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Inefficiencies of Global Capital Markets

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Abstract

This paper sketches some elements of economic theory which recommend the current deregulation of trade, banking and international exchange. Where market participants are not responding to the new conditions as expected, the paper explores (i) the actual opportunities and incentives to which they are responding instead, including (ii) some unexpected interactive effects which freer trade, freer banking and freer capital exchanges have *on each other*, and consequently on the validity of the branches of theory which recommend their deregulation; and (iii) some characteristics of the general kind of science which has guided the deregulatory and other 'small government' policies and expectations. It then suggests what kind of regime might allow a more efficient global economy to serve more humane purposes than it is yet serving, within and between developed and developing economies, if the formidable opposition to such a reform could be overcome.

Contents

Abstract	iii
Introduction	vii
Trade	1
Money and credit.....	17
Global markets: interactive effects of inadequately governed economic structure, trade, banking and exchange.....	41
Economic theory and causal analysis.....	49
What to do.....	59
Sources	79

Introduction

Two twentieth century developments have transformed the options open to the rich countries. They now produce enough, if it were appropriately distributed, to keep all their people in material comfort - but in many of them a century of progress to greater equality and security has lately been reversed. And they are thirty years or so into a bold experiment with new business freedoms, not all of which are being used as expected. This paper explores some effects of the new market freedoms on the rich countries' productive capacities, and on their people's freedom to decide - individually by their market choices and collectively by democratic choice - what uses to make of their high productivity.

Some of the ends and means of economic activity are changing. The 'end of scarcity' frees people to extend the aims of economic policy in new directions, with pressures for change in environmental management, in gender relations, in bringing up children, in the satisfactions of work, and in other links between the economy and the quality of life. Technological changes have allowed some new kinds of good and bad business behavior. A generation ago, unexpected stagflation surprised the Keynesian consensus; now unexpected financial disorders trouble the Washington consensus.

As things change, history and theory play tricks on each other. Simple theories about complex activities can encourage policies which neglect too many of the complexities - and in doing so, divert development from the path which better theory would rightly have expected it to take. Some flawed theories have served well enough in some historical conditions but not in others. Serviceable theories can be outmoded by changing technology, by changing values and social purposes, or by changes in the market or political strength of conflicting interests. This paper sketches some elements of economic theory which recommended the current deregulation of trade, banking and international exchange. Where market participants are

not responding to the new conditions as expected, the paper explores (i) the actual opportunities and incentives to which they are responding instead, including (ii) some unexpected interactive effects which freer trade, freer banking and freer capital exchanges have *on each other*, and consequently on the validity of the branches of theory which recommended their deregulation; and (iii) some characteristics of the general kind of science which has guided the deregulatory and other 'small government' policies and expectations. It then suggests what kind of regime might allow a more efficient global economy to serve more humane purposes than it is yet serving, within and between developed and developing economies, if the formidable opposition to such a reform could be overcome.

Much of the argument will be familiar to economists. To make it clear to other readers and to expose its assumptions where they are unorthodox, it includes passages of elementary theory and sketches of familiar institutional subjects: the Bretton Woods regime and its breakdown, OPEC oil pricing, the progress of financial deregulation through the last thirty years. The purpose is to compare theoretical expectations with historical explanations of the situations, opportunities, incentives and institutional constraints of economic actors, and their actual purposes and choices as far as they can be known. These items of theory and history are necessary, but for the consequent length of the paper and the familiarity of many of its parts, it is right to apologize to professional readers.

Parts of the paper are drawn from three chapters of H. Stretton, *Economics, A new curriculum* (in press) by permission of its publisher, and from Stuart Holland, *Towards a New Bretton Woods: Alternatives for the Global Economy* (Spokesman, 1994) by permission of its author and publisher. I thank Stuart Holland for allowing this use of his work, and Paul Streeten, Paul Chapman and Richard Pomfret for helpful criticism.

TRADE

There is no need to review the manifold gains from trade. It allows productive divisions of labor, economies of scale, useful exchange of natural resources. It is a great transmitter of knowledge and technology and other aids to economic and social development. It can enrich life with wider choices of work, goods, services, arts and recreations than most societies could enjoy without it. The serious questions - and theoretical disagreements - are only about the harm that some trade can do.

Some of the harm is also too obvious to need reminders. Dangerous goods, and services which offend human rights, should not be traded. Some dumping and other predatory exporting is unfair. Some trade worsens unfruitful inequalities of wealth and power - as when rich minorities in poor countries use scarce export earnings to import luxuries and oppressive weaponry instead of necessities of life or investment goods for growth.

Beyond that the list grows more controversial. Most trade improves the exporting country's income, but if it squanders its natural resources it may be improvident. Most trade improves the importing country's material standards, but in some circumstances it can increase its unemployment, exchange difficulties, foreign debt, internal inequalities. In those circumstances some public regulation of trade may improve national income, balance of payments, employment, growth, environmental care, culture and quality of life.

But there are strong disagreements. A great many economists defend the benefits of free trade against most of the exceptions just listed, and oppose most public protection of national industries. How right or wrong is such theory, in principle or in relation to today's imperfect world?

COMPARATIVE AND COMPETITIVE ADVANTAGES

There is no reason to expect that every country will have competitive advantages in enough export industries to earn the means of paying for the imports which its people want to buy. But theorists argue that (i) comparative advantage can overcome competitive disadvantage, and (ii) to the

extent that it does not, market adjustments to rates of exchange will tend to balance international payments by adjusting the prices, and hence the quantities, of traded goods.

The theory of comparative advantage asserts that a country with *no* competitive advantages over others may still gain by trade, and so may its opposite, a country with competitive advantages over all the world in all industries. The theory was introduced by David Ricardo in 1817 with a simple model of trade between two countries in two commodities both of which can be produced more efficiently in one of the countries than in the other. Joan Robinson summarized the model thus:

In Ricardo's example, a unit of cloth in England requires the labor of 100 men for a year; a unit of wine, 120 men. In Portugal, the same quantity of cloth is produced by 90 men, and of wine by 80. Prices in each country are proportional to labour cost. Cloth in England can be exchanged for wine at the ratio of 1 : 5/6 and in Portugal at the ratio of 1:1 1/8. It is therefore advantageous to England to send cloth to buy wine in Portugal and advantageous to Portugal to send wine to buy cloth in England. England then gets its wine at a lower cost by exporting cloth than it could get it by producing at home, and Portugal gets its cloth at a lower cost by exporting wine.

If the countries specialize in that way, a little more wine and cloth can be produced. But will the individual producers be motivated to specialize and trade as Ricardo suggests? If they sell to foreigners at the same prices as they sell to each other they won't. London wine importers (or cloth barterers) will not pay 50 per cent more than the Portuguese price for Portuguese wine. If they want Portuguese wine they can buy it in Porto at 80. At 80, wine will buy less cloth in England than it will buy in Portugal. The comparative as well as the competitive advantages are with Portugal. (Working at both trades, 170 Portuguese workers can produce one unit of wine and one of cloth. Trading wine for English cloth at prices the English are likely to pay, they can get one unit of wine and nine tenths of a unit of cloth, or one unit of cloth and seven eighths of a unit of wine. At those prices trade makes Portugal poorer.) Ricardo seems to expect each country to have dual prices - one for home sales, another for foreigners. But it is not easy to imagine an exchange rate between the countries, and a set of dual prices, at which the trade would occur.

Some trade arises from that sort of comparative advantage, but not usually for Ricardo's reasons. Most

trade arises for complementary reasons (one country has coal, another has iron ore) or for competitive reasons (one makes cheaper or better wine, another makes cheaper or better cloth). Modern economists have nevertheless elaborated the theory of comparative advantage to show that if its principles are valid, they hold not just for two countries producing two commodities, but for a world in which any number of countries produce any number of commodities. And the force which will develop the industries of greatest comparative advantage in each national economy is expected to be the hidden hand: the self-interest of each investor, producer, trader and consumer. Government need only leave them free to invest, produce, trade and consume as their interests prompt them, without any protection from home or foreign competition.

That is very important policy advice. Most of the world's tariffs and other trade aids and restrictions are designed to develop particular industries, often by protecting weaker competitors from stronger ones. If a theory of unaided, market-generated development of industries of greatest comparative advantage is right, most of the legislators who create those controls must be wrong. But there have been periods of protection in the history of most rich countries, often through the years of their fastest growth and increasing equality. If the theory is wrong, history and common sense may be its best critics. But in a world which respects such theory and is trying to enforce it internationally it is also prudent to scrutinize the theory itself.

Limitations of the theory of comparative advantage

Most theories of comparative or competitive advantage which have implied that free trade is best for nearly everybody in nearly all circumstances have had six necessary assumptions, not all of which they have made explicit. They have assumed that:

- . there is full employment
- . each country's balance of payments with the rest of the world is self-adjusting, and the market adjustments cost the country less than deliberate adjustment by regulating trade would cost
- . land, labor and capital are adaptable enough to switch from one industry to another, and the costs of such shifts are less than the gains to be expected of them
- . comparative advantages arise from a country's natural endowments, they cannot be deliberately created
- . no industry or cluster of industries has continuously increasing returns to scale

. maximizing national income, as conventionally measured and regardless of its distribution, should be the basis of economists' measures of efficiency.

Thus the theory *assumes* the presence of the main conditions - especially the most productive use of available resources, full employment, and balanced international payments - which protective trade policies aim to *contrive*.

In practice each of those conditions is sometimes present, sometimes not. When present they have sometimes been produced by unaided market forces, sometimes not. Without any one of them, free trade may not have the good effects which theorists expect of it. Consider three of them: natural advantages, full employment, and balanced payments between national economies. What may free trade do to countries with few and poor natural assets, or with persistent unemployment, or with higher foreign spending than foreign earnings? In that order.

NATURAL AND ACQUIRED ADVANTAGES

Japan's economic modernization owed very little to natural advantages. She has poor coal, no oil or natural gas or uranium; no iron, copper, bauxite; comparatively little good pasture or ploughland. Instead she had human, cultural and institutional resources which enabled her people to develop effective entrepreneurs, well-equipped industries, a skilful workforce, and exceptionally fast growth through some phases of her industrialization. Those efforts were initiated, aided and protected by government, to produce a national economy with far-from-natural competitive advantages.

Advantages of that kind arise from accumulated physical capital, human capital and market experience, and in some industries from economies of scale. With increasing scale and experience and market strength it can happen that whichever producer or national group of producers is biggest is likely to stay ahead, secure against new competitors.

In the short run in those cases other countries may well do best to accept the leading producers' exports. But if a rival can protect a big enough market for long enough, or be subsidized to sell at a loss for long enough, it may catch up with the leader's skills and scale, perhaps with some further advantage from possessing newer vintages of equipment. The newcomer's country may then

be richer from having protected local production than it would have been as a free trader. That may be doubly true if the protected development limits an import bill which would otherwise have swelled to unbalance the country's foreign trade and payments.

When such a new industry has the necessary scale and skill its protection should often cease. But not always. Suppose the industry is a much-prized, high-value-added industry in which a number of countries are competing to overtake the leaders, and in which frequent technical advances occur to alter the competitive conditions. That increases everyone's risks in an industry with long lead times. But several contenders keep trying, so that the world as a whole develops some over-capacity. Free trade may then see most producers producing below their capacity, with losses which outweigh their potential advantages of scale. The best thing to do in those circumstances - if other conditions, and the local industry's capacity, allow - may be to supply a big enough home market from a fully employed industry with reasonable economies of scale and returns from successive vintages. Protecting the market for that purpose may make the country richer than free trade and the loss of the industry may do.

May, not must. Other conditions apply. Are this industry's advantages achieved by a cluster of firms sharing some common facilities but in price competition with each other - or is there a one-firm monopoly? If a monopoly, will it exploit its capacity for monopoly pricing and profit? The effects of that may be worse than the effects of free trade and some insecurity and over-capacity. They may be worse still if the monopolist is foreign-owned and repatriates most of its profits. Free trade looks best.

But reflect. Free trade might have allowed the original leader of the industry to establish and exploit not just a national but a world monopoly. Nobody is in a position to discipline a world monopoly. But a national monopoly that *depends on protection* can be disciplined. A determined government can say "Prices down, or protection down" and enforce it. It can say "Invest to keep your technology up with the best, or protection down" and enforce it. Or if the monopolist strength is being used against the industry's workers rather than its customers, government can say "Wages and safety up to standard, or protection down." Australia has enforced the last two quite effectively at times.

A conclusion: In some circumstances well designed protection can develop more productive industries than free trade would allow. In other circumstances it can

not. Theory alone cannot predict when it probably can or probably cannot. It depends on the facts of the case, including the nature of the industry and the quality of the government.

TRADE AND EMPLOYMENT

Stay with Ricardo's example, but consider the effects of its policy advice in a world (like ours) in which ten percent or more of unemployment is common. Suppose that England and Portugal have the same number of people, and of workers. Each uses 5 per cent of its land and labor to make its own wine and 5 per cent to make its own cloth. The Portuguese make both products more cheaply than the English do. And each country has 10 per cent of its land and labor unemployed. Then changes in transport technology open the possibility of trade between them. The Portuguese winemakers employ some of Portugal's unemployed land and labor to double their output. They sell the surplus to England at two thirds of the English price and put the English winemakers out of business. The English government could defend the industry with a tariff but its members are free trade theorists and enjoy the low-priced Portuguese wine, so they do not.

Theorize the consequences:

When their new vines are in full production the Portuguese supply England's wine. The low Portuguese price induces the English to buy a little more wine, but mostly it frees some spending for other goods. Producing those goods increases English employment by 1 percentage point, with some multiplier effect so that it adds 1 1/2 per cent to national employment and income. Meanwhile wiping out the English wine industry has reduced national employment by 5 percentage points. Nobody will employ those unemployed to make cloth instead. The English demand is already supplied. The Portuguese continue to buy Portuguese cloth because it is cheaper. If other industries had work for the new unemployed they would already have hired half the old unemployed. In England total wage income, demand and spending decline accordingly, and with their multiplier effects reduce national employment and income by 6 1/2 per cent. The net effect of the changes is thus to reduce English national income by 5 per cent, increase unemployment from 10 to 15 per cent, and increase inequalities between rising numbers of unemployed and the well-to-do made richer by paying a third less for their wine.

This strand of theory was designed to isolate relations between trade and employment. But even the protectionist variant of the theory (above) does not suggest that all new or vulnerable industries should be protected. Trade is only one of the determinants of employment. If vulnerable industries are allowed to fail, private initiatives *may* re-employ their workers. Or government may. And government can act in a number of ways to stimulate private investment.

Or rather, it could once do so. The second part of this paper will argue that the simultaneous deregulation of trade and of national financial systems reduces the capacity of *either* market processes *or* public action to maintain high levels of employment in countries whose tradeable industries are not competitive enough to balance their foreign payments. Anticipating those arguments -

A conclusion: To maintain acceptable levels of employment in those countries by means which are not improvident, some regulation of trade may now be even more necessary than it was before the financial deregulations.

TRADE AND THE BALANCE OF PAYMENTS

Countries can find themselves owing more foreign money than they earn for any number of reasons. There may be changes in the world economy. The terms of trade between raw materials and manufactured goods may change, and put exporters of one or the other into deficit. When artificial fibres become popular, wool and cotton producers may lose export earnings and spend more on imports as their children switch to imported fibre clothing. Importing fibre-optic cable may increase the import bill while export earnings decline as the world uses less copper. Uranium and natural gas (which some countries have) replace coal (which other countries have) as main sources of electric power, so balances of trade and payment shift. They shift further as newly industrialized countries bite into older producers' home and foreign markets, and as transnational corporations shift their production of tradeable goods from country to country.

Governments of deficit-trading and heavily indebted countries currently hope to re-balance their trade by one or more of six means:

- . free trade to allow market forces to develop their industries of greatest comparative advantage
- . devaluation or market depreciation of their currencies

- . financial deregulation
- . asset sales
- . unemployment
- . one or more of export aids, import restraints, and exchange controls.

With rare exceptions the first five don't work. The sixth - the protection or improvement of the structure of the national economy by means which include competent trade and exchange controls - has often worked quite effectively. But there are now powerful intellectual and business pressures, and WTO and IMF and OECD and soon perhaps MAI pressures, to ban it.

Notes on the six:

Free trade has not recently rescued any country from unbalanced trade and payments. Trade and exchange have been freer in the last 20 years than in the previous 50 and the main deficit traders of twenty years ago are deficit trading still, and deeper in debt than they were.

Devaluation or market depreciation of deficit traders' currencies was expected to expand those countries' exports and reduce their imports until their trade and payments balanced and their exchange rates consequently stabilized. So their governments need not regulate their trade or exchange transactions: market forces would do it better. In the simple terms in which the theory commonly reached the policy makers, it advised them to expect this:

As your currency depreciates, it takes more of it to pay the foreign prices of your imports.

The foreign suppliers get the prices they always did, but your people as buyers pay higher prices. So they demand and buy less imports. The prices which foreigners must pay (in their money) for your exports fall, so they buy more of them. With a declining import bill and rising export earnings, your exchange deficit decreases. It is the deficit - i.e. your greater demand for foreigners' money than their demand for yours - which causes the rates of exchange to change, so market forces can be expected to depreciate your currency to the level at which your export earnings balance your import spending and your country is in exchange equilibrium with the rest of the world. Reciprocally, surplus-trading countries' currencies will rise in value, so that their people buy more imports and foreigners buy less of their exports, until they too are in exchange equilibrium with the rest of the world.

Instead of that, what actually happened was this:

Market rates of exchange have prevailed since the 1970s. The currencies of countries with exchange

surpluses have risen in value as expected - but instead of their surpluses decreasing, they have *increased*. Except for the US dollar the currencies of countries with exchange deficits have lost value as expected - but instead of decreasing, their deficits have *increased*. There were temporary exceptions - for example, a successful British devaluation - but the trends persisted for twenty years or more from the first deregulations. Why did life contradict such a plausible theory? Some reasons follow. The first two - economic structure, and elasticities of supply and demand for tradeable goods - were probably the most important in most of the countries, until the deregulation of national and international banking developed its full effects in the 1990s.

Economic structure A deficit country is usually in deficit because its investors and consumers demand more tradeable goods than its structure of industries can supply either by its own output or by producing enough saleable exports to pay for the necessary imports.

The country's stock of physical and human capital and its economic organization have developed slowly over time. It may have some idle or quickly expandable capacity in some industries. But if a fall in its exchange rate brings higher demand for a range of its exports it is unlikely to have idle capacity in all or many of them in the short run, or in industries which might replace imports made dearer by the same change. To take advantage of the new opportunities, some of the economic structure has to change. Some industries must expand, some new ones must start. Other countries with declining exchange rates, lower wages or other advantages may be trying to do the same, so there may be competition to beat. The new developments may need public as well as private investment. Some may need some 'infant industry' protection to get established. Some may have long investment lead times. Investors may face unusual risks if the market opportunity is created by an unnatural exchange rate arising from an exchange deficit. What if the new developments succeed in eliminating the deficit, the exchange rate returns to its original level, and the imports are competitive again?

A conclusion. A persistent exchange deficit is certainly a good reason for acting to correct the country's structure of industries, or the efficiency of some of them. But the reconstruction may well not come as an unaided private investors' response to a depreciating currency. Public action may also be needed.

Another way to describe this structural trouble is to say that the price elasticity of supply may not be enough, in enough of the industries concerned, to respond to a currency depreciation by eliminating the trade deficit which causes the depreciation. Thus this item can reappear briefly in the next, under another name.

Elasticities One condition for a national exchange surplus or deficit to adjust as the theory predicts is that there should happen to be helpful relations between:

- . the price elasticity of supply of the country's tradeable products
- . the price elasticity of foreign demand for the country's exports
- . the price elasticity of the country's demand for imports
- . the income elasticity of the country's demand for imports.

Each of those depends on different conditions. No market mechanism adjusts them to each other. If they are helpfully rather than unhelpfully related, that is good luck, not the hidden hand. If not, a depreciation may not change the deficit, or may worsen it.

Suppose, first, that the elasticities of supply and demand are both price-inelastic. (Foreign steelmakers want only so much of your coal and iron ores, foreign manufacturers want only so many of the components they buy from you; cheaper fuel or materials or components will not enable them to sell many more of their finished goods. So their demand for your exports may increase by less than the depreciation of your currency.) Similarly, a deficit-trading country's importers of fuel, components, heavy machinery or tropical products may have a fairly inelastic demand for those necessary items, and may continue to buy the quantities they need despite rising prices. And despite rising prices the country's rich citizens may buy much the same quantities of Scotch whisky, French perfume and Italian jewellery and cause their firms to provide them with much the same German cars. Suppose that all the elasticities are around 0.5 when a devaluation cuts export prices by 20 per cent. If foreigners buy only 10 per cent more, that earns the exporter 12 per cent *less* foreign exchange than before. If import prices rise 20 per cent (in the importers' currency) but the quantity imported falls only 10 per cent, that cuts the spending of foreign currency by 10 per cent. The depreciation has slightly *increased* the exchange deficit.

If both demands are price-elastic, they may together reduce the deficit. Different elasticities for

imports and exports have different effects again. And if the demand for exports is price-inelastic but the demand for imports is strongly income-elastic, governments may have new reasons to fear growth and full employment, and may act to limit them, because they increase exchange deficits disproportionately.

For a generation now, deficit-trading countries have had more unlucky than lucky patterns of price and income elasticity. But that is no longer the main reason why exchange rates fail to equilibrate their international payments in a market way. We will presently notice how the ill effects have multiplied since the government of national and international banking changed to allow banks to borrow as well as buying - or instead of buying - the foreign currency that importers want to spend.

Risk Unstable rates of exchange can make investment in tradeable industries riskier, especially in industries with long lead times and with foreign competitors in their home and foreign markets. How confidently can an investor plant vines without knowing what the exchange rate may be when the wine starts to flow seven years ahead? Or duplicate, for export, an engine plant and car assembly line which will take seven years to pay back?

Export-import price links Many exporters import some of their inputs. In a country with a depreciating currency, rising import prices thus limit the benefit that export industries derive from the exchange rate. If exchange rates with the countries from which the imports come and exchange rates with the countries to which the exports go change at different rates or in opposite directions, effects vary accordingly.

Allocation of resources When foreign currency is scarce there are competing demands for it. Some of the bidders want to import necessary consumer goods, some want to import luxuries. Some want items of public or private capital, some of which are more productive or desirable than others. (Anaesthetic machines or gambling machines? Buses and ambulances or private limousines? Equipment which national producers could supply, or equipment which they could not?) Some of the desired imports would benefit richer people, some would benefit poorer people, some would benefit nearly everyone. Some would contribute to competitive strength, some would not. Market allocation - i.e. rationing by price - does not ensure that scarce exchange goes to the most productive uses, or to the most equitable uses, or to the uses which will do most to correct an exchange deficit.

Nor does it always avoid the income transfers which may accompany export subsidies and import tariffs. The line between 'market solutions' and 'protective subsidies' is blurred when an exchange depreciation increases a country's exports by imposing an unnatural exchange rate, i.e. one which does not reflect the exchanging currencies' purchasing power over their national goods and services. Exports which thrive on such a rate of exchange are subsidized by the exporters' fellow citizens, through the higher import prices which they pay, as surely as if the exports were subsidized by the government from tax revenue. But the World Trade Organization and other theorizing authorities bless that 'market' solution, with the inefficiencies and inequities noticed above, while condemning public export subsidies and import controls which might be applied more discriminately, with better economic as well as social effects.

Financial deregulation is for discussion later. It is mentioned here as one of the means by which theorists have hoped to allow market adjustment of deficit countries' exchange imbalances. Its main actual effect has been to allow such countries' banks to borrow instead of buying the margin of exchange by which their import and debt-service bills exceed their foreign earnings. That keeps the imports coming, and the debt increasing, instead of adjusting either back to exchange equilibrium. To keep the funds coming, borrowers may have to pay quite high interest; the traffic may slightly increase the prevailing international rates. Other deregulations allow those rates to flow through to the participating countries' internal rates. The upward pressure helps to depress the quantity and quality of new investment, employment and growth.

Asset sales Some countries finance some of their exchange deficit by spending capital. They sell assets to foreign buyers: private land, office buildings, shopping centres, hotels, tourist resorts, newspapers, broadcasters, firms in many industries; public gas, power and water utilities, telecommunications, passenger transport systems, hospitals. The sales bring in foreign capital funds. Some of the funds may be used to reduce foreign borrowing or repay foreign debt. But most foreign buyers buy assets which can earn them more than the rate of interest, and many of them want to return their rents and profits to their own or other countries. So in the long run the sales increase the debtor countries' need for foreign exchange, and leave their balance of payments worse than before. (But the case against selling existing assets does not necessarily hold against accepting new direct foreign

investment, especially if its output will include exports or import replacements.)

Thus foreign capital transactions can alternatively correct or increase exchange deficits. But some of the gains are temporary, and most of the losses are long-term.

Unemployment One way to restrain imports is to restrain the demand for them. One way to do that is to restrain aggregate demand by keeping the national economy under-employed. Less investment means less import of materials and equipment. Less employment means less wage income and less consumer spending, including spending on imports. As a way of limiting imports, limiting aggregate demand is wastefully inefficient because a lot of useful production of tradeable and non-tradeable goods and services gets restrained too. The proportions vary with the share of imports in total spending, but in almost all countries the *unnecessary* loss of national output and income is greater - often several times greater - than the desired reduction of the import bill.

Balancing foreign payments has not usually been the only purpose of policies of under-employment. One purpose of the historical Right turn in the English-speaking countries' economic policies through the last quarter of the century has been to let significant unemployment weaken labor's bargaining power. Business leaders and others wanted that to cut the labor share and increase the profit share of income. Governments and others wanted it to restrain wage-push inflation and perhaps encourage investment. So there was already support for it when governments of deficit-trading countries saw it also as a way to restrain imports and improve the balance of payments.

Conclusion Through the third quarter of the twentieth century in many of the developed democracies some tariff and other protection and strict control of foreign borrowing and asset ownership had accompanied full employment, growth at 4 or more per cent a year, balanced trade and payments, increasing equality, and eventually rising inflation. The Right liberation of trade and exchange did then serve some of its own intended purposes: to weaken labor, end inflation, and increase profit shares and income inequality. But it turned a number of otherwise prosperous countries into deficit traders and big debtors, and for those countries the strategy of deregulation has been improvident as well as inequitable.

Better ways to balance trade and payments

There are lucky countries that can prosper by free trading, without harm to their collective social purposes, and they should certainly do so. But there is nothing in the nature of technical progress and unhindered market forces to ensure that national surpluses and deficits will not develop. They can happen if nations have different rates or directions of technological advance, or if the terms of trade between trading partners change, or if exchange rates between their currencies change. They can happen if unprotected tradeable industries succumb to new competitors, or if protected industries lose their protection. And they have happened when financial systems were deregulated and allowed new flows of international credit to finance new imbalances.

A country or bloc does best in the long run by importing only what its foreign earnings (and aid, if any) can pay for. That is best achieved by means which do not raise more prices than necessary (unless for particular social purposes), do not accumulate excessive foreign debt, do not force the sale of assets to foreign buyers, and do not force any unwilling surrender of accountable democratic power over economic policy.

The best way for that to happen is in an ordinary market way. But although balanced trade and payments can develop in a market way, so can imbalances. Where they persist they can force market corrections - sometimes successful, sometimes counter-productive - through adverse exchange rates, or through borrowing and asset sales which must accelerate the growth of the deficit in the long run. It is worth comparing those effects with the effects of deliberate import restrictions, and some discriminate allocation of available foreign exchange.

Import regulation can be doubly selective. First, it can discriminate between more desirable and less desirable imports: for example between necessities and luxuries, between capital goods and consumption goods, between things the country can produce for itself and things it cannot.

Second, some of the restrictions (like tariffs) may raise the prices of the imports which they restrict, but they do not raise any other import prices. A market depreciation of a country's exchange rate raises the prices of *all* its imports: necessities as well as luxuries, capital as well as consumer goods, imported inputs into the country's exports, goods which the country cannot produce for itself as well as those which it can. A selective tariff can limit imports to the volume the country's foreign earnings can pay for at a natural exchange rate, while raising the prices of the tariffed items alone. German cars, French wines,

Scotch whisky and Italian suits can pay a high tariff and be rationed by price, while productive machinery, industrial materials, trucks and buses, medicines and hospital equipment, books and journals and tea and coffee can enter tax-free at competitive prices.

Tariffs, quotas and prohibitions, and regulated uses of available foreign exchange, work with different efficiency at different tasks. But where there is to be any restraint of trade, recent WTO agreements encourage the use of tariffs only. That seems to be for two reasons. Tariffs are impossible to conceal, allow quantitative comparisons between national trade policies, and make them easier to monitor. And unlike more direct controls, tariffs still allow the quantities imported, and their distribution, to be determined in a market way by demand and price rather than on other principles by public authorities. Both principles are debatable.

OTHER PURPOSES OF STRUCTURAL POLICIES

This summary has so far compared import and exchange regulation with alternative means by which a deficit-trading, indebted country can try to develop a national economic structure capable of earning enough foreign currency to pay for the imports for which it generates demand. But other things besides balances of trade and exchange are affected by such policies, and should be in mind when the policies are chosen, just as the effects on balances of trade, payments and foreign debt should be in mind when protective policies are considered for other purposes.

Here follow reminders of some of those other purposes.

Infant industries Some industries add more value per worker or per hectare of land or per dollar of investment than others do. To be rich and fully employed a developing country usually needs some manufacturing, including some advanced manufacturing. It may need to process some at least of its natural resources, rather than neglecting them or exporting them raw (then buying some of them back when processed). If the people want to open the economy to imports they must export some goods, and also produce enough tradeables for themselves to limit the demand for imports to the volume their exports can pay for.

Industries which need to accumulate much physical and human capital including know-how which can only be learned by experience, industries which need some

scale, and industries which need particular public and private services to develop step by step with them as they grow, cannot usually start up in a new country and succeed against imports from established competitors who already have those advantages. Many economists, including free traders, agree that developing countries, or developed countries with persistent exchange deficits, may rightly want to develop new industries and may need to protect them until they have developed the necessary skills, scale, and market and service links. They may be helped by subsidy, public credit, public utilities, technical aid, tariff protection. Some governments have created them as public industries and privatized them when they were commercially viable.

Continuing protection Such a new industry may become reasonably efficient but not efficient enough to be internationally competitive. That may happen because its home market is too small for economical scale. It may happen because the nation's government or labor unions will not let its workers be worked as long or paid as little as the competitors' workers are. It may happen because the national environmental policies are stricter than competitors face. It may happen with less excuse: the new firms are simply not as good as their foreign competitors, and not likely to become as good.

When that happens it may often be right to give notice that the protection will be tapered to zero over a few years, so that the industry must improve or close down. But it may sometimes pay to continue to protect such industries in particular circumstances. For example:

- . The labor protection or the environmental requirements which raise the national producers' prices above the importers' prices, or the employment needs of particular regions, may be regarded by the democracy as more valuable than the price advantages of the cheaper imports.
- . There may be no likely market for anything that the protected industry's land or labor might alternatively produce. If there is already persistent unemployment, there may be no reason to expect that adding more unemployment will attract investors to employ the disemployed resources. So
- . allowing a moderately inefficient industry to be displaced by imports may leave some or all of its resources unemployed, and the country poorer; and
- . the worse imbalance of import spending and export earning may depreciate the currency enough to cost consumers more, through the higher price of all their

imports, than they were losing to the higher prices of the protected industry. Or

- the annual addition to the import bill will be met by foreign borrowing, whose debt service will eventually cost more than the country gains from the cheaper imports.

Except for the first item - the consideration of human or environmental costs - most theorists of free trade dismiss all those excuses for continuing protection. They assume that *any* protected industry has an opportunity cost, i.e. that without the industry its resources would be more productively employed. There is sometimes ground for that expectation, sometimes not. Today's quick-changing technology and competitive conditions make more-productive re-employment hard to forecast. But where there is already persistent unemployment, *more* unemployment rarely increases the rate of new investment or its eagerness to risk and innovate.

- **Risks (1) Rates of change** In a world in which technology and competitive conditions can change quickly, mature as well as new industries can succumb to new import competition. It is often right that that should happen, partly to replace dearer or worse goods by cheaper or better, and partly to maintain the competitive discipline which contributes to everyone's efficiency. But the costs of losing an existing industry may sometimes be higher than the costs of conserving it. Some continuing public aid or protection for established industries may be justified if it allows them time and profit margins with which to modernize and re-equip themselves, or if they contribute to maintaining a level of employment and a balance of payments which the economy could not expect to maintain without them.

- **Risks (2) Big and small countries** Different countries, or the same countries at different times in different conditions, may reasonably opt for different balances of risk and present income, or risk and security.

Comparatively self-sufficient economies, trading less than 10 per cent of their output (as the US and Japan did until recently) and importing comparatively few goods that they could alternatively produce for themselves, may well have less to fear than more trade-dependent countries do from changing technology and competitive conditions in world markets. That degree of self-sufficiency comes easiest to economies with internal markets big enough to allow efficient scale in most industries. Small national markets offer fewer economies of scale. For them, degrees of trade dependence or self-sufficiency may be open to

choice. To maintain a Japanese or US degree of self-sufficiency they may have to protect many of their tradeable industries. That may well reduce the income that they might achieve by trading more freely. But in a quick-changing, increasingly competitive world economy some bias toward security, at some cost to present income, may be a reasonable strategy for a country whose income is already comfortable. It may protect future income from shocks, and give present people peace of mind and expectations of full and secure employment.

But in other circumstances a small country's least-risk course may be to join a giant - the European Community, the North American Free Trade Area - and surrender its trade and structural controls altogether, to get access to hitherto inaccessible markets. Theory alone can not order those strategic options: the choices call for detailed understanding of the particular national economies, and risky judgments of their potentialities.

Key industries and clusters An industry which needs protection to survive may enable other industries to expand on their market merits without protection. The positive income gain from the surrounding industries in the cluster may be greater - sometimes much greater - than the cost of protecting the key industry. A case study offers an example and some relevant theory. Here is Paul Chapman's summary of his study of a regional cluster of industries generated and sustained by a protected carmaking industry.

The direct impact on local employment and income of the presence of two multinational car plants is not of prime importance. The indirect, spin-off effects are. The presence of the motor vehicle manufacturers has (along with past policies of assistance) fostered the development of a range of component suppliers. Many do not specialize solely in motor vehicle parts but produce a range of other goods from clothes lines and mowers to washing machines and airconditioning parts. These supplying industries now cluster about the motor vehicle manufacturers in an array which intersects with other industries. Behind them is a further rim of linked industries supplying to these suppliers. Associated with them is a range of other industries producing other consumer durables and like products. In short, the motor vehicle industry is a lynch pin. It is a focal point within the web of inter-industry relationships described by the industrial structure of [the region].

Because of their size, firms supplying to the multinational car-makers can secure a base-load of demand through which they can attain higher output levels, justify

higher investment (in equipment, training and infrastructure) and thereby reap greater economies of scale over the long term. The motor vehicle manufacturers benefit, through the market, in lower prices. The component suppliers also benefit via higher margins. And other industries, consuming products also made by component suppliers, also benefit. They receive a benefit created by the motor vehicle manufacturers but external to and uncaptured by them. Moreover, the carmakers have brought to [the region] new production technologies and techniques. Uptake of them (or their derivatives) is encouraged in, sometimes demanded of, component suppliers. Again, there are benefits for the carmakers but also for the suppliers and for their other customers.

This process can be repeated up and down the production chain and along other production chains linked to it. Many of the important effects so transmitted are unpriced by the market as they are external to the individual firm. [Thus] the core of a cluster of linked firms ... can help create the conditions for competitiveness in a large number of other industries.

Chapman reminds us of a neglected principle of market efficiency:

Firms are not simply independent and competitive; they are also interdependent and co-operative. If firms are physically close (or at least within a single currency area) and their activities are linked they can be greatly advantaged. They can trade in a stable medium of exchange; they can respond to each other more quickly and cheaply; they are able to coordinate co-operative activities more easily, setting standards, creating industry fora and information networks; they can piggy-back on each other into export markets; they can lobby governments more effectively; they are more able to attract other, linked industries to the region, creating a new round of benefits. These advantages of proximity exist both horizontally and vertically. They account for the phenomenon of clustering and highlight a key aspect of competitiveness.

Protecting some key industries within such clusters may generate more investment, income and growth than it loses to the higher prices of the protected products. But Chapman concludes with a proper warning that the interdependencies vary with time and circumstances. To be effective, public intervention needs to be well researched and well judged. Theory may suggest what to look for, but as a guide to investigation, not a substitute for it:

Industries differ in their ability to create beneficial linkage effects. The quantity and quality of

linkage effects from the motor vehicle industry is different to that of biotechnology or breadmaking. Once we recognize the different potential roles of different industries within a given economy the importance of selective and discriminating intervention is established.*

Equality This connects with the earlier employment item. Some countries act collectively to raise their lowest wages, and improve their worst working conditions, above the levels which might otherwise prevail. In industries affected by the regulations, costs and product prices may be higher than they would otherwise be. Or they may not, if better wages and conditions elicit better work. In non-tradeable industries those requirements do not necessarily reduce national income, they chiefly affect its distribution. But the higher costs may expose tradeable industries to tougher competition from countries whose workers do not enjoy the same protection. (That can include rich as well as poor countries. Some US producers for export pay their workers less and treat them worse than the governments of their European or Australian export markets would allow). A tariff or subsidy which matches and protects the regulated increment of labor costs may raise or lower national income, depending on (i) the direct upward or downward effects which better wages and working conditions have on labor productivity; (ii) the effect on productivity of any labor-saving capital improvements which the higher wages prompt; (iii) the income gains which would be available from cheaper imports, (iv) the income losses if resources disemployed by cheaper imports are not usefully re-employed; and (v) any losses from the contribution of cheaper imports to the balance of payments, rate of exchange or foreign debt service. Without local knowledge, theory cannot tell which of those effects will outweigh which others. Nor can it tell democracies whether or not they ought to prefer more national income to its better distribution, or to more job and income security, if those are achievable.

Conservation Most environmental regulation is of the extraction, use, degradation, consumption or waste disposal of resources, rather than the trade in them. When national governments do regulate trade for environmental reasons it is sometimes to conserve resources for their own people's use, sometimes to influence other countries' uses of them, sometimes for safety at sea. But most of the

* Paul Chapman, 'Towards an Industry Policy' in John Carroll and Robert Manne, (eds) *Shutdown* (1992).

things which trade restraints aim to conserve are cultural or political rather than physical.

Culture Two examples: In the seventh round of GATT /WTO negotiations (1987-1994) the French government fought even more tenaciously, and successfully, for the right to cultural protection than for their agricultural protection. As this is written they are said to be doing the same in negotiating the proposed Multilateral Agreement on Investment. If French film makers are to compete on equal terms with their US competitors they need protection to offset their disadvantages of market scale.

In an Australian case the cultural principle joined with the cluster principle. For many years commercial telecasters were required to have their advertisements made in Australia. That gave Australian film makers a base load of work which made unprotected film-making and television drama for such a small national market more viable than they would otherwise have been.

Besides national gains, the world as a whole may be more interesting with some discriminate protection of its cultural diversity.

Sovereignty Compulsory free trade in goods, money and capital ownership can sharply reduce national capacities for self-government. Competing for transnational investment in those circumstances can induce governments, especially of small and developing countries, to do less than their people would like to protect industrial health and safety, conditions of employment, environmental resources, progressive taxation, balanced payments and freedom from excessive foreign debt. These effects are subjects of later parts of this paper, but in some vulnerable countries compulsory free trade can be a strong contributor to them.

Selection and imagination in the causal analysis of trade policy

The doctrinaire case for free trade in all circumstances has generally rested on two indefensible principles of analysis. First, analyse the actual or potential ill effects of protective policies but none of their good effects. Second, in deciding what those effects are, rely on theory which *assumes* that market forces will reward free trade with the full and efficient employment of available resources, so that the effect of any protective action can be measured by the difference between actual performance and that theorized ideal. In *Tumbling Dice: The Story of Modern Economic Policy* (1994) Brian Toohey cites an Australian example. The country has two rival models of

its national economy. The government's Industry Commission and its Treasury rely on the ORANI model, a neoclassical equilibrium model which incorporates the above principles. The National Institute for Economic and Industry Research (NIEIR), developed in Melbourne University but now independent, has an IMP model with more realistic assumptions. Its director Peter Brain also uses it with more attention to changing conditions. Brain's forecasts have long proved to be more accurate than their ORANI rivals. Toohey contrasts the two forecasts of the effects of reducing Australia's tariffs to zero over the decade to 2000:

	IC ORANI model (per cent)	NIEIR IMP model (per cent)
Real GDP	+1.1	- 1.6
Real Consumption + 0.4		- 0.6
Real Investment	+ 2.4	- 1.5
Balance of Trade	+ 2.4	-3.6
Consumer Price Index	- 3.8	- 0.3
Manufacturing Output	- 1.0	- 4.8
Aggregate Employment	+ 1.0	- 1.0

History has so far followed IMP rather than ORANI. Part Four of this paper returns to the effects of neoclassical theory on the causal analysis of economic life.

THE ONUS OF PROOF

These notes have given more space to the national conditions which may justify industrial aid or protection than to the conditions for free trade. That is partly because the conditions for free trade can be more broadly and simply specified. But it is also because prevailing Economics textbooks and policy papers overstate and over-generalize the case for free trade, so there is need to redress the balance by emphasizing the national conditions which may justify some protection or other deliberate modification of the structure of a country's private sector. But in redressing that balance this paper should not be taken as recommending general protection. If an economy needs protection at all, the protection should be economized. It should discriminate. Defensive protection should be applied only when and where it is needed, and at the lowest rates which will work. Creative protection

should only be applied when it promises substantial gains which will exceed its likely costs. Wherever free trade works, free trade is best. Besides its structural benefits, it has other advantages:

Costs Free trade is cheapest for all parties.

Where government offers subsidies they commonly have to be the subject of investigations which cost business and government time and money. Tariffs have to be designed, administered, collected and enforced and their effects monitored. Traders have to supply prescribed information about their goods, and with *ad valorem* tariffs the value of the goods may need elaborate accounting and be open to dispute, sometimes in court. Thus there are costs in time and money for both parties, and sometimes also for third parties trying to attract similar protection for *their* activities.

Misbehavior Regulation creates opportunities and incentives for disputable or unlawful behavior. Firms can profit by misrepresenting products and values and by smuggling. Officials can be slow, obstructive or corrupt in the exercise of their powers. Every offence or irritation on either side can worsen relations for the next encounter, and worsen the general regard which business and government have for each other.

The burden of government The necessary role of government in modern economies is already large. Its complexities and difficulties already expose it to destructive campaigns to 'roll back the state' and reduce its capacity to perform its necessary functions. Its defenders should be as unwilling as its critics to make its task harder by loading it with *unnecessary* functions. For that and other practical reasons, proposals for new industrial aids and trade controls should be subject to some discount for administrative cost, complexity and nuisance, and even then should rarely be adopted for small or uncertain margins of gain. Free trade is best wherever its effects are tolerable. And when they are not, the onus should be on reformers to persuade the relevant politicians and electors that they are not.

And also to persuade them that government could do better. That should usually be a local question rather than a general or theoretical one. Some societies produce much better government than some others do. But economists like to generalize, and their public choice theorists argue that all government tends to be too venal, incompetent and potentially oppressive to be trusted with any avoidable economic power. Is it so?

THE QUALITY OF GOVERNMENT

Some governments come under more degrading pressures than others do in arriving at their policies for trade and economic structure. And some are better than others at resisting such pressures. The pressures tend to be of three general kinds:

(1) Many influential people keep telling government, its electors and each other that the country needs a coherent economic strategy with effective trade and structural policies.

(2) Many interests may be affected by the policies and try to influence them: owners, managers and labor unions in particular industries, representatives of consumers, regions, local governments. Some of what they contribute is knowledgeable and valuable to the policy-makers, some is understandably biased, some may be positively deceptive. And some may come with financial or political threats or inducements.

(3) Political parties, factions and individuals may have conflicting political interests in trade policy for a variety of regional, factional and ambitious political reasons.

In a country blessed with reasonably good government and political culture those conflicts are not usually too hard to resolve. Leaders plan, propose, consult, conciliate, persuade, or fight and win on enough of the issues in (2) and (3) to arrive at national purposes and policies under (1) which have enough of the virtues, and the public and press and parliamentary support, to prevail. In the process some of the self-interested contenders get what they want and others don't. In a good system and culture those who get what they want do so because what they want accords with a national strategy which attracts enough of both interested and disinterested support to get adopted, and then performs well enough to retain support and continue to perform well enough.

Public choice theorists tend to select some different facts and assert some different causes. Industries are said to get protected by bringing threats, persuasions and temptations to bear on politicians. They contribute to party funds and hire individual legislators as lobbyists. They threaten to shut shop and move to Mexico then have the press tell the people that the rusting factories and queues of unemployed that they leave behind are the politicians' fault. Their self-seeking campaign is not effectively resisted, because the consumers who will lose by paying protected prices will each suffer only marginally, and they are not organized or strongly

represented in the corridors of power. So the concentrated pressure of a selfish few overcomes the diffuse resistance of the selfish many. Besides inflating the protected industries' profits, the tariffs do two other kinds of harm. They distort the national economic structure, retaining industries of less advantage whose resources ought to be switched to industries of greater advantage. And because such rich pickings are available, they are sought by many more firms and industries than actually achieve them. (Why invest in the latest vintage of equipment when for a quarter of the cost you can buy enough tariff from venal politicians to protect the old plant and keep it earning?) The campaign costs in time and money of all the unsuccessful rentseekers must be added to the social costs of the tariffs which the successful contenders achieve.

Why such different accounts? There seem to be three main reasons. The first account above reports both the self-interests and the public concerns of the contenders. The second account reports only the self-interests. (One consequence is that it does not explain why so many contenders for protection don't get it.)

Next, the first account assumes that there can be good and bad uses of economic protection, and the task of good government is to sort better from worse. The second account assumes, and many of its authors insist, that *all* protection reduces national income and is therefore bad.

Finally, the first account was written with West European, East Asian and Australasian as well as American history in mind. Most accounts of the second kind are written by Americans, including many public choice economists, who generalize from some periods of US trade policy. So the two accounts differ partly because they are about partly different subjects. The non-American countries have not all had good government and political culture at all times - some have had some of the world's worst. But no historian of Scandinavian, German, French or Japanese trade policies, or some periods of British and Australian policy, could accept the public choice generalizations as sufficient accounts of those countries' policy-making processes. They are not wholly convincing about American policy either, after half a century which has seen big reductions of American protection. But to the extent that business lobbies do have more influence over American than over European legislators, some historical and institutional factors help to explain the difference.

There are other qualities - including speed of action, effectiveness and generosity - in which American government has often been superior to European. The point is not that either is in all ways best. It is that the

quality and the particular capacities of democratic government vary - from task to task, from time to time and from country to country. And some national policy options can vary accordingly.

A conclusion Most trade policy, like much other policy, issues from elements of short- and long-term self-interest, long-term prudence, and disinterested public and elite concern. Good political systems and cultures are those in which the public concerns tend to prevail, exchanging more support with private interests which accord with good public purposes than with private interests which do not.

TRADE THEORY: A SUMMARY

Some trade controls increase national income. Some controls reduce national income, without compensating benefits. And some controls reduce income but have other effects which may be judged more valuable than the lost margins of income. In that order:

Controls which may increase national income

Import controls, or public aids to export or import-replacing industries, may increase national income if they enable the national economy:

- to employ resources which unaided market enterprises would not employ
- to balance foreign payments which would otherwise be balanced by worse means, for example by improvident asset sales and debt, and/or market depreciation of the national currency, which would eventually cost more income than the trade controls will cost
- to stabilize market expectations for investors in industries of actual or potential advantage which have long lead times but quick-changing international risks
- to enable a promising industry to achieve economies of scale.
- to protect key industries whose linkages and externalities enable clusters of other, including unprotected, industries to develop better scale, technological advances, co-operative research and development, new export links, etc.

Undesirable controls which may reduce national income

- . Tariffs which protect less efficient industries whose resources would otherwise be employed by more efficient industries. ('Would'. 'Could' is not enough, especially in economies with persistent unemployment).

- . Tariffs justified by any of the good reasons listed above and below, but levied at unjustified rates

- . Tariffs which protect industries which do not need protection, but use it to raise their prices or run down their plant to uncompetitive levels

Desirable controls which may reduce national income

Protective measures which reduce national income may nevertheless attract and deserve support if they:

- . improve environmental or other conservation
- . defer income, for example from exhaustible resources, for use by future generations
- . reduce inequalities and inequities in the distribution of income
- . improve job and income security
- . protect valued elements of culture
- . block or discourage the import of harmful products.

In practice judgment is rarely as easy as those neat lists suggest. Problems of causal analysis and uncertain forecasting are discussed later in this paper.

Money and Credit

All money is now fiat money: it is money because some national government says it is. Additions to the supply of it can be created, under public rules, by public or private banks. Experts familiar with the system are begged to be patient with a brief sketch of it for other readers.

PUBLIC BANK MONEY

Each country's Central or Reserve Bank acts as banker to the government and to other banks, and in most countries it regulates the other banks. It has two main ways of creating money. It can open an account on which government writes cheques, which other banks accept. Each cheque creates new money, i.e. money that is not transferred from anyone else. Or it can create credit for government or other borrowers by opening accounts from which they borrow.

Each method may initiate a 'bank multiplier'. As the new money is spent, those who receive it deposit a good deal of it in other banks. That may enable those banks also to create more money, under rules sketched in the following section.

PRIVATE BANK MONEY

Centuries ago, gold and silver coins were the main European money. It was easy to steal, so rich people often lodged it in goldsmiths' strongrooms. The goldsmiths - or bankers, as they eventually became - gave the depositors receipts for the gold held for them. Those notes came to be traded as substitutes for the gold they represented. Owners could make payments with them. Those who received them could exchange them for gold at the banks which issued them or, as the system developed, at other banks which would then settle with the banks which issued them. Thus were cheque money and banknotes born.

Bankers who held depositors' gold could earn interest by lending it to other people - or by lending them similar notes which entitled them to gold on demand. Those notes also circulated as money, because people who

used them were confident that they could convert them to gold if they needed to.

A **multiplier** thus set in. The goldsmith-bankers found that they could fairly safely lend more than they had, because it was unlikely that many noteholders would want to turn their notes into gold at the same time. A bank which stored \$1000 of a depositor's gold might lend notes for \$1000 to each of two or three borrowers - or as time went by and bankers grew bolder, to five or ten borrowers. The bank trusted that most of the borrowers would pay regular interest and repay the \$1000 when it was due, and that no more than one in five or one in ten of the noteholders would ever demand gold for their notes. Bit by bit confidence in gold was supplemented - and in the end, replaced - by confidence in the bankers. They were not expected to back every note with gold, they were merely trusted to hold enough reserves to meet any likely demand for gold.

Now - centuries later - banks' reserves are regulated by law, bank notes are issued and sold to the banks (for cheque money) by government, and most of the money in use is neither gold nor banknotes but cheque or card money: only the banks' accounts record its existence and its depositors' and borrowers' rights to it.

Suppose the reserve requirement for the time being is five per cent. A bank must hold \$5 in reserve for every \$95 it lends. A customer who has sold his house deposits the proceeds in his bank. Another customer offers that bank a hitherto debt-free asset - her house, her farm - as security, and if the bank has the necessary reserve it lends her \$100 000. She spends that on various goods and services and most of the people who receive it bank it. The banks which accept it need only reserve five per cent of it and they can lend the rest - to borrowers who spend it, passing it to people who deposit it in their banks, which in turn reserve five per cent and lend the rest - and so on. In principle the multiplier might multiply a new loan by eighteen. In practice it is never as powerful as that, because quite a lot of the new money escapes from the banks. Some borrowers send money abroad. Most of them keep some in cash. A lot is paid to government - as taxes, public service charges, or to buy government bonds - and because government does not bank with the commercial

banks any money it receives is lost to them, at least until government spends it. And the banks do not always lend as much as their deposits and reserves would allow them to lend, because they cannot always find enough borrowers whom they regard as sound. But despite those and other limitations the multiplier does work, and can expand the amount of money in a national economy, adding spending power for some without necessarily taking any from others. Hence a paradox: when critics complain that private banks create money out of nothing that is not true of the banks one by one: each can only lend money that has been lent to it or deposited with it. But it is true of the banks collectively: as the money which each lends is deposited in other banks and lent again, the 'bank multiplier' can increase the whole sum at the citizens' disposal: the total they own plus the total they have borrowed. The multiplier can also work in reverse if depositors lose income, deposit and borrow less, or repay more of their bank debts than the banks can find new borrowers for.

Private fractional reserve banking thus became the main means by which, in peacetime, growing economies created the rising quantities of money that they needed. But as originally developed by the bankers the system had three troublesome features:

- . The value of the money depended on confidence in the banks: in their honesty, their competence and an absence of bad luck.
- . All additions to the supply of money were created in the form of interest-bearing debt.
- . The money went only to borrowers whom the bankers believed they could trust: people or firms who could earn the means of repaying the loans, were honest enough to repay them, and (in many cases) had property to pledge as security.

Each of those features had some implications for government.

Confidence Perfectly honest and reasonably prudent banks could fail if rumors prompted depositors to panic, demand payment of gold and exhaust the banks' reserves. Unlucky or incompetent bankers could fail by making too many bad loans to borrowers who could not repay. Dishonest bankers could too easily steal from their depositors. If they paid themselves unduly generous directors' fees and dividends and ran their reserves too low it need not even count as stealing. Bigger-scale theft could leave banks insolvent, owing more than they were owed, but safe from detection as long as they kept their customers' confidence.

Competition can be dangerous to bank safety. Banks can compete safely enough by shaving the 'spread' between the rates of interest at which they borrow and lend, and by offering their customers better advice and customer service. But they can also compete for market share, and for a wider spread and faster growth, by lending at higher interest to riskier borrowers than their competitors are doing. When the borrowers are daring technical or business innovators, the risks may be productive. But among borrowers at high rates of interest those productive customers tend to be heavily outnumbered by over-gear'd gamblers on changing asset values: on takeover share prices, general share values, city land prices and development rights; and also nowadays on changing relations between national rates of interest, inflation and exchange. By financing those operators, bad banking can beat good for market share and (sometimes, with luck) for big, quick returns. And that in turn can drive good bankers to shave *their* safety margins, defensively.

Safety Thus the private banks needed public help. They needed public supervision for protection from each other, and to let their customers know that they were honest and solvent and holding adequate reserves. And they needed a lender of last resort - a source of cash for solvent banks which suffered panic runs on their reserves.

Step by step through the last three centuries governments have acted to meet those needs. They have also constrained the banks, in various ways, to serve national economic purposes. That has prompted a distinction between 'prudential' regulation to keep banks honest and solvent and liquid, and 'economic' regulation to influence their services to particular industries and more generally to national rates of investment, employment, inflation, and balance of payments. The distinction is misleading. Rules to keep banks safe can't help affecting their economic performance. Regulating their economic performance can't help affecting their temptations, and safety. Neglect of that second relation has lately had severe effects as governments were led to dismantle what they misunderstood as purely economic controls.

In English-speaking countries, and some other parts of the world outside Western Europe, governments regulating banks have lately tended to do so on false assumptions of two kinds. The first is the theoretical belief that bankers' market situations and incentives will prompt them to give better economic service the freer they are from most economic regulation. The second is the practical mistake of assuming that the banks' safety is sufficiently assured by existing prudential supervision and

has owed nothing to economic policies and regulations. The experience of twenty years of deregulation suggests that the economic regulations were not preventing better economic performance, they were preventing the worse performance of the 1980s and since. And besides their economic services they were also contributing to the banks' safety, which has also deteriorated since they were repealed.

PRUDENTIAL REGULATION

National rules vary, but in most countries the national government licenses private banks. It requires that they render regular accounts to the Central Bank. It specifies the kinds of business that banks may or may not do. And it, or the Central Bank, regulates the relation between the banks' reserves and their lending.

The Central Bank acts as lender of last resort to the private banks. That maintains such confidence in them that the facility rarely has to be used. Banks can become not just illiquid but insolvent, owing more than they are owed - or more than their creditors are likely to repay. Though not legally obliged to do so, governments generally rescue them for their creditors' sake. Recent US and Japanese rescues of some of the world's biggest banks have been very expensive.

ECONOMIC REGULATION

Governments and their Central Banks have regulated commercial banks and other financial institutions for a wide range of economic and social purposes. The ways of doing it have included action to regulate or influence:

- . rates of interest
- . the quantities and directions of lending
- . the amounts which banks may borrow, on what terms, from what sources
- . the operations of other financial institutions including savings banks, building societies, credit unions, and insurance and superannuation institutions
- . rates of exchange with foreign currencies, rights to buy or borrow foreign funds and to lend in foreign countries, and what nationals are allowed to do with foreign funds which they earn or buy or borrow.

INTEREST RATES

Rates of interest vary with risks and administrative costs, but here it will do to focus on the base or average rates - i.e. on the level of the whole set of rates at any time.

There are some market relations between the supply and demand and price of credit. But they are different from the relations between the supply and demand and price of most market goods. In most circumstances (though not in some wild booms) if the price of credit rises, the demand for it tends to decline, as with other goods. But so does the supply, more often than not. That is because prudent bankers only lend to borrowers who are likely to pay the interest and repay the capital. The lower the rate of interest is, the more borrowers can pay it. They usually include more sound borrowers. A great many homebuyers, and many firms in competitive industries, are among the safest debtors but have income constraints which limit the rates of interest they can pay. The more sound borrowers there are, the more the banks are usually willing to lend (within their reserve limits) whether or not they also allocate some of their lending to riskier borrowers at higher interest. So as the price of credit declines, the demand for it and the supply of it tend to increase together, and they tend to decline together as the price rises. In economists' jargon there is no equilibrium price or quantity traded: at *any* rate of interest there is unsatisfied demand, i.e. there are would-be borrowers to whom the banks will not lend.

It is important to distinguish (i) the way credit is allocated at any base rate of interest, from (ii) the way changes in the base rate affect the allocation. In the first case, bankers generally try to adjust rates to risks to yield the same average return to all their categories of lending. If the rate of interest for consumer credit is twice the rate for home-purchase loans, it is because the administrative costs and the risks of non-payment on consumer credit mean that to average the same *rate of return* on the two, the consumers' *rate of interest* has to be twice the home-buyer's rate. On that principle banks don't make more profit from lending at higher rates, they claim to average the same profit from all categories of lending.

But when the base rate itself changes, there are other effects. The safest lending at (say) a base rate of 5 per cent may not be to the same borrowers as could afford to borrow when the base rate was 2 per cent. Further effects follow when inflation makes a big and perhaps changing difference between the nominal and real rates of interest. Borrowers who can afford to pay 3 per cent of real interest when there is no inflation may not be able to borrow at all if lenders expect 5 per cent inflation and add that to the real interest rate to make a nominal rate of 8 per

cent. Nor will the same range of borrowers be bidding for funds if (say) the government changes the real rate to 1 per cent, or the bankers collectively change it to 5 per cent. The effects of different base rates (nominal or real) are the subjects of the following paragraphs on interest and employment, interest and productivity, and interest and inflation.

At any rate of interest, bank officers tend to ration credit to those they regard as reasonably safe borrowers at that rate, leaving some willing borrowers unsatisfied. So there is no market-clearing price: no rate of interest at which the supply matches the demand. The rate of interest cannot perform the equilibrating function which prices perform in efficient goods markets. And except for bond and debenture issues, which are impractical for most borrowers, there is no market alternative to the administrative allocation of loans.

There can be an equilibrium rate in another sense. In particular national conditions there may be a rate of interest which allows full employment if other conditions allow it. Through its effects on investment that rate contributes to an equilibrium between the supply of jobs and the demand for them. But market forces of supply and demand for credit cannot be trusted to arrive at that rate. It will usually need to be contrived by government. Reasons follow.

Interest and employment

Most new investment by established private firms is financed by the firms' earnings. Of the remainder, some is financed by selling new shares. And a varying proportion, especially of housing and small business investment, and office-building and other real estate development, is financed with borrowed funds. That range of investment and consequently of employment tends to be sensitive to the rate of interest. So the level and stability of the rate set limits to the amount and kind of new investment. But the supply and demand for credit do not determine its price in a normal market way. Nor can the forces which actually do determine rates of interest be expected to arrive at a full employment rate. Rates of interest commonly arise from 'the interaction of such factors as monetary policy, conventions employed in financial markets and the confidence in those conventions. There is no reason to expect that those factors will combine so as to determine a long-term rate of interest which will generate a demand price for capital goods and a resultant rate of investment that will ensure full employment.' There is even less reason now that countries with trade and

exchange deficits balance their payments by borrowing footloose foreign funds, and have to keep their interest rates high enough to attract those funds.

Conclusion An efficient and stable rate of interest can only be imposed by government 'as an integral part of monetary and macroeconomic policy; it does not arise spontaneously'. Complex evidence and argument support those conclusions. There is an account of them in Colin Rogers, *Money, Interest and Capital* (1988) from which the above quotations and conclusions come.

Interest and productivity

An important but neglected effect of the rate of interest is on the *composition* of the demand for credit. The demand varies over time with the phases of the business cycle and other conditions. But at any particular time there are usually more applicants for loans the lower the rate of interest is. No bank lends to all the applicants. Bank officers decide which of them to lend to. The lower the rate, the more safe options and the more productive options the lending officers have. As the rate rises there tend to be fewer willing borrowers, including fewer safe borrowers and fewer productive borrowers. This is the most basic and troublesome principle of money marketing, so it is worth spelling it out in some detail. Below are six categories of capital borrowers, i.e. borrowers for other purposes than debt service or consumer credit. They are in *positive* order of likely productivity, but *inverse* order of the rate of interest which they are likely to be willing or able to pay:

1. Price-takers in competitive industries, who cannot afford to mark up their prices to pay high interest, and who may face longer-established competitors who are less dependent on credit and so have lower current costs of capital. (Many manufacturers, house-builders, truckers, retailers, providers of services to business.) Marginal homebuyers whose incomes can service the necessary mortgage loans only at a dependably low rate of interest. For long-term borrowers the expected stability of the rate may be as important as its opening level.
2. First-home buyers with middle incomes. Investors in new housing to let at low or medium rents. Enterprises which are unusually profitable because they are monopolist, oligopolist or unusually efficient or inventive: their rates of profit may enable them to borrow at any rate

of interest, but those profits also enable them to finance themselves from their earnings without much need to borrow, so they generally avoid paying high interest.

3. Investors expecting some continuing capital gain as well as income. Affluent households improving already-adequate houses, trading them for better ones, buying second houses.

4. Developers using borrowed money to create assets (such as office or apartment blocks) whose rents could not service their debts - but whose developers hope to sell the assets quickly to permanent owners investing their own money.

5. Firms attempting debt-financed takeovers or buying and selling assets for capital gains.

6. Financial speculators gambling daily on changing and future rates of inflation and interest and exchange, and other enterprises dealing in forward markets to hedge the risks which the speculators create for them.

That is a very rough guide. There are important exceptions to the inverse relation between price and productivity. Some of the most fertile lending is to risky new enterprises of a productive kind experimenting with promising but untried products or markets or methods of production. Rates of interest rightly match the estimated risks. But promising ventures of that kind are comparatively few, and providers of their venture capital often finance them by buying shares rather than lending to them. So they do not attract much of the whole flow of credit. For most of that flow it remains true that the lower the prevailing rates of interest, the more productive borrowers the banks can find.

It is still a complicated market with many exceptions to those group tendencies. There may well be *some* borrowers from most of the groups at *any* rate of interest. Nevertheless the net effect is usually as described: the higher the base rate of interest before adjustments for costs and risks, the fewer the safe borrowers, and the less productive the banks' lending decisions and the overall allocation of resources *can* be or are likely to be. Economic theory which asserts or (commonly) assumes that national or international capital markets can get funds used most productively by allocating them to the highest bidders, or at the highest rate of interest at which acceptable borrowers can be found for as much as the lenders want to lend, is simply false, and a dreadfully perverse influence on policy-makers.

But in many circumstances high interest serves bankers' interests best. And the conflict between their

profit-seeking interest, their borrowers' interests and everyone's interest in the productive allocation of resources is not like the conflict of interest between buyers and sellers of most market goods, to be resolved efficiently by competitive market pricing. Hence the need for economic as well as prudential regulation.

Interest and inflation

Lenders who expect inflation want to protect the value of the capital they lend. They do not want to be repaid in inflated currency with less purchasing power than they lent. Most financial institutions try to protect them by adding the expected rate of inflation to the rate of interest. Since rates of inflation are hard to predict, banks now make most of their loans either for very short terms, or at rates of interest which the banks can vary during the term of the loans. The economic importance of this response to inflation has not had the attention it deserves.

Suppose that in stable conditions a bank lends \$1,000,000 for ten years at 3 per cent interest per year. It will be paid \$30,000 interest each year for ten years. Then it will get its \$1,000,000 of capital back.

Compare what happens if a bank expects 10 per cent inflation per year, so adds 10 percentage points to the rate of interest. At 13 per cent its \$1,000,000 now earns \$130,000 each year, called 'nominal' interest because only \$30,000 of it is the 'real' interest which pays the bank for the use of its million. The remaining \$100,000 is paid to maintain the real value of the capital \$1,000,000.

Over ten years both those loans return the real purchasing power of the \$1,000,000 the bank lent. But there is a critical difference: the second loan repays a lot of it much earlier. In the first year the borrower at 3 per cent pays the lender \$30 000, the borrower at 13 per cent pays the lender \$130 000, i.e. the same \$30 000 of real interest plus \$100 000 which is really an early return of capital. That \$100 000 of slowly diminishing value used to be lent for ten years. Now it is only lent, in practice, for one year. Similarly the second annual payment will return some capital value which has effectively been lent for two years. If inflation has continued as expected, the \$1,000,000 of capital repaid after ten years has much less value than the \$1,000,000 which the bank lent ten years before; but the lender has had the rest of the real value back in annual instalments, disguised as interest. The annual inflation adjustment would make better sense if it was added to the capital debt rather than to the interest payment. The loan would then be capital indexed to the rate of inflation, with the original value of the capital in the borrower's hands for

the full term of the loan. And the annual adjustments could reflect actual rather than expected rates of inflation.

Most long-term lending suffers in the same way. A normal credit foncier mortgage loan repays changing proportions of capital and interest each year, to allow the borrower to make level payments throughout the term of the loan, with no capital debt remaining to be repaid at the end of the term. In stable conditions most home-purchase loans, for terms of twenty years or more, repay about 2 per cent of the borrowed capital plus one year's interest in the first year. The capital payment increases, and the interest payment on the remaining debt falls, through each year of the term. But if (say) 10 per cent for inflation has been added to the rate of interest, such a loan must repay about 12 per cent of its real capital value in its first year. *Ten* per cent of inflation has thus been allowed to increase the opening rate of capital repayment by *five hundred* per cent. Without any change in the formal term of years or the real rate of interest, most of the capital value has been lent for much shorter periods than before. The real value that the borrower has to repay begins high, and diminishes through the years. A convenient name for this effect of adding the rate of inflation to the rate of interest is 'sloped credit'. Many small businesses and middle- and low-income households with level real incomes are excluded from the market by the need for those high early repayments.

In practice very few long-term loan contracts are now written in that way with a rate of interest for the whole term of the loan prescribed in the contract. Instead, contracts empower banks to vary the rate of interest year by year through long loans; or the banks lend for short terms so that they can adjust the rate of interest to the current rate of inflation at each renewal of the loan. Either method transfers the whole inflation risk to the borrower. But whenever there is significant inflation the 'sloped' effect is the same with any of these methods of protecting the lender, and it excludes from the market many potential borrowers who could afford the credit to buy a house or shop or workshop or warehouse if they could make level annual payments of principal and interest from their level household or business incomes.

An alternative which could eliminate inflation risk for both parties could conveniently be called 'level credit'. The capital debt, rather than the rate of interest, could be indexed to the rate of inflation. In a standard mortgage loan borrowers would then pay the same real value year by year, incorporating the same changing proportions of capital repayment and interest. The annual payments would have the same real value throughout, with

their nominal value inflating at the rate of general inflation, in step with the borrowers' incomes which tend to do the same.

Capital-indexed lending would need some public help: minor legal provisions, and for each currency an official, regularly published deflator (a measure of inflation which avoids some of the distortions of consumer price indexes). It would be good if some governments would make those provisions. Market preferences of lenders and borrowers could then distribute lending between the two alternatives in a dual-flow credit market, and thus give a promising idea a practical trial. It might have some international uses, and allow more international loans to be denominated in the borrowers' currencies, if it could be combined with stable exchange rates.

How government can influence the quantities, prices and uses of credit

No economy has just one flow of credit. Other institutions besides banks borrow and lend money. Government cannot hope to regulate interest on every kind of credit or the use of every dollar of credit. But if it regulates some flows but not others, lenders may switch their funds from the regulated to the unregulated sectors. So to regulate interest rates effectively, government may also need to regulate some of the quantities and directions of lending. And that may be desirable for other reasons besides restraining rates of interest. To cope with those problems the following methods of public influence have worked satisfactorily in living memory, as the first two still do:

. **Public bank money** Public Central or Reserve Banks can create credit or new unindebted money for public purposes. Some reformers want all public investment to be financed by new, interest-free public bank money: why should government license banks to create funds to lend at interest to government, for private profit?

. **Private bank money** Government limits the amount of private bank credit by specifying the capital reserves the banks must hold, and their permitted capital/lending ratios. The Central Bank may also demand special deposits from the banks which do not count as reserves, and thus further reduce the proportion of their funds that they are free to lend.

. **Quantities and directions of lending** Central banks can ask or direct banks to vary their lending for

particular purposes. For example they may be asked to vary upward or downward, by some percentage, their current lending for agriculture, for manufacturing, for housing, for consumer credit or for other general purposes. When the quantity of credit is regulated in that direct way much trouble is avoided. The interest rate does not have to function as the main regulator of investment, and an enemy of its quality. It does not have to *contribute* to inflation by rising high during booms to *restrain* inflation (rising interest has both effects at once). With investment and consumer credit restrained by other means, the rate of interest can be kept low and stable.

. **Portfolio requirements** have often been applied to savings banks, building societies, life insurers and some other financial institutions. They could in principle be applied to commercial banks, though in practice it might take a long time for established banks to bring their lending into line with the requirements. It might for example be a condition of holding a bank licence that (say) two thirds of the bank's money on loan at any time should be for housing, agriculture, manufacturing, retailing, specified categories of small business, and government, in any proportions but at a regulated rate of interest. The rest of their business could be free of either restraint. If other financial institutions also have requirements appropriate to their functions, there can be low and generally stable rates of interest over much of the market without driving funds away to uncontrolled sectors - provided that there are also effective boundary controls.

. **Boundary controls** During wartime and through the third quarter of the twentieth century many countries regulated their people's access to foreign exchange, and their uses of it. Banks could deal in foreign exchange only for approved purposes, which rarely included borrowing or lending foreign currency. The primary purpose was usually to regulate trade and the balance of payments, and to direct available exchange to more valuable rather than less valuable uses. But the rules also had the effect of maintaining a boundary around the national financial system, so that banks could not evade internal regulations - or help their customers to evade taxation - by borrowing, lending or investing abroad. (There are always exceptions: banks are allowed foreign dealing for approved purposes of trade and travel, and may be allowed to hold a specified proportion of their assets abroad.) Such regulation can be irksome - but amply justified by the economic benefits of low and stable interest rates.

ADVANTAGES AND DISADVANTAGES OF FRACTIONAL RESERVE BANKING

Many critics have thought private credit creation a poor way to supply modern economies with the money they need. Why does the world persist with such an odd practice?

Advantages It works. It can and does expand the amount of money and credit as an economy grows. People and firms need banks to mind their money, provide cheque and card and electronic payment services, and accept savings and lend them usefully. That work keeps bank officers in daily touch with the demand for credit, and should make them experienced judges of borrowers' capacities. So it may be economical to have them also adjust the supply of money and credit to the demand for them, rather than have some other institution do it.

The system's pluralism has advantages. Nobody can be denied credit by a single refusal. Lenders and borrowers can shop around. Banks can specialize, or develop departments specializing in lending to particular industries. And borrowers who can't get credit on their business merits cannot try to get it by political means, as they might do if government owned the main source of credit.

The system has some elements of efficient motivation. As long as the banks are not excessively competitive, borrowers can be expertly assessed by officers motivated (by pride, institutional tradition and prospects of promotion) to advise them as helpfully and judge their risks as accurately as they can. Meanwhile interest as the price of credit may not be a good allocator of resources, but it does three other services. It helps to deter borrowers from borrowing more than they need. It pays the banks' working costs. And it provides earnings from which they can expand their services, either directly or by paying dividends which attract share capital.

Disadvantages As argued earlier, relations between the demand, supply and price of credit are not those of an efficient market. There is no market mechanism to determine what the base rate of interest should be. The market demand is not stable, but tends to be strongly, cyclically unstable. Left to themselves banks have often over-expanded credit during booms and contracted it harmfully during depressions. Nor do market forces necessarily direct credit to its most productive or socially desirable uses. Competitive bidding for funds cannot be relied on to allocate them most productively:

- . between housing and other needs
- . between households within the housing finance market
- . between monopolist and competitive enterprises
- . between naturally protected non-tradeable industries and unprotected tradeable ones
- . between uses likely to worsen the balance of payments and uses likely to improve it
- . between asset traders for capital gain and producers of goods and services
- . between producers of goods and services and purely financial speculators on future rates of interest, inflation and exchange, and derivatives thereof.

Arbitrage tends to level the risk-adjusted return to lending throughout the world market at any moment. But market forces do not stabilize the rates over time. Rates of exchange, and therefore rates of real interest and repayment across national boundaries, can fluctuate violently and unexpectedly.

The instability has other effects besides simple price effects. For some borrowers the stability of the rate of interest is as important as its level. High interest discriminates against some productive uses of credit; unstable rates discriminate further against some uses within that group. There are marginal homebuyers, investors in low-priced rental housing, small enterprises starting up in mortgaged premises, and farmers and manufacturers introducing new products or methods of production with long lead times, all of whom need long credit which they must service from limited incomes. Even when current rates are low enough, they cannot risk long loans whose nominal or real rates of interest may rise unpredictably. And the inflation risk on long loans which used to be carried by lenders is now carried by borrowers, as their banks require them to take successive short loans, or long loans with variable rates of interest.

Conclusion If profit-seeking fractional-reserve banking is to continue as the world's main source of money and credit it needs appropriate government. But that is not what most banks received from their national governments through the last quarter of the twentieth century.

FINANCIAL DEREGULATION (1) NATIONAL

There were important links between the internal deregulation of national financial systems and the opening

of their boundaries to allow free flows of capital and credit between them. But for clarity it will be convenient to follow the two histories in turn, then explore some compound effects of their interaction with each other and with the movement to freer trade.

History

The stringent financial controls introduced during the Second World War were relaxed step by step over half a century after the war. But for many governments the main change of mood, from confident financial regulation to a new faith in unhindered market forces (or in some cases a reluctant surrender to them) began in the 1970s. If we spare a page for some of the causes which converged to produce that change, it is only to emphasize that they were of more than one kind, and from more than one source.

Why did Western governments respond to a breakdown of international financial controls (to be noticed presently), and to the onset of stagflation in their national economies, by deregulating their financial systems?

The long postwar boom had been good: high investment, full employment, fast growth, low interest rates, stable exchange rates, low inflation for a time, generous new health and welfare services, a continuing reduction of inequality. It was easy to conclude that the economy was prospering naturally and no longer needed public controls which had been occasioned by war and postwar reconstruction. They could go, now that the world was back to normal. It seemed *better* than normal to many working people who for the first time had secure well-paid jobs, well-equipped houses, cars, reliable welfare services - and increasingly conservative opinions. Capitalism felt better than it used to feel from below. Business voices recovered some of the respect and influence they had lost through the disastrous depression of the 1930s.

But by 1970 the long boom had stalled. The simultaneous increase of inflation and unemployment was new and unexpected. It could be seen as discrediting the public controls which had failed to prevent it - or had helped to cause it, some conservative economists said.

Those shifts of opinion made it easier to argue for freer enterprise, smaller government, lower taxes and more faith in market forces. Some interested parties were ready to seize the opportunity. Some well-off people had always opposed the big government, high taxation and generous welfare that characterized the long boom. Bankers and capital owners could hope to be freer and richer - and many believed they would also be more productive - the less they were regulated. Many employers

disliked the bargaining strength which labor had with full employment and with welfare incomes available to the unemployed. When stagflation discredited the theory of managed full employment, neoclassical economists who had never accepted Keynesian theory began to regain their former influence. Private money financed new think tanks to develop and publicize arguments for privatizing the public sector, deregulating the private sector and reducing taxation especially of the rich. It was as if the appearance of flaws in the postwar economic system prompted conservatives, especially in the English-speaking countries, to recover their nerve and turn from defence to counter-attack, to 'roll back the state' and reverse the trend to greater equality. Social democrats still hoped to repair the full-employment policies, and cut inflation by persuading business and labor to accept price and wage restraints. But from the 1980s the winners in many of the developed countries' elections were leaders (including leaders of some Labor and Social-Democratic parties) who proceeded to dismantle a good deal of the postwar government of the economy rather than try to repair it.

Politicians had some professional reasons of their own for welcoming a change of direction. They were blamed for stagflation, and for contentious decisions about exchange rates now that they were held responsible for them. National and international regulations were becoming harder to design and enforce as they were evaded by ingenious new legal and technological means. The freer the currency traders became, the more effectively they could intimidate governments which tried to regain some control of them. One way or another, politicians could imagine that deregulation might allow them an easier ride. If the conservative theorists were right, deregulation would allow market forces to end inflation, balance the foreign exchanges and even perhaps restore full employment. If the theorists were wrong a deregulated world might at least blame market forces for its stagflation and exchange deficits instead of blaming politicians.

In those conditions, as part of the general shift of economic policies to the Right, national and international financial systems were radically deregulated through the 1970s and 1980s. Different governments took the steps at different dates, but the overall effect was a large freeing of the activities of banks and other financial institutions, including new institutions which were created to exploit the new freedoms. Two aspects of the liberation are particular concerns of this paper: (1) its economic effects, and (2) the light which those effects cast on the neoclassical economists' causal analyses of the effects of

the preceding controls. But first, a summary of the new freedoms.

Fractional reserves

Since 1988 in most OECD countries the amount of credit which a bank is allowed to create is no longer limited only by the amount of its deposits and its capital reserve. It is also subject to rules of 'risk-weighted capital adequacy' which work as follows.

Central banks require commercial banks to hold capital reserves of not less than a specified percentage of the amount they have out on loan. With the change to risk-weighted capital adequacy the required percentage came down from eight or ten (in different countries at different times) to five or less. A five per cent reserve means that for a bank to lend twenty of the dollars it owes to its depositors, it must own one dollar, debt-free. But the loans are now also rated for risk, and the safer they are the more a bank can lend, up to the twentyfold limit. Different countries define the risk categories differently, but in a representative system banks may be required to hold reserves equal to:

- 8 per cent of loans to individuals, to business, and to all borrowers outside the OECD
- 4 per cent of loans to public enterprises, and loans secured on residential property, within OECD countries
- No reserve is required for loans to OECD governments.

That may look more restrictive than the old rule which required one reserve ratio for all purposes, but it actually increases the amount the banks can lend because the old rules required reserves of 8 or 10 per cent or more for all lending. At a new overall requirement of 5 per cent the banks can lend about as much as before against the new 8 and 4 per cent reserves, then about half as much again as long as it is lent to rich countries' governments. Those governments' bonds pay the lowest interest in the market, but they are currency for some of the unproductive gambling which now accounts for nine tenths or more of transactions on the world capital market.

Quantities and uses of credit

Except for the broad categories of risk in the capital adequacy rules, governments in most English-speaking countries and most Central and South American countries no longer regulate or influence how banks distribute their lending to particular industries or types of

borrower. On the contrary, the World Bank and International Monetary Fund have often required governments of the countries to whom they lend to *deregulate* their financial systems, *open* them to foreign banks, and *stop* trying to shape their national economic structures by deliberate trade or credit policies.

Meanwhile the free international movement of capital funds at unstable rates of exchange creates demand for money to gamble on future interest and exchange rates and asset prices. It is thus money which, at least in the short run, its users do not want spend on producing or consuming goods and services. So the volume of money can expand beyond the commercial need for it without necessarily expanding demand and employment if the real economy is under-employed, or necessarily accelerating inflation if it is sufficiently employed. And some of the private banks who supply the gamblers with much of their money are themselves big gamblers in the casino. This paper will return later to a troubling question: if the gambling becomes too dangerous for the participants, or if governments or international institutions act to end it, what will the gamblers do with their funds? Inflate stock and share prices? Property prices? The exchange value of the US dollar or the euro as the safest currencies to be in? Buy assets which come cheap in indebted countries with vulnerable, undervalued currencies?

The gambling freedom combines with two others to reduce public influence over the quantity of money that private banks choose to create. The quantity of money circulating in a national economy is difficult to control if banks, firms, insurance and superannuation institutions are free to invest abroad, lend to foreigners or borrow from them. There is no limit to the number of new banks that most governments are now willing to register if they comply with the prudential requirements. Governments are left with two inadequate means of influence. Their budget surpluses or deficits can reduce or increase the money in circulation, and they retain some influence over the base rate of interest and thus over the supply and demand for credit. Both are less effective, and manipulating the rate of interest can be positively harmful, without the other controls which used to accompany them.

Democratic governments of developed and some developing countries which have directed and rationed credit to particular industries or uses have generally done it quite well and fruitfully. With and without democracy the Japanese government has practised 'directed credit' for more than a century, and recommended it fruitfully to South Korea and other tigers. It was trying to persuade the

World Bank to follow its example when it was persuaded to liberate its own banks, which soon discredited themselves by financing bubble booms and busts in share prices and property prices through the years immediately before and after 1990. That misuse of the new freedom should not discredit the disciplined banking which had earlier contributed to the industrial achievements of the Asian 'miracle', and to the postwar recovery and development of British and European economies.

Interest rates

For thirty or forty years before deregulation most governments limited the interest which banks could pay on deposits, or the rates at which they could lend for particular purposes, usually including housing and government. Outside the US many countries' savings banks were publicly owned and their rates were determined by policy rather than either market forces or regulation.

The slow increase of inflation, accelerating in the 1970s, widened the gap between nominal and real rates of interest. Governments and banks responded by adding expected rates of inflation to interest rates. The consequent 'sloped credit' was an inefficient response to rates of inflation which fluctuated unpredictably: there were periods of negative real interest when lenders were paying borrowers to use their money. Lenders took to lending short, or lending long at variable interest. Thus the inflation risk was transferred from lenders to borrowers.

It was partly in response to those difficulties that the shift to freer market policies was extended to banking. At dates between 1973 and 1990 most countries stopped regulating interest on any private lending. Governments still act to influence interest rates, but they do it now by different means and for different purposes.

Private banks tend to accept, as the base rate of interest at any time, the rate which Central Banks pay them on short loans to government. Governments or their Central Banks now manipulate that rate for three main purposes:

- . To contain inflation they keep interest rates high enough to restrain investment to a level which maintains significant unemployment. That weakens wage bargaining, keeps wage costs down, and restrains income and consumer demand.

- . To smooth the business cycle they try to depress investment during booms by raising the interest rate, and to revive it during recessions by lowering the rate. It is hard to know how far the device works (as originally intended) by its effect on marginal borrowers' investment decisions, and how far it has come to work as a signal to stimulate or

restrain business confidence in a general way. It is also hard to know how far it actually affects investors' decisions. The business cycle continues, though perhaps more mildly than it otherwise would. More investors may be moved by the quantity of unsold goods in their warehouses than are moved by the changing rate of interest.

Since they freed the international movement of capital funds, countries have to discourage capital flight, and those with exchange deficits have to attract foreign funds, by relating their interest rates to the best rates available around the world.

There can be conflict between those three purposes, but in most countries their collective effect is to keep interest rates much higher at every phase of the business cycle than they were before deregulation. Since 1981 long term real rates in the G7 countries (the US, Canada, Japan, Britain, Germany, France and Italy) have averaged three times their 1956-1973 average. Up to 1995 the smallest rise (50 per cent) was in Germany, the biggest (fivefold) in the United States. Besides restraining the quantity of debt-financed investment the higher rates also tend to worsen its composition and productivity.

Savings Banks

Public, mutual or private savings banks continue their special roles in Britain, France, Japan and elsewhere. They have usually been limited by law or policy to (1) accepting deposits and returning them to the depositors on demand; they do not run cheque accounts, so cannot be the main means by which their depositors make and receive payments in the course of their business; (2) lending their non-reserve capital and the deposits they could attract from depositors, without bulk-borrowing from other institutions; and (3) lending to government and for housing, and sometimes for farming, all at regulated rates of interest. In practice those economic restraints served also as quite effective prudential controls - but it was easy not to notice that. In the 1980s the US government and some Australian State governments called off the borrowing and lending restrictions without reconstructing the prudential controls. The US Savings and Loans institutions quickly misbehaved so badly that thousands of them collapsed. To rescue their depositors was expected to cost US taxpayers about \$450 billion. Some Australian savings banks still in public ownership were similarly liberated, hired managers from the private sector, and lost similar sums per head of the populations they served.

Other financial institutions

Some countries used to require insurance and superannuation institutions to keep all or most of their assets in their own countries, and to lend specified proportions of their funds to government and for housing at regulated rates of interest. Most of those controls have ceased.

Hire-purchase companies and other institutions which borrow in order to lend are regulated for safety and sometimes for consumer protection. So are a range of property trusts and investment trusts which manage funds on behalf of their owners. But governments were slow to bring those non-bank financial institutions under *economic* regulation, and their freedom allowed them to attract funds away from the banks by offering higher interest than the banks were allowed to offer. Bankers pressed governments to restore fair competition, either by extending the bank regulations to the new institutions or by extending the newcomers' freedoms to the banks. Most bankers pressed for freedom, and that is what most governments eventually gave them.

National boundaries

Most governments used to regulate their currencies' exchange rates, and the import and export of capital funds. They no longer do so. In most developed economies now, anyone with money can change it freely into any other convertible currency. The international uses of this freedom are subjects of the following section - but their most important effect is to weaken the internal government of national financial systems. Government cannot regulate interest rates effectively if that can drive funds out of the country to find better rates elsewhere. Portfolio requirements may not serve their national purposes if the required lending can be abroad, or if the rules can be avoided altogether by moving funds out of the jurisdiction.

Open frontiers do not only weaken governments' powers. They also weaken market disciplines. If private banks can borrow any amount of foreign money, and private owners can sell any number of income-earning assets to foreigners, market forces cannot stop a country spending more on imports than its exports and foreign holdings earn. As its foreign debts grow, and more of its assets are foreign owned, less current foreign earnings are available to pay for imports as year by year more are pre-empted to pay interest, rent, dividends and capital gains to foreigners. Market discipline cannot bite until the creditors

begin to doubt the debtor country's capacity to continue to borrow, each year, more than its income grows each year. But then the market discipline - in the form of the foreign banks' refusal to lend any more - may bite deep into the national standard of living. So may some of the policies dictated by the IMF, if it comes to the rescue in its usual frame of mind.

It is time to turn to those international aspects of financial deregulation.

FINANCIAL DEREGULATION (2) INTERNATIONAL

Market forces had allowed the financial extravagance of the 1920s and the record depression of the 1930s. Then from 1939 to 1945 strong public management and regulation organized the democracies' economies for war, fully employed and without inflation. Some of the new powers were continued for purposes of postwar reconstruction and social-democratic reform. Among other things those purposes required a better system of trade and exchange than had existed between the wars. The leading powers met in 1944 at Bretton Woods to negotiate a new international regime.

The United States had the biggest, most advanced economy, least damaged by the war. It had a trade surplus with the rest of the world, it was a net creditor, and compared with the rest of the world it had abundant investment funds, or capacity to create them. As a winner on all fronts its negotiators wanted free trade in goods and free movement of money at stable rates of exchange. They did not succeed in freeing the trade in goods. Britain and others desperately short of export capacity and foreign exchange, refused to surrender the right to regulate their imports. (It was not long since the US itself had industrialized behind a high tariff.) But the US negotiators did get the financial regime they wanted. The Bretton Woods agreement had four main elements. The US dollar was linked to a gold reserve at a fixed price. Other currencies' rates of exchange with the dollar (and therefore with each other) were fixed. The International Monetary Fund was created to supervise those arrangements, to lend to countries with temporary exchange difficulties, and to negotiate any necessary changes to the fixed exchange rates. And the World Bank was created to finance development projects, at first in postwar Europe then chiefly in developing countries.

The IMF and the World Bank drew their funds from member nations roughly in proportion to their national incomes. The IMF could advance foreign funds to countries in temporary exchange deficit. Keynes, as British negotiator, wanted the IMF to have a matching power to draw funds from countries with surplus foreign exchange, to give it an even-handed capacity to maintain exchange equilibrium. The US, the chief source of surplus exchange at the time, refused to give the IMF that power. Thus the British failed to get half of what *they* wanted. In the short run they got much of it in another way: the US made generous dollar grants and loans to Britain and Western Europe under the Marshall Plan and other aid programs. But as a permanent arrangement, fully convertible currencies at fixed rates of exchange would not work between countries with different export capacities, different import dependence and different market strength. There must either be some means of recycling surplus exchange back to deficit countries, or some means of restricting countries' imports to their capacities to pay. Once it was in full force the Bretton Woods regime was unlikely to work as planned.

But for more than half its life it was not in full force. Its terms provided for full convertibility of currencies for purposes of trade or travel. (Governments could still control the exchange of capital funds.) But for fourteen years, convertibility was not enforced. Most countries kept control of their citizens' access to foreign exchange. Many regulated the uses of whatever exchange their exports earned. Some restricted foreign investment and ownership within their territories. Broadly speaking, they did their best to restrict their imports to what they could pay for. Their capacity to pay was determined by their export and other foreign earnings, plus any dollar reserves they had, any international aid they were given, and some cautious foreign borrowing. And most of them discriminated between more necessary and less necessary imports.

Thus what operated from the end of the war through the 1950s was a cooperative system. From Bretton Woods came fixed exchange rates and the new World Bank and IMF, but not yet the intended trade freedoms. From the United States, big financial aid to European recovery. From the British and European and some other governments, strict national regulation of trade and exchange. It was a coherent regime, and despite some irksome bureaucracy it worked better than any of the freer arrangements which followed it have done. (Better for productive investors, for citizens as workers and

consumers, for economic development, and for the distribution of wealth and income. Not always better for bankers or owners of uncommitted capital funds.)

Economic growth averaged better than 4 per cent a year, and trade grew even faster.

But - perhaps because it was such a coherent regime - it was easy to misunderstand its success. Its national and international elements complemented and protected each other. But was it safe to assume that each element could if necessary work well on its own?

- . Could fixed exchange rates survive if national governments no longer regulated their countries' trade and exchange to live within their means?
- . Could they even survive free convertibility? Would the IMF's funds suffice to correct national exchange deficits after US aid ended?
- . Would market forces allocate capital funds to their most productive uses if governments stopped rationing foreign exchange and directing much of it to productive uses?

To each question the answer turned out to be NO. Each component of the system depended on the presence of the others.

Breakdown of the Bretton Woods regime

Through the 1950s the British, West European and Japanese economies recovered and achieved high rates of growth. With American aid their rising output and exports began to reduce their general shortage of dollar exchange. As they accumulated some dollar reserves they expanded the list of purposes for which they allowed private banks and firms to buy US dollars. By 1959, led by France and Germany, the major powers were allowing general convertibility for purposes of trade and travel. Trade also was becoming freer, though still subject to many tariffs. Some countries regulated their nationals' new foreign investments, and foreign ownership of some classes of national property. But there was enough convertibility to meet the Bretton Woods requirements. So from 1959 the Bretton Woods regime was in full operation.

Twelve years later it broke down and was soon afterwards formally ended. Why? Basically the *international* system could not work satisfactorily without the *national* self-discipline which had accompanied it through its first decade. Some countries could produce more efficiently and trade more successfully than others. As those others relaxed their import controls, and their control over inward and outward movements of capital funds, they went into exchange deficit. In its full form the

Bretton Woods system was an attempt to balance international payments:

- . *without* requiring any public restraint of imports by deficit countries,
- . *without* compulsory transfer of funds from surplus to deficit countries,
- . *without* market adjustment of exchange rates, and
- . *with as few changes as possible* to the fixed exchange rates.

That was not a coherent set of policies. As Keynes had feared, it could not regulate international payments satisfactorily for long. How *could* it work between countries with different export capacities, different demands for imports, and different rates of inflation? Through the 1960s its troubles took four main forms: a shortage of IMF funds, some conflicts of national interest, some ill effects of the 'creeping convertibility' of capital, and a nasty new business of betting on likely national devaluations and forcing them to happen.

IMF resources The IMF ran short of funds for helping countries with exchange deficits. Its resources were increased a number of times, but with rising disagreement about the need for them and about their proper use. Some advances worked as planned: they helped the countries concerned to get out of debt and develop their capacities to earn the exchange they needed. Other advances failed, and deficits continued, while the national governments which supplied the IMF funds wondered why countries in deficit should be financed to go on living beyond their means.

National conflicts Because of some continuing trade deficits, and because national currencies were being inflated and losing purchasing power at different rates, some of the fixed exchange rates clearly had to change. Governments were generally reluctant to change them, but they were not *equally* reluctant. Surplus traders were *very* reluctant to *revalue* their currencies: that was expected to make their exports dearer and their imports cheaper to their respective buyers and to harm employment and growth in their tradeable industries. Deficit trading countries were readier to *devalue* their currencies, hoping for reverse effects on their tradeable industries. (Those effects don't always follow, but they were confidently expected at the time.)

Under the Bretton Woods rules, the way to revalue or devalue a currency was to raise or lower its rate of exchange with the US dollar. When there were more national devaluations than revaluations, their combined

effect was to raise the exchange value of the dollar without intending to, and without US government consent. But as the master currency of the system and its only link with a reserve of gold, the dollar itself could not be devalued to counter the unwanted effects of others' devaluations. The time came when the American authorities wanted to counter those effects. Through the 1960s the US began to develop an exchange deficit. It still had a positive balance of trade. But capital movements put it into annual deficit and began to run down its reserves. Dollars left the country as US corporations invested heavily abroad. Capital was exported as foreign aid. Overseas military spending increased, especially in Vietnam. But there were also some unexpected uses of the new market freedom. Many economists (not including Keynes) had expected that convertibility and freer movement of capital funds would bring more productive allocation of capital. But they were in for some surprises.

Footloose funds Inventive owners and borrowers of capital funds developed old and new ways to make money without necessarily producing anything. Examples:

- Owners moved funds abroad to avoid taxation.
- Americans pioneered the use of bank credit to finance corporate takeovers. When the practice spread to other countries, some of it continued to be financed by US banks.
- The US government still limited the rate of interest that banks in the United States were allowed to pay to their depositors. So funds flowed out to find higher rates elsewhere. Countries trying to balance their current exchange deficits responded by raising their interest rates to attract and retain those footloose funds. The higher the rate of interest, the more it tended to depress investment and growth. Thus instead of increasing world investment as deregulators promised, the free movement of capital funds reduced it, and probably also reduced its average productivity.
- Gambling on exchange rates progressed from a passive guessing game to a more active manipulative one. Rates still had to be changed officially, by government announcement, and governments tended to delay such changes as long as they could. But speculators knew which countries were accumulating deficits and could guess which was likely to devalue next. When the time seemed ripe they would sell that currency as fast as they could find buyers, who often included the target country's Central Bank trying to defend its currency. That pressure tended to force a bigger devaluation than need otherwise

have happened. The gamblers could then buy back the currency for a capital profit.

A number of those developments helped the US to lose dollars. The breaking point came when the Bretton Woods rules forced it to lose gold.

Gold World output, trade and money were all growing. The supply of gold was not growing at the same rate. Its fixed price might have to rise, which would in effect devalue the US dollar. Meanwhile the British, European and Japanese economies were growing fast, expanding their trade, balancing their payments and accumulating dollar reserves. But with gold becoming scarcer and the US running into exchange deficit, might those reserves be safer in gold? Under the Bretton Woods agreement the US dollar was exchangeable for gold on demand. British and Europeans began to demand gold for some of their reserves of dollars. By 1971 about a third of the US gold reserve had gone. In that year the US government decided to stop selling it.

That turned the US dollar into paper fiat money like everyone else's. The government then devalued it by forcing European governments to revalue their currencies against the dollar. (It levied an additional 10 per cent tariff on their exports to the US until they complied.) In 1976 the governments formally agreed that each would manage its own exchange rate. Some governments tried, for a while, to fix their rates by regulation; then freed the rates but tried to steady them by market dealing; then freed them altogether, except for some regulation of exchanges within Europe.

Lessons from the 'Golden Age'

It would not make sense to recreate the Bretton Woods regime now. It was flawed in its own conditions, and some of the conditions have since changed. But it is wise to remember how the system worked, both to avoid repeating its mistakes and to understand what it achieved while it lasted.

The comparative financial stability of the 1950s owed much more to national than to international government. Specifically:

- The United States recycled the world's main exchange surplus to advanced countries with trade deficits, and to some others. It did that through its aid programs, its overseas military spending and aid to allies, and its private sector's expanding foreign investment. That greatly reduced the pressure for either official devaluation or

market depreciation of the currencies of the countries with trade deficits.

- As long as their shortages of dollar exchange continued, most countries restricted their imports to what they could pay for without excessive foreign borrowing.
- Private traders could not evade those controls or push the import bills above prudent limits by having their banks borrow foreign money for them, because their governments did not allow them to borrow foreign money for that purpose.
- Poor countries had few attractions for private lenders. To augment export earnings they relied chiefly on aid from foreign governments, the IMF and the World Bank, who tried not to put them too far into debt.

The controls on capital movements were imperfect after 1959 but for some years they were still good enough to allow governments to regulate internal interest rates without driving much capital abroad. Stable rates of exchange could thus be accompanied by low and stable rates of interest. Those were ideal financial conditions for long-term investment and fast economic growth, which - from that and other causes - duly occurred, in what some now call the golden age of capitalism.

But through the 1960s, with full current-account convertibility, the capital controls began to be relaxed and by-passed. That allowed two things which the strict regime had not allowed. It allowed a small but increasing flow of capital funds to leave home in search of higher rates of return than they could earn at home. That was the beginning of the end of the low and stable interest rates which served investors so well. For example the British government insulated its regulated national economy from the freer foreign dealings of the London money market. With the US government still limiting the interest which US banks were allowed to pay their depositors, London banks began to borrow dollars from Americans at higher rates to lend back to other Americans at higher rates still. As other rules were relaxed it became possible for private market activity to put national economies into international deficit and debt. Borrowing foreign capital could do that. So could the use of borrowed funds to spend too much on imports, and to do so without necessarily depreciating deficit-trading countries' currencies. In that way, and in other ways noted earlier in relation to trade theory, freer trade in credit weakened the market mechanisms which trade theorists believed would discipline free trade in goods.

Meanwhile the Bretton Woods years showed how countries facing trade and exchange deficits, or needing more foreign exchange for developmental purposes, can discipline themselves without reducing any essential business freedoms. They can stimulate and assist their tradeable industries in a number of ways; limit imports by tariff or regulation; attract useful direct foreign investment but keep public and private borrowing from foreigners within prudent limits; and if necessary, ration the available foreign exchange to its most necessary and productive uses.

Plenty of developed economies have enjoyed market-balanced trade and payments without much, or any, of those public measures. But some cannot, and there is nothing in the nature of unaided market forces which *ensures* international equilibrium. For countries facing serious trade or exchange deficits, some deliberate re-shaping of national economic structure by those familiar public means has proved to be the only reliable strategy in the long run. It was British, European and Australasian policy through the Bretton Woods years, and Japan's, South Korea's and Taiwan's through their decades of fast growth. Some of the necessary public action may be badly done - but in developed and fast-developing economies its financial effects have nowhere been as destructive as the effects of unregulated trade and debt have been, since the 1970s, in some countries at every stage of development.

ABOUT TURN

The Bretton Woods regime and the national policies which supported it plainly needed some re-design. But instead of repairing them the leading governments chose to discard most of them. Step by step through the 1970s they dismantled much of the economic regulation and public market management of their financial systems and their financial relations with each other.

One principle survived the demolition, in ironical form. Leading Western governments, and international agencies staffed chiefly by US-educated American and British economists, continued to believe that international equilibrium depended on national self-discipline. But the discipline they now had in mind was born of a union of winners' interests with a market-trusting version of neoclassical theory. Governments must *not* try to shape their national economic structures, *not* regulate their trade or their exchange rates, and *not* interfere nationally or internationally with the private creation, lending,

borrowing, allocation, exchange or gambling uses of capital funds - except perhaps to limit inflation by keeping interest rates high enough and budget deficits low enough to prevent full employment.

The OPEC countries triggered an early trial of those principles.

The OPEC funds

The founding members of the Organization of Petroleum Exporting Countries were poor countries except for their oil revenues; and with two exceptions they had steep internal inequalities and were ruled by monarchs or military dictators.

OPEC quadrupled the world price of oil in 1973, and increased it again six years later. Altogether the price increased ninefold, to yield the exporters about \$200 billion a year. Those countries under those governments could not invest or spend much of the new revenue, so they accumulated big surpluses of foreign cash. What to do with it? Who might borrow and invest it elsewhere in the world?

In the rich Western countries and Japan, dearer oil did double damage. It raised enough prices to accelerate inflation. And it helped to induce a recession. Investment fell, unemployment rose. Business demand for credit was low. For the time being those countries' producers did not want to borrow back much of the money that the OPEC producers were earning from Western consumers. Hence the paradox of thrift: when OPEC cut Western consumption by raising oil prices, but lent most of the extra profit back to Western banks, it was as if they had forced the West to save too much - to bank more money than its producers could profitably invest.

But in what was still called the Third World there were many countries short of oil, short of foreign exchange, short of investment funds, and in need of all three for development. The new oil price put a number of them further into deficit. When recession hit the rich countries which bought most of their exports, their export earnings declined. International aid and private investment by multinationals did not supply all the foreign currency they needed, and were anyway unpopular in many of the developing countries because of the conditions attached to them. Most of any borrowing for those countries had to be done by their governments, which were often hard-pressed by short-term needs. Some of them were also inexperienced or corrupt. Many of them would welcome unconditional private foreign loans at almost any price. But banks which lent them big sums at high interest would

be unlikely to get much of their money back on time, in full, or (in some cases) ever.

Thus when Western banks were offered the sudden flood of OPEC money, they had three broad options:

1. They could accept only as much of it as they could find safe borrowers for at the prevailing rates of interest. That would have meant refusing to accept a good deal of the money, or accepting it only into non-interest-bearing accounts.
2. They could accept it but maintain their prevailing standards of safety in lending. To do that they would have to allow the over-supply of funds to bring a sharp fall in world interest rates - so they should pay correspondingly low rates of interest on the OPEC deposits. At low interest the West would have more safe and willing borrowers, and loans to developing countries would be less expensive for their borrowers, and more helpful.
3. As a third alternative the banks could accept all the OPEC money at the prevailing rates of interest. They would then need to lend most of it to borrowers willing to take it at those rates plus some profit mark-up. That meant lending to borrowers whom the banks had until then refused because of their unacceptable risks. To lend such a sudden increase of funds without reducing the rate of interest significantly, at a time when the rich Western economies were sliding into recession, there might have to be *much* higher risks and lower standards of safety.

How are the 'market forces' of neoclassical imagination supposed to arrive at a most productive outcome of that situation? As the bank directors consider what to do, those who are keenest on asset growth and market share are likely to preempt the business from more prudent or far-sighted or public-spirited competitors. In the 1970s the banks chose the third of the above options - the worst. Not all did, but enough of them did, led by leading US banks, to accept all the offered OPEC funds at the prevailing rates of interest, in a classical illustration of the hazards of unregulated competition between financial intermediaries. With directors' rewards linked (by their own choice) to gross assets and current returns, those are intrinsic *market* hazards, not to be quarantined from market theory as 'moral hazards'.

What could the banks do to earn the rates of interest they had promised the depositors?

Some of the money found productive borrowers, but a lot of it did not. In English-speaking countries it

financed a lot of corporate takeovers, sometimes loading the taken companies with excessive debt. It financed booms in share prices, city land prices, more office-building than there were tenants for. Billions were then lost when the booms subsided.

Some of the money was lent to communist governments in Eastern Europe. They should have invested those funds in Western capital goods to re-equip their industries. Instead they spent a good deal on Western consumer goods, and on subsidizing their own consumer prices, to buy a few more years of tolerance from their disillusioned and resentful people. When those governments were replaced, economic reform was seriously handicapped by the new debts. Hungary, for example, had one of the best of the communist economies. Before the Western loans it was in exchange equilibrium, its exports paying for its imports. But a few years later its first elected government inherited hard-currency debt equal to a year of national income.

Some of the money was lent to governments or government-guaranteed borrowers in developing countries which had little or no access to private Western credit. It financed some successful public and private investments, especially in democratic countries. Elsewhere, too many of the investments were partly or wholly unsuccessful. Some of the money was stolen by corrupt officials or private borrowers. And a number of countries were indebted beyond their capacity to pay. Considered either as profitable banking or as international aid, that bout of private lending from rich to poor countries has probably done more harm than good both to the banks and to many of the indebted countries. By 1985 world debt had multiplied ninefold, from about one hundred to about nine hundred billion US dollars, since the first oil price rise. The developing countries' share of that debt was a moderate proportion of it, but pre-empted dangerous proportions of the incomes and export earnings of a number of them. Mexico, owing \$97 billion, mostly to US banks, was the first to default when it suspended interest payments in 1982. As other defaults followed, a number of the banks would have been insolvent and out of business if the US government and Reserve Bank had not forgiven and rescued them.

The losses are not borne by the primary lenders. If the OPEC oil owners had done the incompetent lending and now faced the consequent losses, that would be appropriate market discipline. But the lending was done and the losses incurred by the banks, as intermediaries. So the losses are actually borne by other depositors and

shareholders in those banks, by US taxpayers, and by the citizens of Eastern Europe and the developing countries, most of whom had no democratic control over the governments which borrowed and in many cases misused the funds.

OPEC lessons: Whose fault was it?

. *Should the OPEC owners have refused to deposit their money on the terms they were offered ?*

Not if you expect them to behave in a normal market way. They accepted the highest bids for their funds. They were lending to the world's leading banks, which had lender-of-last-resort guarantees from dependable governments, which were also likely,

though not legally obliged, to rescue them from insolvency. All the lenders' risks were thus transferred from the lenders to the banks, and to the governments and citizens of the banks' and the borrowers' countries.

. *Should the banks have refused to accept the funds at prevailing rates of interest ?*

Yes - but there are thousands of banks, including hundreds of big ones, in the global capital market, and those who refused lost the business to those who offered to pay the going rates. Market incentives alone cannot prevent worse competitors beating better in this intrinsically inefficient market. A minimum condition for motivating more prudent and productive modes of competition is an enforceable limit either on the rates of interest which intermediaries are allowed to pay, or the rates at which they are allowed to lend.

. *Should governments have reduced the banks' temptations by withdrawing their public guarantees and exposing them to proper market discipline?*

No, for two reasons. Market pressures would still demand and supply private deposit insurance, which would be more expensive without the public supports, and would still expose the bankers to much the same temptations. And societies would get quite unsafe service from paper money and credit created, priced, allocated, traded and gambled on unstable rates of exchange by competing profit-seeking banks *without* public regulation and protection for their depositors.

It is also fair to blame some of the borrowers. But those in the South and in communist countries were accustomed to borrowers being assessed and disciplined by

Western lenders. Hard-pressed politicians in Africa or South America took what they were entitled to treat as expert advice. Experienced New York and London bankers who offered this flow of private international credit must surely know what they were doing? Or be fair game if they did not?

Conclusion Much OPEC money was misused by owners, bankers and borrowers pursuing their material interests in straightforward ways in inefficient and under-governed markets.

FURTHER FREEDOMS

The OPEC troubles coincided with the end of the Bretton Woods regime. Through the 1980s the powers continued to dismantle the remaining restraints on international financial relations.

Reminders:

International credit Governments used to regulate private lending to foreign countries and borrowing of foreign currencies. They no longer do so. They have also stopped the direct regulation of interest rates. The triple deregulation of interest rates, exchange rates and private international lending leaves the average rate of interest to be strongly influenced, and kept high, by the banks and others in their new role as exchange gamblers. The highest rates tend to be exacted from borrowers who can least afford them: deficit-trading and indebted countries with most need of foreign credit and least foreign earning capacity to service their debts.

International ownership Countries which used to reserve some of their enterprises from foreign acquisition now regulate much less of that business. They no longer confine their own banks or insurance or superannuation institutions to investing in their own country. Some governments still limit foreign ownership of some media and cultural institutions, and banks. But that is about all, and even that may not survive the proposed Multilateral Agreement on Investment (MAI).

Exchange transactions While exchanges were controlled, banks transacted most of them as agents of their Central Banks under Central Bank guidelines. Private traders and travellers were allowed exchange for approved purposes of trade, travel, investment or family support. In most advanced economies now, any person or institution with money can change it into any other convertible currency for any lawful purpose, without question.

Exchange rates used to be fixed, and occasionally altered, by international agreement. For varying periods after 1971 they were fixed by national governments. Except for the special arrangements within the European Union there is scarcely any public management now. Some developing countries and some ex-communist countries maintain official rates of exchange alongside the market rates at which most transactions between their currencies and others take place. But between the currencies of OECD countries, most transitional and some developing countries there is no longer any public regulation of rates of exchange. They are market-determined as the deregulators wanted them to be, and they are more unstable than ever in their history. In the 1980s, with no significant changes in comparative purchasing power, rates of exchange between the US dollar and other OECD currencies rose and fell as much as 40 per cent. Rates between Britain and Australia fell and rose by about 20 per cent. Six months of 1998-9 saw changes between 20 and 80 per cent in rates of exchange between Western currencies and East and South East Asian currencies. Those fluctuations were not caused by sudden changes in trade, investment or rates of inflation. They arose from intrinsic inefficiencies of under-governed money markets. Rather than tending to restore equilibrium to unbalanced trade and payments they did unnecessary harm to trade, investment, employment and growth.

Jurisdictions National governments regulate their countries' banks and other financial institutions. But when they stop regulating credit and exchange across their frontiers, some of their internal regulation becomes easier to evade. Examples:

Havens attract foreign individuals, trusts and firms to register in and operate 'as from' their sovereign territory by promising secrecy, low taxation, a tolerant lack of regulation, or other advantages. They then tax at low rates the big volumes of foreign business which they attract, and may avoid taxing their own citizens at all. In effect they sell foreigners immunity from their own countries' tax or corporate or environmental or labor or industrial safety laws. A lot of New York business pretends, successfully, to be transacted in the Cayman Islands. Some unsafe ships with cruel labor practices are registered in Central American havens. One British tycoon misused his employees' superannuation funds in Leichtenstein, out of reach of the British authorities.

Offshore sometimes means beyond the home jurisdiction. But it has also been used to mean in mid-ocean, beyond *any* jurisdiction. In the 1960s an enterprise

called Investors' Overseas Services registered bits of itself in so many countries that it operated for some years under no effective government, and continued to do so elsewhere after the US Securities and Exchange Commission stopped it trading on US stock exchanges. It borrowed \$2.5bn from unwary people to invest on their behalf, and misused it out of reach of most national laws. On a grander scale in the 1980s the Bank of Credit and Commerce International (BCCI) became 'banker to the world's biggest criminals' and to some of its biggest national secret services. It specialized in laundering dirty money. 'BCCI at one time was the seventh largest commercial bank in the world. [It had] a secret bank within a bank . . . that engaged in massive fraud and bribery itself and . . . moved money for other major international fraudsters, for the very biggest drug empires, for terrorist groups, for Manuel Noriega and Saddam Hussein, for Peru's Central Bank to hide a quarter of the nation's hard currency from foreign bank creditors, for covert nuclear programs, and for illegal arms sales to Iran.' To get away with so much for so long the bank bribed many officials in many countries; but also 'the bank was set up in such a way that it had no home regulator. It was effectively offshore in every country in which it operated.' The quotations are from pp. 222-4 of Brent Fisse and John Braithwaite, *Corporations, Crime and Accountability* (1993). The authors ask 'How should the international banking system and the international banking regulatory system be reformed to prevent latter-day BCCIs from springing up?'

A GLOBAL CASINO

When governments regulated interest rates and exchange rates and the export of capital funds there was not much scope for gambling on purely financial uncertainties, or much need to insure against them. Deregulation has allowed currency dealers (mostly commercial and merchant banks, and private 'hedge funds' operating with or without bank credit) to destabilize the rates - sometimes deliberately, more often by involuntary collective euphoria or fright - and to develop a new gambling industry to profit from the instability. The business is further expanded as producers and traders of tradeable goods are driven to deal defensively in the new futures markets to reduce the risks which the financial gambling creates for them.

Futures trading in commodities tends to stabilize their prices over time. Currency trading, by contrast, tends to impose a uniform price of credit in all

national currencies at any moment, but brings big unexpected disturbances from time to time. Day by day there is arbitrage: trading to take advantage of small discrepancies between exchange rates or between national interest rates. It tends to level the immediate, risk-adjusted rate of return to lending in all the convertible currencies. But it does not stabilize rates over time. Over time there is gambling on future rates of interest and exchange, and action to avoid gambling. In their simplest forms -

To gamble A dealer can bet that a future exchange rate will differ from what the current forward market expects it to be. He signs a forward contract to buy 15m dollars for 10m pounds five years ahead, that being today's forward rate for that date. He is betting that the pound will devalue faster than the market expects, and it does so. When the time comes the spot rate is 15 dollars / 12 pounds. If the dealer is not a bank, any bank will lend him ten million pounds for five minutes to buy fifteen million dollars and sell them for twelve million pounds, for two million profit.

To avoid gambling Five years before delivery a British airline orders a \$150m aircraft from an American manufacturer. How many pounds will it take to buy those dollars when the time comes? The airline contracts for them now at the five-year-forward price, and provides for 100 million pounds in its forward estimates, risk free.

Complexity Forward markets have proliferated far beyond those two simple examples. Besides contracts to buy and sell at future dates there are swaps: agreements to exchange one currency for another on one future day with a reverse exchange on a later day. That is one of a number of 'forward forward' contracts, signed now to do successive deals at successive forward dates. There are SAFES: Synthetic Agreements for Forward Exchange, and other 'derivatives', which allow dealers to bet on the outcomes of notional forward transactions without actually making the transactions. (In the first example above the winner would not buy then sell \$15m when the contract matured, he would simply collect his two million pound profit from the loser.) There are put and call options to sell and buy specified currencies or other assets at or before specified dates. There are options to buy or sell existing swap or other forward contracts - or option contracts. There is a wide range of hedge contracts to limit risks on other contracts. Some of these market instruments can be used to reduce the risks to which traders are exposed by unstable rates of exchange. But that is a small proportion of the market trading, just as currency exchange for purposes of investment, trade or travel is a small

proportion. Arbitrage, speculation and hedging are now estimated to account for 90 per cent or more of all currency exchanges.

Models of the forward money market have been developed. Between any two currencies - and between them all, with the right software - dealers can calculate that if the market is not disturbed by unexpected events there will be determinate relations (which can be expressed in five equations) between (i) the difference between their nominal interest rates, (ii) the expected difference between their inflation rates, (iii) the expected change in their spot exchange rates, and (iv) the difference between their spot and forward exchange rates. The models may not help the gamblers much, because unexpected events do happen - some of them in the gamblers' own behavior - and three of the four terms in the equations are uncertain forecasts.

Instability Various causes can disturb market rates of exchange.

There are the differences in national economic performance on which theorists' explanations tend to focus: national rates of inflation, competitive performance, balances of trade and payments and indebtedness, which affect the supply and demand for national currencies and hence their rates of exchange.

There has sometimes been manipulative dealing to intensify the exchange effects of those national differences. When regulated rates of exchange could only be changed officially by government announcement, governments tended to delay such changes as long as they could. Britain must probably devalue some time soon? Dealers begin to sell the pound busily, at its fixed rate of exchange. The government is forced to devalue sooner, and further, than it need otherwise have done. Dealers buy back sterling for less than they lately sold it for, for a quick capital gain.

Since deregulation, sudden attacks on particular currencies have tended to be driven by a different compound of uncertainty and predatory opportunity. As the volume of speculative dealing grows, gamblers have to worry less about national economic performance and more about what other gamblers are likely to guess, and do. Keynes likened such speculators to the contenders in a type of beauty contest common in his day: 'those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he

thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligence to anticipating what average opinion expects the average opinion to be.' The new currency gambling is partly like that. When the market assault on the East Asian currencies begins in a hesitant way in 1997, each dealer knows that (i) if he sells and the assault does not run, he will lose; (ii) if he holds on and the assault does run, he will lose in the short run; and (iii) if the assault does run, those who sell most soonest will do best.

In this case, as they watch and respond to one another, the assault does run. The pure exchange gamblers gain or lose according to when they join, and as they do, they make opportunities of a different kind for big buyers of the currencies at their new low prices. These winners can be rich and unindebted in the stricken currencies. The afflicted countries suddenly have many grossly indebted owners of developments financed by foreign credit. Western predators can buy, at giveaway prices in their Western currencies, productive assets and enterprises which may have done nothing to deserve such takeovers. Well managed, profitable, productive Asian industries are betrayed, and Western speculators and predators are enriched, by ill-regulated Asian and Western banks. But the fault is scarcely with the banks, whose directors are doing their best for their owners as business custom and market theory expect them to do. The fault is with economists, politicians, financial journalists and all too many others who too readily suppose that money markets work much as markets for goods and services do.

Government disabled The disturbances of exchange *rates* are at least intermittent. Some ill effects of unregulated *transactions* are continuous. Without border controls on the passage of capital funds, it is much harder for governments to influence the price or uses of credit *within* their countries. That in turn reduces their capacity to influence investment, employment and growth.

A MARKET FAILURE

Most of the arbitrage and speculative dealing is done by commercial and merchant banks with their own or their clients' money. Most of it does not improve either the

national or the world allocation of capital funds. Its main economic effects are four:

- It diverts funds from productive investment by offering the creators and distributors of the funds incentives to gamble on exchange values instead of on borrowers' productive and earning potentialities.
- It enables and motivates banks to maintain higher rates of real interest than used to (and could again) prevail under national regulation. That reduces the access to credit, and growth, of a number of the most productive and competitive industries.
- It increases uncertainty about future rates of exchange and real interest, and allows changing speculative moods to make rates of exchange (and therefore of real interest and debt) more volatile, and harmful to tradeable industries, than they used to be, and could be again.
- It denies governments the use of a number of effective aids to investment, employment, balanced payments and greater equality.

Over much of the Western world, since the main financial deregulation began in the 1970s, real rates of interest have doubled, trebled and quadrupled. Except in the US and parts of Scandinavia, rates of unemployment have doubled or trebled. Rates of public and private investment have declined. Trend rates of growth have fallen, some by as much as half. And in the English-speaking countries a century's progress to greater equality has been reversed. The rates of real interest, of investment and of growth are reviewed, by country and by groups of developed and developing countries, in John Eatwell's papers, *International Financial Liberation: The Impact on World development*, Office of Development Studies, UNDP, New York 1997, and 'Global Barriers to the Growth of Employment' in *Aspects of World Employment Strategy*, United Nations, New York 1997.

A number of causes converged to produce those changes. That does not make their causation mysterious, as the theorists and defenders of deregulation claim. Many of the causal processes and their interactions with each other can be traced and understood (rather than deduced from theory) in the changing situations, opportunities and incentives of the actors. It is work for historians, business people, the best public servants and other open-minded and attentive listeners rather than theoretical economists. It suggests that too-free trade into countries with persistent trade and exchange deficits, high real interest, unstable rates of exchange, and some diversion of capital funds from productive investment to purely speculative uses,

have contributed, along with technological and other causes, to the declining performance. Financial deregulation has thus intensified the troubles it was advertised to cure.

It has had two other important effects. One, to be argued later in this paper, is to discredit the economic theorists' principles of causal analysis.

The other has been to strengthen owners of footloose capital funds and directors of banks and other financial institutions against attempts to restore effective public regulation of their business - as follows.

A POLITICAL FAILURE

Roles are reversed: banks now discipline governments. Currency dealers gamble on national rates of interest, inflation and exchange. Those rates are influenced in a number of ways by public policies. The policies are influenced by prevailing beliefs. Some of the beliefs are self-interested, some are not, many are controversial. For example, members of a social-democratic government may believe that full employment is compatible with low inflation, and is anyway more important than low inflation; that there are better weapons against inflation than a high rate of interest; that good minimum wages and welfare incomes need not cause unemployment; that market balances are best - but where they fail, import and exchange controls are the best defence against exchange deficit and excessive foreign debt; that progressive direct taxation is equitable and need not discourage enterprise; and that banks need strict economic as well as prudential regulation. Currency dealers and the bank directors who employ most of them may have opposite beliefs to most of those. So if a government acts on those social-democratic principles, or talks as if it might act on them, owners and managers of uncommitted capital funds will expect to do better, or they will talk as if they expect to do better, in countries under more permissive government. As they begin to sell out of the offending country's currency, its exchange rate declines. Bankers, business leaders, media and the political opposition blame the government for the loss of business confidence.

So - as far as other conditions allow - national governments whose policies please bankers, well-off rentiers, superannuation fund managers and other beneficiaries of high interest rates at home and abroad can expect their currencies and government bonds to be in demand at stable or rising rates of exchange. Governments

whose policies threaten those interests can expect some capital flight or threats of it and a depreciating rate of exchange. The financial press is quick to link such market activity to the relevant government actions or suspected intentions. Politicians scan the screens to see how the markets have responded to their actions of an hour ago or a day ago. Many of them fear that significant numbers of swinging voters respect the market's judgments. Bankers' pronouncements used to be treated sceptically. Cartoonists drew avaricious pot-bellied men with top hats, large cigars

and reactionary opinions. But when the opinions are expressed anonymously by buying or selling the national currency, they tend to be taken as objective market judgments of the government's economic competence. Governments fear them. Among other things, their market power is likely to be used against any attempt to restore effective economic regulation of financial institutions. Or if some reform is unavoidable, they will press governments to have the reform designed by bankers and like-minded economists.

Global markets: interactive effects of inadequately governed economic structure, trade, banking and exchange

Here follows a summary of some relations between:

- . national economic structures, i.e. the patterns of industries and services which different countries develop
- . the trade between them
- . their financial systems, and
- . international financial relations.

The four are interdependent. How each works depends partly on how the others are working. That depends partly on how they are governed. And how each *can* in practice be influenced by government depends partly on how the others are governed. Separate accounts of each component of the system can thus be incomplete, and theories of each can be misleading, without an account of how they work together - and also (ideally) an account of the other forces at work on each of them. What follows is a sketch, necessarily much simplified, of the four as they have tended to work together since the 1970s in the rich democracies which dominate the world capital market, as their governments have moved to reduce the protection of their national industries and to deregulate their financial systems. To make some of its causal assumptions clear, it begins with an even simpler reminder of the many and various forces which converge to shape national economic structures, and patterns of employment, trade, money and credit. Such summaries are repetitious, but sometimes helpful nevertheless.

ECONOMIC STRUCTURE

What determines national economic structures? Short answer: history does, commonly in ways too many and various, and different from case to case, for any general theory to explain all the cases. A country's natural resources make some limits and opportunities. Its human capital includes its people's culture, education, productive skills, and capacities for organized, co-operative,

competitive and inventive behavior. Its physical capital has been produced over time in changing conditions, some of it home-made, some acquired by trade, some contributed by foreign investors. How much of the accumulated physical and human capital continues in productive use may depend on changing technology, international competition, patterns of demand, and many public policies.

All three sectors of the economy contribute.

Innumerable private initiatives and market relations contribute to the historical process. So do many public initiatives, and the general quality of government. So do the households whose unwaged work produces a third or more (depending how it is counted) of the developed economies' goods and services, and whose culture and family arrangements help to determine what sort of people the society brings up.

Structural policies Governments cannot help affecting the directions of economic development. A national government has to decide the structure of its public industries, its educational, health and welfare services, and its provisions of public capital for use by private enterprises and households. Its tax decisions can't help influencing the directions of private investment. Nor can its trade policy or its design and management of the financial system.

The people who make those and other structural decisions have to do it in far-from-unanimous societies. There are conflicting material interests, political pressures, visions of good, and disagreements about what causes what in the economy. Formal economic theory can contribute usefully to some of the decisions, but should not, even in principle, determine them all. That is partly because its abstractions from the life it models have to be radically selective, and there can be no 'neutral' value-free selection. Whatever their authors intend, such theories cannot help being more serviceable to some than to others of the interests and values and social purposes alive in the society. And the theories have often also been technically mistaken or selectively misleading about what causes what.

EMPLOYMENT

How many of a country's people want paid work at any time, and how many can find it, depend on many conditions, including these:

The demand for jobs The prevailing technology affects how many years of education and training people need before they join the paid workforce. (So does their demand for education for its own sake). Income levels and superannuation arrangements affect the ages at which they retire. Medical science and health services affect how long they live in retirement. Household economics and the culture and politics of gender affect the divisions of labor between paid work and household and voluntary work. Employment and unemployment can increase or decline either inversely or together, as the proportion of people who want paid work, and the proportion who have it, both change over time.

The demand for goods and services The detailed pattern of demand for goods and services affects the pattern of skills which can be employed. With changing tastes and incomes and technology, misfits can develop, leaving some skills unemployed - for varying periods or for life - even if the overall demand for labor is high.

Aggregate demand If productive capacities do match the detailed pattern of demand there can still be too little investment and consumer spending to employ the whole workforce. That can arise from a variety of causes:

- . There can be circular causation as unemployment limits total income which causes low demand for consumer goods and investment goods, which causes low demand for labor and continuing unemployment.
- . The unemployment may arise from market causes in the first place, for example if new labor-saving or capital-saving technology cuts employment in some industries, which in turn cuts total income and spending, and so cuts employment in other industries too.
- . The unemployment may arise in the first place from any one of the public policies noted in the next item but one.

Unstable demand for capital and intermediate goods Fluctuating stocks of unsold goods, prompting investment multipliers and accelerators and decelerators, can propel business cycles of boom and slump with fluctuating unemployment.

Public policy Government may create or maintain unemployment if it sheds labor from its public services, or if the relation between its volumes of taxing and spending restrains after-tax income and aggregate demand, or if it depresses investment by cutting its own investment or by setting high rates of interest. It may act to maintain some unemployment for any of a number of reasons, for example:

- . to restrain inflation by restraining total spending, by depressing investment, by weakening labor's wage-bargaining strength
- . to weaken labor's bargaining strength in order to restrain the production costs of exports and import replacements, or to increase profit shares to encourage investment, or to increase wage and salary inequalities for incentive or class reasons.

TRADE

Many countries' export earnings and import spending balance in a market way, or earn surpluses of foreign exchange, without difficulty. Some do not. Recall the alternatives which those deficit traders face.

Free trade Theorists expect that in most cases one or more of three market processes will balance international trade and payments if governments don't interfere with them:

- . Free trade will allow competition to prompt better performance by deficit-trading countries' tradeable industries, to the point where their export and import payments balance.
- . Competition will prompt all countries' investors to develop their industries of greatest comparative advantage, which will balance their trade in a market way.
- . To the extent that those corrections fail, imbalances will have the supply-and-demand effect of depreciating deficit traders' currencies to levels at which higher demand for (cheaper) exports balances lower demand for (dearer) imports, with reverse effects in surplus trading countries.

Those processes sometimes happen, but none of them necessarily or always does. Competitive imports may extinguish existing industries instead of improving them. It may take entrepreneurial flair to replace industries of less comparative advantage with industries of more comparative advantage, and the exchange effects of doing it may also depend on there being full employment in the economies with which the deficit-trading country trades.

The expected depreciation of the currency may not occur if the excess demand for foreign currency can be met by borrowing rather than buying it. Or if it does occur, it may worsen the exchange deficit if the relevant elasticities of supply and demand for the imported and exported goods are unhelpful.

Spending capital In the short run a country can pay for an excess of imports, and service its foreign debts, by selling enterprises and natural resources to foreigners. When the saleable assets are all gone the annual exchange deficit is likely to be bigger by the outflow of rent and profit to foreign owners.

Debt Annual deficits can be financed by borrowing foreign funds if foreigners are willing to lend them. The debt may become self-expanding if its interest and repayment have to be financed by further borrowing, as is likely in deficit-trading and indebted countries.

Regulated trade and exchange Government can make the country live within its means. It can restrain imports by tariff or other means, aid the home production of tradeable goods, limit foreign acquisition of existing assets (without necessarily refusing new direct investment), limit borrowing of foreign funds to prudent quantities and approved purposes, and if necessary ration the available foreign exchange to its most necessary and productive uses.

Only the last group of measures are reliable. All of them have been used effectively in many countries in recent times. But most of them are ruled out if there are international commitments to free trade and free exchange of capital funds.

MONEY AND CREDIT

Reminders:

All money is now fiat money - money because some government says it is and licenses the institutions which create it. Though governments and their Reserve or Central Banks can also create it, most additions to the supply of it are currently made by commercial banks, in the form of interest-bearing loans to their customers or to governments. Though governments have in the past told the banks how much new credit they could create, and for what general kinds of use, they now influence the amount of credit only by varying the base rate of interest.

The supply and demand and price of credit are not related to each other in the same way as are the supply

and demand and price of most market goods. With exceptions, it tends to happen that:

- the demand and supply of credit both decline as the price rises, and increase as it falls
- the higher the price, the lower the average productivity with which the credit is likely to be used so that
- profitability to the supplier tends to be inverse to the productivity of the use.

Nominal and real rates of interest are not determined in a market way by supply and demand arriving at equilibrium prices and quantities. If the nominal rates are not directly regulated they are determined chiefly by bankers' conventions, their profit-seeking as creators of credit and their competition for funds as intermediaries; by competition between indebted and deficit-trading countries to attract footloose capital funds; and by rates of inflation and the choice of policies for coping with it. The continuing public influence on the base rate of interest is used chiefly to move rates up and down through the phases of the business cycle - it can no longer do much about the general level of interest, i.e. the rates between which those up-and-down adjustments are made. If a national government tried to return its average real rate to the level prevailing before deregulation it might well fail as private banks declined to follow the public lead; and if it did succeed, some capital flight and exchange depreciation would be likely to follow. Governments of heavily indebted countries already keep their rates high enough throughout the business cycle to attract and retain the footloose funds which balance their payments, keep their imports coming, and sustain their rates of exchange. Those rates of interest tend to prevail in all the advanced economies, depressing their rates of investment and growth and worsening their inequalities.

Unregulated international borrowing (together with other causes) has the effect that unregulated rates of exchange do not necessarily adjust in a supply-and-demand way to bring unbalanced trade and debt into balance. That uncertainty is compounded by the volume of speculative currency exchange which allows the gamblers' fluctuating confidence and 'beauty contest' guesswork to destabilize rates of exchange, sometimes drastically. That in turn destabilizes the real interest rates and capital obligations of international debts, including those of producers, traders and buyers of real goods and services.

Comparisons

How the present world capital market is characterized depends partly on what it is compared with.

If a **historian** compares it with a money market which still depended on the supply of gold and the services of unlicensed, unregulated and uninsured goldsmiths, it looks good.

If a **neoclassical economist** compares it with an ideally efficient system in which market forces keep the demand and supply and prices of capital funds at a full employment equilibrium, and allocate them to their most productive uses, it is surprising that the system is not doing better. The participating countries' rates of investment, growth and unemployment are mostly poorer than they were when the market was, nationally and internationally, heavily regulated.

If a **banker** compares it to the old system he may think that the speed and freedom with which he can operate now, and the rates of return he can find as his shift-working dealers scan the world around the clock for opportunities, make a marvellous change from the restrictive regime which formerly hobbled the finance industry.

If a social democrat compares the system's performance to the claims made for it by its original deregulators, she will focus on some characteristics which invite reform. As might be expected, that is what this paper will now do.

A social-democratic alternative Imagine the international financial system as it might be now if the major powers had responded to the troubles of the 1970s by repairing the Bretton Woods regime instead of dismantling it. The task might have been confided to French, Scandinavian and Japanese public servants who were still confident managers of their national economies. A main purpose might have been to win what Keynes tried but failed to win in 1944: 'We intend' he said on Britain's behalf, 'to retain control of our domestic rate of interest, so that we can keep it as low as suits our purposes, without interference from the ebb and flow of international capital movements.' Besides financial repairs we must imagine that the reformers have also re-negotiated the GATT/WTO agreements to allow the first of the five main features of their new regime:

1. Subject to international rules and arbitration to prevent predatory or other unfair trading, nations or trading blocs regulate their trade with care for their balances of payment and, if they wish, their wage levels and working conditions.

2. International movements of capital funds are normally confined to aid programs, IMF and World Bank operations, and private transactions approved by both governments (or complying with their guidelines). The IMF is empowered to borrow at low interest from the exchange reserves of countries earning surplus exchange.

3. National governments regulate their countries' interest rates with concern for investment, employment, equity and other public purposes.

4. National governments restrain inflation by methods which rarely have to disturb interest rates. They do it by national wage negotiation and income policies, by occasional use of reserve powers of price control and competition policy, by fiscal policy, by regulating the quantity and general directions of bank lending, and by educational means.

5. Central Banks monitor and enforce compliance with the exchange rates fixed by the IMF, which adjusts them when necessary to inflationary changes of purchasing power.

Such a system might be misused and evaded in many ways, for example by offshore dealing, by various kinds of difficult-to-prevent misbehavior, by the internal financial strategies of transnational firms, and by people taking advantage of inept or corrupt or partisan government. Nevertheless in most democratic countries such a regime would still allow less bad behavior, and better economic performance, than happen now. But a number of its indispensable components are at present ruled out by international agreements and the policies of the international institutions.

The social values, theoretical assumptions and factual analysis which shaped this last comparison suggest the following conclusions about a global market which continues to develop in its present directions.

A GLOBAL CAPITAL MARKET

As long as the world market is supplied with money and credit by many nations:

- each with a national fiat currency,
- many with unbalanced trade and exchange,

41 Global Markets: interactive effects of inadequately governed economic structure, trade, banking and exchange

- barred by agreement and by the World Trade Organization from introducing any new or higher barriers to trade,
- barred or deterred from regulating capital dealings between their currencies, and
- dealing with an International Monetary Fund (IMF), World Trade Organization (WTO) and an Organization for Economic Co-operation and Development (OECD) staffed chiefly by economists with strong faith in the efficiency and beneficence of free world markets in money and goods, it is likely to have these tendencies:

- There will be neither effective public control nor efficient market determination of the quantities of money and credit in the world market.

- Some of the supply will be used unproductively for gambling on changing rates of interest and exchange, with a range of ill effects, and no good effects, on the production and distribution of goods and services.

- Rates of exchange will be subject to frequent small changes and occasional catastrophic changes, with (among other harm) severe damage to international financial obligations and some general increase of financial and trading risks.

- Real rates of interest will be adjusted (by the effects of arbitrage trading on exchange rates) to yield a similar immediate rate of return (adjusted for estimated risk) to all lending between participating countries.

- The underlying rate of interest within each country is likely to be comparatively high through all phases of the cycle, for a number of reasons.

- Open frontiers make it difficult for national governments to regulate the volume of credit in a counter-cyclical way, or to restrain inflation, by other means than adjusting the rate of interest.

- Free trade compels countries with trade deficits to balance their payments by asset sales or foreign borrowing. The need to borrow compels them to match the highest rates of return available in the world market, plus some addition for exchange risk if their debts and exchange deficits are expected to depreciate their currencies.

- Speculative currency trading strengthens bankers' political influence, which they tend to use in ways which keep rates of interest unregulated and quite high.

On balance, with many exceptions, high interest tends to shift some proportion of lending:

- from more productive to less productive uses, including

- from investment and consumer credit to asset trading for capital gain

- from long term to short term lending or to loans with variable rates of interest, shifting inflation risks from lenders to borrowers

- from housing investment by or for poorer households to richer households, so that the overall real productivity of housing investment (in the quantity and quality of home-made goods and services) may decline, or lag behind the growth of national income.

Winners Compared with a regime of low and stable interest rates, a regime of higher and more volatile rates promises to give greater advantage to:

- owners of capital funds, including
- members of funded superannuation schemes
- big, well established firms which can finance most of their capital needs from their earnings, and other unindebted enterprises.

But for some of those participants the promise may be broken by wild instabilities of the kind illustrated in the East Asian crisis.

Losers are likely to include:

- small, new, or otherwise hard-up firms which depend on credit for much of their investment and working capital

- firms, especially new small firms, wanting new equity capital. (Shares are harder to sell when fund managers have the alternative of lending at high interest.)

- credit-dependent firms which are price-takers in competitive industries; new entrants to industries dominated by established self-financing firms; firms with long investment lead times who need to borrow investment funds

- farmers who need credit

- households who need credit to buy housing and household equipment. The biggest losers over household life (unless public income or rent subsidies sufficiently compensate them) are likely to be the poorer households who might otherwise have owned their houses but are excluded by high interest rates from doing so.

Effects on investment, employment and productivity will ensure that the losses exceed the gains.

CONCLUSIONS

When these markets are freed of most national economic regulation they respond with high interest rates, volatile exchange rates, and therefore volatile interest rates and increased risks for international lenders and borrowers. Successful gambling on those uncertainties can be more profitable than productive lending. Many banks and some other dealers therefore do it. Banks meanwhile change their methods of long-term lending to shift inflation risk and exchange risk from lenders to borrowers, i.e. from the creators and owners of funds to their users, including their productive users. The high interest and the risk-shedding and the exchange gambling are rational responses to the opportunities which such a market offers to some of the key actors in it. Compared with competently governed markets for goods and credit, there is less investment. Some of it has higher risks, some of it has lower productivity.

Through the same period the victory over inflation has been won chiefly by restraining investment, income and aggregate demand by traditional macroeconomic means, which also help to maintain enough unemployment and insecure employment to restrain wage pressures and allow some increase of profit shares and inequalities in most participating countries. Freer trade has contributed to unemployment and wage-cutting in some countries, and financial deregulation has contributed to unemployment and to low investment and growth.

A three-point summary

The global money market is an intrinsically inefficient one, as economists understand efficiency, because the price of credit cannot equilibrate the supply and demand for it, or attract bank lending at all reliably either to its most productive or to its most socially desirable uses.

Second, the open national boundaries which establish the global capital market deprive participating

countries of a number of their best means of influencing their national rates of investment, employment and growth. The means which they are driven to use instead, especially the resort to high and fluctuating rates of real interest, not only weaken government's capacity to *manage* the economy. They also do active harm to the economy's *market* efficiency.

But third, the global market is strongly defended. It increases bankers' and other financiers' influence over economic policy and reduces the influence of national governments, their electors, organized labor, and a range of productive industries including manufacturers and many small enterprises. National governments are the only possible reformers of the global market, but as it forces them to mismanage their national economies they tend to lose their electors' support.

An intellectual difficulty The people who benefit from the new anarchy are few and the likely losers are many. If majorities understood the business it is hard to believe that they would not insist on reforming it. But the dominant economic theory which defends it is terribly persuasive. In the English-speaking world it prevails in most financial departments of most governments, in most universities' departments and graduate schools of economics, and in the many institutes which are privately funded to propagate it. As well disbelieve it as disbelieve the recognized authorities in physics or chemistry, law or medicine.

Talcott Parsons' grand theory dominated American graduate schools of Sociology in a similar way before its sudden replacement. When young Andrew Hacker attacked its foundations in a short paper, he did not expect (he said modestly) to 'derail the Twentieth Century Limited by putting a walnut on the line'. In similar spirit it is time to draw attention to a neglected foundation of neoclassical economics: the two principles which shape much of its causal analysis.

Economic theory and causal analysis

Modern economic activity is complex and sometimes irregular and inventive. This discussion of its causal analysis may be summed up in four sentences. Analysts have to select from the complexity of the forces at work. To know what any cause actually contributes to causing any effect they must know or imagine how different the effect would be if the cause were absent or different. Neoclassical economists too often let their theoretical model of the economy dictate both those choices. The faults of the model and some characteristics of human behavior together make that an unpromising way to discover what causes what in economic life.

People differ from one another. They learn from their own and others' experience and change their minds and purposes and ways of doing things. They change their social and economic institutions. They contend incessantly for control and direction of business and government, uncertain who will win. Thus they limit the scope for any determinate general theory of their behavior. Even if such theory could be true to life, its necessary selectivity means that it cannot be value-free, or serviceable to all the society's contending interests and social purposes. It is a wrong kind of theory for most purposes of social science. Even political science, sociology and anthropology are rightly pluralist these days. Only in economics does a majority of the profession still want a single determinate master-theory to prevail throughout their discipline.

SELECTION

Any economic effect has innumerable present conditions and past causes, each of which is in turn an effect of present and past forces. For example for a country to produce motor cars from its own resources, the conditions have to include a supply of steel. Many conditions have to be present for a society to produce steel, and to produce those present conditions there must have been a past history of discovering ores and fuel, developing or importing the technology, educating the skilled people, investing in the industry and so on. Chains of cause and effect reach back through history. And the present conditions for any economic effect depend in turn on *their*

necessary conditions - and so on, through the whole causal interdependence of social and economic life.

Faced with that endless complexity of causal relations, nobody can ever know or report them all. Analysts need principles of selection. Economists with different specialist interests select differently. Those with different social values and political purposes select differently, focusing on different necessary conditions and different links in the endless chains of causation. Differences are inevitable. What parts of the causal pattern an analyst needs to know must depend on *why* she wants to know: what she wants the knowledge *for*, what she wants it to enable people to *do*. She must make her selections in the light of her purposes in researching the subject. In a social science those are social purposes. But in any society, however peaceful and co-operative it may be, some interests always conflict with others, some social values are disagreed. And those different interests and purposes quite rightly and rationally shape different choices in the analysis of patterns of cause and effect in social and economic life.

Objection: Social *life* may be full of conflicts, but surely *science* can have agreed purposes? However economists may differ in their social values as citizens, surely they can agree that as economists they will look for nothing but the objective truth?

Answer: Yes, scientists should look for the truth. But the truth about what? About which social facts, which of their (innumerable) causes, which of their (innumerable) necessary conditions? Truth is a basic principle of science, but it is not a principle of selection. Except for preferring truth to falsehood it is no help to economists' problems of selection.

Models as selectors

The professional models of economic life which economists have developed - mercantilist, classical, Marxist, neoclassical, Keynesian and others - select and simplify what their authors judge to be the most important elements of economic activity. They select the *effects* they will model. (National output? Its unequal distribution

between classes? Between men and women? Rates of growth? unemployment? inflation? Rates of resource use and renewal, environmental care or spoiling?) They select which *causes* of those effects they will model. (The market exchanges? Inequalities of market strength and bargaining power which underlie the exchanges? Current knowledge and technology? The political conflicts and choices? Cultural influences, including the prevailing economic theories?) And for those purposes they select the *concepts* and *identities*, the methods of *measurement* and the criteria of *efficiency* which their models and their analyses of real-life activity will use. Most of those choices necessarily call on the theorists' social values and purposes as well as their observation of facts and their judgment of causal relations. As a selective guide to causal analysis each model then draws its users' attention to particular elements of economic activity: to particular kinds of causes of particular kinds of effects. That may often suggest some particular range of policy options and limitations.

For example:

Suppose that shareholders and banks provide capital funds to a firm which builds and equips a factory, buys materials and hires workers to manufacture washing machines to sell to shops which retail them for cash or credit to households whose members use them to do the family laundry. In ordinary life as in economists' analyses, different observers of those facts will notice different aspects of them and draw attention to different causes and effects of them. Observer A sees an admirable economic system meeting everyone's needs and preferences. B's sense of justice notices that the production is all for profit, the workers get less than the value they produce, so the capitalists get something for nothing. C likewise notices that relation between capital and labor but accepts it because she sees the profit share as a necessary source of investment and growth whose benefits go to everyone, however unequally. D notices how the sale price of the washing machine is split between profits, capital costs, high wages, and advertising costs. She suspects that all

those winners - capitalists, workers and advertisers - overcharge the customers. E sees simple patriarchal exploitation as mostly-male owners take all the unearned income, mostly-male workers take all the earned income, and most of the unpaid work (the household washing) is done by women. Between those five there need be no factual disagreements - but their different selections of the facts suggest radically different social judgments and policy concerns.

Neoclassical selection

The best neoclassical economists are aware of many limitations of the theory they use, and are among the best critics of misuses of it. But in what follows - with apologies to that distinguished minority, apologies which it would be tedious to repeat sentence by sentence - 'neoclassical economists' means the uncritical majority who remember only the coherent account which their first textbooks gave them of a self-adjusting, fully employed national economy whose allocative and productive efficiency are assured by the competitive energies of its producers and the sovereign preferences of its consumers. From government the system needs little more than property law, roads and bridges and some public education. (A safety-net for non-earners may also be desirable, but that can be defined as a social rather than an economic policy and as likely to have economic costs.) Some market failures (monopoly, imperfect information) are possible. But so are many government failures (protection, corruption, pork-barrelling and vote-buying, extravagant taxing and spending). So government intervention to correct market shortcomings brings new risks: the policy choices should be understood as choices between two evils.

Economists' business (in this view) is to understand the working principles of that model economy, to know how well the actual economy is realising its possibilities, and (in policy work) to advise government and its electors how to help rather than hinder the efficiency with which the system meets the consumers' preferences. modelled by the theory, the analysts don't begin an open-minded search for what did cause them. Instead they search for *what prevented them from conforming to the model*. What government interference? What market failure? (They may not think of theory failure, except of theories other than their own.) Some may believe that their theory models all the forces that really matter in economic life. Some may believe that explanations which comply with the prevailing theory are more important than others,

Economists of more than one theoretical school tend to relate their causal explanations to theory in a number of ways. If particular events and conditions *could* be causally related by the forces modelled in the theory, analysts are tempted to conclude that they are so caused and need no further explanation. If the sequence or coincidence of events could *not* have been caused by forces

or more likely to be true. Those may also be the only explanations they have been taught to look for - explanations specific to time and place are belittled as 'mere ad hocery' - pre-scientific, unprofessional, the business of other disciplines. So when investment and growth are going well, theorists too easily assume that the hidden hand is doing its efficient work as modelled, *and is the sufficient cause* of the good performance.

But through the West's mid-century golden age and East Asia's miracle years there was substantial public as well as private production of market goods. Both sectors also contributed to producing the public physical capital and goods and services which national, provincial and local governments planned and paid for because public, private, independent and household producers all needed them and could not do their work without them. It was and is best understood as a three-sector economy of public, private, and unpaid household and voluntary producers. All three need to get healthy, hard-working, adaptable workers from the households which bring them up. They have intricate trade with each other. They all use some public capital (roads and bridges, navigational aids, parks and gardens) as well as their own capital. And each needs its appropriate government. For the public, private and household sectors in the 'golden age', that included extensive regulation of their international trade, investment, exchange and credit.

Thus people attend to each others' material needs in a variety of ways - at home, in neighborly ways, in independent charities, in public hospitals and schools and universities and research institutes, and - for about half of all their work and output - by paid work and market relations in the private sector. The good performance of the golden years did indeed reflect the efficient performance of the private sector - but also of the other sectors, of their services to each other, and of their regulators. The policy-makers were Keynesians or pragmatic institutional economists - or in continental Europe and many English-speaking public services, not economists at all. So while the success lasted there was no great harm if neoclassical academics chose to ascribe too much of the achievement to market forces alone. But it matters now that those beliefs prevail; and as they affect the *selection* of neoclassical causal analyses two of their effects are specially troublesome.

First, the theory models production by the private sector, and some of the public services which that sector needs. It thus models about 60 per cent of modern production. It neglects the provenance of the demand for

final goods, accepting consumers' revealed preferences without minding what forms them. And it insults household production by defining it as consumption and discouraging any investigation of its capital needs or of what determines the quantity, quality or distribution of its output of goods and services, its income transfers or its other contributions to wellbeing. The theory can also encourage bad reporting of what it does notice. Suppose for example that with economic growth a country's people invest some of their rising income in more private household space and equipment and more public neighborhood space and equipment, shorten their hours of paid work, and use the saved time and also more of their leisure time to produce more than before by household and other unpaid work. They thus contribute to the growth of real national product, of work, and of work satisfaction. Neoclassical accounting will report that all three have declined and that the cause is an increase of sloth, i.e. a revealed preference for less work and more leisure than before.

Second there is an effect of the timeless generality of the theory. The theory of trade, of banking and of international exchange may be mistaken, as argued earlier; but for present purposes notice that each of those branches of theory is thought to stand securely on its own foundations. That tempts unwary analysts to forget that a change in the technology or regulation of trade or banking or international exchange may change the behavior of the other two, and upset the assumptions of the corresponding branches of theory. Deregulating private international borrowing, for example, can prevent the market equilibration of international trade and payments, and invalidate the theory which leads people to expect that equilibration.

This discussion of the selective analysis of causes and effects is already overlapping the problem of observing, understanding, estimating or imagining the causal relations themselves.

IMAGINED ALTERNATIVES

To know what something is causing it is usually necessary to know, or guess, what would be happening without that cause. Statements of cause can be turned into negative hypotheticals - 'if A had not happened, B would not have followed.' But it is difficult to imagine social vacuums or stationary citizens, so to imagine a society or economy without one feature usually involves imagining some

substituted feature in its place. Merely to establish that a causal relation is present it is enough to know 'if not . . . then not . . .'. But to measure just what it causes, one must ask 'if not . . . then *what?*' Economists call such imagined alternatives 'counterfactuals'. Laboratory sciences investigate them by controlled experiment. Three things make that difficult in social sciences. The people may not put up with experimentation. On any large scale or over any long period it may be impossible to hold all relevant social conditions constant while some of them are varied experimentally one by one. And people can change their minds and behavior, sometimes in response to what researchers find out about them, so that particular experiments may not support any very general or determinate or durable theory.

Social scientists do their best. They use various substitutes for experimental controls. They compare societies before and after particular disturbances or innovations. They compare them with other societies. They compare real societies with theoretical models of them or with programs to conserve or change them. Those different devices may prompt different questions rather than allowing conclusive answers to them, but they may help analysts in two ways. They limit their work to explaining why an industry or an institution or a society differs from its recent past, or from an otherwise-similar neighbor, or from a theoretical model of itself. And they may allow rough judgments of the amount and kind of effect of the causes in question, present in one comparator and absent or different in the other.

In practice that simple reasoning is often complicated by the need to notice conditions and forces which bear only indirectly on the effect to be explained. They may have shaped the options which were open to the economic actors. They may have prevented some of the actors from responding as might be expected. Scientific considerations alone cannot determine how far out into the surrounding conditions or back into their history a causal analysis need reach. That depends on the practical purposes of the investigation and the areas of action and understanding which it aims to explore. The implications of this for economic theory as a practical, persuasive force are so important that it may help to add a more formal exposition of it, indented so that readers who dislike such argument may skip it. Suppose that:

A is an event which forces economic process B to change; but A's effect does not determine what B must change into. In fact B changes into E. The conditions necessary for B to turn into E rather than into anything else

are a very large number including P, Q, R, S, T, U. etc. P and Q did not force any change in B, and had no direct effect in producing E. P and Q are conditions which allow E but prevent another, otherwise-possible, effect F. Similarly R prevents G; S and T singly do nothing but if both present they prevent H; etc. So if the question is *Why did B change at all?* The answer is A. If the question is *Why did B turn into E-but-not-F?* The answer is APQ. If the question is *Why did B turn into E-but-neither-G-nor-H?* The answer is ARST.

If the question is *What caused E?*, then in social sciences an exhaustive answer is rarely practicable. So - consciously or not - the investigator, in the light of her own or her client's practical concerns, always translates *What caused E?* into *What caused E-but-not-FGH*, or *not -GHI*, etc.

The cause R need not be mentioned until somebody introduces the possibility of the alternative effect G. What may prompt interest in G? If G was likely, as a common outcome of any disturbance of a B by an A, that is a technical reason for introducing G into the question and therefore R into the answer. If G is valued as a specially good or bad outcome, that social judgment may introduce it (and R) more often than predictably likelier but less interesting alternatives. G is rarely introduced if predictably impossible in any circumstances; but there may still be reason for introducing it in order to show its impossibility. The reason may be indirect. For example, suppose that belief in the possibility of G, however widespread, cannot cause G to occur; G remains impossible. The analyst may not care about the pain and frustration suffered by those who persist in expecting G. But their expecting G may cause them to act in ways which cause another effect, X, which the analyst thinks dangerous. So whenever she is asked *What caused E?* she translates *E-but-not-G*, introduces R among the causes which produce E by blocking G, and thus does what she can to show people that G is impossible, and thus to prevent X. (That is the structure of Edmund Burke's explanation of the French Revolution. His *Reflections on the Revolution in France* (1790) spelled out the reasons why the attempt to change too much too quickly could not succeed, and must lead instead to blood and terror and dictatorship. This most famous conservative causal analysis was the more impressive for being an accurate forecast rather than an explanation after the event.)

All the symbols A, B, etc. in the above argument stand for identities, often in practice complex collectives or refined isolations, into which analysts must dismember

whole life if they are to study how it works. In that 'naming of parts' culture and language may be persuasive. But investigators' social purposes and scientific considerations, and their own or their clients' material interests, may all contribute to choosing the sets of identities which promise to allow the most useful questions for the analysts' purposes. Disciplinary boundaries and other conventions may shape some of the selections, but no strictly objective, value-free scientific principles can replace the necessary role of the analysts' social or other purposes in deciding what bits of whole life to separate from what other bits in order to study relations between them.*

For a more recent example than Edmund Burke's, consider causal explanations of inflation. One analyst thinks it sufficient for practical purposes to understand the rate of inflation as an (inverse) effect of the rate of unemployment, as evidenced in the recent history of a number of OECD countries. Because that experience is not universal, another analyst focuses on national methods of arriving at wage levels. Individual contracts? Bargaining by strong or weak unions? By independent unions who compete to match or better each others' gains? By national negotiation between peak representatives of business and labor, as once in Sweden? With government present too, as in Norway? By public arbitration institutions, as in Australia? Do the different records suggest that bargaining methods can affect wage outcomes independently of the rate of unemployment?

Wage outcomes have varied with other things besides rates of inflation and bargaining methods. Do the bargainers respond to persuasion or learn from experience? Historians compare the responses of British and German workers when the OPEC oil price inflated their consumer prices and so reduced their real wages in the 1970s. German unions accepted the cut because they knew they could do nothing effective to prevent it. Among their reasons may have been national memories of the disastrous superinflation of 1923-24. British unions could do nothing effective either, but they demanded and got a matching inflation of wage rates, which further inflated prices and brought them no material advantage and some loss of public and political support.

Japan's experience in the 1990s is reminding Keynesian economists that - like wage-push inflation -

demand-pull inflation can also vary with national culture and ways of thinking. Through a decade of slow growth and under-employment the Japanese government has acted quite effectively to increase households' after-tax income and spending power. But the households are not spending the increment of income as the government imagined they would do, they are obstinately saving it. Surveys suggest that the unsettling behavior of Japanese property prices and now of global and East Asian money markets are reducing Japanese people's economic confidence, and the more anxious they become, the more prudently they save for possible unemployment, for old age, and for their children. Consumer spending is no longer - or not everywhere - the simple function of consumers' income that Keynesians could once assume.

Analysts who select different elements of the causal complexity, and differ also in the imagined alternatives which warrant some of their causal connexions, arrive at their choices in various ways, some more respectable than others. Most of them do want to restrain inflation. Some would like to do it without causing unemployment, so they explore any historical and national differences in employers' and workers' and unions' responses to the problem, looking for what causes such differences, in case they disclose conditions for wage restraint and methods of achieving it which do not depend on unemployment or job insecurity. Other analysts welcome moderate levels of unemployment and insecurity for some of their other effects. Weaker wage-bargaining allows freer cost-cutting adjustment to technology, so bigger profit shares, which in turn allow more investment from retained earnings, so that investment and growth can suffer less from high or unstable rates of interest than more credit-dependent investment might suffer. Some analysts may also welcome some increase of inequality for incentive reasons or philosophical reasons or material self-interest. People who value those less popular effects may avoid saying so, and shape their causal analyses to concentrate attention instead on the more popular restraint of inflation which the unemployment and insecurity achieve.

NEOCLASSICAL IMAGINATION

The comprehensive model of a self-adjusting national or global economy, with individual self-interest as the sufficient engine of the common good, is implanted in the neoclassical imagination by 'Economics One', the

* Adapted from H. Stretton, *The Political Sciences* (1969) pp. 432-4.

student's first introduction to the subject and to pride in professional expertise. To know better than parents and politicians and nearly everybody else can be a strength and a quiet joy at age eighteen. Some studies have shown that economics students average more selfish than others not because the subject attracts selfish people but because of what their first year of study teaches them.

Later courses introduce some recognized kinds of market failure. But they are failures to conform to the ideal model, not to other notions of good economic performance. An economy is regarded as failing if it is producing less than it could. It is not necessarily failing in the neoclassical sense if it generates steep inequalities, or if its faultless service to the steeply unequal consumers comes at the expense of the options and working conditions and job and income security available to the same citizens as producers. Did not the marginal theorists who turned classical into neoclassical theory in the 1870s replace questions about class shares with questions designed to show that each contributor to production earns the value of their individual contribution to output?

Only later - perhaps only in Graduate School, and not always there - do students meet serious criticism of the ideal model in its own terms. Sraffa (1926) and others predict the effects on competitive efficiency of increasing returns to scale. Chamberlin (1933) and Robinson (1933) explore other effects of imperfect competition. Keynes (1936) discredits Say's Law: the self-adjusting economy may be in equilibrium at any level of under-employment. Arrow (1951, 1958) and Debreu (1951, 1959) derive from the model's own assumptions a list of necessary conditions - including no externalities, no monopolies or oligopolies, no increasing returns, no uninsurable risks, perfectly flexible wages and prices, perfect information all round, and a full set of future prices - for the model to function as advertised. A number of them are plainly impossible. But can the model at least guide policy-makers to approach as near as they can to the ideal? Not necessarily: Lipsey and Lancaster's theory of second best (1957) shows that correcting any one market failure does not necessarily improve the whole performance of an economy which still has other imperfections. Kaldor, Kalecki and Balogh at various dates from the 1930s, and many others including students of men's and women's wages, have explored the effects of unequal market and bargaining strength in determining wage and profit shares and wage and salary inequalities. None of these items are merely unhappy social effects of rational economic efficiencies. They are pure economic inefficiencies - productive and allocative and

distributive inefficiencies - of market economies under the minimal government which elementary neoclassical theory assumes and many neoclassical economists recommend.

But in the 1970s stagflation - the simultaneous increase of unemployment and inflation - brought new opportunities, allies and recruits to the neoclassical ranks. Academic and business opponents of the Keynesian and social-democratic consensus joined in attacking its deteriorating performance and replacing many of its distinctive beliefs and policies. Neoclassical economists looked for reasons why the economy was also behaving less and less like *their* model of it. With the usual intelligent exceptions most of them came to believe either that government was the main cause of the new troubles, or that it shared the blame with an upsetting technological revolution to which it was responding in quite wrong ways. Entrepreneurial enterprise was over-taxed and over-regulated. Minimum-wage laws reduced employment. So did job security, which encouraged slack work and made the slackers harder to sack and employers therefore less willing to hire them. Managed full employment and regulated rates of interest were main causes of inflation. If information technology was disemploying workers their relocation and re-employment called for freer labor markets and less enticing welfare alternatives to employment, rather than their opposites. Thus a number of public policies - now called 'interventions', as if the private sector could operate at all without its public components and regulators - were seen as main causes of too much unemployment, as they had lately been blamed for too little.

Thus too many economists came to a fatal conclusion not so much about what the surviving social-democratic policies were causing as about what they were preventing. They were not seen as preventing the market failures or misbehavior which had originally occasioned their introduction. Nor were they seen (by more imaginative analysts) as preventing the anarchic, speculative, destabilizing and comparatively unproductive behavior which bankers and others invented in the 1980s as soon as deregulation and the new information technology together allowed them to. Instead of those competent perceptions, neoclassical economists imagined that the social-democratic policies were preventing something else altogether: they were preventing the economy from operating in the efficient, self-adjusting, market-disciplined way that is modelled in the simple forms of neoclassical theory which prevail in political debate, business

propaganda, a good deal of the press - and in the self-liberating lessons of Economics One.

When information technology creates new opportunities for business misbehavior and weakens some links between lawful profit-seeking and useful production, practical people see a need for regulation or for the transfer of some activities to public ownership. Freer trade and financial deregulation have already led some rich, some transitional and some poor countries into escalating private foreign debt. They have destabilized exchange rates radically, irrationally and destructively as never before. Ninety per cent or more of the liberated international financial transactions are unproductive arbitrage or 'beauty contest' speculation, or producers' efforts to hedge the risks which the new casino creates for them. But a large majority of neoclassical economists still appear to ascribe these disasters to too much rather than too little government, and want to free the business further to expose it to 'the full severity of market discipline'.

A WRONG KIND OF SCIENCE?

As argued already, it is a mistake to try to understand thoughtful, inventive, self-changing human social behavior, with its intricate patterns of constraint and choice, and of conflict and co-operation, by the use of a timeless general theory of a monocausal and axiomatic/deductive kind. Depending on their fields of study economists do better with a more versatile tool-kit: statistical and accounting skills; knowledge of the structures and working of relevant institutions; a lot of codified historical and contemporary economic experience; batteries of questions worth asking in particular circumstances and fields; and a will to understand the minds and purposes and choices of the economic actors as well as possible by all available means, rather than deduce them from theory.

The best neoclassical economists are of course aware of these problems. They have two basic ways, one social and one scientific, of coping with the difficulties which the contradictions between theory and life create for them.

Socially, many of them are as compassionate as anyone else, and as concerned to protect people from economic hardship. But if they can avoid it they don't want to attack the causes of unemployment, insecurity, poverty or excessive inequality by 'intervening' to manipulate the economic system in ways which would 'distort' its supposedly efficient market forces and expose

it to 'government failure'. As far as possible they would rather free its market mechanisms to restore its efficiency, and have government care for any losers by independent welfare policies: unemployment allowances, rent subsidies, aids to re-location and re-training, and so on. Some even favor a guaranteed minimum income (GMI) financed from taxation, though it offends their colleagues' beliefs about incentives to work and it would 'churn' a lot of income to and fro between taxpayers and tax collectors at considerable administrative cost. These concerns involve them in theoretical dilemmas between too little tax and welfare (so people suffer) and too much (so the will to work is sapped, and the imagined self-adjustment of the economy is distorted). Some hope - as did Adam Smith in *The Theory of Moral Sentiments* or Chester Barnard in *The Functions of the Executive* - that some combination of nature and experience might lead the actors in the economic system to pursue only their fair and reasonable self-interests, and only in considerate and forbearing ways - as most people already do in many of their market relations as in their other social relations. These civilized neoclassics tend to be known by their sterner colleagues as regrettably unrigorous.

Scientifically, most neoclassical academics have two related ways of living with the wrong kind of science to which they are committed. First they study, categorize and develop their own professional language for market failures, by which they mean failures of life to conform to theory: externalities, non-convexities, increasing returns, re-switching, monopoly and oligopoly, imperfect and unequally distributed information, the principal/agent problem, and so on. Naming them thus makes those items their own: they become elaborations of the master-theory rather than objections to it. They catalogue life's inefficiencies rather than the theory's inaccuracies. Using that language, analysts can then describe economic life by identification *with* and differentiation *from* the theory. Where it is consistent with theory it normally needs no causal analysis, because the theory supplies that. Where it differs from the theory, the causes of the difference do need to be identified. Defenders of the theory are reluctant to see market forces as the guilty parties if there are plausible alternatives. Can government intervention be shown to have distorted the natural market processes imagined by the theory? If so, the government is reproached and the theory vindicated by identifying the government's mistakes. If not, the market failure can be ascribed to one of the causes which the theory names as a recognized market abnormality. Analysts can proceed in

that way without reproach to the theory because besides shaping their analyses they also imagine that the theory models the best possible economic performance, so is the appropriate vision of good and guide to policy. A critic has likened the procedure to describing the chemistry of matter by detailed differentiation from the golden promise of the theory of alchemy.

Three capital mistakes persist.

In too many academic departments of Economics, especially in their advanced and post-graduate work, the primary subject of study has become the great structure of theory itself, in increasingly abstract and mathematical form. Most of any references to economic life are there to illuminate the theory in some way. It is urgent that that relation be reversed. The primary subject of economic thought and research and education should be economic *life* - as it is, as it keeps changing, as it might be, and as it needs to be governed. And because the life keeps changing, the work is likely to be done best by economists with quite pragmatic and instrumental attitudes to whatever theories or other intellectual equipment they find useful for their social and scientific purposes.

Second, the theory focuses on material costs and products, and a few of their determinants. Its measures of output and efficiency tend to dignify the production and consumption of market goods above other elements of economic life. Its causal selections emphasize the elements of competition and scarcely notice the elements of coercion and cooperation in economic activity. Its commonest way of comparing present and future values is to discount future values at expected rates of interest on borrowed money. These are dangerously inappropriate principles of selection for understanding the economic life, resolving the economic conflicts and arriving at the economic policies of affluent societies. Those societies should be organizing their economic self-knowledge to help them to improve their environmental prudence, the distribution of wealth and income within and between nations and generations, the distribution of income between people's earning and non-earning years, the economic problems of childhood and parenting and gender, the manifold contributions of work to the quality of life; and so on. History offers economists a new agenda for which some of their old theory is unhelpful and some (like the idea that we work only to serve other purposes) is actively misleading.

Third is the incompetence of the prevailing causal analysis of undisciplined economic behavior. As long as theft and monopoly and perhaps collective bargaining are banned, the hidden hand is expected to harness each self-interest to the service of all, with only occasional and correctable market failures. Market activity has lately over-valued some national currencies and suddenly collapsed others. It has created unprecedented quantities of gambling money and used much of it quite destructively. By escalating private international debt, much of it to no productive purpose, it has frustrated the already-inadequate market correction of unbalanced trade.

More capital has been imported to the world's richest country than all the rich countries have exported for other-than-gambling purposes to all the developing countries. Observing fifteen or twenty years of that performance, the leaders of powerful public international institutions and a majority of English-speaking economists continue to imagine that the opportunities and incentives which money markets offer to their individual participants will prompt them to provide the world with optimum quantities of money and credit, and to invest the money and allocate the credit to maximize world output of market goods, if only the banks are *completely* freed from economic regulation. Central Banks can be trusted to keep them solvent and adjust their base rates of interest from time to time.

Bad economics is not a main originator of these troubles. A variety of market and political and class interests, some of them ruthless, some honestly mistaken about their interests and their public effects, drive the business. But the interested parties who drive it could never have persuaded governments to allow the market participants their present powers and freedoms, and to tolerate their uses of them, if economists had not taught politicians, public servants, media proprietors and financial journalists - and through them, enough of the rich countries' citizens - to imagine that a global financial system will work best with least government. The curriculum of Economics One in most English-speaking universities and in rising numbers of their foreign imitators is a serious force in the world. To reform it is at least as important as any other action recommended in this paper.

What to do?

The present government of trade and national and international finance does not promise well. The further reduction of government which many people are urging promises worse.

To do better, developed economies need to contrive low and stable rates of interest; low inflation; employment and job security for as many as possible of the people who want them; a resumption of the long historical trend to less poverty and greater equality; appropriate rates of growth of money and credit; barriers or disincentives to destructive misuses of credit and uncommitted capital funds; stable rates of exchange with managed rather than market adjustments where necessary; effective means of balancing international trade and payments; and appropriate divisions of labor (which may well differ from time to time and country to country) between public, private, household and independent non-profit sectors.

None of those effects, except perhaps low inflation, will flow from unregulated market forces. To supply the necessary government is not to 'replace market by government', it is to equip the markets to do their work efficiently and constrain them to do it sociably. Appropriate rules and institutions for industrial capitalism were developed and adapted step by step through the first century or so of mass democracy. Some of them need attention now because they have lately been weakened or dismantled. Others need it because technical conditions or business organization have changed. We should take the task as seriously as the first factory and mine and bank reformers did in the nineteenth century, or the Bretton Woods reformers did in the twentieth. They had an advantage which the present generation in the developed democracies is only beginning to acquire: they had personal experience of ill-governed, under-governed business behavior. The present state of the Russian economy is a better guide to the directions in which further deregulation is likely to take us than are the unworldly fictions of the neoclassical imagination.

Developing an effective regime calls for strategic decisions about national and international institutions and relations between them, and about the scope for competitive, co-operative and bureaucratic activity and the intricate relations between *them*. In arriving at those

decisions there are difficult dilemmas between measures to prevent bad performance and measures to elicit best performance. There are likely to be national, class, occupational, ideological and other conflicts about many of the necessary decisions, and great difficulty in arriving at a coherent set of them. But their coherence is vital. As argued earlier, for example, (i) freedom for theoretically self-adjusting trade, (ii) competition between banks disciplined only by uniform reserve requirements, and (iii) opening all countries' investment opportunities to all countries' savings and bank credit, are individually attractive policies which are proving deadly in combination.

What follow are first a shopping list of changes which current East Asian and other troubles may have made politically possible: a Tobin tax; some relaxation of WTO rules to allow deficit-trading and indebted countries to control their imports and their uses of foreign exchange; some better tailoring of the conditions attached to World Bank, IMF and other international aid; a way to reduce some lenders' and borrowers' inflation risks, nationally and perhaps internationally; a role for an international authority in managing rates of exchange. Then some options for a more comprehensive strategy, when further experience of the new financial anarchy makes more radical reform thinkable.

FIRST STEPS

A Tobin tax

In 1968 James Tobin proposed a tax on all international exchange transactions, at a rate low enough not to bother investors, traders, travellers or other traditional users of foreign exchange, but high enough to discourage the incessant gambling on changing rates of interest and exchange which now accounts for nine-tenths or more of all exchange transactions. The tax would discourage unproductive speculation, and raise revenue for development aid to the poorest countries. Tobin suggested a rate of 0.02 per cent (2 cents per 100 dollars). Others have since proposed much higher rates, with the revenue

divided half-and-half between the collecting governments and aid programs for the poorest developing countries.

It is a good proposal which could if necessary be justified by its revenue and redistributive benefits alone. It would also reduce the volume of purely speculative transactions, but unhappily not their worst effects. The *incessant* trading which the tax would make unprofitable is mostly arbitrage: each pair of transactions makes only a microscopic gain from some microscopic inconsistency in national rates of exchange and bond interest, but a dozen transactions a day can yield a good annual income. In itself that activity is harmless enough. Most of it does not even occupy funds for which there could be better uses. (Since bank reserves have been regulated by the rule of risk-weighted capital adequacy which became general in 1988, banks can buy big quantities of rich countries' government bonds, to use as gambling currency, with funds which they may not use for any other purpose.)

The harmful kinds of speculative dealing yield bigger gains or losses from fewer transactions, so a Tobin tax is less likely to deter them. When dealers punish governments for unpopular policies by selling down their bonds and exchange rates, each dealer need only sell each asset once, with more at stake than a Tobin tax takes from the transaction. The same is true of panicky 'lost confidence' runs on particular currencies, as recently in East Asia. And it will be true of the more deliberate asset-seeking attacks on small countries' rates of exchange which the East Asian accident may inspire in thoughtful predators. No taxation can do much to prevent those most destructive misuses of unregulated capital markets.

Implementation Governments which favor the tax could agree its terms and require the exchange dealers whom they license to collect it. Agreement of three or four of the most powerful governments could probably attract the consent of most of the rest. They could charge several times the standard rate on dealings with institutions licensed by non-participating governments. Or they could ban dealings with any institution which was not certified to collect the tax on *all* its exchange transactions. If benefit of the international share of the revenue is confined to low-income countries which require their banks to comply, that should enlist the developing countries.

Capital deposit requirements

Other countries could copy the deposit requirements by which Chile and Colombia discourage the entry of footloose capital for short periods and speculative purposes.

Policies of the Bank, the Fund and the World Trade Organization

Internal conditions of aid When the World Bank or the International Monetary Fund gives or lends to poor countries the conditions should not be such as to depress employment, investment and growth below rates which they might otherwise achieve. Inflation should be attacked by means which do not require the national budget to balance when that would enforce unnecessary unemployment, and do not impose high interest rates which reduce the productivity as well as the quantity of new investment. Countries whose balance of payments or level of employment or industrial beginnings depend on some protection should not be deprived of necessary protection. Efforts to make aid effective should not include doctrinaire demands for privatization, deregulation and smaller government. As applied to more than eighty countries now, those 'Washington consensus' requirements have helped to depress global as well as national growth. Some of them are sometimes appropriate, but often not. Efforts to improve the competence, honesty and scope of government may be at least as productive. Conditions for aid should reflect judgments of national circumstances and potentialities, including capacities for good government and good business enterprise, as recommended in the World Bank's 1997 World Development Report though not yet in all of its practice.

The preface to that Report announced substantial changes of Bank policy. Officers of the Bank have since suggested that the Fund should follow suit.

Debt traps

Deficit trading and ill-regulated banking can together get some national economies into unrepayable debt whose interest payments can only be met by further foreign borrowing: a trap which nobody intended, or could prevent under present regulatory policies. Private banks lent to poor countries' governments through the 1970s and to communist and transitional governments in the 1980s. Deregulation has allowed the developed countries' banks to borrow foreign funds freely, and they have found willing lenders because they are known to have effective government guarantees. Foreign borrowing to meet current account deficits has reduced the tendency for market adjustments of exchange rates to equilibrate trade and payments. Banks and governments between them have increased real interest rates on many of the continuing debts since they were first incurred. Changing rates of

exchange have also increased some of the debtors' obligations by more than they have improved their trade balances. Thus by public or private borrowing from foreign private lenders some each of developing, transitional and developed countries have been trapped into self-expanding foreign debt.

In Book IV of *The Wealth of Nations* Adam Smith encouraged deficit-trading countries to finance their imports by foreign borrowing - but not to increase their foreign debt at a faster rate than they increased their national output. Some rich and some poor countries are now breaking that rule, with economic growth below 3 per cent and net foreign debt increasing involuntarily by more than 5 per cent of GDP each year. If the debts are denominated in the lenders' currencies (as most of them except most of the United States' debts are) they also face exchange risks to their interest and capital obligations.

There has been savage damage to some developing countries, especially the poorest. Net financial transfers to all developing countries via long-term lending averaged US\$28 billion a year for the seven years to 1982. For the seven years to 1990, the service of that debt transferred a net annual average of US\$25 billion *from* the developing countries to the rich West and the IMF. Since 1990 capital transfers to developing countries have increased again, with less private lending than before and more direct and portfolio investment. But most of that flow has gone to the richest dozen of the developing countries. The poorest group, who owed US\$106 billion (16 per cent of GNP) in 1980, owed \$535 billion (38 per cent of GNP) in 1995.

The least developed countries were not the only ones to be trapped. Mexico crashed and had to be rescued in 1982 and again in 1994. East Asian economies, including some efficient producers and surplus traders, were in trouble in 1998 from imprudent borrowing and the panic depression of their exchange rates. Australia and New Zealand, deficit traders since drastic cuts in their tariffs and a decline in their terms of trade, may be the next to face serious trouble, with growth averaging 3 per cent or less and net foreign debt growing annually by 5 per cent or more.

First steps To disarm the debt trap may require some radical repair of the regulation of international trade, credit and exchange. Pending that, it would be good to give some quick help to countries already in the trap. The following may be worth trying. The first is already in train, but could be strengthened. The second is available in

some circumstances to developing countries, but could be extended to others:

- The HIPC initiative - the 1996 World Bank/IMF plan to clear the longstanding debts of heavily indebted poor countries within six years - could be improved in three respects. It could be accelerated. It could be accompanied by increased direct aid to enable the countries in the group to accelerate the rate at which they can meet their basic needs for shelter, nutrition, education, and health including reproductive health. And some current conditions of aid (including requirements for freer trade and tighter fiscal restraint) could be modified for indebted, under-employed, deficit-trading countries.

- Where developed and transitional economies are already debt-trapped, their governments could be excused from treaty obligations and World Trade Organization rules as far as may be necessary to allow them to reverse the expansion of foreign debt by regulating their foreign trade in goods and money.

Level credit

Lenders' and borrowers' interests conflict over inflation risks, which may be compounded by exchange risks where loans are international. When lenders respond to inflation by adding actual or expected rates of inflation to rates of interest, that 'slopes' many long loans, as described earlier. High early repayments exclude borrowers who have to pay from level real incomes. Various inequities and inefficiencies follow. As argued earlier, some borrowers and some lenders would fare better, and so might investment as a whole, if it was possible to adjust capital instead of interest obligations to inflation. It would be good if some national governments would create the institutional conditions for level credit and give it a market trial.

Exchange rates

Rates of exchange serve productive and social purposes better the more stable they are. But to conceive and negotiate a new regime - a 'new Bretton Woods' - is likely to be difficult in any circumstances. It will be more difficult if conflicts about such a project, and reports and rumors of the known and suspected progress of its negotiation, are added to the stimulants which already excite the markets and destabilize rates of exchange. So the powers might welcome an exchange truce for the duration of any serious negotiation. A strengthened IMF or a new International Exchange Commission could be empowered to freeze existing rates, move them closer to

Purchasing Power Parity where appropriate, and change them only when significant changes from PPP compel. The truce might be for a year, with annual extensions if the powers agree that they are justified by the experience of the truce and the progress of the negotiations.

This suggestion for calming the markets' likely panic at any talk of serious reform can appropriately introduce the question of serious reform.

REASONS FOR MORE COMPREHENSIVE REFORM

There would be massive business, professional and political opposition to an attempt to restore effective government of national and international banking. Why dream of attempting such a thing? What follows is a summary of the main reasons offered earlier in this paper, without many of their necessary hedges and fences but with some additional support from reports of market participants' responses to the East Asian financial troubles.

Three decades of technological, economic and policy changes have given the world a financial system with (among others) this unprecedented combination of characteristics:

The world's national governments can register any number of banks, which can attract reserve capital, create credit and augment the supply of money in the global market. There is neither any central care nor (after extensive deregulation) much possibility of effective national care for the total that may be created, or for its composition.

Credit can be allocated most productively only if it is in reach of the whole range of its potential users. Among others it has to be accessible to the most competitive industries, to industries with the longest lead times, to new and small firms in those industries; to exporters into competitive markets and producers competing with imports in competitive markets; to small and poor as well as big and rich farmers; to households which want to own their housing and with appropriate credit can afford to house themselves better or more cheaply over time than they can do as renters; to women as well as men; and so on. With important exceptions the productivity with which credit can be allocated and used tends to be inverse to its rate of interest: it cannot be efficient to ration it by price in a global market from whose prevailing rates of interest national economies or currency blocs cannot be insulated. In those conditions there cannot

be most-productive allocation between more monopolist and more competitive enterprises; between naturally protected non-tradeable industries and unprotected tradeable industries; between housing and other needs or between richer and poorer households; between credit likely to worsen national balances of payment and credit likely to improve them; between asset traders for capital gain and producers of goods and services; between producers of goods and services and pure financial speculators on future rates of interest, inflation and exchange and derivatives thereof; or between speculative creators of those instabilities, and productive enterprises trying to hedge the risks which the speculative activities create.

Macroeconomically, there are no longer effective market *or* regulatory mechanisms to equate the whole supply of credit with the productive need for it. Banks still create credit in the usual way for producers and consumers who can afford the prevailing interest rates and risks. But it is now profitable for banks to create, also, funds for purely speculative use by themselves and others, and there is no necessary limit to the demand or the supply of such funds. There is no limit because pure financial speculators gamble on the prices and exchange values of their gambling money itself. They can therefore play their game independently of the real economy, and on any scale. The amount of money which the banks can profitably create and the amount which they and other gamblers can profitably employ is not limited by the world's supply of real goods and services on which to spend it. Nor is the volume of gambling money necessarily inflationary - though it can be, if its users burn their fingers gambling, look for safer prospects, and switch their funds to inflate property or share prices or to expand consumer credit.

But although the scale of the gambling need not be limited by the size of the real economy, the bigger it gets the more harm it can do to the real economy. It is one of the activities which destabilize unregulated exchange rates. By destabilizing exchange rates it upsets national balances of trade, payments and debt. It increases risks in tradeable industries and in others which are affected by the tradeable industries' prices. It increases risks for institutions which have assets and liabilities in different countries. By enforcing comparatively high interest rates throughout the global market it needlessly reduces the efficiency with which capital funds can be allocated anywhere in the market. In those and other ways it limits growth and weakens national governments' capacities for microeconomic and macroeconomic management.

(A moral or equitable question: should the right to lend money at a market rate of interest - i.e. for as much as borrowers are willing to pay - be a fundamental property right of people who own capital funds? Does regulating the rate infringe that right? The best discussions of the principles involved are in medieval theologians' debates about usury. Nowadays one old and one new consideration seem reasonable. First, lending is only one of the capitalist options. Fund-owners can alternatively invest in property for rent and capital gain, or in shares for dividend and capital gain, or they can form firms or partnerships of their own. They are *not* allowed to buy slaves or sell dangerous drugs or live on other people's immoral earnings. All their options are subject to regulation in the public interest. So should money-lending be, especially as lenders' *benefits* depend heavily on public regulation by property and contract and bankruptcy law. Second, a lot of the money with which banks earn interest is money which they create for the purpose by authority of, and under conditions imposed by, their bank charters. It is entirely proper that governments which create and license such an extraordinary private power should regulate its use in the public interest.)

The new game has losers as well as winners, but there can be net gains for its players as a group. They are not mistaken about their market opportunities or their interests: in many circumstances they can expect higher returns from the game than from alternative uses of the footloose funds and the new capacity to create them. They are doing their best for their shareholders as the law requires directors to do, but in a misgoverned market. As rational profit-seekers they will play the game as long as the misgovernment lets them. To excuse their activity as 'inexperienced' and the economic and social harm which it does as 'transitional pain' is simply incompetent. This activity, rather than the most-productive creation and allocation of credit of the neoclassical economists' imagination, is what rational profit-seeking banks will continue to do with some of their resources as long as they are under prudential but no effective economic regulation.

Do the economic costs of the new insecurity buy comparable benefits? Three are sometimes claimed. First, some of the winning gamblers work for widely-owned superannuation funds which have extended the benefits of share ownership, institutional moneylending and 'capital gambling' from around 10 per cent to 30 or 40 percent of the people in English-speaking countries. One effect may be to attract more political support for the new market freedoms from anxious middle-

income people dependent on private superannuation, although many of them might actually have more secure retirement incomes through public or composite public/private superannuation of the West European kind.

A second claim for the new game is that its futures and derivatives markets offer producers and traders of real goods the means of hedging some of the risks which the game creates for them. But it would be better not to create such risks in the first place. The lesser risks which arise in a regime of better-regulated interest and exchange can be more cheaply insured in those better-regulated conditions. And (despite contrary claims) wherever the financial system is financing the economy satisfactorily now, it was financing it as well and at lower interest before deregulation. Even the big projects which used to require public or joint public/private financing still require it - as in the development of information technology, satellite technology and infrastructure, Airbus and very fast trains, the Channel Tunnel. Thus it is hard to find genuine benefits to compensate for the versatile harm which the new anarchy allows and motivates.

An American objection A last-ditch defence of the new freedom credits it with causing the current prosperity of the United States, with its low unemployment, low inflation and continuing growth. Some detailed misgivings about that defence were cited earlier. Here, a simpler response will do. Lower unemployment, higher investment and faster growth were all there before deregulation. So was low inflation, for much of the period. So were the energy, culture, depth and breadth of education, organizing capacity, and entrepreneurial spirit and ingenuity which contribute to American economic performance under the best and the worst conditions. Buoyant employment and spending do not depend on the wage-cutting to which some analysts ascribe them. And their financing has owed as much to government as to the private banks' uses of their new freedoms. Through the 1980s the Republican administration surprised friends and enemies alike with an uncharacteristic feast of deficit budgeting, deficit trading and public borrowing. Big tax cuts and budget deficits sustained high after-tax income, spending and employment, with comparatively low rates of investment. The budget deficits were partly financed by big issues of government bonds. Many of those were bought with the expanded credit made possible by the banks' new prudential rules of risk-weighted capital adequacy, which gave special status to loans to government. So when the combination of buoyant consumer spending with comparatively low

investment brought the big excess of imports over exports through the 1980s, some of the excess was paid for by on-selling government bonds to foreigners, rather than by private borrowing from them. Through the ten years to 1993 country-to-country sales of US Treasury bonds rose from \$30 billion to \$500 billion. Thus the US transition from the world's biggest creditor nation to its biggest debtor financed more consumer spending than investment, and it was achieved with much of the foreign debt denominated in US dollars with the foreign lenders bearing the exchange risks. American financial institutions and hedge funds were the biggest and richest of the new exchange gamblers - and a regulatory change and a burst of public borrowing had together handed them much of their new gambling currency.

Those and other causes might well have done even more for spending and employment *without* the second great change of direction since the 1970s, the historical return to rising inequality. The unequalizing processes include a bigger increase in the profit share than in investment; concentrated gains from the new financial gambling; the accelerating rate at which executives have plundered their corporations since the 'Delaware revolution' in their legal powers in 1967; and the relative and absolute decline of the bottom third of wage incomes, and the decline of union membership, in what Paul Samuelson now angrily calls a 'cowed' working class. Its members work longer hours for less pay, with more casual and involuntary part-time work and with less job security, than their equivalents enjoy in a dozen less rich economies, a number of which have as low inflation and as little unemployment as the US. It is important that the rest of the world not be persuaded by neoclassical economists and some winners from deregulation to see America's new inequalities - rather than her human capital and the other long-standing sources of her productivity - as main determinants of her economic performance.

Living with failure (1) Before the Asian crisis

The people who conceived the new global regime predicted scarcely any of the harm which it has done and continues to do. None of the net benefits which they did predict has occurred (recall John Eatwell's paper, cited earlier). Very few of them have acknowledged their mistakes. But a sequence of adaptations to failure is common. As the market forces are freed the liberators predict that their performance will improve. When it does not improve they say 'Give it time'. When it gets worse they identify 'transitional pain'. As the pain increases

some of them warn that the reforms are incomplete: the benefits cannot be expected to flow until the money market and the labor market are *entirely* free and there are no welfare alternatives to work. Others acknowledge that freedom came too quickly - bankers and others needed more time to re-design their institutions and learn new skills - but with time and experience the original predictions will still come true. When it becomes obvious that some of the highest skills and newest institutions are those of the winning exchange gamblers and asset raiders, the liberators again blame the speed rather than the direction of the revolution: they now see the trouble as the haste with which the regulation and policing of the new system were thrown together. Even some strong critics of the strategy continue to predict its ultimate success. There is, for example, an excellent review of the new market malfunctions in an able paper by Andrew Cornford and Jim Brandon ('The WTO Negotiations on Financial Services: Problems of Financial Globalization in Practice', UNCTAD, Geneva, 1998). But the authors still declare that their observations and analysis 'are not arguments against the benefits of either financial liberation or an expanded presence of foreign financial firms *per se*. But they do point to the disadvantages of excessive haste under either heading. Moreover they suggest that the pace of developing countries' opening-up of their markets should be geared to a conservative timetable determined by the exigencies of the periods required for the implementation of effective regulation and supervision and the putting in place of effective internal controls by financial firms as well as their acquisition of enhanced banking skills.'

Thus rather than admit error, 'effective regulation and supervision' are tactfully re-defined as forward steps in the process of freeing business from effective regulation and supervision. Only so, perhaps, can honest researchers get their embarrassing findings past the orthodox gatekeepers of the international institutions which they advise.

Living with failure (2) Since the Asian crisis

Two things distinguished the 1997-98 East Asian crisis from most earlier debt-and-exchange crises. There was very little regulation or excessive borrowing or default by governments, so the crisis was unmistakably a *market* crisis. And it led rising numbers of the main market participants to doubt the market's new principles and to fear that without a revolution in its government it could never perform efficiently.

Through the 1990s Thai and South Korean banks used their new market freedom to borrow heavily from Japanese, US and other western banks, and on-lend local currency to local firms. That financed some over-investment in otherwise-sound industries, and some speculative buying and over-pricing of property. In a (forthcoming) chapter on the Korean financial crisis of 1997-98 Irma Adelman concludes that 'in the absence of its recently liberalized capital markets, the combined effects of its institutional deficiencies and its policy mistakes would have merely led to a recession rather than a melt-down'. But in the new conditions there was *neither* any public responsibility for the whole amount of new foreign capital debt *nor* any market mechanism to relate the whole amount to the productive, trading and earning possibilities of the region. For a while the inflow seemed to fulfil the deregulators' promise that capital would 'flow from the capital-rich developed world to the opportunity-rich developing world' to the benefit of both. But as optimistic manufacturers expanded more capacity than their export markets could employ, and soaring property prices lost any plausible relation to the properties' earnings, some of the participants saw what must follow and began the panic sale of the borrowers' currencies. Some also began, at last, to question the promise of their new global freedom.

In July 1998 the United Nations Department of Economic and Social Affairs and its Regional Commissions together asked an expert group what had been learned from the first year of the crisis. Christopher Rude reported what some leading Wall Street participants in the market believed they had learned. These were users and had mostly been protagonists of the new freedoms. They included officers of a dozen of the world's biggest American, British, German and Japanese banks. He found that many of them have not only lost faith in the prospect of continued robust growth, [but also] in the merits of financial market liberalization and globalization, indeed, in the viability of free, unregulated international capital markets as well. They worry, in particular, that financial market liberalization and globalization might have unleashed the very contractionary forces that seem now at play. On the one hand, this questioning has led to a heated debate over the future course of the international financial system that is truly remarkable for its freshness and depth. On the other hand, when faced with the choices about which policies should be adopted to avoid a global downturn or prevent a similar financial crisis from

happening again, many market participants find that they do not know what to recommend.*

In the same month Edward Luce, Euromarkets correspondent for the *Financial Times*, invited the readers of *Prospect* magazine to take seriously the proposition that the core of the problem lies in the functioning of financial markets themselves...the world as it stands is dangerously vulnerable to financial instability and is likely to become more so in the years ahead. Such a world . . will become increasingly accustomed to the type of shock it has recently witnessed as the globalisation of financial markets intensifies. Such crises will become more - not less - profound as the pool of capital under private management grows in Europe and elsewhere. And such a world will have to get used to the social and political instability which these crises leave in their wake. The status quo is a dangerous gamble because it contains the potential seeds of its own destruction . But the focus of policy debate at the very highest level may, at last, be shifting from the "whether" to the "how" of regulating financial markets.'

Conclusion

As before: we cannot expect safe, efficient or socially acceptable service from a financial system in which private banks, empowered by many national governments, create most credit, but high and unstable interest prevents its most productive allocation, and there is no effective regulation of its quantity or permissible uses or of capital exchanges between currencies or of private lending between currencies. The dangers are further compounded if deficit-trading and indebted countries which can no longer regulate their private capital flows are also prevented from regulating their trade. As summarized in John Eatwell's papers, the global market has broken all its main promises. Its ill effects are now worse, and hurt many more people, than did the stagflation which occasioned the loss of faith in Keynesian policies and the resort to deregulation in the 1970s. There is good reason for a change of direction at least as radical as that one.

ALTERNATIVE STRATEGIES

There could be alternative ways of providing the world with appropriate quantities of money, and with credit at payable rates of interest for productive uses, with rates of

* The 1997-98 East Asian financial crisis: a New York market-informed view, UN, July 1998.

exchange between currencies as stable as their purchasing power allows, and with acceptable means of balancing national trade and payments wherever unaided market forces do not balance them.

Uncoordinated profit-seeking banks with their present opportunities and incentives cannot achieve those good things. Nor - at another extreme - is a single world currency managed by a world government a practical option. Workable schemes, arrived at by agreement between national governments, will need to relate national and world institutions, and market freedoms and incentives, in quite intricate ways. They may need to include some national diversity - to allow (for example) Americans, French, Chinese and Norwegians to do some things differently because of their different capacities and collective purposes. And developing and transitional and developed countries will certainly need to do some things differently from each other.

Those necessary ingredients might still be combined in more than one way and in different proportions. Negotiators with different interests and visions might try, for example, for:

1. a global money market with the least government consistent with tolerable performance, and with as much as possible of that government provided by the IMF, World Bank, UN agencies and other supra-national institutions.
2. A system which minimizes those international powers and allows each national state or federation to manage its money with the greatest practicable independence. Lance Taylor argues for that approach in *Lax public sector, destabilizing private sector: origins of capital market crises* (UN 1998).
3. A system which - by some yet-to-be-discovered means - fulfils the deregulators' original ambition to maximize world output, leaving any desired improvement of its distribution to local welfare provisions.
4. A system which integrates its social and financial purposes, for example by building some egalitarian and environmental bias into the creation, pricing and allocation of credit and into the rights and obligations of international lenders, borrowers and investors. There is a carefully detailed example in *Towards a New Bretton Woods: Alternatives for the Global Economy* (Spokesman, 1994) by Stuart Holland, whose summary of it will conclude this paper. It is preceded, here, by a proposal of the minimum action which might be necessary to allow developed democracies which want to pursue those social-democratic purposes to do so.

Where there are roles for international institutions there may be questions about the institutions which might best perform them. The Bank, the Fund, the Bank for International Settlements and other established institutions are natural choices. But some of them are commanded and staffed by people who have developed the present system, believe in it, wish to free it further, and would oppose a return to more public ownership or regulation of financial institutions. Should their governing bodies nevertheless command them to comply? Or might new institutions do better where radical changes of belief and purpose are required? The following program assigns roles to some old and some new institutions, more from indecision than as a confident recommendation. Members of the existing institutions, and others who deal with them, should be the best judges of their potentialities.

A PROGRAM FOR DEVELOPED COUNTRIES

The aim is a financial system which is capable of efficient support of productive business, and which frees democracies to opt for a wide range of social and distributional policies. The means need to include:

- appropriate quantities of money and credit;
- economically efficient and socially desirable allocation of credit, which requires (among other things) stable low rates of interest;
- balanced international trade and payments without involuntary or harmful levels of international debt; and
- financial arrangements which are consistent, if other policies allow, with full employment, low inflation, prudent environmental care, and declining poverty and inequality.

Proposals follow. They are politically unthinkable. But they may well be the minimum conditions for reasonable standards of financial safety, allocative efficiency and social peace. So instead of wondering how the opposition might ever be overcome, the program is sketched in the present tense as if, at some future time with its battles won, it is in place and at work.

Banks

Early in the new millennium the World Bank and IMF together recommended, and most countries developed,

a trio structure of savings institutions, specialized banks, and commercial banks. In some countries national initiatives have added a fourth source of credit as their Central Banks finance many of their public investments. Details -

Savings banks - including building societies, credit unions and other savings and loans institutions - are licensed by their national governments to do specified types of business within their national (or currency) boundaries. They lend chiefly for housing, small business and some non-profit and local government enterprises, secured by houses, land, business premises or public guarantees. All their lending is at or below a regulated rate of interest: commonly whichever the lenders prefer of 4 per cent nominal or 2 per cent real. As intermediaries borrowing short to lend long, they have public lender-of-last-resort facilities. The quantity they can lend is normally limited by their deposits, their prudential reserves, and whatever unreserved capital they have; they are not allowed bulk borrowing from other private institutions. The Central Bank can reduce their lending capacity by demanding deposits from them, or increase it by lending to them, but this power is rarely used. Some countries extend the reach and economise the labor of some of the savings institutions by running deposit and withdrawal services for them in every public post office.

Most countries confine these institutions to public, mutual or other non-profit ownership, and limit the rates they may pay their directors and staff. Those provisions tend to attract public-spirited founders and board members, and unadventurous staff with modest ambitions for secure employment, some liking for the work, and often a sense of public or community service. That fits the nature of the work. Such people, in such non-profit institutions, are best able to adopt the helpful economies offered by information technology but to resist the cruel ones. For example they are freer than competitive profit-seekers are to keep marginal branches open when the commercial banks are closing them, and to continue human services to their poorest customers, including walk-in customers in suburbs and villages, and country people at remote locations.

Special-purpose banks replace or supplement or compete with some of the savings-bank services in some countries. The commonest are housing banks, farmers' banks and export/import banks. They exist to develop special expertise in their fields, and to give their national governments or Central Banks greater influence than they might otherwise have over the allocation of credit between

alternative uses. Some of them issue bonds or accept interest-bearing term deposits, but most are funded in one of two other ways. Their national Central Bank funds them. Or they have a mixture of Central Bank and indirect 'post-office' funding in countries which have national post-office savings banks which give their customers deposit and transaction services but do not lend to them. The special-purpose banks lend under the same interest-rate limits as the savings institutions. The export-import banks (alone in this group) are licensed to deal in foreign exchange.

Commercial banks are profit-seeking fractional-reserve lenders of the traditional kind. They create credit under international and national rules. Internationally, they comply with the Bank of International Settlement's amended rule of risk-weighted capital adequacy. If licensed by developed countries' governments, which they have to be to operate in those countries, one per cent of their lending has to be to the World Bank, interest-free. An international agreement limits their rates of interest on secured lending (with one exception, noted below) to rates which average, per dollar lent, no more than the savings-bank limits of 4 and 2 per cent; but they can adjust their rates to risks around those averages. They may not pay interest on cheque accounts, or on positive balances in credit card and electronically accessible equivalents of cheque accounts. Their core business is thus to mind their depositors' money and provide them with transactional services, and to lend at low interest their interest-free deposits. They can accept term deposits and pay interest on them, but the proportion of their lending that they can afford to finance in that way is restrained by the limited rates which apply to most of their business lending.

As an exception to the interest limits on secured lending they may charge any rate of interest on hire-purchase loans to individuals. And they may charge any rate on unsecured lending: on venture capital, card credit, other unsecured consumer credit and personal overdrafts, which have high risks or management costs or both.

The international agreement provides in specific terms that lending may be secured on corporate property but not on corporate equities, and in general terms that banks do not lend to investment trusts or managed funds. The few remaining exchange and futures gamblers have to bet with their own money.

The commercial banks' deposits circulate at much higher velocity than do those of the savings and special-purpose institutions, so they continue to be the

main agents of the bank multiplier, and creators of credit. But their incentives to lend to non-producers, or to create funds for their own speculative use, have not survived the new regulation of interest and exchange rates and capital exchanges.

The governments which agreed those rules enforce them by regulating the banks which they license. Where necessary they act to prevent evasion of the rules by companies which are not specifically chartered, and consequently regulated, as financial institutions. Policies about bank ownership vary. Some countries have some commercial banks in public ownership. Those which admit branches of foreign banks register them under national rules and regulate them impartially.

Because it limits most interest rates, the international agreement acknowledges that governments have to ration credit and manage their national supply of money by other means than manipulating interest rates. Those means may include varying the reserve requirements within which the BIS risk weightings apply; requiring and varying 'non-reserve' deposits with the Central Bank; requiring banks to vary the quantities lent for particular purposes; and discriminate regulation of capital lending, borrowing and exchange with other currencies, provided that there is no departure from the agreed interest limits, or from the fixed exchange rates described below. The agreement also requires developed countries (with IMF help in some circumstances) to limit their net public and private foreign debt to a third or less of national income, or if it already exceeds that limit to prevent its further increase. The means may include regulation of trade, of private exchange dealings and of the uses of foreign exchange.

Public credit International and national authority have thus combined to restore boundary controls to currencies. That restores the capacity to influence the volume of credit within each national economy. That in turn frees national governments to create public credit in a non-inflationary way. Those who do so have adapted a scheme whose Canadian inventors called it 'Sovereign'. A quota of long-term public investment is financed by interest-free but repayable loans from the Central Bank. It is a low quota, based on estimates of the least that all levels of government are likely to invest in any year, and it is stable, subject only to occasional strategic changes. The quantity of private bank credit is adjusted so that the two add up to the desirable total of credit for the economy as a whole. The quota does not reduce the credit available to the private sector, because government would have taken at

least that much of the available credit in any circumstances. What is new is that the public investment which it finances does not pay interest to private lenders. The losers from the scheme are thus private creators and lenders of money, not private investors. The Canadian authors are not alone in asking why a community which owns a public Central Bank should pay private banks to create credit to finance its public investments. The public funding does no harm to private or household investment, and cuts taxes or frees tax revenue for other uses.

The public borrowing is disciplined by three means to prevent extravagant misuses of it. First, quota credit has to be repaid, commonly over twenty years or the expected life of the capital goods, whichever is shorter. The Central Bank thus accumulates a revolving public investment fund and the country does not accumulate a big public debt. Public investments which earn, as public utilities do, pay their own debts. For investments which don't earn (roads and bridges, public parks) tax or other public revenues or deficit budgeting pay.

Second, most decisions about the whole quantity of public investment are about margins of investment above the quota (the quota is set low to ensure that) and credit above the quota has to pay the going rate of interest (whether to the Central Bank or to private lenders varies with national policy, and may vary with macroeconomic considerations at the time).

Third, the whole amount of credit and the public and private shares of it have to be coordinated with fiscal and balance-of-payment policies in policy-makers' efforts to contrive volumes of income and investment consistent with low unemployment and low inflation.

Of course the discipline varies with the quality of government and is everywhere imperfect. The forecasts of activity can err. Interests conflict in the policy-making and can make it incoherent. Some politicians pork-barrel the quota funds if they can get away with it. Some countries are better than others at restraining inflation. And so on - but at its best the system works well, and at its worst it still works more efficiently and equitably than the preceding system did through the last quarter of the twentieth century.

Besides disciplined banking, the financial reform also depends (as the disciplined banking does) on relating exchange rates to market prices of goods and services rather than to market prices of currencies. But before passing to the new exchange strategy, two further items are worth noticing: measures to prevent credit-fuelled booms in city property prices and share prices, and means of accompanying low unemployment with low inflation.

Bank credit and asset prices

Some assets - for example land in city centres, shares in successful companies, precious works of art - increase their value as economies grow. Rising numbers of people with rising incomes shop in city centres, buy successful firms' products and bid for their shares, bid for houses at desirable locations, bid for precious works of art, and so on. As long as there are no catastrophic wars or depressions such assets can make their owners steadily, permanently richer.

Those prices rise as economic growth increases the demand for limited resources. But they can rise faster and higher if banks create and lend more money than usual to the people who compete to own such assets, and bid their prices up.

While they last, booms in asset prices can make all the participants richer. They increase wealth precisely because they do not inflate all prices as a general inflation does: a city office building or a parcel of shares or a Van Gogh painting can buy more bread or BMWs as the boom proceeds. Buy shares or city land cheap early in the boom, sell them before the boom collapses, buy them back after it collapses, and you are permanently richer than you were, at the expense of the traders who failed to get out in time - and at the expense of any bankers who financed those losers.

It is only necessary to get in early and get out in time. So it is a half-truth to say that city land prices and share prices boom and then crash at irregular intervals, generation after generation, because people in those lines of business don't know their history or don't learn from it. The best operators understand that such booms offer better returns than do most alternative uses of their own or their bankers' funds. And property booms allow banks to create and speculators to borrow more gambling money than other casinos do, because the loans can be secured on real estate at market value, traditionally the most respectable of all collateral. There are thus two spectacular inefficiencies. The loans raise the property prices which expand the loans which raise the prices which expand the loans which. . . And as banks compete for the business, there is a strong tendency for the least competent to win a good deal of it. Traders can get out of a boom market at any moment, but banks can only get out when the dealers they finance choose to get out, and get out solvent. The least competent traders are those who buy in or stay in too late, and they tend to have been financed by the least competent lenders.

Share-price booms can generate similar circular self-inflation. None has since soared as high or crashed as far, with as terrible effects on business and employment, as did the boom that crashed in 1929. But substantial damage has been done by the banks which borrowed and lent the OPEC funds through the 1970s, or fuelled the property-price booms of the 1980s, or distorted the East Asian exchange rates in 1997-8. There were good reasons for new measures to prevent bubble-booms in share and property prices.

Share booms Share-price booms are now effectively discouraged by an international agreement which binds most OECD governments to respect contracts signed before the date of the agreement, but to ban any new use of company shares as security for credit. People can still buy shares with money borrowed on other security. But the new rule should prevent serious credit-fuelled inflation of share prices in future. (It also prevents the more speculative, unpromising type of takeover warfare.)

Property booms The ban on shares as security is international. Property prices cannot be restrained by the same means, because mortgage finance is the sensible way - and for many firms and households the only practicable way - to acquire necessary real estate. So mortgage credit reforms are still national, and vary. Two of the best:

1. One country includes the restraint of booms in the responsibilities of its Central Bank, and empowers it to instruct commercial banks and savings banks to restrict particular kinds of lending when it judges such intervention to be prudent. This has the advantage that the regulator can leave the lenders alone most of the time, intervening only in response to danger signals. The lenders value their freedom and usually preserve it by prudent self-restraint. Wherever the political and business culture find it tolerable, this is the most comfortable, economical and effective policy for all parties.

2. Where bankers and their customers distrust discretionary public powers and want clear rights under clear rules, one country links its credit policies to its town planning and land use regime. Contracts existing at the date of the reform can run their course. But for new business, three rules apply wherever land is zoned for urban uses: (i) Firms and households which own the real estate which they occupy may finance its purchase and maintenance by any lawful means. (ii) Rented property must be owned free of debt, except that (iii) rented housing can be indebted if it is owned by a registered landlord. Registration brings the landlord under rent

control as well as the ordinary landlord and tenant laws which apply to unindebted property. Under these rules most city offices, shops and commercial car parks are strata-owned by their occupants or they are owned by superannuation, insurance and other long-term investors of their own or their members' money. They have usually been the best city landlords, and continue to be. Under this regime all useful market freedoms continue (for example as shops and services and households bid for their best locations) but there are few bidders for quick capital gains, and rental housing prices are restrained by their rent controls. The price restraints are strengthened, and any ill effects they might have on private supply are averted, by some competitive public supply of low-cost housing.

Inflation

Rates of inflation vary as before with national culture and historical experience, cooperative or uncooperative industrial relations, the weakness or strength and the unity or otherwise of labor organization, and the capacity (or not) of peak business and peak union bodies to negotiate national agreements and deliver compliance with them. Low inflation is achieved with strongly organized labor in some countries and with ill-organized, market-weak labor in others; with generous welfare in some and with mean welfare in others; with employment secure in some industries and insecure in others. Unhappily both for financial stability and for economic theory, there are no simple, commanding regularities. But it is not hard to understand (for example) how and why low inflation accompanies quite low unemployment, poor welfare, comparatively slow economic growth and rising inequality in the United States, and has accompanied even lower unemployment, generous welfare, increasing equality and Europe's fastest growth in Norway. Inflation does tend to be slower under the new financial regulations. It varies less between the developed countries, and therefore causes less disturbance to their exchange rates. But the improvement may owe as much to accumulating experience and common sense as to the financial reforms.

Meanwhile two innovations are spreading because they are proving helpful. National statistical offices publish consumer price indexes and monetary deflators together, with official explanations about any tax, distributional and exchange-rate changes which account for changing relations between them. That encourages public discussion and understanding of the possibilities and limitations of real wage gains, and of any unreasonable pricing behavior. And where significant inflation does

occur and nominal interest rates rise accordingly, some of the ill effects of sloped credit are moderated by dual credit markets which give lenders and borrowers choices between indexed-interest and indexed-capital terms.

Exchange rates

(*Terminology:* Rates of exchange are between currencies. Euros are the currency of more than one country, and may circulate alongside a national currency in some member states of Europe. But for brevity these notes refer to 'national' currencies and rates of exchange and trade balances. The obvious amendments apply where there are shared currencies or multi-national free-trade areas.)

In this program:

A new **International Exchange Commission** fixes rates of exchange. It decides and publishes principles of Purchasing Power Parity (PPP). It relates exchange rates to PPP, and thus to market prices determined by the supply and demand for goods and services rather than to the supply and demand for currencies. The rates are fixed, and changed only when a currency's purchasing power strays more than a specified percentage from the ruling rate. The Commission determines the permissible distance that a country's rate can stray from PPP before it must be adjusted. The Commission can vary the distance, which it may do in some circumstances to frustrate or punish speculative pressures on particular currencies. As any developed country's currency inflation approaches the PPP limit the Commission can also require its government or Central Bank to assume control of capital exchanges and confine them to purposes of debt service or new direct investment.

Reasons: Exchange rates pose a policy dilemma. There are always likely to be differences between national rates of growth, rates of inflation, and current account balances, all of which can affect both market rates and PPP rates of exchange between currencies. Unchanging *fixed* rates are impossible. The scale of the new exchange gambling makes the misbehavior of *market* rates intolerable. So the rates need to be regulated, and purchasing power parity offers the best basis for comparing the currencies' value. But when their values change, how should that be reflected in their exchange rates? Step by step adjustments, week by week or month by month, will usually yield marginal changes scarcely worth gambling on. But they do not fix international prices or interest rates in the short or medium

term, and a great deal of business would have slightly lower risks and transaction costs if they did. That range of business does best if exchange rates are fixed and change only now and then, and only in response to changing purchasing power which is officially calculated and published at frequent intervals so that its trends can be known to all concerned. But less frequent and therefore bigger changes may well be worth gambling on. As a predictable devaluation approaches, people with liquid assets can sell out of the declining currency and buy back into it after devaluation. Under the Bretton Woods regime they were at first constrained by national controls on capital exchanges; but as those were relaxed, speculators began to bet on likely devaluations. As they 'sold down' a target currency they tended to force bigger changes than an efficient market might have done, and they drained the foreign reserves of any target countries' Central Banks that tried to defend their currencies by market dealing. With an international authority determining the rates on a PPP basis, and with discretionary power to restrict capital dealings with threatened currencies, speculation can do less of either kind of harm. Dealers may still gain and lose money, but on smaller scale and with less effect on the real economy than they have had in the past. But if experience proves otherwise, the Exchange Commission can move toward a more continuous 'crawling peg' process of adjustment (with the disadvantages of that horn of the dilemma) by reducing the distance which it allows rates of exchange to stray from PPP before adjusting them.

Some concerns about PPP exchanges Measures of purchasing power parity have been disliked partly because they cannot be perfectly objective. They are usually calculated by comparing the retail price in different currencies of a basket of goods chosen to include the necessities and common comforts of an average household: commonly about half of all household spending. But (i) societies with different lifestyles buy different selections and proportions even of necessary goods; (ii) some different prices may be paid for 'same' goods of different quality which should really count as different goods; and (iii) national retail prices conceal different patterns of tax, not only on the final goods themselves but on their components, payrolls, transport costs, etc. Recent work has nevertheless refined the technique. For example analysts can price Country A's average basket of goods at Country A's and also at Country B's prices, price Country B's basket at both prices, adjust for the more immediate tax effects, and average the results to arrive at a rate of exchange which may still be open to some detailed

disagreement, but is likely to be preferable to the unstable rates which operated through the 1980s and 1990s, and also to fixed rates based on uncorrected consumer price indexes.

There was once a reason for preferring market rates of exchange to regulated rates. Balances of trade influenced market rates of exchange, whose import/export price effects tended to maintain or restore balanced trade. As argued earlier, the balancing mechanism was not entirely reliable because it depended on elasticities of supply and demand for the traded goods. It became quite unreliable when banks began to borrow instead of buying some of the exchange which their importers wanted, so that the supply and demand for currency no longer reflected the supply and demand for traded goods; and through the same years speculative exchanges came to exceed trade-related exchanges many times over and radically destabilized the market rates of exchange.

If fixed PPP rates of exchange are protected against speculative attack they have advantages over market rates, and they do not necessarily rule out some pricing adjustment of unbalanced trade. Prices can be adjusted in an ordinary protectionist way by taxing deficit traders' imports and/or subsidizing their exports. Rightly used, those methods need not be regrettable. They can be more economical than the indiscriminate re-pricing of all exports and imports by exchange-rate changes. Tariffs can be confined to goods the country can make for itself or goods it can do without, so they can be less inflationary than a general devaluation. Export subsidies can be confined to goods for which the elasticities of supply and demand are helpful. And as noted earlier, scarce exchange can if necessary be directed to the import of most-needed categories of goods.

SUMMARY OF THE REFORMS AND THEIR EFFECTS

When it is in force in the developed economies this (imagined) regime:

- limits rates of interest on most secured lending .
- regulates (as and when necessary) the volume and general directions of credit within national economies, and lending between them.
- effectively prevents bubble booms in share prices, but raises average share prices a little by reducing returns from most moneylending.
- reduces the number of corporate takeovers.

- prevents or moderates bubble booms in property prices if competent governments make good use of the relevant powers.
- may or may not have some moderating effect on rates of inflation.
- imposes fixed PPP rates of exchange which are changed only when national rates of growth and inflation compel. People can still speculate on expected changes - but
 - (i) they must bet with their own money so the volume of gambling is much reduced,
 - (ii) it cannot affect the exchange rates or increase their volatility, so
 - (iii) it does not do much harm to the real economy or to the solvency of financial institutions.
- allows national governments to exert effective influence on the volume - and if they wish, on the directions - of investment within their boundaries; on employment; and (over time) on economic structure and balance of payments.

UNFINISHED BUSINESS

The new conditions make good government of developed economies possible, but do not dictate its collective purposes and directions of development, or its quality. In themselves they do not prevent widespread tax avoidance by rich people and corporations; lawful executive plunder of private corporations in English-speaking and some other countries; damaging conflicts between some host countries and some foreign investors; high unemployment, insecure employment and increasing inequalities in many countries; continuing conflicts about development, conservation, environmental care and generational equity. They do not resolve questions about men's and women's working, earning and parenting roles; or about the desirable roles of public, private and independent non-profit enterprise in education and health services, in industry, in superannuation; or which public services should be tax-financed and free to their users and which should be user-paid. But on all those subjects, the new powers and institutions give governments and their electors more and better choices of policy direction and effective action than did the late twentieth century arrangements which they replace.

For business the new regime has brought some increase of bureaucratic regulation. Some of it is irritating

and time-consuming, and increases business costs. There are fewer ways of making money without producing anything or financing producers. There are fewer opportunities to take over conservative firms, to raid small countries' currencies, or to bully governments into relaxing their protection of natural resources, or conditions of work, or consumers. But some of those restraints help more enterprises than they hurt, and the rest of the program helps many more than it hurts. Some firms, some industries and some national economies benefit from the relaxation of World Trade Organization rules against the protection of infant industries, and of key industries in industrial regions and clusters. Some firms benefit from the use of trade controls to reduce foreign debt and balance foreign payments. Prudent long-term strategies no longer expose efficient firms to hostile takeover. Low and stable rates of interest help many firms directly, especially small and young ones, and help them indirectly by encouraging more passive savers to buy shares rather than lend their money. Besides card and EFTPOS credit, producers continue to benefit from hire-purchase credit for their customers, which is exempted from the interest-rate limits on other secured lending. Stable rates of exchange help most firms in most tradeable industries, and help others who trade goods and services with the tradeable industries. In countries whose public investment is financed by interest-free credit there is higher public investment than there used to be in health, education, transport and other infrastructure, and in the high arts, museums and libraries, and playing fields and performance spaces for popular sports and arts. Those crowd in more private investment than they crowd out, and they provide the private sector with good human capital and public capital and services.

Constitutional questions

National powers may still have obstinate limitations. Examples:

Executive plunder The proposed national powers and financial boundaries should enable countries with unitary governments to regulate the rewards open to directors of companies which those countries charter. But the plunder is led from the United States where reform may depend on first amending the Constitution to transfer the corporation power from the states to the federal government. (States compete for company tax by empowering directors to plunder their firms).

Public and private provisions With economic growth and scientific, technological and cultural changes people learn for longer before they start earning and live

longer after they retire. Those developments change the proportions of income which people need to transfer from their earning years to their non-earning years. Most of those transfers can be done better by public than by private action, or by cooperation between them. Medical science is increasing the proportion of income that can usefully be spent on better health and longer life, and much of that spending can be financed more equitably and economically by public than by private investment and spending. People may also want to spend more collectively on environmental care, on arts and recreations, or on other public provisions. Europe's Maastricht treaty severely restricts those options by limiting the proportion of national income that may pass through public hands. That restriction means that if needs for such services grow faster than national income does, the services and income transfers must be privatized, however undesirably, or they must be degraded as public funding per unit of service declines. West European systems of public/private superannuation, which other developed countries might do well to copy, may be among the first casualties. The treaty has constitutional status in that it removes whole policy areas and possibilities from democratic jurisdiction. It should be renegotiated to repeal the general budget limit, or to except income transfers and health and educational services from it.

International business Two negotiations were initiated, then shelved, in the 1990s. One aimed at a treaty which would reinforce the rights of national governments over foreign investment in their territories. Business influence blocked it. The other aimed at a multilateral agreement on international investors' rights. Opponents saw it as an attempt to entrench the new business freedoms against any revival of government. Early in the new millennium conciliatory voices suggested a balanced agreement on international business and government. It should establish corporate property rights, uniform company tax, minimum conditions of employment for labor, environmental protocols, and the extent of national powers over consumer protection, competition policy, defence and public procurement, and foreign trade and payments. The negotiations made no progress - business hostility to labor and government was too strong, national situations and needs were too diverse. National governments benefit from the international regulation of rates of interest and rates of exchange, but are free to discriminate between foreign initiatives that look helpful and those that look harmful in their particular circumstances. Wise voices had recommended that national role: Paul Streeten in 'The Judo Trick' in L.

Orchard and R. Dare (eds) *Markets, Morals and Public Policy* (1989) and in *Thinking about Development* (1995); Lance Taylor in 'Lax public sector, destabilizing private sector: origins of capital market crises' (UN, July 1988).

Now please return from that imagined future. It may all happen as sketched if the necessary international treaties are signed and observed, the international institutions work effectively, and national governments make good use of their powers. In those conditions national strategies can still range from Right to Left, from business-biased to labor-biased, from growth-oriented to leisure-oriented, from environmentally prudent to wasteful and pollutant. Policies can be designed to increase or reduce inequalities between richer and poorer people, between women and men, between people's earning years and their non-earning years, between generations. They can be shaped by conservative, liberal-individualist, social-democratic or other visions of good. The suggested regime does not foreclose any of those possibilities. It merely suggests some minimum institutional arrangements which might open those options to effective democratic choice, with fewer sources of frustration, insecurity and breakdown than they face now.

International inequalities

Among their recent choices the developed democracies, and the international institutions which reflect the influence of the most powerful of them, have lately been less helpful to developing countries than they could have been. Misgovernment and ethnic hatred in some poor countries, dwindling generosity in rich countries, changing technology and terms of trade, have all contributed. So have some terrible misuses, by both lenders and borrowers, of the new financial freedoms. The reforms sketched above would *allow* better financial services to developing countries, but do not include a coherent program for their design and delivery. Stuart Holland has proposed such a program. An outline of it follows. It includes some reference to ex-communist countries, but it was published before Russia and the other successor states of the Soviet Union were in quite the trouble they are in now. Their problems are not treated in this present paper (for lack of time and expertise) though they add to the evidence that markets need government.

A PROGRAM FOR DEVELOPING COUNTRIES

In *Towards a New Bretton Woods: Alternatives for the Global Economy* (Spokesman, 1994) Stuart Holland proposed international financial arrangements for developing countries and reforming (i.e. ex-communist) countries. With his permission his summary of the program is presently quoted in full. An introduction recognizes 'that diverse problems for different economic systems need to be addressed and resolved through greater diversity in ideas and policies, rather than constrained by a single paradigm of structural adjustment and gains from trade, or a single model of governance.' Under past policies of the relevant international institutions 'one of the main features of structural adjustment. . . has been the degree to which its costs in too many cases have been borne by the poorest people in the poorer countries, and especially by children. Getting exchange rates and prices right too often has wronged the poor, without the intended gains of export-led growth or trickle-down in their favour.'

Holland proposed, and the Socialist International has since endorsed, institutional responsibilities for assessing the amount and kind of aid and exchange that would enable each developing and reforming country to achieve specified standards of food, shelter, sanitation, education, health care and social care; what foreign funds they would need for investment in environmental programs and further development; and where the funds should come from and on what conditions. The responsibilities of the International Monetary Fund and other 'Washington' institutions are checked and balanced by roles for United Nations institutions whose membership and purposes reflect their more direct representation of developing countries and their poorer people. The financial targets are in 1994 values so may need adjustment.

In Stuart Holland's summary:

1. The UN Regional Economic Commissions, in association with UNDP and UNICEF, should determine the **Development Expenditure** in individual countries which would ensure that minimum standards could be achieved in nutrition, housing, sanitation, health care, education and basic social services, with an interim target of raising such expenditures to \$1200 per head, and a longer-term target of \$2000 per head. The candidate countries would mainly be developing countries. Higher imports by the developing countries on the basis of agreed criteria for increased social expenditure should be designated **Development Deficits**.

2. The new Development Expenditure targets should be incorporated into a global recovery programme determined by the G7 or its reformed equivalent resulting from widened membership on either a national or regional basis. Finance for the programmes should be through increased official development assistance, with generation of counterpart funds by local governments. The expenditures - reinforced by **Environmental Programmes** for both the developing and reforming economies - would in turn promote and sustain the global recovery programme.

3. The IMF should disaggregate such a recovery of mutual import and export trade by main regions of the world economy, with target import levels for the reforming and developing economies. Development Deficits would be itemised by the Fund in an annual report on **Social expenditure, trade and payments** of the countries concerned. The Regional Economic Commissions of the UN also should jointly undertake an independent assessment of such target trade levels and their impact on the different regions and countries of the global economy.

4. The IMF should then determine the **Balance of Payments** support necessary to sustain the currencies of individual developing and reforming economies on the basis of such Development Deficits, and relate this to the restructuring of debt.

5. **Social conditionality** should be imposed on the implementation of the social expenditure programmes which give rise to Development Deficits. The UN Regional Economic Commissions jointly with the Regional Development Banks would have joint responsibility for monitoring the implementation of the specific programmes, with the penalty of reduction or non-continuation obtaining for those governments which did not implement them.

6. **Financial Conditionality** could still be imposed by the IMF on governments which failed to meet performance targets in areas other than those of the social expenditure and environmental programmes agreed with the developing and reforming economies. But the targets themselves should be set in a manner which assists rather than obstructs adjustment to new paths for development. In this context the Fund should be obliged to take account of parameters such as those proposed in the UNECA report on an alternative framework to structural adjustment programmes. Further, countries should be able to appeal against alleged breach of such parameters to an independent body representing a wider framework of the UN agencies and some member countries.

7. Investment finance for both social development and environmental programmes for the developing countries and reforming economies should include elements of Keynes' original intention for his Bancor unit, i.e. to be related to the potential growth of world trade, income and taxable personal and corporate revenue accruing from the Global Recovery Programme for mutual import and export trade between all economies. Such finance should not imply a formal increase of IMF quotas or Special Drawing Rights, but should constitute a new **International Development Facility [IDF]**. The rate of interest on drawings from the IDF should be indexed in terms of the income per head in purchasing power parity terms of the borrowers.

8. This facility would be backed through subscription by governments of the OECD countries to a new **International Development Bond [IDB]** which should fulfil Keynes' recommendation on the recycling of surpluses in international trade. In practice, at present, Japan is - and is likely to continue to be - the main surplus country and one of the main potential subscribers to the IDB. But the US and the European Union also should undertake to be major subscribers. Lending in the main to creditworthy countries, the IDB should be expected to earn a market rate of interest. It could be administered by an **International Investment Trust**.

9. The International Development Bonds should constitute a main source for the finance of Environmental Programmes in the reforming economies. Developing countries should be able to draw on the International

Development Facility for investment concerning social programmes. Serious consideration should also be given to the establishment of new **Regional Monetary Funds**. With the existing UN Regional Development Banks, and in line with the European Bank for Reconstruction and Development and the new European Investment Fund, these should be entitled to undertake their own bond issues. Regional Monetary Funds not only could ensure more pluralism and response to local development needs than a single International Monetary Fund, but also could offer advantages in higher local quotas on a regional basis for subscribers than may prove to be the case with a reform of the quota share of the IMF.

10. **Payments Clearance Unions** should be encouraged on a regional basis in order to reduce the need for countries in specific regions to settle their accounts in hard currency other than at the end of given financial years. In the case of the reforming and developing countries it can be anticipated that many member countries of such unions would remain in deficit in hard currency terms even on an annual basis. In such a case they should be entitled to apply for IDF or IDB borrowings. The index of the rate of interest on borrowings from the IDF, in such cases, would be related both to the PPP income per head of the countries concerned, and also to their performance record on repayment.*

Since that program was written the East Asian crisis has further dramatised the need for it, and the wisdom and humanity of its design.

* Stuart Holland, *Towards a New Bretton Woods: Alternatives for Global Economy*, Spokesman, 1994, pp. 31-4.

SOURCES

Much of the information on which this paper relies comes originally from the annual development reports of the World Bank, the United Nations Development Programme, the Organization for Economic Cooperation and Development and other international agencies, but it comes as distilled and reconsidered in papers written in the shadow of the East Asian financial crisis.

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