 5 percent of the world's population than it does to the majority of the population of the world. But to have a cartel that's even stronger than that and can literally use this to pressure governments to adopt a whole set of policies, it was even worse.

But this is something that everybody should know about, should be talking about, and should be observing the results of it. We have been observing it in Latin America. First, I have to always show this graph here, because this is one of our goals is to get the media to report this more. And they actually have quadrupled the mention of this fact in the last year, thanks to our work. You can see, this is just Latin America's growth in per capita GDP, the most basic measure that economists have of economic progress, 82 percent from 1960 to 1980. Nothing phenomenal. South Korea grew twice as fast during that period and Taiwan almost three times as fast, but still enough to produce rising living standards that reached even the bottom of the societies in that region.

1980 to 2000, the era that is called neo-liberalism in Latin America, or the Washington Consensus, you know, 9 percent growth, quite a drop. Now it has picked up in the last couple of years, but still this is not looking like a great decade. It is 5 percent for 2000 to 2005. Take an estimate for last year, you get another 3 percent per capita for 8 percent. So something has gone terribly wrong, and most of our mission in this area has been to try and get some discussion of this rather than just ignoring it completely and pretending that these things have been successful: these policies, this indiscriminate trade liberalization, the opening up to capital flows, the massive privatizations, the abandonment of development strategies, industrial policies, the things that seemed to have worked in the past and obviously in the countries that were free from IMF influence, but also in the period of the sixties and seventies in Latin America. So we want some discussion of this. I believe that this collapse of this cartel is really going to be, and not so long from now the economic historians are going to say this was a major turning point in the international financial system, that this is in fact as important as the breakdown of the Bretton Woods system in 1973. It happened a little more gradually, but it is extremely powerful.

I gave the example of Argentina, but you know, as a result of this failure there has been now elections in Argentina, Brazil, Bolivia, Venezuela, Ecuador, Uruguay, all these countries where the electorate has basically gone over the heads of their political classes to deal with exactly this, this worst economic failure, long term failure, in over 100 years in Latin America. And because of the collapse of this cartel and because of this change in power relations, and I would argue that this same change in power relations is what's leading to the impasse in the WTO. The developing countries now have a bigger voice than they did when that organization went into effect 12 years ago. And so because of this change in power relations, governments can now do some of the things that they promised.

I was in Bolivia in February of last year, and I met with the government, including the ministers, and one of the first things I asked, "What about the IMF agreement? You guys have been under IMF agreements for 20 years." And you know, their income per person is still less than it was 27 years ago, despite the fact that both the Fund and the Inter-American Development Bank say they are one of the leaders in adopting the reforms that were advocated, including massive privatizations and everything else. And they say, "Well, you know, the IMF, we're not going to renew that agreement. March 30th, that's the end." And I said, "Great. What about your other sources of aid? What about the Europeans? Their aid has always been dependent on an IMF agreement." They said, "Well, it doesn't look like that is true any more."

So that's the change. This is a poor country. This is not Argentina, this is not Brazil or Venezuela with $50 billion in oil reserves. This is the poorest country in South America, a HIPC country which has had its debt cancelled from the IMF and the World Bank and a big chunk recently from the Inter-American Development Bank, and yet they can now make their own policy in a way that they haven't been able to do for quite a long time. What are the results? Well, they've got an extra 6.7 percent of GDP and hydrocarbon revenue. That's big. Imagine $900 billion extra for our U.S. federal government. That would be the proportional same amount here in the United States.

So these governments are pursuing different policies. And another thing that has really made this possible, of course, has been the provision of an alternative source of credit, and that has been Venezuela. They've accumulated $50 billion in reserves, and they have been loaning it to their neighbors without policy conditions attached. Argentina, Bolivia, Ecuador and other countries as well, the Petrocaribe initiative for the Caribbean countries. So this has made a difference.

We are economists, and we are for competition. That's one of the things people forget, that competition, you know, because they often think that it's just a free market versus the state or something, that that is what the debate is about, and somehow the progressive part of the debate is the state. We want competition, too. We want international competition. And one of the things that is going on right now, actually the ministers were meeting in Ecuador on Tuesday, and they will be meeting here in Washington as well, to create a Bank of the South in Latin America. Countries negotiating include Argentina, Brazil, Venezuela, Ecuador, others as well, and they are talking about creating another institution which would have some different purposes. It would provide some of the insurance that is now provided through self-insurance and reserves. And this isn't the only one. The Chiang Mai initiative obviously exists. You guys didn't mention it, but I know that you are quite familiar with it. That's the Asian countries agreement that now has $75 or $80 billion. But one problem there is that only the first 10 percent of those reserves are accessible without an IMF approval. So they are still tied to the Fund.

And the poorer countries in the world are still, in Africa, for example, they are still subject to the same creditors cartel that existed in the middle income countries for the last 20 or 30 years.

So this, I think, is what is going to have to change. This grip is going to have to be broken. The initiative will come from countries, it will come from changes at the national level, it will come from countries using their reserves and providing alternative sources of credit, whether through regional institutions or even individually as Venezuela has done, as China is beginning to do, is providing another source of investment, for example. And I'm afraid that this new, I believe it is some ways off, but the new financial architecture that we are all looking for is going to come more from the ground up, more likely than we'll live to see it come from the top down. And I'm not saying it's impossible, and again I support all efforts at reform coming from the top. But if we look at the people and the institutions, the voting rights, the individuals, the Treasury Department, I don't see the changes coming.

Thank you.

(Applause)

MR. ANDREWS: We have, unfortunately, only a few minutes left. Let's open it up to a couple of questions, and let's try to keep our answers brief because it is just a few minutes before noon already. Yes, sir? And please identify yourself.

QUESTION: I work with the World Bank, and I am very pleased to be here. Thank you very much for all your comments. Not everybody at the World Bank has the same thinking, as you may know. So I very much agree with all your points. I have a question for Professor Stiglitz, and I have one for both Dr. Weisbrot and Ocampo.

On your description of the IMF program to solve the financial crisis, and also reading your books, I think that there is an underlying standard Keynesian theory about demand driven policies to recover from a recession and the like. And when I talk with my modern neoclassical liberal friends, they told me, "Well, you are forgetting the theory of the rational expectations of Bob Lucas. and so agents will anticipate these demand driven policies by the government, and it is not going to work." So I would like to know if you can provide me with another analytical tool to respond to that.

To Mark and Dr. Ocampo, are you afraid, to some extent, that the new policies in Venezuela and Bolivia --which I think are for the most part good for the poor, in terms of the emphasis on, again, industrial policies and development strategies -- on the other hand, might entail some problems from the inflation side, and how do you think they can avoid getting again into a trap of excess inflation as happened in the eighties?

MR. ANDREWS: Joe, before you jump in, it just occurred to me that perhaps a good idea would be let's take about five questions, and then you can answer them all, just run through the answers.

Yes, please?

QUESTION: Hi. I'm Emily Kaiser from Reuters. I wanted to ask what all of you thought of the IMF sort of softening its concerns about global imbalances yesterday. When we heard from them a year ago, they seemed a lot more concerned about global imbalances. Yesterday we heard, "Well, actually, things are starting to go the way we need them to go. The imbalances are getting better.

Things are looking a lot better." Do you think this is just complacency, or how would you describe that and what is your thought on it?

QUESTION: Hi. I'm Sony Kapoor. I used to be an investment banker but now work primarily on international finance and development issues. I just wanted to add a bit more of the private sector perspective. In terms of the problems of the imbalances, there is the supply side of things in terms of the U.S. deficit, but there is also a demand side, part of which is the reserve problem, but that is only part of it. There is the private sector demand side of dollar assets, part of which comes from what Professor Stiglitz mentioned, the massive amounts of mis-invoicing and transfer mispricing, and the about $500 billion of illicit capital flight that is associated with it annually. And to add to that, the massive amounts of pension fund investment and hedge funds, etc. So there is a huge demand for dollar assets.

And in terms of what the mediator said, the costs of instability, whether there is a problem with instability or not, I think the big problem is that instability, especially of the larger scale as happened in Southeast Asia, has asymmetric costs, asymmetric in terms of the impact on developing versus developed countries, but also importantly on the various income groups. And this is highlighted by what happened recently, what was reported by the *Wall Street Journal* and Reuters, which is Moody's recently upgraded the bank ratings of a number of international banks to AAA, saying that there was an implicit government guarantee that some of the banks, for example, in Europe, for example, international banks like Citicorp, etc., were just too big to fail. And I think part of the problem that has come from the unregulated growth of the financial system, of the massive amounts of interlinkages through derivatives, through the international regime, etc., has been partly that. And that was a recognition that moral hazard is still with us and has actually grown massively, and if there is instability, if there is a crisis, the costs shall be borne by the public purse, which is people like you and I who, actually, don't have that much money.

And just to conclude, the point about lack of transparency, I think that is a big problem that has not been talked about enough. Again, part of it is to do with the massive growth of derivatives, part of it is due to the banking secrecy and tax havens, etc., but the biggest problem is when the two combine wherein a subsidiary or an offshore vehicle in some banking jurisdiction has derivatives which are credit risks which are carried by a reinsurance firm which has no idea how to evaluate credit risks. The risk is there, it has built up, and it is being carried by institutions which do not have the competence to carry it. Banks are no longer the major holders of credit risk. And it is banks which were traditionally the ones who were most qualified to handle it.

Just finally, another recent report that appeared, which was to do with regulation -- just one last point -- in Europe there is a current discussion about who is going to regulate European banks. This has been, again, part of the problem where perhaps there is a role for the Fund that the international regulators have not kept up with the massive growth of the international private sector, again, a big potential problem.

Thank you.

MR. ANDREWS: One more question. Yes, please?

QUESTION: I belong to the Latin American Network on Debt and Development. We think it is necessary to create an international financial court as a regulation framework. I would like your ideas about that, Mr. Ocampo and Mr. Stiglitz. Thank you.

MR. ANDREWS: Joe, do you want to start off?

QUESTION: What is the shape of Africa in your thinking in this country and in discussions in development. Because, you know, I am the only African here. I came from (inaudible) a poor (inaudible) country. I asked for the floor, and you give the floor over, and you even don't try to select people who could represent something in your thinking. (Inaudible) asking for the floor.

MR. STIGLITZ: Let me try to go through some of the questions fairly briefly. The first question on the issue of the role of rational expectations and whether it undermines the kinds of analysis that I put forward illustrates, actually, a modeling problem that pervades the IMF and those who have similar kinds of policy perspectives.

If you assume that there are rational expectations and perfect markets, then there is no need for government because there is no such thing as unemployment. Everything works beautifully. But we know that's not true.

Then the question is, what drives the results of those who claim the government policies, for instance, counter-cyclical demand policies, or counter-cyclical monetary policies are ineffective? Is it the rational expectation assumption or is it something else? Well, this is a question, actually, that I asked Peter Neary, who is a professor at Oxford, actually 25 years ago, and we formulated a model with rational expectations but *imperfect* markets, for instance, wage and price rigidities. And what we showed was that government intervention was more effective with rational expectations than it was without, that actually traditional models had *underestimated*, not overestimated, the efficacy of government policies. And the reason was almost obvious, because when government stimulates demand this period, one of the limitations of that stimulation is that some of the money doesn't get re-circulated, but gets saved. But when it gets saved, it is saved to be consumed in future periods. That means in some future period demand is going up. If people today anticipate that future increase in income, that reinforces their increasing consumption today and enhances stimulation today.

So all this stuff about rational expectations undermining traditional Keynesian analysis is hogwash. It's just wrong. If you assume that markets are perfect and there is no unemployment, there is no need to have government intervene to correct the problem of unemployment. That's true. But we happen to see unemployment, at least periodically, in many countries around the world.

The issue of the second question about do I feel that the problems of global imbalances have gotten better in the last year, I think the answer is clearly not. The numbers that you were citing, in 2006, the numbers have gotten larger. I think there is no reason to -- there is a kind of reasoning that some people have engaged in that says, "Look at, you guys were very bearish. You thought that the system is not sustainable and we got through another year. Therefore, you are obviously wrong, and we'll continue on forever." The alternative conclusion is, you got through another year, you were lucky, but those cumulative imbalances, the deficits accumulate, and things are worse now than they were a year earlier.

I happen to be in the second school of thought, and I think we'll see in the next two or three years what will be the outcome. You have to remember one of the important things is that the financial markets really are very much worried about timing. When you are in the financial markets you worry. We have the liberty of saying there will be a problem within the next five years. You know, people like Volker have said that, lots of people have said that. We are not betting our money on whether it's going to happen in the next three months. If we were in the financial markets and making those bets, we wouldn't be academics. And I'm not sure we would do very well. What we are looking at is these long-term structural problems, not the short-term movements and not making a precise work as to when this is going to happen.

The issue that you raised, is instability necessarily a bad thing? What is true is you want adjustment. The world is changing and has to adjust. If you didn't adjust -- well, you can't. You have to adjust. The real question is, do you postpone it and get big adjustments periodically or small adjustments all along.

That's not what is being argued here. The question here is the ability of the market to reduce risk rather than to amplify risk. Can we design institutional structures that lead to more stability and enhance the ability of people within the society to cope with that instability, or do we have institutional structures that amplify instability? Let me give you an example. There are automatic stabilizers like unemployment insurance that when the economy goes down automatically put more money into the system, and that helps stabilize the economy. It also enables individuals who are adversely affected to bear the cost. There are other things that help destabilize the economy. Capital market liberalization is something that helps destabilize the economy. Sharp capital adequacy standards with no forbearance act as automatic destabilizers in the economy.

So the argument here is not whether there is going to be adjustment, but can we find institutional structures, policies that help stabilize the economy and help individuals cope with the instability that is inevitably going to be there. And my concern is that some of the policy recommendations of the past have gone in the wrong direction.

For instance, one of the critiques of the fixed exchange rate system in the case of Argentina -- it kept it rigid. It was stabilizing it for a while, but it was a building up of problems, and eventually the system broke and the cost was very enormous. The system of a managed exchange rate is an attempt to both stabilize, but avoid extremes of the kinds of experience of Argentina.

Let me just make two other remarks. One of them is on the issue of international courts, procedures for dealing with debt and including debt restructuring. I do have a chapter in my book, "Making Globalization Work," that deals with this. I'm very strongly in favor of some mechanisms that do it in a more orderly way. Argentina's restructuring could have been done much better had there been an international court. That international court, I actually talk about some of the principles that might underlie it. For instance, when it is odious debt, the kind of debt, for instance, that the Congo had as a result of Mobutu borrowing, or Ethiopia, arms that went to Mengistu, that would be written off. When loans were made with advice on projects from international lenders and that advice was wrong and the projects were poorly designed, with the strong support of these international institutions, again, there should be more of risk sharing where the lenders should bear some of the risk for bad lending.

And I think every country has now internally have a way of dealing with individuals who can't pay their loans, corporations. That's why we have bankruptcy laws. We don't have that internationally, and this is an example of where, of the problems of governance of the international institutions. Because even the IMF has recognized the importance of doing something about it, but the United States has effectively vetoed this effort. I think that illustrates the problems of legitimacy, or the problems of the IMF.

The final remark I want to say is something about Africa. Clearly, Africa represents the greatest challenge for anybody concerned about poverty in the world. Problems of debt that I've just been talking about, including some of the problems of odious debt, are particularly important there. There has not been an adequate amount of debt relief.

A lot of the problems, we haven't here talked about issues of trade, but the failure to have a true development round is particularly hard on Africa. Remember, the last round, the Uruguay Round, was so unfair that sub-Saharan Africa, as a region, was actually made worse off. So it wasn't that it just got a small share of the gain, it was actually made worse off.

So the intellectual property regime which makes access to life-saving medicines, like AIDS, is particularly harsh on Africa. Think about it. The cost for a year's treatment of AIDS medicine, generic medicines cost $150, the brand name costs $10,000. People with a per capita income of $300 or $500 can't afford $10,000. So when they signed that agreement in Marrakesh, they were in effect signing the death warrants of thousands of people in Africa.

So it seems to me that many of the issues that we talk about in global social justice really come to a head in talking about Africa. I think too often we think about these in abstract terms, but when we think about what's happening in Africa, it makes it more personal.

Finally, one of the reasons why Africa has not played an important role in the discussions of global financial markets is that in spite of the fact that there are many countries today in Africa that have put in place good macroeconomic policies -- are even growing -- private financial market real investment is not coming to Africa. So it has not been part of the global financial system and even when it follows all the prescriptions. And I think it is another example of the problems of the global system.

MR. ANDREWS: Can I focus you guys on a couple of questions that were raised here? Somebody raised the question of too big to fail and said that moral hazard has grown. And that would be a really big systemic problem, a huge contributor to stability. It would be bad for growth, bad for stability, bad for everybody. Do you guys think that that is, in fact, a problem? The problem of moral hazard, for whatever reasons, is bigger than it used to be, which it shouldn't be in an era of transparency and openness.

Somebody else raised a question about hedge funds, unregulated sources of finance. They are huge. Can you comment on that?

MR. WEISBROT: I was going to ask Antonio to take those, because there were a couple that I wanted to address.

First, the question about Africa, because I think it is important. It is really ignored a lot in the United States, in the media, really everywhere, for a variety of reasons, most of which have to do with, you know, the business press doesn't care about it and you don't still have the institutions here. We at CEPR have not done as much as I would like to do. We have gotten involved at various times around debt cancellation, for example, and also there've been people here from Jubilee USA , I saw them, who have worked a lot on debt cancellation.

But also, you know, one of the things we did a few years ago, 2000 to 2002, it took two years and a lot of fight, and this is an example, I think it's very important, of kind of harm reduction strategy with regard to the international financial institutions. The World Bank had a policy in place for over ten years where it was requiring poor countries, mainly in Africa, to charge user fees for primary education and health care. We helped put together a coalition and worked a lot on it, of 120 groups, we went to Congress. It took, as I said, took two years because they cheated on the agreement at first. But we finally forced them. The Treasury had to vote, the U.S. Representative had to vote -- they passed a rule that said they had to vote against any loan or Poverty Reduction and Growth Facility agreement that required user fees for primary health care and education. And it did actually put an end to the bank forcing those things, and it did cause some millions of children to be able to go to school who had previously not been able to.

So I think it is really important. This is an example of the lack of attention. How was this policy in place for so many years and nobody even noticed it or did anything about it? It didn't take that long to force them to change it.

That's why I said when I was talking, well, that this is really the next step in the change in the international financial architecture, is for the African countries to achieve the level of independence that the middle income countries have achieved in recent years.

The only other question I'll address is the one about inflation in Latin America. I think it's important, and I think both of you probably agree with me, a lot of this is the generals fighting the last war a little too enthusiastically. I mean, that was, you know, high inflation and even hyperinflation was a problem. Yet, there is a good section in this book here [***Stability with Growth***], which both of you co-authored, on inflation and growth. Sure, inflation is higher in the faster growing countries. It is higher in Argentina than it was in the past. If you ask an ordinary person, which would you rather have, 10 percent, or 8.6, 9 percent growth, with millions of jobs created and have 10 percent inflation or have 2 percent inflation and very little growth, maybe even a recession, for most people it's much better to have the growth. And the exception, of course, is the financial class, the bond holders. And as long as they are controlling the central banks, they do make the tradeoffs very often in the wrong direction from the point of view of the majority.

Venezuela also has high inflation. That's the other fastest growing economy in the region. Their inflation is higher than Argentina, but it is not, in neither of those countries does inflation show any sign of spiraling or getting out of control or even to the levels prior to '98. Venezuela rarely got below 29 percent inflation. It's, I think, 18.5 now. It's still, again, it's the highest in Latin America. It's higher than the government would like. The same is true in Argentina, it's higher than the government would like. But, again, the growth is much more important. In Argentina, they have used heterodox methods to keep inflation under control, including price controls, things that economists are usually against. But it has worked. The other choice would have been to sacrifice their economic growth and risk throwing the economy into a downturn or a serious slowdown. And I think so far they have made the right choices.

MR. OCAMPO: Before I get into your questions, let me just reinforce a couple of points. First, on the question of instability, is it really that bad? I will answer in two ways. Self-correction is always good. But the problem is some of the corrections are destabilizing. There is a correction after the debt crisis of 1980's. That was a correction. There was a correction with the Asian crisis. Those corrections went in the wrong direction. There are some corrections that go in the right direction, perhaps the one that took place recently.

Even when that takes place, the basic problem, and this will lead to another point, is that it may seem to reflect the pro-cyclical patterns of flows. You say yes, mortgage markets are correcting in the U.S. You know, great, they are correcting. No. I say maybe not. For the people who depend on mortgages, it is actually the reflection that they can only get mortgages in the good times. They will not get mortgages in bad times. So that is a reflection of what I call the essential asymmetries of the financial system. That's probably also for developing countries. Of course, the Asian crisis was a correction. And so far as I can see, lenders did better than borrowers. The same thing with the debt crisis.

So I think the self-correction reflects the essential underlying asymmetries and inequities of the system. Then, you know, I really prefer a different system. I prefer to attack the sources of the problem.

On the issue of stability, on whether rational expectations are good or bad, let me say that I think one of the basic problems of the world we have been living through is that the essential recipes that have been given to developing countries are to do pro-cyclical macro-economic policies and markets have behaved to reinforce, because of the element of rational expectations in markets, to reinforce pro-cyclical flows.

If we move in a world, socially, the old Bretton Woods system in which there was a presumption that a government will act contra-cyclically, I think markets will actually help reinforce that pattern. So I think what is fundamentally wrong is to continue predicating pro-cyclical policies. That is one of the essential problems that we are living through in the current world economic system.

That leads me to the issue of hedge funds. In my presentation my point is those unregulated financial activities. They always, you know, it's the same thing as some financial markets in general. To the extent that they really help to diversify risks, great, they do. But to the extent that in some circumstances they behave pro-cyclically, they can be terrible. Here is Randall Dodd who told me this sentence, that short term capital can be hot money, and derivatives can be microwave money, which I think is correct. They can really help to totally destabilize markets. That is why present day they say, "Oh, my god," you know, and that's why I think the complacency should not be there. Because when not even the major private agents know what is impacting the risk around in derivative markets, as I heard some private bankers say. So that world is not for me a very safe world. So you had better carefully look at what is going on, because I don't think we should really be complacent.

This leads me to the issue of moral hazard, which I would say to debt framers. I am totally for some multilateral system to manage debt issues. I would actually not use the case of Argentina, Joe, because Argentina was such a large debtor that it was likely to have a good deal, you know, it was tough. Many other cases, Ecuador for instance, the debt restructuring of Ecuador is actually one example of when you have a smaller country, you don't have the power to negotiate in tough terms. So actually a multilateral framework would actually be good the smaller the country is.

You can see it two ways. One way is the negative, part of this is -- that will lead to lenders evaluating risk more carefully and then not lending to certain countries as much as they are willing, or charging a higher interest rate. So for me, always a debt framework such as that has to be associated to some framework that allows post-crisis situations to be managed, which is some sort of guaranty scheme of some sort, or emergency lending. But then of course, you have moral hazard.

I will say on moral hazard the following: I think on behalf of a lender that has been some significant moral hazard, I have never understood the argument which has been repeatedly made that borrowers also incur a moral hazard. As far as I can see, there has been no developing country which has been willing to run into the risk of going to the IMF. Countries run into the IMF, but are not willing to undertake this knowing that they will have to go to the IMF, or to any other adjustment, the Treasury. So I really think that moral hazard has been overstated, particularly on the side of borrowers. I don't think there is such a thing as moral hazard on the side of borrowers.

MR. ANDREWS: I think we should probably wrap this up about now. I would just draw one conclusion tentatively from this, and that is that one hears a lot here that suggests that the system right now, for all its imperfections, may in fact be changing before our eyes, may be decaying. Mark's arguments are persuasive in many ways. I think the world is changing so fast that the authorities and the orthodoxies and the conventional wisdoms are changing. So perhaps some of the complaints that we are venting here are already in the process of being addressed, perhaps. That's my hopeful note. Thanks a lot.

(Whereupon, the meeting was adjourned.)

END