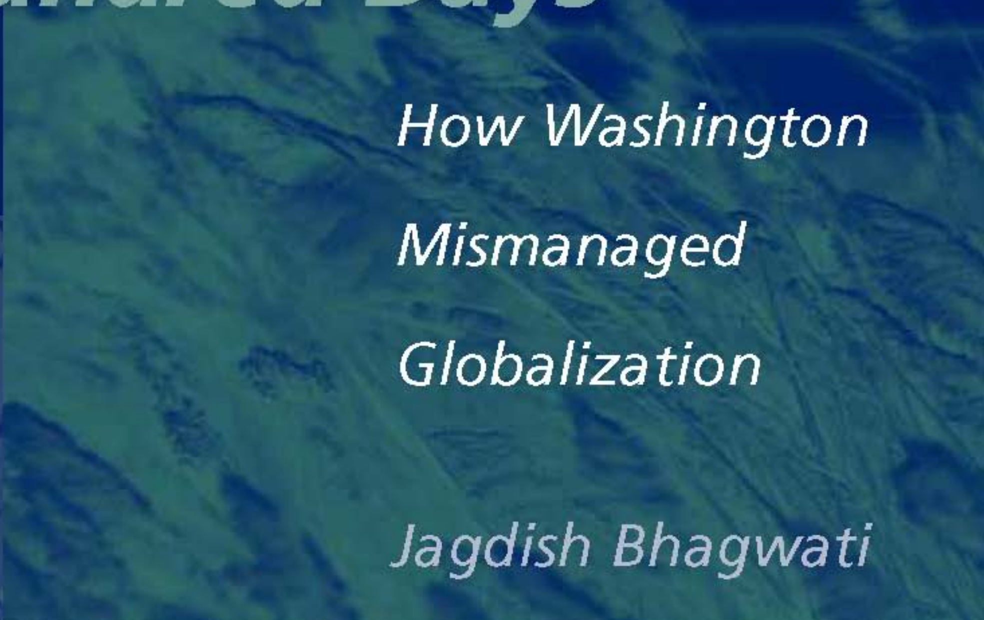
I met the wind of the hundred days.

It covered all the nights with sand,

Badgered my forehead, scorched my lids.

— Octavio Paz

The Wind of the Hundred Days



How Washington Mismanaged Globalization

Jagdish Bhagwati

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How Washington Mismanaged Globalization

Jagdish Bhagwati

The MIT Press
Cambridge, Massachusetts
London, England

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For my teachers

Paul Samuelson
and
Robert Solow

and my student

Paul Krugman

Kindred spirits, seeking social good by combining deep scholarship with effective public policy writing

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Contents

Preface xiii
Introduction xv

I The Two-Edged Sword: Capital Flows 1

1 The Capital Myth: The Difference between Trade in Widgets and Dollars 3

2 Why Free Capital Mobility May Be Hazardous to Your Health 13

3 Free Trade, Yes; Free Capital Flows, Maybe 21

II From Miracle to Debacle: The Asian Drama 25

4 The "Miracle" That Did Happen: Understanding East Asia in Comparative Perspective 27

5 The Asian Economic Crisis: What Do We Know Now? 51

6 A Friend in the United States, but a Crony in Asia 61

III Free Trade: Fair Trade, Wages, and Human Rights 65

Free Trade and Fair Trade 67

7 Free Trade in the Twenty-First Century: Managing Viruses, Phobias, and Social Agendas 69

Downloaded from http://direct.mit.edu/books/monograph/1847/bookpreview-pdf/2432990 by guest on 24 January 2025

8 Free Trade: Why the AFL-CIO, Ralph Nader, and the Sierra Club Should Like It 87

9 The Folly of “Fair Trade” 105

10 Is Free Trade Working for Everyone? 109

Trade and Wages 119

11 Play It Again, Sam: A New Look at Trade and Wages 121

12 Globalization: Who Gains, Who Loses? 137

Moral Obligations and Human Rights 151

13 Moral Obligations and Trade 153

14 Trade Linkage and Human Rights 157

15 On the Efficacy of Trade Sanctions 169

The Design of the WTO and Trade Negotiations 171

16 Fast Track: Not So Fast 173

17 Short on Trade Vision 177

18 Global Fixes 179

19 Fifty Years: Looking Back, Looking Forward 183

20 On Thinking Clearly about the Linkage between Trade and the Environment 189

The Dispute Settlement Mechanism at the WTO 201

21 Mismanaging the Banana Dispute 203

22 An Economic Perspective on the Dispute Settlement Mechanism 205

Downloaded from http://direct.mit.edu/books/monograph/1847/bookpreview-pdf/2432990 by guest on 24 January 2025

Trade and Culture 207

23 Trade and Culture: America's Blind Spot 209

24 The West's Triumph: Did Culture Do It? 215

IV Regionalism, Multilateralism, and Unilateralism 225

25 Fast Track to Nowhere 227

26 On the Perils of SAPTA 235

27 The FTAA Is *Not* Free Trade 239

28 Think Big, Mr. Clinton 251

29 In Favor of China's Entry into WTO 255

30 Free Trade without Treaties 261

V The Debacle in Seattle 265

31 WTO's First Round: The Seattle Agenda 267

32 Labour Standards and the WTO: The Case for Separate Agendas 273

33 Don't Muddy the Waters 281

34 Did Clinton Take a Dive in Seattle? 285

35 What Really Happened in Seattle? 287

VI Investment and Immigration 291

36 Illegals in Our Midst: Getting Policy Wrong 293

37 Why Borjas Fails to Persuade 299

Downloaded from http://direct.mit.edu/books/monograph/1847/bookpreview-pdf/2432990 by guest on 24 January 2025

38 A Close Look at the Newest Newcomers: Immigration Debate Takes Skill 309

39 Who Needs the Multilateral Agreement on Investment? 313

VII Globalization 315

40 But Mr. Clinton, Globalization *Has* a Human Face 317

41 Globalization, Sovereignty, and Democracy 323

42 Poverty and Reforms: Friends or Foes? 343

43 Growth Is Not a Passive “Trickle-Down” Strategy 357

44 Living with Globalization 359

45 The Global Debate 363

46 Globalization in Your Face 365

Index 373

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I met the wind of the hundred days.
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Octavio Paz, "Happiness in Herat"

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Preface

In writing these op-ed articles, essays, lectures, book reviews, and occasional letters to the newspapers, I have drawn on the help of many students, current and past. They have acted as sounding boards for my ideas; and they have tracked down all sorts of things on the proliferating websites that would have been well beyond my modest technological competence. I would like to thank, most of all, Maria Coppola and Bikas Joshi, enthusiastic and insightful aides who have worked beyond their contractual obligations, wonderful specimens of the "overworked Americans" who are making the news these days.

My MIT students—Robert Feenstra, Gene Grossman, Paul Krugman, Steve Magee, Jeffrey Frenkel, Maurice Obstfeld, and Ken Rogoff—all now extremely distinguished international economists, and also my later students at Columbia—Elias Dinopoulos, Kar-yiu Wong, Doug Irwin, Don Davis, Peter Rosendorf, Ian Wooton, Rodney Ludema, Vivek Dehejia, Pravin Krishna, and Devashish Mitra—already well known in the profession for their considerable scientific abilities, have provided ideas, directly or through their important research, that I have profited from as I have worked my way through the many complexities of international economic policy today.

My debt is equally great to T. N. Srinivasan, Arvind Panagariya, Koichi Hamada, Richard Brecher, and John Wilson, who have collaborated with me on a great deal of scholarly research without which the contents of this volume would have been intellectually the poorer. I have also learned much on trade policy from Robert Baldwin, Avinash Dixit, and Alan Deardorff.

Finally, my thanks go to Terry Vaughn, Economics Editor of the MIT Press, whose good judgment in trying to publish almost everything that I have written in the last decade cannot be faulted! Frankly, without his tender loving care and his patient nudge at critical moments of distraction, lavished without stint on this book and others, few of them would have seen the light of the day.

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Introduction

A previous selection of fifty-six of my op-ed articles, essays, book reviews, letters, and lectures, *A Stream of Windows: Unsettling Reflections on Trade, Immigration, and Democracy* (MIT Press, 1998) was received with a warmth that exceeded all my expectations. It drew reviews in leading newspapers, magazines, and professional journals around the world, while winning the prestigious Eccles Prize for Excellence in Economic Writing.

That would be reason enough to go to the well once again. Few novelists, savoring the triumph of their first novels, are so timid or content that they will not write again. Indeed, success is likely instead to produce hubris and most of us will yield to the temptation to seek yet more. But that is not really why I have now put together yet another selection of my most recent popular writings. It is rather because I again have a unifying theme and an overriding message.

In *A Stream of Windows*, which had a broad intellectual range, the central conception (developed by me over nearly forty years of reflection and writing, from the time I returned to India from study abroad at Cambridge, Oxford, and MIT in the late 1950s) nonetheless was that the best economy and the better society was one that combined both markets and democracy. In that context, the virtues of freer trade and a more expansive policy on immigration were underlined and underlay much of what I had written.

Running intermittently through the long book, however, was also dissatisfaction with recent trends in U.S. policy, generally in regard to trade. In particular, the Clinton administration was faulted for:

occasional pandering to Japan-fixation and perhaps even Japan-bashing when Japan was considered omnipotent;

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the embrace of preferential trade agreements (such as, and even beyond, NAFTA) instead of leadership aimed at strengthening the nondiscriminatory multilateral trade regime in general under the GATT then, and WTO now;

an inadequate and inappropriate response to the growing demands on the trading system by the environmentalists and labor unions; and

a growing surrender to, and witless encouragement of, the cries by these and other groups for "fair trade."

But while I was hinting at, even highlighting, the irony of the administration's flaws in trade policy despite the widespread perception of the administration's success with trade policy, the years since the Asian crisis broke in mid-1998 brought into sharp focus a yet different aspect of the Clinton administration's failings on the international front. For, while the shortcomings of the administration on trade policy were apparent only to the informed scholars, and even eluded many of the sophisticated journalists in the leading newspapers, the Asian financial crisis was too dramatic and obvious an episode to be dismissed from public attention without raising the suspicion that somehow the administration had blundered.

Was this huge failure President Clinton's *real* scandal? And if so, the irony would be that, even as the administration had chalked up great success in domestic prosperity, it had visited a fierce firestorm abroad, creating the worst man-made crisis in the world economy since the notorious Smoot-Hawley Tariff of 1931.

The paradox would then be the simultaneity of admirable domestic policy success and abysmal foreign policy failure. As it happens, that specific judgment, which I advance in this set of essays, is altogether arguable, even plausible, when we examine (as I do in many of my essays) the financial debacle in Asia and elsewhere without wearing partisan eyeglasses. But even my thesis of the presidential goof-ups on trade policy, a hard sell earlier, has now gathered more plausibility from the debacle in Seattle at the 1999 WTO Ministerial meeting in late November and early December, a failure that has been properly laid at President Clinton's door by critics everywhere. That disaster has been mitigated in no way by the successful House vote in May 2000 on the trade deal with China: the terms were so totally biased in favor of the United States that it was a no-brainer, and yet another loss by the president, despite the cards being stacked overwhelmingly to U.S. advantage, would have certified him and his administration as klutzes.

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The Financial Debacle

President Clinton's foreign economic policy failure, especially the ravages wrought by the Asian financial crisis under his watch and even a result (partially, if not wholly) of his own men's prodding, defines the subtitle of the collection, while the evocative image of devastation in Octavio Paz's chilling line "I met the wind of the hundred days" has provided me with the title.

And the volume opens therefore precisely with an essay in *Foreign Affairs* (May/June 1998) that pointedly noted where the administration had gone wrong, while the five chapters that follow discuss how our errors helped change the Asian economic "miracle" of the last three decades into a debacle.

In particular, the *Foreign Affairs* essay has produced a worldwide following to the point where I was recently awarded the (first) Suh Sang Don Award, by a major Asian NGOs' World Forum, based in Taegu, South Korea, for alerting the world to the elements of asymmetry between the case for free trade and the case for free capital mobility and hence to the dangers that unregulated capital flows pose to countries. The subsequent writings in late 1998 on capital flow controls by Paul Krugman (in *Fortune* and elsewhere) and by Joe Stiglitz (from the World Bank) supported the position that I had taken. Over time, Barry Eichengreen, IMF's adviser on the subject, also appears to have had a change of heart on the matter.

My essay also introduced into the public domain and into the political-economy literature the nonconspiratorial concept of the "Wall Street–Treasury complex" with which I, in the spirit of Dwight Eisenhower's military-industrial complex and Wright Mills's concept of the "power elite," sought to explain how powerful lobbying "interests" on Wall Street, working within a network of like-minded people moving back and forth between Washington and Wall Street, had combined with a growing shift to markets imprudently extended to capital flows to push the developing countries into a hasty embrace of capital account convertibility without adequate safeguards.

The influence of this complex can be seen in the massive resistance it showed at the outset to admitting the mistakes that had been made; it is also manifest in the fact that U.S. negotiations on admitting China into the WTO were held up during the Chinese premier's U.S. visit in 1999, for the most part, by the failure to get yet more concessions from China on opening its financial sector, even as the Asian economies had

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not yet worked their way out of the devastation of the financial crisis. Indeed, many leading members of the Wall Street–Treasury complex have been keen to scapegoat the Asian financial crisis onto the Asians themselves, citing "crony capitalism" as being the cause of it.

Chapter 6 in this book argues that cronies are part of every political system. A little role reversal and examination of our own system with the spectacles that we wear when looking critically at others will convince the objective analysts that, by our criteria, President Clinton's cronies include Barbara Streisand, other Hollywood figures such as Alec Baldwin and Kim Basinger, and Terry MacAuliffe, who went so far as to bankroll in effect the Clinton's mortgage on their New York house in Chappaqua. Besides, cronies were totally compatible with rapid growth and transformation of these Asian economies in the previous three decades. I have rarely seen a satisfactory explanation of how the same institutional phenomena that produced economic miracles were suddenly to be regarded as the phenomena that ended them so shabbily!

Chapter 6 probes more deeply the question of corruption and development, in the process also distinguishing between two types of corruption: "rent-seeking" and "profit-sharing." The former occurs when monopolies are created and policies pursued by the state such that "rents" are earned on artificial scarcities and these are then given to one's friends and political supporters, examples being President Suharto's and Prime Minister Indira Gandhi's sons enjoying the proceeds of special protection on their pet car projects vis-à-vis rival foreign and domestic car producers. Such "rent-creating" corruption has high economic cost. But where the corruption takes the form of "profit sharing" so that, as in China (especially in the Guangdong provinces on the coast where economic activity has boomed for long) and (partially) in Indonesia, the well-connected are paid off by being given a share of the profits, the incentive to earn profits is great and economic incentives and allocative efficiency tend to be the way things are done. Such "profit-sharing" corruption is then economically compatible with rapid growth of the economy and its costs are more political (since corruption siphons off some of the profits to the undeserving) than economic. The corruption in hegemonic countries like the United States also takes generally the profit-sharing form and none are rewarded through creation of rents: Cronies such as the Spielbergs and Streisands are rewarded, not by giving rent-creating domestic

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monopolies to their films and songs, but by rewarding them and Hollywood and the United States generally at other (frequently poor) countries' expense through forced opening of markets (which often lead to legitimate complaints about the United States ignoring other countries' cultural concerns) and through tough enforcement of excessive intellectual property protection in all sorts of ways.

The Trade Debacle

While therefore it is hard to maintain that the Asian financial crisis was homespun in Asia, and the accusatory finger can be properly directed at the U.S. administration for its principal role in this policy disaster, the failure to understand and manage the question of free trade today has been a failure of almost equal magnitude.

The bulk of this volume addresses the challenges that have repeatedly faced this administration, and its often-inadequate and even inappropriate policy responses and outcomes, on several specific matters such as NAFTA, its extension to South America, the desire to get fast track authority renewed, the intended launch of multilateral trade negotiations in Seattle, taking on Japan's trade policy, the accommodation of demands from the unions and the environmentalists, and the issues raised by human rights activists on China's MFN renewal with the United States and the question of its admission to the WTO.

Underlying these themes, however, is a central critique of the trade policy of President Clinton that I may stress. The American scene by now has become dominated by the notion that trade must be "fair," not just "free." This is, of course, a convenient route to protectionism since, if you say you want protection because you cannot hack it against your foreign competitors, it is a trifle difficult to get protection: after all, we economists have succeeded in convincing most politicians that protectionism is, next to four-letter words, a temptation to be avoided if they wish to promote the social good. But if you can say that your rival is an "unfair" trader, that works wonders, particularly in a society that prides itself on equal opportunity rather than equal outcomes, on equality of access rather than equality of success. This is a principal reason that economists have argued against the use of antidumping (AD) actions by firms facing increased import competition as a way of getting import relief: these AD actions invoke, by arguing that "dumping" (a pejorative word) is taking place, the notion of "unfair trade"

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and hence typically work to secure protection more effectively than other import relief procedures such as the use of simple "market disruption" provisions.

Fairness, like beauty, is of course in the eye of the beholder. It is apparent therefore that if one starts down the road of claiming that "trade must be both free and fair" or, more emphatically, that one must have "fair trade before free trade," then one has inevitably played into the hands of the protectionists. What President Clinton should have been doing therefore is to challenge these dangerous slogans, recognizing them for the subversive verbiage they represent. Instead, he and his administration actively encouraged them, lending them respectability.

Thus, President Clinton came into office in 1992, riding on a wave of Japan-bashing. Supported by the Silicon valley that endorsed him, appointing Laura Tyson (obsessed with Japan at that time) as the chairperson of the Council of Economic Advisers, putting at the center of his trade agenda the confrontation of Japan with a revived Super 301 policy that would enable us to condemn Japan as an "unfair trader" and subject it to tough retaliatory action, Clinton was elevating "unfair trade" to center stage. My earlier collection of essays, *A Stream of Windows* (MIT Press, 1998), contains extended documentation and analysis of this folly, which accelerated the notion in the United States that Japan was an unfair trader, and that indeed we were virtuous and others were in sin when it came to open markets and fair practices. Chapters 7–9 in this volume underline the problems that this self-inflicted wound has caused the president in moving toward freer trade.

But Japan was not the only cause of the phenomenal rise of fair trade arguments in the United States in the Clinton years. NAFTA also aided in this process. This happened because bilateral and regional trade agreements enable the protectionists to zero in on this form of trade liberalization by converting nontrade into trade issues. Thus, if Mexico is being brought into freer trade with us, the protectionists will go to town and say, with apparent plausibility, that Mexico is not entitled to free trade with us because "Mexico is not a democracy," or "Mexico has bad environmental standards," or "Mexico's labor laws are not adequate." In short, any warts, real or imagined, on Mexico's face become weapons to destroy a trade pact with it. And if this is not done, and you manage to make Mexicans raise their standards, you at least manage in turn to raise the costs of production there to moderate the competition that you fear from NAFTA as a protectionist. But the net result is that

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all kinds of nontrade issues that have little to do with trade liberalization are then elevated in the public debate and imagination to the status of "fair trade" preconditions for free trade. I can speak from my own experience in public debates, on the multilateral trade liberalization under the Uruguay Round, at the same time as NAFTA, that few protectionists thought it fruitful to attack the Uruguay Round on such nontrade grounds: It would have been much harder to do so, with too many countries and too many issues at stake and with no easy way to zero in therefore on one country's warts and exploit them to advantage. So, both the Japan-bashing of the Clinton administration, which legitimated a number of "unfair trade" complaints that extended to domestic policy measures and institutions (e.g., keiretsus, retail distribution systems, savings habits) in foreign nations whose fault was merely that they were different from ours, and its witless backing of NAFTA (which was after all a preferential trade agreement with all its disadvantages vis-à-vis multilateral trade liberalization under GATT auspices, an issue that I discuss in chapters 25–28), and hence the legitimation of yet other complaints about "unfair trade" (on labor, on environment, on governance), would leave a legacy that was to prove difficult for the administration when it sought new initiatives for trade liberalization.

In each case, the president and his advisers played drafts, settling for options that would apparently win a battle. But they never looked ahead, playing chess, to win the war. Fair trade notions played well in Peoria, and with lobbies including certain vocal NGOs; but they defined and set in cement the ethos of fair trade that would hobble new trade initiatives.

Now, these lobbies are very much on the trade scene, causing the president to lose the fast track and also contributing to the Seattle debacle in December 1999. Demands to eliminate unfair trade by introducing a Social Clause on labor and environmental standards, for example, are rejected by the developing countries, which see them as daggers aimed at their exports.

Presented also as moral agendas for other countries, these demands make little sense because they are always framed in a way that singles out the poor countries for moral lapses, not the rich ones. Besides, if such "empathetic" desires are behind the demands for a Social Clause at the WTO, it is easy to show that these agendas are better advanced by shifting to nontrade methods and programs at other, more appropriate agencies such as the ILO. For instance, with nearly 200 million

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children at work, and with only 5 percent of their output exported according to the best available estimates, trade sanctions (as implied by putting the use of child labor as a ground for market access suspension into the WTO through a Social Clause) will most likely bounce children engaged in exports into other occupations, even into prostitution, as happened with children in textiles in Bangladesh when the U.S. Congress was considering the Harkin bill on Deterrence of Child Labor. Child labor is thus, in the words of the remarkable British Minister Clare Short," a development, not a trade, problem." Better measures can be devised that do not use trade sanctions and advance more effectively the reduction of child labor in the poor countries. But these measures, which require working with local NGOs, with aid programs, with local governments, and with sustained dedication are indeed starting at the ILO, which is the more appropriate agency, and the demands for trade sanctions at the WTO are simply wrong, even morally wicked. In supporting the latter rather than urging a shift to the former just because misguided unions want the latter, and in thus prompting the poor countries to walk away and causing a failure of the Seattle talks on launching a new round of multilateral trade negotiations, President Clinton regrettably betrayed a cynicism, indeed an abdication of moral responsibility toward others, that has almost become the hallmark of his international economic policy. That is the burden of chapters 31–35 on the Seattle debacle: These essays spell out precisely why the administration's trade policy has been a disaster waiting to happen and why the disaster has happened.

To state it unequivocally, these define then the central theme of this volume: The huge financial and economic failure in Asia and the tragic debacle in Seattle mark this administration as ironically guilty of colossal mistakes, of economic policy and architectural design of the financial and trading system. The story is that of a Greek tragedy: disasters brought on itself by an administration supremely oblivious to warnings and advice, hooked on focus groups and on the polls, never leading and heading off the impending disasters through prudential but creative thinking.

There are other related themes in the chapters. In particular, in part VII on globalization, I note how President Clinton's lazy echoing of the ill-informed views that one heard again on the Seattle streets, that "globalization needs a human face," has been an implicit surrender to the view that globalization *lacks* a human face. Thus, he neglects the abundant evidence that globalization (on the trade and direct foreign

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investment fronts) has been a force for good, not evil, as chapters 4, 11, 12, 40, and 46 in particular argue from available evidence. I similarly challenge the platitudes against globalization and liberal market reforms as being irrelevant to poverty reduction, and the populist charge that they constitute "trickle-down" economics that does not work. I argue that these reforms produce growth, which is an important "pull-up" strategy to bring about poverty reduction through increases in gainful employment of the poor.

These chapters provide a blunt attack on economists whose writings have implied the contrary, and whose platitudes about poverty reduction and feel-good but inappropriate policies based on them are likely to accentuate the very poverty that they deplore. Indeed, in countries such as India, the economists who profess to worry today about poverty and India's abysmal experience with its reduction are themselves the cause of it, having opposed economic reforms during nearly a quarter of a century when the autarkic and inefficient-public-sector-dominated economy, blessed with these very economists' accolades, was growing at an average of about 3.5 percent annually and naturally failed to reduce poverty.

A fierce recognition of these failings of the antiglobalization and the antimarket policies needs to be kept in view, and reforms in these areas by the developing countries need to be fully and continually nurtured if they are to take hold. The reforms are still fragile and could be undermined by institutions such as the World Bank whose aid-dispensing power is large enough to overwhelm good with bad policies. The gift horse of aid under the Bank's present leadership, is in real danger of turning into a Trojan horse.

Hence, I have turned a critical eye on Mr. Wolfensohn's dangerously naïve pronouncements and policies in a letter to the *Financial Times* (chapter 43) that generated a large outpouring of critical letters on Mr. Wolfensohn. All in a good cause; besides, coming from India and having worked for four decades on problems of poverty and development, I may be forgiven for presuming that I perhaps know, and care, more than Mr. Wolfensohn, a boutique investment banker by profession and a recent novice in the complex task of development, about what we next need to do in both India and other developing countries.

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I The Two-Edged Sword: Capital Flows

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1 The Capital Myth: The Difference between Trade in Widgets and Dollars

In the aftermath of the Asian financial crisis, the mainstream view, indeed the prevalent myth, that dominates policy circles is that despite the evidence of a crisis-prone world of freer capital mobility as inescapably brought to our attention by the 1994 Mexican peso debacle and the current Asian tragedy, a world characterized by full capital mobility continues to be not just inevitable but also immensely desirable.[1]

Instead of returning to a world of carefully restricted capital mobility, we are told that the only sensible course before us therefore is to continue working toward unfettered capital flows; the favored solution is to do this principally through the IMF, by turning it even more firmly into an international "lender of last resort" that dispenses bailout funds to crisis-afflicted countries. In fact, while the obligations originally listed for member countries of the IMF in Article VIII of the Articles of Agreement included only "avoidance of restrictions on payments for current transactions" and did not embrace as an obligation or even a goal the embrace of capital account convertibility—which means that you and I, nationals or foreigners, can take capital in and out freely, in any volume and at any time—the Interim Committee of the IMF issued a statement virtually endorsing an eventual move to capital account convertibility by the IMF members, at the Hong Kong meetings last September.

This is a seductive idea: freeing up trade is good, so why not also let capital move freely across borders? But the assertion of the huge desirability of free capital mobility fails to persuade: substantial gains from free factor mobility have been asserted, not demonstrated; the gains

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from transnational capital flows can be obtained mostly by (direct) equity investment instead; and there are good reasons to believe that even a resource-augmented IMF and attendant changes in its methods of operation will not rule out crises or reduce their costs significantly. The myth to the contrary has been created by what I shall christen, implying not a crude conspiracy but only a nuanced networking ethos, the "Treasury–Wall Street complex," following in the footsteps of my erstwhile colleagues at Columbia University: President Eisenhower, who had talked of the "military-industrial complex," and the sociologist C. Wright Mills, who had written of the "power elite."[2]

Capital Mobility Ideology

Until the Asian crisis sensitized the public to the reality that free capital mobility could repeatedly generate crises and attendant costs, many assumed that free capital mobility among all nations is exactly like free trade in their goods and services, a mutual-gain phenomenon. Hence restricted capital mobility, just like protectionism, is harmful to economic performance in each country, whether rich or poor. That the gains might be problematic because of the cost of attendant crises was not considered.

Now that the crises cannot be ignored, the myth has been weakened and modified to address this problem. It is conceded now that this downside exists. But it is claimed that it can be downsized, if not eliminated, and free capital mobility's immense advantages be enjoyed by all by simply fixing the system. The conservatives would do this by "letting the markets rip," untended by the IMF, which would then be sidelined or even disbanded. The liberals would do it instead by turning the IMF into a supremo, the world's lender of last resort, dispensing funds during crises with conditionalities of several sorts, and overseeing, buttressing, and managing the world of free capital mobility.

It is necessary to understand why the stronger myth, which propelled the above noted adoption by the IMF of capital account convertibility as a sensible goal for all member nations, was just that. True, an economist is certain to say that there is a correspondence between free trade in goods and services, and free factor mobility: interfering with both will surely produce inefficiency losses. But equally, only an untutored economist will argue that, therefore, free trade in widgets and life insurance policies is the same as free capital mobility. Capital flows are characterized, as the economic historian Charles Kindle-

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berger of MIT has noted in an influential work, by "panics" and "manias."[3]

Each time a capital-inflows-related crisis hits a country, it typically goes through the wringer. The debt crisis of the 1980s cost South America a decade of growth. The Mexicans, who were vastly overexposed through short-term inflows, were devastated in 1994. The Asian economies of Thailand, Indonesia, and South Korea, all heavily burdened with short-term debt, went into a tailspin nearly a year ago, drastically lowering their growth rates. Sure enough, economic "crises" can arise at times without short-term exposure; macroeconomic mismanagement in Japan has reduced its growth rate over nearly seven years by now, and Japan is a net lender of capital. But it is a non sequitur to suggest, as the defenders of free capital mobility do, that this somehow undermines the view that short-term borrowings under free capital mobility will be, and have been, a source of considerable economic difficulty.[4]

Downsizing Gains

When a crisis hits, the downside of free capital mobility arises. Martin Wolf has described well the huge gyrations of exchange rates, and resulting internal turmoil, that have been imposed on countries that were hit by crises that reversed their short-term capital inflows.[5] To ensure that capital returns, the afflicted country must do everything that is supposed to restore the confidence of those who have taken their capital out. This typically means higher interest rates (as imposed by the IMF on Indonesia), which in turn have decimated in the Asian case the many firms with high debt exposure. It also means having to sell domestic assets, greatly undervalued because of the credit crunch, in a fire sale to foreign buyers with better access to funds when, in fact, the conventional advice has been the exact opposite: restrict foreign access to your assets when your credit has dried up but not that of others! Thus, Thailand and Korea have been forced, as if they were actors in the Theater of the Absurd with the IMF playing the role of the Italian Nobel Laureate Fo, to further open their capital markets, even though the short-term capital inflow (resulting from borrowings under a partial move to capital account convertibility) played a principal role in their troubles in the first place!

And one should add to such economic losses the loss of political independence to run your own economic policies as you deem fit. That you lose it, not directly to foreign nations, but to an IMF that increas-

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ingly is extending its agenda for borrowing nations and is being geared up, at the behest of the U.S. Congress, to invade domestic policies on matters of social policy as well (as with the acceptance by the Treasury of the Frank Amendment which seeks to attach environmental and labor standards conditionalities to the proposed augmentation of bail-out funds), is small consolation indeed.[6]

Thus, any nation contemplating the embrace of free capital mobility, as acceptance of capital account convertibility would obviously imply, must reckon with these costs and weight them by the not negligible probability of running into a crisis. The gains from economic efficiency that would flow from free capital mobility, in an impossible but hypothetical crisis-free world, must be set against this loss if a wise decision is to be made concerning the adoption of capital account convertibility.

But I should also emphasize that none of the proponents of free capital mobility have ever estimated the magnitude of the gains from capital mobility that they expect to materialize, even leaving out the losses from crises that can ensue. For free trade, numerous studies have measured the cost of protection. The overwhelming majority of trade economists would judge the flip-side gains from free trade to be significant, lying somewhere between Paul Krugman's view that they are too small to be taken seriously[7] and Jeffrey Sachs's view that they are huge and cannot be ignored. But all we have from the proponents of capital mobility is banner-waving, such as that of Bradford De Long, the distinguished Berkeley economic historian and former deputy to Lawrence Summers at the Treasury:[8]

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

And of Roger Altman, the investment banker:[9]

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

These assertions assume, without evidence, that free capital mobility is hugely beneficial, while simultaneously failing to evaluate also its crises-prone downside. But, even a cursory glance at history suggests

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that these gains may be negligible. After all, China and Japan, both different in politics and sociology, as well as historical circumstance, have registered remarkable growth rates over long periods without capital account convertibility. Western Europe's return to prosperity was also without capital account convertibility. Except for Switzerland, capital account liberalization was pretty slow at the outset and did not gain strength until the late 1980s, and some European countries, among them Portugal and Ireland, did not make it until early 1990s.

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

But that brings us to the issue raised by the *weaker myth*: that the downside of the crises under capital account convertibility can be eliminated. We have, of course, heard this assertion before, as each crisis has been confronted, and then we have been hit by yet another one! Like cats, crises have many lives, and macroeconomists, never a tribe that enjoyed a great reputation for getting things right or for agreeing among themselves, have been kept busy adding to the taxonomy of crises and their explanations. None of the solutions currently propounded can give us the confidence that we will finally and fully rid the system of free capital mobility of its crisis-proneness.

Thus, while no one can disagree with Secretary of the Treasury Robert Rubin's contention that greater transparency and reform of the banking systems around the world will help, few should agree with him that this will eliminate the crises that unregulated capital flows inherently generate. Nor can the abolition of the IMF and its "lender of last resort" bailouts eliminate crises be the magic bullet: there were crises before Walter Bagehot invented the domestic "lender of last resort" function for central banks in the nineteenth century.[10] Nor can making the IMF a more powerful lender of last resort kill the crises or give it the nonexistent macroeconomic wisdom to manage them with least cost when they arise.

In short, when we penetrate through the fog of implausible assertions that surround the case for free capital mobility, we realize that the idea and the ideology of free trade and its benefits—and this extends

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properly to the continuing liberalization of trade in goods and in financial and other services at the World Trade Organization (WTO)—have, in effect, been hijacked by the proponents of capital mobility and used to bamboozle us into celebrating the "new world" of "trillions" of dollars moving across "daily" in a "borderless world," creating gigantic economic gains, rewarding virtue, and punishing profligacy. The pretty face presented to us is, in fact, a mask that hides the warts and wrinkles underneath.

The Wall Street–Treasury Complex

The question, then, is why the world has nonetheless been moving in this direction.[11] The answer, as always, reflects ideology and interests (i.e., lobbies).

The ideology is clearly that of markets, and the steady move away from central planning, overregulation, and general overreach in state intervention toward letting markets function has now reached across many sectors and countries. This is, in my view, all to the good and promises worldwide prosperity. But this tidal wave has also overwhelmed many economists and policymakers into complacency about the pitfalls that certain markets inherently pose even when these were understood in the classroom: free capital mobility is just one supreme example of this unwarranted attitude. Indeed, Stanley Fischer, the deputy managing director of the IMF, admitted as much in a recent appearance on *The Charlie Rose Show* on PBS: yes, he had underestimated the probability of such crises arising in a world of capital mobility.[12]

But interests have also played a central role. Wall Street's financial firms have obvious self-interest in a world of free capital mobility since it only enlarges the arena in which to make money. It is not surprising therefore that Wall Street has put its powerful oar into the turbulent waters of Washington political lobbying to steer in this direction. Thus, when testifying before Senators Hank Brown (Rep.) and Diane Feinstein (Dem.) on the Senate Foreign Relations Committee on South Asia in March 1995, right after the Mexican peso crisis of 1994, I was witness to the grilling of Undersecretary of Commerce Jeffrey E. Garten on why India was not fully open to U.S. financial firms (implicitly, as under capital account convertibility). To his credit, Garten said that this was not an exactly propitious time for the United States to pressure India in this direction!

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I should also recall that, right before the same Mexican crisis, the CEO of a major Wall Street financial firm, sitting next to me at the annual dinner of a Washington think tank, lectured me on how Mexico was the best developing country in the world because it had capital account convertibility, so that he could freely take his money in and out. Of course, a few months later, he did take it out, and the rest is history!

Then again, Wall Street has exceptional clout with Washington for the simple reason that there is, in the sense of a power elite à la C. Wright Mills, a definite networking of the like-minded luminaries among the powerful institutions—Wall Street, the Treasury Department, State Department, the IMF, and the World Bank most prominent among them. Even a casual glance will show that Secretary Rubin comes from Wall Street and will likely return there; Roger Altman went from Wall Street to the Treasury and back; Nicholas Brady, President Bush's Secretary of the Treasury, is back on Wall Street as well; Robert Hormats went from State to Goldman Sachs; Ernest Stern, once acting president of the World Bank, now heads J. P. Morgan; James Wolfensohn, an investment banker, heads the World Bank today: one could go on.[13]

This powerful network, which may aptly, if loosely, be called the Wall Street–Treasury complex, is unable to look much beyond the interest of Wall Street, equating it optimistically with world good. Thus, the IMF has been relentlessly propelled toward embracing the goal of capital account convertibility. The Mexican bailout of 1994 was presented as necessary, which was true. But so too was the fact that the Wall Street investors were bailed out as well, which was not. Surely, other policy instruments could have been deployed simultaneously to punish Wall Street for its mistakes but were never considered. Even in the current Asian crisis, our banks could have been all forced to the bargaining table, absorbing far larger losses than they did, but were cushioned by the IMF bailouts where the IMF virtually acted as a lender of first, rather than last, resort: certainly in South Korea.

And despite the evidence of the inherent risks from the crisis-proneness of free capital flows, the Wall Street–Treasury complex is currently proceeding on the self-serving assumption that the ideal world is indeed one of free capital flows, with the IMF and its bailouts at the apex in a role that (it must not be forgotten) guarantees its survival and enhances its status. On the other hand, the weight of evidence and the force of logic points in the opposite direction: toward

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restraints on capital flows. It is time to shift the burden of proof from those who oppose to those who favor liberated capital.

Notes

1. Sure enough, there are a few cracks. Thus, for example, skeptical views were expressed by me as early as in an interview in *The Times of India* (New Delhi), December 31, 1997; and most recently, a powerful case for regulation of capital flows has been made by Martin Wolf in "Flows and Blows: After the Asian crisis, the question is not whether capital flows should be regulated but how," *The Financial Times*, March 3, 1998. But, as typified by the writings of Stanley Fischer of the IMF and of Lawrence Summers of the U.S. Treasury, also in *The Financial Times*, the preponderant view is the myth I describe in the text.

2. Eisenhower's famous 1961 speech on the military-industrial complex said, among many things, that "This conjunction of an immense military establishment and a large arms industry is new in American experience ... we must not fail to comprehend its grave implications ... we must guard against the acquisition of unwarranted influence, whether sought or unsought, by the military-industrial complex." Cf. Dwight D. Eisenhower, *Public Papers of the Presidents*, ed. Alfred D. Chandler Jr. Stephen E. Ambrose, associate editor. (Baltimore, MD: Johns Hopkins Press, 1970), 1035–1040. C. Wright Mills had written already in 1956 in *The Power Elite*, (London: Oxford University Press), in a far more penetrating and persuasive way of the growth of a powerful elite in the United States. Thus, he wrote: "The conception of the power elite and of its unity rests upon ... coincidence of interests [and also] upon the similarity of origin and outlook, and the social and personal intermingling of the top circles from each of these dominant hierarchies" (292).

3. Cf. Kindleberger, *Manias, Panics and Crashes* (New York: Basic Books, 1978).

4. Cf. Lawrence Summers, "Go with the Flow," *Financial Times*, March 11, 1998. Summers argues that "before we turn the clock back in favour of new controls on foreign borrowing, we should remember that a good number of countries that have recently got into difficulty have been exporting capital."

5. Wolf, "Flows and Blows."

6. I agree with Martin Feldstein's complaints about the IMF's expanding conditionalities in both economic and social directions unconnected immediately with macroeconomic bailout, as expressed in his brilliant 1998 article, "Refocusing the IMF," *Foreign Affairs* 77, 2 (March/April): 20–33. (http://www.nber.org/feldstein/fa0398.html)

7. See his "Protectionism: Try It, You'll Like It," *The International Economy* (June/July 1990): 35.

8. Bradford De Long, "Asia's Flu: A History Lesson," January 11, 1998, from his homepage on the Web site http://econ161.berkeley.edu or email him at delong@econ.berkeley.edu.

9. Roger Altman, "The Nuke of the 90's," *The New York Times* (Sunday Magazine), March 1, 1998, 34.

10. Cf. George P. Schultz, William E. Simon, and Walter B. Wriston, "Who Needs the IMF?," *The Wall Street Journal*, February 3, 1998.

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11. This question has been posed also in a recent, splendid analysis by Robert Wade and Frank Veneroso, "The Asian Financial Crisis: The High Debt Model and the Dangers of IMF Strategy," Russell Sage Foundation, Working Paper #128, February 10, 1998. Available from the Russell Sage Foundation, 112 E. 64th Street, New York, N.Y. 10021.

12. In jargon, he referred to "multiple equilibria" as characterizing this market. Indeed, such analysis dates back almost two decades, starting with Robert Triffin's seminal work on capital mobility and its downside.

13. Cf. Mills, *The Power Elite*: "The inner core of the power elite consists, first, of those who interchange commanding roles at the top of one dominant institutional order with those in another" (288); and "As an elite, it is not organized, although its members often know one another, seem quite naturally to work together, and share many organizations in common. There is nothing conspiratorial about it" (294).

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