

Latin America, Asia, and Russia: Have the Lessons Been Learned?*

The principal problems in international finance today involve the sustainability of exchange rate and cross-border lending mechanisms. Only classical liberal solutions are sustainable.

The standard set of solutions proposed for resolving the recent (1982-1989 and 1994-1999) international debt and payments crises generally has emerged without reference to the rich financial history and the extensive economic literature on such crises that preceded the Bretton Woods era (1945-1971). Despite interesting but generally unsuccessful efforts to reinvent the wheel in international finance since about 1973, the financial crises recur and increase in magnitude. Depending on the resolution method selected, the intensity and incidence of the crises tend to be masked from public view, giving off an ill-founded feeling of well-being and recovery among foreign investors and international agency policymakers, even as unpleasant surprises and eroding living standards for ordinary people continue without interruption in the debtor countries.

In the long run, only classically liberal approaches to international finance are sustainable without extensive public subsidy and official protection. Basically, lenders should either lend prudently or not at all, for economic instead of political reasons (such as, it is a cheap form of charity or foreign aid). Also, foreign lenders should be willing to suffer the amount of loss determined by the market on the downside if they expect market-determined rewards on the upside. International borrowers should rely more on direct, permanent investment in fixed assets instead of faddish short-term capital flows to finance development.

Problems of International Lending

Instead of learning the classical and historical lessons just described, the offi-

cial approaches to international development that lenders and policymakers have pursued since 1982 have been either corporatist (involving the heavy hand of central planning, public subsidy, and official protection, 1982-1989) or utilitarian (involving moderate degrees of planning and protection but perverse and increasing levels of public subsidy through the International Monetary Fund [IMF] and complementary agencies like the U.S. Treasury's Exchange Stabilization Fund [ESF], 1995-1999). Profound changes of institutional structure are required, like terminating both the IMF (it could be merged into the World Bank as a junior partner, for example) and the ESF.¹

The ersatz structural solutions now being pursued (a bigger but somehow more compassionate IMF, for example, and no change whatsoever at the ESF) simply will not work and merely pave the path to more extensive and more expensive official interventions in the international economy in the future. Briefly, it has proved exceedingly difficult to persuade the U.S., European, and Japanese leaders who are arranging the outcomes of the current set of crises that any course other than muddling through is worth pursuing. Moreover, individual economists and community activists who understand the futility of the current exercise as a historical matter seem powerless to compel their leaders to apply the right lessons and advocate prompt reduction, cancellation, and forgiveness of international debts that obviously are not going to be repaid.

¹ See Anna J. Schwartz, "Time to Terminate the ESF and IMF," in Committee for Monetary Research and Education, Inc. (CMRE), *Time to Abolish the International Monetary Fund and the Treasury's Exchange Stabilization Fund*, Monograph No. 54 (December 1998), pp. 4-27.

Summary of the Controversy

A series of international payments and debt crises erupted in emerging market economies since December 1994, when Mexico suffered a sufficient drain of international reserves during a crisis of confidence in the Mexican peso to warrant a one-third devaluation of the peso and, within two business days, a free float of the currency. Since then, several East Asian countries, commencing with Thailand in July 1997, followed by Russia in August 1998 and Brazil in January 1999, have suffered Mexican-style crises that triggered large-scale international financial rescues of their principal foreign creditors, known colloquially as "bailouts."

These are not the first international financial crises affecting emerging market economies, and these are not the first bailouts of such countries' principal foreign creditors. But one of the most frustrating characteristics of both the emerging markets debacle of the 1980s and the current morass is the steadfast refusal of the principal policymakers to learn some fairly obvious lessons—or at least some obvious questions to ask—on the way to ultimate resolutions, short of making emerging market countries' debts full faith and credit obligations of the United States, which is the logical end state of the moral hazard problem.

The principal question to ask is whether it makes sense to attempt to foster development of the real economies of emerging market countries by cross-border lending from privately owned financial institutions in the industrial economies in the first place. In the developed economies, no one questions seriously the proposition that the pace and profundity of development may be increased by permanent, fixed investment in emerging market economies, like building an automobile factory. The benefit of important minority or controlling share ownership in developing economy companies intuitively is a middle-ground proposition: As long as practices resembling absentee ownership in 19th-century Ireland or painful reminders of pre-1962 colonial status in developing countries are avoided, foreign share ownership may prove helpful to de-

* This article is by Walker F. Todd, currently a Visiting Research Fellow and Faculty Associate at American Institute for Economic Research.

velopment because of generally more efficient management techniques and reduced susceptibility to local incentives for corruption, compared with local management and ownership.

But the historical record does not fully vindicate the proposition that merely passive portfolio investment or even activist cross-border lending by the private sector in industrial economies is more helpful than harmful to the medium-to-long-term development prospects of emerging market economies: A grand casino effect might be (and on recent evidence often has been) created instead. The Executive Directors of the IMF finally have acknowledged this problem in the 1998 Annual Report.

It is important to pay attention to the volume of financial flows into underdeveloped financial markets: Why should anyone be surprised when “investment fad of the month” inflows of foreign financial resources into an economy like Mexico’s or Thailand’s or Malaysia’s cause any result other than (a) surging local stock markets, (b) surging local real estate prices, or (c) surging capital flight by local governing elites?

It is plain to see that questions of these types are rarely asked. Instead, the net benefit of foreign lending and investment is generally assumed, because recently it has been both convenient and profitable in the short term to do so due to the availability of bailouts from official sources.

Summary of Relevant History

The relevant history may be summarized briefly as follows: During the gold or gold exchange standard periods of American and European history (generally gold or bimetallism only, except during suspensions, 1790-1934 for the United States, and 1720-1931 for the United Kingdom; gold exchange versus a gold-linked dollar in the Bretton Woods era, 1945-1971), the availability of sufficient gold reserves for both borrowers and lenders constrained both banking systems and central banks in the amounts and durations of their international lending. Creditor countries’ banks tended to make cross-border *loans* only to finance current *trade* transactions (for which either they could obtain collateral or they or their borrowers could purchase insurance against the risks of loss during shipment) instead of aggregate negative *balances of trade* (for which either they could not obtain collateral easily or purchase insurance against the risks of loss). Creditor countries’ bankers interested in medium-to-long-term cross-border finance tended to buy *bonds* instead.

U.S. banks’ foreign loans became an official problem for the first time during

World War I. Toward the end of the war, proceeds of the Liberty Loans were used to pay down British and French debts to the U.S. banks, thereby substituting the U.S. Treasury as debtor to the banks instead of the original foreign sovereign debtors. This was the first of the modern bank bailouts as we have come to know them in this century. However, by 1934, official disgust with the procedures of international debt defaults, reschedulings, bailouts, and the like provoked Congress into enacting the Johnson Debt Default Act of 1934, 18 U.S.C. Section 955, which made it a federal felony for any person (including banks and bankers) to make a loan to any country in default on its official debts to the United States. At that time, almost all countries except Finland, which owed only a few million dollars, were in default to the United States, so U.S. banks’ foreign loans essentially stopped until after the close of the Bretton Woods era, in 1973.

Foreign loans of all types were no more than about five percent of all U.S. banks’ total loans as late as 1973. Thus, with no U.S. private sector foreign loans to worry about (either prohibited before 1945 or virtually non-existent until 1974), the United States did not have to develop an international bailout policy before the end of the Bretton Woods era. To the extent that a bailout policy did exist, it was firmly, “No bailouts.”

Competing Political Economy Models

It is important for analysis of the recurring international payments and lending problem to understand that there are four principal modern political economy models and that the elements of those models are not applied consistently or are ignored by policymakers in devising solutions to this recurring problem. Since the end of the 19th-century and early 20th century monarchies, the four main modern models in the G-10 (industrialized) countries have been socialism, corporatism, positive liberty (utilitarianism), and negative liberty (classical liberalism).

The main problems of the competing political economy models, as applied to international lending issues in democratic governments, are roughly as follows: Sir Isaiah Berlin (a classical liberal) argued that it is a profound intellectual mistake to assume that attributes of one model may be interchanged willy-nilly with those of other models. Utilitarianism and classical liberalism are at odds with each other, for example, regarding the importance of due process and voluntary exchange regarding property rights. Utilitarian synthesis might be politically convenient but is

rarely sustainable in economics, politics, or international lending.

The problem of conflicts among the elements of the political economy models becomes all the more serious when one is presented with a written, negative liberty constitution, a distinct product of the 18th-century Enlightenment, on the one hand, and political and economic systems that seem increasingly to tend toward utilitarianism at best and outright authoritarian corporatism at worst, without written changes to that 18th-century constitution effected in the legitimately prescribed way. To the extent that the political and economic desiderata of the day prevail over explicit constitutional language and clear understandings embedded within the classical liberal model that underlies that constitution, trouble almost inevitably follows. In a nutshell, this is the dilemma presented by the stated desire of the Washington Policy Consensus to intervene in international financial crises and even to establish an international lender of last resort (LLR).

The Washington Policy Consensus claims utilitarian objectives but attempts to achieve them by corporatist means. No pretense is made that every citizen should have equal access to a state-sponsored LLR: Only the most important citizens have access to the LLR. If maintaining aggregate amounts of cross-border lending and derivatives exposure is the objective of the Consensus, then enough of a LLR needs to be created to sustain those exposures.

The Consensus approach to the problem of the international LLR is hostile to classical liberal objectives (and our classical liberal constitution). This approach adopts the methods of central planning (maintaining aggregate international exposures) instead of allowing voluntary negotiations between creditors and debtors to resolve problems on a country by country, regional, or even debtors’ cartel basis. Constitutional and classical liberal presumptions against pledges of the public credit in support of private enterprise also are compromised by the utilitarian or corporatist desire to socialize creditors’ losses while privatizing the lions’ share of their profits.

In these circumstances, it would seem to be unwise to give the IMF more resources than it already has, together with an expanded mandate, or to seek to transform either the Treasury or the Federal Reserve into the international LLR. None of these objectives can be fitted into the classical liberal political economy model or, on measured efficiency of the bailouts thus far, into a mildly utilitarian political economy model.

Recommendations of a Classical Liberal

Market-oriented economists and classically liberal historians and social scientists should not need a review of the application of basic principles to the international financial crises of recent decades, but apparently the review still is useful. For example, it is comparatively easy to figure out what Adam Smith or Thomas Jefferson or James Madison would recommend be done in the recent emerging markets crises. Principally, they would advise ignoring the crises, advice analogous to that given by Garry Kasparov regarding Russia. That is, the U.S. government should neither encourage nor guarantee the foreign investments and loans of its private citizens or the citizens of other lands, and it most certainly should not act as LLR for such loans or fund another entity, like the IMF, that would like to act as LLR.

On international finance, before and apart from Bretton Woods, at least, even Keynes had strong classical liberal tendencies. His constant and abiding recommendation, a good one even today, is that international lenders always should be ready to reduce, cancel, and forgive the debts for good cause, and that debtors should be ready to default, if necessary, to obtain the attention of the creditors for their good causes.

Keynes was generally sympathetic to the claims of producers and workingmen, which the controllers of the Washington Policy Consensus today emphatically are not, and he led the way in pointing out the transfer problem (the collection of foreign debts that can be repaid only at the expense of the external and domestic commerce of producers of goods and services competing with the debtors' goods and services), an old problem that lies at the root of present-day "anti-dumping" complaints regarding, for example, steel lodged against Russia, Brazil, and Mexico.

Thus, the present international payments conundrum (it lasts too long to be a real crisis) enforces a reciprocal austerity on both debtor country populations, who typically had little say in incurring the debts in the first place, and on creditor country producers, who typically cannot control the proclivities of a mostly politically unaccountable Washington Policy Consensus and its European Establishment cohorts.

The final recommendation involves matters of social equity. Plainly, those who have no qualms about doing so can "work the system." They can invest grandly in shares of enterprises plunging into Mexico, Brazil, and Korea, and then argue strenuously for bailouts when re-

quired. The government (or the IMF) stands ready to rescue them if their investments go astray. This is the "smart," blame-shifting, corporatist thing to do.

But anyone who understands the overriding importance of equitable transactions in human affairs, or even merely the eco-

nomical efficiency of the thing, will make no such investment, or at the least will make it clear that, if they make such an investment, they agree to incur the risk of complete loss. Nothing less will conform with classically liberal, constitutional, and moral touchstones. □

BUSINESS-CYCLE CONDITIONS

Although second quarter GDP growth did not keep pace with first quarter's increase, our leading and coincident indicators point to further expansion, and the lagging indicators show no signs of pending bottlenecks.

Four of our twelve leading indicators reached new highs this month. They are: *M2 money supply*, *new orders for consumer goods*, *the ratio of manufacturing and trade sales to inventories*, and *the index of common stock prices*. (Stock prices and all other dollar denominated series are reported in constant dollars.) After two consecutive months of decline in the base data, this month's surge in stock prices boosted the series' moving average to a record high. Further expansion in the sales to inventories ratio suggests a healthy balance in the manufacturing sector. All four series are appraised as clearly expanding.

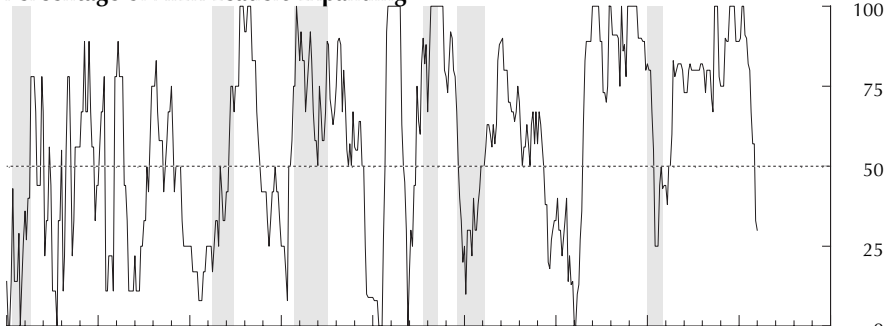
The *initial claims for state unemployment* (inverted) series remains appraised as clearly expanding. Jobless claims fell 6,000 to 295,000, nearing the series' cyclical low of 291,000 recorded last February. The series for the *3-month change in sensitive materials prices* warranted upgrading from probably expanding to

clearly expanding based on continued strengthening in its base data. Although the indicator's base data crossed into positive territory for the first time since October, the 6-month moving average used to smooth this highly volatile series has yet to follow suit. Most notably, however, the series' recent behavior is now more consistent with its historical behavior.

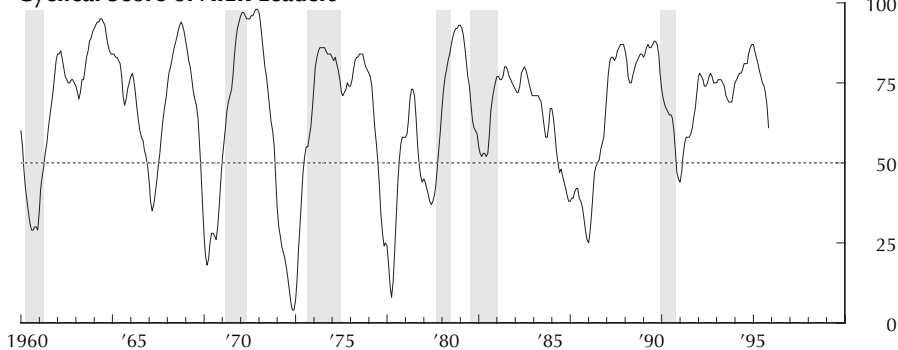
Decreases in the base data for *M1 money supply*, the narrowest measure of money, and *contracts and orders for plant and equipment* were sufficient to warrant downgrading both series from clearly expanding to probably expanding. In contrast, *vendor performance*, the percentage of purchasing managers reporting slower deliveries from their suppliers, was upgraded to probably expanding from indeterminate following four months of steady increases in its base data.

After downgrading the *3-month percent change in consumer installment debt*

Percentage of AIER Leaders Expanding



Cyclical Score of AIER Leaders



from clearly expanding to probably expanding in July, the series warranted further downgrading this month to cyclically indeterminate. Although the indicator's base data and moving average are falling, it is not clear whether the series is expanding or contracting. *New housing permits* in July numbered 1,632,000, slightly below the revised June estimate of 1,641,000. Despite the slow down, the series' 3-month moving average reversed direction and is now expanding, but its cyclical status at this time is ambiguous. The *average workweek in manufacturing* rose .2 hour to 41.9 hours, and overtime increased .1 hour to 4.8 hours. Although all series must eventually be appraised as expanding or contracting, the average workweek has no identifiable trend.

Overall, 100 percent (nine out of nine) of our primary leading indicators with apparent cyclical trends are expanding, repeating last month's count. The cyclical score, a purely mathematical assessment of the leaders, was also unchanged at 78. Both diffusion indexes are well above the statistical threshold of 50 below which recession is more probable than expansion.

Four of the six primary roughly coincident indicators reached new highs for the cycle, including *nonagricultural employment*, the *index of industrial production*, *manufacturing and trade sales*, and *gross domestic product (GDP)*. All are appraised as clearly expanding. Nonfarm employment rose by 310,000 in July, well above this year's monthly average of 208,000. While the service-producing sector and construction industry continued to add jobs, manufacturing employment grew for only the second time since March 1998—albeit by a modest 31,000 jobs. Advance estimates indicate that second quarter GDP grew at an annual rate of 2.3 percent, down sharply from the first quarter's final estimate of 4.3 percent. Advance estimates, which are based on incomplete source data, have historically been revised within a range of -1.0 to 1.3 percentage points.

Personal income in manufacturing, although not at a high for the cycle, reached a new high for the year and is now appraised as clearly expanding. In contrast, a decline in the *civilian employment to population ratio* raised sufficient doubt about the series' trend to warrant downgrading it from probably expanding to cyclically indeterminate. According to the latest statistics, the employment to population ratio fell .2 percent to 64.1 percent. The decrease is largely attributable to women leaving their jobs and exiting the labor force.

Overall, 100 (five out of five) of the primary roughly coincident indicators with apparent cyclical trends are expanding, unchanged since August 1996.

Four of our six primary lagging indicators this month are appraised as clearly expanding, with one—*commercial and industrial loans*—reaching a new high. The *average duration of unemployment* (inverted) dropped 6.2 percent to 13.6 weeks, owing to fewer numbers of persons unemployed 15 weeks or more. Both the number of unemployed and the unemployment rate were largely unchanged from June at 5.9 million persons and 4.3 percent, respectively. The base data for *manufacturing and trade inventories* fell for the second consecutive month, reducing the chance of developing imbalances in manufacturing, given that sales are also rising. Although the *ratio of consumer installment debt* decreased from last

month's record high of 18.08 percent, it remains at 18 percent.

The base data for the *percentage change from a year earlier in manufacturing labor cost* declined following two consecutive months of increase that pushed the series near zero. Unfortunately, the new data did not help establish an identifiable trend for the series. *Short-term interest rates* rose 11 basis to 5.11 percent in July. The increase was sufficient to warrant upgrading the series again this month, this time from probably contracting indeterminate.

Overall, 100 percent (four out of six) of the primary lagging indicators with apparent cyclical trends are expanding—up from 80 percent in July. Nonetheless, there are few indications that bottlenecks are forming that could thwart further economic expansion. Rather, the current outlook remains highly favorable. □

Statistical Indicators of Business-Cycle Changes

Change in Base Data				Primary Leading Indicators	Cyclical Status		
Apr.	May	Jun.	Jul.		Jun.	Jul.	Aug.
- ^r	-	-		M1 money supply	+	+	+?
+	+	+		M2 money supply	+	+	+
+	+	+		Change in sensitive materials prices	?	+?	+
-	+	+		New orders for consumer goods	+	+	+
-	+	-		Contracts and orders for plant and equipment	+	+	+?
-	+	+	-	Index of new housing permits	?	?	?
-	+			Ratio of manufacturing and trade sales to inventories	+	+	+
-	+	+	+	Vendor performance	?	?	+?
+	-	-	+	Index of common stock prices (constant purchasing power)	+	+	+
+	+	nc	+	Average workweek in manufacturing	-?	?	?
-	+	+	+	Initial claims for unemployment insurance (inverted)	+	+	+
-	+	-		Change in consumer debt	+	+?	?
				<i>Percentage expanding cyclically</i>	89	100	100
				Primary Roughly Coincident Indicators			
+	+ ^r	+	+	Nonagricultural employment	+	+	+
+	+	-	+	Index of industrial production	+	+	+
-	+	+		Personal income in manufacturing	?	?	+
-	+			Manufacturing and trade sales	+	+	+
-	+	+	-	Civilian employment to population ratio	+?	+?	?
+	+	+		Gross domestic product (quarterly)	+	+	+
				<i>Percentage expanding cyclically</i>	100	100	100
				Primary Lagging Indicators			
+	-	-	+	Average duration of unemployment (inverted)	+	+	+
- ^r	-			Manufacturing and trade inventories	+	+	+
+	+	+		Commercial and industrial loans	+	+	+
-	+	-		Ratio of consumer debt to personal income	?	+	+
+	+	-		Change in labor cost per unit of output, manufacturing	?	?	?
-	+	+	+	Composite of short-term interest rates	-	-?	?
nc				<i>Percentage expanding cyclically</i>	75	80	100

Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.

PRICE OF GOLD

	1997	1998	— 1999 —	
	Aug. 21	Aug. 20	Aug. 12	Aug. 19
Final fixing in London	\$323.00	\$285.30	\$260.30	\$258.00

Research Reports (ISSN 0034-5407) (USPS 311-190) is published twice a month at Great Barrington, Massachusetts 01230 by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization. Periodical postage paid at Great Barrington, Massachusetts 01230. Sustaining memberships: \$16 per quarter or \$59 per year. POSTMASTER: Send address changes to **Research Reports**, American Institute for Economic Research, Great Barrington, Massachusetts 01230.