THE OPACITY CAPACITY
OF INTERNATIONAL FINANCIAL INSTITUTIONS

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Just as domestic problems have provided the excuse for giving more power and money to regulatory agencies, international crises are being cited as the reason to give more power and money to international agencies. The greater the failure, the greater the budget. This may not be the ideal incentive system. Still, it is easier for many people to just assume that excessive freedom must be the source of any and all economic difficulties. A front-page *Washington Post* story, October 5, begins: "Forget about the Asian miracle . . . and the triumph of free markets."

Free markets *must* be the problem, so the solution must lie in more government controls: Let the experts do it. Maybe we need an Economic Planning Agency, like Japan, to plan our recessions better.

The word "transparency" has acquired fashionable appeal. After all, who could object to more information, particularly if the *cost* of that information is borne by someone else? Unfortunately, transparency is rarely defined to mean the public getting a glimpse into the books and plans of governments and central banks, much less of international financial institutions. When government and quasi-government officials speak of transparency, they seem to be thinking of a one-way mirror--where their own actions remain cloaked in secrecy while they demand greater authority to pry into the affairs of the private households and firms.

When you look more closely at the sort of information that has surprised the markets, it normally turns out to be the belated discovery of outright lies by governments and their agencies. Phony figures on foreign exchange reserves, for example, or strong statements in defense of a currency about to be trashed. Such political information is inherently untrustworthy. Politicians take great care to make sure their guarantees are not binding, and to exempt themselves from civil or criminal liability for fraud.

A few years ago, I wrote a paper entitled, "The IMF's Destructive Recipe: Rising Tax Rates and Falling Currencies." It was published this year in *Money and the Nation State*--an Independent Institute anthology edited by Kevin Dowd and Richard Timberlake. The IMF does not openly reveal what sort of policy conditions it attaches to its loans, but the record can be reconstructed from news reports. I did that. The IMF record is frighteningly bad, a series of horror stories. I am still waiting for someone to show me a single IMF success story. Just one.

It is somewhat surprising that the World Bank routinely capitulates to IMF decisions about which countries deserve more cheap loans. In principal, the World Bank's mission is to *increase* the flow of private and official capital into developing countries. In practice, the IMF's passion has been to *shrink* such capital flows. An IMF "adjustment program" defines "adjustment" as shrinking the current account deficit. Since the flip side of a current account deficit is the capital inflow needed to finance it, the IMF and World Bank should be in continuous battle. I propose a barbed-wire fence along 18th Street, separating the sprawling complexes of the World Bank and IMF.

Why does the IMF focus so single-mindedly on the current account deficit? Because, by slashing imports and redirecting production away from domestic uses into exports, poor countries are supposed to free-up more cash with which to repay the multinational banks (and the IMF). Shrinking the current account deficit *is* the IMF's definition of success, even though it usually means deliberately engineering a deep recession. There are hundreds of statistics in the *IMF Financial Statistics*, but the unemployment rate is not one of them.

At times, IMF missionaries appear to believe that *all* countries should run trade surpluses (even though this does not add up very well). They also seem to believe that all countries can become more "competitive" by repeatedly devaluing their currencies against one another (which is also arithmetically impossible).[1] So, the IMF teams have been telling each of the wounded Asian tigers to slash imports and expand exports. But most Asian trade is within the region. That means one country's reduced imports must be a neighboring country's reduced exports. The so-called Asian contagion is largely a matter of Fund *design*, not some inexplicable accident.

What about the IMF's infamous obsession with squeezing more tax revenue out of troubled economies? The budget fetish actually follows from their mercantilist objective of treating imports as evil. That is because, believe it or not, the Fund actually acts on the once-faddish theory of "twin deficits."

Only a few years ago, famous proponents of the "twin deficits" theory confidently predicted that any budget surplus in the United States would be matched by a trade surplus.[2] By

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[1] Robert Samuelson's *Washington Post* column of October 7, cheerfully titled "Depression Omens," cites Barry Eichengreen and Peter Temin who blame the Great Depression on the (overly-managed) gold standard. They appear to argue that countries first to devalue, like Britain in 1931, gained a better share of shrinking world trade. Inflation did help Britain reduce the real value of the dole, and therefore unemployment. But industrial production from 1931 to 1936 was much stronger in France than in Great Britain or the United States, and France was the one who remained on gold. In any case, one cannot argue that any competitive advantages from devaluation by some countries could have been extended to all countries. Trade warfare was a "real" shock, not a monetary shock, although the burden of tariffs was greatly magnified by deflation (because tariffs were so many cents per item).

[2] Alan Reynolds, "Revisiting the issue of twin deficits," *The Washington Times*, February 25, 1997. Available at: http:\\www.areynolds.com.

the same theory, today's huge budget deficit in Japan must surely be matched by an equally huge Japanese trade deficit. Such forecasts have proven to be as ridiculous as the theory that spawned them. Yet in *The Economist* of October 3, IMF chief economist Stanley Fischer is still recycling the "twin deficit" theory to excuse the lunacy of trying to somehow force collapsing economies into a big budget *surplus*:

> Thailand embarked on its IMF program with a current account deficit of 8% of GDP. To shrink that, the program included an increase in the budget surplus of 3% of GDP.[3]

In late 1997, this sort of IMF "twin deficits" advice led to increased taxes in some Asian countries, higher tariffs in others (a tariff seems to attack the "twins" at both ends, cutting both imports and the budget deficit). Bad theories produce bad policies. Even a large current account deficit that persists for many years can be extremely beneficial, not problematic, providing it is financed by voluntary foreign investments that go into the private sector. Current account deficits typically become troublesome when investment decisions are *politicized*--that is, when the government is doing much of the borrowing and the allocation of credit. That was happening in the smaller Asian NICs, and Korea, hence the charges of "crony capitalism." Such charges do not apply so easily to Hong Kong, Singapore and Taiwan, yet those countries too are being pulled down by the import-contracting policies of their neighbors, and by the implosion of worldwide credit channels.[4]

Misallocation of excessive bank credit in several East Asian countries does not justify the IMF's wholesale assault on current account deficits throughout the region. Every country that ever experienced a sustained period of unusually rapid economic growth has always done so with the help of a large and sustained current account deficit--that is, with foreign capital inflows. The United States did this for most of its history, and still does.

The right solution is not to foster larger and faster capital flight--with devaluation, higher tax rates and tariffs, or capital control--but to pursue policies that will *not* scare foreign capital away. That also applies to the United States, where recent spells of weakness in the dollar have been closely matched, day by day, to declines in the U.S. stock market.

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[3] It is a convenient hoax that the dangers of Thailand and others were a big surprise that suddenly appeared in July-October 1997. In an "Emerging Markets Update" sent to consulting clients on March 24, 1996, I wrote, "Thailand has the region's largest current account deficit — 6.8% of GDP . . . [which] makes Thailand vulnerable to anything that would disturb exports and/or cause foreign capital to fell the region."

[4] Alan Reynolds, "Pacific Grim: Asia's Financial Implosion," *American Outlook*, Hudson Institute, Spring 1998.

The current fascination with capital controls, thanks to the pop internationalism of Paul Krugman, is just another angle on the IMF theme. Anyone frightened of current account deficits has to be equally fearful of capital inflows. To put any sort of arbitrary restraints on capital outflows is, of course, an excellent way to discourage capital inflows. If I can't get my money out, I'm not about to put it in. And without capital inflows, countries cannot afford to import any more than they export.

To make capital controls work, it would probably be necessary to ban computers and suitcases. But if such controls did work, and if many countries adopted them, then the effect would be quite similar to the effect of worldwide trade warfare. International trade, specialization and competition would all contract. Many enterprises had been created to cater to export markets would have to shut down. So would those involved with transporting and marketing imported goods. Credit extended to such enterprise would go bad, killing more banks. No business is nasty business.

It is truly peculiar to see this poion being peddled now, at a time global capital is already rushing out of almost every foreign country as fast as can be imagined (with the proceeds sometimes hoarded as currency). Excessive foreign interest in their stocks and other assets is scarcely the current problem in East Asia or Latin America.

An Organization Even More Secretive Than the IMF?

From public choice theory, we should expect that regulatory institutions, domestic or international, are created and expanded in order to help interest groups which, in turn, support the politicians who create and expand the agencies. The influential political constituency of antitrust agencies consists of politically generous corporations who would like to use the courts to hobble such rivals as Microsoft, Intel, or Visa and Master Card. The constituency of the World Bank includes multinational construction companies.

The constituency of the IMF is multinational banks. But the banks also have another, even more secretive ally--namely, The Bank for International Settlements. *The Economist* (June 6) noted that "for most of its 68 years, the BIS has deliberately shrouded itself in mystery." Why? Do they have something to hide?

Most people have never heard of the BIS, nor of the Basle Accord of 1988. What went on there--and why--is a fascinating story, which I have shamelessly stolen from a fine article on "Redistributive Cooperation" by Thomas Oatley and Robert Nabors in *International Organization*, Winter 1998.

In 1982, one of Mexico's periodic "debt crises" provoked capital flight from the Latin American region, posing a serious threat to America's money center banks. Exposure among the dozen largest American banks in the five most indebted Latin American countries ranged from a

low of 82.7 percent [of capital] to a high of 262.8 percent, with most banks falling between 140 and 180 percent.

Risks of being decapitalized by Latin American loan defaults led the banks to put considerable lobbying pressure on Congress to approve $8.4 billion of new money for the IMF. The IMF, in turn, would attach strings on the loans that required their wards to keep making debt payments to the U.S. banks. This was such an obvious bailout that some prominent politicians actually hesitated for a moment.

Ferdinand St. Germain, chair of the House Banking Committee stated, "At a time when millions stand in unemployment lines and thousands of small businesses are filing bankruptcy petitions, the idea of an international bailout for adventurous U.S. bankers may not be the most popular idea on the legislative agenda."

The big banks were asking Congress to shift the cost of their mistakes to taxpayers--to socialize their losses--at a time when the United States was barely emerging from a nasty recession. In order to get away with making such a gift to the banks without *too* much voter backlash, Congress had to appear to be “getting tough” with banks. Politicians needed a cover. Tougher regulations were a way to appear to be punishing the banks while simultaneously laundering money to them through the IMF. Unfortunately, banks that had enough political influence to get a big bailout also had enough clout to resist regulation.

To win cooperation from U.S. banks, any new capital standards had to be international. The United States sought imperial bank regulation. Why? International capital standards would mainly curb Japanese banks, who had been making huge inroads into the commercial lending business, in the United States and globally.

By the end of 1987, when the United States and Britain finally used a bilateral cartel to shove others into the deal, there was no international debt crisis. The only crisis was the U.S. effort to shove the dollar down, for mercantilist reasons. That contributed to the famous 1987 crash in the U.S. stock market, and to excessive global investor interest in Japanese stocks and land.

The Basle Accord required that by the end of 1992 banks had to maintain capital equal to a minimum of 8 percent of risk-adjusted assets, where risk just happened to be defined in a way that favored government bonds over business loans.[5]

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[5]. In May 1993, the Basle Committee on Banking Supervision proposed that a bank's stock, securities, and foreign exchange assets be marked-to-market. For a properly critical discussion of that idea, see *Proceedings of the 1998 Milken Institute Global Conference*, Santa Monica, pp. 221-24.

De Carmoy's 1990 book, *Global Banking Strategy,* provides a sampling of capital-asset ratios from 1981 to 1987. That ratio averaged 2.5 percent for three large Japanese banks, 1.9 percent for major French and Belgian banks, 3.2 percent for three German banks, 4.3% for the United States, 5 percent for Great Britain, and 5.4 percent for Union Bank of Switzerland (home of the BIS).

Higher capital ratios were obviously going to pinch a lot harder on Japanese banks (as well as French and Belgian) than on the United States or Great Britain. Germany was in between, but sided with the Japanese and French in opposition to the fanciful U.S. crusade for one-size-fits-all capital standards, because universal banking is so different in Germany.

Did relatively higher capital ratios in the United States and Great Britain mean they were less exposed than Japan to LDC default? On the contrary, even in the late eighties outstanding LDC loans still amounted to 93-199 percent of the capital of the largest U.S. banks, and as much as 82 percent for British banks, but only 55 percent for Japan. American banks *seemed* to have more capital. But unlike Japan, all of the capital of U.S. banks, and sometimes much more, was exposed to LDC default.

The 1982 LDC debt crisis provided the political rationale for the 1998 capital standards, but it did not provide the real *reason.* After all, the crisis had long since passed.

The United States had begun pressing for international capital standards in 1983, but the idea was strongly opposed by Japan, France and Germany. In January 1987, the United States cut a deal with Britain, and threatened to impose the standards of that regulatory cartel on foreign banks operating in either country. That forced Japan and Continental Europe to capitulate.

In short, the Basle Accord was a political device to cut down on competition from Japan, and thus redistribute earnings from Japanese to American and British banks.[6]

Political Innocence and International Regulatory Cartels

The habitual response to financial instability is to assume the "free market" must be the cause and more regulation must be the cure. Unstable is considered synonymous with unregulated. More regulations are treated as *equivalent* to more stability. The political and economic innocence of this attitude makes transparency unimportant for outfits like the BIS or IMF, because it rules out any serious look at what is really going on. By definition, there is no

[6] After Japanese banks were put in their place, other big banks became more concerned with securitization, by which companies and rock stars bypass banks (and the fat spread between rates on loans and deposits) by selling their own IOUs to investors. So, in the summer of 1994, the Basle Committee and the International Organization of Securities Commissions issued guidelines to harmonize minimum capital standards for both banks and securities firms. Nice try.

need to even consider any evidence that IMF adjustment programs could possibly worsen the "aided" economies, or that regulations like the Basle Accord could cause far more problems than they solve.

Would Japan's banking crisis be nearly as bad as it is if the Basle Accord had never existed? I seriously doubt it. After all, the Accord was clearly designed to damage Japanese banks, and it may well have been too successful in that respect.

The Basle Accord was a long time brewing, and phased-in gradually. That provided Japanese banks with a strong incentive to make riskier loans until the new capital standards took hold. At about the same time (most memorably in October 1987), the United States was using leverage and rhetoric to drive the dollar down. The resulting rise in the yen made the Japanese stock market attractive to U.S. and other foreign investors. Any rise in Japanese stocks was magnified in terms of dollars, and the rising yen also meant that costs of manufacturing inputs were falling in terms of yen, helping profit margins. The drop in import prices also kept measured inflation low, possibly fooling the Bank of Japan into expanding the monetary base too rapidly.

Whatever the cause of the "bubble," it was quickly deflated as soon as the BIS standards began to bite. That is unlikely to be a coincidence. Bank lending was cut back hard, even rationed, and the monetary base turned negative for a couple of years.[7] I have argued that the squeeze on money and bank credit was compounded by new taxes on stocks and land, which had the unforeseen effect of debasing loan collateral and reducing bank capital.[8] It is true that many loans have gone "bad" largely because the Japanese economy, and its assets, have gone bad. Yet the problems of Japan's banks and Japan's economy are self-reinforcing, because the domestic Japanese economy had become dangerously dependent on banks in general and on Japanese banks in particular. In short, the Basle Accord looks like a major contributor to the Japanese banking crisis, and therefore to our present discontents throughout Asia and the world.

The relevance of this old story is that institutionalized secrecy at places like the BIS and IMF may be hazardous to our financial health. International transfers, like domestic transfers, tend to go to those with the most political clout, which is unlikely to include poor countries or poor people. The IMF is once again asking for more billions to loan to the governments of troubled countries. Why? So those countries, in turn, can repay their loans to the big Western banks, without the banks having to be bothered renegotiating a less favorable deal. *Déjà vu* all over again. The "moral hazard" of playing this game too often is finally becoming obvious,

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[7] See the Appendix on money in Alan Reynolds, "Toward Meaningful Tax Reform for Japan" at this Cato Institute Website: http://www.freetrade.org/pubs/speeches/ar-4-6-98.html

[8] Alan Reynolds, "Japan Should Cut Taxes to Spur Investment," The Wall Street Journal, September 11, 1998;
"Rising Sun, Falling Yen," *American Outlook*, Summer 1998 .

though it is not obvious what is so moral about it. As Bernard Shaw once remarked, “any government that borrows from Peter to pay Paul can count on the support of Paul.”