Rudi Dornbusch
Essays 1998/2001

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CHINA: A BEGINNER'S GUIDE

Napoleon said, "if China awakens, the world will tremble." Well, China has. In all areas from possible devaluation to military issues, to WTO membership and the prospect of mega deals China is now part of the global economy and is increasingly so. With apologies to the China expert and my friends in China, here is a collection of information on the Chinese economy. It is obvious that because of the dynamism, complexity and awesome problems of the Chinese economy, we will spend more and more time learning about it and may hold our breath if things get tough. It is therefore useful to have a picture of key characteristics of this economy. The best way to get that is going there, but even then some perspective helps.

Some History

Over the past 40 years, China has gone from an extreme of autarchic non-market economics embodied in the great leap forward (see the film *To Live*) to get the flavor to an immensely ambitious scheme to transform the entire state enterprise sector in just a few years. The market is now the rule, the ownership question is unresolved, and the governance question up for grabs. The market is now so much the rule that the institutions must urgently be created to get governance or else the country loses stability.

Table 10 Some History

- *1958-60* The Great Leap Forward Disaster and Famine
- *1966-69* The Cultural Revolution
- *1976* Mao dies
- *1978*, 11th Party Central Committee Meeting condemns the cultural revolution. Deng in the ascent."4 modernizations" program: agriculture, industry, science & technology, national defense. Family farming system replaces agricultural communes.
- *1978-84*. First stage of economic reform; emergence of town and village enterprises (TVEs) and coastal special economic zones. End of mandatory agricultural plans.
- *1984-92* Shifting outright to the market economy.
- *1989* Tiananmen Square.
- *1992* Deng visits Southern China. "*To get rich is glorious*".
- *1997* 15th Party Congress endorses reformist economic program and makes Deng's pragmatist "theory" becomes part of the official catechism, along with Marx and Mao.
- *1998* President Jiang Zemin (71) and Premier Zhu Rongji (69) commit to a radical reform of finance and state owned enterprises (SOEs).

From a distance, it is hard to understand how China functions without clearly identified property regimes. On the spot the issue is handled more pragmatically; somehow it seems to work, mostly.

From Mao to Zhu, China has moved by a century in just 20 years. Today the talented young people in China like America and want to study finance; they speak English and have access to the Internet. At the same time, the communist party remains in charge even though the membership amounts to only 5 percent of the population. Somewhere along the line some form of democracy will come, presumably first at the local level and then, almost inconsequentially at the national level. If China is lucky; the economic restructuring is accomplished before the full political liberalization comes. In the meantime, integration in the world economy is seen as part and parcel of the restructuring process of the state sector.

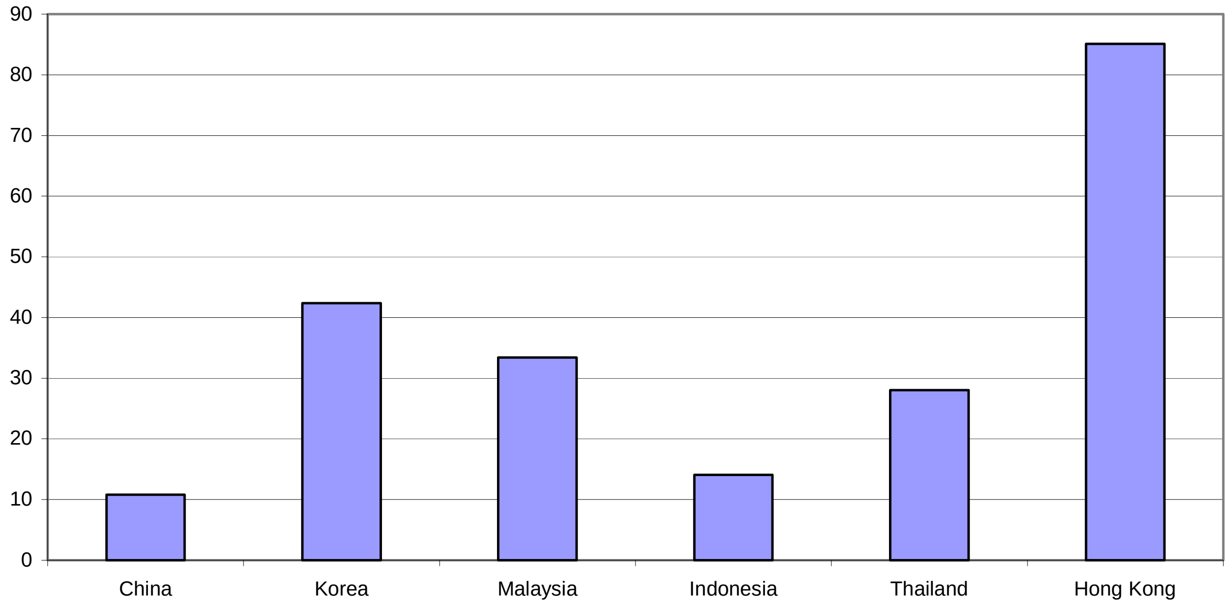
How Large is China?

There is much discussion of China overtaking the US by 20000 and become the largest economy in the world. Others argue it will break up before it gets there, or it will break down. In any event, don't rush; China has a huge population but is very poor. Much of the spectacle of the coastal region is not shared by the rural population, which still accounts for more than half of the total. Using GDP in dollars, converted at current official exchange rates (and thus we do not measure standards of living), China is one tenth of the US economy today. It is a third or so smaller in dollar GDP than the UK or Italy but significantly larger than say Canada and at least twice Korea. Any discussion of China bypassing the US is not a story of dollar GDP but rather PPP-GDP, which measures the purchasing power of income, i.e. haircuts in China at international prices. On that basis, per capita GDP today is about 11 percent of the US standard of living.

But because China's population is so much larger the total GDP in "international dollars" comes out to half that of the United States. Since China will grow at a far higher rate than the US, GDP in international dollars will exceed the US level sometime in the next 10 or 15 years. Which measure is more relevant, dollar GDP or GDP in international dollars (the standard of living measure)? For most trade issues straight dollar measures are right. On that basis, China is still only a 2 percent share of world trade, far away from the US, Japan or Germany. When it comes to the domestic market it becomes more interesting to argue that China has a middle class of the size of France, but not quite the same middle class income. But it is getting there and, at the current pace. A decade will make a huge difference.

In terms of regional comparisons, China is, of course, very poor even using the standard of living-adjusted PPP measures. (See Figure) It is behind Indonesia, far behind Malaysia and Thailand and a huge distance from Korea or Hong Kong. That comparison suffers, in part, because of the huge regional differences with China. Clearly the urban-coastal regions are much richer than the rest, but even so the comparisons stand.

PPP PER CAPITA GDP
(1995 International Dollars, US=100)



China is clearly one of the 5 big emerging markets in the world today. (The term was coined before Indonesia tanked). The accompanying table shows key characteristics.

Table 11 The 5 Big Emerging Markets

	China	India	Indonesia	Brazil	Russia
Population	1,200	929	193	159	148
GDP Per Capita (PPP, US=100)	10.8	5.2	14.1	20.0	16.6
Growth 1985-95 (per capita)	6.3	3.2	6.0	-0.8	-5.1
Trade/PPP GDP	7.1	4.5	13.6	10.2	19.8

Source: World Bank *World Development Report* and *World Development Indicators*

Structure of the Chinese Economy

The accompanying table shows a number of summary statistics on where people work, what is the form of ownership and what is produced:

In terms of broad generalizations, we have the following:

- Agriculture accounts for only one fifth of GDP but more than half of the labor force.
- State owned enterprises account a third of industrial output, half of fixed assets and nearly 65 percent of urban employment.
- Collective-owned forms are an ideological in between that got started in the 1980s, has typically smaller scale than SOEs (but still into the thousands) and accounts for more than one-third of industrial output. Collectives include the famous town and village enterprises (TVEs).
- Exports of goods and services account for 21 percent of GDP. Export trade is predominantly in manufacturing. Exports have a very significant import content, estimated upward of 50 percent.

Table 12 China: Structure of the Economy and Employment

Share of GDP		*Share of Industry Output*		*Share of Labor Force*	
Agriculture	20.6	SOEs	34.0	Agriculture	52.9
Industry	48.4	Collective-Owned	36.6	Industry	23.0
Services	31.0	Individual-Owned	12.9	Services	24.1
		Other	16.6		
Share of GDP					
Consumption	58.0	*Share of Labor Force*		*Share of Total Employment*	
Investment	40.5	Rural	72.2	SOEs	18.0
Net Exports	1.5	Urban Staff & Workers	24.5	Urban Collectives	5.0
		Urban Individual Workers	3.3	Other	1.4
Share of Exports					
Primary Goods	14.4	*Share of Fixed Assets*		*Share of Urban Employment*	
Manufactures	85.6	SOEs	54.4	SOEs	64.9
		Collective	16.4	Urban Collectives	18.2
Share of GDP		Individual	12.8	Indiv. Workers	19.9
Exports	21.0	Other	16.3		

Source: World Bank *China 2020*

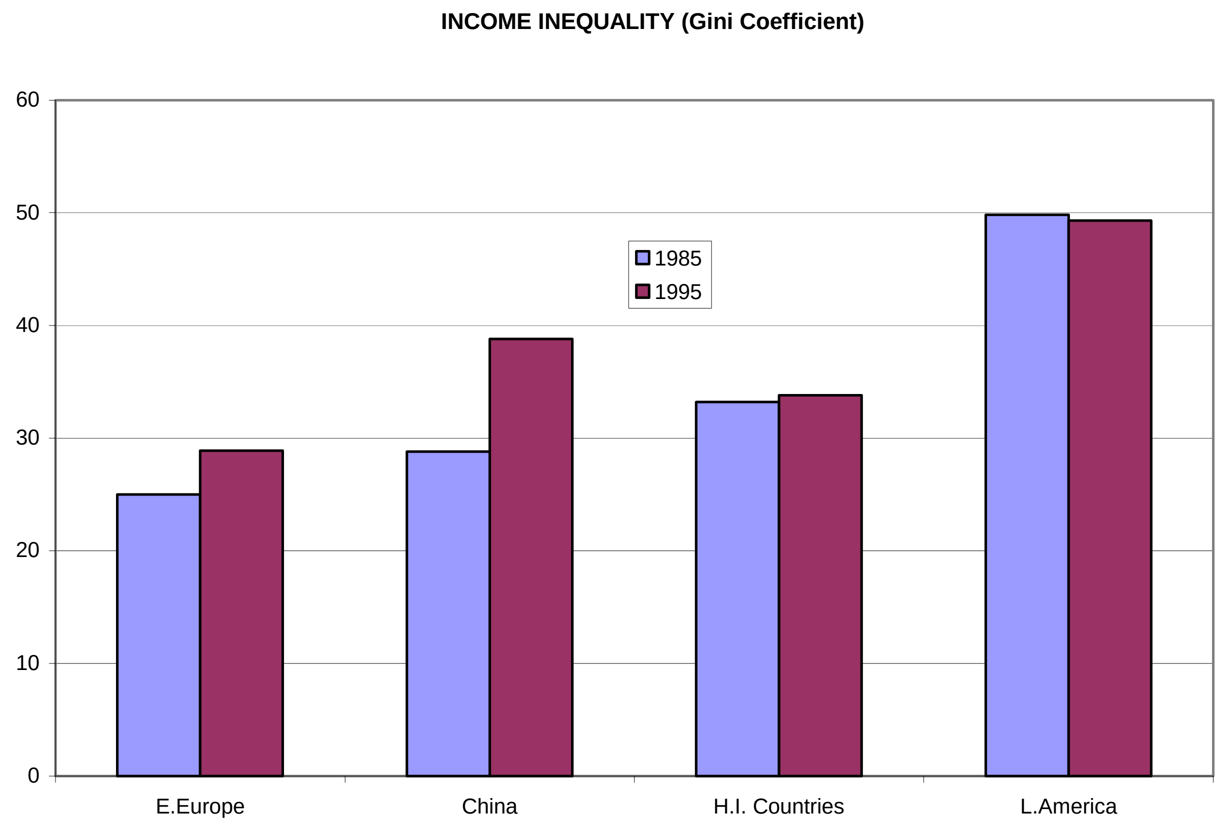
Policy Issues: Inequality

China is both a country with significant income equality—somewhere in between Eastern Europe and the industrial countries (HI), quite unlike Latin America, according to World Bank estimates. At the same time it is a country with extreme regional inequality. The latter is, of course, as extraordinary issue both in terms of politics and in terms of economic pressures, including migration. Moreover, the regional income discrepancies are rising rapidly as the coastal region is growing at several times the pace of the backward regions. In fact, regional per capita income differences at the extreme ends are 10:1.

A decomposition of the spectacular increase in Chinese inequality in the past decade, shown in the following Figure, coming out of World Bank research, lists the following sources:

- 74.4 percent if the increase stem from urban-rural inequality
- 9.3 percent from intra-urban inequality
- 16.2 percent from intra-rural inequality.

In sum, most has to do with the very different development underway in the coastal-urban region from the interior underdeveloped regions. The point of the inequality discussion is less the existing level of inequality, but the very rapid change that has been underway. It is the latter that carries the risk of instability. In terms of policy responses there is no easy answer: China is trying to dismantle the State; that is a poor time to bring in the welfare state. The natural disadvantage in terms of resources and human capital of the interior cannot be easily remedied. The inequality that results, at least in the transition, from SOE restructuring will add to the problem



Policy Issue: SOEs

The problem of the SOEs has several features: First, they are large – upward of 100,000 firms with more than 100 million employees. Second, they are making losses. Third, their poor performance makes them uncompetitive in price and quality. This leads to reduced competitiveness of their customers and to protective barriers to shelter them, both within China and internationally. Finally, the SOEs provide the full range of in-kind income to their employees ("small societies"), including housing, so that their reform requires a much wider restructuring of in-kind income.
The SOEs remain the commanding height of Chinese economy in terms of their share of GDP (one third), employment (two-thirds) and investment (three-quarters). And because they are bad, this is an unsustainable situation. By one measure the productivity growth differential between joint ventures and SOEs was 3:1. They are, of course, also a critical part of the bank's bad loan problem.

Of course, it would be a mistake to assume that all public sector enterprises are loss makers. In fact, the World Bank reports that as a whole they made 2 percent of GDPO in profits. BUT, more than 40 percent of the enterprises made losses which, in 12994, amounted to 6.1 percent of industrial GDP. A survey of SOEs revealed that labor redundancy in firms was of the order of 10 to 20 percent.

Table 13 Government Subsidies to SOEs (% of GDP)				
	1985-88	1989-92	1992-95	1996
Operating Losses	2.9	2.7	1.1	0.5
Capital Expenditure	6.5	4.1	2.8	2.1
Source: World Bank				

Starting in 1993, the state sector came under scrutiny with a 10,000-100-100-10 program: 10,000 small and medium sized firms to be inventoried, asset management for 1000 large firms, 100 big firms to be transformed into shareholding companies, and 10 (now 18) cities were to undergo comprehensive reform of their SOEs and social services. All of this is both underway and thoroughly incomplete.

The table above makes it clear that, however imperfect, some discipline has already been coming to the state sector. Of course, the sharp slowdown in 1998 will have made things worse, including the prospects for rapid reform

Policy Issue: Bad Finance

China's finance revolves around the banking system. The budget deficits of the past have been financed by the banking system, i.e. by money creation. There is almost no public debt (some 5 percent of GDP apparently), while money holding is about 111 percent of GDP.

Little is known about the quality of the balance sheet. Occasional references are made to nonperforming loans, most recently 25 percent of all loans. That is not surprising in that the banks are the captive source of credit to the state enterprises sector. The banks were credit stations not institutions that sought out good loans and effectively enforced financial discipline.

Table 14 Banking Survey (1996, Billion of Yuan)

Net Foreign Assets	920	Money	3,066
Domestic Credit	6,641	Quasi-Money	4,543
Claims on Central Gov't	218	Bonds	23
Other Claims.	6,423	Capital	411
		Other Net	-394

Note: 1996 GDP was 6,850 billion yuan
Source: IMF

The banking problem now involves a number of steps. First, to assess the balance sheets and determine the state of bad loans. Second, to recapitalize the banks. Third, to create an effective system of bank regulation and supervision. Fourth, to separate decisively the banks from the SOE sector. The list is formidable, but it is not uncommon in countries that have experienced a banking crisis.

The recapitalization is not an important technical issue. It merely means an increase in the public debt, which is placed in the balance sheet of the banks to fill the gap left by bad loans. Since the public debt is moderate, a 20-percentage point increase is both unpleasant and affordable. But even that number may overstate the damage since surely the bad loans have some collateral value, if only in real estate.

The regulation and supervision issue is much harder. The case of Japan makes it so obvious that starting with nothing, it takes quite a while. But if it takes a while, the moral hazard issues in the transition is formidable. It will take a very firm hand to control the banks as they are looking forward to complete rescue. Even though they are public institutions, they can misbehave just as much.

The separation of banks from the SOE sector means that there is a need for a capital market. Both bonds and equity need a formal, supervised market. That way the government can disengage itself and the budget, the banks can be pulled out and investment discipline can start. The creation of a capital market is a formidable process that needs to come very fast.

Closely related to the banking issue is the question of financing the government. SOE reform will cost a fortune, more so since massive privatization to the rest of the world does not seem an immediate prospect. Relying on money creation is not a good option, except for that portion consistent with a growing non-inflationary economy. Supposing that the income elasticity of money demand is unity, and growth averages 5 percent, approximately 5 percent of GDP are available from seignoriage. As capital markets develop as well as private housing, the ratio of money to GDP will fall and with it the affordable revenue from money creation.

Policy Issue: Integration in the World Economy

China's integration ion the world economy raises a number of issues. First, the remaining level of tariffs and quantitative restrictions remains high. Second, openness to foreign direct investment should be far more pervasive and uncomplicated. Third, capital account opening should ultimately come but not before sound finance. Lastly, the exchange rate question needs an answer. Should China devalue? (See the separate essay)

China has definitely opened up to trade. Weighted average tariff rates in this decade have fallen to half and so has the standard deviation of duties. But even so, tariff rates remain high, in part because their purpose is to shelter inefficient state enterprises. In the WTO accession, China will have to bring a major market opening. Since the government is striving for efficiency, further integration in the world economy can bring just that.

Table 15 China: Weighted Average Tariff Rate

	1992	1996	1997
All Products	40.6	25.4	20.8
Primary Commodities	22.3	19.4	19.9
Manufactures	46.5	27.6	21.2

Source: World Bank

Of course, beyond tariffs there are quantitative restrictions, which have a far higher burden in terms of inefficiency.

Foreign direct investment has started to play an important role in China over the past decade. It now can play a very special role in three respects, First, employment growth is crucial. Hence anyone who has good ideas about creating businesses and opportunities should be welcome. Second, in the restructuring of the SOE sector, experience and technology will be particularly important, as is capital to finance the modernization investment. Foreign firms have just that. Third, the government is entering a phase where access to cold money is particularly desirable in terms of foreign exchange. For all these reasons, China should become far more open and un-bureaucratic toward foreign capital.

External finance has been very conservative. The external debt is just above $120 billion, predominantly long-term and more than matched by reserves. The current account is in surplus as the trade balance. Until this year, reserves have been rising. In other words, there is no external finance problem, at least yet. Of course, a lasting Asian crisis or a deepening one can put a lot of pressure.

Optimism?

The Chinese government has announced a growth target of 8 percent for the next decade, 8 percent for each year. Clearly, that is not happening. The Asian crisis is cutting into export growth and the home economy is still groggy from the slowdown engineered to fight inflation. Those who watch industrial production are maximally pessimistic – it has been falling-- , those who don't believe the government data have all but given up on China. Those who see the 500 empty skyscrapers in Shanghai conclude that either there is a problem or a very large problem.

Business as usual is clearly not the answer. It is clear that the next few years will test the determination and the skill of the new team to transform China. So far they are doing well.

Table 16 China Growth Outlook				
1979-88	1989-96	1997	1998	1999
9.8	9.6	8.8	6.7	7.2
Source: IMF and *Economist* Consensus				

China has drawn attention for the extraordinary, almost uninterrupted growth of two decades, ever since 1978. In growth accounting the question is always asked how much of that growth is attributable to increased factor inputs, capital and labor, and how much is accounted for by increased total factor productivity (TFP). That discussion was stated in the case of Alwyn Young who showed surprisingly low TFP growth rates for Asia. Capital accumulation accounted much for growth and increased productivity very little. That idea matches one's image of SOEs madly accumulating inefficient capital.

Interestingly, the second generation of that discussion comes up with a far more optimistic answer, especially in the case of China. As the accompanying table shows, in the reform period since 1979, almost 40 percent of growth are due to higher total factor productivity, more than double that of the pre-reform period.

Table 17 China : Sources Of Growth (%)		
	1952-78	1979-94
Productivity	18.0	41.6
Labor Input	16.9	12.8
Capital Input	65.2	45.6
Source: Hu and Khan "Why Is China Growing so Fast?"		

Among the reasons for sharply higher productivity growth the role of foreign trade and the declining share of SOEs are obvious candidates. A broader concept of opening, including ideas and information surely applies, too.

Interestingly, the total factor productivity growth rate for China of 3.9 percent per year, on average, far exceeds that of other countries in Asia, including Japan, or Latin America! Moreover, in the 1990s TFP growth has accelerated! This kind of result, for the case of China, is supported in a number of other studies.

The strong growth of total factor productivity in China raises two possibilities. The friendly one is to argue that investment has been efficient, is getting more so as decentralization and opening allow the market economy to play its role more powerfully, and hence China will grow at high rates if only it manages to maintain macroeconomic stability. The pessimist view is that output and output growth is vastly over-reported. In that view, China is not special at all except that it fakes the data more.

SHOULD CHINA DEVALUE?

Pessimism has been a good rule of thumb of late in judging Asian financial prospects. Is it now time for China to join the Club, lose stability and become part of the ever-widening Asian problem? Chinese devaluation is on everybody's screen. (See FT, July 31, 1998). China does not need a devaluation; its leaders would do well to reject it squarely rather than hold it out as a solution to the growth problem or a blackmail tool in high stake international poker.

The belief that China will devalue, sooner or later, rests on the fact that the country faces extraordinary restructuring challenges both in the banking system and the state enterprise sector. These problems are hard to solve at the best of times, but without high growth the prospect strains political and social stability. But unfortunately growth is down substantially, running somewhere between 5 and 7 percent according to most recent outside forecasts. That compares unfavorably with the 10 percent average of the past 15 years and lies below the officially announced target of 8 percent. The growth problem is in large part a reflection of an export collapse: Asian markets are central for China and they are gone and so is export growth. In the past decade it amounted to 20 percent, in the first half of the year it was down to only 10 percent and by now it may well be running at zero. Since exports (in value added terms) account for 10 percent of GDP, going from 20 to zero growth costs directly 2 percent of GDP and including income effects perhaps as much as 4. The problem is real and not about to disappear. Hence the conclusion: devaluation to get back to export growth is inevitable. The problem is this conclusion is wrong.

China clearly has control of its exchange rate. True, all of Asia has undergone a competitive devaluation leaving China with an overvalued currency and poor export performance. Even so, the external front is not under siege. Capital controls are quite tight (and getting tighter as the Liberation Army is coming under scrutiny), there is a substantial current account surplus and there are sizable foreign exchange reserves. That picture differs sharply from all the economies that have gone under. Moreover, if an extra buffer is needed, capital inflows can be made substantial by allowing more flexibility on joint ventures. That appears to just have emerged in telecommunications and, with pressure, might come in further sectors. The point here is that China is not hanging on to the last penny in reserves, about to call in the IMF and the US Treasury for their emergency package. On the contrary, on the financial side they have the wherewithal to hang in and defend the present exchange rate if that is the policy choice.

Devaluation then is an option, but a poor one, not something inevitable. A small devaluation does little, a large devaluation will surely trigger a major round of financial instability and currency depreciation throughout the region, including Japan. A small devaluation does nothing because, in China’s case, import content of exports is upward of 50 percent. A 10 percent devaluation thus gains barely 5 percent in competitiveness but of course highlights the prospects of further depreciation to come. A large devaluation will directly help competitiveness, but if it triggers repercussions (starting with a collapse of Hong Kong) and competitive devaluation everywhere, or higher interest rates to stem such an outcome, it does not help create better export opportunities. China is a big player; as such it cannot pretend it is inconsequential and get by with undercutting everybody. It is also the case that China’s substantial trade relation with the US is already a problem—a bilateral trade surplus upward of $US 50 billion. Reinforced by a Chinese devaluation, it will have every opportunist in the Congress complicate key policy objectives such as the WTO and permanent MFN. In sum, devaluation might be a really bad idea.

On the domestic front, too, devaluation is highly doubtful as a strategy. A large devaluation will make it obvious to every Chinese that the Yuan is not as good as the dollar. The obvious implication is the emergence of a black market in dollars and bank runs to convert deposits into currency on the way to dollars. Losing control of the shaky banking system under the pressure of a devaluation is distinctly less interesting than banking reform over the next few years in the context of domestic financial stability. The Chinese leadership abhors financial instability: they have long memories remember that the Kuomintang lost China when they allowed extreme inflation. In fact, in the late 80s, the authorities very deliberately pushed down growth to fight inflation and the same happened in the last 2 years. Financial stability is politically even more important than high growth.

Domestic expansion can make up for poor export performance. The Chinese budget deficit is very small and so is the domestic public debt and inflation. Accordingly, there is absolutely no reason not to move ahead with fiscal expansion to shore up growth. Such spending need not take the form of extra empty skyscrapers in Shanghai; it might just mean dealing with the pervasive bottlenecks in China's infrastructure. The substantial leeway for fiscal expansion offers some reassurance on the growth front and thus takes away some of the urgency of an export revival. Of course, it does not help much in calming pressure for devaluation from the export lobby.

Talking out of both sides of their mouth, Chinese officials have joined the discussion of devaluation. Threatening the prospect of devaluation, they have railroaded the US into trying to save the yen. At the same time they try and leave no doubt as to their commitment to being Asia's leading stable economy. China would do well committing itself to the current exchange rate (taking pressure off Hong Kong) and hunker down for a few years with a focus on domestic growth and reform. Growth at 6 percent is a miracle anywhere else, it should be enough for China to both raise the standard of living and deal with economic restructuring. If China gets too close to devaluation, what seems like a controlled event will turn out to be a catastrophic loss of control. The Chinese leadership should get on with the WTO and get off flexing international financial muscle with the devaluation blackmail. Devaluation is a loser's game.

US RECESSION -- NO, THANK YOU!

A flagging US stock market, and sharply lower second quarter raise the question whether the *New Economy* has suddenly become the "old". It is not clear just how it might end, but at least three candidates for an untimely death are in line. The expansion might be running out of steam as demand fizzles. More brusquely, it might fall out of bed as Asian depression overwhelms earnings prospects, stock market values and hence household confidence, or finally whether it might be done in by Chairman Greenspan in the time honored fashion of the Fed murdering expansions before they get a chance to die of old age. Not to worry, this expansion will run forever; the US economy will not see a recession for years to come. We don't want one, we don't need one and therefore we won't have one. The reason is never mind how the expansion is threatened, we have the tools to keep it going.

A slowdown is surely possible, as is stock market correction, but not an old-fashioned recession; at most a banana. The notion that expansions come to an end, only to give way to the next, is superficially attractive. It has biological overtones and, of course, is just a sheer fact of history. This is already the 10th expansion in the postwar period and by the law of averages it's supposed to be over. Only one expansion, from February 1961 to December 1999 has lasted longer. But we can take optimism from a post-mortem. None of the postwar expansions died of natural causes, they were all be murdered by the Fed. Time and time again, inflation was the issue. Once an expansion got underway and unemployment came down, wage and price inflation would pick up. As the late Fed Chairman Martin said, the Fed is like a matron at a party: Just as the going gets good, the

Fed has to take the juice away. Often quite late, but unfailingly, the Fed has done just that.

The situation today, deep into the second longest expansion, is quite different in two respects: First, there is no inflation and hence natural causes of death rather than the Fed will have to bring the economy to a stand still. Second, the government's coffers are overflowing with budget surpluses. Thus, monetary and fiscal are there to keep the party going in a way we have not seen for ages. Our current policy team believes in their potency and they won't hesitate to bring them into the battle for continued expansion.

Suppose a drop in the stock market undercuts consumer confidence and spending, or Asian distress undermines exports and hence growth, what comes next? If budget deficits stood in the way of tax cuts or inflationary pressure kept the Fed from cutting interest rates, that would be it. The drop in demand would lead to production cuts, resulting in falling incomes and spending which in turn would soon turn into a recession. Policy makers would stand by watching the spectacle: the Treasury, the White House and the Congress would bemoan the limits on fiscal policy coming from large deficits and the Fed might (privately) applaud the recession as affording the badly needed cool off. Some fools would talk about the benefits of creative destruction. Clearly that scenario is not relevant today.

Inflation is at a record low. True, we remain suspicious that this is too good to be true and keep waiting for the bad news that surely must come. We have no clue who is right on why inflation is so low at what is patently full employment – New Economists who are typically not economists or special factor Phillips curve doctors who cite the dollar, commodity prices, Asian crisis,… Inflation is low and that means the Fed has absolutely no reason or excuse not to stand by and prop up the expansion should it need a shot in the arm. True, when last heard, Alan Greenspan held out the risk of inflation and unhealthy valuations of assets. He seemed more nearly on the verge of restraint than giving extra life to the economy and the markets. But that is all for the good; he is not supposed to prescribe steroids for the Dow Jones, he is just there to keep full employment growth on track.

The Fed is a keenly political institution simply because that is the only way to keep the independence necessary for good policy. Just as it won't raise rates to tumble the stock market in the absence of inflation, it will very certainly cut rates, and sharply if necessary, if growth withers in a situation where there is no inflation. That is the situation today and hence the Fed can be fully counted on. Of course, rate cutting is not quite enough. Because there are lags—a year from the rate cut to the impact on demand--, the Fed must act promptly. But fortunately bond markets have learned to simulate the Fed and thus move the term structure even ahead of FOMC decisions. That has become a built-in stabilizer.

The leeway the Fed enjoys on the inflation front is particularly important in case of a stock market disaster. A minor correction surely won't lead the Fed to cut rates – the three hawks on the board won't stand for it, nor will the chairman. But if a massacre gets underway, just as in 1987, Greenspan is sure to act very quickly. That in turn assures that markets won't melt down and that in turn rules out one potent source of recession, namely a precipitous unbounded loss of confidence.

If the effectiveness of monetary policy is hampered by the long lags, quite unlike any time in the past, fiscal policy is also there to help big time. There is a budget surplus waiting to be raided. Fiscal policy works, tax cuts burn holes in pockets as households rush out to spend and firms add to the capital stock. Who does not want a tax cut? And fiscal policy works fast, since we can even make it retroactive. In fact, we all know that it is a race between the President and the Republicans in the Congress to see who will offer anti-recession tax cuts first. Surely they will squabble about who gets the money, businesses or households, the middle class or the poor, tax cuts or big-government but there is enough to go around. The middle class does not even have to wait. They can spend the money and by the time their credit card bill comes, the tax cut drops in the mailbox. For policy makers living without inflation and with budget surpluses, and a recession is just an unforgivable mistake.

Just-in-time policy is there to give the present expansion years of life. The payoff on a competitive and fully employed economy is low inflation and budget surpluses, i.e. double-barreled anti-recession weaponry. They carry the potential of a virtuous cycle in that monetary and fiscal policy is freed to keep the economy from being accidentally derailed. That in turn feeds back to longer horizons, deeper confidence, higher valuation and better performance. If you can't stand the good news, worry about Japan where everything is the other way round.

October, 1998

RED ALERT FOR THE WORLD ECONOMY

Only yesterday there was prosperity, perhaps not everywhere but never mind as long as we had it. And then from one day to the next, the world economy drew Europe and the US into a vicious cycle of bad news and the worst fears. Asset markets have lost the fire in their belly and suddenly turn purple, paper wealth is going up in flames. Ever worse weakness of the Japanese economy, emerging market crises spreading around the globe and a US economy that is rapidly losing its glamour add up to a fragile world economy. It seems only a short step from there to deflation, world recession and worse. Just how serious are these risks and what can we do to be confident that things stay under control? For many it certainly looks as if this might become the second time in this century that the world economy is buckling under and capitalism fails. And for those who stick to their believes that free markets work best, there is an all too obvious wish that policy makers would throw their weight behind a drive for stability and prosperity to rescue the good cause.

In the late 1930s the vicious cycle started with a dinky bank in Austria and soon engulfed the world economy in bottomless depression. Today there are far more fronts of vulnerability but there is also, at least so we hope, far more understanding of how to stabilize a sinking world economy. Rightly, financial markets and by now just about everybody asks just how confident one can be that policy makers have the magic potion and will use it, generously and in time, and that the world economy will react to treatment. The skepticism is appropriate because a spectacle such as Japan does not bring much confidence nor does the increasing awareness of the very fragility of stock market wealth. If it is just a bubble being burst that is all right; if this is the end of postwar stability it warrants red alert. If policy makers are fighting the last war – inflation and budget deficits--, let them be woken up to the immediate threats to world stability. Let them not get by arguing that it would be premature to rush …etc. We need a strong commitment, here and now.

Two factors make our world economy particularly vulnerable. One is financial deregulation around the world. This has had two important effects. On one hand inexperienced lenders and borrowers have eagerly taken advantage of the newfound freedom and used it to abandon with the result that risk taking has been extreme. These risks are obvious in the loans in Asia or Brazil that are coming under pressure but the same is true in the leverage-financed adventures of financial rocket scientist in Wall Street. The upshot of all this is that finance is suddenly far more important just because it is so much of a house of cards. The “markets” are suddenly the center of gravity and concern that they might crash and take much of the real economy with it, as in Asia, is all too real.

The second special feature is globalization. It involves sharply higher interdependence—what happens in Thailand or Korea or Russia triggers consequences in Brazil and what happens there is short-wired to US stock, the growth outlook of industrial countries and the very stability of the world economy. With these special features in place, a heightened sense of vulnerability is fully justified. We are right to ask what can go wrong and can and will policy respond to limit the damage. Or, is this the bad news, have financial deregulation (and irrational exuberance, to use Greenspan's term) put us in a new game where stability can no longer be counted on?

The risks of a world recession, and deflation around the globe are no longer small. Yes, they do exist. The periphery is financially distressed, won't get much credit and will not have much growth. That is true of Asia and Russia as it is of Latin America. Forget the propaganda about strong post-election growth in Brazil, there will be a recession. Forget about Korea emerging from the crisis with a reformed and strong economy—they are becoming more and more like Japan. Add to the stress on the periphery the very fact that Japan is still in the tank. If the fiscal stimulus implemented this year does not bear fruit a meltdown is a real possibility. All that is the bad news. Now as to the good news, it comes from two places. Europe is growing strongly with domestic demand more than making up the poor world markets. In the US growth is now slowing down, in part because of the world economy.

A while back one would have said that of course, the US is far from recession and most surely won't have one. Monetary policy is available both to rule out financial meltdown (as opposed to "correction" which we now have had) and to keep up some growth. There is no inflation and hence the Fed has both hands free to sustain growth. There is also a budget surplus and hence big tax cuts are readily available to spur growth—targeted on the spenders and retroactive—should the need arise. Sure, the dollar will decline further on European currencies and long term interest rates will fall; growth in Europe and the US can be counted on to keep the show going and that is why the world economy is not near a cliff. That enthusiasm now is tempered for three reasons: hedge fund distress is deteriorating credit conditions though much of the financial system. Next, the President is making too strong a stand against tax cuts as an election ploy—a position from which he may find it hard to move fast and lastly Latin America is going under big time with unhappy trade and growth effects for the US. It is still unlikely that the US will have a significant recession, but it surely has to work hard on interest rates to avid one. Hard to turn

Of course, Europe also has some question marks and they are getting bigger. Interest rate cuts are badly needed. The Bundesbank is reluctant and still fighting the last war; Lafontaine's provocation will make Tietmeyer only more stubborn—rightly. The new ECB will want to establish its credibility and that means tight not easy money. On the fiscal side, the hard fought for consolidation will not easily be jeopardized by audacious tax cuts to stimulate growth. Thus Europe is mostly a good story because of its ongoing growth and much less so as a player on the world team. In fact, convergence and the Euro are making Europe much less of a world place and far more concentrated on what happens within its borders. That might be the wrong vision at a time of a fragile world economy. How to respond to a more acute world crisis is surely a very important agenda item for European policy makers. Tempting though it is, Europe is too big to be a free rider.

Confident that the world economy will keep going, despite stress on the periphery, we should take one extra step: avoid bad ideas. There are two bad ideas in the making. The first is capital controls. The idea of capital controls as a system is dead wrong—the cries in emerging markets come from too short maturities not from capital mobility per se. Better bank supervision and sounder borrowing are the right answer, not more bureaucrats and more corruption. The other bad idea is a return to fixed exchange rates. France is championing the idea of a reformed international monetary system and so is Lafontaine in Germany. Forget it, we need flexible rates because there is no way on earth the new ECB can or should get tied to the Fed, there is no way governments can coordinate fiscal policy across the Atlantic, let alone do anything with Japan. The international monetary system is very imperfect except by comparison with anything else we have had.

The third mistake is to start questioning the benefits of open and competitive economies, from trade to finance, and the prosperity potential of free market economics. We do not have a crisis of capitalism; we do not have a disaster except in countries where sleaze in government and shortsighted risk taking are meeting the requisite discipline. All is well, particularly when the stock market takes a dip—that is part of finding out that there are downsides to gambles.

A REQUIEM FOR CHANCELLOR KOHL

After the war, Churchill suffered resounding defeat at the polls. In the long perspective of history, that is an inconsequential footnote. Much the same will be true of Chancellor Helmut Kohl who just was ousted in no uncertain terms by the German electorate. He, too, has played an extraordinary role that will remain in the history books for centuries. The fleeting humiliation of electoral defeat is just a footnote that was by and large inevitable since no great leader (and small ones even less) can let go before he is let go by the voters.

Whatever the quarrels about EMU, and genuine questions about the costs of getting there or the benefits once there, no question that having European Union is an extraordinary achievement. It surely is clear that Europe's move forward in a progressively strong integration, the internal market measures and the common money, are all for the good. Europe has major problems, but there are also the extraordinary advantages of an increasingly large and competitive market. It took stubborn insistence to hang in, fight for it and make it happen. Kohl has delivered just that. Without his insistence, the world currency crisis would just now be knocking out Italy and perhaps even France. As it is, they are basking in the aftermath of interest rate cuts.

Kohl has accomplished two great deeds, unification and European Union. These deeds change the face of Europe forever, and for the good. Inserting an economically dominant Germany in a European Union meant heading off a hegemony quest that, just as in the past, could have gone badly wrong. Just the same can be said of unification: Kohl himself eagerly recounts a moment when, standing on a balcony in Berlin, he received an urgent message from Gorbachev "if your tanks roll, so will ours". Tanks did not roll; the undoing of communist rule was unbelievably peaceful, even ultimately in Russia! Unification needed very cool heads at a time where people in the street were just grabbing freedom as if it was a foregone conclusion. Far from it; if it had not been for the special relation Kohl had cultivated with Gorbachev, unification might not have happened and instead we could have had an uprising and suppression just as in the 1950s. Kohl gets the credit.

Much of the discontent expressed in Germany's election has to do with the here and now—someone that sets the European direction for the next century might well neglect the here and now of interest to the voters—jobs, feel-good rhetoric. Schroeder has filled the vacuum; it is always easy for a broad alliance focussing on the immediate—and promising what they cannot deliver—to oust someone who has been around too long and has lost the skill of being genuinely dishonest with the utmost sincerity. The red-green alliance will make the headlines much less with its accomplishments and much more with its quarrels, disagreements and ultimate breakup.

Kohl might have engineered a soft landing, letting the next generation step in rather than his party being kicked out. He failed in that, but not necessarily for the worse. Much better what has happened now: the left gets a chance to discredit itself, the right can get a moment to rethink an agenda for the center, the next election will throw the weight to a group of genuine reformers on all sides. Mr. Schroeder is still flirting with a 3rd way. Yes, there is one, but it is dead end street. The world economy holds out extraordinary promise, but also very substantial stress and tension. Europe now, more than ever, needs to take an active part in managing the world economy. Europe needs a leader to shape that role. Even before he has started, it is increasingly doubtful that Mr. Schroeder is a candidate for that job description.

BRAZIL'S POLICY OPTIONS FOR THE 2nd TERM

President Cardoso is as popular with the IMF, the US Treasury as he is in his own country. But that should not fool us to believe that he is competent or has achieved anything in his first term. His accomplishment is to get the constitution changed to have a second term, at the expense of no change to the country's devastating fiscal problems. He is good at two things, borrowing to run deficits and selling state assets to get to the election. He has so far shown n interest in either stability or rising living standards in his country. And even less interest in bringing about lasting changes to improve income distribution. In just 4 years he has run up huge debts, gotten the country to mega real interest rates and possibly a big collapse that still lies ahead. He may shine by comparison with his communist opponent, Lula. But he is a failure and a fraud when contrasted with Zedillo or Menem.

Brazil is different, and always has been. Through the Mexican crisis, through the Asian crisis, and through the Russian crisis still underway—Brazil manages to hang on and hang in. One remembers the quotes of the early 1980s: President Figureido, a cavalry officer by intellectual roots, noted that "if inflation were a horse, I would already have dominated her." And Finance minister Delfim Neto is remembered for his remark that "debt is not paid, debt is rolled." Yet, Brazil once again remains the leading candidates on everybody's list of country's at the cliff or beyond: Large budget deficits, large current account deficits, and mountains of short term debt are a give-away to the crisis spotters. Brazil is right in the firing line because it has all of those.

Of course, Brazil enjoys more confidence than Russia or Venezuela; it just is so much more of a real economy with world class businesses, plenty of charm and the most persuasive financial diplomats. And then, to leave a comfortingly seamless future, there has always been the firm expectation of a reelection for President Cardoso in the first turn and the resulting mandate for major reform in his second term. That may well happen, but it is not going to do away with the fact that even in the most optimistic scenario, Brazil is going to be in very bad shape over the year ahead and beyond.

Without nuclear weapons, Russia would just be Africa and Venezuela -- an inconsequential sideshow. Brazil is different. It is a major league but has never quite come through on its promise. Yet, hope springs eternal and all disappointment notwithstanding, investors are not quite willing to give up. The government's well-trained interior decorators (minister Malan the best of them – a true Pitanguy in his cosmetic attention to budgets, balance sheets and above all investor egos) have been essential to the notion that Brazil is the country of the future. All that is not enough once the election is past. The country has been living on the promise of things to come, but they do have to come some day, specifically in the next half a year. Without critical policy steps lenders will lose confidence and once that happens, the dyke breaks.

What needs to be done? The key results to look for is the combination of reduced financial vulnerability and increased growth. . The two goals are, of course, interrelated: higher growth improves fiscal performance and hence reduces financial vulnerability; less vulnerability lowers interest rates and hence raises growth. Reduced vulnerability is important because you cannot hold your breath forever, living with an almost state of siege defensive posture where macroeconomics casts a shadow over everyday business life. Increased growth is essential because Brazil has been doing miserably in the past two decades, including the Cardoso years. From near 8 percent in 1960-80, growth fell to barely 2 percent in the 1980-98 period. That is just above the growth of population, meaning that the average person has not really gotten ahead, more so if we include the increased indebtedness and the fact that most government assets now are gone. Add to that the recession, which already starts and the lack of a successful strategy is all apparent. And don't blame in ton the Asian crisis. Brazil set the stage by creating the vulnerability and Asia provided the little extra impetus.

What role can exchange rates place in the return to a *painless* return to financial stability and growth? Not much, there is no nifty trick that gets the country out of the box. A *maxi* devaluation is a terrible answer and has always been, at least since inflation and balance sheets have become a major issue. A more aggressive crawling peg would have been a very good strategy early on in the real plan and it would have avoided the costly real appreciation that is now reflected in low growth, a large external deficit, sharply increased debt and heightened vulnerability. Going the other way has had a payoff in lower inflation but of course, at a quite formidable price in terms of fragility and growth performance. Even if it is accepted, in hindsight, that the policy choice was bad, rewinding the tape years later just is not an option. There are two options now: one is to go, too late, to a very fast crawl of 20 percent per year for 2 years. That puts the exchange rate gradually in a competitive position but it means, of course, abandoning the zero inflation ambition. The other option is to fix the rate flat out and forever and just be done with any discretion in this area: adopt a currency board, just do it and do it well.

Nobody believes the Brazilian government; they have failed investors too often just because their horizon is short and their greed for immediate gratification is large. High interest rates show that lack of confidence on the part of foreigners and locals alike. Keeping one's options is expensive in world finance where investors rightly assume the worst. Wider bands and an uncertain pace of crawl are a risky strategy for a country that has poor public finance and large external vulnerability. Investors will charge a premium for that policy option. If Brazil's policy makers are committed to low inflation, they will surely resist a major move in the currency. And if that is their intention they might as well go all the way in commitment and thus get rid of paying unnecessary premia to investors. The magic word here is currency board.

Brazil does not know how to manage a stable and competitive currency. That is why it should throw in the towel and go for a currency board. Does it make sense for Brazil? Clearly, in Argentina it has been a decisive step to establish normality. In Brazil, as President Cardoso becomes a lame duck and other possibly less promising policy makers come in the horizon, institutionalization of financial stability is critical. Linking monetary policy rigidly to a fixed currency value is not at all plausible. It might be thought that this is a strategy for financially distressed economies only and banana republics and not for a large and successful economy. Unfortunately, Brazil's status is damaged by two decades of mismanagement and hence does not have the luxury. The country has to show that independent of domestic politics of the day and personalities, there is a commitment to stability; that takes more than talk. That is surely even truer in emerging market finance disillusioned by 3 years of crises or two decades of crises.

The quest for financial stability then involves predominantly the virtuous cycle of budget cuts inducing lower interest rates, lower deficits and so on. If these cuts are lasting and not just provisional emergency measures there is room here to make an important difference. But budget cuts will surely hurt growth, at least in the outset. The lower growth will improve the external balance and that helps some to foster confidence. But investors understand that a Brazil without much growth is a risk. Hence more commitment on the exchange rate front is an essential step to leverage the budget cuts into important interest rate reductions.

If competitiveness cannot be gained by exchange rate movements, labor market flexibility and productivity must be the means. Too little has happened here, in part because the government overly politicized *all* fronts of economic adjustment. The prospects of undoing a large overvaluation by this strategy can at best be limited; Argentina has gone that way with the greatest of energy. Wherever the government could find impediments to exports or unnecessary excess costs, from poor ports to cumbersome regulation public finance, they have been all out aggressive. There has been quite a bit of success, but clearly not enough to offset a high exchange rate. If Brazil wants to do well; it will have to match at the very least the Argentine enthusiasm for competitiveness. Labor market flexibility is, of course, a key extra issue with links both to better employment prospects and reduced costs. Wages in local currency must come down and employment must go up. The two together, whether in Argentina or in Brazil, will only happen in far more competitive markets and with a major withdrawal of government from interfering in the market place.

There is much hope that in the 2nd term; President Cardoso can unwind much of what may have been done wrong, or not done, in the first. As a result, so the story goes, Brazil can then quickly move on to strong performance; no more recurrent state of siege of near-currency crises and record interest rates. The expectations are all too favorable. The central scenario is surely just 2 to 3 percent growth, but not in 1999 which is already marked for deep recession. The external environment is less benign than it has been in the past and the expectations of political support for radical reform are far too optimistic. Moreover, investors soon will look ahead beyond Cardoso and Lula and they may see, unlike just now, much uncertainty and little comfort. President Cardoso has been a failure in the past, creating good feelings by borrowing grand time; if in his second term he fails Brazil again, deep crisis lies ahead.

RUSSIAN MELTDOWN

Whatever possessed Treasury Secretary Rubin and IMF Managing Director Camdessus to believe that Russia could do miracles in restoring investor confidence; as Schumpeter said, “don’t make a donkey sing.”

Only a month ago, in another cliffhanger weekend, Russia got a major IMF and G-7 bailout package; important reforms were promised, a measure of confidence was restored. In no time, Russia was back in the tank; decisive reform did not happen, confidence did not last, overnight investors tried to bail out. Whether Russia now goes into meltdown remains to be seen; clearly it is a prospect.

Hyperinflation and total collapse, well underway, may run their course unless a draconian stabilization is imposed. Possibly the current crisis galvanizes enough consensus to move ahead and do some of the hard work that every country in the end achieves. Its is only a question of time, and of how deeply living standards fall in the interim and how much politics deteriorates toward extremism, just as in the 1920s. In the end everybody stabilizes because instability becomes unbearable.

Russia's central problem was debt and deficits, not the exchange rate. But what starts as a debt problem, easily becomes a currency problem when foreign creditors and the locals just as much flee to the safe haven dollar. Russia has resolved the debt service hemorrhage problem for a moment, the moratorium and capital controls stop the outflow of dollars from the central bank for debt service. But they do not end the drain induced by loss of confidence on the part of Russians and everybody else. Confidence must be restored and the only way to accomplish that is by establishing stable and sound public finance— still the same problem Russia has faced and failed to solve for the past decade.

Like many other emerging economies and new democracies, Russia had trouble limiting its budget deficits. A major progress had been accomplished a few years back when money creation and hyperinflation were stopped. But the budget problem had not been solved; the only thing that happened was borrowing rather than printing money. Not surprisingly, in time rather than hyperinflation there was a debt problem. Moreover, because Russia, just like many other doubtful borrowers, could only get short term loans, its financing was highly precarious—any day, creditors could stage a run, demand immediate payment only to find that there was no money to meet their claims. Not surprisingly, creditors demanded record interest rates to face the risk, not surprisingly budget deficits and record interest rates combined into a snowball of debt. A process that is well-known in high debt countries, in Russia went in the express lane.

In freezing its short term debt – some $60 billion—Russia has stopped the clock but not the printing press. Debt restructuring needs to be done well and cannot possibly be punitive, but the debt burden and its terms needed to be resized to meet Russia's ability to pay, which is minimal. That is a time-honored process in emerging market finance. Russia also needs to make immediate and striking progress on deficit reduction. That is not just an issue of passing laws as seen in all Latin economies; it means implementation and that takes a lot of time and a fierce determination. Yeltsin's indecision on taking his political cronies, the Mafia business community, to the tax office (or jail) accounts for much of the difficulty; lack of broad based taxation at affordable rates is a key issue. Appointing high profile tax collectors has little effect if they are not allowed to actually collect.

The third step is to stick with serious monetary policy that avoids all and any chance of renewed inflation. Russia's central bank was in the past few years the best part of the story. It had stopped hyperinflation and stuck to stable and predictable policies. Any attempt to undermine its independence or bring it back to financing budget deficits would be fatal. Of course, that has just happened with the mandate to print for wage arrears and bank bail out and more. More than ever, their independence must be restored. A currency board would be a very good next step.

Finally, Yeltsin must recognize that Russia's failure to grow in almost a decade of post-communism has much to do with his temporizing on economic reform. Unless Russia grows, public finance cannot be stabilized. Growth requires a dramatic advance in economic institutions (property rights, legal process, and ending corruption) and a major advance in privatization including in agriculture. Among other benefits, this would undermine the strength of communists; of course, that makes it extra difficult to accomplish. Yeltsin should have taken the risk of full stabilization and a broadening of market reforms to be more inclusive and less an opportunity for oligarchic plunder; his failure left the vacuum now being filled by populism under the auspices of tough communists.

Russia has no center of gravity other than the hope of the young to escape from poverty and instability. While the borrowing lasted, and speculation took the forefront, everybody could dream. Russia is now back to the starting line. Yeltsin has failed to build a normal economy and is on the way out; the reformers are discredited beyond further use and the bad guys are in. Populism is now the word as the new leaders promise stability and jobs, but the reserves and stability that might make this a lasting venture are absent.
A combination of hyperinflation, expanded statism and pervasive controls are next and beyond that expect a more aggressive nationalism and statism drawing on the fringe that already stands by, from Luzhkov to Lebed and worse.

GERMANY: ECONOMIC POLICY FOR A DYNAMIC SOCIETY

The current European economic upswing is more than welcome. It will make a small dent in the ever-rising unemployment. But it does not really obscure the fact that Germany, and much of Europe, is doing poorly. Few would dare predict that 10 years from now Europe would be triumphantly at the top of the world, replacing the US which in turn has taken over from Japan, which now appears pathetic.

Yet, not only does everybody very eagerly aspire to just that situation—some to spite the US, some out of a genuine and fully justified aspiration for a great European destiny—but in fact many of the basic ingredients are there: human capital, latent creativity, financial stability, world class businesses. Yet, the elements so far don’t come together to produce the desired results. With few exceptions, business uses defensive strategies, labor is cooperative only on the status quo and he pervasive bureaucracy is part of the problem even as it busies itself to offer help. Germany goes in circles, obsessed with a futile *Standort* discussion, legislative approaches to economic dynamism and pervasive subsidies as seeds of prosperity. All this is made worse by Waigelism—a superficial recognition of fiscal responsibility, which more basically reflects a fear of a bold growth gamble.

THE MISSING PIECES: OPPORTUNITY & RESPONSIBILITY: The starting point of our discussion is to argue a simple point: Government, German-style and any style, is the worst enemy of economic progress. *Beamte* (civil servants) are the very last people who can lead a country to dynamism and prosperity. The very essence of a Beamte is to avoid risk—that is why they became Beamte—as is their insistence on doing things by the book, in triplicate. That is the opposite of a striving and aggressive business environment.

Yet, Germany's political leaders from all quarters believe that they can incubate some version of US capitalism, suitable modified for the German taste. Forget it.

Germany may not choose to go the way the US did, but it is interesting to ask just how it worked that over the past fifteen years a lame and limping hegemon had a dramatic come back in terms of every dimension: business and technology leadership, financial stability, full employment, economic confidence that will even survive a stock market sell off. One thing is clear; the government did not produce those results with creative new laws and bright bureaucrats implementing beachheads of technology breakthroughs. This is not the payoff on an Al Gore industrial policy. Whenever German policy makers come to visit Route 128 outside Boston or Silicone Valley or all the other US poles of high tech creativity, their minds go click-click: lets transplant this, where do we get the seeds. The point ids that the government has zero to do with this; it is strictly private, the spin-off on great private universities, unlimited private initiative in the pursuit of wealth, the sheer absence of any bureaucrat who hangs around trying to get in the way of people getting rich.

The basic ingredient of US performance, not surprisingly, is individuals looking after their own prosperity, talking big risks, using maximum creativity, to collect mega payoffs. Opportunity and responsibility are the key ingredients—which nobody is there to offer the answers on how to get ahead and nobody is there to offer an alternative to making it. There are few places left that are cushy, but there are plenty of ways to break out and move ahead. That is an uncomfortable culture for anyone who want s to be in the slow lane, it is glorious for anyone who wants to play hard and fast. It may not at all be the answer for Germany, but it is important to recognize that he model works because the government stays away. That, of course, is quite unlike what we see in Germany where the government hopes to breed the businesses of the future, built around a "knowledge society". Knowledge is useless if it sits in the minds of people who lack both motivation and opportunity; knowledge is useless if it is stifled by a restrictive economic environment and a paternalistic state.

Not only government is the problem; business is just as much. Too many years of living off the fat has turned German business lazy and bureaucratic. Managers risk more nearly being administrators than entrepreneurs, their status and perks have become the socially acceptable way of rewarding their position. Yet, that reward structure also tames them to be "socially cooperative", i.e. don't make waves. What reward is there for taking significantly more risk, for making a lot more profits? Of course, that is not true everywhere in German business; but precisely those few eye-catching counterexamples make the point.

It is significant that at no time business, and surely not the public at large, have rebelled against big government. Few express amazement at the mind boggling number of *Beamte* who sit in the *Bundestag* only to make things worse or at the vast number of *Beamte* in all the ministries who day after day work hard to stop people from creating and growing businesses. Until recently the Bundespost was the world joke in telecommunications responsible for a measurable retardation of German high tech business. Even the

Bundesbank that courageously points to subsidies everywhere is grotesquely overstaffed organization living off the land. Everybody is in this together; nobody has a right to be surprised by the results. Just as in Japan, the nail that sticks up will be beaten down. Better to work with the system! But on that course, in no time, one tomato looks like another. Germany has a uniquely corporatist economy.

In sum, the unsatisfactory performance of the German economy is not an issue of a few strategic subsidies missing or a few nefarious laws to be rescinded; the system is wrong, like ingrown toenails, and it needs a revolution. All the people who are paid to do nothing or worse to stop others from getting ahead need to be pushed out of the way. All the people who say impossible need to get out of the way.

DEMAND AND SUPPLY SIDE POLICIES:

There is also a mode immediate issue of demand and supply side policies to turbocharge growth. The issue is often cast as a choice. For some it has to come from the side of supply – growth in potential output is the only productive growth. They believe in the chicken –and-egg of prosperity, demand must come first. Not surprisingly, we don't need to chose, we don't have a choice. Demand policy without supply side changes is irresponsible, but supply side revolution without demand in sight is politically inconceivable. The choice therefore is between two uncomfortable extremes: do nothing and just keep talking, defending the deeply entrenched positions—the status quo of the past decade—or else move boldly on an entirely new project.

The do nothing, or worse nothing can be done, strategy has been around, is tired and does not deserve further comment. What does an alternative look like? The alternative strategy endorses a massive deregulation of economic activity and the abolition of the welfare state—i.e. stop paying people who do not want to work. Just as in the US the abolition of welfare had to wait for a Democratic Administration <u>and</u> full employment, Germany is unlikely to embark on such an experiment under current management and in an economy with growth so little that it barely contains unemployment. Accordingly, there needs to be a big blast of demand policy to go along. Monetary policy is no longer available since now it is European (more on this below. Hence fiscal policy must do the work and it needs to be big. Unfortunately the Waigel pact poses an obstacle. The defect is near the Wangle limit, hence nothing can be done. The right answer here, for Germany and for Europe, is to take out a loan for a dramatic investment: Give the Waigel pact a 5 year interpretation. Cut taxes by 5 percent of GDP—a huge fiscal stimulus by any definition—even as deregulation, welfare reform and competition free up labor the labor market and make available millions of extra workers. Growth will spurt to 5 percent, investment will skyrocket, and jobs will be created by the minute. Ands as jobs are created, the fiscal dividend starts showing. In the Us reckless tax cuts (and deregulation) have led to full employment, a balanced budget and record low inflation. Germany would be no different if only there is the courage for the double-barreled approach.

The Waigel pact is, of course, a wonderful disciplining device in this situation. Socialists who only want big government get a NO as do those who want to maintain monopolies or payrolls full of bureaucrats. The supply side potential (and hence the tax base potential) of the deregulation effort must be demonstrated before the Treasury starts writing the checks. He political bargain is the big give and take of ending regulation and welfare in exchange for prosperity. A small move in that direction is uninteresting bad will be debated into the ground by all those who perceive their petty interest threatened. A big move catches the imagination of the public, overrides the vetoes of the cliques and creates a worldwide excitement about a big time bid for prosperity. The Euro was a great and courageous concept but with a very slow fuse. The next bid needs to be as bold, but it needs front loading for immediate confidence and exuberance. It is too much to hope for from the present coalition.

Needless to say, big fiscal expansion without deregulation and an end of the welfare state cannot work. It would be fiscally irresponsible and, in no time, inflation would show up. Similarly, deregulation and ending welfare without demand stimulus is an experiment that no sound mind should endorse. Thus, do both or opt for the status quo. What are the likely reactions to such an idea? Its not that easy, one can’t just do such a thing, how do we know it works…. It is all too easy to rationalize the status quo, just as has happened for a decade. But don’t believe there is an alternative.

There is no such thing as a knowledge society in Germany suddenly giving every unemployed a great job. There is no such thing as spontaneous growth, which suddenly pays everybody’s pensions and unemployment benefits forever. The welfare state was a promise that could not be kept, and it was a promise that undermined society’s productive motivation. Both the fiscal and economic consequences are already very clear.

Fortunately Germany is rich enough to break out with a bold bid for prosperity. And if it does, who doubts that all of Europe will fall over itself to do the same. Who doubts that the Central Bank is bound to underwrite the growth in productive potential? Yes, it will work and it does not really matter whether it is 5 or 7 years. What does matter is that there is a fundamental change in the outlook for Europe.

SOMEONE NEEDS TO ROCK THE BOAT :

There is a famous story from biology: put a frog in a water pan and gradually heat it to boiling temperature; the frog will sit and get cooked, it won’t jump. Yet, the same frog thrown into boiling water would jump out. Germany and Europe are like the frog being cooked. There is no growth miracle about to come, nothing ordinary will bring unemployment down, nothing ordinary will pay the rising bills of a bankrupt welfare state, nothing will contain competition from Asia or all the other regions of the world. Europe’s privilege has lasted long and, starting from sufficiently high, the decline is only gradual and not even pervasive. But why wait until good choices are no longer available, why deny so many young people the opportunity of a meaningful productive life. Why fool ourselves that there is a good job for everybody just around the corner. The turn of the century is Europe’s opportunity for a dramatic bid to be #1 or a sure ticket to be the most uninteresting spectacle on the globe. Someone needs to start rocking the boat.

SCENARIOS FOR EUROPE

It will take a while and it is not quite clear how we will get there, but a decade from now Europe will call the shots in the world economy. In the 19709s, the oil producers were at the top of the heap—it was just a few years before they would fully own the world. A decade later we were all on the verge of paying rent to the Japanese. Their discipline and saving earned them top grades and their bubble wealth was buying them every piece of overpriced real estate around the world. And just now, or until a few weeks ago, the US was tops with technology and top valuations and just being awesomely cool. It is obvious that now Europe's turn is coming. But the US will get fat and lazy, asset prices will meet reality and the finance franchise will wear thin, not saving a penny (even with a balanced budget) will become a problem. That is Europe's opening, first with a strong currency and ultimately with a deep restructuring of its economy that has as many problems today as it has genuine opportunities for tomorrow.

Nobody looking at the US economy of the mid-80s would have discerned the makings of a zero-inflation, balanced budget, full employment and big time boom economy. The Japanese were talking about a lack of US quality and technology, the Europeans were bemoaning the lack of saving, and Us gurus were looking offshore for magic recipes for superior corporate governance and management. In the same way, just now, it is hard to discern in Europe the very makings of a world champion. For those believing in the market, there is just plain too much socialism from Jospin to Lafontaine and there is too much corporatism everywhere. And then there is Brussels, which is all too easily seen as big government in the making, captured by every lobby that looks to limit competition.

But there are clearly other forces at work. European companies are furiously restructuring to reinvent themselves as global players. Governments everywhere have no money and hence are on the sidelines in shaping market developments. Brussels has, at least for now, a furiously anti-statist and pro-competitive commissioner in the person of Karel van Miert. Even more importantly, even the last person is getting the message that the government won't be able to do much for them and that it is getting time to look after themselves. These new forces will put Europe art the top, not with a dramatic revolution, not in a year or two, but surely over the decade to come, piece by piece.

The *Euro* may play its part in all this. The big payoff on the Euro is, of course, in the capital market. Reinforcing financial deregulation and internal market measures that allow cross border competition, the *Euro* creates the basis for a single-denomination European capital market of a potential size and depth comparable to the US. It will move from the dull bank-based financing structure (almost as bad as the post office being your investment banker) to big time debt markets and markets for corporate equities that offer transparency for the mismanaged or sleepy European companies. Capital markets are good at kicking butt and just that is what European corporate giants need. The capital market also favors come-from-nowhere upstarts and that is essential in Europe where status quo has been the rule and Schumpeterian creative destruction the big taboo.

Europe has two great problems: pervasive regulation and inefficiency including big and intrusive government on one hand and mass unemployment on the other. Ultimately these two formidable problems are also the key to Europe's shot at world championship. Abandoning a mindless welfare state where some people work and pay taxes so that other people can sit at home offers a prospect of years and years of high and non-inflationary growth. There are at least 8 million people who can and should work. Deregulation and downsizing of government adds the market environment in which new opportunities are opened up and new businesses will be formed everywhere. For every civil servant that loses his job and gets out of the way, two new jobs will be created by the market.

Europe is emerging from a decade of convergence: tight money, tight budgets, tight everything. True, that has created the financial environment in which European monetary Union was a serious proposition rather than an irresponsible elopement. But now the time is ripe for a big deal: a Europe-wide major tax cut paid for by the very prosperity that it creates. Accompanied by jettisoning the welfare state, such a bid for prosperity creates the environment in which growth and change can go hand-in-hand.

December, 1998

LESSONS FOR E.EUROPE FROM ASIA AND BRAZIL[1]

What do Hungary, Poland or the Czech Republic have to lose in giving up their monetary sovereignty and national control of mismanaged financial systems? Nothing. In fact, their hope for strong economic progress and the ambitions to fully join the European Union can be leveraged by bold steps in the area of currency and finance. This paper argues that Central Europe should draw the lessons from the Asian and Mexican crises: hard money and sound credit are essential in a world where capital is intensely mobile, contagion pervasive and the economic and social costs of crises nothing short of formidable.

Central Europe is in a special position to draw this lesson: its credit system urgently needs repair and the experience with bad banks and fragile currency arrangements elsewhere ought to strengthen awareness and resolve to deal with this issue urgently. The Asian crises also demonstrated that countries with a sound financial system and a currency board could stand up to the crisis, as shown in Hong Kong and Argentina, somewhat battered but clearly far less damaged than others.

In Eastern Europe, a currency board system is eminently plausible because trade patterns link the region closely to the European markets. Moreover, the arrival of the Euro, in conjunction with the intense desire of the East to become integrated in the European market, removes the traditional nationalist objections to a currency board. Finally, Eastern Europe's demonstrated inability to run a solid macroeconomic policy—as the Czech Republic has recently shown--reinforces the case for a major reassessment before a crisis in the region, or in Russia or elsewhere pulls Eastern Europe into the crosshair of a speculative attack.

The crises of Mexico and Asia make it clear that exchange rate policy, and financial policy more broadly, can no longer be treated in a business as usual fashion. The economic and social costs of mismanaged currency and financial systems are formidable. There are two ways out: controls on international capital flows as part of a new international architecture, or a better management at the country level. A new international system is unlikely to materialize: key countries including the US and Germany do not favor capital controls even if their effectiveness as a crisis prevention mechanism could be demonstrated in theory and implemented in practice. That puts the burden on countries to put in place a stronger financial structure both in terms of currency arrangements and bank balance sheets. This is not a luxury but a first best strategy to avoid crisis exposure. At the same time it provides important impetus for integration in the world economy by lengthening horizons, limiting government discretion and reducing risk premia. As such it puts in place a strong mechanism for economic development.

[1] This essay draws on joint work with Francesco Giavazzi of Bocconi University.

Currency Crises Mechanisms: A Brief Post-Mortem

An anatomy of the crises in Mexico or of the events in Asia reveals a conjunction of four elements:

- Large volumes of short term, foreign-currency denominated external credit;
- bad banks and a pervasive lack of balance sheet transparency;
- Discretionary and hence less than fully credible exchange rate arrangements;
- Central banks that run off reserves in support of the currency without accompanying tightening of domestic credit. The set of circumstances translates a mere speculative attack into a financial and economic disaster.

The mechanism of a crisis is straightforward. A currency comes under pressure either because authorities lower interest rates below world levels adjusted for risk or because the currency has become overvalued. Capital outflows deplete reserves, often this happens off the balance sheets as central banks gamble away reserves in the forward market. Interest rates cannot be raised because the bad balance sheets of the financial system make it too fragile to withstand tight money. When reserves are gone, the currency goes. At this stage the fact that debt exposure is large, liquid and foreign-currency denominated takes over to sink the ship. The rest is history.

There are three key messages from this anatomy. There needs to be automaticity in the link between reserve losses and tightening of domestic credit, otherwise the currency is undefendable. Second, the balance sheet of the financial system must be strong enough so that it does not cave in when rates rise. Third, a good regulatory system avoids value-at-risk exposure (directly and second-hand) in terms of mismatching of denomination and maturity that can bring down the financial system overnight. With these issues in mind we now look at policy design.

Currency Boards as Poison Pills

Only a decade ago, currency boards were either unknown except to a handful of monetary historians or else thought to be positively eccentric arrangements. They have gained in stature for two reasons. First, experience in the area of central banking and research have emerged with the central message of credible commitment: the *credible* part is hard to achieve, the *commitment* part is hard to believe; the two together are built up over time. There is no magic to substitute for persistence; if a crisis does come, it has the silver lining of providing an early test of determination. If an attack is fended off, that goes to the credit side of the ledger with increased stability and lower risk premia.

Alternative exchange rate arrangements go from the proverbial fully flexible rate that exists nowhere, to dirty floating, a managed system of crawling bands, to fixed rates until further notice, to currency boards and in the extreme full use of an external currency. In principle any one of these systems can do the job, together with wage price flexibility and an appropriate setting for central bank credit. Experience suggests, however, that flexible rates are uncomfortably volatile. Fixed rates, by contrast, have a way of getting out of line with reality and credibility. Dirty floating is no system; rules-based managed rates solve no problem—they accept inflation and seemingly offer some flexibility of the real exchange rate but they lack because of an insufficient commitment and an ambiguous division of adjustment between wages and prices on one side and the exchange rate of the other. The European experience with the EMS, and its collapse in 1992, is there to remind us that managed exchange rates do not survive the abolition of capital controls.

Currency boards are a poison pill; failure to stick to the commitment amounts to a catastrophic outcome. And because it is a poison pill, if other essential prerequisites are met, it achieves credibility, which translates into low interest rates and long economic horizons. It is not a panacea, but it is the radical opposite of the hand-to-mouth stability, until further notice, that characterizes many emerging market economies.

The commitment to a currency board involves two elements. First, there is a major institutional commitment of a fixed exchange rate relative to a major currency, say the Euro. Second, the monetary mechanism is subjected to that fixed rate commitment in that money creation or destruction is rigidly linked to reserve flows. Sometimes there is a third element, namely that the reference currency has legal tender status. The combination of measures assures that monetary policy is put on automatic pilot or literally outsourced – like investment banking services or high tech, it is best supplied from abroad.

Of course, there are objections to currency boards. First and foremost, they take away discretion and substitute a rigid set of rules. That is an old-fashioned objection that does not hold up easily to modern scrutiny. Rules-based central banking is in; discretion has been discredited in the inflationary experience of the 1970s in industrial countries and throughout the emerging market world in the past decade. Flexibility is desirable, but you can only afford it if your central bank is the Fed or the Buba: elsewhere its practice has left a trail of poor performance.

The second key argument against currency boards is the sheer cost of setting up the scheme. There needs to be a credible backing of the money stock – perhaps not 100%, but surely a very substantial portion. This raises the question of whether a country's international or domestic credit should be applied to this investment in institutional capital or rather applied to more conventional forms of capital formation. The question is easily resolved in the aftermath of hyperinflation when local money has become negligible relative to reserves or GDP, it is a hard issue in countries that are substantially monetized. The issue is made worse in that seigniorage—the revenue from annual money creation—is foregone since the central bank has to acquire reserves as a counterpart of growth in real money supply rather than just using the printing press.

There is no way of belittling these limitations of a commitment to a currency board. The only argument that can be brought is that the hidden costs of an unstable macroeconomic performance are vast and that when and if it comes to a currency crisis they are phenomenal. Moreover, the integration benefits of a hard money regime—in terms of economic horizons and reduced risk premia may well translate into extra growth which easily finances the loss of seigniorage and amortizes the set-up cost all by themselves.

The third argument involves sovereignty: Like the flag, language and culture, a country's money is a quintessential expression of its national identity. The argument is serious enough for Mexico, as a case in point, to rule out a currency board, or Israel in the 1980s. In the European context, however, it cuts the other way. Western Europe has just taken the dramatic step of creating the *Euro* and the *European Monetary Union*. This has two implications. First, it is no longer necessary to run a currency board with Germany as the reference country, something that for a country like Poland might have been touchy in view of history. Furthermore, and very important, Eastern Europe is more than keen to integrate with the European Union, collecting the benefits of access to trade and capital markets, pulling away from their recent past and to assert their historical place as European economies. A currency board thus becomes a springboard to implement the wider political agenda, a mechanism to assert the fundamental ambition to be part of the European community and the willingness to adopt institutions, which cement that bridge.

A fourth objection deals with a real issue in many countries, not so however in Central Europe. This is the point that a country with a diversified geographic trading pattern, say Hong Kong, does not have a natural reference country. In Central Europe, in a rapid change from the past decade, trade is already centered on the European Union: one third to one half of total trade (see the data in the Table in the annex) happens with the EU. Economic geography and the entry into the European Union that lies ahead will reinforce these trade patterns. The Euro is the natural reference currency.

Adopting a currency board does not seem totally essential to moving ahead; a sine qua non like open markets for example. It represents a leap and an uncomfortable change in policy making toward rules and away from discretion and opportunism. Except in the aftermath of a financial blowout, and even then, the cost-benefit calculus is not all clear cut. Our contention is that the leap is worth taking to avoid further sub-performance and, possibly, to harvest critical growth bonuses from a better capital market integration. The bond market is watching and imposing harsh costs on aberrant policy makers; the implication is to throw in the towel, get a first-rate currency set-up and abandon the illusion that turning the currency dials is a way to exploit residual money illusion.

A non-argument deserves exposure: the argument is that a currency board condemns a country to a balanced budget. This is, of course, not the case. True, seignoriage revenue is lost, but beyond that argument, there is of course both the potential for domestic and foreign public debt. There is no argument whatsoever that a currency board requires a balanced budget; that would be the case only if a government had lost all access to credit and was using raw money creation as its way of life, on the way to hyperinflation. In fact, one might well argue the opposite: a currency board clears the ground for a domestic-currency public debt by reducing the risk premium and it enhances a country's international standing by providing transparent institutions. This point is reinforced by the financial institutions recommended in the next section.

The Need for Sound Credit

No exchange rate regime can stand up to a speculative attack unless interest rates can rise to reward the holding of domestic-currency denominated assets, and thus raise the cost of carry of a speculative position. That is true whether the rate is fixed, managed or flexible and it applies to a currency board just as well. In fact, it has been said that a currency board transforms balance of payments crises into banking crises. That somewhat overstates the special arrangements of a currency board—it is not possible under any fixed rate regime, except with unlimited reserves, to defend the currency without raising rates--but it certainly puts the emphasis in the right place. A sound financial system is the critical counterpart of a credible exchange rate arrangement. Without it, the monetary authorities cannot defend the exchange rate and it is a short step from vulnerability to defeat.

The need for repairing financial systems is obvious worldwide, from Japan and China to emerging and transition economies. But in the former Soviet Union there is a special issue: in the planned economy, credit was treated like electricity—it was allocated by the planning bureau with a view to meeting production targets. No surprise then that on the books of financial systems are claims which have no prospect of recovery. Moreover, they are there side by side with the new credits of an emerging private sector. As financial repression is lifted and cross border capital flows become a possibility, the seriously impaired balance sheets become an unstable mass.

For our purposes, a sound financial system must have two characteristics. First, it cannot be burdened with substantial nonperforming loans on its balance sheet. Bad loans imply a whole in the balance sheet, vulnerability of the institution and hence a process of adverse selection in which loan quality deteriorates as high rates are paid on the funding side and ever more risky loans are made on the lending side.   An episode of increased market rates puts that mechanism of bank deterioration in the express lane. Next, the exposure of financial institutions, both in their own funding and that of loan customers, must be storm-proof. Large liquid and foreign-currency-denominated exposure of institutions or their customers tend to build up when domestic rates are high because the currency is less than fully credible but institutions or corporations are willing to take the gamble of borrowing offshore at what seem to be bargain rates, forgetting about currency and liquidity exposure. The resulting mismatch of denomination and maturity implies a dramatic value at risk position for the national balance sheet.

The obvious answer to these issues is a financial system that is cleaned up of the legacy of bad loans and keenly supervised according to top standards as for example those in the UK. It is also clear that, politics quite aside, the institutional capacity to do this job is absent in most emerging markets including Central Europe. The answer has to be twofold. First and foremost, nothing is being gained by allowing impaired banks to go on functioning. The losses are already on the books and they are growing; all experience indicates that an early move to clean up avoids both large losses and possibly very large risks of financial crises. There is a fiscal cost to this clean up, but if the costs rise at more than the rate of interest, which they demonstrably do, early action is cheapest.

Second, the financial system needs substantial credibility of its balance sheet. The less the government is able to provide it by fiscal guarantees that backstop any supervisory failures, the more it has to be accomplished by preemptive measures. An effective way to accomplish this is to require banks to have offshore guarantees of their liabilities by high-grade foreign financial institutions. The mechanism has two advantages. First, it provides the lender of last resort. Which reduces risk premia. Second, importantly, it provides the supervisory function that domestic authorities are poor at implementing. Foreign institutions that guarantee will, of course, not only collect a fee (or partnership) but also inspect the books; their own money is at stake. This is a modern way for a small economy to take advantage of the international capital market to solve both capital and emergency supervision issues. It amounts to privatizing both the lender of last resort and the supervisory function. These steps are more important the more strain there is already on public credit and the larger the institutional deficit. In other words, Central Europe is a prime such a move. Moreover, in conjunction with a currency board, such a banking arrangement represents a remarkable highway to the international capital market.

Concluding Remarks

There are important transition issues if only because cleaning up the financial system won't come overnight. Of course, that is not a reason for procrastination. There is also the very practical fact that the Euro, while starting on January 1, 1999, actually won't be available as hand-to-hand currency for another three years. There is also the perennial and very real question at what rate to commit a currency in the move to a currency board. In particular, should there not be one last devaluation, is the exchange rate not overly uncompetitive, etc. Finally, what is the rush; there is no crisis.

These issues are real and, they cannot be swept away. It is also true that they will always be there and they will always be a reason for procrastination, except in the aftermath of an awesome crisis where the quest for establishing a firm ground overrides all details. Of course, waiting for a crisis is not a good answer if the issue is precisely to avoid crises.

The argument for moving now is *opportunity.* Europe is in the midst of a historic transformation that affords governments with an absolutely unique opportunity to do those things, which ordinarily are politically impossible. One has seen that in the run-up to the Euro in Western Europe, say in Italy. Central Europe can harness the same forces and make the critical jump by capitalizing on thew dramatic end-of-century events of its partners in the European Union. A piggyback *Euro* currency board has more political attraction and sheer plausibility than yet another IMF program.

THE TROUBLE WITH OSKAR

Oskar Lafontaine, Germany's new economic Tsar, continues to make waves. He is not center left or new-left, he is unreconstructed left-left, he is bright, he is a schemer, he is the winner in Germany's power struggle and if he gets his way he will shape the future of Europe and not for the better.

Europe has had its skirmishes with the center-left: Delors championed a Christian-democrat view of the market economy and Jospin, and his activists, came from further left . But they all wound up in the middle, by and large making their compromise with the capital markets that have little patience for the do-gooders and even less for architects of a *new social economy*. True, throughout Europe, even into the corporate boardroom, everyone leaves no doubt that they are unwilling to go to the US extreme of "perform or perish"; they all want to keep some commitment to the welfare state however expensive, unaffordable and counterproductive. It was part of the culture and beyond narrow economic calculus. With Lafontaine's agenda, Germany is going backwards as if the road to the competitive market economy, beyond the welfare state, had been a dead end street.

Schroeder was the Trojan horse; with the elections barely over, Schroeder virtually disappears and the party leader and parliamentary leader, Lafontaine, has taken over. Schroeder will be kissing babies and cutting ribbons while Lafontaine sets the agenda, implements the agenda, changes the world. From the perspective of deregulation, restructuring ands modernization of Germany's and Europe's economy a worse outcome is hardly conceivable. Yet, the outcome was predictable. A broad based coalition could defeat Kohl and it was essential that it should not spell out any detail or any concrete steps. Once elected, the coalition needed a program and since Schroeder had failed to seek a mandate or stand for anything, he was pushed aside by the people with a program: Lafontaine with his left-activism and crude Keynesianism.

Lafontaine understands that he can strengthen his hand by reaching for European support. That is done by getting to the activists that have not gotten their way with Jospin and that have been in the wings (ostracized during EMU convergence under Prodi) in Italy. Surely, the ambition must be to turn Brussels into an instrument of pushing a new social agenda of sheltering labor from the market economy and taking from large corporations the front seat in the orchestra. While the free market economy had its heyday, until the world financial crisis revived skepticism about the benefits of unrestrained capitalism, all this would have been difficult. Now it is easy to give speeches about the need to control markets, the need to create demand, the merits of using the Stat as a powerful way of achieving better economic outcomes.

What can Lafontaine accomplish? First and foremost, deregulation of labor markets and social benefits is going into reverse or, at the most, into the slow lane. Second, Waigel pact budget discipline will come under attack not as a complement to supply side reform but rather in a very crude spend and create demand way. Third, war will be declared on the ECB since cheap money is the easiest way to create jobs and take credit for it. The war will be made easier by the ECB's president who has not yet understood that he need not get into every debate that is offered. All of this will be very counterproductive: stock prices might rise under the pressure of demand, but that won't last. Long term interest rates will rise as savers perceive that discipline is lost, wage increases will be encouraged by pro-labor governments and that means inflation will much more easily be an issue. In sum, an agenda of the past and thought dead is having a come back.

The demand side rhetoric will take little time before we see references to the US in the 1960s – bold fiscal expansion supported by monetary accommodation and fixed exchange rates, the way ahead. True, it have the US a long period of expansion and record low unemployment; it also lead to the great inflation of the 1970s. In Europe the inflation will come much sooner, as is always the case with populism, because the encouragement for wage increases is already in the air.

Whatever Lafontaine may think, fixed exchange rates won't be part of his world economy. Britain surely will not sign up to a Europe that is going intellectually off the deep end and the US will most assuredly not link and fixed currency rates unless things get bad enough and Gephardt becomes president. And even then, deep skepticism of European macroeconomics will make the US want distance and independence from a plot to overthrow the market economy.

Lafontaine has his time on the stage and the first act may well be impressive simply because Europe is dying to have some growth. He will provide just that, much as the Keynesian economists did for Kennedy in the 1960s. But in this global economy that is inflation sensitive in the bond markets and wage-hungry in the labor market, it is too late to believe that big government, printing money and borrowing from one's children are the way to get ahead. Yes, Lafontaine Avenue is a third way, but is a dead end street.

CARDOSO AND THE IMF

President Cardoso has gotten his second term but he did not quite get the mandate he had hoped for and now the trouble starts. He did just about anything and everything to get that reelection: It was a spend, borrow and be happy environment just to make sure the economy would last to election day. Today the deficit is larger than when he started, the debt is larger; privatizations have happened but the revenue is gone. No wonder he is popular with so much spending, no wonder he has trouble now explaining that the country is in trouble.

To keep money coming, he shortened the maturity of domestic and foreign liabilities, and to keep the music going he gave state governments leeway to spend money they did not have. He almost made it without a glitch but not quite. Capital flight is on big time; $40 billion have already left the country not counting all the money the government spent behind the scenes buying back its debt to support prices in the world market. The IMF obliged and put together a big package, announced that it was ready to give Brazil the way of getting beyond the election before the moment of truth.

The simple facts are these: the public debt has rapidly risen to near 40 percent, netting out even the money owed by state governments that will never be paid. The budget deficit is 8 percent of GDP, the current account deficit comes to 4 percent in a year where growth nearly zero. The maturity of domestic debt is very short and the external debt is even shorter—everything is a roll-over situation and therefore confidence is totally essential;

without confidence, Brazil will go the cliff even faster than Korea. But why should anyone be confident? In fact, there is substantial skepticism as witnessed by capital flight in the order of 4 to 5 billion $US a week before the election and still a pace of $1 billion afterwards. The IMF package of $40 billion – and don't believe that all the money is real and can be used- will not provide much in terms of confidence. It will merely finance capital flight for a while, just as in Russia.

Confidence has to come from dramatic Brazilian program which, finally, gets done with the bad macroeconomics of fully 2 decades and creates a well-functioning market economy of the kind Argentina established at the beginning of the decade. The plan hatched by the IMF and Brazil is this: a 2.4 percent cut in the budget, more is said to be "politically impossible". The budget cut is supposed to instill confidence, cause interest rates to fall from their current 30 percent real level, stop the outflow and thus bring stability. The chances of that happening are not zero, but they surely do not exceed 20 percent. Here is why. First and least, the President may not get a 2.5 percent budget cut here and now. We have already seen that with the defeat of the social security portion of he plan. He has never made a difficult decision, he only knows spending and borrowing, pay-offs for a second term. The betting is that he thinks more about "too large to fail" than about the sheer possibility that his country now may go over the cliff as a result of his persistent mismanagement. Next and importantly, if the budget cuts happen, they will create a recession: the estimate for Brazil is that a 2.5 percent budget cut will cause a loss in GDP of some 3 percent unless there is a dramatic offset from interest rates and confidence. But interest rates are unlikely to fall. Just as in Hong Kong, investors will argue that with a recession, the temptation to devalue to get out ultimately is just too much. Hence interest rates will stay high, the budget does not really improve, the recession weakens the President's political base, future and further budget cutting becomes doubtful and a vicious cycle ensures. With capital flight intensifying and domestic debt refinancing becoming ever harder, it s a short step from there to capital controls and even possibly an uncontrolled currency problem. Brazil's policy makers flatter themselves that they are magnificent interior decorators., that they have lived with crises forever. Yes and true, but they may well have come to the end of the rope. If they can't instill confidence than controls will complete the picture. Needless to say, if Brazil fails, it will take much of Latin America with it.

Brazilian policy makers are frozen in denial mode; don't count on them for a successful program. Four problems must be addressed. First, the maturity of debts must be lengthened to accomplish a reduction in interest burdens. Second, the exchange rate must be credibly frozen. Third, the budget must be improved over and beyond what comes from a fall in interest rates. Lastly, the economy must be reformed to reduce statism, instability of the rules of the game and to enhance flexibility and competitiveness.

A currency board is the only plausible way for investors and the public to believe that the exchange rate is beyond discussion. That is counter-cultural for Brazil but anything else is unaffordable as evidenced by the current level of interest rates. Second, the public debt must be lengthened; that is unpleasant but has ample precedent. A lengthening done while events can be controlled need not cause any losses other than taking away the illusion of liquidity which investors now entertain but could not actually exercise because the country could not pay them. A lengthening of much of the debt reduces interest burdens, stabilizes public finance and hence supports the currency regime. Brazil needs, of course, to go beyond “time out”: on the debt by making a major fiscal effort in the direction of a balanced budget. The cuts must go substantially beyond 2.5 percent to create confidence that the Real Plan finally has its counterpart in fiscal stabilization. Lastly, because he currency board freezes the exchange rate stable rules flexibility of wages and prices has to start playing a far bigger in making Brazil competitive.

Just doing a bit on the budget won’ solve the problem and simply invites a crisis in a few months. There is little comfort in the fact that Brazil’s crisis will be less extreme than that in Russia. But surely it is time tell the IMF to start being serious and courageous in adopting radical winning strategies rather than gamble on the seemingly less painful options peddled by their client governments. In order to allow Cardoso to win and keep the music paying, the MF has long bought into the propaganda story that Brazil’s problem is the budget, not debt or the exchange rate, and that the budget is the fault of the Brazilian Congress. Having helped peddle the story, the IMF is now locked into asking for a bit on the budget and pronto here is a big bailout package. One is reminded of Keynes' saying “in the street it is better accepted to fail by conventional means than to succeed by unconventional ones.” That has been IMF strategy and it explains the failure in Russia and quite likely the one in Brazil to come.

February, 1999

POLICY OPTIONS FOR THE BoJ

No serious analysis reading of the great depression in the US would miss that the Federal Reserve played a critical role; true, other avenues of recovery were botched—fiscal policy never turned expansive—but the Fed played a unique role in allowing a credit contraction to hammer the economy. The Bank of Japan risks the same reading. It is standing by while the economy goes under with a real chance of helping create a depression just like the one that devastated the United States. Just as in the case of the Fed, petty arguments are being used to stall in what should be a decisive commitment to an unusual but highly effective monetary intervention to push up stock prices and push down the Yen with a view to stabilize prices and foster recovery.

With continuing poor performance of the Japanese economy – the Consensus forecast looks to a 2.8 % recession in 1998 followed by –0.5% growth in calendar 1999— the BoJ is now at the center of discussion. Fiscal policy works poorly in the first place because of targeting and implementation problems, because Japanese businesses and households are very pessimistic and because downgrading issues feed back to JGB yields and this hamper growth via adverse cost of capital effects and capital losses in balance sheets. The last resort, therefore, is the BoJ with its ability to create money. The question is what kind of framework is likely to be most productive?

The clean up of the banking system is under way. This has been impatiently expected, but it is also quickly becoming obvious that the clean up will be incomplete, that the insurance companies are next and that even with good balance sheets the banks are not about to embark on a lending spree: good credit risks are scarce and on the side of borrowers good prospects are lacking. This is a near-depression situation where money is easy but credit is tight in the sense that those who need to cannot get it and those who could cannot use it.

So far, the BoJ has been targeting short term interest rates and expended some effort in directly relieving credit problems by buying corporate paper. The balance sheet of the BoJ has expanded dramatically, but the monetary base has expanded little. The difference is made up by a sterilization intervention: the large expansion of assets, by creating liquidity, would push down short rates if it had not been for the BoJ selling massively interest bearing BoJ bills. Ads a result, at a loss to the BoJ, banks hold BoJ bills rather than reserves. This helps explain why, balance sheet expansion notwithstanding; short rates have not gone to zero.

The BoJ is probably right in arguing that conventional monetary expansion can at best succeed in making balance sheets more liquid and thus, importantly, help limit credit contraction, but that it is unlikely to lead to loan expansion. Fear of loan losses is dominant and, as a result, banks are willing to hold vast excess reserves, more so if they carry some interest rate as they do in the case of BoJ bills. The banking system is basically willing to hold any amount of liquidity, reserves don't burn holes in banker's pockets; they offer, instead, cool reassurance.

In the meantime, large and prospectively unlimited debt issue is leading to a downgrading of Japanese debt; the downgrading reflects the distant but increasingly plausible result that debt will be bad—not paid, inflated away, restructured – whatever happens to debt that is out of control. It is argued that gross liabilities of the government amount to 90 percent of GDP and that *gross* is the right concept because the government's claims on the private sector or local governments are unlikely to be honored. There are also pension liabilities of at least 100 percent of GDP. With continuing recession – The JCER, for example, products – average -0.7 percent growth in the 1997-2003 period—the budget will not get better. Current and projected deficits of 10 percent per year over the next decade add another 100% of GDP in debt. In addition there are further costs associated with bank bailout and the coming bailout of insurance companies. The prospects of increasing yields means further weakening of balance sheets, an increasing cost of capital and hence weakening spending and worse deficits.

It is obvious then that Japan is in an exceptionally fragile situation and that the BoJ can certainly not take the view of business as usual. Among the menu of proposals for action we single out the following:

- *Short Rate Targeting*

The status quo is short rate targeting with some term structure play and some direct credit relief for corporate paper. Large sales of BoJ paper contain monetary base growth in the face of a large expansion in the balance sheet. The Diet wants higher interest rates and the economy wants zero interest rates or less. The status quo is not good enough. The most recent reduction in the overnight target rate to a fraction of a percent signifies nothing other than a continuing lack of strategy on how to support recovery.

- "*Credible Commitment to Inflation*"

With nominal interest rates near zero, MIT's Paul Krugman has widely advocated that the exit from Japan's liquidity trap must be to lower **real** short-term interest rates by a credible commitment to inflation. The idea is that with inflationary expectations up, real interest rates are down and hence interest sensitive spending revives. The mechanism to get to inflation is money issue, big time.

There are two problems with this proposal. First and importantly, it is unconventional for central banks to commit themselves to inflation. Keynes has said, "in the Street it is better accepted to fail by conventional means than to succeed by unconventional ones." The BoJ is surely no exception to this rule. More importantly, the prospect of inflation would of course risk causing a loss of confidence and possibly lead to a rise in saving rather than a rise in spending, it would be certain to raise JGB yields and cause vast capital losses in balance sheets. In sum, it might backfire and be a really bad idea. It is certainly not one a responsible central bank should underwrite.

- *JGB Yield Targeting*

In the 1930s, and until the 1950s, the Federal Reserve supported the yield of US government bonds at near 2.5 percent. The practice ended only when Korean War inflation made the Fed look for independence in monetary policy. Targeting long rates in the face of massive budget deficits and deteriorating debt rating involves, of course, a large expansion in the money stock. It certainly involves, too, a depreciation of the Yen as more and more liquidity is being created and it is likely to imply a rise in the stock market at liquidity looks for returns above the low T-bill or JGB yields. The Yen depreciation helps create competitiveness and that is all for the good. It also helps in balance sheets to revalue the external holdings notably of insurance companies and that is positive. The stock market gain, in the same way promotes revaluation of bad balance sheets. Finally, the pressure of depreciation will mean less deflation or even inflation and as such a fall in real long bond yields which can be expected to have a favorable effect on spending or at least not an unfavorable one.

The trouble with the strategy is, of course, that it looks like an open-ended inflation strategy. At a time of deflation and distress that sounds like what the doctor ordered, but the question is whether one could not go further to limit the fears about inflation or loss of sound central banking while, at the same time a very strongly expansionary policy.

- *Aggregates Targeting*

Targeting of the aggregates is a direct way of assuring monetary expansion with the hoped for impact on currency depreciation and stock revaluation. Just one question here, how much is enough? In the end any sensible strategy will involve an end of sterilization and a very aggressive monetary expansion. The point is that it would help to relate it to the central bank objective of growth and price stability. Announcing 10 or 20 percent growth of a particular aggregate does not obviously translate into so much growth or so much less deflation. This is even more the case since the credit channel of monetary policy has substantially broken down.

- *Price Level Targeting*

Our preferred policy option is price level targeting. Suppose the bank of Japan commits itself to maintain a stable price level, on average and over a period of say a year. Whenever prices are falling, money growth is increased and whenever prices are rising, it is curtailed. The policy accomplishes two objectives. First, it stops deflation while making sure not to go to the other side, inflation. Second, to stop deflation it must succeed in pushing output substantially up to potential. It therefore revives the economy. How is that accomplished? By currency depreciation and stock market revaluation; long-term bond yields would be expected to fall both from the liquidity effects of the policy but also because a more stable economy diminishes the risk of cumulative credit quality deterioration.

It is immediately obvious that implementing such a strategy is necessarily experimental. Traditional links between money and spending have broken down—households have a sharply higher preference for liquidity, interest rates are basically not anymore part of the transmission mechanism.

- The first step of such a policy is to engineer a very large *one-time* increase in the quantity of money. If currently output is 7 percent below potential than current monetary expansion should be targeted at just that change and to be accomplished in a very short time frame. But with a breakdown of the credit multiplier, to achieve a 7 percent increase in M_2 the BoJ will have to conduct a monetary base operation that is even significantly more ambitious. It would be essential to stop the sterilization policy, which today limits the expansionary effects of BoJ balance sheet growth.

- It is also useful to ask what the BoJ should buy. In principle, the BoJ could buy private debt, real assets, short-term government debt or JGBs, stocks or dollars.

- *It would be well advised to do some of each, but to focus very clearly on the possibility of buying equity and dollars with an immediate impact on the prices*. Moreover, the policy should be understood to be a dynamic one: As long as prices continue falling, purchases will continue. The focus on equities and the dollar help demonstrate immediate price results, improve immediately the cost of capital and balance sheets, improve immediately competitiveness.

- As the price level starts stabilizing, the policy shifts downward to a potential output-oriented policy—the money growth compatible with stable prices given growth in potential output. It is therefore clear that there is no vicious cycle of inflation and depreciation here and no inflationary liquidation of debt.

Should the BoJ be concerned about its balance sheet? The quality and liquidity of the assets matters of course in a first sense; the BoJ, or the government more generally, should not bail out inefficient businesses and hence should avoid stock picking. But in another way there is no concern. The quality and liquidity of assets matters if the BoJ should find itself in a position of having to sell assets to limit excessive money growth. In the case of Japan, that is not on the horizon. Moreover, it surely is the case that with a recovering economy—should the policy work—capital gains will be made on the equity portfolio and on the currency position. The position therefore even makes a long-term contribution to the Treasury. If the policy fails, it makes little difference what the balance sheet f the BoJ looks like; there will be far more dramatic issues to be considered.

Money growth at the pace of 4 percent per year which is the status quo just won't make the critical difference that must come now, not when it is too late and the difficulty of reviving the economy even more formidable. The BoJ has a chance to pull the economy out of the depression cycle if it acts both *decisively* and *unconventionally*.

THE TARGET ZONE CONTROVERSY

In discussions between the Fed and the US Treasury it surely would not occur to either party to make a formal agreement—this is the range of interest rates, this s the range for the budget and if we get to the edges, this is what either of the two parties must do. And yet, these are the authorities in charge in a single country. And if we add the Congress as a complication, the chances of coordination commitments are even less. Why on earth should we believe that target zones among governments are a good and practical idea? Target zones is the new hot word in international policy debate. The French government has called for new international monetary arrangements—no more benign neglect of currency fluctuations, the new German government has joined the band wagon with great enthusiasm and the Japanese, whether they mean it or not, have expressed great interest. Should we believe that target zones are it, that the upcoming Cologne Summit will bring a blueprint for the Euro-dollar rate to move in a narrow range, that the Yen won't do its wild dance any longer? Forget it, no chance on earth that the US will join a scheme that limits our policy flexibility and puts responsibility for US economic performance in the hands of financially inexperienced and statist-minded socialist governments. And just as remote ids the chance that the US will agree with Japan on narrow exchange rate margins; they can't manage their own economy, why should we tie ourselves to their ill fortune?

The superficial reason for target zones is that without large fluctuations in exchange rates between the dollar and the yen, the Asian currency crisis just would not have happened. True, the dollar yen rate moved a lot in the last 5 years; it visited the high 80s Yen/$ and it went all the way to the 140s. Currencies like Thailand's bhat that were fixed to the dollar went on a joy rise when the dollar weakened and then they crashed when the Yen tumbled. And much the same, of course, is true for the rest. The currency movements were just the straw that broke the camel's back. The fact of a crisis, and the extreme dimension of it, have above all to do with an extraordinary mountain of irresponsibly short debt and an awful banking system. That is where the dynamite was, the dollar/yen rare was at best the spark that started off the explosion. Avoiding financial crises, from Mexico sand Brazil to Asia has to do with a sound financial structure and good exchange rate policy. The message is not to fix the dollar/Yen rate but to find better exchange rate policies for emerging markets. In Eastern Europe that means currency boards on the Euro, in Latin America it means full dollarization and forget to amateur-manage an exchange rate and central bank. In Asia it means flexible exchange rates. It just has nothing to do with a case for target zones among G3.

If emerging market problems are not a good or real reason for target zones, how about the risk of extraordinary instability in the world economy provoked by vast international currency swings? Again a non-reason. In the past, on an ad hoc basis, governments have gotten together on a few occasions where rates had gone extremely far. That was the case of the dollar in 1985, it was the case of the Yen in 1995. Ad hoc joint intervention worked impressively on both occasions in large part because rates had gone too far in the first place. As a result, speculators were willing to be scared by governments saying "no further. "There is every reason to believe that we could get the same ad hoc joint intervention should circumstances warrant it. No government has an interest in fomenting an obviously bad situation. But if intervention done right works, of there is conviction that governments in the right circumstances collaborate, why not go the extra step of formalizing it. Why not draw lines in the sand just now so the problem never emerges in the first place? This is here the judgments part. The French and the new German government always like the idea of fixing anything that moves, the British or the Americans by contrast are deeply suspicious of market intervention. They will point out that intervening at relatively extreme points needs nothing more than a show of force but intervening in the small needs much more to convince markets: coordination. They rightly argue that there is no such thing as coordination. The US Congress will not accept European interference, the ECB will not take instructions from the US Treasury, Greenspan wants his hands free to run the US economy and all of that is an immutable fact. Target zones will just create confusion.

Of course, the European love of target zones is not quite so innocent. European policy makers have two important reasons for promoting bands for exchange rates. The first is the belief, or at least the recognition that the dollar and the Yen will weaken on the Euro in the coming year. Japan s dying and about to monetize its debt, the US stock market is running out of luck and with it the US economy and, on the other side, the Euro has its attraction in portfolios. The obvious risk then is that Europe's unemployment problems will get even worse. And here comes the second reason and the hidden agenda: Europe's finance ministers cannot make the central bank march to their tune but they can make currency arrangements. Thus, if there were a target zone and the Euro were to appreciate strongly, the ECB would be forced *–like it or not*—to cut interest rates and limit the appreciation. Target zones are the hidden way to recover some of the control over monetary policy and the rest is just dressing it up as internationalism that should not fool anyone. If that were all, the US might even agree. But imagine the target zone arrangement work on both sides so that the US is called upon to raise interest rates a time its economy and currency weaken. No way, that is where the Congress, the Treasury, and just anyone and everyone will say no thank you. No way we have exchange rate arrangements put in jeopardy US prosperity. And that is the very last word on the topic.

Of course, to bring Japan into the discussion is plain absurd. In what is a pathetic spectacle of incompetence, the Japanese economy is sinking and public finances are moving to junk bond status. Japan cannot get a recovery, it cannot limit is deficits or at least make them produce growth, it cannot decide whether its central bank should monetize debt or support inter4est rat5es, it can't decide whether it wants a strong or weak Yen. It is inconceivable that Japan could be part of a well functioning target zone arrangement.

European governments have used the fear caused by trembling capital markets last fall and the crashing currencies of mismanaged third world countries to shape what looks like an internationalist, responsible agenda. They are trying to drag the US into a domestic debate about the ECB. They will fail and have to be satisfied for castigating the US as a dogmatic free marketeer, which it is indeed, fortunately. They would do better to look for a more competitive and dynamic economy so that the exchange rate becomes a less desperate battle line. Forget target zones; Markets on occasion may be irrational, but more often than not socialist policy makers are worse.

BRAZIL BEYOND TROPICAL ILLUSIONS

Brazil is now in financial free fall; in rapid succession they have gone from a failed mini devaluation (like Mexico in 1994) to a small exchange rate band that collapsed within a day to a market driven mega depreciation. Policy makers are shell-shocked by what is happening in the markets and so far unable to bring that major change of regime, which would justify renewed confidence in the country and its finances. True, its Congress has started passing the laws hat might have been enough last year, but now they are way behind the curve. They look back to defend a record of interior decorating disguised as genuine progress. But prosperity is not measured by the stock market and privatization and all the money borrowed but rather whether the economy's output per head is up and investment in the future has been high; after 2 decades of experimenting with bad money, unsurprisingly, they are not. The country got caught up in defending its overvalued currency and lost sight of the more basic question of growth and stability; they made a big bad debt, doubled and tripled the stakes and now have been kicked out of the Casino. It is time for drastic reform.

As so many stabilization attempts in its own history, and throughout Latin America, now the Real plan has crashed. It lasted much longer than the others and looked a lot better but that was because a gigantic amount of money was borrowed. On top, the revenues from privatization were made available to finance an appearance of stability and normality which everybody wanted to believe for their own reasons: the president to get another term of office, Brazilians because the pain of normality in a poor country with vast inequality is too stark. And investors were happy to join the fantasy because it was good business: Agreed, Brazil is different. Yes, as always, until further notice; until then, lets deny reality. The Asian crisis had little to do with Brazil's collapse. It is all home made, just as Mexico at the time, with and overvalued exchange rate and a huge budget deficit, vast short term foreign obligations and an explosive indexed domestic debt

Brazil's claim to credit was that it stopped inflation but it did nothing to make it stick. The first phase of a stabilization without fiscal austerity, and with a strong currency, is always euphoria; inflation is low, money comes in from abroad, stock markets boom, consumption rises, growth is finally back. The second phase, once the doubts come and investors take their pound of flesh, means high interest rates and a shortening of maturities and indexing of the debt—one more helping of money please, just to the election and the IMF will help make it safe. And then comes the inevitable third chapter when investors want to get out while there is some money to leave and that is when the house of cards collapses. Interest rates can't stay high forever and that means the currency won't hold and that means you have to get out, fast. Just like every other bubble.

The basic theorem of currency crises is this: they take a lot longer to come than you would think and then they happen a lot faster than you would have thought. And then there is another theorem: of 3 crises predicted by economists, two never happen and the third is far worse than expected. Brazil confirms these truths. The amazing thing is this: after Mexico, after Asia, after Russia, just what were the Brazilians thinking? The investors are easy to understand—they know there is a brief window of reserve use and IMF money that allows them to jump shop and get off the boat with their feet dry. But how about those who hold the bag, in particular the government, do they still believe in Santa Claus and too large to fail? And the IMF or the US Treasury, should they not know better by now to be more skeptical when they see just promises and absolutely no reality? The answer that Brazil's government was unwilling to cooperate sounds absurd, is probably true and just means that the IMF has now become an unconditional lender of last resort playing, promoting instability rather than sound finance. IMF chief Camdessus has become the world's biggest croupier; Earth to Camdessus, get a grip.

There are three steps that have to be taken to create a stable and ultimately successful economy. First band most immediately, the country must adopt a currency board. The inflation and the exchange rate have been a perennial problem in the past 20 years, responsible for the fact of zero per capita growth in all that time! Basta, get rid of the central bank just as Argentina did. That ids a difficult step for a large and proud inward looking country. But it not just reflects an adaptation to a modern capital market that is trigger-happy and unforgiving. It is just common sense after the awful economic record of two decades. The traditional argument for a central bank comes in three parts: national pride, the ability to create money and the flexibility gained from an ability to adjust the exchange rate rather than undergo painful domestic adjustments. A second's reflection shows that none of these apply to tropical situations where each and all have become a liability. To be proud of the 5^{th} currency in just a few years is a joke, to print lots of money is a risk and to adjust the exchange rate would be nice, but overvaluing it first and then have it collapse is perhaps not quite the idea. Currency board in Hong Kong and Argentina are not a panacea, but they are an extraordinary pillar of stability in the midst of regional turmoil. They are the way to go.

The second step, unfortunate and inevitable, is a restructuring of the domestic debt. It is of extremely short maturity and indexed to the dollar or money market rates and accordingly growing at explosive rates; large interest payments on snowballing debt are a large part of the fiscal problem. Lengthening the maturity at preset, moderate but indexed rates is not punitive and can solve the problem which otherwise, along the way, would simply become another write off as Brazil did just a few years ago. The argument that nobody will lend to Brazil anymore is absurd; lenders come back in no time the moment that last debt is locked away or written off, as they always have.

The third step is t make a down payment on structural reform and creditworthiness. Brazil should immediately put the remaining privatizations on the table and get them done, without corruption. Such a step will create confidence and help reduce the cost of capital as Brazil comes back to the world capital market. Getting the government out of business is half the story of reform. The other half is for the government to retreat from arbitrary rule making and interference with business life. A century of big, powerful and unstable government has created a business life that seeks favors and privileges in exchange for support of bad government. Horizons are short and investment—as opposed to speculation and asset sales—is low and so is growth. Brazil is at a crossroads, it has run out of both money and jeitinho .

THE IMF HAS FAILED, SHOULD CAMDESSUS LEAVE

If emerging markets have become a speculative casino, surely the managing director, Monsieur Camdessus is the chief croupier. Over the past few years, from Mexico to Asia, Russia and Brazil the IMF has stood by while currency crises were building up, the IMF was fast to mobilize vast amounts of money to be thrown into the battle, the IMF allowed a debate on controversial adjustment programs to gain ground, the IMF was responsible for a lack of decisive remedies that would move countries out of the danger zone. Now if all of this right, why should the managing director keep its job? There is an urgent need for dramatic reform at the IMF, the managing director has no clue and has lost his legitimacy, and he must now go.

The first failing of the IMF has been a pattern of missing every single crisis or misjudging the sustainability of a precarious situation. Russia is a case in point: Yet, another program, yet another pile of money but no decisive changes forced on Russian policies, definitely no debt restructuring and surprise, Russia collapses. The IMF's answer: if we had restructured the debt, there would have been a risk of devaluation. As it is, we had debt default and collapse, far worse than even a bad outcome under preventive care. Or take the case of Brazil. President Cardoso bamboozled the IMF into thinking he was a reform President. Just how is bot clear since he has never done a hard thing in his life? In the end, the IMF talked like the Brazilian finance minister—no problem, no overvaluation, everything will work out. And then, of course, things blew up. Or Korea. Where was the IMF when fragile Korean banks borrowed huge amounts abroad with overnight maturities, and put the money in Brazilian and Russian bonds. And all that half a year after Thailand was gone already. Where was the IMF when prudence would have suggested an early deep look at Indonesia's banking system? The point is that preventive care is all-important in avoiding very bad surprises and in that area the IMF has been strictly useless if not worse.

The second problem is IMF programs. The come late, they are shy on drastic measures, they do not use the most powerful ammunition. A country that is drowning in debt needs a debt restructuring. If that does not come debtors will try and escape the burdens of dollar debt by staging a run on the central banks reserves the currency will collapse and make debt burdens and the situation of banks and companies even worse. And that restructuring has to come very early and it needs to be very drastic because otherwise a debt problem becomes a problem of default, bank collapse and currency collapse. IN Indonesia the IMF failed to have an early debt moratorium and as a result fostered a currency collapse. In Russia the IMF failed and now again in Brazil. As long as the bad debts are at the center of the stage, collapse of finance and currency is extreme.

But the IMF has also failed in supporting aggr4essive measures to restore currency credibility raising interest rates to the sky in country that has bad banks and bad debt is not very convincing. A far better alternative along with debt restructuring, is the idea of currency boards—abolish the central bank, abolish the exchange rate, take away the toys that create currency crises in the first place. The IMF has lacked the courage to put thi8s option in the forefront. Their argument is": if it fails, we will be blamed. Yet it is clear that a bold move to a currency bard, say in Brazil today, would immediately create a wave of confidence throughout Latin America, restore capital inflows, avoid the deep recession that is building up.

People who lack courage, vision and competence cannot stay at the helm. There needs to be a strong message to the IMF that it needs to shape up, needs to understand better the modern financial system, needs to be prepared to lead rather than hide and blame others. The idea for more money for the IM to fight battles with speculators on a grander scale is preposterous. The best idea, of course, ids to bring back Jacques de la Rosiere, the former and vastly successful head of the IMF. Failing that, the IMF needs a no-nonsense British civil servant who looks at the facts instead of schmoozing with finance ministers, who judges financial risks instead of cultivating fond hopes about politicians with a long record of failure. Above all, we need someone who does not look for yet more statism to make crises bigger but rather for a withdrawal from bailouts and therefore a return of market discipline.

April, 1999

A CENTURY OF UNRIVALLED PROSPERITY

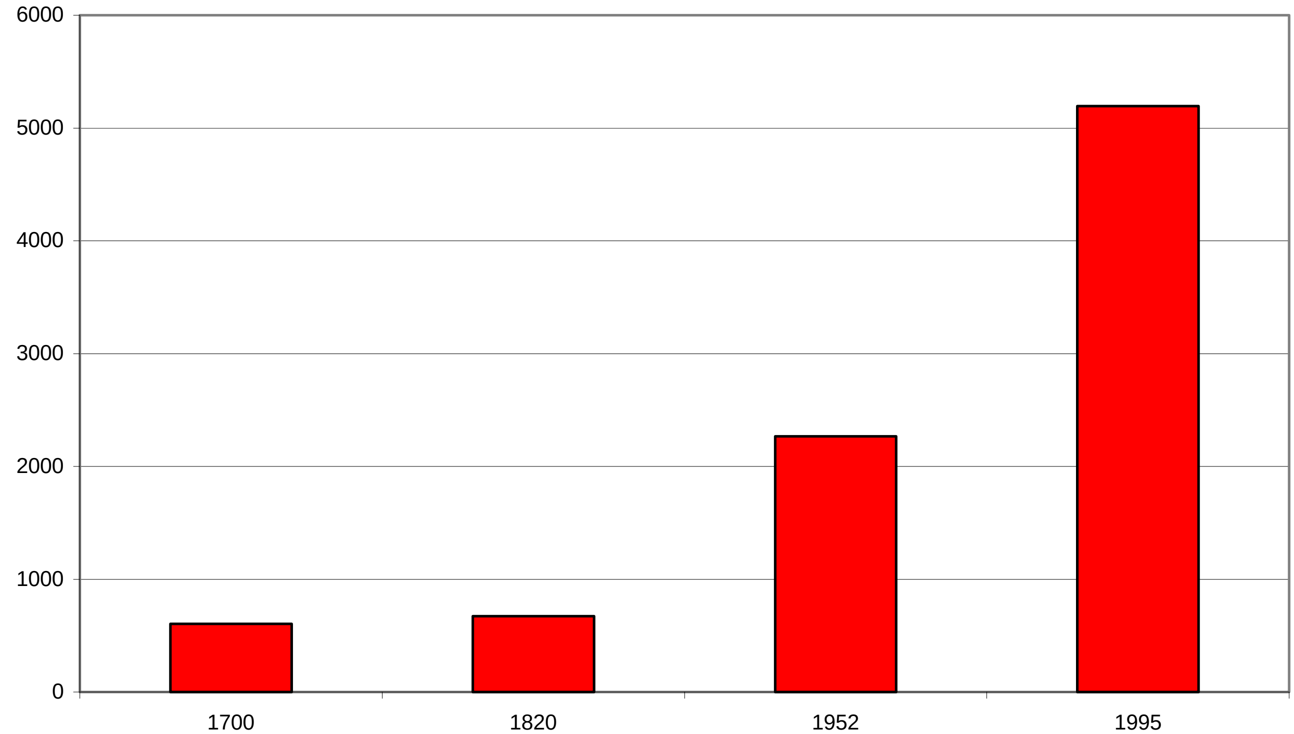
On the verge of deflation, Japan bankrupt and Europe moving at near-stalling speed only, the emerging markets battered and the US beholding a glorious bubble—how can this mark the end of a great century of prosperity? And yet, this has been the best century ever, never mind the great depression, a momentary setback from communism and socialism, and two great wars. Mankind today is far and further ahead of where it has ever been and there are the seeds of innovation from biology to the Internet for better and richer lives even beyond our wildest dreams. One of the great economists of this century, Joseph Schumpeter – Austrian finance minister of the 1920s and Harvard professor at the end—wrote of creative destruction as the dramatic mechanism of economic progress.

This century, and in particular the last 3 decades, have witnessed just that as the nation state has been dismantled in favor of a global economy, state enterprise and economic repression give way to and free enterprise, and breathtaking innovation and greedy capitalism break down government and corporate bureaucracies. . Anyone who says *impossible* finds himself interrupted by someone who just did it. The process is far from complete; innovation and free enterprise spread the mindset, the success and the acceptance of this model to the horror of status quo politicians and the sheer exuberance of all those who are willing to embrace a can-do attitude. If this century taught anything it is surely this: even daunting setbacks like depression and war are only momentary tragedies—buying opportunities, if you like-- in a relentless advance of the standard of living and the scope for enjoying better lives.

A Century of Unrivalled Growth

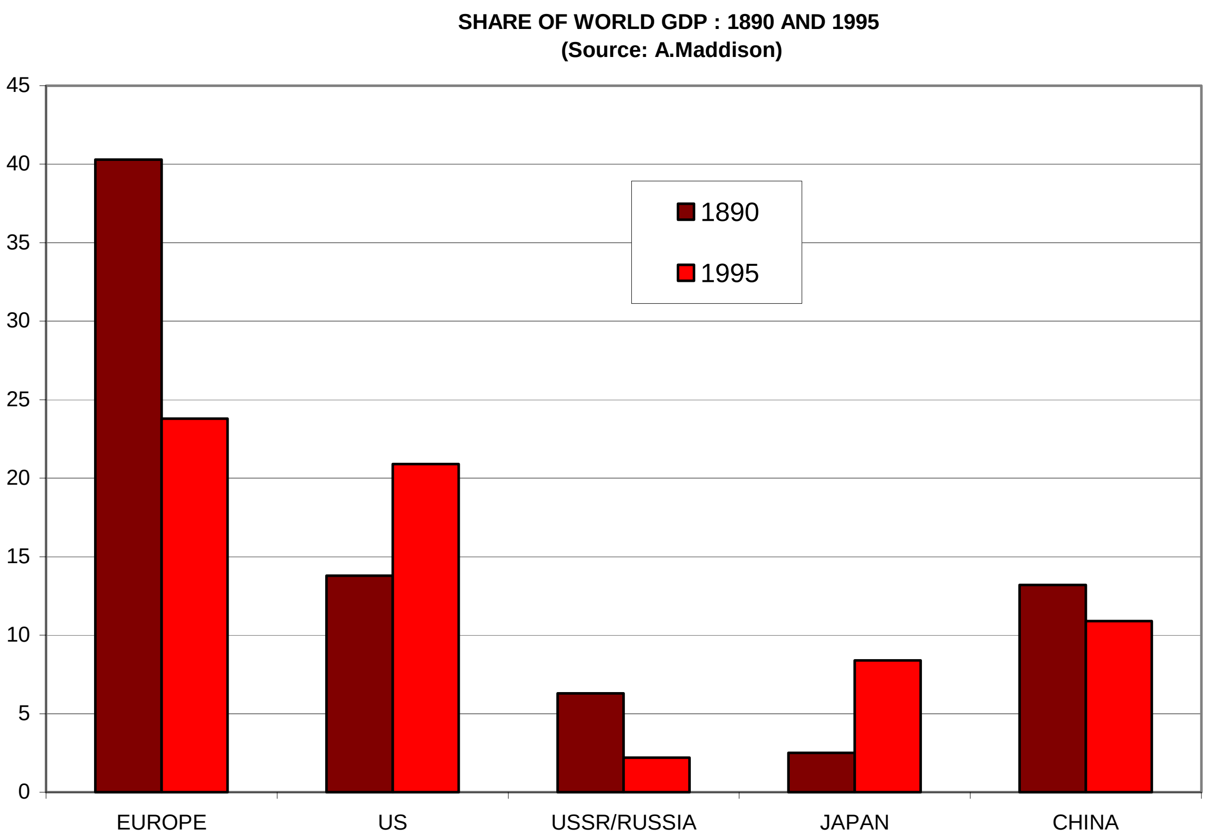
For centuries human progress was limited by low productivity. Estimates of per capita GDP in 1700 that we owe to the creative work of Angus Maddison show every region in the world with much the same income per capita and minimal differences between the US, China and India. From 1700 to 1820 almost nothing happened to world per capita GDP. (See Figure) True, Europe then was somewhat ahead, but less than twenty percent. A century later, by 1820, the differences had widened to give Europe and the US twice the income per head enjoyed China, Japan or Russia where near-stagnation had been the rule. Yet, at the time India and China combined accounted for one half of world GDP! And then comes the first burst of dramatic growth that triples Europe's standard of living in the 19th century while quadrupling that in the United States. After centuries of virtually no progress, rapid advances in the standard of living changed both the fact and the aspiration of what could be achieved. The driving forces were capital accumulation and technical innovation, the division of labor and the spread of skills and capital around the world.

WORLD PER CAPITA GDP
(1990 Int. Dollars)



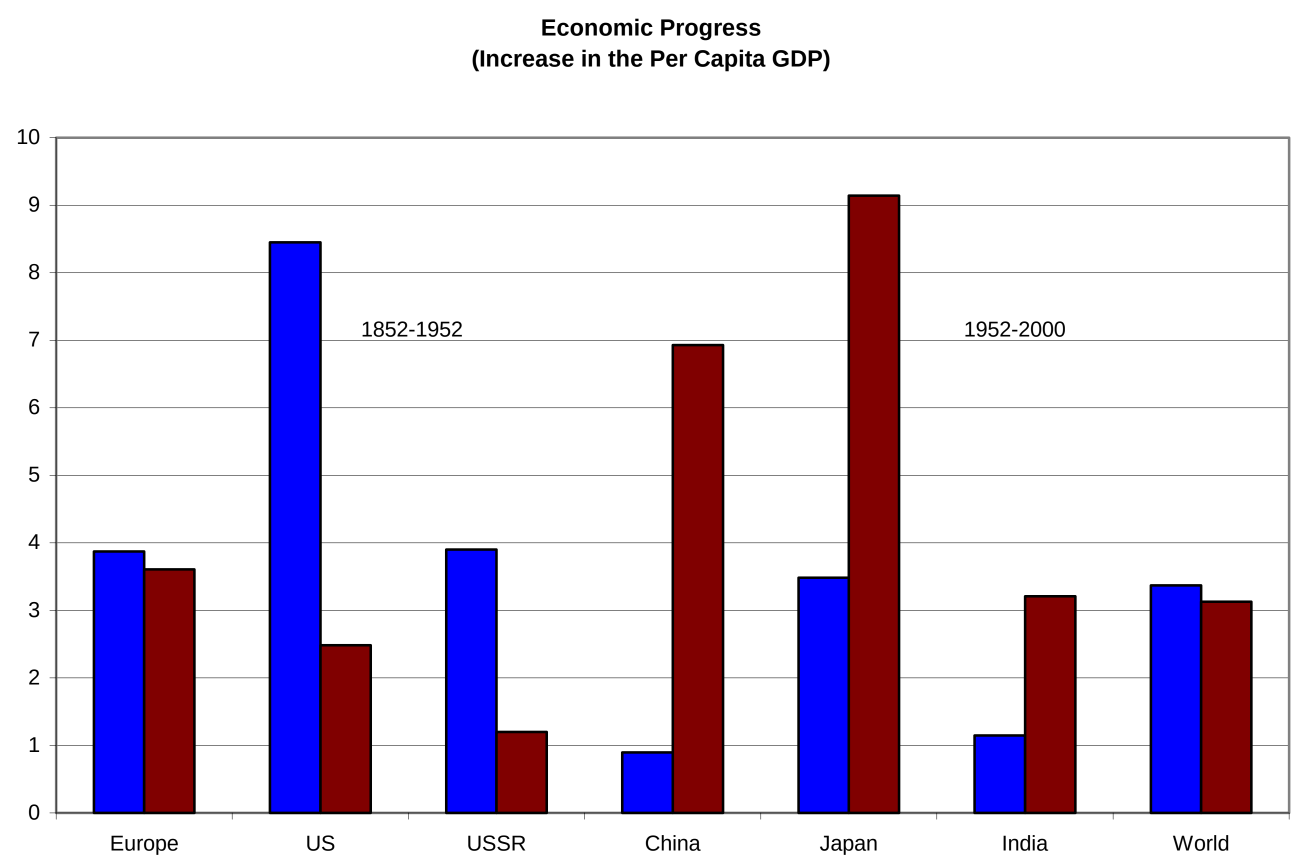
But what seemed dramatic progress in the 19th century does not hold up the achievements of this century. The 20th century as seen the most rapid advance in living standards on record, much of it concentrated in the second part. Just since the 1950s, Japan has increased its standard of living 8-fold; China has raised more than 7-fold its per capita income in that period. And emerging market Asia has done much the same. An opening world economy, high savings almost everywhere (except in the United States), and the implementation of ever better technologies and economic structures have done much to provide the engine and a half venture of peace (and super power competition) has helped not divert attention from economic growth. Whether progress is measured by automobiles and TV sets per head, the decline in the cost of phone calls around the world, exploding capacity of an ever smaller computer, the increasing perfection of a CD recording, or the laser surgery that yields a new life—by any of these measures, 1900 was the stone age compared o where we stand today. Long distance learning live and on the screen is far leap from black and white still photography.

The record pace of growth in per capita GDP in the second half of this century naturally invites the question of what is behind it and whether there is a common explanation that is useful everywhere? Economics identify two elements: first, and quite obviously, a high pace of saving and capital formation in the world. This equips the labor force with increasing amounts of machinery and structures and thus makes labor more productive. No less obvious is the other factor, technological progress that means that we learn to do things better so that the same amount of labor and machinery produces increasing amounts of output. In the same vein, technical progress also means that over time new ideas and improved technologies are embodied in better machinery and hence improved productivity. And so does better ways of organizing production and institutions that are more conducive to specialization and productivity. Some highlight creative destruction and others view stable accumulation as the trick —have war and ideological clashes held back progress compared to what it might have been without? Or is it possible, on the contrary, that they have been drivers of progress by destroying inherited crusty structures and obsolete technologies. The case has been made by observing Japan's progress and that of Germany after World War II, putting them far ahead of the rest of the crowd. But then why did it not work in France?



Economics Nobel laureate Robert Solow was the first to ask just how much of growth derives from capital formation and how much to attribute to the "residual" aptly named technical progress but really a bag for everything else. His stunning conclusion gave capital formation credit for just one-third of per capita growth and unidentified technical progress was responsible for the rest. That conclusion remains dramatic because it does suggest that the emphasis on saving and investment—s popular among communists, in Japan and in Europe—is perhaps overdone. After all, the economic game is about consumption, and if it is possible to both consume and get ahead, so much the better. But that is probably the wrong conclusion to draw.

The right one focuses on increased interest in just what makes up the mysterious technical progress. Is it good financial institutions, is it an economic setting that fosters efficient allocation, is it political stability and property rights, and is it Japanese-style of obedience training in schools and on the job? Is it copying other countries' best technologies or is that hard and unrelenting pressure of stock markets to extract yet better cost performance from CEOs and workers? Disappointingly, the empirical evidence does not give us a short list of factors enhancing technical progress; the evidence remains open except in a few respects: instability, inflation, mindless bureaucracies, closed and repressed economies—all these are environments where progress is possible but only by working and saving extra hard. But when it comes to corporate governance, US style versus Japan, or labor market characteristics with European long term relations or a US-style high turnover, it is hard to show that one or the other has the better influence on how to get ahead. Japanese governance and German labor market once seemed to hold out the prospect for much better performance; today one is identified with the bankruptcy of Japan and the other with the sclerosis of Europe. The search for lasting good answers continues.



Both the 19th and 20th century saw the rapid progress of the advanced countries and there is no surprise in that we identify them with innovation and sustained high rates of capital formation. But the surprise is surely that in just a span of 50 years developing countries have shaken off century-old backwardness. Japan was the first to embark on this path, starting with the reform waves in the last decades of the past century. (See Figure) But it was in particular the last 3 decades of this century that witnessed the dramatic performance of emerging economies throughout Asia but also, off and on, in other parts of the world. In this period, India near-tripled its standard of living. From endemic near-starvation it moved far in the direction of sustained rates of per capita GDP growth. Singapore came from nowhere to overtake Great Britain, China accomplished a phenomenal six-fold increase in the living standard starting from a situation in 1950 that was no different from what it had been in 1700! There must be no mistake in reading the Asian performance: it does involve very hard work—more hours and more days—and it involves formidable sacrifices of current consumption in favor of capital accumulation and economic advance. There is no indication at all that with equal effort Asia would have made the big lea forward. But yes, it has done so and they have covered the path of centuries elsewhere in just a few decades. Only very authoritarian regimes can accomplish such progress since in open societies sacrificing a few generations is not a viable option.

One is tempted to ask which major country is the great winner of this century. Clearly, Russia is not since there has been more suffering and deprivation and less progress than almost anywhere else is. That was not obvious by the mid-1970s when Russian per capita GDP peaked but it is beyond discussion today and it is increasingly the case. Europe, Japan, the US and China are among the finalists; on the sheer numbers Japan is the winner, the Great Depression and a drastic defeat notwithstanding. China is next with awesome growth of the past 3 decades. Europe and the US did well enough by historical standards—quintupling income per head in a century had no precedent, but just that and not the pace of Japan or China. That is quite in line with what modern growth economics teaches: the ones who come from behind move faster and tend, ultimately, to converge. But that pace of convergence is still very unequal and its continuation is not even a foregone conclusion: Russia and Africa are moving backwards, India is advancing but not at the gallop pace of Emerging Asia. For those who lead the pack, growth tapers off to moderate rates.

Globalization

The late second part of the 19th century had seen the steamship, railroads and telegraph as the major breakthroughs in joining the periphery to the world's center economies. Globalization was the rule in trade, in migration and in the free flow of capital. The gold standard was but part of what made the open world economy function. The rich countries write the rules, they had the gunboats to collect debts and they had all the interest in keeping open the world economy even as they collected colonies, spreading the benefits of free trade. This was the period where the US had risen rapidly to prosperity and where Australia and Argentina came to top rank in the world economy. Migration to the New World, and the migration of capital, rapidly developed the world's periphery. If there were concerns about globalization then, they were not memorable enough to be remembered.

The dramatic event if the century was the Great Depression—the total collapse of trade flows, belief in open trade, belief in free market economics. In a handful of years the lessons of a century were discredited. In just 3 years, from 1929 to 1932, world trade fell by 70 percent in value terms and 25 percent in real terms. Prices in world trade collapsed, and trade restrictions were mounted around the world, as "beggar-thy-neighbor" policies became the rule. Tariffs were escalated, quantitative restrictions and selected preferences became the rule, exchange control soon followed. The open economy had given way to protection of national markets and an overwhelming presumption that economics stops at the border. If these were the policies at the center, the periphery responded in kind. Debt default was common and industrialization behind protective barriers became the rule in those countries were commodity collapses no longer afforded a living. Latin America is a case in point.

But already by 1934, driven by the all-important US Reciprocal trade Agreements the attempt to reopen world trade got underway. But it would take decades to gradually break down the fortresses. A key part of that reconstruction was the Marshall Plan, which rewarded European restoration of trade. An attempt at a World trade Organization failed, but the General Agreement on Tariffs and Trade (GATT) became a pragmatic way of negotiating reciprocal, nondiscriminatory opening of trade. At the end of the 1950s gradually exchange controls were dismantled, for trade first and increasingly for all cross- border transactions. But all this was only the case for the advanced countries; the world's periphery and Japan had firmly accepted protection and currency controls as the only way to go. For them, opening up had to wait for the 1980s.

By the 1980s the world was basically back to where it had been before the collapse in the Great Depression. Of course, communications had improved radically and that made for more openness and trade and so did dramatic improvements in transport. But at the time, fully in the midst of an open world economy, it would have been a rarity to find sharp skepticism of globalization. That seems to be an issue of far more recent vintage, fostered predominantly by five factors: First, corporations learned to operate globally in the pursuit of markets and cost reductions. The recipe was easy, capital was mobile and I no time workers anywhere felt the competition from workers everywhere. Second, because of the mobility of capital, more financial accidents occurred, inevitably or not. Their large fall-out costs evidently cast a deep suspicion on globalization that had allowed the money to come in.

The third reason the global economy has a bad name is that competitive pressure forced governments to retreat from their statist policies. That left workers with a reduced sense of protection; standard responses of trade protection were ruled out by international agreements; there was no way to leave the ring. Fourth, with leverage and integrated world capital markets, a disturbance anywhere immediately becomes a problem everywhere. With more volatile economies and markets no day passes without reminders of the precariously small control people have over their economic lives. Lastly, the sheer pace of change in technology and finance, innovation, products, winners and losers outstripped people's ability to cope: their reaction is to opt out simply because things were happening too fast. They see predominantly the threat and very little of the vast benefits. They certainly fail to recognize that when jobs are threatened it is mostly better technology, which in itself is a blessing, rather than cross border competition that puts people out of their job.

Globalization is the great challenge of the end of the century because, unlike in 1900, the pace of integration of the world economy has become phenomenally large. Competitors like China can in a decade or two move from entry level technologies well into the middle level, threatening not only emerging markets but even established industries at the center. Workers believe that globalization is responsible for poor real wages and governments feel that their ability to control events, or at least give the appearance, is sharply diminished by the impact of world shocks on the domestic scene. The wish to opt out, or at least limit the interdependence, is heard all too often.

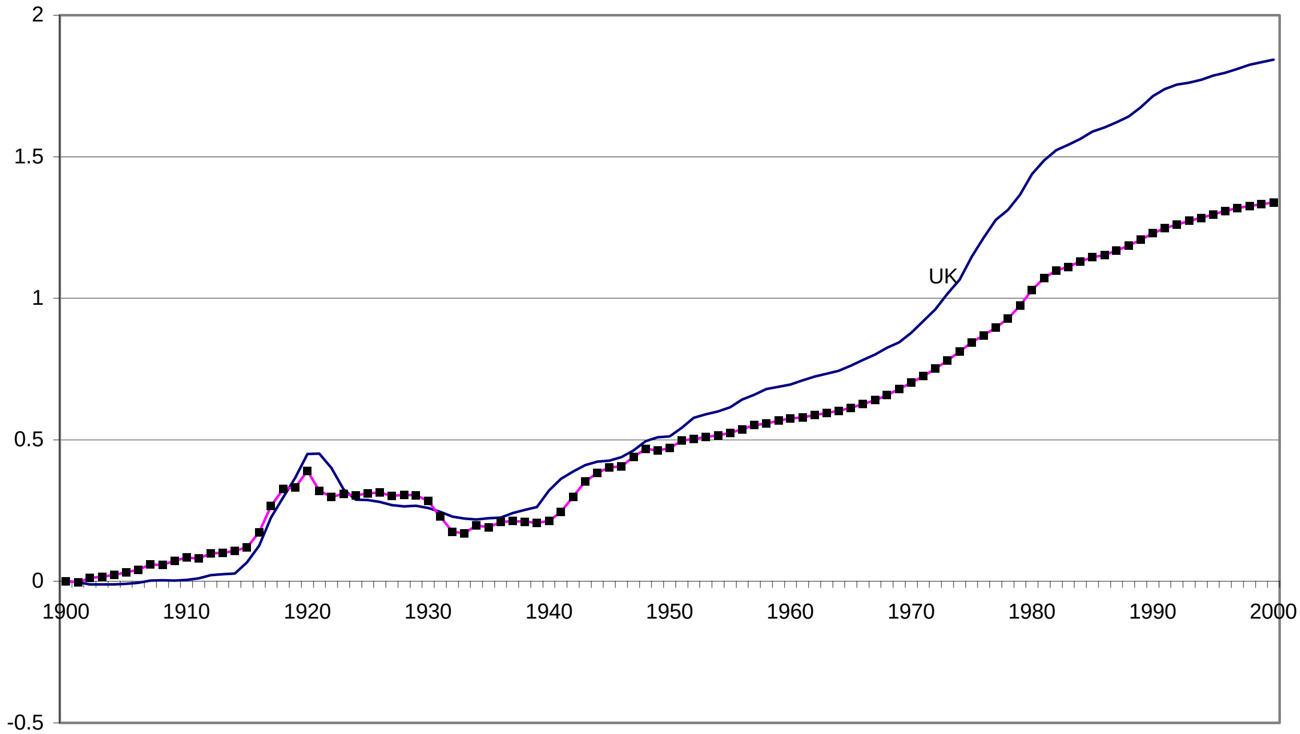
The openness and interdependence of the world economy is not going to be sacrificed. Nor can we be sure that volatility of financial markets declines or the pace of innovation and implementation of techniques slows down. Globalization will cease to be a concern in a generation or so when the young who have known no other world and are tuned to less stability come to be representative. But that means globalization will be controversial and will be challenged for quite a while and with a sympathetic hearing. It puts the burden on policy makers to keep the world economy open and to deal with unnecessary instability in a sound way.

The Fate of Good Money

Throughout the century, major changes in the value of money have been a prime economic and social issue. As the century draws to a close, the circle is complete: we are back to good money and to institutions that promise to keep it just that way. For most of the century we had inflation, interrupted briefly in the interwar period. The postwar II period in particular raised the issue of intolerably high inflation as the result of irresponsible monetary policy. (See Figure) The price paid for instability has been steep; both while it lasted and in the aftermath as good money had to be restored.

The century started with the gold standard: Britain has been there for a century, the US joined after the civil war and Germany after the Franco-German war; by 1900 every major country from Japan to Europe and Argentina was on gold. Very few countries were on paper standards and even fewer were hanging on to silver. The gold standard meant fixed exchange rates around the world, moderate inflation because gold discoveries were not plentiful and central banks or politicians had not yet discovered the printing press. Public finance as for the most part conservative and economic horizons were long—British perpetuities yielded 3 percent for much of the second part of the 19th century and onto World War I. Pax Britannica was a good monetary regime.

PRICE LEVEL IN THE US AND UK
(LOG SCALE, Index 1900=1)



World War I ended all that in the most dramatic fashion: Along with revolution and social upheaval, good money and the emperor all landed on the garbage dump. Governments who could do virtually nothing could do that one thing, printing money. Anmd that is what marked the early 1920s: phenomenal money creation and even more extreme inflation throughout central Europe and Eastern Europe. From Germany to Russia, from Austria to Greece. France, to its own surprise did not go quite as far, Britain and the US not at all.

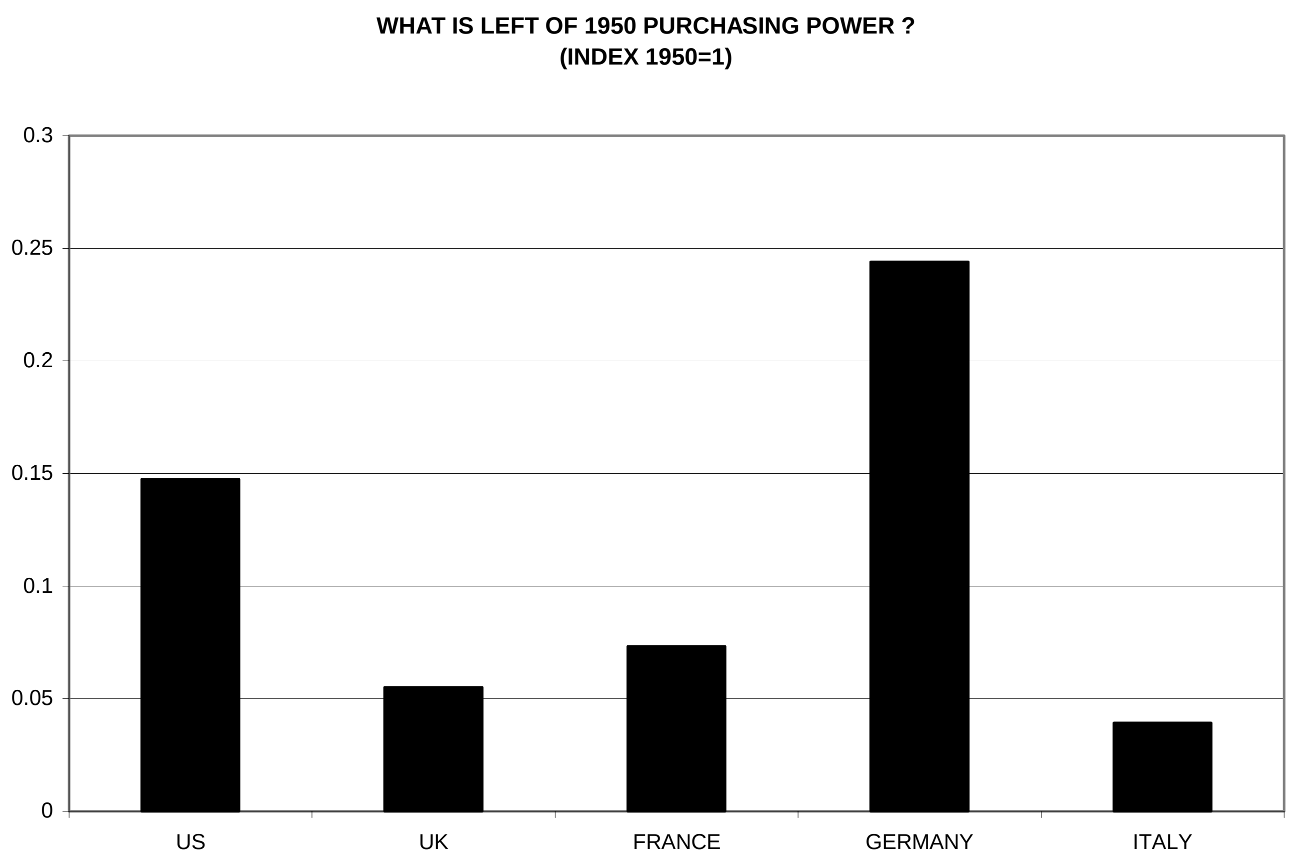
The hyperinflation of the early 1930s, was the first to be witnessed in recorded history. True, the gold discoveries in earlier centuries had led to a trend of rising prices, but ever so moderately. There had also been sporadic episodes of paper money inflation in France during the period of the assignats, in Russia in the 19th century and a bit in Austria, and in Latin America. But they were after all insignificant compared to the vast destruction of stability and wealth in the 1920s. Lenin said "if you want to destroy a country, destroy its money" sand that is, of course, what happened. There could be no more convincing and lasting undoing of the established order and the middle class. Hyperinflation was surely the prime reason for extremism to come.

The brief restoration of hard money in the 1920s did not last. Britain that had championed the return to gold around the world, and had in fact returned at the prewar parity locked itself into a desperately uncompetitive situation. From there it was just a few years to the next bout of instability as, following Britain, country after country went off gold, competitive devaluation became the rule along with exchange control and a collapse of world trade. But going off gold was neither easy nor obvious. It was a deeply counter-cultural move, going against the grain of everything Britain and the City stood for. In fact, Winston Churchill said at the time "nobody told me you could do that" – famous last words for the end of Victorian finance. Where in the 1920s hyperinflation was the rule, the Great Depression brought deep deflation, which was just as unsettling to stable finance or public confidence. Those who tried to stay on gold did terribly; those who printed more money and debased their currency most aggressively did best. The world had turned upside down. Internationalism and capitalism were discredited, nationalism and ever more pervasive government took their place.

Postwar monetary reconstruction did not come easy. Huge debts, private and public, had been accumulated everywhere and many of the assets, including the tax base, had been devastated. Price controls everywhere held off the confrontation between a vast monetary overhang and a shortage of goods; black markets were the rule, from foreign exchange to sausages. Monetary reform and reconstruction, including drastic write-down of private claims and public debts were the rule throughout Europe. Monetary reform paved the way for price liberalization and the extraordinary resumption of economic activity thought by many impossible. The audacity of reform in Germany, in particular, stands out as notable: US General Cassius Clay told the great reformer Ludwig Erhard "Mr. Erhard, my advisers tell me your boldness is crazy" and Erhard replies "General, my advisers say the same." Still, Erhard proved right, without functioning money, economic activity could not possibly start, with good money it could flourish.

On the domestic front, sound money was restored rapidly almost everywhere. With a brief interruption during the Korean War, inflation was not an issue. But on the external side it took to the end of the 1950s to restore convertibility and even then it was not general. France had recurrent lapses and Britain got there only in 1980 as one of Mrs. Thatcher's first moves in office. Japan got there almost a decade later and increasingly the entire world. Among major players, only India and China remain with inconvertibility as a vestige of government control.

The century's monetary history would not be complete without one more attack of instability and the fierce reaction to restore hard money at any price. US overexpansion of the 1960s, oil shocks of the 1970s and, above all, an unwillingness to confront slow growth or even recession to maintain good money are behind the Great inflation of this period. True, by the standards of the 1920s, this was serious inflation, but double-digit rates of price inflation alarmed the electorate and became an even more pressing issue than unemployment. In hindsight, a half-century of inflation has shrunk the purchasing power of money drastically in every advanced country. Germany fared best— of a 1950 Deutsche Mark there is almost 25 percent left in real terms; in France, the UK or Italy it is only around 5 percent. (See Figure) Clearly it is time to return to stable money and that was the battle of the past decade. The mandate for much better money emerged in a strong fashion and turned central banks deaf to the pleas for accommodation. A new order, dating from the early 1980s, increasingly took hold as inflation was pushed down hard and harder. It took a decade and another decade to make credible and lasting.



Today the world has no more inflation and, if it comes back it will soon hit a concrete wall. Central banks, in Europe and in the United States, are independent and committed to the idea that needs to be killed at its very inception. Surely that proposition still needs to be tested, surely bond market yields do not quite reflect that lasting regime change quite yet but skeptics are sure to be proven wrong.

Thus monetary and financial troubles prevailed basically from World War I to the late 1960s, that is for half a century. The world we know today s pretty recent even if it is a return to where we were a century ago. The fight for hard money that has market the past two decades has bought important changes in finance. Governments had to retreat and formally give up their authority over central banks. In Europe that has gone furthest with the disarmament of central banks in the soft money belt of Europe, from France to Italy and Spain. Debate about whether the ECB is a bit too stingy with interest rate cuts must not obscure the central achievement, money has been taken out of the hands of politicians who have mismanaged it for the better part of this century. The ECB is a monument to the proposition that money is too serious to be left to politicians: in these matters there is no such thing as a responsible politician, democratic money is bad money.

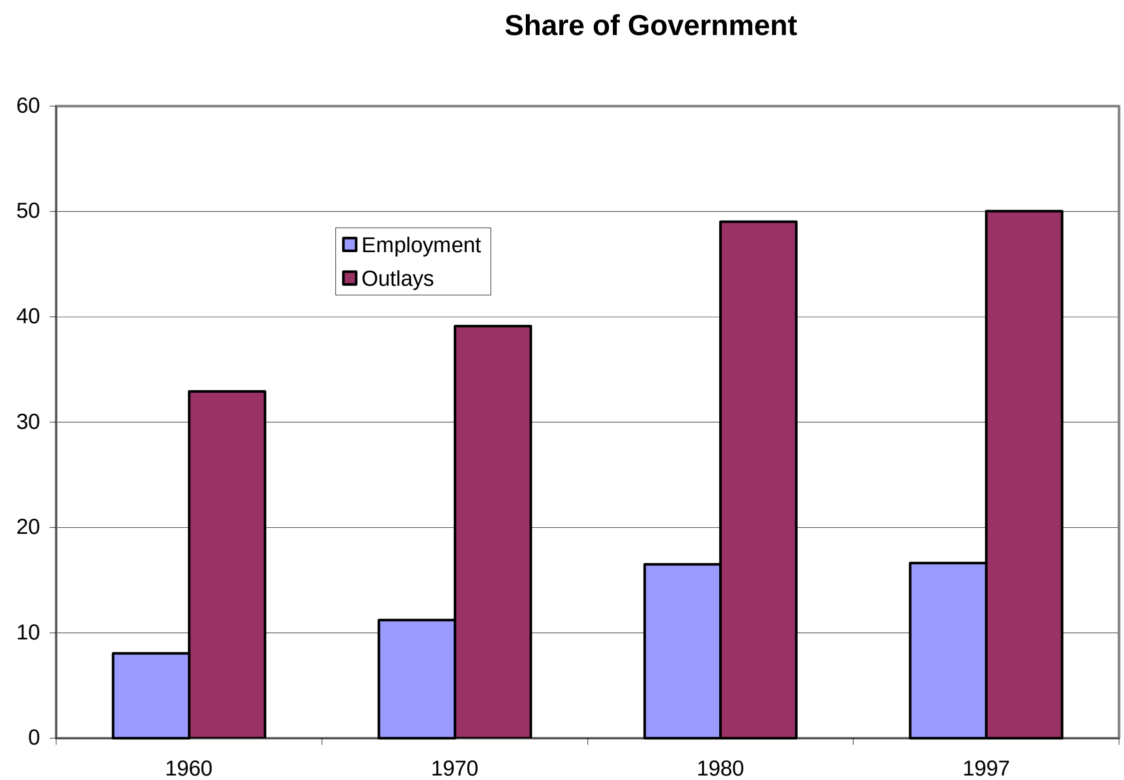
The quest for hard money is also taking over the periphery: country after country has suffered the clash between bad central banking and fixed currencies. In the aftermath of defeat and collapse, a simple lesson is becoming quite apparent. Countries with poor political and financial institutions cannot afford their own money. They will do far better with unconditional surrender to the ECB or the Federal Reserve. They should adopt the Euro or the US dollar as the national money, get the benefit of sound money and low interest rates, avoid crises and thus enjoy a better prospect of economic development. Surely, 20 years from now there will be very few currencies left in the world—just as at the beginning of the century. Perhaps there will be Chinese money is Asia, the Dollar for the Americas and the Euro for everything else. And perhaps the Swiss Franc as a collectors' item. The vast change in public understanding of hard money, and the resulting stability and lengthening of horizons is a great accomplishment at the tail end of a century of monetary turmoil.

THE STATE

In response to both the trauma of the Great Depression and a deep skepticism of free enterprise, the State has become a dominant part of economic life. At the outset of the century, outside periods of war, the state was minimal and so were levels of taxation, government employment or public outlays. Where before business and finance were substantially unregulated, now the State moved to the center in repressing free enterprise and initiative. Where before trade and finance flowed freely across borders, now it became national and regulated? Even in the area of production, state enterprise emerged as a response to bankruptcy or private economic power judged excessive. For some the rise of the State was an ideological response to a loss of confidence in capitalism, for others it was a pragmatic answer to a collapse of the world economy and of economic activity.

Whatever justification there may have been for big government in the Depression years and wartime, it was clearly gone by the late 1940s. And yet, big government had become the accepted paradigm and growing government the rule. But for whatever reason the State took center place in economic life, in the post-war years it has been awfully difficult to roll back the large advance the State made in every dimension. In fact, once the State played a key rile in economic life, it was natural to look for ways of expanding its functions and powers to deal with an ever wider range of "problems", substituting government employment, subsidies or spending for adjustment. The government grew; the private sector shrank in freedom, size and initiative.

It is interesting to consider just a few numbers marking the case of Germany. (See Figure) By 1960, government employment accounted for 8 percent of the labor force. By 1997 it was 16 percent. And that number does not completely measure the government's largesse since there is in addition the large group of unemployed who are paid not to work and thus keep the status quo and social peace. Government outlays in 1960 amounted to 33 percent of GDP and by 1997 they had almost reached 50 percent. Surely it is not exaggerated to say that much of the spending is devoted to stop people from working and that much of the state apparatus does little but to slow down private initiative and success. Just what was the problem the government was solving that the private sector could not deal with? The answer is obviously that society rejected adjustment and free market responses as a solution—why accept hardship if the government commands purse and power to sustain the status quo. People were paid not to work or firms were subsidized to keep producing as if reality had not changed. Regulation completes the picture in the product market by barring initiative and competition.

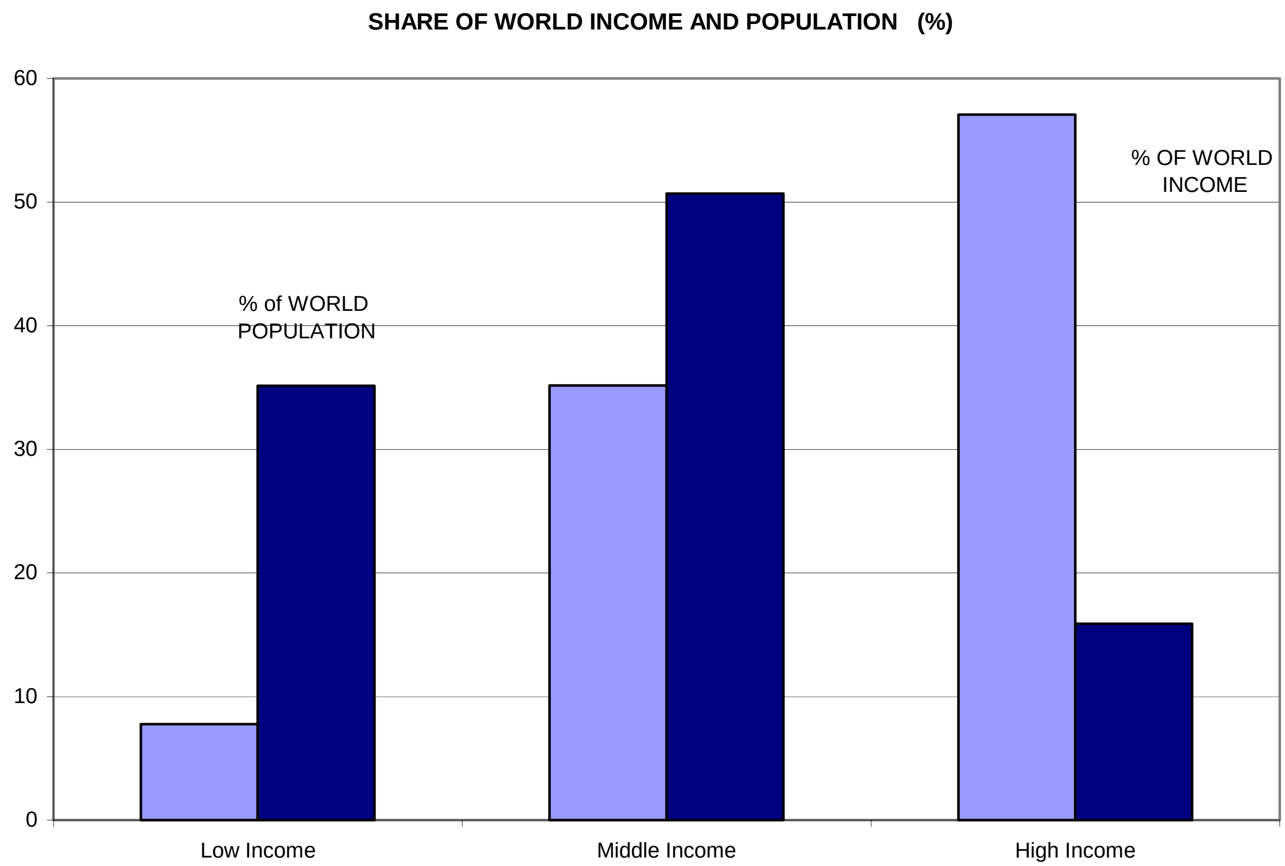


The fight to restore stale money was much easier to win, particularly in Germany, (See Figure) than the battle for a more productive and financially responsible economy. The reason is obvious: inflation is an immediate threat to the current generation's assets and their sense of stability. They react immediately and give policy makers a mandate to fight for stable prices. But when it comes to government spending and jobs the choice runs the other way: borrow from the future and support current waste. Never mind that resources are wasted today and create huge tax burdens for future generations, stick with the status quo. It is apparent now that it is unlikely that a major boom resolves these problems and affords an easy adjustment. Communism has fallen, but capitalism is still not accepted in large parts of the world, notably in Europe, where statism keeps being entertained as a third way. It is not a third way in fact; it simply amounts to shifting burdens to future generations. The reality is that the bad habit of bloated public sectors and bloated unemployment rolls, the lack of individual initiative and responsibility are a dramatic mortgage on future generations and the next century.

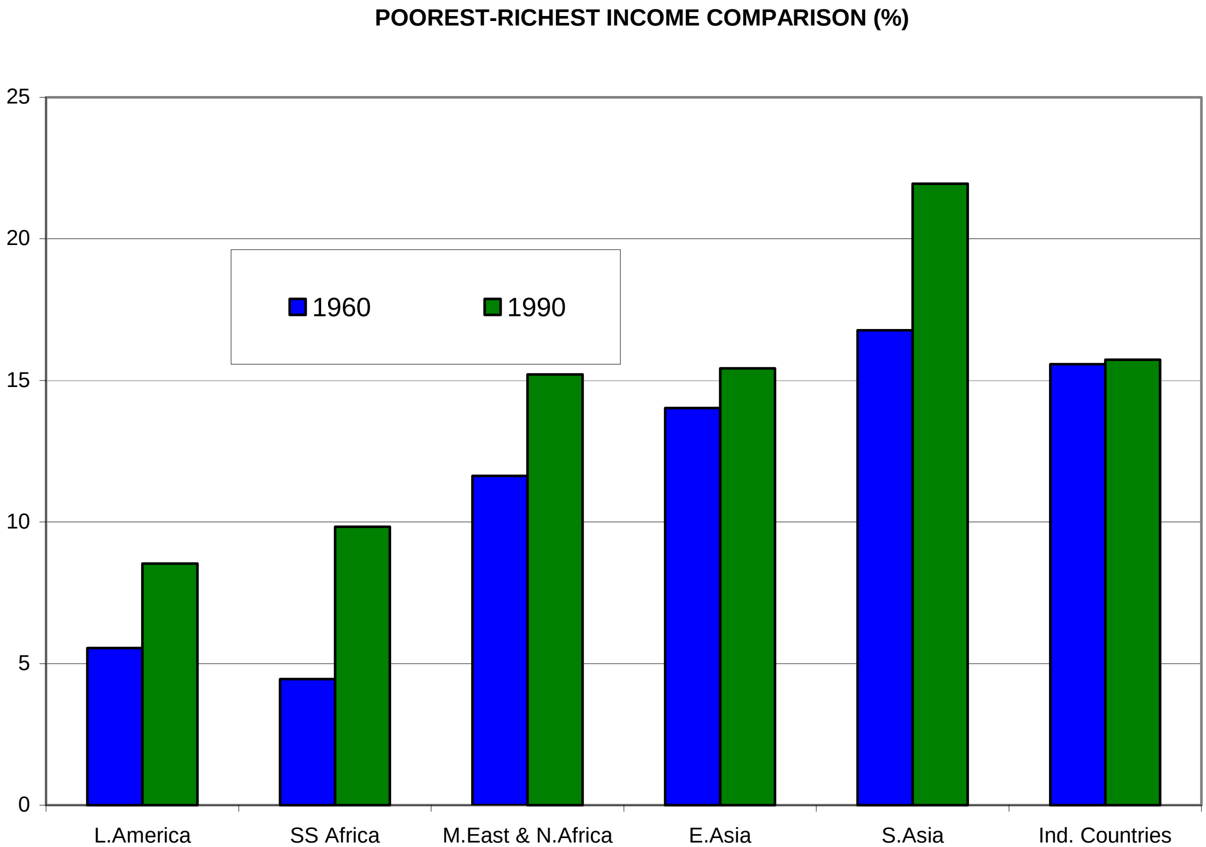
Inequality

Inequality in the world economy is real. It is there across countries, between the rich center and the poor periphery. And it is there with countries where wages are often highly dispersed. Inequality, of course, must not be confused with poverty even though at the bottom they might feel the same.

The most immediate pass at this issue is to look at the distribution of world income and population (See Figure). Not surprisingly, high-income countries have the overwhelming share of world income, nearly 60 percent, but have barely 15 percent of world population. By contrast, the poorest countries in the world have 35 percent of world population but less than 10 percent of world income. And even these averages disguise the even more striking differences between the upper income groups in rich countries and the poorest in poor countries, day and night. Clearly, there is nothing remotely resembling equality nor is there a trend in that direction.

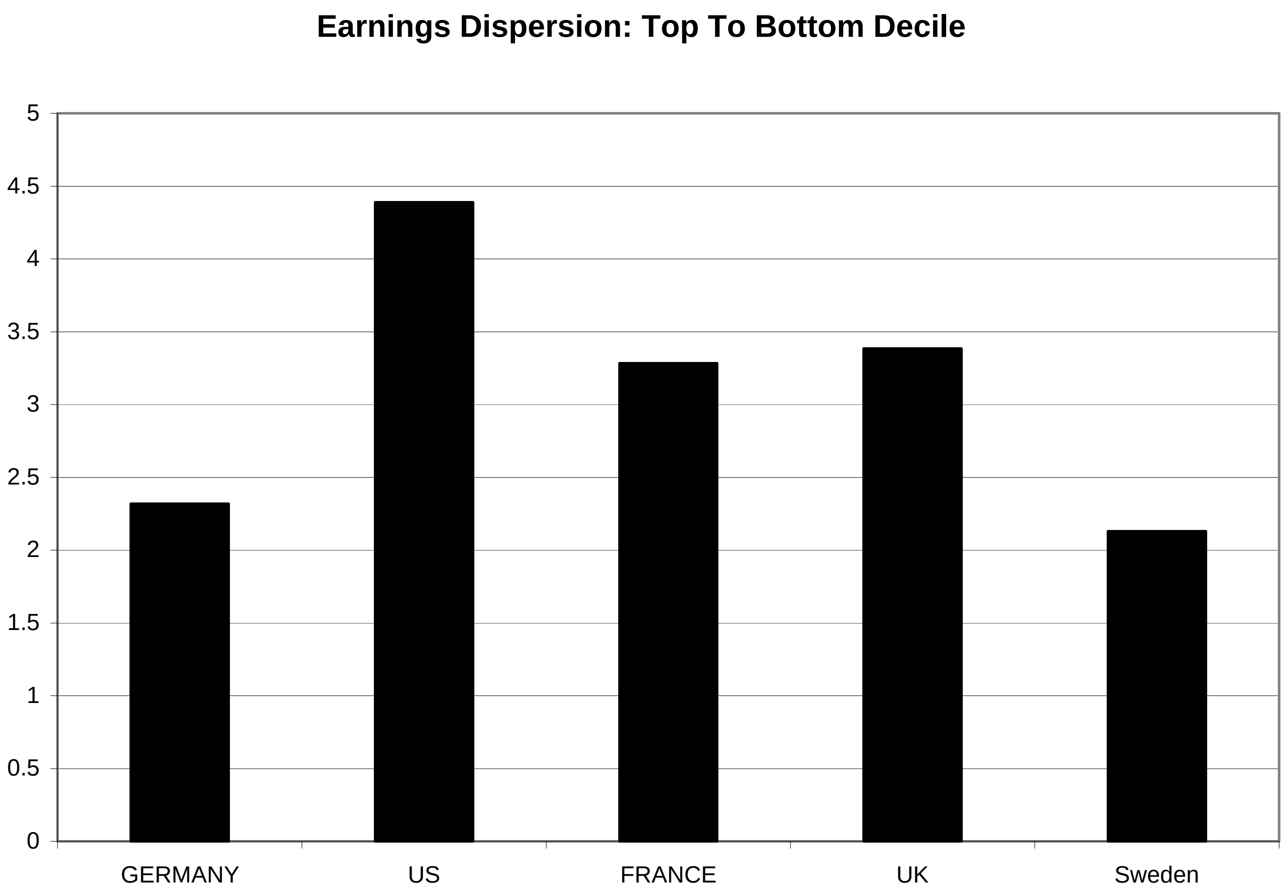


Within countries, comparisons of poor and rich the story is actually more favorable, at least in the past 30 years. Of course, the poor have a far smaller income share than the rich, but everywhere the discrepancy has declined. In Latin America where the poor used to have 5 percent of the income of the rich they are now up to nearly 8 percent. In the far more equal Asian region, the poor have moved from 16 to22 percent of the incomes accruing to the rich.



And there is a third dimension of inequality, this one on the job. How do the top and bottom groups (deciles) of the labor force compare in earnings? Are wages highly compressed by custom or unions or the fact that one worker is just like any other in skills and motivation or anything else that counts? Or are wages dispersed with starts and losers. (See Figure) Across industrial countries we see dramatic differences: as expected, the US has the largest dispersion, almost twice that of Germany. Not surprisingly, German workers resist the American model because pessimistically they believe that somehow they will wind up at the bottom even though not everybody can be at the bottom.

What is wrong with inequality? Poverty is bad, but inequality is not. Surely this is one of the battles of the end of the century. In open and competitive markets, wages in any year or for any person may have a large good luck/bad luck component. But surely on average they reflect energy and talent, motivation and investment in human skills. Any society that limits rewards to accomplishment will achieve equality, but it will come on a low common denominator. Rewards to excellence, or inequality if one wants to call it that, are the great driving force of progress. Public policy should be concerned to give broad access to strong education and pay less attention to the outcomes of the economic race. Three cheers for inequality; it is good for growth and growth is the best way of rooting out poverty.



THE ECONOMIST IN THE 20TH CENTURY

A century of dramatic economic events can be viewed in terms of its great economic controversies and the leaders that have emerged in the profession. In this perspective, the century started with Victorian calm— everything was known, Alfred Marshall of Cambridge had codified it and there only remained the details to be filled in. Free enterprise, stable money and an open world economy were the playing ground for prosperity. There was not much in terms of policy other than the gold standard.

The interwar period with growing depression in England, the collapse of financial markets and the ensuing Great Depression, was a dramatic challenge to the profession.

This was not supposed to happen, at least not cumulatively and ever for the worse. By 1930 the classics were on the garbage dump and a new generation was brought revolutionary new ideas to cope with the greatest threat to prosperity in memory. They were all rather special: Schumpeter who as finance minister failed to stop hyperinflation in Austria, ruined a bank and then became a professor. He said he had three hopes—to be the best horseman in Austria, the greatest lover in Europe and the best economist in the world— and claimed to have succeeded at two of them. John Maynard Keynes who was as much an intellectual and brilliant writer, a financial wizard (he lost two fortunes and made 3, mostly in the German hyperinflation) as a deep economist and an acute policy maker. And then there was Irving Fisher of Yale, gone bankrupt 3 times (his own, Yale’s money and that of his wife) in misjudging the stock market, famous inventor of the Rolodeck and live healthily and the answer involved sleeping outside, in particular in winter.

While Keynes comes away as the winner in the context for dramatic and practical ideas, Schumpeter and Fisher left important legacies in the way we think today about business cycles, growth processes and the interaction of deflation and economic activity. Keynes clearly dominated the scene: his focus on inflexibility of wages and prices and the limits to monetary policy in a depression (now rediscovered in Japan) brought fiscal spending to the foreground. Leave gold and start spending. Governments should pay people to dig holes, never mind that nobody needs the holes, pay them to fill them in again and the incomes earned will be spend and if done on an ambitious enough scale, the economy can spend itself out of recession or depression. This was radical thinking, both in fiscal terms and in the role of government, and it worked. No surprise that governments for decades bought into Keynesian ideas until public debts had become too high and waste too big to give it further credence.

The next generation of formidable economists was Paul Samuelson and Milton Friedman, the heroes of the 1960s and into the 1970s. Friedman was the free market and hard money advocate, and a brilliantly articulate advocate at that, the very incarnation of the Chicago School. Samuelson of MIT, by contrast, was the modern Keynesian, a Democrat in politics and a formidable thinker about how to formulate a modern and mathematical of economic theory. Both had their victories: Samuelson won in the 1960s when he urged (along with many others) the Kennedy administration to spend its way to prosperity—and they got there. The only rival to that expansion is what is still underway today. But overexpansion gradually build up wage and price inflation and by the early 1970-s, with dollar collapse an oil price shocks the experiment became largely discredited. Pump priming with monetary accommodation can go some way but if overdone will crash. No sooner had inflation emerged; Milton Friedman had his time on the stage. Monetarism was the rage; the quantity theory of money was back in full swing. But his contribution, and that of other scholars at the time, went further: crudely summarized, it said, you can fool some people all of the time and some people some of the time but not all people all of the time: more technically, the public catches up with what governments do, they (ultimately) have rational expectations. The practical implication was to minimize the scope for government cyclical policy.

Friedman's doctrines became the background for a dramatic period of rethinking economic doctrine: the leadership was provided by Robert Lucas of the University of Chicago. Taking rational expectations to the rigorous extreme, his theories concluded that government should adopt a monetary rule, an unchanging flat tax rate and be done. In other words, government activism merely confuses, misfires and distorts, government get out of the way! Economic agents are rational, they do not leave $100 bills lying on the floor, and the economy does better without activism in policy. Few, at least of my generation, would believe the starkest renditions of this view. But the truth is that our profession by and large views Keynesian economics with deep skepticism, accepts monetarism by and large, assumes that government has a proclivity to make things worse. The profession has become deeply conservative just as it had been at the beginning of the century. And governments are going that way too, from the care in creating a tamper-proof ECB to the Waigel pact, balanced budget amendments, currency boards and overarching respect for the bond market.

ANGST 2000: WHO IS IN CONTROL?

People of middle age and up around the world perceive that globalization undermines the stability of their lives and that volatility, falsely perceived to be higher than ever, puts them at grave risk. They feel they have lost control and they perceive the same is true of their governments. They want assurance that security is regained, someone has to do something. Surely these sentiments will get far worse if and when Japan crashes. That is altogether possible since Japan's debt is huge, its budget deficit is mind boggling, its financial institutions are bust, its investments have been bad, its policy makers are unconnected to reality, and the loss of confidence is pervasive.

And there is the potential of a US crash, less likely because monetary and fiscal policy can respond but never say never. Even with all the US prosperity, the world today has had an overdose of finance and hence it is far more likely that a serious accident can happen. And if it does, we can be sure the fall-out is worldwide and we must fear that the first instinct is to play the defensive and destructive strategies of the Great Depression.

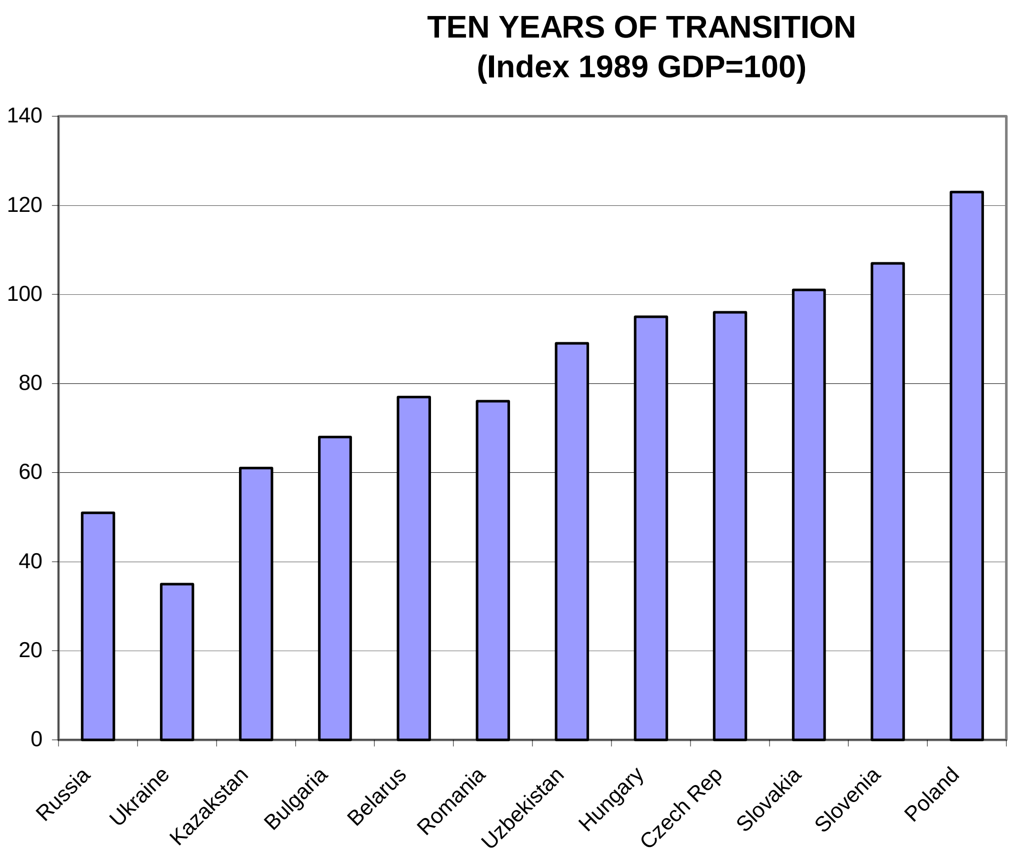
Citizens want to know who is in charge? The answer is nobody; the US can't lead Japan, Europe cannot lead the US. The US urges Europe to move to prosperity policies but has no resonance; the US urges Japan to move out of recession but gets no hearing and surely no success. Europe is critical of the huge US trade deficits and lack of saving, not recognizing that if the Us started saving the dollar would come down and Europe would lose jobs on a large scale. The Japanese dream of not buying US T-bills, not realizing that the Yen would go through the roof and the Nikkei through the floor.

The world does not need more regulation and agreements to fix this or that; it does need a heavy dose of prosperity policies. Milton Freedman, in commenting on the Great Depression, criticized the Fed for not printing money massively. That is the message to Japan. To Europe the message surely is to get deregulation underway so that dynamism in business and employment starts freeing up the fiscal side for emergency use. If Japan and Europe start moving it is time for the US to think of a smaller trade deficit; that will come automatically as the rest of the world recovers. The US role today is to assure that stock market problems at home do not become world problems and to make certain that ideas to fix exchange rates get nowhere and, along with its partners, insist that the world economy remains open.

June, 1999

TEN YEARS OF TRANSITION

Economic transition in the aftermath of communism over the past decade has by-and-large been quite disappointing. It is interesting to ask just why. But some facts first. The accompanying Figure shows estimates of 1999 real GDP relative to the base year 1989. Poland, Slovenia and the Slovak Republic are above the 1989 line, Poland quite a bit so. The rest lies below to various degrees. Russia and Ukraine are the worst. Of course, there is an immediate need to question the numbers. True, official estimates tend to focus on the survey of large industrial firms, precisely the ones hardest hit. As a result, the most industrial countries would seem to do worst. By the same token, much of the new activity is informal or outright underground and hence is substantially or altogether missed in the GDP estimates. All of this is somewhat correct and it is also easily exaggerated. Perhaps one wants to scale up the bottom countries somewhat to make allowance for the far larger prevalence of the underground. (The data reported below are EBRD estimates updated with IMF growth forecasts for 1989 and 1999). It is just not the case that Russia, correctly measured, trailblazed ahead with 7 percent growth a year. It is not a fact that Ukraine rather than being a pathetic misgoverned post-communist place is a star performer. The numbers mostly tell what happened—moving backwards in the worst places and moderate advances in the best.



Now where to look for the reasons? There are three deep reasons for relative performance. We might call them the initial conditions.

- In economic performance, as in retailing, location is everything. The well-performing countries have the tangible and intangible benefits of immediate proximity to Western Europe. (East Germany got an overabundance of it by marriage)
- The strong performers have a far more recent communist record and, as a result, could get back to their roots that much easier.
- The strong performers had relatively favorable politics—no federal issues as in Russia, for example, because Czechoslovakia split up at the outset.

But beyond these immediate facts, there are strong forces that flow from poor performance to poor institutions and back from there to a lack of growth. Here is an immediate list:

- Fiscal and Monetary Instability. Maintaining fiscal discipline is a hard task, more so in the collapse of an empire. In the 1920s,m in the breakup of the Austro-Hungarian Empire, hyperinflation was the rule for the center. And the same has happened to much of the Soviet Union.
- Lack of economic institutions. The absence of property rights and their enforcement, and more generally deep criminalization of economic activity, focuses attention on

asset grabbing rather than the building of institutions and businesses. (See the book by A. Shleifer and R.Vishny *The Grabbing Hand.)*

There are more detailed issues such as the quality of the financial system, the presence or absence of large initial debts, the extent to which an economy's initial production was absurdly uncompetitive, the presence or absence of important primary resources. And the list surely includes politics. Does a country have excessive social democracy or is it disillusioned relatively early. Does a country have high levels of literacy or has it, on the contrary, low standards of education and suffered selective emigration. But we must not overexplain. After a while, everything becomes more or less endogenous, reflecting the country's performance and priorities rather than what was there at the outset.

And what comes next? Will the laggards start picking up speed even as the front runners get their act together and start closing GDP gaps with the West at a rapid pace? Neither is very likely. The front runners are not the old-style Asian economies where investment rates are huge and productivity growth stunning. They are more nearly laid back and slow motion. Five percent is a great growth, 4 is good enough. Catching up with the West may be an issue of 50 years or more. And as to Russia, Belarus and Ukraine, extreme pessimism is surely the right answer. It will take another economic revolution to put in place an economic system that is not outright dysfunctional as the present one. The notion that assets without owners makes for a troubled economy was totally right. But the strategy of building up a Mafia had far more extreme economic and political consequences than the reformers, or anyone else, imagined.

GERMANY'S ECONOMIC FUTURE

The German economy has two faces. One is that of an immensely successful country, near the top in living standards in the world; so rich and stable that even the momentary appearance on the scene of a Lafontaine could not do much more than make a momentary dent in the stock market. The other view is that of a country that is plan stuck: mass unemployment, slow growth, and no idea of what to do about it and even less courage to try. Not try, at least outside the established boundaries of consensus and don't rock the boat. That was true for Kohl who basically did nothing (other, of course, than unification for which he deserves a big place in history). And it is even truer of Schroeder who looks the wrong way every time he gets a chance.

What is left are plenty of initiatives where Beamte of all stripes try to teach business how to get ahead and where experts look at the myriad distortions to make shopping lists of a grand agenda. Predictably that leads nowhere. And why would it; Germany is rich, most things in every day life go right, small changes in the right direction help rationalize why much more is not only impossible but perhaps even inessential. There is no crisis, there won't be a crisis anytime soon, and without one, why expect that anything will change?

Not The Worst

To start with, here is a benchmark. Germany is by no stretch of the imagination the worst; not in living standards among the richest economies, not in hourly compensation and surely not in sheer effort expanded on working life. Far from it.

Germany ranks among the top in the world when it comes to hourly compensation: workers are paid more, and the government piles costs on top, than in virtually any other place in the world. And as to hours worked, those Germans who do work spend fully 25 percent less time on the job than Americans or the Japanese. How does all this translate into living standards? Not so good! GDP per head, adjusted for purchasing power parity and on a scale that places the US at 100, Germany stands at 75 percent, i.e. far less successful in terms of the living standard. In fact, Germany runs behind France or Belgium, Canada ands Scandinavia and only marginally of Italy. Yes, the wages are high, but the purchasing power is low and the combination takes much away from what would seem a super rich country. Of course, we can debate how the numbers are made, but by World Bank measures, that is what comes out. That surely is also part of the quality of life.

Of course, these all measures of accumulated success, a payoff on the efforts and creativity of the past decades. A more current reading, particularly from a business perspective, comes from the world Economic Forum *Competitiveness Report.* Here Germany is thoroughly uninteresting, placed #24, far behind the Anglo Saxon economies, the Singapore's, Ireland or Switzerland. It is right there with France, Sweden and Spain who share the disdain for free market economics. What is the high standard of living to workers looks like a serious lack of competitiveness to firms. True, when Germans work, they do work! But they work fewer hours, they cost a fortune, and each worker has 6 Beamte and 10 trade unionists walking behind him to make sure work does not get out of hand.

Another perspective on how Germany ranks comes from the stock market. Consider the relative value of the German and US stock market. Not a good picture even if we admit as is surely right. For years the relative value of Germany has fallen. Investors don't see what good news lies ahead. And they are right. Companies are moving in small motion on things that elsewhere happen at a hot pace. Investors are a sideshow; they get what is left after trade unions and the government, and regulations and inefficiency, and lack of competition have taken their toll.

True, the US stock market will tumble one day and that will change the picture. But if and when it does, will the German market go, too? And even if it does not, with say a 30% drop in the US market, holders of stocks in US business are still way ahead of those who have put their bet on German firms. The stock market is forward looking; it asks what lies ahead. Of German stocks it says, “not much, sorry”.

The overall picture is mixed; accumulated success, comfortable living standards if not the best. But surely it is not the place people talk about when they look for a business opportunity. But if they do not, who will pay the upkeep? Unemployment is huge, the welfare state is generous, debts are high and unfunded pensions are huge. True there is no crisis, but is there a reality that is being denied? Not even that; there is sheer and patent discomfort already. Reality is not altogether denied, it is merely resisted. Everybody knows that all the jobs-summit talk notwithstanding, unemployment will not fall. Everybody knows there won’t be a boom that solves all problems, everybody knows that there is a mountain of public debt that won’t go away. But in the absence of a perfect answer, i.e. an answer that everybody can accept, no answer is the best that can be expected. In the meantime, tax reform is a good topic, but it surely is an insignificant part of any solution strategy and more nearly diverts attention from essentials.

Hopes of the Euro

It is as well to dispense with any thought that the Euro, or more broadly the European Union, provides answers that make the status quo more viable. The Euro has already lost quite a bit of its glamour—it was supposed to carve out a major place in world finance, push the dollar aside and soar in currency markets. Not quite, at least for the time being. In fact, just now there risks being too much disdain for the Euro. After all, it will have some beneficial impacts for European growth, albeit small benefits and they won't come fast either. To start with we must denounce a claim that surely is exaggerated.

- The Euro will not lead to great gains in competition and transparency: Exchange rates have been fixed in Europe for more than a decade (discounting Italy's momentary departure). Everybody can divide by the exchange rate and any repeat purchaser surely will. Price discrepancies in Europe reflect two facts: first, all prices (like all politics) are local. Second, price discrepancies do have a lot to do with the limited competition at the retail level and anti-competitive practices.

- One great payoff on the Euro is the financial disarmament of the periphery—Italy and Spain, even France. The common money has made these regions safe for investors and that in turn is reflected in lower interest rates and higher growth; risk premia have been sharply compressed because they no longer have central banks or exchange rates to play with. Macroeconomics is gone as far as local initiative is concerned and that is a good thing in a world where whenever the Banca d'Italia practices "independent monetary policy"; investors can't run fast enough. In this respect, the Euro is a thoroughly modern institution, well adapted to a highly integrated and trigger-happy world capital market.

- In the medium term, the Euro reinforces financial deregulation (national and cross border) in Europe to create a broad and deep capital market. Europe comes from a very segmented national and bank-based financial structure. It is on the way to a US-style capital market where households hold funds and companies issue paper and stocks; intermediation margins are small and governance significant. European companies will benefit from the transformation and it is likely to be the most significant supply side influence we will now see.

- There is no prospect of the Euro changing deeply and fast the world capital market in the sense that portfolio shifts will favor the Euro and that some alleged dollar privilege – remember General de Gaulle speaking of the *exorbitant privilege*, always a French obsession--. The Euro will not, per se, appreciate on the dollar just because it is the new kid on the block. In the labor market, Europe cannot afford a steep appreciation and that, for one, is why it won't happen. Central banks are well equipped to avoid the appreciation by offsetting open market operations and treasuries can reinforce it with their funding policies.

In sum, The Euro, complimenting a lot of other deregulation measures and the force of new financial technology will help Europe have a better capital market. That is very good, it does not unfortunately mean that growth will double. The benefits are measured by perhaps one tenth of 1 percent extra growth. Nice, but not on the scale of solving big problems.

If the Euro won't make the difference, how about the rest of the world? Can we look to a world economy which brings strong export growth. That would be nice because with strong export growth, solving problems might be postponed or they might get solved all by themselves. No good news here either.

Hope on the Domestic Front?

If the rest of the world does not solve the German problems, perhaps the cure can come on the home front. Not so, because two major obstacles stand in the way of a major upturn in growth and a virtuous cycle of mobilizing energies for growth and prosperity. The first is a deep-seated proclivity for consensus.

Historically that is easily understood. Coming out of the Nazi years and with communism next door, a very inclusive economic regime was the obvious strategy for consolidating politics. Government, unions and business all crawled into the same bed and never came out. "Social Partners" is the euphemism for the corporatist arrangement, which of course stifles competition and initiative, not to speak of reform, deregulation and dramatic deregulation. First growth was high enough not to raise issues of structural rigidities. Next, when the rigidities did start to come to the fore, the government simply borrowed for 2 decades to paper over the frictions. By now there is not much growth and there is far too much debt. The answer is obvious, but doesn't expect it to be implemented outside a major crisis. In the meantime, there is too much talk about fairness and too little talk of individual responsibility and self-help, and of the sheer social unacceptability of people shirking work and ripping off the taxpayer.

The second problem is an endemic lack of initiative, taught in the schools, reinforced in the business organizations there is a nasty little story that circulates about a major German corporation that went shopping for high tech boutiques in California. On the home front the research team rebelled: "we can do the same things, they said" So why haven't you, management asked. "Because nobody told us to," was the answer. Germany excels, and is stuck, in mid-level technologies—great cars. But it has little of the upper level technologies that matter today to be a front runner, nor the mindset and the structures to quickly become a player. True, education levels are far superior to those in the US; but formal education does relatively little if the mindset is passive and the reward structure set by business discourages innovation adventures. The government's attempt to foster a learning society, reminiscent of Al Gore at his worst, completes the picture of a country that can see where it should be, but cannot get itself to make the big leap. That is not surprising, things are basically o.k., so why rock the boat?

Could it be that Germany made a big mistake getting rid of Lafontaine in great haste? Perhaps it would have been better to let him do his thing, produce a crisis and, in the aftermath, thus give way to an entirely different economic policy model. Germany's consensus model is its greatest enemy.

What then is a plausible assessment of Germany's economic future? The central scenario is thoroughly average behavior: 2 percent growth, stable unemployment, increasing fiscal problems, substantial vulnerability if the world economy goes wrong. Not a winner by any stretch of the imagination, nor a problem case for sure. Being part of Europe, and Europe becoming a key player in the world economy, will detract increasingly from comparisons of economic performance of one country or another. The American Century is over and the European one is not about to start. More likely than not, Japan's formidable economic problems and emerging security issues of Russia and China will be on the agenda soon and the economic race of post-communism will look like a golden age even for the losers.

August, 1999

PRIVATE MARKET RESPONSES TO FINANCIAL CRISES

Much of the discussion of what happened in Mexico, Russia, Brazil and Asia just cannot get itself to accept a simple proposition: the central reason for currency crises is deep mismanagement of national balance sheets, exchange rate policy and political responsibility. Is it a surprise that many of the crises occur shortly after an election? And if that is correct, should we not be intrigued to ask whether there might be a sheer coincidence here or more nearly a pattern?

Similarly, in looking for remedies, much of the discussion is hampered by looking for answers within the confines of existing institutions. But there are perfectly good answers which, even though they are no panacea, offer a real answer in many instances. The answer of course, is to push private sector solutions in place of and expanded role for international institutions combined with limitations on private initiative.

What Went Wrong?

The reaction to the Asian crisis was striking: Asian leaders and much of other commentary was astounded that Asian economies should go on the risks. After all, in these economies there was no inflation to speak of, no history of public finance in disarray but on the contrary high national saving and investment rates, unrelenting hard work and abstinence. This was not Latin America where crises were as much and as plausibly part of the landscape as day and night. With these reflections in mind, it was natural for Soros and Mahtir to concur that markets were out of control, institutions deficient, the beast was loose. Just how to tame it and lock it up might give rise to differences of opinion, but yes something had to be done to limit speculative access of private capital.

It is useful at the outset to make a distinction between old style and new style currency crises. The old style crises centered on the current account: with limited reserves and limited borrowing ability, overspending and misaligned currencies would ultimately lead to a crisis simply because the money for finance would run out. Moreover, the end of resources was clearly there for everybody to see. There might be a little issue of how a government by controls and other expedients might gain a few extra months, but ultimately the days of the exchange rate (and the finance moi9nister) were counted. And then the crisis would happen and it would be mostly anti-climatic: a devaluation, the fall of the minister, ands soon the beginning of another round of overspending and overvaluation. The basic characteristic of these old-style crises are three: first, they are not really crises, since nothing much happens when the currency goes. Next, they are highly predictable in that they are *slow-motion events,* and third they have little fall-out since they typically happen in a situation of repressed finance.

By contrast, currency crises today focus on the balance sheet and they are the outgrowth of large and liquid liabilities relative to a country's ability to muster assets at short notice. These are *fast-action crises* and they are highly explosive since they bring down not just the currency but much of the national financial sector and public finance. These balance sheet crises are emerge in the aftermath of financial deregulation, domestic and cross-border, and they reflect a reckless approach to value at risk: the balance sheet, national in the financial system and large corporations' balance sheets as well as cross border. The balance sheets are misaligned in respect to maturity and currency denomination.

The value at risk perspective ids central to understanding these crises: In the aftermath of Mexico's earthquake the discovery was made that many high-rise buildings were constructed in violation of safety standards—too much sand and too little cement. Corruption in the supervision was, of course, the explanation. Much the same is the interpretation of the balance sheets in the currency crises countries: teso bonos in Mexico, the public debt and the banking system's unhedged dollar exposure in Mexico, the investment bank's Brady bond assets And short-term dollar liabilities in Korea, and on the story goes. The common point everywhere is the utter inability of balance sheets to face bad news and the explosive interaction of foreign-currency denominated debt and extremely short maturity of the liabilities. Asian economies, indeed, saved a lot and invested a lot but they also ran reckless balance sheets just as Russia or Mexico or Brazil. This is the common point that needs emphasis, not the precipitous and devastating withdrawal of capital when the bad news strikes. The notion of sound and unsound balance sheets focuses precisely on the need not to be exposed to unmanageable withdrawal risk, not to have a single event –withdrawal cum devaluation, bring down the financial sector like a house of cards.

The balance sheet and value at risk perspective draws attention to the distinction between the immediate reason why a crisis may have occurred—a government's inability to keep interest rates high or a movement in the dollar yen rate on one hand and the actual devastating events which are unexplainable without reference to the appalling state of balance sheets. Not focussing on balance sheets misses the point unless one is interested in cover up which, of course, policy makers always are. But in a post-mortem designed to lead to a better institutional set-up the near-exclusive focus should be on the balance sheet issue rather than the details of what broke the camel's back.

No Panacea Either

Much of the official reaction to the recent crisis is the recognition that yes there were balance sheet issues but emerging market economies have little institutional capacity to remedy these. Accordingly the answer should be found predominantly in the area of exchange rate management and increased resources for the IMF. Surely, that is not a panacea.

Increased exchange rate flexibility, for example in the form of flexible rates cum inflation targeting which is the new truth, is hardly a mechanism for avoiding currency overvaluation, the build-up of bad balance sheets in the process and the ultimate prospect of a currency crisis. In fact, inflation targeting was precisely what got Chile into problems in the late 1970s, or Mexico, or Russia.

More money for the IMF is attempting solution— the forces of public order should be able to outgun the hooligans. But surely it is also the case that the IMF is in fact utterly incapable to exert the discipline that goes along with lender of last resort functions. The IMF is totally political, dominated by the convenience of member countries, including importantly the US. Far from avoiding crises, the IMF does not even see them coming! More money therefore must predominantly work to weaken the incentives for creditors and debtors to focus on balance sheet risk. There may well be room for a lender of last resort, but not without supplementary policies that create more incentives for sound finance.

Getting to the Right Answers

Recognition that currency crises come from the interaction of bad domestic financial policies and bad balance sheets leads naturally to a three-part reform proposal. Currency boards and the closing of national central banks, offshore lenders of last resort on a commercial basis, and mechanisms for an automatic lengthening of debt maturities as a market mechanism. These measures are not a panacea to remove all and any kind of instability, but they certainly would take us far in the direction of reduced vulnerability to crises. For countries in compliance with this agenda, it makes even sense to contemplate a lender of last resort that focuses on systemic interests.

<u>Lenders of Last Resort and Supervision</u>: If not the fact of the crises, surely the magnitude was strongly affected by the terrible balance sheets of financial institutions. Of course, the state these balance sheets were not an inadvertence but rather a combination of the fallacy that in high growth and high saving countries balance sheets are irrelevant because the sheer passage of time solves all problems and a deeply corrupt process of governance. How to do better. The argument that administrative capacity in organizing bank supervision is lacking may well be right but it is not the last word.

An obvious solution goes in this direction: mobilize off shore *private* lenders of last resort. For a commitment fee these lenders will be there to provide capital when banks are up against the wall. This is organized on a commercial basis and hence the lender of last resort has all the incentives to measure and control the risk of being called to the mat. Accordingly they will do two things: first, they will do the due diligence and supervision that governments are unwilling or unable to provide. Second, the prices they charge, competitively, will reflect the expected risks. These prices in turn feed back to the owners of banks as an incentive to run less risky balance sheets. Even governments come into play. High commitment costs imply a high national cost of capital and hence poorer performance on growth. Accordingly governments have an incentive to contribute to a macroeconomic environment that is more congenial to financial stability. Thus decentralizing the problem and using a private market solution creates a virtuous cycle of a far better banking system.

True, like all arrangements, there is some homework to be done in creating contracts that are enforceable— specifically, avoiding that as the contingency arises, guaranteeing banks balk at having to pay up. But that is no different from credit lines or other commitment arrangements that are unwelcome for the guaranteeing institution since they arise precisely in those instances where lenders would prefer to be out of the play. There is no indication that credit commitments are routinely defaulted on. It seems too flimsy an objection to a scheme that for many countries might be a good first approach to risk reduction and risk management in national balance sheets.

Maturity Risk: The sheer magnitude of currency collapses, and the resulting dislocation of balance sheets, credit and activity is closely related to maturity mismatching. Balance sheet liabilities are very liquid and assets, such as real estate or corporate loans, are at best medium term and definitely totally illiquid. The mismatching implies that at the slightest sign of trouble, rollover of debt is denied and a big gap opens up on the external side as a country is put in the impossible situation of paying off at short notice much of the external debt. The implication, of course, is a currency collapse and that very expectation adds capital flight to the outflow.

The answer, of course, is a better management of maturities. An attractive way of doing this is a contingency in contracts. Should an international institution, say the BIS (or any other mutually agreed party) declare a state of illiquidity, loans automatically are rolled over and maturities are automatically lengthened. Of course, this would be part of standard loan agreements and loans would be priced accordingly. Countries that are highly stable would more easily and more favorable terms get access to credit. Countries that appear less predictable and more vulnerable would pay higher fees.

The incentives work in the direction of countries perceiving that there is great merit in creating better institutions and entertain better policies so that the cost of capital declines. This is just another version of the lender of last resort except that in this instance it is an automatic rollover, which avoids the liquidity crisis and thus creates a mechanism to avoid pervasive bankruptcies, debt default and overdepreciation. It is a market-based approach to “baling-in” the private sector. As such it is much preferred to the current ex-post approach of bending arms to rollover debts that are basically unplayable.

Currency Boards: National central banks have been key players in creating the financial vulnerability that was the back drop of the crises of the past few years. Closing the central bank is a thoroughly modern response to a world of high capital mobility and powerful international speculation. The great hope of emerging market economies is to get interest rates as close to NY as possible. But currency risk and credit risk leaves spreads that can be extreme. The currency risk part is totally redundant since it is a premium paid for misconceived national pride and the option to debase the currency.

There are few advantages to national money and none to a mismanaged one. The common argument is, of course, seigniorage—the one or two percent of GDP in revenues accruing to a national treasury from the issue of a *sound* money. This argument is correct but, of course, against it must be held the cost of financial crises that may occur as a result of having a national money. It is not at all obvious that the balance is unfavorable to the currency board solution.

The other powerful argument involves the loss of relative price flexibility. With a currency board, easy adjustment of relative prices via exchange rate movements is gone. Hence there is the need for going the hard way via deflation of wages and prices. Again, the argument is correct but two caveats carry the balance. First, governments do not actually use the timely flexibility. On the contrary, they overvalue cxurre3nces in search of disinflation and then protect the overvaluation with high real rates until they ultimately experience the crisis. Examples such as Mexico or Brazil, or Asia, amply make the point. Second, reserving the option of devaluation carries a currency premium in interest rates. Accordingly, the cost of capital is increased and that may have as much or more of an adverse effect on competitiveness as a misaligned fixed exchange rate. In other words, the devaluation option of a discretionary exchange rate regime adds to the cost of capital and deteriorates competitiveness, more so the worse the country's macroeconomic tradition and prospects.

Even if the need for relative price flexibility is given more room, it is useful to ask just how much flexibility we need. The answer is almost always very little. In a world of extensive capital mobility, transitory disturbances can and should be financed rather Ethan adjusted to. That is the message of inter-temporal economics. That leaves permanent disturbances as the instance where relative prices should
It is obvious from trade patterns that a currency board model fits Latin America, using the dollar, and Eastern Europe with the Euro as the reference. But there is a genuine question of what to do with Asia. Pegging the en is one answer, or the Yuan even though that is obviously premature. In the meantime, just pegging the dollar may be a better solution—as suggested by Hong Kong, than mismanaged pegs or ad hoc policies.

Concluding Remark

There are two basic approaches to reform of the international system. One is to expand the scope of what has patently failed so far: more money for the IMF. Calomaris and Meltzer (*National Interest*, May 1999) express well skepticism of this approach. The alternative is to pose an entirely different question: how can private market solutions contribute to making an inroad. Even with that approach, there will be crises, no doubt. But maybe they do not need to be quiet as frequent, big and above all predictable as we have seen in the 1990s.

The proposal leaves no special room for the IMF because it has not shown itself particularly adept at detecting potential crises or preventing them. But with a year hindsight it is worth saying again that IMF remedies, once the crises hits, were dead right. Currency stabilization is the sine qua non of stabilization. On the macro front the IMF did well and hence Asia is doing well!

SHOULD CHINA DEVALUE?

A year ago, I published this essay "Is China Next?" in the *Financial Times* (August 4th). It is reproduced here, followed up with a more fundamental argument. What can be said a year later. The World Bank's chief economist is calling for devaluation and rumors abound. Is China about to throw the bomb? May be China is, but at least as interesting is the question: "should China devalue?" The answer given here is a clear no, the solution lies to its woes lies somewhere else.

Is China Next?
Pessimism has been a good rule of thumb of late in judging Asian financial prospects. Is it now time for China to join the Club, lose stability and become part of the ever-widening Asian problem? Chinese devaluation is on everybody's screen. China does not need a devaluation; its leaders would do well to reject it squarely rather than hold it out as a solution to the growth problem or a blackmail tool in high stake international poker.

The belief that China will devalue, sooner or later, rests on the fact that the country faces extraordinary restructuring challenges both in the banking system and the state enterprise sector. These problems are hard to solve at the best of times, but without high growth the prospect strains political and social stability. But unfortunately growth is down substantially, running somewhere between 5 and 7 percent according to most recent outside forecasts. That compares unfavorably with the 10 percent average of the past 15 years and lies below the official target of 8 percent. The growth problem is, of course, in large part a reflection of an export collapse: Asian markets are central for China and they are gone and so is export growth. In the past decade it amounted to 20 percent, in the first half of the year it was down to only 10 percent and by now it may well be running at zero. Since exports (in value added terms) account for 10 percent of GDP, going from 20 to zero growth costs directly 2 percent of GDP and including income effects perhaps as much as 4. The problem is real and not about to disappear. Hence the conclusion: devaluation to get back to export growth is inevitable. The problem is this conclusion is wrong.

China clearly has control of its exchange rate. True, all of Asia has undergone a competitive devaluation leaving China with an overvalued currency and poor export performance. Even so, the external front is not under siege. Capital controls are quite tight (and getting tighter as the Liberation Army is coming under scrutiny), there is a substantial current account surplus and there are sizable foreign exchange reserves. That picture differs sharply from all the economies that have gone under. Moreover, if an extra buffer is needed, capital inflows can be made substantial by allowing more flexibility on joint ventures. That appears to just have emerged in telecommunications and, with pressure, might come in further sectors. The point here is that China is not hanging on to the last penny in reserves, about to call in the IMF and the US Treasury for their emergency package. On the contrary, on the financial side they have the wherewithal to hang in and defend the present exchange rate if that is the policy choice.

Devaluation then is an option, a poor one, but not something inevitable. A small devaluation does little; a large devaluation will surely trigger a major round of financial instability and currency depreciation throughout the region, including Japan. A small devaluation does nothing because, in China's case, import content of exports is upward of 50 percent. A 10 percent devaluation thus gains barely 5 percent in competitiveness but of course highlights the prospects of further depreciation to come. A large devaluation will directly help competitiveness, but if it triggers repercussions (starting with a collapse of Hong Kong) and competitive devaluation everywhere, or higher interest rates to stem such an outcome, it does not help create better export opportunities. China is a big player; as such it cannot pretend it is inconsequential and get by with undercutting everybody. It is also the case that China's substantial trade relation with the US is already a problem—a bilateral trade surplus upward of $US 50 billion. Reinforced by a Chinese devaluation, it will have every opportunist in the Congress complicate key policy objectives such as the WTO and permanent MFN. In sum, devaluation might be a really bad idea.

On the domestic front, too, devaluation is highly doubtful as a strategy. A large devaluation makes it obvious to every Chinese that the Yuan is not as good as the dollar. The obvious implication is the emergence of a black market in dollars and bank runs to convert deposits into currency on the way to dollars. Losing control of the shaky banking system under the pressure of a devaluation is distinctly less interesting than banking reform over the next few years in the context of domestic financial stability. The Chinese leadership abhors financial instability: they have long memories remember that the Kuomintang lost China when they allowed extreme inflation. In fact, in the late 80s, the authorities very deliberately pushed down growth to fight inflation and the same happened a few years ago. Financial stability is politically even more important than high growth.

Domestic expansion can make up for poor export performance. The Chinese budget deficit is very small and so is the domestic public debt and inflation. Accordingly, there is absolutely no reason not to move ahead with fiscal expansion to shore up growth. Such spending need not take the form of extra empty skyscrapers in Shanghai; it might just mean dealing with the pervasive bottlenecks in China's infrastructure. The substantial leeway for fiscal expansion offers some reassurance on the growth front and thus takes away some of the urgency of an export revival. Of course, it does not help much in calming pressure for devaluation from the export lobby.

Talking out of both sides of their mouth, Chinese officials have joined the discussion of devaluation. Threatening the prospect of devaluation, they have railroaded the US into trying to save the yen. At the same time they try and leave no doubt as to their commitment to being Asia's leading stable economy. China would do well committing itself to the current exchange rate (taking pressure off Hong Kong) and hunker down for a few years with a focus on domestic growth and reform. Growth at 6 percent is a miracle anywhere else, it should be enough for China to both raise the standard of living and deal with economic restructuring. If China gets too close to devaluation, what seems like a controlled event may turn out to be a loss of control. The Chinese leadership should get on with the WTO and get off flexing international financial muscle with the devaluation blackmail. Devaluation is a loser's game.

The Debate Continues

That was last year's text; a year later, the debate continues. Chinese devaluation rumors abound and the most common view is that sometime next year a more flexible policy is inevitable, likely, to be expected or the thing to do. The continuing focus is the lack of growth in China, deflation, the formidable restructuring problem and the clear loss of competitiveness.

Accepting Chinese numbers at face value, mostly because there is no alternative set of data and even critics have been unable to offer anything better, the external side is not the problem. There are capital controls, a current account surplus, and high reserves. The debt numbers further encourage the belief that the situation is manageable. Debt is low (not much larger than reserves) and mostly long term. Domestic debt is very low, less than 20 percent of GDP not counting the prospective bank clean up. And that number understates the net with of the public sector on account of the vast holdings of state assets, which in principle could be sold.

Table 9 The Chinese Macro Data

	1997	1998	1999	2000
Inflation	2.8	-0.8	-1.8	0.5
Growth	8.8	7.8	8.2	8.4
Current Account (% of GDP)	3.3	2.3	1.1	1.5
Export Growth (%)	21.0	0.5	1.8	6.7
Reserves (Bill $US)	143	149	150	150
Budget (% of GDP)	-1.6	-5.1	-6.0	-6.0

Source: Goldman Sachs

The argument for devaluation therefore must come mostly from the growth front, the old-style beggar-thy-neighbor argument. At present, a large increase in public sector spending keeps China going and interest rate cuts reinforce that mechanism. But low confidence in the face of restructuring and unemployment make it hard to sustain growth and hence the conclusion that a devaluation would help.

Suppose we take 1996 as a benchmark in judging what has happened to China's external environment. The accompanying data show both the size of external markets and the competitors' or markets' price levels in dollars. (We use exchange rate adjusted-CPIs for simplicity). The European and US markets have grown while the Japanese and emerging

Asian markets of the crisis countries are almost back to their 1996 levels. With further growth ahead, the market issue increasingly goes away.

On the side of competitiveness the problem is real. All Asian crisis economies, as well as Japan, have a fall in their dollar price level. For Japan this is insignificant. But for the other economies the decline in price levels ranges from 15-25 percent to near 50 percent in Indonesia. Moreover, inflation rates are not high and hence will not rapidly eliminate their real depreciation. True, since 1998 there has been a significant improvement in China's competitiveness but not enough to return to 1997 or 1996 levels.

Table 10 The Chinese External Environment
(Index 1996=100)

	1997	1998	1999
External Markets			
Emerging Asia	104.3	96	98
Japan	101.4	98.6	99
US	103.9	107.8	112.5
Europe	102.3	105.2	107.4
Dollar Price Level			
Japan	92	85	94
Thailand	85	70	79
Korea	88	64	76
Indonesia	86	39	56
Singapore	97	86	84

China's current account surplus and export growth have fallen sharply. In part that reflects an aggressive export strategy in Asian economies where the collapse of domestic demand has brought about far more export dumping over and above what comes from increased competitiveness. But competitiveness is decidedly an issue, too. In China, on balance prices have fallen slightly so that relative to Japan there is not much of a change in competitiveness. Relative to the US there is a minor gain. Consider next China's trade pattern. Near 60 percent of China's exports go to Asia, a third of that number to Japan; near 20 percent of exports to North America, somewhat less to Europe and the rest a little bit everywhere. A rough number for the loss in competitiveness is 10 to 15 percent—by no means negligible, by no means devastating. Accordingly, the numbers don't get us much further than arguing that there is a problem, that devaluation is the traditional medicine and the question of whether and when it will happen.

We noted above that the World Bank, or at least its chief economist Joe Stiglitz, has publicly advocated Chinese devaluation. From a point of view of the world trading system that is of course dead wrong. Urging on large surplus, low debt countries devaluation is an invitation for beggar-thy-neighbor policies 1930s style. No doubt, a Chinese devaluation would trigger a new round of devaluation all over Asia, or at the very least the expectation thereof. Asset prices would fall everywhere including ion Japan, and growth would fall off. An already far too high dollar would be pushed even higher as Asia seeks to resolve its employment problems by ever-larger trade surpluses. Emerging market lending would once again get hit. WTO accession of China would become even more troubled as protectionists everywhere get hit by another cheap-Asia wave. Clearly, this is not a good direction to go.

China has been right to use monetary and fiscal policy. As a temporary strategy, this cushions the impact on demand of a more difficult external environment. What is exchange controls useful for if not to cut rates dramatically? And what is a low debt situation useful for if not to run temporary budget deficits. And yet these are just temporary remedies that cushion the unfavorable external and domestic environment, they go no further than that. Something more needs to happen.

China's problems won't be resolved by a devaluation of 20 or even 40 percent. Much of the trouble is not the bit of loss in competitiveness from the recent devaluation of other Asian economies. China is stuck in a much more fundamental way, stuck a third of the way between inefficient statism and free enterprise. China needs to make major moves in the way it organizes economic activity. A vast number of people can be employed if only the government stops protecting State enterprises by restrictions on production and internal trade. China needs to decentralize by opening up the production system to private initiative; self-employment as well small and medium sized businesses have to be the way out. Aggressive lending of a cleaned up banking system with a new credit culture supplements that strategy as does business friendly taxation. This is a time for very radical moves.

And as if that were not enough, opening up China to a major joint enterprise, foreign direct investment or privatization drive provides a one-time bonus to prosperity over and beyond the supply side effects. The proceeds can be divided between equally workers, local authorities, a general tax cut and the central government. In short time, money and entrepreneurship would create a boom in employment and activity. Large countries cannot expect to recover lastingly at the expense of the rest of the world; they need to find ways to bootstrap domestic demand. China with its huge state enterprise sector and the pervasive restrictions on just about anything that is useful has a unique way to do so. More so in that it has an immensely entrepreneurial culture that can't wait to be allowed to play the game. Its mistake has been an excessive attachment to the existing economic structure, which has turned deeply counterproductive and needs now to be dismantled very fast before the loss in confidence pushes the economy much deeper under water.

Anyone who believes devaluation is an answer to China's problems misses the point. If the leaders look to devaluation as the answer, they may make their problems even worse.

October, 1999

ROBERT MUNDELL—NOBEL LAUREATE IN ECONOMICS

There was a time when all great international economists were Canadians; Robert Mundell, this year's Nobel Laureate fits the pattern with abandon. He surely is the most creative economist in his field in the second half of this century. Even though his most decisive work lies a few decades back, accomplished by a very young man at the time, it has stood the test of 3 decades better than most of economics and without much amendment. The Spanish philosopher Spinoza said that poetry is a net with which to catch reality; Mundell's models are just that, too. They are powerful abstractions, stripped to a clean minimum to make a fundamental point of just how the world economy works. A great prize for a great master.

Mundell's research honored with this prize falls into broad categories. One strand asks how monetary and fiscal policy work in a world of capital movements, i.e., the real world of today and quite unlike that of pervasive exchange control of the 1950s. His argument was this: Small countries, e. g., Canada, cannot get far away from NY interest rates; if the monetary authorities try to push rates down, one of two things happen. Under flexible rates money will try and leave and, as a result, the currency depreciates and that is how stimulus is created. By contrast under fixed rates money also tries to depart and it succeeds, frustrating the attempt to expand the money stock and to push down rates. Drawing on the Canadian experience under fixed and flexible rates that nobody had given much attention, Mundell created today's understanding of how policy does work in open economies and the conditions under which it can or cannot succeed. Similarly, he demonstrated that under fixed rates fiscal expansion works like a charm, under flexible rates it is useless because currency appreciation offsets the fiscal stimulus. If this sounds like a big deja vu, it is because you learnt it in college; in the 1960s it was the most dramatic revelation of how to think about policy once capital is mobile.

The second line of inquiry is the question of monetary standards. An economy where no nominal quantities are fixed —the exchange rate, -- any of these: the wage rate, the quantity of money—has no anchor. Economies without a nominal anchor are unstable and the quality of money is poor. By contrast, hard money regimes do have an anchor such as the gold standard, currency boards or just fixed exchange rates. In exploring alternative monetary regimes, Mundell focused on the conflict between the advantage of a flexible exchange rate, as an adjustment mechanism in international competition, and the disadvantage of flexible rates in segmenting the domain of what otherwise might be single money. Money is better the larger its domain, but the fewer exchange rates there are the larger the need for something else to yield, namely, wages and prices, which are notoriously inflexible. Out of this reasoning came the formidable notion of an optimum currency area—mobility of labor within the area substituting for exchange rates as a way of solving regional adjustment and on the outside the exchange rate does the work. This line of reasoning led to the idea of a European Central Bank and common European money, with a flexible rate on the dollar, long before European politicians and even fewer economists imagined common European money as we have today.

A third direction of thinking has been far more speculative but ultimately just as productive, namely, the idea of supply side tax cuts. It caught on with the *Wall Street Journal*, it caught on with Ronald Reagan and it was a cornerstone of the American boom that is still on today -- much to the surprise of the skeptics at the University of Chicago who could not figure out what was there other than blind faith in search of a model. And the same goes for Mundell's recurrent fascination with gold. For most economists gold goes in teeth, around the neck or on the pinkie. In Mundell's rendition it has a more central place as the basis of a monetary standard in a world otherwise without an anchor. Whether he is quite serious in this is open to doubt; he does like on occasion to be outrageous, intellectually, and delights in leaving an audience baffled.

If Mundell is celebrated today for his path breaking thinking he deserves no less credit as a formidable teacher. Just about a year ago his students, and their students, got together to honor him on his 65th birthday – the assembly was Who's Who of international economics, all sharing affection and admiration for a teacher who had never answered a single question but many. He probably never read an exam but was immensely generous in allowing his students to grow and shine. Among the many that deserve mentioning is the present governor of the Bank of Israel, the chief economist of the IMF and the late Doug Purvis of Queen's University.

Mundell is not your typical academic nerd. A portrait would be incomplete without highlighting just how much he enjoys the unconventional: He paints, and not pretty flowers. He has been rebuilding a castle outside Siena in Tuscany; he is the proud father of grown-up children and now of a 2 year old; and he loves throwing intellectual bombs. Watch out for the next one, perhaps in his Nobel speech.

THE IMF AND RUSSIA

Ironically, for all its sins, the IMF is now brought up on charges of conspiracy to launder monies for the benefit of the Russian Mafia. Of course, the IMF has no friends in Washington and surely could not win popularity contests, no more than Treasury Secretary Larry Summers or Vice President Al Gore. They all get thrown into the same pot— they screwed up, they lost Russia; and they probably failed in their responsibilities when they poured money into Russia that soon reappeared in NY money laundries or Switzerland. For Republicans who have no real issues in this boom economy, here is a wonderful chance to cry foul, dig deep, throw mud and hope some sticks. This whole debate is silly; there are serious IMF-Russia issues but they certainly do not have anything to do with the recent money laundering allegations.

And even more serious is the question what the West should do with Russia.

Consider briefly the money laundering issue. Under IMF programs, in exchange for policy measures that enhance stability—low inflation, stable currency, balanced budgets—the IMF provides foreign exchange loans. These monies, by their sheer presence in the client-country's reserves, inspire confidence and help bring about stability. And, if necessary, they are used as a central bank sells dollars in the market to prop up its own currency and hence avoid currency collapse and an inflationary spiral. That is what IMF loans do, and they did so successfully in Mexico and Brazil, in Korea and Thailand, and many other places. Now suppose a central bank actually uses some of these borrowed reserves. Someone will buy them and, unless there is a bureaucracy that takes down everybody's name, address and shoe size, nobody will have a clue who bought the dollars. That is, of course, what happened in Russia. No doubt, when the central bank sold in the open market, among the buyers were the Mafia, which has been buying dollars and taking capital out of Russia for much of the past decade. In some sense then, the IMF money literally financed the capital flight of the bad guys, that is the kernel of truth. Of course, that is not really true in the most literal sense: Dollars in the central bank also come from trade surpluses, direct investment inflows and foreign purchases of securities. Exactly which dollar bill wound up in the hands of a gangster nobody can tell and it is really not interesting.

What alternatives were there to avoid the financing of capital flight? The IMF could, of course, have insisted on rigorous capital controls—the system invented by Hitler Germany in which the central bank reserves foreign exchange for approved trade transactions and in principle does not, except on a selective and discretionary basis, support the export of capital. Such regimes do exist and they universally function poorly because they can and will be circumvented by corruption. They are certainly at the very top of measures the Republicans and the stalwarts of free markets would find acceptably interventionist. Indeed, free marketeers would have rushed to the conclusion that this is a system that favors the Mafia with their disregard for law and their lack of inhibition in bribing their way to the cash register.

Alternatively, the IMF might have given no money and the Russian central bank, as a result, would have been forced to practice flexible rates for sheer lack of ammunition. In that world, without central bank sales of dollars, the currency would have depreciated to the point where trade surpluses arising from low wages earn the dollars to finance the capital flight. There would have been less political stability, less economic stability and as a result greater opportunities for the Mafia and greater incentives to take their money out. In that world, it is the workers' low real wages rather than the money from the IMF that finance the capital flight. In sum, IMF or not, there would have been capital flight. The money laundering charge has no plausibility in a literal sense or even in a more abstract one.

The interesting question is where the IMF went wrong in the past, contributing to derailing the transition to a functioning and successful market economy. And what kind of proposal might the IMF put on the table at this point, if any? The first big issue was the failure to support the reformers in the early 1990s with a huge financial package. The parallel is often drawn with the Marshall Plan. Had the reformers been able to avoid hyperinflation, create a semblance of widely shared prosperity, the move to a market economy might have taken an entirely different path. Instead of having now mass poverty, destitution and an obscene oligarchy, the rising economic tide could have brought with it a center-based democracy much of the kind seen elsewhere in Eastern Europe.

Absent this large support, Russia today looks more nearly and increasingly like Germany after Versailles. Of course, blaming the IMF for this historic failure misses the point; the US played the lead role and had no vision and the partners in Europe even less. It was too easy to believe that the move to a market economy would by itself solve the problem and pay a bonus; it was too easy to argue that throwing big time money at the problem could carry the risk of actually delaying reform. It is not obvious that a large-scale support of Russia would in fact have led to an altogether different course. But, *in hindsight*, there is no question that not to try was a big mistake. Today, the reformers are gone and their cause is discredited.

A second key juncture came in the past 2 years when Russia had brought inflation under control but had not managed to cut its budget deficits. Instead of printing money they were now financed by borrowing at home and abroad. The IMF was a key part of that situation, steadily trying to draw Russia into yet another program, setting targets, compromising on the targets, staying engaged. By this time Russia had become too large to fail, in the eyes of the IMF, in the mind of Russian policy makers and most surely in the fervent belief of emerging market investors. A house of cards was built up and the IMF did its parts to put a few extra floors on top. Indeed, at a time where drastic currency reform and debt restructuring might have avoided the all-out collapse, the IMF kept believing that yet another Duma session would all of a sudden ratify extraordinary steps in support of stabilization and avoid drastic financial surgery. The “If only…” we hear today is a poor rationalization for a deep lack of judgment in Russia, just as in Brazil. Too little courage, too naïve about believing people rather than the facts -- that is how the IMF went wrong in Russia.

At home, Russia is avoiding with mixed success to slip into yet another blow-up— it takes time to get there again because hyperinflation destroyed the money and the massive default of last year wiped out domestic debt. Russia and the IMF have struck another deal: Another loan has been made, the proceeds of which go to paying Russia’s previous loans from the IMF. That frees money to pay the eurobonds which by now, presumably, were bought at rock bottom prices by the oligarchs who will lose no time to convince the government that it is a good idea to pay foreign debt because that opens spigots of new money. We are at a juncture where Russia is neither getting ahead nor collapsing.

A keen observer of Russia, Anders Aslund, has observed that this is a very special time: The state is so bankrupt that there is nothing left to steal; now things will change. But in what direction? There are two possibilities: Russia will be mobilized, just as Germany in the 1920s, by increasingly autocratic governments which we must view with alarm. Or else Russia will start deep reform simply to alleviate the pain of stagnation and poverty. If that latter course has any chance at all, it will become far more likely if the West makes a bold bid to support the next president of Russia, past Yeltsin and his mob, with a very large and extended financial program, unconditional and far away from IMF bean counting. By now Russia knows what needs to be done; large financial support will make it politically possible to do the job. Russia and the West have failed at the first pass; there may be another chance. We would be foolish to pass it up and most decidedly can afford it.

EUROPEAN RESTRUCTURING

Europe's economy is clearly on the upswing: growth forecasts run at 3 percent and even more is quite possible. The world economy looks better and even inside Europe demand is on the move. Plenty of reason therefore to be a bit optimistic - World crisis goodbye, forget the risk of a stagnant Europe.

But there is even more good news, promising perhaps to turn the current upswing into something more durable. Whatever the channels and quantitative benefits to be expected of the new euro currency, that there are benefits there is no doubt, if only because the Club Mediterranee with its crisis potential is now firmly integrated in German-style monetary discipline.

But the interesting new fact is surely the belief, hope and perhaps reality of economic restructuring on a few fronts. Governments have started a few privatizations with radical consequences for competition, say, German Telecom and the price wars underway. Young people are increasingly recognizing the dramatic importance of modern information technology and are finding their way to the Internet and the *Neumarkt*—the German small cap attempt at venture capital. And big companies, too, are in the game. Europe is abuzz with mergers not only to take advantage of Europe's new economic space but also to confront the tough competition in world markets. In sum, the place is *hot.* Who knows how deep these changes go, how fast they turn Europe into the express lane?

No day passes without major headlines of big time mergers in Western Europe; Germany is ablaze as its mammoth corporations are performing mating rites, In France big strategic plays are underway in banks and fashion, Italy is seeing its major players position themselves on a European and world scale. And in the smaller countries, appropriately downsized in terms of scope and excitement, a lot is happening, too. Just what does all this mean for European growth and prosperity? Could it be that, with all the complaints about the American model, it is just that which now is underway in Europe?

Not! The claims are vastly overstated, the beginnings are relatively minor—privatizing a telephone company is done in every third world country and it is not making them rich overnight; getting on the Internet is routine in Bolivia and China, it is not an accomplishment to write home about. And as to corporate mergers, it remains to be seen how many are better than just an oversized vanity play of CEOs who do not face tough stockholder scrutiny.

Three reasons stand out as to why all this is not transforming Europe fast and deep. First, importantly, it takes a very long time to change an economic culture and an existing business organization that is more nearly an administration than a management. In the US large companies were fat and lazy until the new generation of Jack Welch et al took over and played tough. Twenty years later the benefits are patent but it took a long time getting there even if much and most is done right. Next, governments seem mostly uncooperative, but nowhere more so than in Germany. The Kohl government did nothing nor does the Schroeder government—they talk, talk and shy away from decisive moves to change the economic landscape; Blair without Thatcher is the emperor without cloth and that is exactly what a Schroeder is today. But, worse, a country where 70 percent of members of parliament are teachers and bureaucrats, as is the case in Germany, can surely not hope to get dramatic legislative change. The cultural orientation of bureaucrats and teachers is deeply anti-market, anti-risk taking and in support of the status quo. No chance of a regulatory revolution.

There is another reason to be circumspect on the force of change. Unlike the United States, Northern Europe has a culture not of entrepreneurship, experimentation, risk taking, dealing. Rather, the State tells everyone what to do, the State and business authorities tell everybody what position to play. Of course, there are exceptions, but the dominant mode is passive… "Nobody told me to."

All this sounds pretty pessimistic but is not meant to be; it is meant to calibrate that change takes a lot of time, more so if it is tentative and reluctant. But change is taking place at least and who knows, it might just become a new wave. Europe has accomplished an extraordinary move forward with the euro, why not in other areas? The euro was not an expensive step, except in Germany where it ran into all and every prejudice. What comes now is much harder because it steps on lots of toes and puts at risk a lot of beneficiaries of the inefficient status quo.

Normally a crisis brings the legitimacy for a dramatic move, but Europe is not in crisis; hence the gradual if not slow pace of progress. But there is one great source of optimism: today Germany is the loser in Europe, viewed by the French and even Italians as the losers—overweight and immobilized by bureaucracy and regulation. Germany had its turn at the head when hard money was the issue of the day; today it is trailing because the restructuring mode does not fit comfortably with its traditions of pay without work and disciplined followers without courageous leadership.

Nothing better could happen to Europe than just this discussion; perhaps it generates the kind of shock that drives more ambitious change. In the meantime, the significant upturn in growth makes radical change far less important and it is a short step from there to putting it on the back burner.

THE 1920s: CAN IT HAPPEN AGAIN?

Surely no decade in this century has witnessed more drastic and deeper going events than the 1920s. From the collapse of empires and the ensuing hyperinflation in Central Europe and Germany to Bolshevism in Russia and the Great Gatsby in the United States and, if that were not enough, the collapse of stocks and exuberant confidence when the big bubble burst in 1929. These events have marked much of what happened in the century.

Of two events in particular we wonder whether they could come back, the crash and the ensuing world depression or hyperinflation and the resulting demise of stable societies. The good news is there is no prospect of an encore in major economies. To have any confidence in that judgment, it is necessary to see what they were all about why they are not even remotely around the corner.   In fact, aren't we are much too cocksure in dismissing these possibilities? Wasn't the feeling last year, after Russia and LTCM, the very verge of a world economy going over the cliff? And isn't the sharp gold price rise a warning of financial instability?

Keynes in his admirable columns for the Manchester Guardian of the early 1920s commented on extreme inflation, saying that a country fallen to the lowest conceivable level had yet one way to pay its way, the printing press. That was true of Germany, Austria-Hungary and Russia in the aftermath of war and destruction, the collapse of empires and the breakdown of government and society. And print they did even if nobody had any longer confidence in the money or was willing to hold it for any length of time. In fact, anyone who held money lost in purchasing power at a horrid pace; it was said that one ordered 2 beers at a time because the price rose faster than they were getting warm. Or one would prefer a taxi to a bus because the payment came at the end of the trip. Currency became worthless—a lady who left for a moment a basket with bank notes found the basket was gone but the notes had been left.

The accelerating pace of price increase was as much driven by the formidable printing of money (notes were stamped during the night to have an extra 3 zeros the next morning) as they were by the flight from money on the part of the public that knew it had to get rid of it fast before the next wave of price rise. Businesses would pay workers in kind to keep them on the job, or they would pay and break twice a day so that workers could rush to go shopping before price hikes made their pay worthless. Every city would issue its own money, competing with the government's monopoly of note issue and the Reichsbank countered by the fabulous announcement that the money problem had been solved by the installation of high speed printing presses. The middle class disappeared and, in Russia, Lenin announced that if you want to destroy the State, destroy its money. And he was right because of hyperinflation came the radicalization of Central Europe which led to totalitarianism and World War II.

Can extreme inflation happen again? In the 1960s or 70s we would have said no, nowhere. Hyperinflation, defined as more than 50 percent inflation per month sustained for more than a year, was just a monetary curious. Of course, we have seen it again in much the same circumstances as in the 1920s, in the breakdown of the Soviet Empire but also in the Latin American political transition and perhaps it is about to come in Indonesia. But, for the advanced countries, and most other ones, extreme inflation is gone as a solution or a threat. In fact, inflation is gone and hard money is the ruling paradigm. And just as democracy is the best check on corruption, open world bond markets are the best check on bad money.

Italy has learned that closing the central bank is a dramatic step toward low interest rates and the US, long an offender on the hard money front, has bought fully into orthodoxy. The ECB is sound and all the Anglo-Saxon economies share now a view of sound money and competitive markets. These fashions last and increasingly sound public finance gives them extra strength. Bad money, in this century, was an aberration. Fortunately, open capital markets are a wonderful way to remind central banks every morning that they are awake and vigilant. Luigi Einaudi, Italy's postwar stabilizer, said that bondholders have the memory of an elephant, the heart of a deer and the legs of a hare. That is the best assurance against a return of bad money.

Well, what about a crash? There is far less confidence about avoiding financial collapse and the potential of a Great Slump and even a Great Depression. In the midst of the Asian crisis, with Japan threatening meltdown, our great confidence in governments' ability to stem a cumulative downturn suddenly seemed academic. Yes, it is true that, if a major region in the world, say, Asia led by an implosion of Japan, loses ground we can all go down together. The quick move to shore up its banking system and thus head off a dramatic collapse of confidence was decisive and effective. Soon the worst was gone and chances of something much worse are gone. In Europe there is no prospect whatsoever of a Japanese-style crisis; sure there are problems, but just that. And for the time being, growth is recovering and the major fear is that growth is too good and there fire reforms will be too timid—far away from anything that has to do with depression. In the US the scenario of deep trouble is most inviting: the stock market is in stratosphere, even more than it was in Japan before the crash, even more than it was in the 1920s!

Isn't it a short step from there to collapse, loss of confidence, fall in spending and growth spilling over to a highly vulnerable world economy? No worry here: The Fed has shown in 1987 and again last year that it is unwilling to stand by as market melt down; they have had the maneuvers, they have the experience and the public would not forgive a collapse that came from sheer incompetence. There is also a formidable budget surplus waiting for a tax cut, which any sign of recession and fiscal expansion will trigger and blast the economy back to prosperity. Yes, it looks like Gatsby, yes, stocks can fall 20 percent, but there is a lot of experience and policy tools to limit the damage. In the meantime, contemplate the perspective that high growth and high valuations might create a second-generation rise in stocks of all the formidable improvements that are underway!

In sum, world depression is out as a realistic possibility, even though stocks can tumble a bit. And extreme inflation is gone, even if we might see 3 percent per year on occasion. Sure, there will be new and possibly dramatic problems. Where to look for them? Inequality is definitely one of the candidates, more so if world growth comes to a halt. What can we do about it? Don't look back, don't believe in a third way, and, above all, keep growing. The other formidable problem, not of this century but of the one to come, is demographics. We promised the olds to pay them pensions but we have no clue of how to do it; the money is not there and the day of reckoning is not that far off. Again, growth is the best chance to pay the bill, reform and restructuring the sagest way to get it, full steam ahead, particularly in Europe and Japan where the unpayable bills are largest.

KOREAN REFORMS IN THE CROSS FIRE

Korean reform is a hot topic. Almost 2 years after the collapse of the Korean economy, in the midst of a very substantial upswing but also dramatic balance sheet problems of companies and banks, sharply opposing views can be hard. G7 is mostly pleased that a big headache has gone away so easily—so easily, because their focus is mostly on getting on and less on the dramatic costs suffered on the way. In Korea itself the discussion is inevitably politicized and traumatic treatment at the hands of the IMF is confused with wider issues of industrial structure and the insertion of Korea into the world economy. And then there is outside commentary of all the self-appointed gurus and the lesser commentators, who add their own repertoire to the debate. Most prominent and sharp among the latter is, of course, Japanese guru Kenichi Ohmae whose harsh criticism has shocked many Koreans even though they also had very positive resonance. What to make of all this?

Ohmae's Attacks

A good way to proceed in cutting through the noise is to focus on Ohmae's commentary in 2 articles published in *Sapio*. His basic contentions, are these:

- Korea surrendered to the IMF and the US in accepting shock treatment and reforms designed to recover the money lent by American banks and to fill the pockets of US investment banks. This strategy, imposed by the US and accepted by a weak and disoriented President Kim, undermines Korea's economic structure and hence dooms the country -- "a leader who ruined his country by dismantling the Korean economy."

- Korea's economic structure is bad, not in the sense that chaebols are a weak spot (on the contrary), but because Korea does not have self-sufficiency. In the all-important manufacturing industry it does not produce parts and parts is what it is all about. As a producer of "pseudo-Japanese" goods, without self-sufficiency, Korea will continue to be exposed to the vagaries of yen-dollar exchange rates. Moreover, any shift to an information society is barred by a lack of English and mathematics on the part of the labor force. In his words, "Korea will never become an advanced nation."

- Opening up of Korea will mean collapse of the secondary sector under the onslaught of superior Japanese goods and loss of a tertiary sector "monopolized" by the US. The primary sector will simply be abandoned to the low cost agricultural producers in Asia and the world.

- The right strategy is to identify and target products which the country can make uniquely, to phase out chaebols gently under competitive pressure rather than through forced dismantling (He notes, "If Korea gets rid of the chaebol, there will be nothing left."), to subsidize the creation of new firms started by young people, and to open up the financial markets to participation by Japanese investors who are eager to get in but are kept at bay by regulation.

I have great problems with Ohmae's charges. Where economics have something to say on the issue, his suggestions are dramatically at odds with what is taught in first courses in economics. For the rest, there is just an excess of Korea-Japan prejudices and hang-ups; too much thinking that Japan might be a good model at a time when any outside observer believes that Japan's model looks pretty pathetic.

The notion that countries should be vertically integrated in manufacturing flies in the face of all of basic economics. Yes, there have been cranks for 100s of years debunking the notion that countries should specialize on what they are best at. They have not had the upper hand; country after country going the opening up way, decentralizing and choosing market-based competition for resource allocation experience significant progress. Countries that dig in to defend a moribund system, like Japan, lose energy, become financially distressed and ultimately sink. They may look better for a moment but when you kick the tires, the car falls apart.

I have great trouble with much of what Ohmae charges. I don't know anything about manufacturing parts, but I do know that it has nothing to do with economic growth or the trade balance. No distinguished economist, and surely not any Nobel Laureate, who has singled out government targeting of industries as a winning strategy. And if they did this sometime in the 1950s, the financial collapse of emerging markets where this was practiced, or Japan, surely has taught them all a lesson.

Surely, it is precisely the hand-in-glove of bureaucracies and large business units that has produced the decade and more of negligible rates of return on capital in Japan and in Korea which are now the focus of balance sheer crises. The people have worked extremely hard, they have saved an unbelievable share of their income and they now find there is very little to show for it and they can't be sure that their pensions can be paid.

A steady theme of Ohmae's diatribe is the selling out of Korea to Japan; no doubt, that reflects a quintessential Greater Prosperity Area view held by Japanese officials and many scholars: let Asia solve its own problems with its own time-proven remedies. But there are two problems here: first, the major lenders to Korea were Japanese banks, not US banks. The major concession was to Japanese banks in the form of Korean government guarantees for interbank credit lines. This was forced into the IMF agreement by the Japanese authorities in an effort to avoid the collapse of the highly exposed Japanese banks just at the time of the Japanese bank runs. The other important concession was an opening for Japanese automobile parts. Surely Ohmae cannot be that ignorant as to be unaware of the facts? Or is he, in which case we should not listen to him.

And then there is the silly issue of US investment banks making money at the expense of the Korean economy. True, they made money and probably a lot. Good for them; the same is true for the surgeon in the emergency room. They took Korea back to the market, they risked their reputation, they helped bring down Korean interest rates in no time. Yes, they are mercenaries, but could Korea have done without them? Japan today relies on US investment banks because Japanese savers are increasingly skeptical of their own institutions and Japanese businesses that need to restructure or sell off assets can't do without American expertise. If "even" Japan uses their expertise, perhaps we should praise the Korean government for going to the best hospital in town.

And that, of course, is also true for the IMF. What were Korea's options in December, 1997? The country could have defaulted on its external debt and allowed an open-ended collapse of the currency and domestic finance. Or it could have, late but finally, cooperated with the proven remedy of an IMF strategy. And, of course, it has worked: the currency has recovered, interest rates are back toward US levels, growth is high enough to be virtually back to pre-crisis output levels.

Does the US benefit from the "Americanization" strategy? Yes, definitely. A weak Korea is a security risk, a financially and economically weak Korea contributes to a weaker Asia. Helping a country back on its feet is good world strategy and what is good for the world is good for the #1 player. Any notion of "monopolization" of Korea by US service businesses is grotesque. Their own cutthroat competition surely does not look like a monopoly and, for the rest, the playing field is open; The fact remains that Japan does not have an investment banking industry. How come? Big government and big business with their head in the sand! Enough said about Ohmae's views. I think Korea would do well to forget the advice, forgive the ignorance and move on. Where are the real issues?

Another View

Even though there is a vigorous recovery underway, this is not the end of the Korean story. The banking system is bust, the chaebols are under water and the political agitation around reform is formidable. The politicization of economics is particularly ferocious since it involves the temptation to do the wrong things for immediate political benefit and thus make a bad situation worse.

In my judgment, the immediate steps to take are these:

- Fire half the bureaucrats, here and now. Pay them generously, but make them go away.

As long as bureaucrats sit in their jobs, reform means nothing. They will find ways to be important and have a role; and the best way to do that is to get their hands on public money to support inefficiency, to stop market openings to protect political constituencies, to stop progress because they might be blamed if it goes wrong, never mind that they have no judgment where the risks lie. The last point is important because the crisis shows that the Korean bureaucrats are either clueless or irresponsible beyond belief.

Focus on getting rid of the older ones, those over 30, because they are responsible for the mess. Don't worry, the less the young know about the traditional system, the better. There is nothing wrong with the US system where winning parties bring in the top 5 layers of personnel in the ministries; it brings ignorance and expertise but, above all, it avoids the long standing alliances between business and government that are responsible for the low social rate of return to capital in the business and finance sector.

Look at it positively. The best performing economy in the world, in terms of reform, restructuring, business dynamics and innovation is surely the United States. Where are the bureaucrats that tell business what to do? There is no such ministry; there is no such person. VP Gore thought for a moment he knew a lot about the Internet and how government could help companies understand the great future trends. He has become very quiet, overwhelmed by the recognition that he knows little and decentralized millions of profit-hungry people aged 13 to 45 know it all.

- *Allow and Foster US-Style Capital Markets*

Much of the American success in the past 2 decades surely stems from the central role played by the capital markets. Owners of capital insist on a good rate of return. They understand that management may have a different agenda and that is why they are vigilant and active. Management may be reluctant to cut costs because that is always unpopular; management may be reluctant to fire useless middle management; management may be reluctant to focus because doing all is fashionable. Stockholders are there to ask the hard questions of both top management and the boards. And when CEOs get fired because stockholders are dissatisfied, the climate starts changing. Two decades later there is a trim and efficient, forward looking and dynamic business environment thriving on innovation and sound risk taking.

Korea has a tradition of a huge rate of investment and a very low rate of return on investment. The poor rate of return and the risky financial structure reflected in a phenomenal debt-equity ratio are a reflection of capital market malfunctioning. Korea needs a capital market just like the US's**.** The only way to get it is by a total, unrestricted opening not only on paper but also in fact. Of course, corporate governance is a touchy issue; perhaps the country could chose between a far-sighted Japanese capitalism and a greedy short-horizon US model? Forget it!

The Japanese model has long been a tea ceremony for cronies and mobsters to defraud investors; it has proven disastrous in its long-term rate of return performance. And even now, the market is not forcing dramatic action; only a few far-sighted entrepreneurs such as Sony's CEO understand the need for a dramatic overhaul of corporate structure. The US model, which now is being elected by major European companies, is the right treatment for Korea. Korea has to understand that even workers have no interest in bad investment decisions; in the end they pay when the companies go bust. Economic nationalism is out of fashion; it is too expensive, particularly for a country like Korea, which is now on probation.

- *Decentralize*

The Korean business structure is intensely regimented. It is organized on the notion that ignorant peasants need to know what to do. Of course nothing could be further away from a modern successful business structure. Even the military, at least in the US, has moved away from such a system to one based on empowerment and decentralization. Korea has an incredibly hard time letting go, as if the smallest concession to independent thinking and initiative threatens to bring down a house of cards. Where else can one see a room full of 100 men in white shirts as if it was still the old days of IBM? Compulsory military service surely helps to reinforce the mold and break individuality which, everywhere else, is increasingly recognized as a great source of progress.

Korea needs to decentralize in all dimensions. The government has to get out of business; the business sector must shed the vast and counterproductive concentration, young people must learn to challenge the system, not with silly campus rebellions but with independent thinking and single-minded excellence. It will take a long time to undo the poured-in-concrete Korean system, It is the greatest obstacle to a more flexible and creative economic structure in Korea.

- *Take a Breather*

When the crisis hit, the immediate decision of the chaebols was to increase working hours, increase effort and push out more of the same stuff. There is no evidence that there was a deep rethinking of a dramatically wrong financial structure, a deeply flawed system of dramatically low rates of return, a corporate culture reminiscent of the Japanese army, a level of government intervention that makes Europe look like a free market dream.

The crisis is not over; the balance sheet problems are just starting to catch up with the chaebols, the banks and ultimately the government and taxpayers. This is a good time to ask deeper questions about how Korea can pull out of the crisis most effectively and assume with confidence the resumption of economic progress. The answer is don’t work so hard, work smart; don’t save so much, learn to invest better; above all, stop being so hung up about catching up, take a breather.

December, 1999

THE ECB & EUROPE'S UPSWING

Europe is well on the way to an upswing in growth and ∈-phoria. But how long can this last. The ECB has already fired the first shot across the board, showing all the signs of nervousness expected in a new recruit. Will they now wait for inflation to be really there, -- not shoot before they see the white in their eyes, so to speak? Or will they empty their gun at the first ramblings of the cycle, fearful not to have staged a fight, to be caught of guard. Of course, the ECB might surprise by successful pragmatism, Greenspan-style, but that is too much to expect. The ECB can't expect to be popular, at least it must try to be successful. At this stage, ECB success is measured by just one thing: inflation stays below 2 percent. Everything else, including the lack of a persistent upswing can and should be blamed on the supply side.

The new ECB has very rapidly found its way to accustomed and safe ground: it has accepted Tietmeyer's cruising speed argument. If inflation is to stay below 2 percent, cruising speed cannot exceed 1.5percent. That leaves just enough room for accidents that add to inflation and yet leave it below a total of 2. In that context, the current upswing is the test. Coming from barely more than 1 percent inflation, the upturn in Europe (and in the world, including oil and commodities) will inevitably add to inflation. The risk of passing to 1.7 percent in the year ahead has been cited as the risk motivating the latest 50 basis point hike. In the capital market, the commitment to not accept inflation and not even be remotely experimental was welcomed with a lower long-term rate. What lies ahead?

Over the next 6 months we will see the wage rounds in the new Europe. To paint the extremes, there are two important possibilities. First, and most optimistically, wage earners throughout the new European Monetary Union understand the force of permanently fixed exchange rates. With trade open and unrestricted and exchange rates gone, there is now full blast competition. Labor in each country has lost much if not all of its pricing power. No union in anyone country can any longer pretend that they have captive employers who can and will pass on wage increases into prices without much consequence for profitability and employment. In this New Economy argument for Europe, wage discipline will be stunning and, as a result, the ECB will encounter no problem of inflation. Growth can go forward at significant speed; wage inflation has ceased to be an issue.

The pessimistic argument is simply this: Nothing has changed; Germany and France have had fixed rates for years, and so has Austria, the Netherlands or Spain. Nothing new ands hence nothing different except that now governments are leftwingish almost everywhere, most drastically so in Germany. In this view, labor views business as mostly captive, markets as segmented, the unemployed generously supported by the State, i.e. no more moderation, profits are back and so it is time to get back to higher wages.

We won't know for a few months just which way this plays out. But it helps to look ahead and appreciate the very narrow room for the ECB. With inflation already near Tietmeyer speed, there are just a few, if any, tenth of a percent of extra inflation that can be accepted—maybe 1.7 rather than only 1.5 percent. Clearly the issue is on the second digit and we can already hear the ECB refrain: "surely, nobody will argue that a an extra one-tenth of a percentage point inflation can help growth, surely everyone must agree that an unambiguous success on keeping inflation below 2 percent does help growth, no room for experiments." And up go the interest rates to slow European growth. If the European Union or the ECB forecast near 3 percent growth for 2 years in a row, hold your horses. One year yes, two years no unless there is really a new economy/

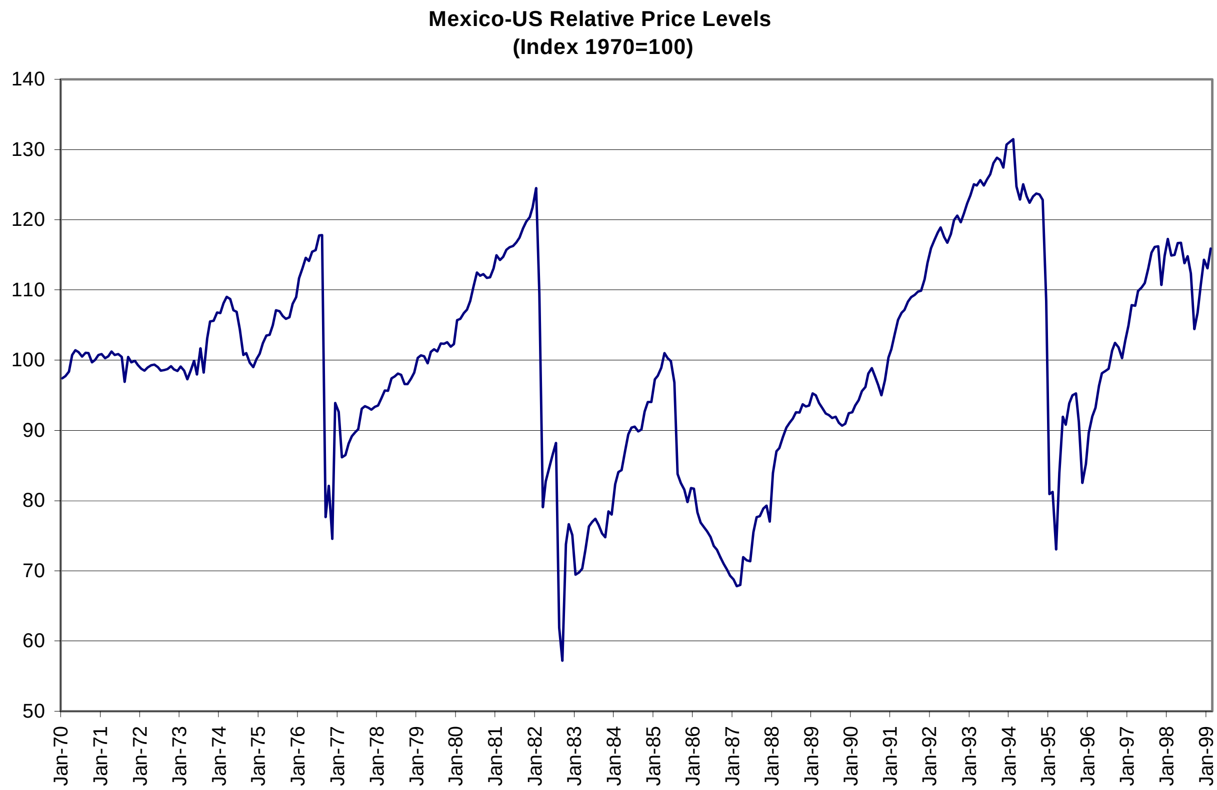
The EDCB has come full circle to where the Bundesbank has been for over a decade. The central bank cannot create growth in an economy that has a bad supply side; in the US, with highly competitive markets, the central bank can afford to accommodate and stand by. In Europe where competition ands flexibility are in short supply, indeed outright disdained by the leadership, the central bank must be preemptive. In case of doubt, fire your guns. The ECB is entirely right to establish its credentials as a non-inflationary central ban; it is entirely right to be unambiguous in educating the labor market to the total absence of accommodation. Only when that point is established, if necessary at the cost of a growth slowdown, can we expect to start seeing some bonus in the labor market. But even a slowdown will not enough as long as governments accommodate labor's quest for unwarranted real wage gains (and the resulting unemployment) with generous income support. The payoff on the Europe cannot come from the central bank, it must come from the governments recognizing that it has become even clearer that the ECB cannot make growth, only they can by creating a far more competitive supply side.

Of course, it is hard to see even the smallest indication of a more competitive supply side. Governments, most strikingly in Germany, seek escapee from their political dilemmas by talking about the transition to a learning society and other dreams. At the same time, however, they go out of their way to stop a radical cure from aggressive mergers or tough corporate workouts. None of this will change without a crisis first. But Europe is rich and for that reason won't have a crisis any time soon. In essence, Europe is satisfied with low growth and borrowing from the grandchildren just because that keeps the peace and it keeps confused and undecided governments in power, just a bit more. In fact, not just a bit, they can surely play the same game for another decade

If the economy performs poorly, blame Schroeder and his ilk (and corporatist business thinking), don't blame the ECB. New central bank and old economy can only mean one thing, low inflation and low growth.

DEJA VU ALL OVER AGAIN? MEXICO, THE SEXENNIO & BEYOND

With the sexennio approaching, it is fair and reasonable to ask whether Mexico will collapse once again, as it always has shortly after the new Administration enters. With elections in July is this a deja vu all over again? Mexico is back to growth, 3 percent and perhaps a bit more. Inflation is falling from a level already down to 10 percent. The debt has a comfortably long maturity and the budget is sound. The exchange rate is flexible and somewhat but not extremely appreciated in real terms. The presumption has to be that this time round there won't be a collapse; lessons have been learned.



President Zedillo deserves already a lot of credit for turning over to his successor a sound economy. He deserves credit, too, for opening up the political system and notably the PRI. The primaries have shown resounding success for the candidate, Mr. Labastida, and that in clean elections! Moreover, the chief opponent, Madrazo, has been kept on board thus avoiding a further split and assuring a land slide victory in the coming elections. So far so good, but will Mexico now move to star performer status? Not without a fundamental move on currency policy!

In the aftermath of the Mexican, Russian, Brazilian and Asian lessons must be drawn for exchange rate strategies on the world's periphery. Europe's periphery should adopt the Euro on a currency board basis and countries like Mexico should follow the Argentine example of a currency board on the US dollar. In the case of Mexico the message is totally clear. By geography and capital market integration it plainly does not make sense to run a central bank that is good but not quite good enough to avoid a significant Mexico premium. Emerging market experiments with central banking have had their time on the stage; they should now give way to hard money as the single best development strategy. Hard money does not just mean an independent central Bank with an option to depreciate the currency but *NO* central bank.

Open capital accounts have done away with independent interest rate setting, too much money printing has done away with money illusion, endemic inflation and devaluation policies (or catastrophes) have undermined economic horizons and the chances of sustained growth. The private sector has dollarized spontaneously to get away from the expropriation policies of their governments. It is time to get back to an agenda of governance and that includes as the top priority, solid money. Most emerging market economies cannot convince their residents or the capital market that their national institutions are capable of delivering first-class money on a sustained basis—Italy or Spain could not either and hence benefited so much from EMU! Hence outsourcing money services by a currency board is the right strategy

Over the past decade two developments have undermined the case for national central banking. First, we have experienced sharply increased international capital market integration and at the same time domestic financial deregulation. These developments have raised the cost of policy mistakes at the central bank. In fact, the cost of policy mistakes is far more catastrophic than earthquakes or other more traditional hazards. Second and closely related, the scope for monetary policy to create lasting employment benefits has been abused to the point of being wiped out. In one emerging country after another country, inflation has been rising to the point of extreme or even hyperinflation. *Having a central bank has become a liability.* The notion that a central bank could cut interest rates below that set by the ECB or the Fed is just inconceivable. The world capital market charges high premia for the option to practice devaluation and inflation. *Unconditional, unilateral disarmament of the central bank is the first best option.*

There are, of course, a few technical issues that need to be addressed. Above all there is the fiscal soundness requirements for a currency board. Next, is there not a need for a sound banking system before one has a currency board? Third, what happens to the lender of last resort? And also, are there enough reserves to start the project? Next, surely there is a loss of flexibility in terms of exchange rates and money. Finally, is the strategy ultimately not outright dangerous in the sense that Latin America is congenitally unable to stick to any commitment, i.e. the credibility issue? All deserve attention, none is decisive.

The central question involves the endemic lack of credibility in many Latin American countries. Over and over again, governments try with overvalued currencies, the printing press and borrowing to deliver artificial prosperity and sooner or later they fail. A currency board amounts to a commitment not to change the exchange rate and not to have uncovered issue of money. Who believes that the sheer discipline is there to do just that. Of course, Argentina is a case in point.

Whether it is the disillusionment with having tried and failed with all other seeming options or the sheer success of the Convertibility Plan, nobody would go back. People who argue that Latin America is incapable of discipline and therefore should stick with IMF policies do not give enough credit to the deep changes of a decade that now are asking for a more formal framework to harvest the benefits that come with it. And that is particularly true of Mexico!

With an election year ahead, everybody rightly asks the question of whether Mexico will once again follow its sexennio pattern of a currency crash. The idea is not altogether farfetched; the historical pattern is persuasive, as is the fact of yet another substantial real appreciation. But it is unlikely this time: the political uncertainty is already resolved since the PRI candidate Labastida is sure to enjoy a landslide victory. The external environment ids also calm and that just leaves the domestic economic uncertainties. Here, too, the news is favorable: no tesobonos, no large overvaluation, no big budget deficits and the benefit of a flexible rate that can move but not collapse. All that encourages the belief that Mexico is doing well and need not contemplate any major new and bold steps. That conclusion is questionable.

Mexico with its present policies pays a high premium in the capital market. That premium raises the cost of capital to Mexican business and lowers competitiveness and affordable real wages. In emerging markets, capital costs account for far more of total cost than in rich countries and as a result their impact on competitiveness deserves far more attention. At the same time, Mexico has sunk into a long-standing pattern of very poor growth performance. Mexico has a very disappointing growth performance: 1.5 percent per year in the 1980s and barely 3 percent on average in the 1990s. The growth rate of output barely exceeds that of the labor force so that poverty, unemployment, informality and crime are increasing by the day. Business as usual is possible, but it certainly is a disappointing choice.

Table 13 Mexican Economic Growth (Percent per year)			
1960-69	1970-79	1980-89	1990-99
7.0	6.4	1.5	3.0

The next Mexican government will surely ask itself how to shift out of the present crisis-prone strategy and the poor growth record to a far better performance. The budget is not an answer, either with more or with less austerity. Exchange depreciation or similar adventures will not go far. Higher growth involves a far higher rate of investment and that in turn means a better situation in the world and domestic capital market. The only way to get there is by a radical change in Mexican currency risk, premium, the perception about Mexican financial stability and the restoration of a functioning banking system and a viable credit culture. And it is worth recalling that disinflation from 10 percent is not done either fast or easily. The shift to a currency board can do miracles, nothing else can.

It is tempting to list the 1001 reasons why this cannot be done, should not be done, cannot be done yet, all the preconditions and so on. The right answer is to just do it, and on the way make all the essential changes that make it more likely to be the total success that must be hoped for.

EAST GERMANY: 10 YEARS Of UNIFICATION WITH A VENGEANCE

Ten years after the Wall came down, Germans look at all the money spent in the East and can't help feeling that something went wrong; all that money spent and more to come and so little to show for it! Who got it wrong, what critical decision derailed success?

The basic charge is that what cost so much has bought very little. East German productivity remains low and the wage costs are formidable; unemployment is huge and runs at twice the West German rate not even counting the make-work programs of all kinds; growth is slow and productivity catch-u is in the slow lane. Basically it's all a big and costly disappointment.

Critics of Russia's failed transition to a market economy (*Who Lost Russia?* Read the NY Times' supplement cover) place much store in the failure to establish institutions before letting market forces take their course. That surely cannot be the argument in East Germany—institutions came overnight with world class West German law, property rights and courts, public administration, banks and capital market and to crown it all, West German money. Overnight, East German economy got everything economic civilization is all about.

Table 14 East German Catch-Up		
	1991	1998
East/West Ratio (%)		
Per Capita GDP	31	56
Productivity	31	59
Wage	48	77
Unit Labor Costs	151	124
Transfers from the West (% of E.German GDP)	51.5	34.7
Source: CESifo conference and Goldman Sachs		

The popular explanations for the failed experiment go in two directions. One, not at all politically correct but yet common, blames poor progress on the fact that East Germans are bad economic agents, blunted as they are by more than a half century of dictatorship. Even given a chance at first-rate capitalism, they prefer to sit the game out on the guidelines, financed by a generous safety net. The alternative explanation is espoused by the ayatollahs of transition: the blame 1:1 monetary conversion and the quick drive toward pay-parity pushed by the coporatist German system They argue that the wage is key to growth and failure to have low wages is the crux of the story. How to implement that in a one-Germany situation? Restrictions on mobility, permits or maybe the Wall.

It is naïve to cherish the view that East Germany could have been kept at low wages and deprived of a substantial safety net without the risk of massive westward migration; it is even more naïve to believe that a democratic German government could have even envisaged unification with residence permits. This is even more absurd at a time where the European Union was phasing in unrestricted mobility. And the same goes for the whole economic security blanket—accepting the commercial code but eliminating worker co-determination and unions, job protection and the like was just a sheer mad fiction. In fact, nobody entertained the notion for a moment. Perhaps those are idea en vogue in Korea as it envisages unification, but even there it will be hard to accomplish it when the time comes. The claims of alternative strategies have therefore to be set at a somewhat lower level— say the initial exchange rate which might have been chosen to make East Germany a low ge country. Even that is a dream since, in the face of high unemployment, East German wages increased substantially every year relative to West

Germany. At a more depreciated conversion rate we would have simply had a more rapid rate of wage inflation.

The true alternative strategy, remotely conceivable, is that West Germany would have understood the failure of the experiment before even embarking on it. The problem after all is not in East Germany but rather in the West. Unification meant that everybody gets not only the benefits of west German economic institutions –0 property rights and hard money—but also all the disastrously negative institutions: unions, overpaid unemployment and excessive job security, pervasive regulation. If West Germany, in the face of unification, had rolled back all these unaffordable limitations to the free play of markets, the economic costs would have been far lower: East and West Germany would have more nearly full employment, the drive for productivity would have been far more aggressive.

Of course, German corporatism did not allow such a solution: unions wanted their wage protection. The only way to get it was for the government to pay lots in unemployment compensation in a high wage East Germany. Politics was competing for the East and that meant giving them a visible gain on day one thus creating the precedent of pay without work. And German business was in it fully, since they got free of charge investment in the East plus a formidable spending boom up front. Everybody knew exactly what they wanted in East Germany and they did get what they planned. The good news is that unification took place, the bad news is that East Germany became an even worse economy than the West, -- unification with a vengeance

If East Germany has become the perfect *mini-me* of West German bureaucratic ands social inefficiency, there is another chapter to the story. Today, East Germany is pleading for relief from West Germany'' welfare state. Perhaps there is a glimmer of the fact that ultimately there will be a hard landing and the money will be cut off. Better to try a soft landing by phasing out the excessively costly welfare state than to have a full scale crash some time down the road. East Germany is starting to whittle down wages in firm bargaining and away from industry settlements; East Germany is even moonlighting.

The great lesson of East Germany is this: West Germany is responsible for the unaffordable problem. Unification will not go away, and therefore West Germany must change or pay more and more, and forever.

US INEQUALITY & PROSPERITY

How real is the US economic performance and can it last? From Europe to Japan, that is the #1 question about what is going on in the United States. The question deserves an answer if only because the end of US strong performance can be anything from a problem to a disaster for the entire world economy. Of course, the question is also of interest simply because continued strong performance suggests that there may be a lot more to the US model worth emulating than has been admitted so far. That question naturally cannot be answered just by the growth performance. It is essential to ask at what social price the economic performance was bought?

The Record

The current situation, measured by a broad range of economic indicators, is far better than it has been in the past 30 years: the unemployment rate is near the very best of this century and the best in more than 30 years. The inflation rate is lower than it has been in more than 30 years. The economic expansion has lasted already longer than the only competitor in the great expansion of the 1960s. The budget surplus is unrivalled since the early 1960s. Not only is the poverty rate is the lowest in two decades, the stock market is higher than ever in history. In sum, there is something quite spectacular, particularly if it lasts. And if it does not last, that will be spectacular, too.

And the news is getting better every day. The newest estimate GDP accounts, making proper allowance for corporate software as investment, show growth rates far higher than expected, well above 4 percent for the past few years. And the news is even better than that since much of the extra growth reflects the possibility of a major upturn in productivity growth. Lost somewhere in the 1970s, productivity growth had been diddling along at not much more than 2 percent and now it may be running at as much as 2.7 percent. That good performance of productivity is not just an issue of better performance in the long run. It has an immediate message, too: If productivity growth is sharply up, inflation is far more certain to be benign. And if inflation is benign, the Federal Reserve will stay on the sidelines and allow the longest-yet expansion to go far behind just beating the historical records. And if the Fed stays on the sidelines, letting the economy run, so will the stock market as it capitalize greater wealth creation than has ever happened before.

The story is, of course, not just one of paper gains in the stock market unconnected to underlying progress. The sheer fact of strong of above-4 percent growth is just one message. But a more fundamental one is the pace of discovery and implementation of new technologies that change the world. There is also the extraordinary human capital formation as just about everybody learns to use the technologies, experiments and discovers huge gains in personal productivity,

That much for the good news; where are the weaknesses in the story? They come in two ways. First, it may just not last. Just as in the 1920s, in the end inflation – or whatever-- gets in the way and a loss of confidence, internal and external. What now looks like a phenomenal performance then suddenly is called unsustainable, unsound and from there it is a short way to everybody noting that, quite obviously, it could not last! That judgment has been wrong for years but it may become right one day.

The other weakness is, of course, the social side. Is not much of the "progress" on the narrow economic front bought at the price of a dramatic social deterioration? And if so, as must surely be the case, is it worth emulating? More than that; can it be assumed that this situation can last? Will those left out and behind not revolt, capture politics and turn the wheel back? These things don't happen necessarily fast, but surely they will.

We now turn to these key issues in judging the US situation.

Between A Rock and A Hard Place

Soft landing is uninteresting. In that scenario growth gradually slows down to the now higher pace of trend growth, say 3 percent. The stock market mildly corrects but shows upside. Unemployment does not rise significantly. The best party ever is won. Even if it is the central scenario, it just does not command the same attraction as the hard landing scenario where there are no easy choices and no parachutes either

The hard landing scenario focuses on two unsustainable situations. One is the huge US external deficit, now reaching more than $US 300 billion per year. The other is a stock market valuation near 200 percent of GDP, higher than ever and far higher than that of Japan just before their crash. What if all of a sudden the pressure comes on so that stocks start falling under the weight of overvaluation and the dollar melts in currency markets under the pressure of excessive deficits. The Federal Reserve would be helpless, or so it would seem. Cutting interest rates to shore up the stock market might work but would make the dollar situation worse. Raising interest rates to defend the dollar would put extra pressure on stocks to collapse. Whichever way the Fed cuts it, there is trouble. And would not the house of cards collapse, revealing in the process a lot of the fragilities that now attract too little attention: the negative saving rate of households, the excessive debt of the household sector, highly leveraged balance sheets in the investment banks? Who is to believe that confidence holds up under these conditions and from there it is a short step to fears about recession and worse.

The story is good but not really good enough. True, we may well face a situation where both the dollar and stocks come under pressure and the Fed musty chose. But the choice is entirely obvious. Faced with a dramatically falling stock market which carries the risk of a recession and worse, the Fed will cut interest rates. Never mind the dollar. The central preoccupation of the Fed must be to avoid a massive meltdown of stocks, wealth, confidence and spending. True, that leaves the dollar quite possibly lose and tumbling. So what, it is the problem of the rest of the world.

Benign neglect of the dollar is appropriate; a dollar fall does not contribute much to inflation and nobody is anxious to get more jobs simply because there are no extra workers. Abroad of course the situation is very different. In Europe jobs is a big issue and in Japan, with the Yen already strong, a major extra appreciation would be far more than a headache. Accordingly, as always in the past, central banks in Europe and Japan would do whatever it takes to shore up the dollar. And if they don't, it is mostly their problem.

The Fed has always maintained that sustaining a stable US economy is the best contribution to world economic stability. And that answer it is right. In the context of stick market and dollar risks the right step is to support stocks, not the dollar. The right division of labor among governments is that the US looks after domestic prosperity and the rest of the world picks the level of the dollar they can live with. Any other assignment is dangerous. If the Fed were to defend the dollar at the cost of a stock market collapse, US growth and world growth would go into the tank. Interestingly then, the central scenario of how US prosperity goes on the rocks is simply unrealistic.

There is a deeper and far more dangerous concern. This is the time to remember that this is the 70th anniversary of the 1929 stock market crash. Suppose that the scenario of a loss of confidence and a big sell off of stocks happens, suppose indeed the Fed attempts to rescue the situation promptly, what if it does not work. Here is the real fear. Yes the fed would obviously cut rates, yes it has worked in the past, lets hope it works next time, too. Any confidence that there is no hard landing ultimately rests on the demonstrated ability and preparedness of the Fed to maintain liquidity and breath confidence back into the system. That happened in 1987 that happened in fall of 1998. That makes a good case but it does not offer conclusive proof that it will work next time. Let us just say that if it does not work, hard landing for the US, and the world economy, understates the consequences.

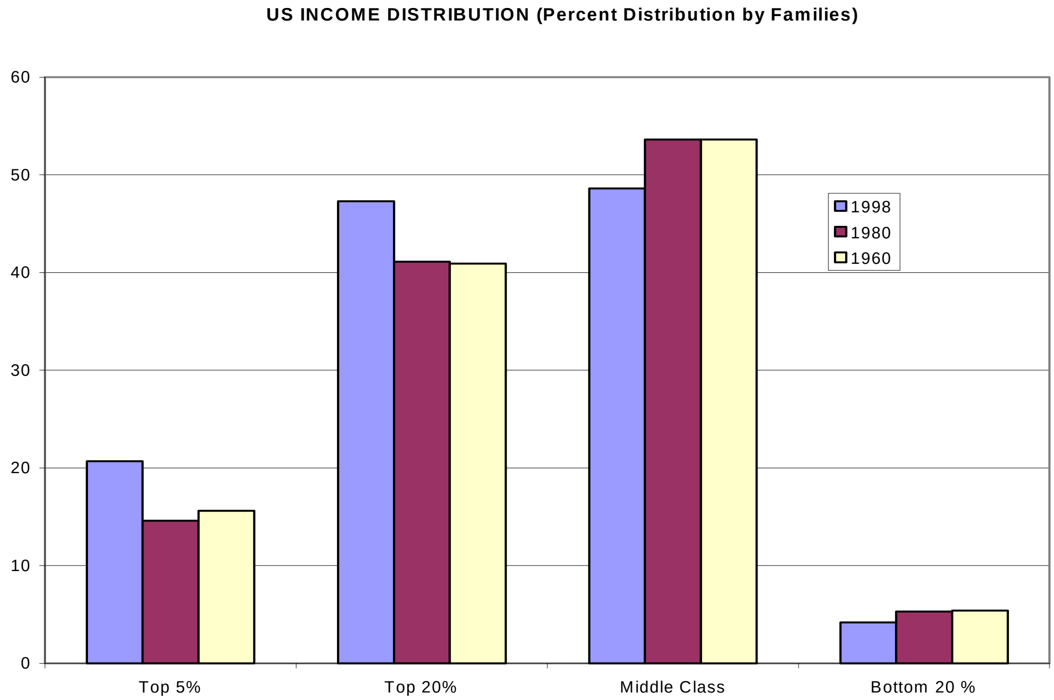
Inequality & Poverty

The other US weakness is in the social area. It helps to start with the facts. Poverty is a continuing problem even though it is somewhat less so than at the beginning of the decade. And inequality, if it is accepted as a problem, is far worse than it has been in the past 3 decades.

On the poverty side, progress was dramatic during the Great Society programs of he 1960s. The percent of people in poverty fell from more than 22 percent of the population to just about 12 percent. The 1970s held that achievement but in the 1980s there was some reversal. Today, with the longest expansion and the resulting formidable job creation, we are back to just under 13 percent as the poverty status. In other words, we broadly have the progress achieved in the 1960s but no more. Exuberance about economic performance has not trickled down in a big way. True, everybody has a job but for many the job does not pay enough to put them above the poverty level. Jobs are not enough. And that is particularly true for the major group of households in the poverty group, families headed by a single female.

One more point on poverty. The poverty rate is nearly though not quite back to the levels of the late 60s. But that is not true for the numbers. With a far larger population today, the number of poor is, of course, also much larger.

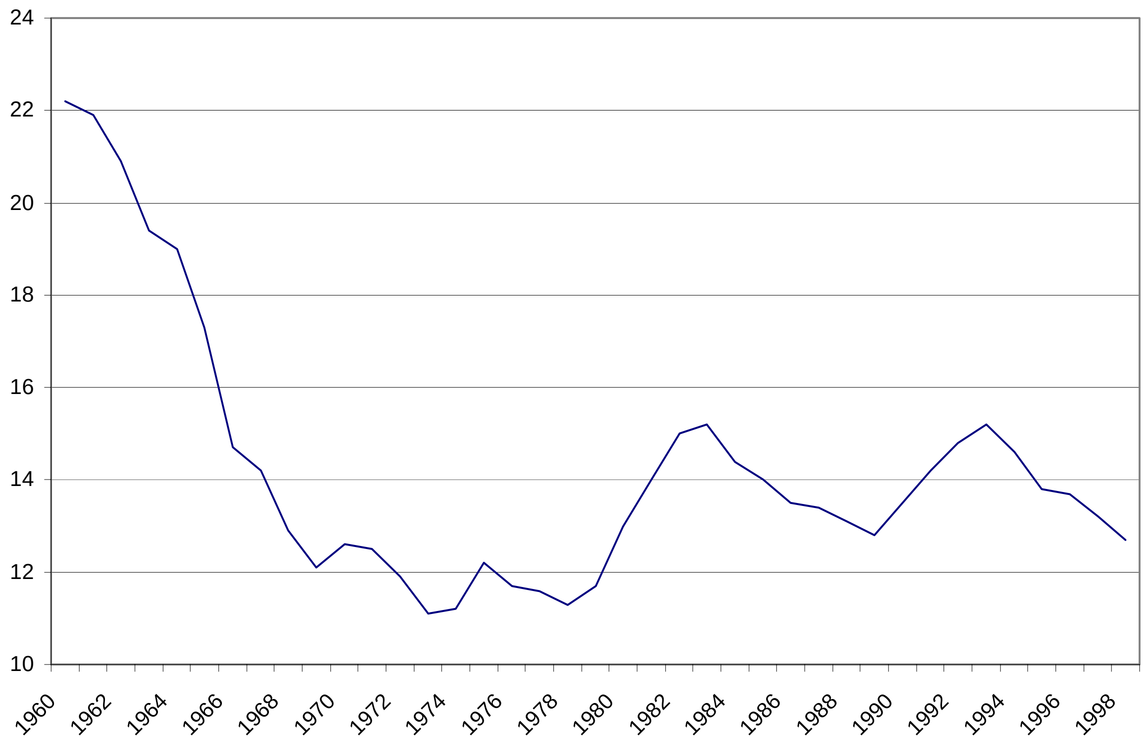
On the side of income distribution the facts are even more disappointing. In 1960 and 1980 income distribution was much the same, the Great Society notwithstanding, i.e. a rising tide raises all boats. But compared to 1980, today there is a major shift. The top 5 percent of the households are receiving an extra 6 percent of total income raising their share of the pot to 20 percent. The redistribution comes from the middle class and the poor.



Finally, what about the median household, neither the extremely affluent nor the dirt poor? The median real income today is just under $US 40,000 versus $US 133,000 as the entry level for the top 5 percent. What has happened to these most typical representatives of the US economy? Their real income has very gradually grown but at a frustratingly low rate—0.6 percent on average in the 1980s, 0.5 percent per year in the 1990s. They are ahead, absolutely, and on a per capita basis because their families are smaller. But even so, for them the US economy has assuredly not been a get rich quick scheme.

Nobody can plausibly argue that anytime soon all this becomes much better, that the foundations have been laid and soon the results in terms of reduced poverty, better distribution and increasing real incomes will be harvested. In fact, the risk runs the other way. A slowdown and the accompanying increase in unemployment would make things worse quite fast.

US POVERTY
(Percent of People Below the Poverty Level)



The interesting question then is whether US social conditions are at all sustainable. The answer seems quite clear from politics. The candidates in the coming presidential election do not question the model, not even remotely. Politicians with strong progressive commitments are not part of the central scene; business is not in disrepute. Indeed, the most liberal candidate, Bill Bradley, mostly focuses on the poverty status of children and their lack of access to health care. For many observers it leaves a bad taste not as much because of the basic proposal but rather because Hillary Clinton left a bad memory.

In the meantime Bradley supporters eagerly remind any skeptic that he was the one who reduced in the early 1980s the top marginal tax rate to 26 percent whereas now it is back up to more than 40 percent. The point is, there is no revolution in the making. Those who hope for and see the finals between Bradley and George W. Bush do agree with a discussion about targeted, efficient government and they certainly expect their protagonists do upset the basic model of a competitive and tough US economy where everybody mostly looks out for themselves.

In summary, the social model is neither getting out of hand with progressive deterioration of society nor do politicians see a prospect of getting into office with a radical questioning of the business model. No crash here either although, of course, less poverty would be immensely desirable.

The US and Europe

The US is often held up as the model for Europe and, with as much vigor, rejected as a model. What some consider as the desirable flexibility and dynamism, others reject as an unacceptable approach to society's cohesion. We have argued that the US economy is sound and has a good chance of a soft landing with continued growth. We have also argued that the social scene in no way is unraveling. What about Continental Europe?

Europe most assuredly looks better on the social front, and with as much assurance it does not on the issue of economic performance. But that is not the point. The right focus is that European companies inevitably because they are in world competition, must restructure and that European governments inevitably must reform toward more flexible markets. And as they do, great financial pressure will be put on the social safety net. Worse than that, the extraordinary unfunded pension liabilities present huge debts that today are not recognized but are real nonetheless. Europe may look good right now, but it would be naïve not to look ahead 15 years and see the extraordinary conflict that is brought into play by an excessive and no longer affordable welfare state, modest economic performance and big debts. The US is already beyond those problems and, for that reason, offers the better prospect in both the economic and the social dimension.

IMF v. WORLD BANK: THE VERDICT

Who was right, the IMF with tough treatment or the World Bank recommending alternative medicine? Just about two years ago, Korea collapsed as the last Asian economy to go. Mexico had already gone in 1995 and Brazil was to follow shortly. The IMF debate has raged ever since: Were Fund policies too tough, or even perverse, were they pushing economies deeper under water, further into bankruptcy, were they to be blamed for the disastrous social fallout of the crises? That latter view was argued everywhere in Asia where governments, including that of Japan, were calling for an Asian IMF and alternative medicine. They gained extraordinary and unexpected support from Joe Stiglitz, the World Bank's chief economist and senior vice president— the same one who recently advised that China should practice competitive devaluation and beggar-thy neighbor policies.

Stiglitz's proposed treatment uses rose petals, fragrances and scented candles along with melodious sounds and a finger in the eye of traditional economics. That was formidable support indeed and at the very least confusing for policy makers. It was music in the ears of Japan that was trying to pursue its own agenda in Asia and for the likes of Mahatir, Malaysia's ruler, in his anti-establishment kick.

On the other side of the debate, and very much in the firing line, was orthodoxy as defined and defended by the IMF chief surgeon Stan Fischer, the first deputy director and an economist just as formidable in academic reputation as Stiglitz across the street. And that debate has gone on, right to the recent conference in Singapore where the last round of the battle left the Mahatir-Stiglitz team with a resounding victory and standing ovation of an Asian top business crowd. It is not obvious they understood the issue or appreciated just why their economies were alive again; they just liked the sound of Stiglitz-Mahatir populist and anti-establishment rhetoric. And, once again, the Japanese officials present made their case for an Asian IMF, and alternative strategy without the pain of IMF austerity and the unaccustomed transparency.

Who is right? Surely, as the saying goes, the proof is in the pudding? Asia today is in the midst of a steep recovery; the crisis countries have already or Are about to recover their pre-crisis levels of GDP. The currencies that took a nose-dive in 1997/98 have recovered substantially, the markets that collapsed have turned up. Money is coming back everywhere. Korea, the latest of the collapsing economies is doing best with double digit growth and interest rates not much above US levels. Yes there was a crisis, yes the debris is still lying around, but stabilization has been nothing short of astounding. The V-shaped recovery that Mexico had experienced earlier came off bigger and faster than expected. And the same was true in Brazil where the crisis was almost over just as it happened.

How come? IMF policies worked. Asia, Mexico and Brazil did adopt and follow IMF strategies; they did raise interes6t rates to the sky to bring about stabilization of currency and only then, over a few months, brought them down as confidence recovered. And the Asian economies paid attention their budgets at a time where huge bailouts made it all decisive to show at least a glimmer of fiscal conservatism, That strategy c9oimined with IMF support starts over a few weeks and months to make the difference; money starts coming in and helps push exchange rates back. In conjunction with IMF support and capital reflows, reserves rise and confidence returns. What at first sight seemed a meltdown, gradually is just a very bad situation and soon a surprisingly rapid turnaround.

But why give the IMF strategies the credit? Every country followed much the same strategy (including Malaysia, rhetoric notwithstanding). The exception was Indonesia where we had at first a come and go. A wonderful textbook case since every t9ime the resolve weakened, the currency collapsed and every time the country returned to the program, the currency sharply strengthened. Of course, everyone should have recognized that Asia was just going through the same cycle Mexico had just completed. Unfortunately the IMF failed to point out its success in Mexico, unfortunately the Asian economies were allowed to think that their experience was uniquely different even if, on the way down and on the way up, it was just replay of what Mexico had just experienced.

Buy the time it came to Brazil, at the end of 1998 and early this year, everybody knows the script: election, barely delayed currency collapse, IMF program-cum-money, and a rapid rebound. IMF strategy worked once again. What are the lessons? The IMF is terrible at anticipating and denouncing emerging crises -- just as the capital market but with a better excuse, namely its executive board. It is also awful at surveillance; but it is totally right and unquestionably successful once it comes to post-trauma treatment.

Needles to say, the World Bank's alternative treatment clinic and Japan's Asian IMF are not drawing too many clients. Crisis countries know better. When their economies collapse in ways never expected, governments rightly reach for true religion and hard cures. They have no illusion that in the midst of a financial crisis and a speculative exodus, big time deficit spending and easy money cannot be the right answer; that strategy would simply it defies common sense. Cheers for the IMF, cheers for its tough medicine, don't leave home without it. And cheers too for its chief surgeon.

February, 2000

THREE CHEERS FOR EMMA BONINO

Everybody agrees, Europe needs a revolution of its economic structure. But how to get there is quite another issue. Advocates of the status quo note that there is no crisis, so why rush? They place their confidence in gradualist restructuring and, above all, in all the interesting high-tech startups driven by the young, the knowledge society getting to implementing the agenda in a European way. And from there it is a short leap to proclaiming that the American model cannot work in Europe because it is socially reprehensible and in any event is about to crash. On the other side of the debate, desperate reformers see no way to trim, roll back or blow up obsessive bureaucracies and consensualist politicians. They see the first signs of the beginning of a possibility, a glass far less than half-full—of reform and restructuring, but they are impatient with the slow progress.

True, Europe is moving at a painfully slow pace**,** but the front of attack on the State, an ossified supply side and dinosaur-stake holders is widening**.** But this is not an issue of sweeping moves that change the world from one day to the next. The devil is in the details. And that is where the attack must focus. A wonderful example is the referendum promoted by Emma Bonino, Italy's maverick politician. Among many issues, the referendum proposes three measures: end automatic tax withholding, end judicial power to reinstate dismissed workers, end automatic withholding of union dues from pay checks. Three cheers for Emma Bonino; never mind if she fails, Rome was not built in a day and it will take many more to reform it!

At first sight it seems out-and-out unreasonable and indeed irresponsible to undermine the all-too difficult task of collecting taxes by taking away automatic withholding. It is hard enough to collect taxes, how can possibly going back to a world where the tax office has to run after the taxpayers. Isn't withholding the brightest idea since the sliced bread? True, withholding makes tax collection easier and that is the point. The referendum advocates want to make it much harder to tax and thus force the government to retrench on the untouchable spending front. This is an old idea from the California tax revolt that was an import part of the supply side revolution. Milton Friedman always said, take away the government's tax revenues and that way, and only that way, can you get spending cuts.

No better way to undermine taxation then to make the government work hard to get its money, for people to get their paychecks and after they see it the government comes and takes away the money. Only when the difference between gross and after-tax becomes painfully obvious will taxpayers revolt, only when they figure out very concretely that half the day they work for the government do they really start agitating about big government. A wonderful plot to force the State to retrench, but don't get your hopes up too early. The Supreme Court has ruled that taxation is not for the people to decide.

The proposal about union dues works just the same way. At present the dues are automatically withheld and hence workers have basically no clue how much they pay for their union. But if it becomes a matter of choice—do I send a check or do I keep the money – union revenues and membership and power will shrink very rapidly. If one believes that less unions and less State are the first steps toward a better supply side, this referendum item deserves praise.

The third issue highlighted here is the quaint Italian labor law that allows a dismissed worker to go to court and seek a reinstatement. It is obvious that this measure creates havoc in businesses and leads to deeply unproductive outcomes. There is no issue here of weakening workers' rights but rather one of recreating an even playing field. The proposed alternative of separation payments but no recourse in court is the right economic answer or at least it goes in the right direction.

It will be interesting to watch status-quo Italian politicians faced with these issues. There are no supply-siders in Italy except the referendum-rebels; in Italy everybody near government is playing the end game of accepting the existing system and getting the maximum out of it. The central banker stands in the way of cross border financial mergers, the union bosses stand in the way of free choice for workers, the business leaders have too much to gain from the State to see any interest in rocking the boat.

Yet, over the next few years, Italy ultimately cannot avoid the road laid out by the referendum. Economic performance has been horrible for two decades; the system is grinding down to a halt. The stock market, rightly looking ahead, already sees the prospects of change. The politicians and administrators, as always, are missing the message. In the meantime, even if the referendum is lost under the onslaught of bureaucrats, politicians and union bosses, the revolution is alive.

WHAT IS WRONG WITH ITALY ?[2]

The growth rate of Italy, once a dynamic country, has plain faltered. Spain, in many ways the same as Italy, has kept up substantial dynamism. Over a 20-year period the difference shows. Spain's per capita GDP increased almost 25 percent more than that of Italy. This growth discrepancy starts as early as the mid-1980s. What is wrong with Italy?[3]

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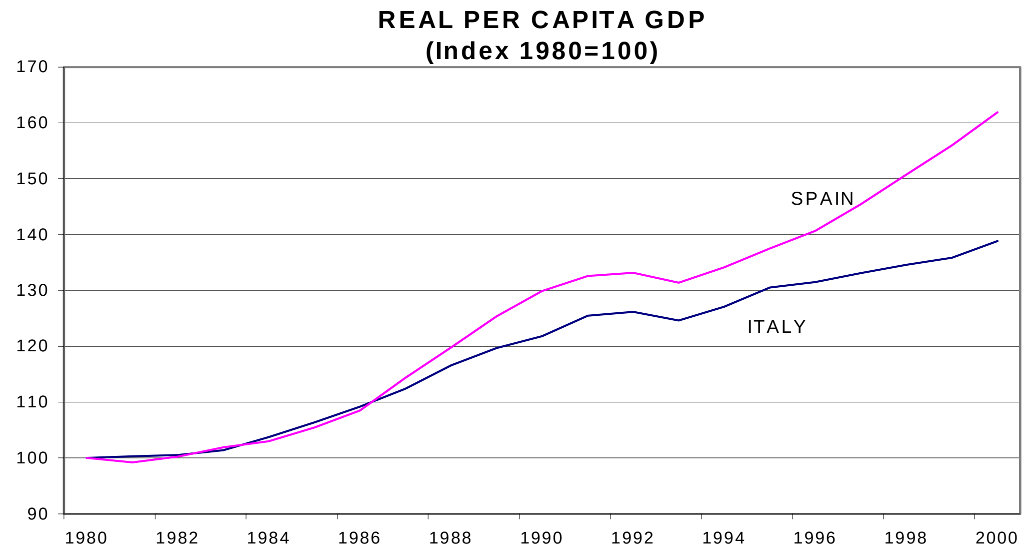
[2] This note draws on research in progress done jointly with Francesco Giavazzi of Bocconi University.
[3] A policy study by the European Union focuses in depth on the Italian case, see "Italy's Slow Growth in the 1990s. Facts, Explanations and prospects" art the EU website.



There are some immediate possibilities:

- Italy has a big underground economy, that is the strongly growing sector and, as a result, the true performance of the economy is vastly underrated.
- There are two Italy's, the one that works in the North, and the other one in the south that is paid not to work.
- Spain had no industry, Italy had a dysfunctional one. In Italy a decade was spent undoing the wrong structure, in Spain the time was applied to state of he art investments in highly competitive ventures.
- The time period coincides with Spain joining the EU and hence getting the boost of the low-wage country with fresh market access. This made Spain an obvious target for direct investment and all that happened in traditional Italian manufacturing industries.
- Spain exploited its cultural links to Latin America to keep up export dynamism.
- Italy allowed itself to be hollowed out by EU competition, as exemplified by the invasion of German automobiles in a market traditionally almost exclusively captive for Italian firms.
- The frenetic pace of turnover of Italian governments destroyed any perspective of stable rules of the game thus destroying incentives for investment.
- Italy, unlike Spain is overly regulated.
- In Italy, unlike Spain, rules are strictly enforced.
- Italy had to carry the burden of a dramatic fiscal adjustment to enter the EU, Spain had not much of a problem to start with.
- Italy, unlike Spain, entered the EMU with an overvalued exchange rate.
- Spain has a long tradition of entrepreneurship while in Italy the State has been the answer all along.

- The Spanish left has been more cooperative in limiting negative effects on profitability and effort.
- Spain is a pooper country than Italy. As an empirical regularity, poor countries grow faster as they catch up.

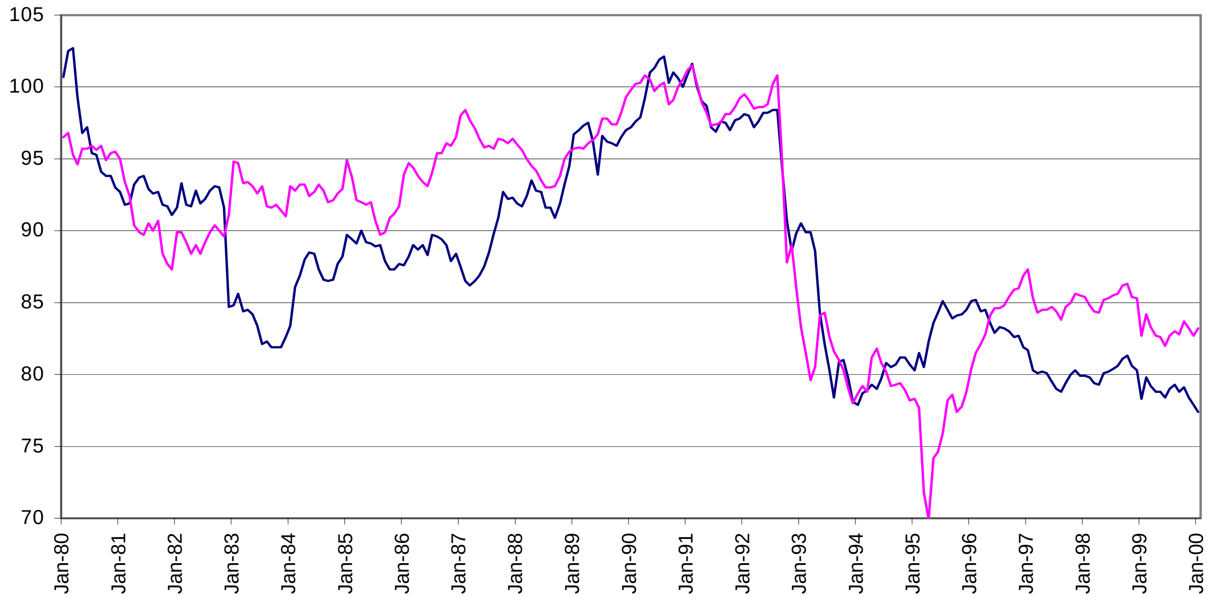
These explanations, and more, range from the patently absurd to the eminently plausible. There is certainly seems to be no simple unique and overarching explanation. But, in a more systematic way, we might look at four headings: the functioning of the economy, including regulation and flexibility. Public finance, debt and budget correction. External trade performance. Saving and the efficiency of its allocation.

We look here at the trade side. A first pass is the real exchange rate. The comparative behavior of Spain's and Italy's real exchange rate is shown below. The real exchange rate picture does not offer much f an explanation—the average behavior in the 80s was much the same, the average behavior in the 90s was much the same and even the '92 drop was almost identical. Any appearance from the diagram notwithstanding, there is just no way here to get an obvious message. The Table makes this clear.

Table 17 Average Real Exchange Rate
(Index 1990=100)

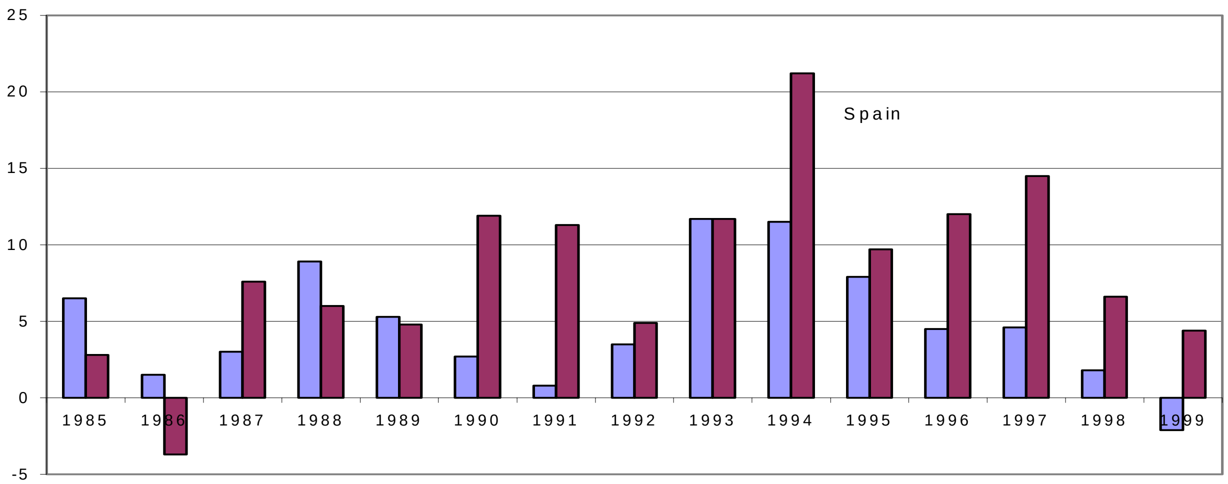
	1980s	1990-95	1996-99
Spain	92	89	81
Italy	94	89	83

REAL EXCHANGE RATE IN SPAIN AND ITALY
(JPMorgan Index 1990=100)



Yet there is something happening on the trade side: Spain has definitely a far higher export growth rate than Italy. A higher export growth rate and faster GDP growth sounds just like a Japanese story of the 60s and 70s.

EXPORT VOLUME GROWTH (%)



Where might be an explanation for the export side? A tempting direction here is the level of wages. Spain has been and continues to be cheap compared to Italy, very cheap. Over the past 15 yes Spanish relative wages (including all overheads) have risen from 60 to 70 percent of the Italian level. But the point is they share still cheap. Both Italy and Spain are producing with great overlap (Germany by contrast is into much higher value added), they compete in the same market, so why would Italy not be hollowed out?

Table 18 Hourly Compensation in Manufacturing
($US per hour)

	1985	1990	1995	1998
Spain	4.66	11.38	12.88	12.14
Italy	7.63	17.45	16.22	17.11

Source: BLS

The trade part is surely not the only story. The other sets of issues will also make their contribution. It is unlikely that we can come up with a detailed accounting, but it is surely the case that Italy needs urgently to improve the profitability of business to restore growth dynamism. There might be lessons to be learned from Spain. But the more immediate strategy must be to look at all infringements of good economics and start dismantling them. In the corporate sector that is starting, the government cannot avoid joining the movement that is getting underway throughout Europe. That will boost growth.

A YEAR OF THE EURO

The first birthday of the euro is overshadowed by foreign exchange troubles. The appearance of problems is exaggerated: flexible rates are cyclical and, at this point, the US is in a super boom and Europe is not. No surprise the dollar is strong and the Euro is weak. If it were not a new money, there would be far less excitement. Expectations of massive diversification into the Euro were premature; even euro lovers pick their time and wait for a bargain.

If the number 1 were not there, the issue would be much smaller. Let not the forex troubles of the Euro detract from the recognition that something formidable has, indeed, been accomplished. Euro-foes proclaim deep dissension in Europe, unmanageable rivalries sand, indeed, cross border friction to the point of war. That has far out extravagant, out of proportion with the issues and defying common sense. The Euro, now that it exists, is good news. Learning to live with it, including scaling down expectations of an early unseating of the dollar as premier money will be essential.
How can earlier euro skeptics, such as this one, get to a positive judgment? First and foremost, the earlier discussion was whether the euro would happen and whether it would be on terms that would not undermine sound money in Europe. On both counts the answer has been altogether satisfactory. Yes, the euro did happen and the uncompomising pursuit of convergence criteria (with really minimal cheating except by the standards of bean counters) was an enormous support for financial stability in countries like Italy. The euro was the kind of excuse without which a financial crisis would seem to have been difficult to avoid. The other side of the coin is this: once created, the euro precludes financial crises of weaker countries and as a result gives Europe a higher average growth rate.

The big positive of the euro is not in the area of transaction costs and transparency. That is mostly a propaganda issue. The real great boon comes from an integrated capital market and a Europe-wide vision of businesses. The formidable wave of mergers underway would not be as easily accomplished without the notion that the European institutions, including a common money, create a vast economic area and require a repositioning of businesses to take advantage of scale and capitalization. The European space becomes a focal point in a way that a Europe of dinky-segmented countries could not possibly have been. But that very wave of business repositioning is a driving force for productivity, for innovation and for opposition to continuing counterproductive regulatory measures that are pervasive. The euro has given business the backbone to start revolting, it is forcing governments to look at a new reality and use it as the excuse fir taking big steps. Germany's tax reform is a case in point.

In time the euro will attract international diversification a major scale. Nobody is in a rush while the US is strong and stable. But that will not be forever and Europe will not look like a half empty glass forever. Of course, Europe is of a divided mind: Euro-nationalism wants a strong currency in terms of the dollar as a show0-you to the US. That is naïve, immature and unaffordable. The other instinct is to hope for a euro that is weak so as to create easy jobs. That is a mistake, too, because easy jobs are bad jobs. The right answer is to have a bit more self-confidence and, as a result, a bit less obsession with the exact reading of the exchange rate.

The ECB has been a focus of concern in the run-up to EMU. It has come out of the probation period with flying colors. The first days were hard and it took a moment to understand what sound communication is all about. But by now the ECB is there and it is running a good central bank and only the most extravagant can imagine that in Europe politics gets to hijack the central bank. Fortunately for all, LaFontaine came at the right moment, early on, and the public at large rejected his notion of political money. The ECB, wisely, stood by and let the market and the public demonstrates in support of sound central banking.

Are fixed rates a problem. Not in practice: Europe has been on fixed rates for all purposes for already 125 years; there is just nothing new here. Nobody wants a culture of depreciation and inflation, and the associated high interest rates. For 15 years already Europe has fought to get out of that mode. Hence it IOUs naïve to bemoan the loss of flexible rates; they were buried a decade ago.

There is the issue of Britain. Should it join? The answer is entirely dependent on how Europe looks in 2001. If it is on a wave of excitement with restructuring, profits, creating jobs and making money, Britain is in. If it is cannot-do, sorry Britain will wisely stay out. Britain hags obvious gains if Europe is dynamic and market friendly, Britain faces obvious losses if it gets re-infected with Europe’s still unsatisfactory supply side.

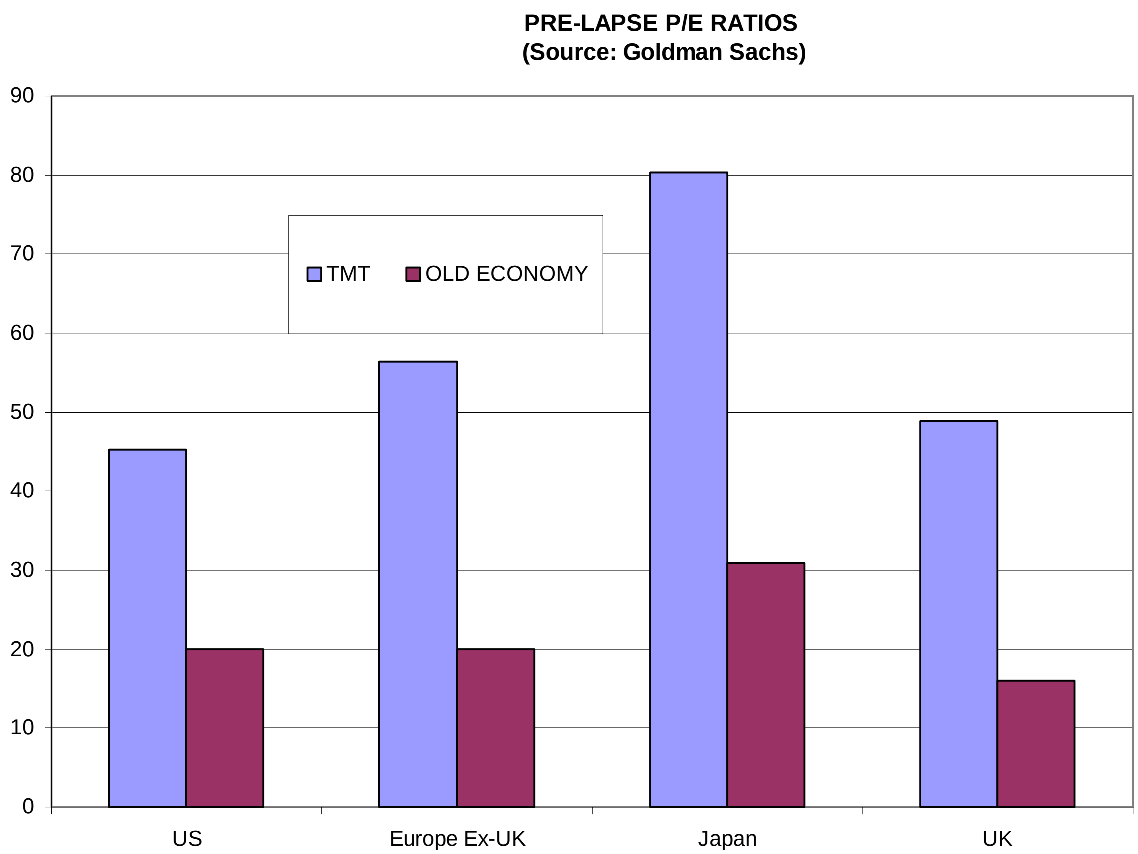
April, 2000

ARE STOCKS OVERPRICED ?

The market correction proves value investors right, from Greenspan to Buffet, -- fortunately they have the good judgment not to gloat.[4] It is important to listen to their lessons of history; it as important not to go overboard. After the first-pass lapse of stock prices, it is worth revisiting the "bubble" issue. The question comes up in two ways, old economy versus TMT (Technology, Media and Telecommunications) but also US versus other major economies. A very helpful (early-April) data from Goldman Sachs helps make the comparisons in terms of price/earnings ratios. The numbers in the figure must be judged against a US 50-year average of the S&P price/earnings ratio of merely 15. All this to remind of what is the basis of stock valuation and to make a few comparison points.

Note first that everywhere TMT P/Es are high relative to old economy stocks. Note also that Japan is high for everything and that old economy UK is priced low (not necessarily cheap, though. Remember, UK old economy means Rover.). Compared to the other markets, the US does *not* stand out as extravagant neither in new or in old economy! With these data in mind, focus on a US bubble, is not justified.

[4] For sobering reading on equity valuation, see Robert Shiller's timely book Irrational Exuberance as well as the relevant chapter in the new IMF World Economic Outlook.



The traditional valuation of stocks figures the price as the discounted present value of earnings. Three factors then affect stock valuation: current earnings, the growth rate of real earnings risk-adjusted real discount rate. Hence, stocks are priced higher, the higher are current earnings and their growth rate and the lower the discount rate. If price earnings ratios are to be rationally high relative to their past levels, and by a very large factor, something must have happened to these determinants.

Economy-wide, P/E ratios can only rationally increase if the current and prospective earnings rise or the risk-adjusted discount rate falls. With an economy-wide unchanged level and growth rate of GDP, the only way capital can earn more is by taking it away from labor. Indeed, in the US the capital share in GDP has been rising over the past 5 years. But, in addition, the boom means higher earnings and the increases expected growth rate due to new economy effects means that capital earnings are also expected to grow faster. All this means equity prices should rise and should rise relative to earnings. In more detail, stocks are worse more (via the earnings channel) if government is business friendly, recessions do not happen anymore, business costs can be depressed deeply by technology and restructuring.

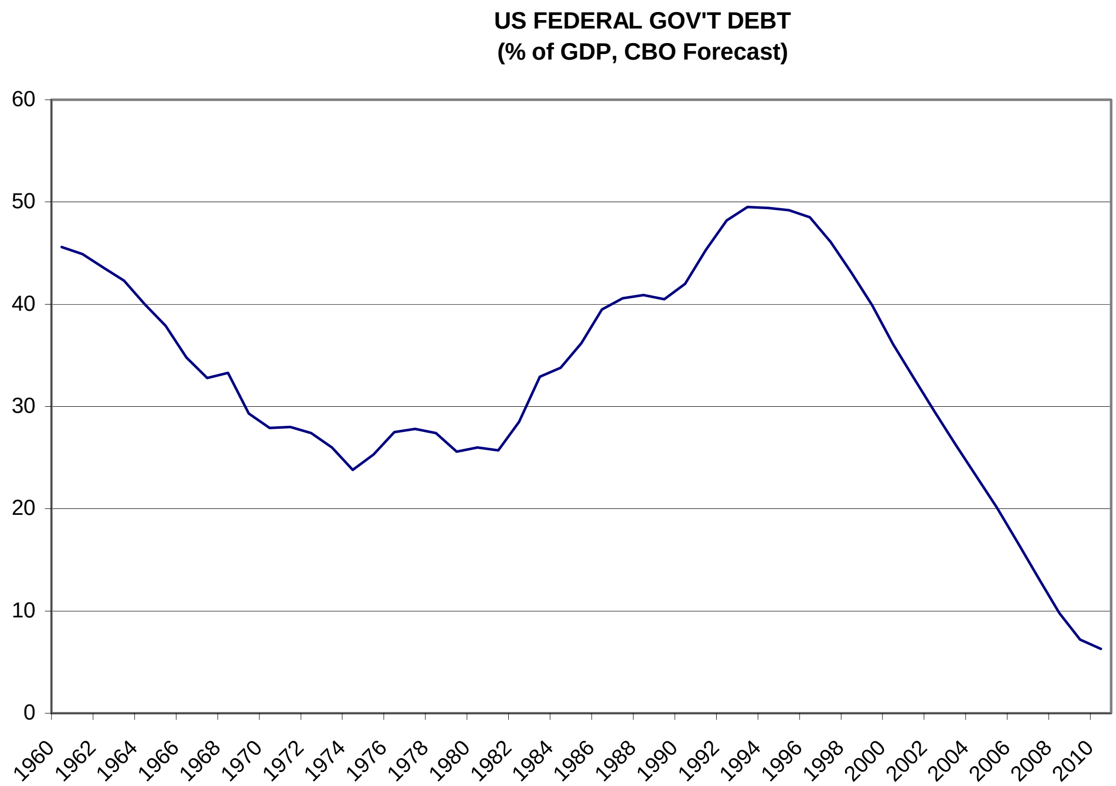
The risk-adjusted discount rate has surely fallen, too. It is made up of the risk free rate (the real yield on government debt) plus the equity risk premium. The real yield on government debt should be down because inflation and inflation fighting have disappeared as a major issue. The equity premium should be down because diversified investment, which has become low cost sharply, reduces the risk of a portfolio. In sum, several good reasons for high prices and high P/E ratios. All this is very true in the US; it is a prospect in Europe and Japan. In that sense, US valuations are more plausible than those of Europe and Japan where much of the work is on the horizon or in the pipeline but still have to happen.

Leaving the economy-wide picture and focusing on sectors, TMT is in many areas a new industry and as a result can grow at a much faster pace than the economy at large. As a result, P/E ratios must be based on the far higher expected growth rates of the industry—their share of capitalization is in excess of 30% but their share in terms of GDP somewhere near 10%, the gap reflecting expected high industry growth of earnings. There is a separate question of whether the large discrepancy in TMT and old economy P/E ratios is justified; that there should be one is not in question, that it should be as large is just being questioned. The most recent market judgment is to take down the earnings prospects and hence the equity prices.

The limited correction—lapse, not collapse—of stock prices over the past few weeks suggests that investors are looking back to traditional valuation. Stocks were not cheap and even now are not cheap. But that is not to suggest for a minute that we should remotely expect to return to a P/E ratio economy-wide of say 15 just because that was the average of the past. The US economy is a far better place as more and more of the corporate sector is becoming “new economy”, capitalism is doing far better worldwide, the business cycle has become a banana. All that supports far higher equity Valuation than we have had in the past. Three cheers for stocks, particularly in the US.

WHERE DOES PUBLIC FINANCE REALLY STAND?

In the US, government buy-backs of debt and the prospects of surpluses forever have created havoc in capital markets not accustomed to the notion that public debt might actually and literally disappear. The accompanying chart uses the most recent CBO forecasts. By 2010 there is not much debt left relative to GDP, US government bonds might become collector's items barely 20 years after a discussion that had at its center an explosion of debt and deficits.



The US forecasts are almost surely far too optimistic. They are based on a steadily growing economy with moderate inflation and no significant interest rate hikes. That part is all right because, if there were a slowdown, that creates disinflationary room for somewhat faster growth later and thus episodes wash out. No problem here. But there is another assumption that is far more ambitious: that Congress can keep itself from cutting deeply into surpluses.

Table 14 US Federal Gov't Fiscal Prospects (% of GDP)			
	2000	2005	2010
Budget Surplus	1.8	2.2	3.3
Debt	36.1	20.1	6.3
Source: CBO Baseline Projection			

Over the past decade, in a haphazard fashion, there was indeed a lot of discipline: spending kept being pruned, taxes kept being collected at high rates, spending caps kept being observed. But all that is now under attack. In fiscal 2000 there is huge real growth in discretionary spending and presidential candidate Bush is calling for tax cuts. Yes, there is plenty of money in the budget to finance these adventures-- adventures because a booming economy does not need the extra impetus to spending. But the point is that in the end the present outlook for budget surpluses and for cumulative massive debt reduction may just be a fairy tale. It is safe to predict that debt/GDP ratios below 10 percent by 20210 are not going to happen. The money is already burning holes in congressional pockets!

Of course, Europe is nowhere in the same neighborhood of super performance, but at least the picture is sharply improved from a decade ago. There is seemingly room for plenty of optimism: budget deficits are small or non-existent. General government debt levels are not exactly low but they are at least stable. Hence public finance is not an issue of active concern. The accompanying table certainly conveys that message.

Table 15 General Government Debt and Deficits
(% of GDP)

	Gross Debt	Budget
EU	74.8	-1.2
UK	51.2	0.8
US	57.1	0.9

Source: OECD

But the optimism suggested by small deficits or surpluses, substantial primary surpluses and sliding debt ratios is vastly exaggerated. It is exaggerated in two ways. First, as already suggested by the US case, after awhile politicians get fed up with austerity and that is more the case the less there is a crisis atmosphere.

There is a far more tangible way to assess the state of public finance, which comes from an intergenerational assessment. In that long run perspective, the question is asked what are the fiscal burdens on the future of unrealistic economic judgments about growth and demographics, given the initial debts? This is inevitably a speculative task and nobody should think it an exact science. Over long periods, demographics can shift, trend growth rates can change and so too can key government policies toward retirement, social benefits and the entire area of public health care. With these caveats, intergenerational economics asks: What must happen *NOW* to public finance to keep burdens on future generations from being far higher than on present generations? The answers are deeply discouraging-- it takes a massive fiscal consolidation in the euro area, in the US and much less so in the UK. We don't even report the conclusions for Japan!

Table 16 Public Finance and Intergenerational Equity: How Much Correction is Necessary?				
	% Cut in Gov't Purchases	% Cut in Gov't Transfers	% Hike in All Taxes	% Hike in Income Taxes
Euroland	34.7	13.4	9.6	36.9
UK	9.7	8.1	6.3	9.7
US	27.0	20.3	10.8	24.4
Source: Kotlikoff et al.				

The message is out and out bad. A 10 percent across the board tax hike for Europe and the US is certainly not what the electorate is waiting for. Nor are they waiting for double digit cuts in transfer programs. (In interpreting the numbers, comparing the EU-11 and the US, it must be kept in mind that in the US transfers, for example, are much lower than in Euroland. As a result, in comparative terms, the US looks much worse than it is.) Cutting government spending by a third in Europe or a fifth in the US would seem unimaginable. Yet, the message is that unless this happens, the burdens on future generations will have to be far higher than these corrections-- they will have these corrections *plus* the extra cost of having postponed them by a decade or two.

How reliable are these estimates? They are pretty heroic in that they have to make assumptions about trend growth rates and long term interest rates, about demographic trends and the persistence of current budget and pension policies. Change the assumptions and the conclusions will change. The underlying assumptions made here are not at all far out; this is the best disinterested judgment we are likely to get. Sure, politicians intent on avoiding action can create amore rosy scenario by arguing that growth will increase and interest rates will fall but why should we believe it?

There are three issues raised by these questions. First, how did we get to such a situation? The answer is easy: while debts were low and the philosophy of the welfare state was popular, big spending was politically attractive and easy to finance. Once the policies have been in place, they are viewed as entitlements rather than an unaffordable extravagance. The US has been able to make some inroads, the UK has been able to do much on the pension front by delinking benefits from current wages, but Europe has accomplished extremely little.

The next question is why, with debt and deficits seemingly under control, things get so much worse over a 20 or 30 year horizon (much faster in Japan, though!). Here the answer is demographics: retirements at great and early benefits with increasingly fewer taxpayers to foot the bill. If retirements were pushed out aggressively, retirees would be taxpayers instead and the equation would change dramatically. That remains a totally controversial and mostly unsuccessful discussion in Europe.

The third question is how this whole bad dream might (or will) go away. After all, most bad dreams don't actually materialize. Major initiatives of farsighted politicians are surely not the answer. (In fact, President Clinton gives massive attention to staging highly visible buy-back ceremonies to be remembered as the one president who did!). The answer would have to come in one of two ways: far better growth performance on average for a very long period of time. That is not impossible and could even be underway already in the US. The other possibility is a sharp change in demographic trends so that birth rates and immigration rates pick up and yield a large new pool of taxpayers. Neither is sufficiently likely to put much faith in. That makes future public finance one of the most formidable problems of the world economy.

THE WASHINGTON IMF-WORLD BANK PROTESTS

This is the third round of protests, Seattle, the City of London and now the demonstrations against the IMF. Perhaps as many as 15,000 people demonstrated against all and everything that irks them: human rights issues, women rights issues, workers rights issues, ecological rights issues along with anti-war issues, Tibetan rights, and a myriad of other concerns that the 50 plus groups brought to the occasion. A brief look at the demonstrators' website *a16.org* gives the full flavor, including even the anarchists' domain. The extraordinary phenomenon is not protest per se, but the sheer ability to aggregate and mobilize so many diverse groups into one giant anti-everything-that-is-wrong-in-the-world scream. The central focus of the protest is, of course, the large and greedy, profit making multinational corporation. Should we take it seriously, is there a message, is this representative of a widespread rejection of the way the world economy is working?[5] Or is it a well-organized mobilization to lend a voice to fringe issues that cannot carry their weight in the democratic process?

The demonstration is sure to get worldwide attention; it's the best show in town. But no, we should not pay attention and surely not be dissuaded from a sound economic approach to managing the world economy. The most important reason is that, behind the scenes but not really hidden, is the chief force, namely, US organized labor. It all comes from the people who have terrible problems with free trade (Nafta, China, the WTO and anything that looks like market opening). And when they play internationalist, don't believe it for a minute. It is all about raising labor standards abroad to the point where workers in poor countries are overpriced and lose their jobs. Policy makers in poor countries have long understood that their chief enemy is the "fair trade" league in the US, unions and environmentalists.

More narrowly, in the minds of the demonstrators, what exactly is wrong about the IMF and the World Bank? They are singularly inarticulate on the issue, but four points do

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[5] Surprisingly, there is some professional support for the demonstrators, notably the former World Bank chief economist Joe Stiglitz. See his piece in *The New Republic* and for a comment see "Stiglitz vs. IMF" in my website http://web.mit.edu/Rudi/www.

emerge: First, no to IMF programs that fall on workers and the poor. How to avoid it? Their answer is bankruptcy arrangements and haircuts for creditors, bigger social programs, capital controls. Many countries have barely recovered from such bad ideas, what a tragedy if that were to come back. The second issue is environmental. The demonstrators indulge an idyllic world of windmills throughout the emerging world where happy farmers and their donkeys bond with an ever-renewing nature. A wonderful image if it were not for abhorrent poverty.

Lastly there is always the “dump the debt issue” of freeing the poorest from unbearable and crushing debts. Yes, let's cancel those debts but lets get in exchange better governance rather than a no-ties write off that can only worsen credit standing and does nothing for economic performance. Of course, conditionality is just what the demonstrators have the biggest problems with. They like a world where countries are governed by their own needs and priorities. They do not acknowledge that misgovernment is the rule and conditionality is about getting a minimum of stability and progress. Lastly, there is the issue of transparency—why does the IMF not hold town meetings, why does the World Bank not reach out to all the NGOs and at least listen? They try to do just that, but seemingly nobody pays attention.

The most intriguing question is why trade and corporations have such a bad name and what to do about it. This is even more surprising in the US where there is full employment and a seemingly unending boom. The answer is surely that, even with jobs and easy credit, workers never have lost the memory of 20 years of deregulation and restructuring. They have a job and they say jobs are easy to find. But good jobs, no they are gone. And who took away the good jobs? The large and greedy multinational corporations, the people who behind closed doors make reckless decisions about peoples' lives and even get unbelievably rich from it. New Economy is wonderful for economic performance, but it imposes adjustment, pace of change and strain on many far out of proportion with their ability to cope. It’s a young peoples' model; it’s a winners’ model. Europe and Japan will inevitably go the way the US has traveled, let’s see how the governments cope with the revolt.

The Seattle and Washington demonstrations make another point: If CNN turned the world into a global village, the Internet goes six steps further. The ability to organize via the web is out and out mind boggling. There is a future for activists and a scope for mobilization that are only starting to become apparent. Around the world, we will be getting direct and in-your-face democracy in a way that is all out formidable. The web is making large traditional political parties as obsolete as bank branches or bookstores. Virtual politics, whatever that will be, is around the corner.

June, 2000

NEW ECONOMY - NO REQUIEM YET

Until recently the new economy" was reigning supreme: there was the boom—no inflation to speak of, stocks at all time highs and beyond, four years of 4 percent plus growth, full employment, budget surpluses and a benign Federal Reserve. A new world had opened up and even the most cynical septic had to surrender to the new economy. But now everything looks a bit different. There are signs of inflation in product and labor markets and the only question now is whether the economy will slow quickly by itself or whether the Fed has to beat it into the ground, as has been the case in past expansions.

Suddenly the New Economy (NECO) does not look so cool. Hence the question, was it all hype, exaggeration or will it stand up beyond the slowdown? Yes, NECO will live on in the US and it will spread throughout the world; it will become as pervasive as the welfare state and big government did in the 30s. It will shape our economies and our lives for the next decades.

New Economy involves four interacting drivers: technology, competition, and a new economic culture for government, households and business. Investment complements these drivers. Let us review these briefly. Technology is the most obvious part: a revolution in telecommunications that is far more pervasive and more importantly spreading more rapidly than the telegraph or the telephone did in their time. There is also the information revolution with a formidable ability to create software programs that restructure dramatically tasks from accounting to ticketing, from finance to shopping to leisure. All this is far from done: in fact, just the past few years have shown the dramatic step from possibility to reality for a widening range of applications. The explosion of computing capacity introduces opportunities that simply were out of reach even of anyone's imagination.

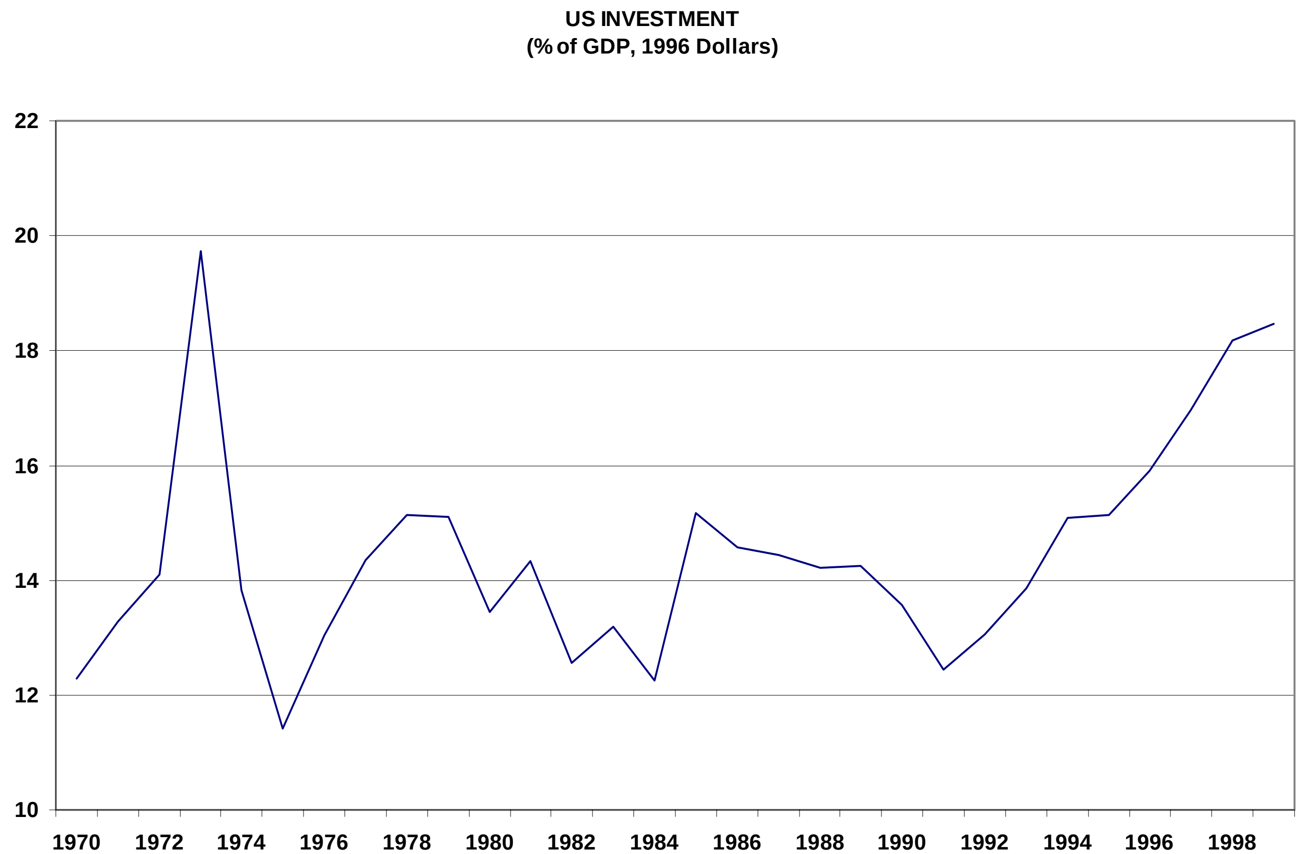
The second driver is competition: we have not had as much and as pervasive competition since early in the century or perhaps ever. Moreover, sharply higher competition is even becoming the rule in countries that hate it like the devil—Germany, France, Japan and more. The agents of competition are of course world trade, made more effective by technology, domestic deregulation or dismantling of the welfare state, stockholders that for the first time insist on getting their pound of flesh. Risk capital is available to anyone, not just the establishment, and there is no limit. Suddenly everybody has choice, learns fast about best opportunities and best practice. It is a short step from there to the breakdown of protected markets. It's a rat race, but everybody, at least as a buyer, is king.

The third driver is a new economic culture. Central banks and treasuries have learnt not That stable prices and sound budgets bring am extraordinarily important contribution to prosperity. At least as important, individuals and businesses have gotten the two key messages of a world where everything is possible: " Don't take NO for an answer!"

And “Don’t wait for the government, if you have a problem solve it.” These new attitudes fundamentally change the way the world works: middle management, the great establishment of tradition is being liquidated as is the case in every revolution, protagonists of the status quo are kicked out. Risk talking us valued rather than shunned. Young people want to be in startups, not in investment banks. The man who said it was impossible is interrupted by someone who just did it.

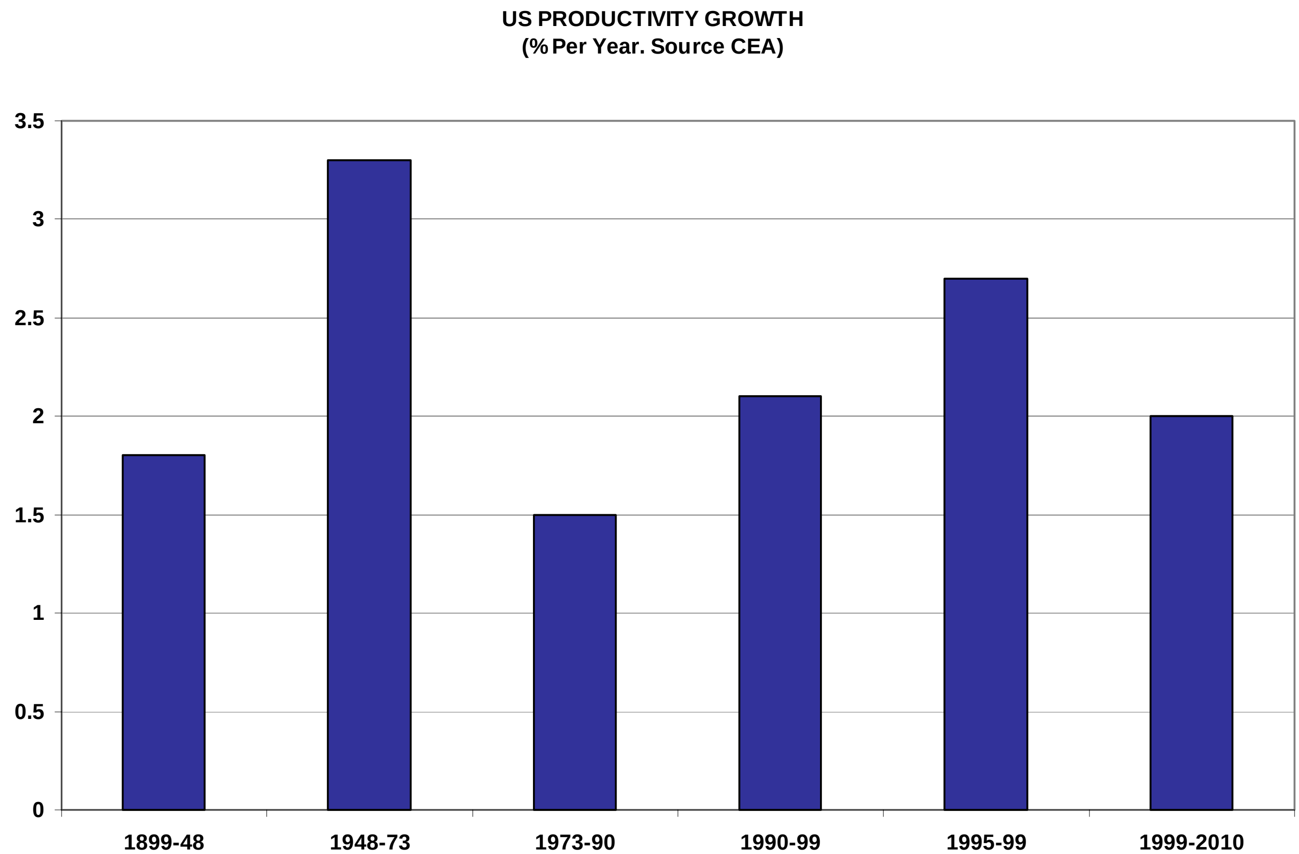
These NECO drivers create a formidable force for change, something Schumpeter (the beginning of the century failed Austrian finance minister at 21, bankrupt banker shortly after, and formidable Harvard economist after that) called creative destruction. He envisaged the result of a major market opening by trade or changed rules of the game, or of an important innovation. The result would be that the existing economic situation—prices, players, rules of the game—would change throughout the economy. In the process a dramatic reshuffling would greatly raise productivity as the established and tired organization of the economy breaks up. Surely there is no better example of Schumpeter’s creative destruction than what has happened in he US over the past decade. Surely too, that cannot stay a US story; indeed, it is the very proposition of creative destruction (reinforced by economic openness and technology) that it now will sweep the whole world.

Skeptics keep arguing that competition and technology wreak havoc for the established harmony in society, that it created inequality and does away with the middle class. True, NECO is tough for those who sit on their backside and live at the expense of stockholders or taxpayers, true it gives a chance to people on the sidelines. Interestingly, in the US it has meant full employment and, most recently, a sharp improvement in the economic status of the poorest. Yes, [people change jobs, yes they have to hustle, but who want s to go back to the 80s? Not the parents who see great mobility and opportunities for their kids, not the kids who have the time of their life. Three cheers for creative destruction. In the meantime, productivity growth is formidable and high rates of investment push out bottlenecks and implement the new economy.



All this used to be called neoliberalism and free market economics-- for many that was ad derogatory connotation. Now it is “New Economy”, everybody’s game. It plainly has come of age. Of course, even with NECO the world is still round. It does not offer a quick way to riches, it does not double the growth rate, it does not happen to you by just breathing the air. It is hard work and its miracles are limited but real: Finland as a high tech center of the world, Germany lagging because change is trouble, Japan’s slumping economy rescued by formidable technology potential, the US with an extra 5 years by pushing out the bottlenecks that typically translate expansion into inflation. Fresh juice for a world economy that does not have anymore central banks or treasuries to create false prosperity. And most important, perhaps we have even done away with the business cycle. Far too early for a requiem, NECO is just starting.

In the meantime, even with boom growth rates, as boomy growth in productivityholds the Fed on the sidelines. The show keeps going.



THE FED, STOCKS & LATIN AMERICAN VULNERABILITY

With its recent rate hike, the Fed has declared open war on inflation, Bad news for Latin America! Every country in Latin America has a current account deficit, (every country in Asia has a surplus), every country needs money from abroad. And if the money does not come there is trouble: interest rates will rise, currencies will depreciate where they are flexible; crisis rumors will come where they are not. Nobody will look good. That surely is the outlook for the coming year.

The only hope for Latin America is a resounding crash of US stocks because, in that case, the Fed will cut rates aggressively to restore confidence and provide ample liquidity. That is possible but very unlikely. The central scenario is much higher rates in the US, a large increase of risk spreads for Latin America, slower US growth and hence from the combined effect, inevitably a slowdown in Latin America. Those problems will be more acute the less reform has happened, the bigger budget problems and the more intense other factors that are already straining the inflow of money.

On the US side there is no question about what needs to be done. The boom must be brought under control, hopefully with a soft landing. Forever the amazing question was "Where is inflation?" Don't look further; it has finally arrived. It is here and it must be dealt with. The Fed cannot hope for the best and do nothing, it cannot assume the stock market will fall and slow the economy. It can take nothing for granted, it must act to bring avoid a serious slowdown from 5 percent growth over the past few years to something like 3 percent in the coming year. The way to do it is to raise interest rates, gradually but steadily, but at least 100 basis points and perhaps more. Over time the economy will adjust to the tightening and, with a bit of luck experiences a soft landing. There is no risk of a catastrophe—both monetary and fiscal policy, and a lot of experience of policy makers, can avoid such prospects as stock market crash and deep recession. But the economy will slow and the monetary tightening will bring down stocks and raise credit spreads and increase credit rationing at home and in Latin America.

The full extent of rate increases remains uncertain: demand growth must slow down but that can come via higher interest rates or via the impact of falling stock prices on wealth and spending growth. The more stocks fall, the less the Fed will have to do. When everything is done and markets have cooled off, we will be left with rates that have risen less the more stocks will have fallen. That has to be Latin America. By contrast, if the stock market is stubborn, the Fed has to fight harder and Latin America is under more stress.

The months ahead are not good for Latin America, no way. When there is trouble at the center, there is lots of trouble on the periphery. But it is not just that. This is the 6th year in Mexico and every 6th year Mexico collapses. Will it happen again? There is civil war in Colombia and the government is losing there is a difficult president in Venezuela, Ecuador is bust, Peru has political trouble, Argentina is in the midst of formidable credit problems.

The region once again does not look at its best and that, of course, vastly amplifies the risks from volatility generated by center policy shifts in a direction of high rates and illiquidity. It would be a mistake to conclude that the entire problem comes from US policy, as – so goes the story—it always has. No, the problem is in Latin America in that the economies are not resistant to bad news and, for that reason, any bad news becomes a major issue. Of course, it is hard to have bulletproof economies. The government agendas are loaded with important social issues and plenty of political priorities. Hence, n surprise, insufficient attention goes to cleaning up and strengthening economic institutions during those brief periods \where there is no stress. That was the case everywhere, notably in Argentina, where the Menem government in its second term went to rest. The incoming government also, beyond some moderate measures, assumed Falsely that there was no dramatic problem and hence opted for the soft touch. No surprise that it's long standing credit problems suddenly become an emergency. Of course, there won't be devaluation but as surely the credit quality issue is intense. Soon its time for a new team with Cavallo-style credibility.

It is tempting to put much stock in the latest US news of a slowdown underway, of very soft landing in the making. Yes, that would be wonderful – crisis avoided once more! But don't believe it yet. The Fed cannot assume that the economy has shifted into slow gear just on one set of data. There is more to come and for the time being the latest inflation numbers are far more of a concern than the first indications of the possibility of a slowdown.

FINANCIAL CRISES, EXCHANGE RATES AND THE IMF[6]

George Soros has been on two sides of international financial battles: as an important protagonist in bringing down currencies, as in the case of Sterling or the Ruble, and as a commentator reflecting on existing arrangements and their shortcomings. In this volume honoring his accomplishments as a philanthropist, a world financial personality and a thinker on issues of the market and the open society, it is appropriate to comment on current issues in the very fields he has taken an interest in. Leaving philosophy per se to others, comments here will focus on several topics in the area international financial institutions and markets.

Emerging Market Financial Crises

Among developing country currency crises another useful distinction is that of the old-fashioned slow motion current *account crises* of the 60s and 70s and the new ones that might be called fast motion balance *sheet crises.*

The old style crises involved misaligned exchange rates and spending levels. With spending high relative to income and the currency appreciated in real terms, in time financing runs out. When capital inflows no longer finance the current account deficit, reserves start running off. And once that process gets moving it is only a question of time. With finite reserves and borrowing facilities, deficits are unsustainable and hence must one day end. Of course, governments can invent extra lives for an overvalued currency by introducing exchange restrictions, trade restrictions, restrictions of all kind. But even these cannot add much time even though they come at a great cost to economic inefficiency. In the end the devaluation comes and a new chapter is opened.

In the old fashioned world in which capital flows and balance sheets plays no role and hence the run-up to and the actual event of devaluation are thoroughly uneventful. They do not really deserve the name "crisis" except that the devaluation does offer a resolution, at least until further notice. Today it would seem to find a candidate for such a crisis. In most emerging economies capital markets have been liberalized both within and cross-border and hence the sheer thought of an oncoming devaluation creates havoc. But there are, indeed, a few left. The best candidate today is probably Egypt: the country keeps appreciating in real terms, reserves keep falling. Everybody waits for the government to make up its mind that devaluation is desirable, necessary and inevitable and it is only a question of time. Everybody knows it is some 10 percent or so, not much more, and God only knows when.

In other words, a very dull situation for everyone except a handful of people who will lose their job when it happens simply because someone needs to get the blame. In the

[6]To appear in Essays in Honor of George Soros on his 70^{th} Birthday, a publication of the Central European University, Budapest.

meantime, somewhat increased interest try and rates restrain imports and the little capital that might leave. Repressed finance, to use the technical tem describing a bankrupt and government controlled financial system, is mostly untouched by what goes on.

The difference with the new fast-motion crises could not be more different. The background here is one of *some* vulnerability in the domestic banking system, in the government debt market or on the external front in the form of misaligned exchange rates and out-of-line current accounts. The problem can be inside or on the external front, little difference. The next point is the understanding that if anything goes wrong, everything will go wrong. Why? A default risk of banks means a domestic financial collapse and the wise preemptive move for foreign lenders or domestic residents is to get one's money offshore. The same if there is a question about domestic public debt, foreign debt, or the exchange rate. Whatever weakness is expected, it undermines deeply the national balance sheet. And when, in he end, one and hence all of these vulnerabilities come into play, the blow-up ids enormous.

But let us get somewhere mid-way into the story. The country has been discovered, it is a miracle country with growth success and bold reforms, not in the least the opening up of financial markets. The exchange rate system is predictable and offers a vast excess return on borrowing offshore to make loans at home, real estate and all. No questions are asked and where necessary envelopes change hand to grease the wheels of easy credit.

The next phase is some question about the sustainability: Can the exchange rate last? Have the loans made with borrowed money sound, will money keep coming. At this stage there will be a difference of opinion: Those who believe the government ort have no alternative but continue the Ponzi game of borrowed prosperity will accept to borrow more, in dollars and at shortening maturities. Those who believe they have seen it all before will take their money out. The central bank is caught in between: raising interest rates might keep the money in but worsens the balance sheets of financial institutions and the prospects for growth. Lowering interest rates helps growth and the balance sheets but it also means that money will more plentifully leave. We are already in the last phase, which has the one certain outcome; the currency, the banks and many companies will. That might only come a year later or even two, but it always happens. And the longer it takes to get there, the more betting will have taken place and the worse the balance sheets of those who believe that ultimately everything will work out.

When the crisis does come-- Mexico, Russia, and Asia-- the result will be a formidable mismatching of maturities and of denominations. Banks may have borrowed in dollars and let in dollars but to customers who do not earn dollars. Or they lent in local currency and break for that reason. Or they get caught by the short maturity of their liabilities relative to the long, illiquid, and often impaired credits on their books. The experience a sudden stop of rollover of their funding -- " it is not speed that kills, it’s the sudden halt " the bankers saying goes and the rest is history.

Two summary points in these crises are worth bearing in mind: first, it does not really matter where the misalignment is; in the end, everything goes. In Korea it was the banking system and the Chaebols, in Indonesia it was everything, in Russia it was the public debt and the banks. The reason is that soundness does not exist, the entire balance sheet is vulnerable, value at risk is formidable. Even though the country may have functioned with the system for years, the decisive shock of a run, a funding cut off, or a massive capital outflow followed by currency collapse brings down *everything.* And because everything goes, the benefits of a sharp real depreciation are little solace because the costs of a destroyed financial system are formidable. The second point is about timing: financial crises, even when they are quite obviously in the making, take longer to come than you think; and then they happen much faster than you would have thought. A good chance for economists to be wrong twice.

With these characteristics in mind, what s the recommendation for avoiding crises in the first place? The answer surely comes in two parts. First, emerging market economies should not have exchange rates. Their institutions are far too weak for the enormously difficult task of managing sound money. Even Italy and France surrendered in a merger with the German Bundesbank; alone they could not deliver good money! Emerging market economies should have a rigid currency board arrangement. Eastern Europe should be on a currency board with the Euro and, ultimately, be part of Monetary Union. There can be no reason to wait even a day.

And Latin America, obviously, should be on the dollar. This is most obvious in Mexico where, once again, the real exchange rate is in discussion and the typical 60year cycle is conceivable though unlikely once again delivering a collapse. And what goes for Mexico also holds for the rest, from Central America to Brazil and Chile. Argentina has no easy time given its credit history and debt overhang, but at least it has the confidence that stems from a decade of sound money. In Asia the pattern of trade makes it harder to select but even here, rather than the current undefined regime, a dollar currency board would be a great advance pending the arrival of China as the center country in the next decade or two.

The second critical element for financial stability is a sound banking system. Given institutional weakness and the politics of banking as a preferred agency of political loans and parking lot for dead credits, the banking system should be sold to offshore sound banks. They, in return, would have to provide the lender of last resort function which central banks ands treasuries are too weak to do effectively. That means good banks and this is, of course, a prime ingredient for growth.

The IMF

In the aftermath of the Asian crisis, the IMF has become the focus of widespread criticism and a call for reform. Some like former Secretary of State George Shultz propose to abolish it. Others, including some members of the Meltzer commission look for radical reform. Still others, including the US Treasury seek moderate refocusing of goals and operating procedure. Yet others, most prominently Joseph Stigilitz the former World Bank chief economist and distinguished academic, see nothing right about the IMF and merely offer scathing (ignorant and misdirected) criticism.

There are three sets of overlapping issues in IMF reform: how to make the IMF better prepared to anticipate/prevent crises, what remedies to apply when a crisis does occur, i.e. are IMF programs right, and how to restructure the IMF as part of international financial architecture.

Consider first the crisis prevention issue. In health care it is widely accepted that preventive care vastly lowers the costs of a system by both avoiding the build up of crises in the first place and by early detection. Much the same surely applies in international finance. The interesting crises in this perspective are of course the ones that are large have spillover potential and bring down regions and perhaps even the international economy. Clearly, these are balance sheet crises and the appropriate prevention must focus just here. As I have argued elsewhere, the IMF should conduct systematic *Value at Risk* analysis of client countries' financial systems.

Such analysis is complicated, there is no unanimity about appropriate models, and it is often a scenario issue rather than a daily risk measurement. All that is true, but responding by doing nothing is absurd. Yet, until very recently the very notion of value at risk was alien to IMF country inspection. Even today, now that it is recognized that the fact and magnitude of the crises is a reflection of balance sheet vulnerability, value at risk scenarios have not yet become routine. There is a focus on data dissemination but not on risk measurement.

What would such analysis reveal? It would have shown the exposure of Korean investment houses to Russian and Brazilian debt financed with short-term dollar or Yen loans. It would have revealed the exposure of Thai and Indonesian banks to a funding run. It would have exposed the maturity and denomination of Mexican funding and the resulting explosive vulnerability of the entire national balance sheets. Of course, that issue continues to be live in many countries.

The second issue that attracts very lively criticism is the particular form IMF programs take. Why so much austerity, why high interest rates, why fiscal contraction in the midst of what already is a crisis? This range of criticisms became most vocal in the Asian crisis, unlike during the Mexican events. Countries were indignant with the fact of a crisis--they had been stars and now they were goats. They were struck buy the balance sheet collapse and could not fathom why the way out were high interest rates. Their questioning was reinforced by Japanese criticism of IMF programs and, most vocally, by the ex-chief economist of the Word Bank, Professor Stiglitz. In a lead article of the *New Republic* he lambasted the IMF and the US treasury for their alleged mismanagement, for poor economics and an unqualified professional staff.

The criticism is misdirected. When a crisis does occur, hemorrhage must be stopped and there are only two ways: disrupting a commitment to an open capital market in the manner of Malaysia or else by a demonstration of an unwavering commitment to financial stability. When countries are carried into the IMF, as it were on a stretcher and into the emergency room, it is a poor time to try cute ideas. Basic trauma treatment is appropriate and niceties must be set aside in favor of basic survival treatment. The latter route worked in Mexico and Brazil and in all those Asian economies, notably Korea, that signed on to full and unqualified IMF treatment.

The remaining issue is the reshaping of the IMF. Issues range from lending policy to conditionally, from transparency to governance. At one extreme, there is an attempt to have unlimited support for pre-qualified customers. This is the view of the Meltzer commission that wants to narrow IMF rescue down to having countries pre-certified on their policies so that any crisis situation is an "honest mistake". That leaves open the limits on bailouts and, more importantly, the question of how to look after the system when a big or a group of big debtors go into crisis, honest or not.

At the other extreme is the IMF's deputy managing director's position, Stan Fischer. He makes the case for the IMF as a formal lender of last resort, an important stepping up from the current ad hoc role. Neither of the extreme proposals will go anywhere. The IMF remains the policy tool of the major economies in the world, it will operate-- principles or not-- in their interest and, at the best, it will improve its surveillance and transparency.

The right focus, in any event, should not be the bailout function but rather the preventive role. That could be done in a minor way with transparency but it is much better accomplished by having currency boards and offshore banking guarantees. That direction of reform would abolish amateur central banking in emerging economies and it would make crisis prevention market-based by enrolling the self-interest of the private offshore lenders of last resort.

The Euro

Among the current issues in international finance, the creation and the early performance of the Euro has rightly drawn important attention. This has been a once-a-century audacious step. Its success remains to be seen, but there is no lack of conjectures. Among the chief critics were George Soros and Martin Feldstein .

The Euro raises three important questions. The first is surely whether the European Monetary Union in some significant way improves on the preceding arrangements of a Bundesbank-led hard money zone. That, indeed, had been the prior arrangement although the ability to temporarily opt out had been used in 1992 by Italy, for example. The main conceptual idea in evaluating the usefulness of a monetary union goes under the heading of "optimum currency areas". This perspective, due to Nobel Laureate Robert Mundell, argues that in principle a world money is the best solution in minimizing information and transactions costs. But flexibility of relative prices is essential, too. To the extent that, with an economic region, wages and prices are inflexible a flexible exchange rate toward the outside can make up as an adjustment tool. Hence the optimal domain of a currency union is the economically integrated region that experiences common shocks relative to the test of the world. Europe pretty much meets that criterion.

There is also an entirely different and probably more important perspective in looking at the integration of capital markets. A monetary union can play an important role in creating a region of financial stability. Brining under the same roof a stable core-- Germany-- and a more precarious periphery helps stabilize the latter, avoids regional currency and fiscal crises. Surely the Europe has accomplished that even before it started: Italy and France were house-trained, Italy's looming fiscal crisis went away by the simple fact of common and low interest rates. The Euro did miracles.

There is the next question of whether the Euro can last or whether the inherently divergent political objectives and monetary cultures must clash within and across the Atlantic. This point has been made by Feldstein when he notes "If EMU does come into existence. It will change the political character of Europe in ways that could lead to conflicts in Europe and confrontation with the United States." Outside the United States this way of thinking has been widely interpreted as sour grapes in the face of a dramatic European quest for a role in world leadership.

It is hard to be impressed by the argument that the Euro breeds conflict. For a decade or more, European central banks, notably in Italy and France, have pursued a follower-role to the Bundesbank, accepting the leadership even when Buba policy was not obviously in their interest. Today money is managed jointly. A European focus is explicit and the role of the ECB is accepted in its commitment to price stability (remember Germany's finance minister Lafontaine falling from grace in no time after his attempt to usurp the independence of the ECB. It is certainly true that Bundesbank policy conducted with Europe in view is not right for everyone-- Ireland has a boom and Italy stagnates. But surely Italy would not prefer to devalue and it is not obvious that Ireland would want to appreciate. Yes there are tensions but it is also recognized that monetary policy cannot solve all problems. In fact, the very creation of the ECB makes it more apparent that it is a mistake to overburden the central bank and neglect a serious commitment to supply side economics.

As to a conflict with the US, a more seriously managed European money, and seriously managed US money, surely are an expression of partnership. To argue that Europe grows stronger as a result of an economic and monetary Union is totally appropriate. It is also appropriate to note that precisely this has been the US objective for the past 50 years. The US has believed, and acted on the belief, that a strong Europe is good for the US both in terms of security and of economic prosperity. Viewing it as a threat is confusing American interest with a soccer game.

The remaining issue is, in the perspective of mid-2000, the deep depreciation of the Euro against both the dollar and especially the Yen. The Euro, at least in the eyes of Europeans, was to take away the US hegemony in world finance. Massive portfolio shifts into the Euro, and out of dollars, were to eliminate the "exorbitant privilege" that de Gaulle criticized and that has chafed the French ever since. Embarrassing as it is, we are on the verge of seeing the US Treasury having to bail out the Euro. It has not come quite to that, and Europe's pride would suffer immeasurable, but here we are.

The Euro depreciation surely won't last for much longer. Its principal reason is that just as the Euro was introduced, with unimpressive economic performance in Europe, the US unveiled a spectacle of super performance in growth, innovation and financial stability. No way Europe could compare even with an upswing to 3 percent growth, what is called a boom in Europe but in the US would surely be seen as a slowdown. It will take seriously bad news in the US, and at least neutral performance in Europe, to see a major shift in currency values. Returning to the high opening quotation enjoyed by the Euro any time soon seems hard to believe.

Surely there is no chance of the European Monetary Union breaking up or its commitment to monetary stability being undermined-- with open capital, markets, undermining monetary stability is a luxury governments no longer have! Surely nobody can afford to opt out at the bottom because they would pay with formidable interest rates. Opting out at the top, as Germany did when it left the fixed rate system at the beginning of the 1970s, is indeed an option and it would mean a tendency for currency appreciation. But Europe's supply side is so bad that this might be more nearly an option for Ireland than for Germany. But what would Ireland do? Float freely? Surely that is an uncomfortable regime, too. For decades to come, the Euro will be there and the interesting issue now is the widening of the Euro area as Eastern Europe looks for rapid access.

Both breakdown of the monetary union or, even less plausibly, Trans-Atlantic war induced by Europe's new might are far-fetched ideas!

G3 Exchange Rate Arrangements

After three decades of flexible exchange rates among major currencies, the discussion about international monetary arrangements for G3 remains alive. For some the current plight of the Euro is a case in point, or the strong Yen, or the overvalued dollar. Hard landing is always around the corner even though the US has not experienced it in a long time. It did not experience it in the aftermath of the 1985 overvaluation and it is unlikely to happen now.

The center of attention in the exchange rate discussion are the large swings in major bilateral rates, swings that are seemingly unjustified by commensurate swings in relative fundamentals. The accompanying Table shows peaks and troughs of the Yen/$ rate in the past 30 years. An episode like 1995-1999 makes the point.

Table - Yen/$ Exchange Rate (Nominal Rate, Monthly Averages)			
Date	Weak	Strong	% change
8-71	356		
5-73		265	-26
12-75	306		15
8-78		188	-39
4-80	252		34
1-81		202	-20
10-82	271		34
4-84		225	-17
2-85	260		16
6-88		127	-51
6-90	154		21
4-95		84	-45
8-98	145		73
12-99		102	-30

One answer, of course, is to recognize that there were, indeed, important swings in fundamentals. That is most conspicuously the case for Japan in the recent episode. From 1995 to 19988, Japan moved to the very verge of a depression with near-default of its banking and insurance system and a steep decline of activity. In the ensuing year dramatic policy in guaranteeing the financial system and providing huge fiscal stimulus restored a measure of normality and certainly moved the country away from imminent depression. There is little doubt that a flexible rate should broadly exhibit the pattern it did show.

But there is the extra point that even if the broad outline is right, the extent of movement is far exaggerated. Why, for example, did the Japanese currency appreciate all the way to 84 Yen/$ in mid-1995. Sometimes there is nothing stark in fundamentals that might justify these movements and when that is the case, the discussion gets in no time to alternative exchange rate regimes.

At the intellectual level there is some progress in understanding why asset markets exhibit outsized movements. At this point, the best story is based on the "noise trader" model in which a group of exuberant agents can with their optimism or pessimism dominate market trends *and* make money! Of course, the very basis of this phenomenon is the distinction between "fundamentals" traders who understand reality and exuberant traders. Ex post we know who is who, ex ante everybody believes they have the right judgment.

At the level of policy, there are two views. One is the recommendation of having a system of managed exchange rates with a specified band around declared target zones. The other is to live with what we have, including opportunistic intervention when the misalignment of rates is extreme and intervention is promising. The target zone view, most prominently held by the institute of International economics in Washington DC does not have a broad following. This is the case in part because identifying benchmark equilibrium exchange rates is hard. Models that focus on PPP or on equilibrium current account imbalances don't do very well.

But more importantly, even if there were agreement on target rates, there is the formidable issue on making exchange rate targets the focus of policy. Would the Federal reserve and the US Congress is willing, and would they be well advised, in making exchange rates the target of monetary and fiscal policy? Would Japan do the same, and the ECB and European parliaments?

Consider the simple case of the Euro today. By any definition of equilibrium rates we have had from the target zone crowd, the equilibrium level of the Euro is somewhere near 1.20 $/Euro. How to get there? The US would have to cut interest rates in the midst of a super boom or Europe would have to hike rates in a non-inflationary mild upturn. No question this will not, and should not happen. And if there are situations like this one, then target zones are not going to be persuasive as a policy regime.

Most observers will accept that large and possibly exaggerated swings in currency rates are regrettable but that doing anything about the situation is even more so. That leaves them with the possibility of intervening at extreme points to help the realignment once it gets underway. Even here success may be elusive. In early1995 the US Treasury tried on two occasions to reverse the extreme upswing of the dollar but the market was not ready; only on the thirds attempt did it work. Similarly for the Euro today, intervention would be very unpromising. While intervention remains part of the policy arsenal, just an central bank intervention to sustain financial stability in the face of an asset market collapse or credit market freeze, target zones for asset prices including currency are not going to happen.
No country has the luxury to escape these changes, not Japan and not Italy; no country can afford to borrow forever to keep up present equality at the expense of future generations. Italy needs sweeping change to reverse the current decline. The talent and creativity are there but kept from contributing and so is the potential for dynamism coming from Italy’s youth. What is needed now is a pervasive recognition and consciousness that regulation, statism, absurdly privileged labor contracts, intrusive bureaucracy, complacent equalizing and sweeping government discretion must go. Politicians need to receive a loud message from the public: we are fat up! Unfortunately, the referendum on these issues failed to get a quorum. Nevertheless, it was one step in that direction but it is just a beginning; a much deeper counter culture must build from there.

REINVENTING ITALY

Whatever the progress at stabilization over the past few years, in large part the benefit of EMU participation, Italy economy remains bad news. In fact, unaffordably bad.

In Between Two Crises

Italy is living a brief moment of quiet, in between the fiscal crisis just overcome and the next one that lies ahead. The formation of the European Monetary Union brought down Italian interest rates radically and, in that way, avoided what otherwise would surely in time have become an unsolvable public debt problem As a result of lower interest rates, and the Waigel Pact's limitations on budget deficits, public finance just now is not much of an issue. The warriors of past budget wards seemingly can take a rest and claim an area of budgets without pain.

Not so! The demographic trends that lie ahead bring about another crisis a decade or two ahead. That is far off, it would seem, but unless the issue is addressed soon it will be an altogether formidable crisis. Its dimensions can be judged from research reported recently in the *American Economic Review*. The researchers conclude for the case of Italy, that interttemporal equity – leaving future generations with the same burdens of taxes or benefits of public spending as the current generation—requires any of the following: an immediate 49 percent cut in government purchases, or a 13 percent cut in government transfers, an 11 percent hike in all taxes or a 28 percent rise in income taxes.

These are formidable adjustments to occur immediately and, of course, they won't happen. But the conclusion is that future generations will have to make them, and more! Italy is plainly shifting vast burdens to the young. Moreover, those who have to pay the extra are the same young who are currently unemployed or making time unproductively in the universities. Of course, at a minimum, policy might focus on how to raise economic growth and, in that way, contain the rapidly rising future costs of demographic transition and present profligacy. But here there is bad news too: Italy's growth performance is getting worse.

Bad News on the Supply Side

Unlike the Us or other economies that have espoused supply side reform and harvested economic booms in return, Italy's supply side is bringing down growth far below the levels of past decades and increasingly so. By all accounts Italy is a bad place to do business and that means little chance for jobs, investment, productivity growth – all the things that raise standards of living while reducing fiscal burdens and interttemporal inequity.

Just how bad are things? A survey by the IMD research institute reports that Italy is ranked #30 among a large group of countries. Not among the top 5 in the world, not the top 20, #30. That means mediocre or worse. The Davos World Economic Forum rates Italy #35 in competitiveness, -- in between Costa Rica and the Philippines on one side d Peru/Indonesia on the other. No ambiguity here; in its economic institutions, Italy ranks among third-tier economies. That is not nice to say, but more important, it would be a deep mistake to ignore it. The gap to leading industrial countries is so formidable that it would be amazing if it did not show in performance. Not surprisingly, Italy is by now the worst growth performer in Europe. The bad supply side has caught up.

More detailed analysis of Italy's bad supply side comes from a major survey conducted by the OECD. In this wide ranging investigation of regulation ands intrusive state presence in goods and labor markets the results are unambiguous: Italy is the worst performer in Europe with a score far more devastating than any single other country! Italy has more obstacles to entrepreneurship, less reform in labor markets, more state presence throughout the economy; whatever criterion of over-regulation, inflexibility or statism we pick, Italy is there as the worst economy. Indeed, Italy is the very incarnation of "old economy". To round the story out, a report by UNICE, a European business research group, notes that Italy ranks near-worst on a lot of criteria relevant to business formation and in obstacles to entrepreneurship.

No surprise then that Italy is doing very poorly. Moreover, since there is little sign of change there is also no prospect of better performance and, with that, Italy is heading straight fore the next crisis. This one much bigger and politically more divisive than the last one. Minor adjustments to the status quo will not be enough; Italy needs radical change of the kind the UK or the US have undergone in the past 2 decades

The Italian status quo is an unaffordable luxury of the immediate beneficiaries—the labor aristocracy, inefficient business, the governing class and the bureaucracy. We here forever about crises but it is amazing how they have been able to keep the consensus going, keep the corporatist model afloat. Italy is misgoverned by this consensus and it is in need of a counter culture that vigorously embraces economic reform. Italy needs to reinvent itself so that everybody can work, that government stops handing out favors its discretion, limits competition at its discretion, sustains inefficiency and rigidity in the name of equality or just plain convenience. Italy needs to cut back on its bureaucracy that spends much of its time stopping people from in motivation, creativity or just plain work.

It is not right to say that overregulation is not an issue, that black markets get around these things. Of 3 firms that are unprofitable in the formal economy, one might make it but the other two will not. And that means fewer jobs, lower tax collection and a lower tax collection and a lower standard of living. The black market culture also means that cheating becomes part of normality, a bit here, a bit there and a bit everywhere. That is a self-inflicted disgrace society should not accept. It is also a major detriment to foreign investment and to cross border business opportunities more generally.

No country has the luxury to escape these changes, not Japan and not Italy; no country can afford to borrow forever to keep up present equality at the expense of future generations. Italy needs sweeping change to reverse the current decline. The talent and creativity are there but kept fro9m contributing and so is the potential for dynamism coming from Italy’s youth. What is needed now is a pervasive recognition and consciousness that regulation, statism, absurdly privileged labor contracts, intrusive bureaucracy, complacent equalizing and sweeping government discretion must go. Politicians need to receive a loud message from the public: we are fat up! The referendum failed to get a quorum but was in the right direction. It was just a beginning; a much deeper counter culture must build from there.

August, 2000

EUROPEAN UNION ENLARGEMENT

In Latin America, the pressure for a US engagement in the direction of increased integration is increasingly felt: Mexico's incoming president has made free labor market integration an important agenda. Argentina is hoping to achieve a free trade agreement as a way of moving closer to the US, at lest in the eyes of investors, and thus avoid punishing risk premia. In Asia, noting the fragility experienced in the Asian debt crisis of 1997, Japan is aggressively promoting Asian economic integration. Swap credit lines have been negotiated with various central banks, a free trade pact has been offered to a reluctant Japan. Even monetary integration is being urged on the Koreans who are nothing but terrified by this sudden Japanese embrace.

In Europe, too, integration is the prospect as the European Union opens to the East. After the Southern wave (Portugal, Spain and Greece), the next round involves in various stages 10 Central and Eastern European economies. Most prominently in terms of economic size and proximity there are Poland, Hungary and the Czech Republic. But the list goes ultimately deep into the Balkans with Romania and, who knows, even Turkey.

Table 11 EU and Accession Candidates

	Population	Per Capita GDP (PPP Index, EU=100)
European Union	375	100
10 Eastern Candidates	103	34.3
Turkey	63	31.0

Europe is not for a minute relishing the prospect of eastern opening; exports have always been wonderful. Producing offshore has been somewhat of a success. But integration is another matter, more so when it comes to issues like free labor mobility, participation in the rich European social safety net, and access to the trough of European subsidies. The East can't get there fast enough, the West, never mind the inevitability, wished all this was not true. But true it is. Never mind high European unemployment (i.e. people paid not to work), never mind European agricultural protection and regional subsidies, never mind the emphasis on a coherent and homogeneous society. The East is knocking at the door and if there is no answer, they will jump the fence.

The question naturally emerges whether Western Europe will benefit from a full opening to the east. For the East there is no question, everybody accepts that access to markets and to capital can only do good. And if there were any doubt, why the eagerness? And if there were remaining doubts, look at Mexico and the stunning success its northern regions have experienced by integrating with the United States. Nor has there been any sign of stress in the US—the “giant sucking sound as jobs go South” never happened. In fact, Mexican workers are going back home, attracted by the boom in Mexico’s prosperous North. But for Western Europe the discussion is more open. Surely, labor opposes the competition, taxpayers agree awed by the increased burdens of spreading the welfare state and the subsidy system to the East. Who in fact is benefiting, why not just say “No, thank you?”

It is not at all clear that Western Europe stands to gain if the riles of the game are to spread Western inefficiency and the welfare state to the East. Better to save the money and close the ears to the pleas. Economic integration of East Germany, on West-German welfare state and union terms, has been formidably costly and not noticeably effective. Repeating the experiment in a grand style throughout the East would be nothing but folly.

The right answer, surely, is for Western Europe to make a dramatic, clean break: Get rid of all regional subsidies to Italy, Portugal and Spain. We all know that the subsidies have no economic function, they are merely political payoffs that keep regions and people out of the market. Also, get rid of all sector subsidies from agriculture to coal and shipbuilding and the myriad other inefficiencies. And deregulate aggressively the labor market, including unemployment compensation. Welcome the East on these terms: full and unrestricted free trade to be phased in rapidly and fully complete over a decade; full and unrestricted service trade; full and unrestricted capital mobility. No need for full labor mobility, no need for early partnership in a European Union political integration that is still looking for definition, no chance of it either.

The East can accomplish much in the meantime. Why would a country that wants access to capital not rush in a unilateral currency board to assure investors f stable finance? Why would a country that seeks capital not foster property rights and economic institutions to become more attractive? And why, seeing the experience of East Germany where West German unions are now held responsible for high unemployment, would the East not go much slower on the welfare state and much faster on thorough capitalism. The more they take these steps, the more apparent it will be that integration is a win-win proposition rather than a costly bail-in, the sooner the West will move, the earlier the East will turn into high-growth performance and rapidly rising living standards.

TWO LOST DECADES

There is, rightly, a lot of discussion of all the positive things underway in Latin America: stabilization of inflation is the paramount story but there is much more.

Telecommunications and the Internet are opening up financial and economic opportunities; privatization's everywhere give the private sector a chance. Globalization, with all its tensions, is making its imprint on the region. Yet, none of these forces are dramatically new with important results inevitably delayed. Much if not most of this has been around for a decade or two and yet has not translated into dramatically improved performance. For the past decade, not just the decade of the 19870s, then called the "lost decade", growth has been pathetic and continues to be.

The benchmark, of course, is not Africa but Asia: Why should an Argentina rich in human capital or a Brazil where nothing is lacking, from entrepreneurship and talent to resources and scale, do so poorly compared to the East? But first, lets recognize that these are the facts: For 20 years, including crises here and there, Latin America has done awfully both absolutely (more so when adjusted for population growth) and relative to Asia. Once that fact is accepted, including the crisis and recovery years 1997-2001, we can move on to analysis of dismal performance.

Table 12 Long-Term Growth: Asia vs. Latin America

	1982-91	1992-2001	1997-2001
Asia	5.0	6.0	4.5
L.America	-0.3	1.7	1.6

Source: IMF *World Economic Outlook*

Each of the regions is a potpourri of economic regimes and experiences: In Asia, China and India are steadily successful, one a quasi-communist economy and the other perhaps only two-thirds of the way in the difficult transition from pervasive statism to a free market economy. There is a near-collapse Indonesia and there is a booming Korea. And there is a confused Philippines, which is some crossbreed between Asia and Latin America with the potential of having the worst of both. In Latin America there is always crisis-prone, always-reforming Mexico, unbelievably lucky, do-little Brazil, suffering Argentina, star-performer Chile or Peru reclaimed from the Shining Path. There is disoriented Venezuela on the verge of a historical experience in 1920s style totalitarianism and Colombia bogged down in civil war.

There is no single place (excepting perhaps Chile and Singapore) where economists would be mostly delighted. Yet, the growth performance is starkly different. It cries out for some conjectures beyond free market versus statism, which often is an important point, but won't make the difference here. Nor does corruption; surely for every Indonesia there is a Mexico. Nor does the legacy of colonialism, which is fully shared by the regions.

One is tempted to say chance, sheer chance. But that surely is not right since superior Asian performance goes back a while. Moreover, who would bet against the proposition that in the next decade, Asia does not once again, hands down, outperform Latin America?

For more than one hundred years, the *deep* explanation has been culture and institutions. The German Historical School noted that Calvinists were great at making money, Catholics were mostly awful. That approach would seem to carry over easily to the notion that Asian culture, Confucianism for short, is a form of super-Calvinism in its economic implications. It would seem to explain the formidable difference between Latin America and Asia. Yet, it is far way from asserting culture as the deep underlying force to identifying what precisely are the channels that translate into higher growth.

Most visible, of course, are two: First, the very high rates of saving and investment, easily a third or more higher in Asia than in Latin America. That does help growth, no question, and it explains part of the growth differential but not all. The second cultural difference is surely a deep appreciation of human capital and the implied commitment to discipline and learning. That helps growth. Third, and not obviously related to Confucius, is the Eastern, mostly Chinese, love for risk taking, gambling in any form. Lastly, the leadership is held accountable (even outside formal democratic processes) for delivering governance and performance. "politically impossible" as the excuse for a lack of courage and vision is not commonly heard in Asia. Importantly, the leadership responsibility extends to producing social results. Yes there are crises and sometimes formidable ones, but on balance the region gets ahead strongly. Moreover, Asia has far, far less inequality than Latin America. In Indonesia, to take a bad case, the ratio of the income shares of the top 20 percent relative to the bottom is 4.3; in Chile the comparable number comes to 17.4 and in Brazil amazingly to 25!

Even if these deep cultural differences explain historical patterns, they surely cannot be used anymore as an excuse. Where culture does not help, institutions must take over. If politics promote bad macroeconomics, why not have currency boards – an issue immediately relevant for a politically weak new Mexican President. If corruption is endemic, why not throw a clean legal system up as a barrier. If saving is insufficient and the returns on publicly managed funds ridiculously low, why not privatize social security and along with it entitlement to health and education? If domestic business is lazy and sheltered, why not throw the borders wide open to competition. Above all, why wait? Take Brazil's by now highly unpopular President Cardoso. What possibly does he have to lose? What stops him from pursuing aggressive reform to put a great country back on a great path? Surely, "politically impossible" is a pretty unimaginative answer. But let us be clear on this, without reforms that deeply change the economic landscape, this decade will not be any better than the last two. And in the background, with rising inequality, the clock is ticking for the worse.

<u>BOOK REVIEW</u>: Alan Murray <u>The Wealth of Choices</u>, NY: Crown.

Alan Murray is no modest man, his title and his perspective borrow from Adam Smith's *The Wealth of Nations* and the Friedmans' *Free To Choose*. Not a low risk-strategy, but he fully pulls it off, explaining what makes the New Economy function. And he does so as effectively as Adam, Milton and Rose do in their work.

This is not a book about money grabbing or getting rich quick; it is more nearly a plea and a convincing demonstration that the new economy is real and offers a formidable opportunity. There is a joke of a man who every day, day after day, prayed to the lord imploring her to make him win in the lottery. On and on he prayed to please, please win the lottery. One day the heavens open up and amid thunder and lightening a voice is heard: "For heavens sake, why don't you just buy a ticket." Murray's is that voice, get your ticket.

The book pursues two tracks: one show how deregulation and information technology have vastly enriched choices available. The second track explores in a down to earth fashion the range of these choices. The book fully accomplishes its mission to convince anyone that yes, indeed, there is a new economy and, by Jove, what a wonderful thing and I can't believe that I have not been more active getting my share of it. No apologies in this book for the new economy; if it has not worked for you, blame yourself for not taking advantage.

America's super boom has given the *New Economy* a good name: full employment, budget surpluses, rising real wages, moderate inflation, millionaires and billionaires by the day-- who could possibly complain? But what accounts for the stunning performance? No sermon diatribe about rules of the game, property rights, free markets-- the standard diatribe of old economy conservatives-- will easily capture the formidable dynamics that have been unlocked in America in the past two decades. The left used to bitch about neo-liberalism and free market economics but is destabilized by what has happened and has as yet to discover a counter ideology and hence is lying low. It is easy to attack neo-liberalism, its another thing to cry foul about the new economy where corporations start in the garage or the attic and are organized around stock options rather than "exploitation." Just like the routed Left, the flourishing writing on globalization (*Turbocharged Capitalism*, *The Lexus and the Olive Tree, A Future Perfect*) is not managing to deal with what is going on. It is awed by the breakdown of barriers but hastily denounces the rise of inequality. It has no real handle on the new economy; it just offers the old and tired "on one hand and on the other."

Alan Murray's splendid book takes you on a very different trip. It is an unabashed celebration of liberation, the brilliant insight that the leitmotiv comes down to *Choice*. Of course, choice is quintessentially American, positive and desirable. Having found a key to understanding what makes the new economy tick, Murray has no need to be particularly intellectual. He simply throws the light on just how choice as a powerful driver is quickly transforming the world. It is a short distance from there to provide a manual of "how-to": managing your money, testing the fit on venture capital, investing in human capital, securing retirement, managing your health care, getting off junk mail lists, living off specials, discount shopping around the clock.

Most readers will find, page after page, that they are behind the curve, that they have not exercised nearly enough their myriad choices to participate in the wealth creation and improvement of opportunities that the new economy can offer. A prominent business paradigm of the day comes from a successful booklet *They Moved My Cheese*. It extols the idea that in a world of change, entitlement thinking is a killer. Murray's book cultivates the complementary and positive paradigm: when new opportunities, embrace them aggressively, grab them.

Is it surprising that the Washington DC bureau chief of the Wall Street Journal should be writing a best selling book about the New Economy? Not at all. Washington DC is the capital of world deregulation and of the New Economy, and the home of paradigm-busting new technologies. A handful of the richest counties in the country are now in the DC area. It is just another manifestation of how much our world has changed in the past decade. Galbraith and Gephardt (D-Mo) are lying low and are gone from most people’s active memory; George Gilder and Steve Case are it. Yes the NASDAQ might crash, who cares but the real show goes on.

Get your copy now! And if your favorite bookshop (more likely than not) has run out of it, Amazon.com will deliver tomorrow.

GOVERNOR HAYAMI’S VERY BAD IDEA

This has not been a good decade for Japan and exit from troubles is far from assured. Most forecasts are now upbeat, looking to 2 percent growth but that outcome is far from assured. The Sogo bankruptcy points to more and more latent failures and awful balance sheets. Bad news as it is, it has had at least the silver lining of keeping off, for the time being, Governor Hayami's ill-advised rate hikes.

Over the past decade, the average growth rate has been a mere 1.2 percent on average, shockingly low compared to the 6 percent average in the 30 years up to 1990. In the 1990s just about everything went wrong; no new ideas in manufacturing but important catch up elsewhere, a formidable asset bubble and a dramatic crash, an overage political structure failing to deliver governance, and a botched upturn in the middle of the decade when premature fiscal cutbacks killed a weak recovery. By now we are back to the story of an upturn; the consensus forecast looks to 1.7 percent growth in 2000 and 2.0 percent the following year-- nothing big, but at least some growth. (Remember too that Japanese population is no longer growing so that these are also the growth rates of per capita GDP).

There are also important risks to this more optimistic outlook. One immediate issue is whether investment and consumption spending do in fact turn up and deliver the assumed growth. Deep ongoing restructuring causes raising unemployment and a significant check to household enthusiasm for spending; ongoing corporate restructuring takes the focus away from spending plans even though ultimately successful companies cannot do without investment. These risks are serious and they may well mean that the growth to be looked to is more nearly one percent than tow. But far more dramatic risks are now coming on the horizon; one is the risk of a premature monetary tightening from the Bank of Japan (BoJ), the other a downgrading of Japan's public debt by the international rating agencies. These two factors can combine to provoke a serious debt situation in Japan and, unlikely but conceivable, even a full-fledged debt crisis.

Consider first the problems that may or will come from the BoJ. In response to the crisis, deflation and serious risk of depression, the BoJ had shifted to an explicit zero interest rate policy. Short-term interest rates have been zero for more than a year and that has helped both some recovery but also cheap deficit finance. That policy is now up for reconsideration and the governor of the BoJ, Mr. Hayami -- not an economist, not an experienced central banker of the caliber of Greenspan, Volcker, Tietmeyer, Trichet all of whom have a deep appreciation of history and a deep concern for staying away from experiments that might spell disaster-- has decided that 'normalization" is essential now that recovery is getting underway. Of course, what does normalization mean and how far will he go? If it is an issue of a quarter of a percent and no more the topic is interesting, if it is an issue of a full percent it totally changes the outlook for Japan.

What are the arguments for what obviously looks like a premature move, just as premature as the fiscal consolidation a few years back that killed the last attempt at an upswing? A few arguments are cited, most prominently that zero interest rates create a bad loan environment, that many people live on interest income, that the bank of Japan has to show its independence, that deflation is over. So many arguments, and more to spare, that it is quite clear that the BoJ is about to pull the trigger. And if they do, they increase significantly the chances of undermining a recovery that is barely, if at all, underway. They will also increase significantly budget deficits because growth will be less and the higher interest rates increase dent service costs. This most unwelcome development comes at a time where Japan already has, and will continue to have, formidable debt and deficits.

The accompanying table shows Japan in a comparative perspective: the debts are phenomenal, the deficit is huge. Moreover, according to the OECD forecast, the debt will steadily rise in the coming 5 years and by 2005 the deficit will still be as high as it is now. What economy can afford to offer investors such a prospect? Moreover, the Japanese debt is already the single largest in the whole world, larger than that of the US even though that country ids twice the size of Japan. Larger than that of all of Europe even though that region is much larger than Japan.

And this is precisely where the other problem kicks in. the rating agencies looking at Japan conclude that this is most assuredly not a AAA situation. They have been at work downgrading Japan. Fitch has just initiated another round; Moody's is expected to do the same and surely so must the rest. Unlimited deficits and huge debt can only snowball into ever-bigger numbers. The prospect of stabilizing debt and moving it down is patently not there. Of course, for the time being Japan still commands investment grade rating, it is not yet a junk bond but in time it will get there. The dynamics will be increasingly unfavorable as increasing risk premia raise debt service and debt accumulation.

Table 13 Government Debt and Deficits (% of GDP) Source OECD and IMF)		
	Debt	Budget
US	57.4	1.0
Euroland	71.4	-0.8
Japan	136.1	-8.4
Source: OECD and IMF		

For the time being, Japanese household loves Japanese debt. They have lost money in everything else big time; they bought dollars at the peak, real estate at top prices, impressionist art at exorbitant valuations, stocks wherever they were at unprecedented level. There has not been a single bad investment that Japanese investors have not made. The great exception so far is their own government bonds which, with near zero interest rates, has sharply increased in value. That now gets put in question as rates are pushed up by the BoJ and the risk premia induced by the rating reviews. Wouldn't it be ironic if Japanese investors lost even on this last investment just as they have lost on everything else?

Is all of this just crying wolf? Surely, in the early 1980s the US had a formidable deficit problem and today that has all gone. Won't Japan go the same way once things come together? Two answers here: yes, the US had big deficits and they are now all gone, but at the time the US had a debt ratio of merely 30 percent while that of Japan is already on the way to 150 percent. Moreover, the US put in place a formidable restructuring effort and sustained to the point where it paid off with a boom. In Japan restructuring is out of discussion and significant and sustained growth is not in sight. In fact, official agencies view Japan's potential output growth as something like 1 percent a year! No way to grow out of debt with anemic growth.

The other issue is the proposition that Japan's debt is a domestic debt and hence it is not a problem, quite unlike the US debt stemming from a long history of current account balances or the dollar debts of emerging economies. True, Japan's debt is special because for the time being households love their government bonds and view the US and Euroland with suspicion. But let the rate hikes come, the rating slip, the deficits grow and even Japanese investors will desert the sinking ship. At that point it will look exactly like an emerging market crisis. The numbers have gone very far, it is not clear how to bring back normality. And all that before talking about 150% of GDP in unfunded pension liabilities and a huge amount of claims that are counted as government credits but have no chance of collection.

There are serious doubts about the deficits forever strategy and nothing else. There have to be formidable concerns about the proposed increases in interest rates. What then is a strategy that does not end up in deep trouble? The answer surely is pervasive reform and restructuring throughout the public sector and finance. A strategy of “buying time” can only work if in fact hard work is done in the meantime to create a deep transformation of the supply side. Corporations have starting doing this out of sheer crisis-driven necessity. The public sector has done virtually nothing. Surely the Us experience of the past 20 years, from debt problems to steady surpluses and rapidly falling debt spells out clearly the right message: supply side reform in the public sector is the only bridge from fiscal troubles to prosperity.

MEXICO & PRESIDENT FOX

A lot of credit goes to the outgoing Mexican President, Ernesto Zedillo, for the political opening and the economic stability that made this transition possible. To the last moment, the lingering fear was that the PRI would once again steal the election. That is what the PRI had done for 71 years to protect their power base and, until very recently, the systematic looting of the State. Not so this time; the opposition candidate won a sweeping victory with a mandate for democracy and a fresh start across the board. Mexico had done well enough economically to have the courage for change.

And now comes the hard part. The incoming President, Vicente Fox will soon find out that he can make a first impression only once. Here is a new President without much experience, without a team and mostly without an agenda other than to supercede the PRI. It is always much more easy to win, than it is to govern. That task will be extra hard because with democracy, economics gets more difficult because compromises must be struck, control of budgets is harder, taking shortcuts is more tempting. Yet, capital markets after a short elation with the arrival of Mexico will very soon start asking hard questions. He does have a chance to introduce sweeping change or he can opt for a conventional strategy of continuing substantially along current lines, hiring a few of the present technocrats, making generally favorable free market noises, muddling on.

Mr. Fox will find out that unless he stakes out a set of policies before he comes to the bargaining table, he will find his powers and his mandate eroded in no time. There is one silver bullet unlike any other to change Mexico dramatically: a currency board.

A currency board, or going even further to full dollarization, would do away with Mexico's recurrent problems of currency instability. The exchange rate would be gone, Mexico would (almost) be like Texas or New Jersey in its link to the dollar. Abolishing the central bank -- a good central bank today but with the handicap of an awful history-- and pegging the currency irrevocably to the dollar would lead to these consequences: an immediate collapse of Mexican interest rates, a boom in Mexican asset prices, and a shift to a significantly higher growth rate on a medium term basis.

There is no other way to secure these benefits anytime soon. The European experience with convergence suggests that it takes much more than a decade for financially delinquent countries to start building credibility. There is surely no reason that a Mexico could build that record any sooner.

Mexico needs nothing more urgently than a period of sustained high growth so as to start eroding endemic poverty. Failing that, the Left will come one day and reverse years of reform and progress. But a currency board helps too in starting financial intermediation for the benefit of small and medium sized firms who have been starved of capital by the experience of recurrent crisis and bad credit. Small and medium sized firms need to become part of Mexican capitalism.

Mexico's economy has had a good few years now; that was not hard with a US superboom and plenty of liquidity in capital markets. Their own skillful success at rebuilding OPEC contributed to good performance as did the determination to hang on to and even widen the Salinas reforms. But in the coming year and beyond, Mexico must now count on a more difficult external environment as credit becomes far more selective and the US economy slows down. That is a new game just as is the far more open domestic politics including a divided Mexican Congress. Two good reasons here to stake out a powerful position on the currency front that does away with uncertainties and offers a genuine free lunch in the form of a collapse of interest rates and the cost of capital.

Mexico saves little and its investment needs are more substantial. That implies current account deficits that need to be financed. Direct investment from the US and Europe are the obvious answer-- Mexico is naturally a manufacturing platform for Latin America. The only question is how to leverage the location more significantly so that the money comes more readily and requires far smaller risk premia. The obvious answer is to make Mexico far more like the US in all economic matters. Most prominent among these issues is total financial and trade integration. NAFTA has been doing its part, the financial part still goes begging. Full currency integration on a lasting basis is the key step that completes the bold trade opening that is already showing its formidable payoff in the North of Mexico.

A currency board is certainly no panacea but yet it is a powerful tool for a new government to get a far better chance to make a quantum improvement in Mexico's economic outlook. Against that background, the new government will have a better chance to take the government out of all areas of the economy and thus reduce both poor performance and corruption. A currency board is ultimately a powerful complement in making a democracy more effective by giving it a serious wind of prosperity in the back.

October, 2000

NO BERKELEY, NO WOODSTOCK

Everybody should have demonstrated some time in their life; not doing so surely amounts to unbearable conformism. The trouble jus now, of course, is the sheer absence of a good issue. The old ones warmed up once more are stale; they are already the agenda of some ministry. The good new ones ("free Napster"?) are hard to find and the rest might make you feel positively weird. Is that the problem with the anti-globalization protests? Protests that now have become routine wherever the IMF and World Bank hold their meetings -- Seattle, Washington, Prague. On the surface these are sit-ins against globalization and big corporations, but is there more to it, perhaps even some deep moral message that should be a wake-up call to us all?

Monsieur Jove Bove, a French farmer (both parents are apparently U. of Berkeley graduates), made headlines when he hitched his tractor to the bright red roof of a McDonald establishment and drove off, roof included. He has since become an icon of the anti-globalization movement in France, a hero standing up against the one-haircut-fits-all view of globalization, against “malbouffe”, against Americanization plain and simple. Condemned to 3 month of jail, he is on appeal and to judge from his sense for drama, he is sure to be heard of soon. Who does not chuckle at the gesture, particularly in the case of Big Macs?

Protests against globalization have become routine, but they have much less of a claim to message or importance than Mr. Bove's appeal. There was London where protesters took on the financial establishment which found itself barricaded in their offices but had the good humor to rain fake sterling bills on the occupation forces. There was Seattle, amazingly successful because of the formidably incompetent local police. And then there was Washington where the police had learned their lesson and gracefully offered protesters courtesy arrests for those activists who wished to build activists' credentials. Now we have had Prague, on more round of rioting against globalization and all its ills. On a day without rain, 10,000 will come and chain up in protest, just protest. They are a motley group with one thing in common: no to the status quo, no to those in power, no especially to big and greedy corporations.

There are environmentalists, anti-vivisectionsts, anti-war activists, women's' rights promoters, free-Tibet champions, gender advocates, anti-cheap labor practices volunteers, the save-the-Indians crowd. Animal rights promoters, and many more, including anarchists of course. Ant-globalization and anti-corporation is the tenuous common platform. (Start with www.Gatt.org and let yourself be carried on from there). It all comes in one great mass of protest without even an effort at coherence and message except this: we don't like what is going on and we want you to know. If it were not for the anarchists that organize the violence against Nike and McDonalds, who would mind? On the contrary, a world without protest and demonstrations would be frightening; how could we be sure we are not braindead?

There is nothing new in protest and demonstration, in going to the streets to be heard and to change the course of events. Certainly in the US, both the civil rights demonstrations and the anti-war activities in the 1960s, starting with Berkeley's Freedom Park, were formidably important. They must be looked upon, by the participants and by anyone looking back, as a great moral crusade. The same has been true of the "Peace Now" demonstrations in Israel that carried a profound message and brought change. But, of course, not every demonstration is remembered as particularly useful.

What, after all, was the point of the Paris uprisings of 1968-- one remembers the authorities' "Tais-toi and soit jeune" and not exactly what it was all about. If it had anything to do so with the education system, it certainly did not change the ways of France; the system was useless than and it still is. And there was the glorious Woodstock, a mass gathering to do all the things you were taught not to do, things that would your parents' hair stand up, counterculture in the mud for 500,000 who soon graduated from hippies to corporate leaders, senators and judges. They succeeded loosening up America and give it a great lift; "if it works for you,…" is now the mind set and it surely was not before. Does the current round of demonstrations carry the seeds of anything wonderful like that?

For the rest, first and foremost, these demonstrations do not carry an agenda -- they carry a thousand and none. What does women's rights in Iran have to do with the IMF or the World Bank, what is the link between Mr. Kohler at the IMF and the practice of vivisection in medical research? Beyond their cafeteria, what does the IMF have to do with animal rights? Wasn't it US Treasury Secretary Larry Summers who put women's rights on the World Bank agenda ages ago? The grouping of a mass of issues in a single demonstration is new and powerful and that it is where it ends, a spectacle to watch but leave it at that. The activists want to be heard and seen, it is not nearly as important to actually accomplish a result. Indeed, beyond CNN coverage and a report on the website, possibly the good luck of an arrest, what might the result be? But they do have a vague coherence in their objection to globalization and corporations; that theme just keeps coming up over and over again. Is there something we should heed? First a word apart about the environmentalists.

The environmentalists' concerns today have wide resonance, far beyond a narrow green fringe. Yes, they are still there at the rallies, yes they are vocal. But they now have a big dilemma. They have succeeded beyond their wildest dream, their concerns have become the corporate agenda, and they are quite mainline to the point of being embarrassed about their fellow demonstrators from the fringe. Much of their time is occupied affirming that they are different, not extreme, not opposed to capitalism per se or even corporations for the most part. Without the environmental protests of two decades we would not have gotten there. Having become main line and corporate agenda, what to do next? Indeed, where is the corporation risking to be caught on a major environmental blunder -- bad for stockholder value, bad for management? Maybe the time has come for environmentalists to now change sides, leave Green Peace behind with the skinheads and anarchists and get a corporate job in environmental communications. The hippies of the 60s made the transition; just the same, the environmentalists might as well declare victory and move on.

Here is, of course, the area of deep, profound ignorance. Could it be that long after China concluded that markets do miracles and WTO as well as foreign corporations are good for jobs, the protesters are not getting the message? Could it be that their boredom with progress and prosperity in the world translates into an ignorant rebellion against those institutions and practices that, indeed, are creating gradually better conditions in all those countries that chose to play the globalization game? The World Bank, (www.worldbank.com) reluctantly-- because it would love to be totally eclectic--, has to confess: "globalization is good for the poor, growth is good for the poor, foreign direct investment is good for the poor."). They just missed one extra credo, this one a bit harder to swallow but still true: " the IMF is good for the poor."
Forever, young people have rebelled against a too-settled truth. As governments buy fully into the globalization agenda, the protesters are sending the message that prosperity alone is not enough of an agenda or, indeed, the wrong way. If they are so eager to do good, why are they not out there doing good? Why don't they join a Peace Corps, why are they not working in hospitals or in the slums of Peru or India? Why do they drop their beer cans and litter? If they love peace, why do they organize or accept violence? If they hate Nike, how come they wear them? Why don't they use their computer and organizational skills, so obvious from their websites, to target them to something other than useless protest? More likely than not, they are weekend activists and protesting is a past-time, a way of being connected, part of a movement, a little different from a Bologna Ducati Festival because of the moral pretense but in the end also less fun.

Protests without an agenda will run their course. Keep listening because, sometimes, there is an important message. In the meantime, the anti-corporation and anti-globalization diatribes are just ignorance. They are best overcome by a career job and some good economics. (In the authoritarian old days one would have said "have a hair cut and move on" but that is no longer the case since Harrison ford sports haircuts, Bill Gates is down on excessive hygiene, jeans and ponytails are *de rigueur* in first class on United Airlines to San Francisco.)

This is no Berkeley all about peace, no Woodstock where the young rebel against a stale culture and seek more freedom and a kind of fulfillment different from the past straightlaced and uptight mode of their parents. It is just dumb. Above all we must encourage our leadership not to elevate all this to the status of a meaningful partner in dialogue. Protest is an important force, sometimes it is all-important; much and most of this one, however, is just eccentric or worse. Lets just look the other way, schedule the IMF/World Bank meetings always in dull and rainy places, and above all move on.

THE ECB CREDIBILITY DEFICIT

The Euro needs a formidable show of confidence but how to accomplish that with a central bank that lacks credibility and an economy that has arthritis? The right answer is to introduce the Euro currency coins and notes NOW , bite the bullet and just do it rather than linger on and leave speculation as together all this proud planning was a mistake and in time will actually get undone. Of course, the Brussels argument is some rubbish like it is too complicated.

Written in August, everything here remains relevant even after the anemic rate hike and the relatively unsuccessful intervention. You can only make a first impression once. The Euro is doing so with a vengeance. The external value has gone to pot in no time, and inflation is running at rates that are far away from Tietmeyer's rule of 1. 5 percent.5 Percent. Has the ECB lost its bearings? Are those people in Germany right who now are saying, "Ich hab das ja gesagt, die machen unser Geld kaputt." The ECB is behind the curve, no question. Failing to raise rates very aggressively-- 50 basis points-- this week means throwing in the towel in the fight for a sound Euro. Looking for yet more special circumstances that might rationalize holding off is understandable but inexcusable.

When the European Central Bank meets this week, it will have the tough task to decide whether to rescue the currency or let the boomlet run on. The Euro, barely into the international hard money competition, is losing round after round. On the external front it hovers at the magic .9 $/Euro -- if it slips further it might crash big time. On the domestic front it has inflation written all over it. The inflation objective for the new central bank is 0 to 2.0 percent. And that is what the hard money constituency of European savers demands. But in fact, that is not at all what is happening: year over year, inflation in Europe is 2.4 percent. Indeed, inflation in *every* member country of the new monetary zone is running above 2 percent.

Of course, it is easy to plead special and non-recurrent factors: the depreciation of the currency has added to inflation pressures and so has, without doubt, the steep rise in oil prices and the recovery of prices in world trade. No doubt, too, the European upturn, which is strongly underway. But a central bank cannot afford to live by special factor accounting; rationalizing inflation by adding up the specials works well when they are strictly temporary and likely to reverse in short order. But clearly that is not the case: a huge fall of the dollar is not on the horizon, nor is a collapse of oil prices. Without a reversal there is at best the hope that these specials will cease being an adverse influence and just go into neutral. Yes, that may well be the case today -- no extra oil price increases, no extra dollar depreciation. But that is not enough of an assurance; the immediate question is whether these past disturbances are now feeding into wage settlements and hence into prospective inflation. That, of course, is more likely the tighter and the more uncompetitive the labor markets. Recorded unemployment rates in Europe are high. But surely that is more a reflection of people being paid not to work rather than a suggestion that there is a mass of inflation fighters out there ready to step in and forestall any wage gains. In sum, the ECB is at a cross roads, at that unpopular point where it has to say goodbye to the European boomlet, uncomfortably early but such is the fate of central banking in an inflexible welfare state economy. It is a plain fact that Greenspan has better material to work with.

In the good old days of German-led central banking for Europe, the speed limit was 1.5 percent inflation. That was Buba President Tietmeyer's rule and it worked well because it left some room for bad surprises and yet assured on average the stability of money, good money. The ECB has lost ground and is nowhere near these sound precepts. The Euro has been shot from under them on the external front, Euro-11 inflation is running off untamed -- 2.4 percent year over year, 2.7 percent annualized in the past 3 months! Those who put a lot of faith in continuity -- the ECB inherits the traditions of the Buba-- now must raise serious concerns. The ECB is running a credibility deficit and now must take urgent steps to resolve the growing doubts about what it stands for. There is only one good answer: hard money at any price. And the more convincingly that answer is asserted and implemented, the sooner it will start paying dividends in wage-price discipline and in a stabilization of the Euro.

A lot is at stake in recovering ECB credibility and a Euro that in no longer teetering on the cliff. It is altogether in the hands of the ECB to make the investment in sound money and, with it, in a strengthening of the external value of the Euro. That in turn is a precondition to make it attractive for international investors, including the beneficial spillover to European stock markets. The Euro had its IPO with more hype than any .com company on the Nasdaq, -- instant victory over the dollar was a foregone conclusion and the valuation was accordingly high. All of that is gone and more down than the Nasdaq, its time to reconsider just what the prospects might be. Surely, even though the IMF research claims that he equilibrium value of the Euro is something like 1.26 $/Euro, there is no prospect of getting there anytime soon. That rate is calculated by asking what is necessary to reduce the US deficit to zero-- we are not going to see zero deficits if only because the rest of the word cannot prosper without the US overspending. But at least we could hope that resolute ECB action could move the Euro off the cliff. For the rest, if ECB rate hikes take away the dope of currency depreciation as the engine of growth, perhaps those forces more and more policy makers to look for the growth answer on the supply side. One side benefit of that kind of growth is that the central bank can stand on the sidelines and cheer on the show.

ARGENTINA'S PLIGHT

The consensus view is that Brazil is out of the woods, for the time being, and Argentina is on the ropes. Views of Argentina range from pessimism to the darkest predictions of collapse. Collapse is not in sight but stagnation is a foregone conclusion and worse is likely.

In Argentina, even keen observers and contributors to past success, from Cavallo to Calvo, profess a need to break with the currency board and find some way out of the box -- a tablita, a basket peg, a devaluation follow by full dollarization. Everybody has their scheme; everybody is stoking the fire of imagination. All the talk about debasing the currency yet again, of course, cannot fail to get into interest rates. None of it has an effective counterpart in the government creating an impression of immutable firmness on the currency issue. Nobody wants devaluation, but…

Argentina missed a decisive chance when the new government opted for a weak cabinet, rejecting hard liners such as Ricardo Lopez Murphy in favor of Jose Luis Machinea; a former central banker who presided over failed stabilization in the 1980s. One was too much, the other was just right. True, they accomplished labor reform and some tax consolidation and even a minor public sector wage cut. Fairly brave and well focussed but too little and without follow-up and always too much taxes. Argentina is not a country that can be governed y the weak and faint-hearted; it needs a Cavallo or a Lopez Murphy who have an almost religious commitment to hard money. It is not clear what this government believes in and that lack of clarity is finding its way to the market. True, the blame does not fall exclusively on the new government, Menem's second term was a period of slipping back and getting weak; he deserves a share of the criticism for incomplete and stalled reform.

It is commonly assumed that Argentina's #1 problem is the lack of competitiveness, reinforced by Brazil's currency collapse of 1998. It is certainly the case that the price level in dollars, in Argentina, is high, very high and that as a result it is difficult to see a booming export sector. And failing an export boom, what else is there to drive growth; the government is basically penniless if not bankrupt; investment is limited because profitability is low and consumption financed households running down assets has its limits. Hence the current slump. The Tequila crisis, the Asian crisis, the Brazilian crisis--wherever there is a crisis, Argentina is in firing range. Too many crises, too many push-ups, the confidence is gone and so are good answers on what to do next.

Devaluation is a very poor answer for this dollarized economy; just where the exchange rate and prices might wind up the next day is an open question; whether Argentina would look any better after the post-devaluation debris settles is wide open to doubt. The social situation is strained, who doubts that an uncontrolled devaluation would not make it worse? Uncontrolled, some might argue, is an exaggeration. Did Brazil not have a history of hyperinflation, did Brazil not have a massive devaluation that restored competitiveness and did not reignite inflation? Why not play the Brazilian game? The answer surely ids that Brazil is not Argentina, it is continental non-dollarized and de-indexed economy, much more like the US than poor Argentina that has lost all illusions, including importantly money illusion.

A radical alternative is to have a coordinated reduction in wages and public sector prices, say 30 percent. The slump is moving wages and prices in that direction anyway, but far too slowly. Why not do it in one fell swoop, restore competitiveness and be done. The answer is right and the politics are obviously difficult! There is also the important question of how to deal with debts and nominal assets: should debts be written off along with deposits in the banks? That is playing with fire, but maybe inevitable. Should external debts be consolidated? That is playing with fire too for a country that runs current account deficits and must rely on foreign funding by the day. Better not to touch debts and banks, better to play the sound money and finance card, reinforced by full dollarization.

Coordinated wage cutting sounds radical, but remember it is just the scientific way of reestablishing competitiveness without the likely uncontrolled and often random fallout of currency devaluation. An economy like Argentina cannot afford to recover from domestic demand-- it would blow even more open the external accounts and the dependence on already difficult financing. It would surely lead to a downgrading of its credit. The answer has to come from the external sector and that means sharply higher competitiveness, sharply higher profitability of investment. A bold move like that attracts financing, doing nothing is a war of attrition that Argentina will lose.

The world economy is not becoming more favorable for the periphery: flows to the periphery are drying up because there is no apparent upside -- the NASDAQ has a more convincing story of unlimited opportunities than do Brazil or Argentina. The Argentine government pursues lots of little interesting initiatives, helpful domestic deflation is at work; but unfortunately disillusion is also and it works faster and deeper. All that is good but not enough. The government is basically penniless if not bankrupt; investment is limited because profitability is low and consumption financed by households running down assets cannot last. Profitability must urgently and conservatively be restored to avoid a progressive hollowing out. Most Argentines recognize that hard money is probably the best thing they have established in the 1990s. Save that, build on it.

For Argentina today, the old Chinese precept of Tung Tsu in *The Art of War* applies: "When encircled in deep ground, break out!"

THE MISALIGNED EURO

Caught by rising inflation from oil prices and the strong dollar, the ECB has raised rates yet another notch and, surely, there is more to come. Growth is wonderful, inflation is terrible and the central bank cannot avoid the difficult choice; it must restore price stability even if that means sacrificing growth. And that is what lies ahead, unless there is a sudden relief from a turn in the fate of the Euro. How realistic then is it to expect a significant rally of the new money that has been under siege virtually from day one?

The Euro started high and mighty. In the run-up to its introduction it reached impressive heights in the run-up to the IPO to use the analogue of speculation on the Nasdaq. But the IPO and the quotations thereafter crashed miserably. Since its introduction it has fallen further from the peak then even the Nasdaq has, so far. Just as for the Nasdaq, there is the question of what is the fundamental value, whether there is a fundamental misalignment and just how long it might last. It is commonly assumed (but nobody takes big bets) that the Nasdaq has major downside risk while the Euro, sooner or later, must return to normality, whatever that means. Could the opposite happen first? Certainly.

A recent study of the IMF reports on “equilibrium” exchange rates derived from models of long run determinants of currency values. The equilibrium rates are reported in the accompanying table and so are the current actual rates. According to these IMF theoretical equilibrium rates, the Euro is crassly misaligned: 30 percent underpriced against the dollar, 18 percent against the Yen!

	Actual	IMF Equilibrium Rate
Dollar/Euro ($/€)	0.88	1.26
Yen/Euro (¥/€)	93.1	113.3

In judging whether these theoretical values are foreshadowing a very important Euro realignment, lets see where they come from. First and importantly, these equilibrium rates are based on a theoretical model where long run current account balances tend toward a sharp reduction -- not zero but a reduction to less than half the present numbers. Hence, any country that runs persistent and large current account balances must look forward to some relatively hard landing and a commensurate currency correction. True, no country can borrow forever or at least at very high rates. But that surely is not to say that current account constraints apply to a major and financially stable industrialized country. Canada has run current account deficits for 50 years (with 3 years exception) and the US has been at it for 30 years. There is no expectation of a dramatic change in a year or even a decade. As long as a borrowing country is stable and attractive, a major reversal to current account balance will not be forced by the market. That, of course, is the story of the US: investment is running high, eagerly financed by the rest of the world; public finance is formidable and inflation ids not a significant issue; new economy prospects run unabated and asset markets are revealing increasingly that even if there is a bubble, it is unlikely to burst Japan-style. In that environment, long run equilibrium rate models are pretty useless as guideposts to short or even medium term exchange rate developments.

The second limitation of long run models is this: they are estimated from past history and hence make no allowance for dramatic changes in the supply side or financial environment. Japan, for example, is in the midst of a growth crisis and well into a public finance disaster. Surely those are not characteristics of an appreciating currency. On the dollar/Euro front, the Us has embarked on a high productivity trend not matched anywhere; never mind the current account, the upswing in productivity (combined with financial stability) becomes the dominant feature whatever the current account. The counterpart of this story, because exchange rates always ride on *differential* performance, is Europe's continued poor supply side performance and the ongoing pervasive Japanese economic distress.

There is yet a third reason why estimates of long run equilibrium with current account balance may be uninteresting. Do we really believe that Europe and Japan want to see the US with external balance? Are they are willing to see the dramatic gain in US competitiveness necessary to get there? Surely not; Europe and Japan, and the whole emerging economy world is living off the US deficits. These deficits are what keeps the world going! If there were a risk to the funding of US deficits by the private sector, in no time the ECB and the BoJ would step in to buy all the dollars that their private sectors refuse to buy. There is ample precedent for this: whenever the dollar weakens a lot, foreign central banks are extremely eager to help out. As John Connally, President Nixon's Treasury secretary said, "the dollar is our money and their problem".

The chance of seeing exchange rates any time soon anywhere near the IMF values is very distant indeed. Yes, the Euro can tend toward 1$/€. But it is also plausible that the lack of support for the Euro and the ongoing US miracles turn the table, that the Euro sinks from here to exceptionally low levels near 80 and even less. The Euro is not "way cool", for the time being investors think of it as a problem and so does the ECB. Yes, the IPO crashed because it came at the time the US went into super mode; the European product is certainly going to make it, it certainly will see in time its moment on the stage but right now it has no chance to shine.

MEXICO'S DEMOCRACY NEEDS GOOD ECONOMICS

With the election of Vicente Fox, in a sweeping surge of democracy Mexicans put 71 years of PRI rule behind them. This coming December Mr. Fox enters office for his 6 year term. Expectations are formidable, but unfortunately the economic results are likely to be disappointing. No, there is no expectation that Mexico will collapse yet again as it does almost always at the end of a sexennio; the progress on stability is important and the bad news is not that devastating. But still, it is important to be prepared for disappointment. Disappointingly, the supporters have already started rationalizing failure. The most commentary from Mexico is invariably this: After 71 years of PRI rule, how can anyone expect to do well. And this, a new democracy simply cannot be expected to do well. The latter comment in particular had been the chief explanation used in Brazil for poor economic performance. All the more reason to use the dramatic mandate before it dissipates!

There are four reasons why the incoming Fox administration will do poorly and face a showdown with reality. The first reason is that Mr. Fox does not really know much about Mexico's reality and about its neighbor in the North. This is most evident from his stunning initial pronouncements upon election—the pursuit of free labor mobility with the United States. He might be forgiven for early enthusiasm, but he repeated the same message (plus a big US-financed bank to lend to Mexicans) when he visited the United States a month later. What a thought, in a US election yes, to propose such an idea, how poorly can a man be briefed before he goes to Washington? There is no evidence that he is any better briefed on Mexican economic reality. In fact early announcements about sweeping energy privatization has since been withdrawn.

The next concern ids that Mr. Fox has no economic team that is remotely of the quality of the present team. The members are not known, they assuredly do not have the contacts enjoyed by the present administration in the US, from Washington to Wall Street. An economic team, and more broadly an able administration is essential in Mexico just as anywhere else in Latin America; there is always the issue of managing the inflows of capital, of sustaining confidence, of having investors understand what is going on. The role of economic personnel is entirely obvious if one reflects for a moment on say the role of Fraga in Brazil or Cavallo, in his time, in Argentina. There is no such candidate available and there is a concern that the shows of the present team will be filled by far less accomplished people. Yes, democracy is wonderful but it is no substitute for technical expertise. And what goes for the economic team goes, of course, for the entire administration. Mexico is still a state-run economy. How can a new government learn overnight how all this functions? And if they cannot, there is of courser frictions of not trouble.

The third important reason for disappointment is the genuine difficulty to govern Mexico now that there is finally democracy. Transition to democracy does not make automatically for easy and good economics; on the contrary, as Brazil knows so well. The new President does not control the Congress as the PRI did for many years. He has to govern by compromise and coalition and that will make everything so much harder. The PORI dinosaurs won't facilitate his task and having looked for support among the leftist Cardenas supporters will make it that much more difficult.

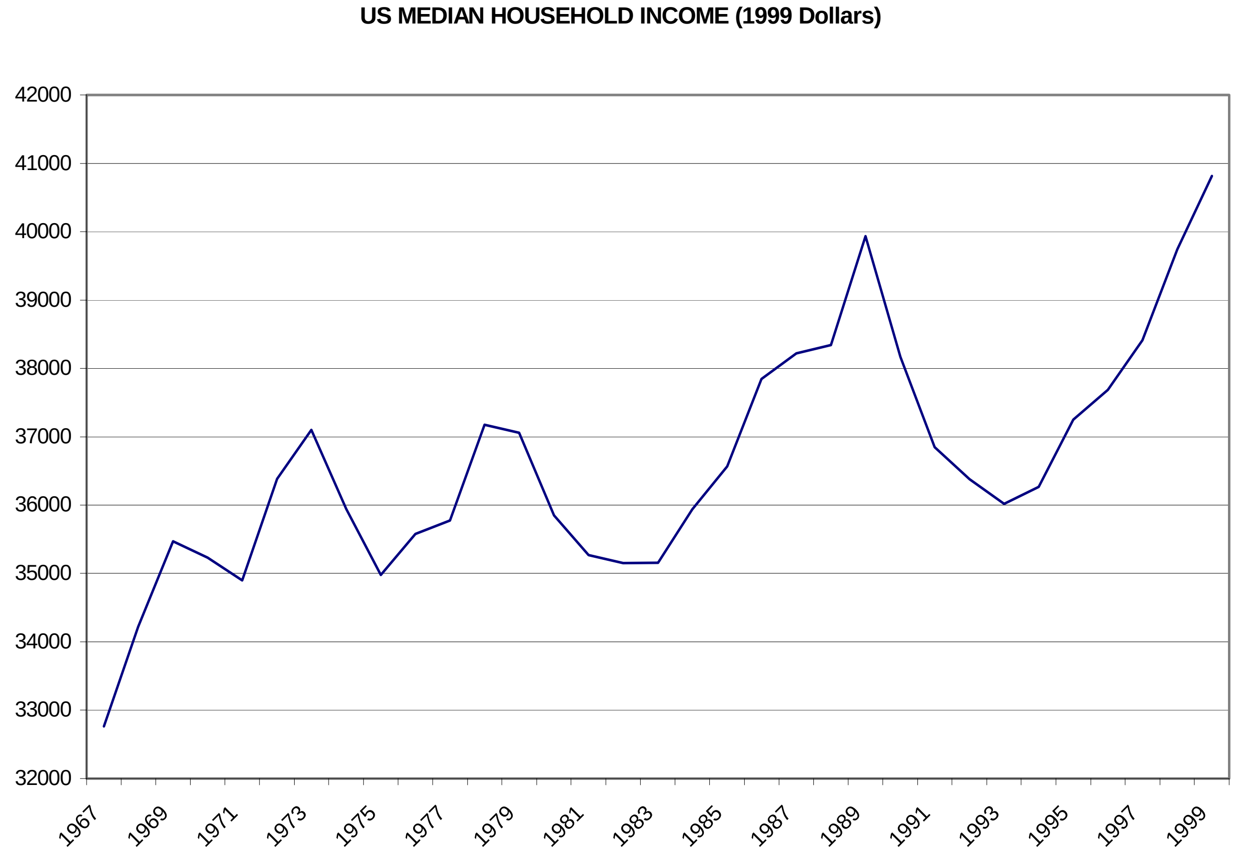
If all this were not enough, there is the extra difficulty of expectations. Having emerged from the crisis, and enjoying a very strong year just now, Mexico wants more. But delivering a lot more is very difficult once oil prices fall back next year. The currency is already as appreciated as it was prior to the last collapse; the current account even with formidable oil prices is in deficit. The sad conclusion is that Mexico will disappoint: growth will fall off, the currency will come under pressure (not attack, just weakening), interest rates will go up and all the problems of poverty and progress made even more urgent by an open democracy won't get any better answers than in the past.

Yes, Mexico must be proud of its democracy. It is unfortunate, however, that the incoming President seems to take the economic issues too lightly and hence runs the risk of short changing the country. He rightly focuses on the need to create a democracy. But he seems overly enamored with his sweeping mandate and he might underestimate how difficult it is to deliver world class results. Mexico is not on automatic pilot, or at least no longer. Growth and stability must be skillfully nurtured by the day even as democracy makes these tasks so much harder. Yes there is an independent central bank and a very successful central banker; but that is not enough once policy performance slips and financial markets start being frustrated.

Mr. Fox could make his life easier, and that of Mexicans much better, by opting on day one for a currency board to complement the trade integration that is already proving dramatically successful. Unfortunately that does not appear on the agenda just now. Perhaps it will come once, a year from now, the honeymoon is over and the need for strong remedies to have democracy and good economics coexist becomes more apparent.

NEW ECONOMY AND US SOCIAL PERFORMANCE

The new economy story involves radical restructuring and reform driven by new technologies as well as increased competition. Sharply higher productivity growth as much as the pressure for cost cutting creates an environment that tests a society's cohesion. Doubtlessly these pressures must be highest in the US, the place where new economy has been driven with more exhilaration and zest than anywhere else. At the same time, the US at least in comparison with Europe, is the country where the social net hangs low and has lots of wholes. No question then that the US is the place to look for the footprints of what new economy might do to the social map. The old story was one of the hamburger flipping society and the homeless, the new one might be that of mega-billionaires and the displaced worker. And if that is mostly the story, no question that governments in economies that are lagging in their new economy efforts might have second thoughts. So what is the record?



Data just released make four points: First, the US poverty rate is at the lowest point in 20 years. Yes, still more than 30 million in poverty but a few million less than the year before. Second, real median family income is at the highest level in the more than 30 years for which the date exist. Third, the unemployment rate is at the lowest level in 30 years. Finally, there is one more statistic, this one distinctly unfavorable: Over the past few years, the income share of the bottom 20 percent of households is at its lowest in more than 30 years while that of the top 5 and 20 percent is at the highest.

Those who look for a positive picture will find it in median income, reduced incidence of poverty and record low unemployment. But those who look for the bleak side will find it in continuing mass poverty--12 percent of the population-- or in the deterioration of income distribution. No, the US has not abolished poverty in the midst of plenty, the progress is more limited at the bottom to just absolutely and relatively fewer people in destitution (i.e. less than $17,000 for a family of 4). The data do, however, contradict the view that the rich are getting richer and the poor are getting poorer. True, the rich are getting richer --a lot richer--, but the low-income groups are getting a little bit ahead, too. Of course, their advance is very disappointing compared to the economy at large and even less in comparison with the top 20 or even 40 percent. The top 5 percent starts at an income of $142,000 while the bottom 20% peaks at 17,00, a ratio of 8.3. The comparable ratio has steadily increased over the past 30 years from the much lower number of 6.3. Yes, the rich are getting richer, absolutely and relatively.

Table 12 US Income Distribution				
	1970	1980	1990	1999
Percent of Total Income				
Bottom 20%	4.1	4.3	3.9	3.6
Top 20%	43.3	43.7	46.6	49.4
Relative Incomes Multiple				
$95^{th}/50^{th}$ Percentile	2.7	2.9	3.2	3.5
$50^{th}/20^{th}$ Percentile	2.4	2.3	2.4	2.4

The verdict then is less poverty, higher median incomes, and more inequality. That, indeed, is the mixed blessing of New Economy.

The good news is surely that everybody is getting ahead. Even skeptics must accept that that is unambiguously positive. It is interesting to ask what exactly is at work. Surely, increased competition, restructuring, new technologies involve a vast possibility of displacing workers. How then is it that even they get ahead? The answer lies probably in this fact: increased competition and important productivity growth have reduced the inflationary pressures that in the past came with economic expansion. As a result, economic expansion could continue much longer -- the longest expansion on record-- and, in that way ultimately get everybody a job. And a job, of course, is the single most important part of getting ahead on incomes. The chart above shows important setbacks in medium income during recession periods in the early 198-0s and early 1990s. Continued strong growth since has taken the middle class ahead with adjustment effects more than offset by the impact of steady growth.

Europeans in particular will look at the US picture to argue that inequality rather than getting ahead is the major issue. They will argue that a country where more than 30 percent of households earn less that $25,000 is a country of working-poor, a country where working does not give you enough to live on. That is, indeed true and is the chief predicament. From the US side there is an answer, better to work than be on unemployment or welfare and gradually become marginalized. The European answer has traditionally been to abolish extreme inequality and poverty by lavish unemployment compensation that puts a floor under the willingness to accept poor jobs. That strategy has cost a fortune and, it is widely understood, is no longer affordable. As it gets under gradually dismantled, Europeans will have to work, too, and with it will experience more inequality though perhaps not US poverty levels. In the US, by contrast, there is rising recognition that the education system is appalling and is the chief reason for inequality. Very poor education in turn is not the counterpart of an unwillingness to spend the money but rather an inability to get results.

Will new economy one day get to education, too? That will be the day when people create broad alternatives to schools dominated by teachers' union. The experiments underway show that in church-operated schools and in private charter schools education works extremely well; the problem is not the students, it is the union teachers. The bigger problem to be overcome is that, not surprisingly, they are well organized and are the major campaign donors (along with lawyers). That is what keeps new economy-style education vouchers off the table and poverty in the charts. In the area most important to economic and social performance, the US has been unwilling to bite the bullet. Interestingly, just as this being written, there are the first incentives of cash-based rewards in some districts for teachers who deliver improved grades. And there are signs of publication of comparative school evaluation-- competition is on the way in, don't underrate the new economy!

December, 2000

TURKEY AND THE IMF

Out of left field and without warning, Turkey went into a financial crisis. Within a week, $6 billion in foreign exchange had been lost by the central bank with only 18 left, barely enough fir another week before an all-out exchange rate and financial collapse had to be expected. But, unlike in all other instances of the pat few years, this time the IMF came in time, brought the money, got the policy commitments that made the rescue plausible, and put Turkey back ion the way to stabilization. Praise to the IMF for getting ahead of an unnecessary crisis, compliments to Turkish policy makers for accepting to play by the IMF rules. The Asian crisis left many observers with the criticism that IMF high interest rate strategies kill banks and create a disaster. With that in mind, watch the events in turkey and always along the way ask what are the alternatives. A short period of high rates will seem an attractive alternative to capital controls or currency and banking collapse.

For years and years, turkey has been on the short list of candidates for a financial crisis. The deficit in the budget is large, the current account deficit is large, the public debt is high, the banks are bad, the foreign short term debt is high relative to reserves, politics includes issues ranging from human rights and fundamentalism to deep-rooted corruption. With so much tinder around, who is surprised that a crisis did emerge? The immediate background is appropriately minor -- inside every little problem, there is a bigger one waiting to get out. Some Turkish bank suffered the bankruptcy of a bank it owned in Rumania. Not surprisingly, a run on the bank ensured and on other banks that had doubtful portfolios and serious questions about legal issues pending. As is always the case in emerging markets where the presumption of banks being much worse than meets the eyes, the run was out of Turkey and into foreign exchange. That would, of course, automatically be the case if foreign creditors pull credit lines in order to avoid become part and prisoner of a banking crisis.

At first the central bank played lender of last resort, keeping bad banks afloat by putting in money at the front door only to feed the deposit run and reserve losses. In a few days it became clear that this was a full scale repay of Indonesia, that it would involve exhausting reserves in an effort to save banks and that, in the end, bot the banks and the currency would go.

Enter the IMF. Turkey is under an IMF program that includes an exchange rate-based disinflation strategy reinforced by fiscal targets, limits on the expansion of net domestic assets of the central bank (i.e. on bail out operations by money creation), as well as banking reform measures. The IMF surely must be behind the governments new-found religion of stopping the money-financed bailouts, letting interest rates go to the sky and putting in receivership at least one doubtful bank. Interest rates became astronomical but within days money came back. By the end of the week, with rats starting ever so slightly to decline, nearly 2 billion had returned. More is expected as the government sticks to its credit targets. Th program is getting back on track. In fact, it probably is now getting better than it was. The high interest rates and extra fiscal measures will slow growth, something totally essential to bring down inflation and make the exchange-rate based disinflation work. There is also good news in breaking the procrastination on privatization of Turk Telecom, there is good news in Europe about opening the door to Turkey's membership, and there is good news in Turkey on human rights. All parties used the crisis to break procrastination and misalignment. Long live the program.

It is too early, of course, to proclaim victory. Offshore banks with exposure in Turkey may want to reconsider and that would mean a drain in reserves far larger than the IMF has brought. Also, continuing high rates -- and they are still at emergency levels-- add o deficits and debt and worsen the banking system. The crisis will cost the government quite a bit and the fiscal situation is quite bad to start with. It is tempting to ask whether letting the exchange rate simply go might not have been a better answer. That is too easy a story because, in a high inflation economy like Turkey and in the context of high growth, big depreciation would have meant a resumption of inflation, a back to square on giving up a year of significant disinflation.

Of course, there s another possibility that took no time emerging in Turkey: if the IMF does not bring the money, rather than exchange rate collapse or record interest rates, why not capital controls? Of course, if Turkey had gone that way, it would have become almost certainly the presumption everywhere when a country gets into trouble. That is a serious system issue, it surely was on the mind of the IMF but that would not have deterred Turkey. It was a close call.

There is another interesting aspect to this IMF intervention. It is well-known that at the IMF, the US Treasury, among German officials and just about everywhere there is a deep suspicion of anything that remotely looks like a fixed exchange rate. In fact, Argentina is one of the last countries with such an arrangement and it is n the IMF emergency room.

One might have been tempted to believe that with this thinking, a floating rate or some such thing would have been the answer. Not so. The IMF stuck to the program at least for the time being, recognizing that it was a banking problem that lit the fire and not an exchange rate problem. The IMF is to be congratulated for understanding that the exchange rate is not the answer to just any problem.

All this said, the IMF and Turkey have a long way to go in turning the current program into a completed success story.

THE CHICAGO SCHOOL IN THE 60s[7]

Chicago in the 60s, no doubt, offered one of the great times in economics; maybe Keynes was the center of a great moment in economics, but the time we had in Chicago is hard to match. Robert Mundell and Milton Friedman were very much at the center of it, as were George Stigler, Harry G. Johnson, Al Harberger and more. There was the “oral tradition” and there were the “workshops”, the formidable feeling for students and faculty alike of a revolution in the making. The great issue of the day was just how the economy works and what role government must play if any and what role monetary policy must definitely not be allowed to play. This is when Keynes died –actually he was long dead by then but his powerful ideas were fully there and had just animated the great Kennedy-Johnson expansion-- and the resulting inflation monetarism was born in the midst, and in reaction, to the wave of inflation of the time. This was when “Chicago Boys" were made -- a derogatory term at the past but rather a brand name by now. Note, Mexico’s new finance minister, Francisco Gil Diaz, is another Chicago boy trained in just those special years in the late 60s.

Chicago economics was built on two pillars: price theory and monetary theory. Price theory was about resource allocation, how markets work, how government for good reasons (patronage or capture by business interests) misallocate resources to create rents for themselves or their clientele, how competition tends to be the rule, how ultimately all and everything revolves around incentives and economic responses, from crime and love to corruption and trade restrictions. In Chicago, complex problems had simple answers, --easy to understand wrong answers the enemies would say.

The second pillar of the oral tradition was monetary theory, a formidably sophisticated and deep excursion in why there is money, how it works and how it can be destroyed. Even today, years later, Chicago students can expound forever about deep aspects of the demand curve for money. Anyone who sat through Friedman’s lecture emerged with an altogether profound respect for the proposition that tinkering with the quality of money is profoundly destructive of economic life and, indeed, society. This is where people learnt that stable prices promote long horizons, that monetary instability promotes economic misallocation.

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[7] Contributed to the *Financial Post* in Canada accompanying an email debate between Chicago School Nobel Laureates Milton Friedman and Robert Mundell.

Even though the ideology was patently free market economics, politics was really not to be seen. I might we contradicted by those who note that during the 68 campus riots, the department continued lectures as if the outside world had not stopped for dramatic events. I remember vividly demonstrators—presumably political science activists-- entering Friedman's class only to be told that they were interfering with the freedom and choice to learn of all of us. Moreover, not having registered they were not even free to stay quietly. In hindsight, amazingly, the protesters left and our insular clique went on experiencing the quantity theory of money. We missed the revolution.

Beyond the classes, with a formidably competitive and merciless decimation of class size by the "core exams", one proceeded to the "workshops" where the real action was. Here students and faculty presented their work in progress and submitted to the unrelenting bombardment of the workshop members. Yes, there were double standards; there was some kindness to students who made their first attempts, there was no mercy at all among the faculty, there was absolutely no mercy for junior professors who were plain beaten up. If they survived, there was nothing more to shock them or throw them off course.

Mundell and Friedman could not have been more different. They continue to be revered by their students but with starkly different memories. Milton one remembers for his unbelievably baggy brown suits (from East Germany, I surmise), his incisive uncompromising mind and a sweet smile going along with "what you really mean to say.." yes, Milton. Bob Mundell, by contrast favored a continental appearance and demeanor, his Canadian background notwithstanding. His mind looked for paradigms and always set out to upstage received wisdom, challenging dogma, being the *enfant terrible* that he still is.

Friedman's money workshop, on the contrary, was molded on his own principles of predictability and structure, rules and responsibilities, no exceptions. Everybody present had to present a paper, no spectators. Everybody had to read the paper ahead of time (i.e. there was a paper) and discussion would proceed page by page. Friedman ruled, the rest mostly trembled or slurped the biblical pronouncement.

The international workshop of Mundell and Harry Johnson was quite the opposite; often there were no papers and even when there was something, Mundell's tendency for going off course to his latest ideas easily penetrated; order was discouraged, speculation was at a premium. Harry Johnson would carve little animals from wood and occasionally pronounce, Mundell was unstoppable and Socratic.". He never, never in the time I saw him in Chicago answered any question other than with another question. He always held that what was already on paper was too stale to look at or talk about, what was just in the making was the challenge. He favored "oral papers." That was not easy for the paper presenter. Michael Mussa, the most brilliant of the group and today the outspoken chief economist at the IMF, came close to strangling Mundell (at least in his mind). What did the experience do for us? Surely, it was the most extraordinary learning experience, questioning established truth, learning to think through a proposition, getting a view of the economy in our head with which to think on our feet.

Mundell and Friedman ran very different schools: for Friedman open economy was a short topic: flexible exchange rates—fully flexible—and free trade what else was there to say. For Mundell it was, rightly, hard to understand how Friedman could talk about monetary policy in a closed economy as if there were such a thing. As time went on and the rate moved to flexible rates, Mundell increasingly favored fixed rates, monetary areas, world money. He always knew that fashions move in a circle so now his view is back to full chic and he continues to be the trend setter whether it is about monetary arrangements or about the then heresy of supply side economics.

Ever so often there was a gladiator event, a workshop where for some reason faculty from different areas got together and get at each other. Mundell vs. Friedman were special events. Friedman obviously admired the sheer creativity of Mundell but would not let him get by, sparks would fly. With half-baked ideas. Mundell recognized Friedman as an icon but understood that he could play the bad boy with success. I remember the unspeakable from Mundell: “Milton, the trouble with you is you lack common sense”. I do think Milton was speechless, one of those treasured moments so rare in the life of the Great. Mundell and Friedman ran very different schools: for Friedman open economy was a short topic: flexible exchange rates—fully flexible—and free trade what else was there to say. For Mundell it was, rightly, hard to understand how Friedman could talk about monetary policy in a closed economy as if there were such a thing. As time went on and the rate moved to flexible rates, Mundell increasingly favored fixed rates, monetary areas, a world money. He always knew that fashions move in a circle so now his view is back to full chic.
Both won the argument, we could not choose. But even so, each had their cohort and the cohort would imitate the master in style and speech and mannerisms. It must have been peculiar for anyone looking in, maybe that is why it was called the Chicago School. And then there was the day when Mundell presented to a full-full house his new theory of the policy mix—monetary policy for price stability, fiscal policy for supply side growth. Suffice it to say that this a very noisy afternoon.

In the Italian city of Siena those born inside the city walls think themselves the true *Sienese*, born *sulle pietre*, unlike those from the surroundings, born *sulla terra*. Much the same goes for Chicago economists; having vaguely right-wing tendencies does not make for not having been there and being part of a great experience. These were formidable years for economics, they have changed the way our profession today thinks about money and the word economy. Two Nobel laureates later, with independent central banks, flexible exchange rates, low inflation and “new economics” what was done there has helped change the world.

LATIN AMERICA: WHERE IS THE UPSIDE?

Argentina’s situation may just now be the most precarious in Latin America but the problem is far more widespread: there is very little upside for investors and there is long list of problems none of which is going away. On the contrary, they more nearly are building up in a vicious circle of reduced growth and diminished credit worthiness.

The first and central issue is that Latin America needs money: wherever thee can be a deficit, there is a deficit—in the budget, in the current account and over and above that in the rollover enthusiasm. Countries that need money are vulnerable to investor enthusiasm; at the least they risk higher rates, at the worst they meet outright credit rationing which puts financing of deficits and rollovers in question. That us the case of Argentina today.

The next most obvious difficulty is the deterioration in the external environment: the US has embarked on a “soft landing” but it remains to be seen just how soft the landing will be. Surely part of the adjustment is a significant deterioration of the credit environment for anyone but the best. Spreads for less than top companies will rise and the same, of course, is true of emerging market borrowers. Nobody in their wildest dreams will say the US is unsafe, lets lend to Latin America instead. Spreads rise in part because of reduced credit soundness and in part because of sharply higher liquidity concerns. Of course, making a good impression when interest rates e high is a difficult challenge for Latin America.

So what is on the other side to encourage lenders? Not much and that is for there reasons: first, Latin America is tired of reform and second, politics are now much more open and less tightly focused on an ideology of reform and stabilization. Tiredness of reform is apparent everywhere, even in Chile and certainly in Brazil or Argentina. In other places like Venezuela it is not even in the menu. More politics is clear from Mexico to Argentina and Brazil with an election on the horizon is no different. This is not a good time for broad and deep initiatives, second generation reforms that start working on the fine points of institutions and stability.

The third and most critical problem is that investors do not see an upside what is there that could suddenly emerge as the great promise, creating important except returns to balance the risks that are so apparent everywhere? There is no new wave of stabilization of hyperinflation as in the past. No new wave of privatizations, no new wave of anything except possibly bad news.

Argentina's economic minister Jose Luis Machinea has announced that the country has a "liquidity" not a "solvency" problem and that the IMF money will look after liquidity so that Argentina is all right. Not so! Of course there is a liquidity problem-- short-term debts are large and domestic confidence is plunging. But there is also a solvency issue: the debt is large relative to any measure of ability to pay; growth has virtually stopped and the world environment is not helpful. Argentina, even with IMF money, will not get back on its feet.

There is one upside possibility, though, that must not to be overlooked. The newly appointed finance minister in Mexico is Gil Diaz, a Chicago Boy by any definition, not only his economics degree. He has in the early part of this year, before his appointment seemed at all like, advocated dollarization in Mexico. Suppose he still believes that is the right route, suppose he has in fact persuaded the incoming President Fox of that strategy, that would be the piece of news that would set off an entirely new and dramatic enthusiasm for Latin America. Nothing else will do the trick.

ASIAN BALANCE SHEETS THREATEN WORLD STABILITY

Europe and Japan fear a US hard landing -- a collapse of the stock market and of the dollar at the same time, leaving Chairman Greenspan torn between raising rates to defend the currency or cutting rates to save stocks, confidence and growth. They are mistaken: with inflation addressed by the slowdown, monetary policy and tax cuts limit the downside and pave the way for a prompt return to significant growth. Rather, the risks are in Japan where bad balance sheets, beyond repair, create the potential of a world financial crisis.

Japan's public sector is basically bankrupt. The government has a public debt well above 200 percent of GDP if unfunded pension liabilities are included, as they should. The budget deficit is in the range of 6 to 7 percent of GDP with no prospect of a significant reduction. A recent report of the prestigious Japan Center for Economic Research (JCER) notes " Because of rapid aging of the Japanese population, the public medical insurance system as well as the public pension system is likely to collapse in the near future". Absent high and sustained growth, there is no chance of stabilizing the debt ratio and even less of bringing it down. Exploding debt means higher interest rates and a tendency for savings to look for safety offshore, even in Japan. When that happens a world financial crisis is not far off. Some problems are solved by the sheer passage of time or, this one will not go away.

In principle Japan might grow out of these debts. But growth prospects are poor. The JCER reckons that GDP growth will average 1.3 percent over the next 25 years or, in an optimistic scenario, 2.3 percent. Declining population already underway is one of the reasons for low growth, poor productivity performance because of opposition to deregulation is another. Even though interest rates are very low, low growth rates along with stable prices imply ever rising debt levels relative to GDP. At some point there is a rendezvous with bankruptcy. It might be argued that a similar discussion occurred in the US in the 80s and we came out just fine. But the debt ratio was 40 percent with much more favorable growth and demographics, not 200 percent with a falling population and minimal growth.

At present, Japan's debt is rolled at very low interest rates. With an uncannily poor sense of timing, Japanese investors have lost money on just about any investment around the world -- stocks, bonds, currencies and real estate buying at the peak and getting out at the bottom-- except their government bonds. Hence the willingness to hold them at virtually no return. But looking ahead, increasing skepticism about growth and deteriorating public finance will translate into capital outflows, increasing interest rates and hence an acceleration of fiscal instability. The downgrading by offshore credit agencies which today is still a sideshow will help make the problem even more apparent. And the problem is big: This is the largest debt in the world, bigger than that of the US or all of Europe!

The political dominance of the non-reformist LDP rules out a growth miracle. Other possibilities include a great inflation to wipe out the real value of debts, heavy taxation, or selective debt repudiation. None has any plausibility. Inflating away debt carries the grave risk that households-- already old and having suffered a major wealth loss in this decade-- will save more to make up and hence precipitate a depression of economic activity. The independent Bank of Japan would be poorly advised to try the gamble. Heavy taxation to achieve budget balance had its trial a few years ago; it immediately pushed the economy into recession and it would be the same this time round. Debt repudiation, or haircuts for pensioners, does not easily fit the Japanese social model. Reform of entitlements and retirement rules is a strategy in other economies that are 3 or 4 decades away from the problem, not Japan where it is already knocking at the door.

If savers choose to hold and roll debt, or are required to do so, where is the problem? The problem only emerges once they try to opt out. The obvious answer, fully in line with Japanese thinking and practice, is to paper over the problems by returning to repressed finance and capital controls. In a high saving and current account surplus economy such as Japan, repressed finance and capital controls assure that the debt can be rolled perhaps not forever but certainly beyond the horizon of the LDP. Japan's experience with open capital markets has been nothing but trouble. Capital controls and repressed domestic finance will seem a low cost, workable strategy.

Japan is not the only country to face serious balance sheet problems and aversion to restructuring in finance. Korea is turning out to have finance just as bad as Japan -- behind the bad banks there are surely bad insurance companies, unfunded pensions in the staggering Chaebols and more skeletons everywhere. And the same pattern is emerging in Taiwan although it may not be quite as bad. Returning to repressed finance and closed capital accounts will seem an attractive policy to refocus on hard work, high saving and economic stability and away from financial crises. That was the argument for Malaysia when Dr. Mahtir revolted against the system and sought refuge in controls. With common problems, who doubts that we will see cooperation in closing down. Thus ends the hope of a world of open, deregulated and efficient capital markets.

SUPPLY SIDE OBSTACLES

The debate about supply side reform often comes down to slogans: flexible labor markets, deregulation, competition. And then everybody agrees and nothing much happens. Suppose you were the economics minister, suppose you were serious about fostering the supply side but short of ideas of just what exactly to do. Here is one interesting answer that comes from a research group at Harvard organized by Andrei Shleifer, a distinguished scholar whose work focuses on how governments make economic life much harder than it need be. The new research project looks at a group of 75 countries and asks how many formal steps it takes to create, legally and without bribes, a company, how long it takes and what is the cost. The interest of the careful survey is obvious: if it's hard to create companies, don't be surprised if there are not many new companies. And if new companies don't get created, where are growth and employment to come from?

The accompanying table gives a flavor of the Odyssey involved in setting up a business: the average for the 75 countries shows more than 10 separate steps of getting certificates of this and that, a cumulative time of 63 days spent to get the paperwork done (assuming no bureaucratic delays) and total payments to the government as high as fully one third of a year's per capita GDP. The numbers are stunning— what is there to be done other than registering a name and getting a tax number? Who has the time to spend a 110 days, as in the Slovak Republic, to just run around government offices, who has the money to spend a sum of $ 1,000 as in Poland just for the paper work?

Business Formation Hurdles			
	No of Steps	No of Days	Cost (% of per capita GDP)
Canada	2	2	0.014
75 Country Average	*10.2*	*63*	*0.34*
	11	121	0.25
Italy	15	67	0.67
Brazil	10	26	0.28
Poland			
Source: A. Shleifer et al. "The Regulation of Entry."			

The winner in the contest of bureaucracies is Canada: totally minimal, user friendly and low cost; even quite a bit better than the US. Three cheers for Canada! And who is the worst? Bolivia. In between sits the lot, including Western European economies. In Italy is a case in point, a bureaucratic embarrassment where it takes 4 months to get to set up a business. Is any of this strictly necessary? Brazil, your typical Latin American country looks pretty awful in this competition and so do most Eastern European economies. When you go beyond North American the Nordic countries of Europe, Australia and New Zealand – the world supply side league, it gets pretty awful pretty fast.

The Harvard researchers ask this interesting question – why so much bureaucracy, to protect future customers or to tip off future businesses? An attempt to show beneficial entry regulation fails, the "grabbing hand" hypothesis predictably wins. Bureaucracies set up hurdles to put themselves in place for rip-off, bribes or simply cushy jobs. In other words, not only does the economy suffer by having far fewer jobs than it might enjoy with more user-friendly entry conditions, it suffers on top the burden of paying and enduring a bureaucracy. Since excessive entry regulation serves no other purpose, reformis6t governments should not blink for a minute, get rid of the obstacle course.

Of course, the argument will readily be made that all of these hurdles in practice mean nothing: if the obstacles in the formal economy are too cumbersome, businesses just open in the informal economy. They work just as well, the argument goes, so where is the damage? Of course that is deeply wrong. Not only is it a very bad economic strategy to criminalize business formation and operation by pushing it underground, the fact is that a lot of businesses simply will not come into existence, not even in the informal sector.

Suppose again you are the minister in charge, you are indignant at the corruption and bureaucratic excesses, you insist on change. What to do? Brazil once had an interesting experiment, a minister of de-bureaucratization. This is a true story and there is even some success to report. The newly appointed minister went around the country, looked at every single form to be filled out in the various interfaces with the government and got rid of perhaps a third. Nothing short of a triumph in a country where officialdom loves to stamp pieces of paper for just about anything. And then? Nobody remembers what happened next, the ministry no longer exists and the paper maze has grown back to full flower. This of course confirms the rule that the only way to control the bureaucrats is to get them out of their jobs. As long as they sit there, they will find something to do and, unfortunately, it always comes down to one simple thing: "protect the public from business" or, in other words, stop business from working.

THE ART OF CENTRAL BANKING

The Euro trouble of the past months, and more particularly the October gaffe of Mr. Duisenberg, bring back an old question: what are the rules of good central banking? Just now nothing seems to work: raising interest rates weakens the economy and that weakens the Euro, half-heartedly intervening in currency markets does not do the trick, and talking a lot without much conviction makes everything worse. Successful central bankers of the past two centuries are remembered for their outsized stature, and the poor ones have gone down with their currencies. Central banking seems more zen and art than science, a skill and maybe a rulebook, not something that just anyone can handle.

That would leave one with the impression that central banking, much like the performance of great generals in the field, is a deeply personalized skill. That it has mostly to do with sizing up a situation, using appropriate discretion in one's move, and more generally create an aura of infallibility or, as it is called now, credibility. All that is somewhat true but there is more to the story.

On the technical front, two discussions have settled down by now. The first is what central banks should look at, growth or price stability. The answer, no question here, is price stability. Whenever there is a choice to be made, whenever monetary policy risks being overburdened, price stability must get priority. That leaves operational questions such as how vigorously the task must be pursued, how fast the target should be attained but there is no doubt that the central bank cannot waiver from it. The past 20 years, the very rise of independent central banks, is all about getting priorities right, getting rid of democratic money which is always shortsighted, bad money.

The second issue, once priorities are clear, is the question of rules versus discretion. Should the central bank operate very mechanically—say an x-percent growth rate of the money and just hat whatever or is there room for discretion where the vigor of response, the timing and the time path are calibrated to the special circumstances of the day. That is a very uncomfortable issue: central banks want discretion, lots of it, because that gives them power. Economists are suspicious because what goes by discretion becomes all too easily the pursuit or accommodation of some side objective other than just price stability; the exchange rate or the stock market or employment might just sneak into decision making and the central bank, overestimating what it can achieve, might lose its sense of priorities. But the broad consensus remains that because money demand is so unstable, the central bank should have room for discretion; ex ante, automatic rules just do not do as well.

But the moment we concede discretion to our central bank, we open the door to a muddling of objectives and the risk that price stability gets the hind seat. History everywhere, notably in the US, before Volcker and Greenspan (and even Greenspan some will argue), is replete with such misjudgment, deliberate or by accident. That takes us to the third issue, transparency. The more our central bank has a license to use its judgment in the month-to-month pursuit of monetary policy, the more important is it for us to know what their target is and how they rationalize their monetary policy decisions in terms of these targets. An explicit inflation target is now the rule in many countries. Not though that the all-powerful Greenspan has said no thank you top that and gotten by with it so far.

The best way to understand what the central bank is doing, in fact, is to publish the proceedings of their deliberations. It shows where the board thinks the economy is just now and where it is moving, what treatments required? Over time financial markets get to understand "the model" and the personalities and learns to predict what comes, over time financial markets learn to simulate what the central bank will do; the term structure of interest will come to project what ultimately will be the course of short term rates set by the central bank. That is good policy. Bad policy is to hide the transcript and even worse, make a point of "surprising the markets". Central banks that get into an antagonistic stand with markets are deeply in the wrong place; they reflect their failed performance rather than the market being wrong.

There is one extra critical; aspect of successful central banking: communication. That is, of course, another feature of transparency, but it goes beyond that in telling the public "here is how we see things, here is what we believe is important, here is what is our responsibility, here is our record, here is where we see things going. Over and over again, until the public gets the point and becomes a strong supporter of the central banks mission, policy stance and performance. There is no substitute for this communications strategy and it is definitely not well addressed by a rambling press conference that takes the place of a policy meeting's minutes. The great art, of course, is to communicate what the framework is rather than get bogged down in question of what is the next move. It is hard to imagine even a press question to Greenspan of whether rates will go up or there will be intervention. Everybody knows that question won't get an answer and is entirely in appropriate. Such information might appear in the minutes, in the discussion of the policy committee's bias for rate his to come. That is the right place not only because it allows a more measured and controlled communication but also because it is a committee decision, not a central bank presidents personal choice as he or she sees it in the heat of a press meeting.

New central banks face extra burdens. A long history of learning, including precedent created by good central bankers –Trichet, Poehl, Tietmeyer, Volcker, Greenspan— creates a framework in which markets increasingly know what to expect and how to take the hurdles. That was true for the Buba, ultimately for the Bank of France and also for the Fed over the past 20 years. The ECB is the stark opposite. A new central bank has little to back it up, neither in the experience of its governing board nor in the functioning of the money at home and in world markets, nor even a strong research staff appointed for excellence rather than nationality. How to respond to these extra challenges? The answer, of course, is to be holier than the Pope, so to speak. More clearly stated targets, more transparency, more measured communication; avoid amateur hour at all costs. Avoid betting price stability on the hope for timely bad news from the US or early decline in oil prices. Above all, do not ever, ever come close to projecting benign neglect toward money, bonds, or the currency in exchange markets. If the US Treasury feels it is essential to uphold the mantra of a strong dollar (because some foolish Secretary of the Treasury once measured benign neglect only to see the currency crash), that surely should be a lesson to Europe's central bankers just as much. And if the US Treasury does not talk about undervalued or overvalued, there is a messiah there, too.

The worst performance of Duisenberg, of course, was his attach on Secretary Summers for the alleged failure to rescue the Euro. Surely, the Euro is the responsibility for the Europe is that of Europe and its central bank and treasury officials. If they, and the public, do not have confidence in the Euro and are unable to create it, blaming the US seems far-fetched. Mr. Duisenberg's attacks remind one of Malaysia's Dr. Mahtir blaming his country's crisis on George Soros rather than the country's dismal financial structure that was the true reason. Barring very bad news from the US, the Euro will not strengthen substantially until Europe can get itself to believe that the new currency venture is a sound idea and a good money; only then will the rest of the world, too, buy into that proposition. Surely the best idea would be the immediate introduction of Europe coins and currency notes. Unfortunately the answer is that this in impracticable, not enough money is yet printed and ready to go, that the introduction must be perfect, that the vending machines are not adapted yet, etc.

When in the postwar period, the new German currency was introduced, the then central banker, W. Vocke, – a man of deep judgment faced with an inflation flurry—stated unambiguously "soft steps don't make a hard money". Europe's new money is too new, too important, and too vulnerable to be left to the hazard of bureaucratic timing and amateur press conferences.

February 2001

FEWER MONIES, BETTER MONIES

so much of barbarism, hover, still remains in the transactions of most civilized nations, that almost all independent countries choose to assert their nationality by having, to their own inconvenience and that of their neighbors, a peculiar currency of their own." (John Stuart Mill, (1894, p.176))

A century ago, being civilized country surely meant being on the gold standard; gradually countries had converged to the internationalist solution, overcoming their nationalist experiences with peculiar coinage, paper, silver or whatever unusual and segmenting arrangement. And if countries were not outright on gold, at least they were on sterling or the dollar. After World War I disrupted a financially integrated world, the very first priority was to get back there. All that fell apart in the Great Depression with capital controls, competitive devaluation and discretionary central banking.

It has taken 50 years to explore all possibilities offered by money without rules and the harvest has been disappointing. But following the great inflation of the 1970s and extreme monetary experiences in many developing countries, the past 20 years have brought a fundamental transformation to monetary management. Independent central banks with transparency and some inflation target, more or less explicit, are now standard. In many emerging economies we also now observe independence of central banks and, where rates are flexible, some variant of an inflation-targeting policy approach.

At the same time, monetary integration is a live theme. In Europe this has become a fact with the creation of the European monetary Union and that experience is growing with the increasing incorporation of countries in the East, a handful as early as 2004 and quite a few on the waiting list beyond. Indeed, membership in the European Union comes *automatically* with membership in the monetary union and some form of representation at the European Central Bank. But even though membership in the European Union is clearly on the horizon, the larger candidate countries so far remain attached to discretionary exchange rate regimes, forsaking the readily available option and benefits of unilaterally adopting the Euro.

In the Americas, progress on monetary integration is far more haphazard: Argentina and Ecuador have chosen a unilateral currency board solution in their peg to the dollar. There was a fleeting US Congressional interest in support for dollarization strategies in the Americas, and there was some talk in Central America but that is mostly it. Academic support is mixed but far from indifferent. (See Calvo (2000a, 2000b) on the supportive side versus the material assembled by N. Roubini at http://www.stern.nyu.edu/globalmacro/)

Well-governed countries, in the monetary area, such as Mexico, Argentina or Chile seem content with their national solution of managed flexibility cum inflation targeting. Europe and the Americas, accordingly, seem to be going different ways. The extent of political integration is not the central reason; central bank independence makes political integration an uninteresting issue in this context. It rather seems that a national currency, as oppose to a hard dollar peg, is seen as an unquestioned plus. If that is for anything but nationalistic reasons, it is worth finding out where the merit lies. Perhaps, however, we are just encountering one of those deep-seated prejudices against rules and the belief that discretion must be maintained, whatever its price.

In Asia, the discussion of monetary arrangements is picking up at the behest of Japan. Noting the European developments and some discussion of dollarization in Latin America, and the fragmentation of the region in response to the Asian crisis, Japan is exploring what kind of monetary arrangements might make sense. (See Ogawa and Ito (2000)). First discussions, however tentative, are underway with Korea. As a concept, this goes far beyond the discussion of an Asian IMF or the establishment of central bank swap lines that are already in place.

Traditional arguments

Four arguments make up the case against currency board arrangements. They are, respectively, sovereignty, the loss of seigniorage, the loss of monetary policy, the loss of a lender of last resort and fiscal preparedness. On the surface, each argument is persuasive; on closer scrutiny none really is. Sovereignty is beyond discussion; when it comes to the quality of money the argument does not come up; when it comes to national pride it should not come up in most countries.

The loss of seigniorage is, of course, a critical issue for public finance. The inability to pursue an optimal inflation strategy to extract maximum revenue (as a function of the inflation sensitivity of money demand and the growth rate) limits public sector revenue and forces either spending cuts or recourse to possibly more distortionary forms of taxation. This argument is more appropriate for full dollarization, but even in the case f a currency board it does apply with the only mitigation that interest is earned on foreign exchange reserves. This limits the seigniorage issue to the spread between a country's borrowing and lending rates times reserves -- we can imagine reserves being borrowed to support the currency on a long term basis but invested short term. The spread is a reality and the seigniorage issue accordingly is real. But there is an important offset to the loss of seigniorage from the reduction in public debt service costs that result from reduced interest rates -- more on this below-- and this factor is surely far more significant than the 1 percent or so of GDP in seigniorage loss. Of course, any kind of stability-oriented monetary policy will yield some bonus but currency boards and dollarization presumably command the highest bonus.

The loss of monetary policy is, on the surface, very obvious: if money creation is tightly and mechanically linked to reserve flows, the external balance not the local central bank determine interest rates. But there is surely an illusion here: what central bank in say Latin America can cut interest rates below New York or what central bank in Eastern Europe can go below Frankfurt. Their fondest hope is to get down to these levels and the safest way to get there is to foreswear all and any kind of independence. In principle there might be some scope for deeply undervalued currencies, expected to appreciate, to achieve lower nominal interest rates than New York but achieving such levels of undervaluation is unseen in the region except in the immediate aftermath of a collapse at which time inflation fears typically abound. The monetary policy issue, therefore, is point with little practical relevance.[8]

The loss of the lender of last resort function is intriguing. It is based on the assumption that the central bank, not the Treasury or the world capital market, is the appropriate lender. There is surely nothing encouraging about the scene of money printing to save banks that are facing an external drain -- the brief Turkish experience of December 2000 with this strategy stark reminds us that this is an express train to currency collapse. In that situation, the central bank poured money into failing banks even as that money poured out of the country cutting central bank reserves at the pace of a billion a day and more. At most then the lender of last resort issue has to do with substituting good credit (not money) for bad credit. That is intrinsically Treasury function or, if the treasury cannot be a source of good credit, the good part of the banking system if any or the rest of the world. It may be the case that there is no good credit available and that as a result bank closure is inevitable; much better to recognize this than to conceal the fact in a process of money creation that blows up the currency and the good banks, too. Lender of last resort, more often than not, is failed or failing banking policy.

A surprising argument in questioning currency boards is fiscal preparedness. Of course, at an elementary level there is a point here: the central bank must be cut off from the treasury, all back doors must be closed. It is hard to see how a discretionary monetary and exchange rate policy can accommodate a lack of good fiscal situation better than a fixed rate. At the most extreme level this may just be an argument about the government being unable to do without seigniorage revenue. As argued above, the savings on debt service from lower interest rats under a currency board amply compensate and take away much of the sting of this argument. But if it is not that, there is no argument. To believe that inflation and devaluation are constructive solutions to a fiscal problem is contradicted by much of financial history. Indeed, from a political economy point of view one might argue that the favorable political and growth effects following upon a shift to a currency board might offer a quite unique opportunity to implement an important fiscal reform.

The Exchange Rate Issue

The most serious and contentious point about a currency board is the abandonment of the exchange rate. This objection comes in two ways. First, in response to an unfavorable disturbance, a flexible exchange rate offers an easier way of adjusting relative price levels and hence competitiveness than general deflation. Second, a fixed rate sets up a one-way option that is bound to be a target for speculative attacks.

Consider first the loss of easy relative price flexibility. This argument is overdone in a number of ways. First and importantly, most disturbances are temporary rather than

[8] The point is relevant for Switzerland in joining the EMU because Swiss inflation and interest rates are far lower than those in the European Union.

permanent. As a result they should for the most part be financed rather than adjusted to. But before we even get to that discussion, there is, of course, the question of whether exchange rates are, in fact, a short run stabilization tool. With low short-run elasticities it is entirely possible that rate movements could destabilize the current account and employment. That view is more relevant the more the discussion focuses on temporary disturbances as the target of rate movements.

But the more substantial issue is to view the response to disturbances in a context of intertemporal optimization including an explicit role for capital markets. In a world where there are international capital markets, cyclical disturbances at home or abroad or temporary terms of trade fluctuations do not require offsetting movements in relative prices so as to maintain current accounts balanced. On the contrary, from a perspective of intertemporal optimization, partial adjustment of consumption or investment and current account financing should be most of the buffer. But if current account adjustment is not part of the script, here is the need for relative price adjustment? Of course, this overstates the point because there will typically be some adjustment of consumption or investment and, as a result, some need for relative price changes to deal with full employment. To some extent this need is met by flexibility of wages and prices but that flexibility may be incomplete, more so in a new regime. That leaves a bit of an exchange rate issue but it also puts it in a cost benefit perspective. In terms of the models used in new classical economics, the exchange rate can be used as a "fooling device" to create unexpected changes in real factor rewards but these will last only as long as expectations and wags-prices cannot adjust.

At the same time, the option to fool agents comes at a cost in the capital market. If recourse to unexpected movements of the exchange rate are part of the regime they will translate into a premium in interest rates and hence the cost of capital. That in turn translates into a loss of competitiveness which must be made up by lower equilibrium real wages. (This discussion assumes that capital is mobile and labor is not.) The point of the discussion is to say that the devaluation option has limited scope in labor markets, as new classical economics warns, and it surely has a cost in the capital market. Closing the circle suggests that a regime with the devaluation option translates into lower average equilibrium real wages compared to a hard peg.

For the case of permanent or highly persistent disturbances the role of exchange rates becomes, of course, more prominent. Here it is an issue of adjustment rather than financing. This adjustment of the relative prices would, of course, seem to be favored by exchange rate movements. But it is also true that price-wage adjustment can do much the same. If they cannot, because of "rigidities", it stands to reason that the exchange rate will rarely do the job without some complication. That certainly has been the experience of Latin America where inflation-devaluation cycles have been the centerpiece of the monetary regime.[9] If anything, exchange rates have been the dominant instrument of destabilization.

[9] Martinez, Sanchez and Werner (2000), for example, note that pass-through from the exchange rate to prices is as high as 65 percent, of which 50 percent occurs within 2 quarters.

It takes a very special kind of money illusion that accepts real wage cuts from a large and perfectly obvious devaluation but cannot generate a fall in wages or prices. Perhaps it says more about the monetary authorities' unwilling to create the conditions for deflation but their willingness and ability to get by with real wage cutting by depreciation and inflation. After all, the wage-price regime is not written in stone but rather is mostly written by the central bank's systematic policy conduct.

The Gains

The gains from a currency board or dollarization come in the financial area and derive from a far enhanced credibility in the exchange rate and hence inflation performance. The gains come in two forms. First and most obviously, there is a dramatic decline in interest rates with all attendant benefits. That gain is, of course, more important the more debilitated a country is financially. (See Giavazzi and Pagano (1988) who called it the gain "from tying one's hands") In the case of Greece or Italy becoming part of the EMU they were altogether striking and they have been just as much in Argentina. In countries that are not outright fragile, the gains are still significant since in a modern financial setting a cost of capital difference of a percentage point or two are decidedly relevant. But the gains from abandoning money are inversely proportional to its quality, past, current and prospective.

As important are the transformation of the financial sector and the lengthening of agents' horizons. With low inflation and stable inflation, and a stable currency, economic horizons lengthen. The lengthening of horizons, in turn, is conducive to investment and risk taking which translates into growth and this closes a virtuous circle. Moreover, once an economy moves out of crisis or state of siege mode, distortions and inefficiencies become far more apparent and can become the target of public policy. There is ample evidence that inflation hurts growth, and high and unstable inflation does so with a vengeance. Hence a monetary regime that delivers and maintains low inflation, other things equal, will help growth. While these points are quite obvious-- and were behind the agitation for low inflation targets on the part of central banks in advanced economies-- on the periphery and notably in Latin America they are still to be reaped.

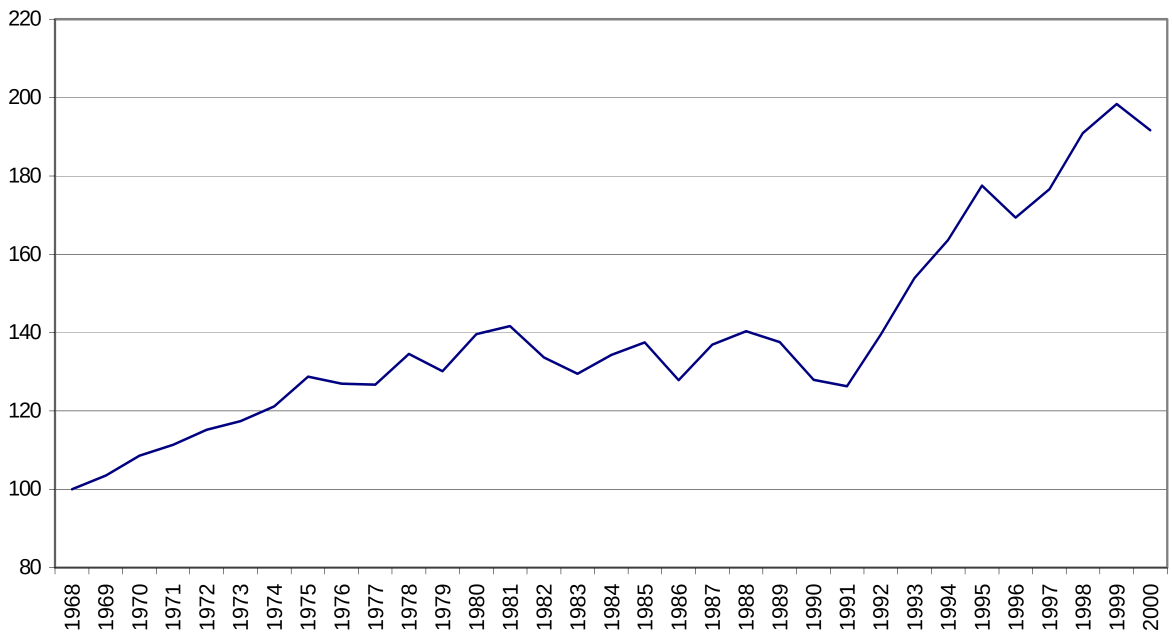
The Case of Argentina

Much of the current prejudice against currency boards comes from the Argentine experience. Argentina is viewed as trapped by its currency board, unable to break out to a more competitive real exchange rate and with it to a resumption of growth. Events like world emerging market crises or a neighbor's crisis and currency collapse are viewed as situations that do require a devaluation response and the inability to respond in that fashion condemns a country to no or at most poor growth.

It is, of course, a grave mistake to misread the Argentine experience with a currency board in this fashion. In the aftermath of the adoption of a currency board in 1991, Argentina has had one of the best growth performances in this century, some 5 percent including even the setback of the Tequila crisis and the Brazilian collapse. Moreover, the political success of the currency board, and the wise use of it as a driver, made for a formidable restructuring of Argentina's public sector and the very distorted economy.

But the currency board did not change three fundamental facts. First, that Argentina has a very high level of debt and a very poor fiscal situation. The present crisis is above all a fiscal crisis-- the question of whether Argentina can successfully roll its debt and attract financing for its current account deficit. That question is intimately linked to the second issue: Argentina has invested little for the past 50 years and its economy, much restructuring notwithstanding, is highly obsolete and very closed. Third, Argentina has a legacy of labor relations that is not constructive. Unions continue to view the economic situation as an end game and that, of course, stands in the way of an economic reconstruction or an investment boom. Beyond the first few years of stabilization and reform, governments have readily fallen back into accepting this situation.

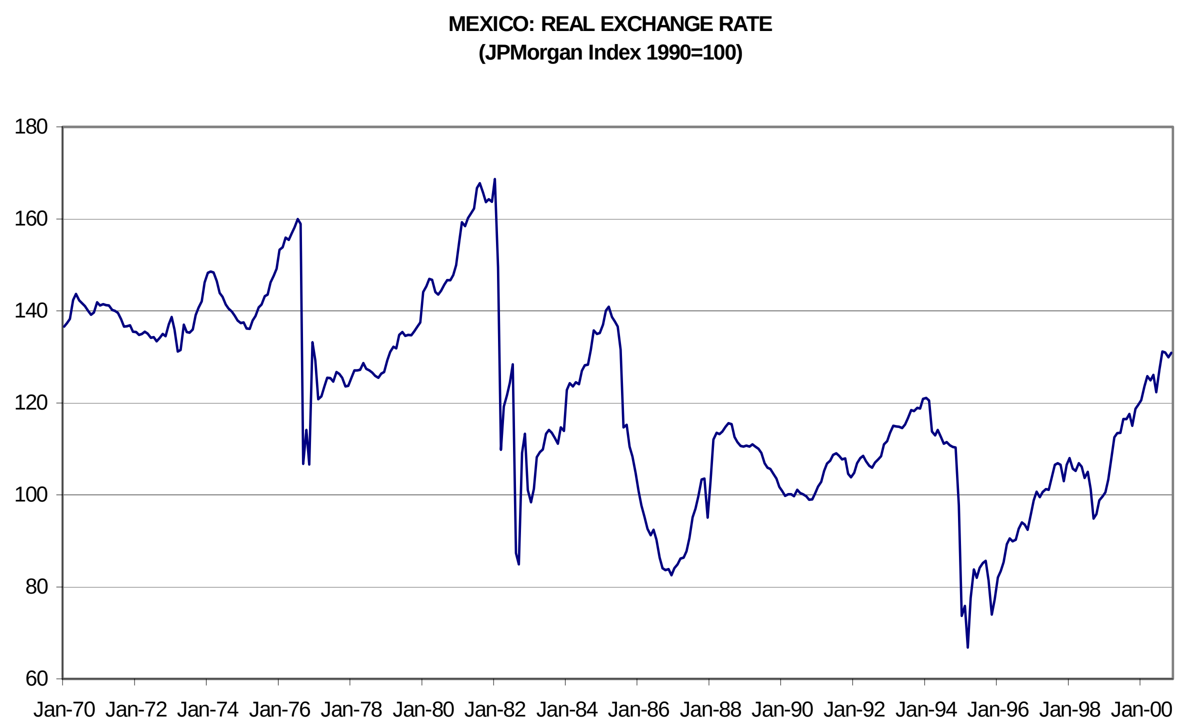
ARGENTINA: REAL GDP
(Index 1968=100)



Would devaluation -- abandoning the currency board or the other version of devaluation followed by full dollarization-- change things materially? There would be a formidable shock to the banking system and with that an extra debt ort wealth shock in a country that already had a few too many. But there is also the question whether devaluation would importantly change growth. The share of trade in GDP is just 10 percent and much of industrial Argentina's output stands little chance in world markets because it is of poor quality or outright obsolete -- that was the experience of Eastern Europe and Argentina is not much different. As a result, devaluation may not do much and destroy the one very positive factor at play now, confidence in the financial system. Rather, Argentina will have to refocus its politics and its economy to the reality of having run out of credit, asset sales or other easy options.

The Case of Mexico

Frankel (1999) has argued that there no one exchange rate regime right for each country and each time. Against this agnosticism consider Mexico: It has had unstable economic performance for all of 25 years. For a while, with surprising regularity, the currency collapsed every 6 years, shortly after the new president took office. Invariably, the exchange rate has been used to bring down inflation only to collapse again and open yet another cycle.



Far from being used as a stabilization device, the exchange rate has been the very focus of economic instability and dismal macroeconomic performance of only 2.7 percent average growth in the past 20 years, not much above the growth rate of population. Nafta and a broad range of reforms carry the promise of a far stronger performance and the newly independent central bank with its flexible rate might work in that direction, too. But it would be a mistake to believe that there is a well-established and unquestioned commitment to sound money, understood and accepted by politicians and the public.

Mexico, quite obviously, is a candidate for a currency board arrangement. Its trade focus on the US, the increasing integration deriving from Nafta, the long history of recurrent monetary instability which now is being tested for the first time in a wide open democracy. All these are important reasons but there is more. Interest rates are high and financial development, including horizons, are held back; uncertainty about the exchange rate is pervasive because of its high level in real terms. The gains would seem to be formidable.

But there is also an argument from the other side, what does Mexico need an exchange rate for? An obvious answer might be fluctuating oil prices. But oil is entirely in the public sector and in the external balance, with negligible spillovers to the home economy. Therefore temporary oil price fluctuations are a textbook case of financing the budget and the external balance in the world capital market rather than of adjustment: during booms there would be a surplus and debt reduction, during low oil price periods deficits would be financed by the worlds market.

This would seem a far better strategy than bringing an exchange rate into play and with it the risk of misuse-- which has been endemic-- and the extraordinary crises that destroy the financial system and real wages over and over again. Here is an economy which, even if it has reformed; it will gain further from deeper financial integration with the US. Mexico may well have reformed. If so, an unnecessary premium is being paid and holds back growth and social performance.

The System

Currency boards or dollarization are strong measures that tend to be applied in quite extreme circumstances, when everything else has failed. And even here, many see them as transition solutions to be set aside once normalization offers the leeway to return to more flexible settings for monetary and exchange rate policy. This view does a disservice to the institution. On the contrary, there is a whole range of economies that are doing all right, say Poland or Mexico, that would benefit from the immediate introduction of currency boards to deepen economic integration and hence build much better growth prospects. Discretion does not have a good record and even if it is not putting the house on fire for a moment, it is thoroughly out of line with open capital markets and the opening up of repressed finance.

Convergence on regional monies is a no-brainer; at the front end the burden is on the periphery to recognize and collect the bonus. The benefits of good money and credit do not stop at the border. There comes a point where the center also must recognize the gains from system safety and create the presumption of a lender of last resort. Somewhere along the line, seigniorage sharing also becomes plausible. Like unilateral trade liberalization, unilateral adoption of a currency board is in a country's interest. But there is further ground to be covered. The benefits can be enlarged on both sides if the center also contributes with risk management-- that large area between default and triple AAA where the presumption of support yields low risk premia which in turn assure sound credit performance-- and seigniorage sharing. There are moral hazard issues that need an answer, but that should not be the end of the discussion.

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LIVING STANDARDS COMPARED

Occasionally we are lucky and some organization goes to the effort of putting together a comparable set of data on incomes, prices, taxes and everything involved in coming up with a single number -- internationally comparable measures of living standards. The accompanying table (or Figure) shows just that. A survey of after-tax incomes of 12 professions (from cooks to engineers, clerks and bus drivers to teachers) and a basket of 111 goods and services (from cars to dry cleaning, from apartment rental to food and clothes) comes up with the summary of after tax purchasing power of income.

Yes, incomes are high in the richest countries -- easily 5 or 6 times the salaries in Brazil so that they seem positively astronomical. But so are prices. What matters then is the combination, the purchasing power of after tax incomes. In these terms, people in NY or Zurich are at two and a half times the level of real income in the same professions compared to Sao Paulo. On this measure, no surprise, living standards are highest in the rich countries: America and Switzerland lead, far ahead of Japan and Germany and very far ahead of France or the UK.

Living Standards Compared (NY=100, Source: UBS)	
Sao Paulo	38.2
Buenos Aires	50.0
Santiago	40.2
Mexico City	22.2
Madrid	79.9
Paris, London	75.7
Lisbon	55.3
Seoul	48.5
Warsaw	20.6
Shanghai	10.9

For emerging markets, the numbers carry a few surprises: Sao Paulo and Santiago report approximately the same living standard. Why a surprise? One might have thought that 15 years of strong growth, reform-driven, had put Chile further ahead. And then there is Buenos Aires versus Sao Paulo, a full 30 percent gap. Argentina continues to be the rich country in Latin America, but can Argentines really afford their position? Lack of growth, as well as high unemployment, suggest that the living standards enjoyed today are increasingly out of line with reality. And then there is the formidable difference between Sao Paulo and Mexico City, the two great metropolis of Latin America. Sao Paulo living standards are double those in Mexico City-- Mexicans are really poor!

More surprises-- Warsaw in Poland, on the border of extremely rich Germany, has the same appalling poverty as Mexico and that is even true a decade after the end of communism. Asian super-tiger Korea is behind Argentina. Lisbon, in the European community, does not do much better than Argentina. Madrid is different; Spain has moved in the past 2 decades quite formidably. Who would have thought that our group of earners in Madrid are already ahead of their counterparts in London and Paris?

How exact are these numbers in capturing precisely the living standard of a mechanic or a teacher in Sao Paulo versus Lisbon or Shanghai? Of course they are only approximate-- there are such issues as the quality and availability of public health and education which do differ across countries and are decidedly part of the standard of living. Clearly, a mechanic in Zurich will get better schools for his children and will find better health care in public hospitals than their counterpart in Brazil. But it would be surprising if they were much out of line with the reported differentials. But there is another dimension in which differentials may be radical. In Mexico City of Sao Paulo people spend their lives in traffic jams, in New York or Santiago they do not do quite as poorly in just that dimension.

Changes in living standards happen very slowly, particularly on the way up. Who will be the gainers and losers in the next decade? Over the past two decades, economic progress in Brazil and much of Latin America has been very slow and it has been extremely fast in China. Over the next decade Shanghai will continue to do very well-- skills and productivity are rising, foreign investment is piling in, competitiveness is formidable and crises are unlikely. And Argentina is certain to go the other direction, continuing relative decline of already a century -- finance is strained, investment is lacking, there is just no driver of prosperity at work.

Enlargement of the European Union to the East will benefit Warsaw, just as it helped Spain and Portugal in the past two decades. That effect should work for Mexico just as much and, in the North where integration with the US is deep, it does in fact. But Mexico City is left out, swamped as it is by endless immigration from the impoverished south. No gains here! How about the race between Sao Paulo and Santiago? No question at all, Santiago is steadily moving ahead: growth is high, human capital formation is significant, no crises worth talking about. All that pushes Santiago increasingly toward European living standards; it will take a decade or two to get to Lisbon levels but Santiago will get there. For Sao Paulo that question is more open: a strong two decades of growth would do miracles for prosperity, but two decades of growth are hard to get in a country that is managed from hand to mouth.

A PRIMER ON EMERGING MARKET CRISES

Over the past 20 years there has been an outpouring of emerging market crises and a vast accumulation of commentary -- descriptive, theoretical and applied-- highlighting the origins and mechanics of each crisis and of crises in general. And there is plenty of analysis on how to deal with crises both in terms of prevention and of cures. Is it possible now to distill from all this a simple set of propositions that summarize the experience and capture the chief lessons?

This paper attempts to set out a few propositions that summarize what is known and accepted. The interest in doing so is to promote a set of presumptions about what is unsound practice with a presumption that it cannot fail to engender, in time, a crisis. Moreover, crises are not just financial experiences but rather involve large and lasting social costs and important redistribution of income and wealth. That makes it especially important to secure agreement on what constitutes bad practice and identify areas of continuing controversy.

I. Slow vs. Fast, Bad Regimes vs. Big Collapses

A useful distinction can be drawn between old-style or slow motion crises focussing on the financing of the current account in a financially repressed economy and the new-style balance sheet crises of a financially opened economy. The distinction is not only useful in highlighting what is new but also to have policy makers understand the great speed of new-style crises and their devastating cost compared to earlier experiences.

Old-style crises involve a cycle of overspending and real appreciation that worsens increasingly the current account; while resources are ample and before real appreciation bites into growth the process is politically popular. In time resources become more limited and unpleasant options such as demand restraint and trade restrictions have to be mounted but they cannot last. Ultimately devaluation comes and the process starts all over again. The "stabilization" may last if there is little accommodation; but if money is passive and the increased external room is used for quick expansion the process is more nearly a *regime* of an inflation-devaluation spiral.

Exchange rate adjustments in an old-style setting have very little of a crisis aspect. Richard Cooper has noted that it normally or invariably involves the fall of the finance minister but not much more. The central issue, as Diaz Alejandro (1966) noted, is the fall of the real wage and the politics around it.[10] Because finance is repressed, the build up of sensitive balance sheets is ruled out.

[10] Diaz Alejandro (1984) , writing about the debt crisis of the early 1980s, keenly appreciated that finance had now become the key actor and aptly signaled this with the catchy title "We are not in Kansas anymore..". He would have needed yet another title to characterize the extraordinary increase in size and speed of the finance factor in recent crises.

Example: One of the few old-style situations till in play is Egypt; occasionally a widely anticipated moderate devaluation happen to relieve trickling reserve losses from current account imbalances and suitcase capital flight.

An important part of the story, obscuring its simplicity, is the occasional arrival of external resources (new access to the world capital market, the World Bank, etc) which gives room for better growth without the early arrival of the external constraint. But these resources more often than not are debt and hence have in itself an adverse effect on the current account. Accordingly, unless there is significant productivity growth, trend real wages will have to decline in order to generate debt service. Alternatively, new resources or debt reduction must make room for keeping up real wages.

A new-style crisis involves doubt about credit worthiness of the *balance sheet* of a significant part of the economy --private or public-- and the exchange rate. It may originate with questions about either the balance sheet or the exchange rate, but when there is a question about one, the implied capital flight makes it immediately a question about both. In no time capital flight wipes out reserves and precipitates a currency collapse. That process is only brought to an end by a resolution of the credit issues and the commitment of monetary policy. External intervention has high leverage in resolving credit and credibility issues.

The capital account plays a key role in the run-up to the crisis and in its unfolding. There is too much credit on the way in and far too little once the crisis hits. The bankers adage is "its not speed that kills, it's the sudden stop". Frank Taussig (1928) captured the point when he wrote :

"*The loans from creditor countries.. begin with a moderate amount, then increase and proceed crescendo. They are likely to be made in exceptionally large amounts toward the culminating stage of a period of activity and speculative upswing, and during that stage become larger from month to month so long as the upswing continues. With the advent of crises, they are at once drawn down sharply, even case entirely*."

The central part of the new-style crisis is the focus on balance sheets and capital flight. Balance sheet issues are, of course, fundamentally linked to mismatches; even if there were solvency they still create vulnerability related to liquidity problems. Exchange rate depreciation, in a mismatch situation, works in an unstable fashion to increase the prospect of insolvency and hence the urgency of capital flight.

Because new-style crises involve the national balance sheet they involve a far more dramatic impact on economic activity than mere current account disturbances; this far larger impact arises both in terms of magnitude of the financial shock as well as *disorganization effects* stemming from illiquidity or bankruptcy. [11]

[11] *Disorganization effects* are developed in Blanchard and Kremer (1997) to help understand the output collapse in transition economies but have not been applied in the setting of emerging market crises where they are as useful a guide to grasping dramatic output adjustments.

II. Vulnerabilities

There are three central sources of vulnerability: a substantially misaligned exchange rate, or balance sheet problems. Trouble in the balance sheet can come in one of two ways: existing big holes in the form of nonperforming loans or else exposure. Nonperforming loans or vulnerable loans, not quite gone yet., speak for themselves except to note immediately that they limit the room for higher interest rates and hence are a major problem for an interest rate defense. The other problem is exposure in the form of mismatches. In a national balance sheet there can be two kind of mismatches: *maturity* mismatches leading to liquidity issues and *currency* mismatches. In a situation where the willingness to hold assets on current terms is impaired, these misalignments or mismatches become explosive. The willingness to hold assets can be impaired either because there s a question about the exchange rate or about the willingness and ability of debtors to meet their liabilities.

The exchange rate can be the starting point of a crisis when it is patently out of line. This is typically the case in exchange rate-based disinflation programs which succeed in bringing down inflation but do so at the cost of a significant real appreciation. The resulting widening of the current account deficit and the disappearance of growth, from appreciation and as a result of increased interest rates required to attract continued financing, make it obvious that the program cannot last because it is not self correcting. At some point, see below for detail, a speculative attack occurs which cannot be met by yet high rates or reserve depletion. At that point currency depreciation interacts with balance sheet issues. The worse the balance sheets, the bigger the collapse.

The initial large real appreciation of an exchange rate is often justified by the argument that it reflects restructuring-induced dramatic rates of productivity growth generating Balassa-Samuelson kind inflation. The argument is invariably suspect because it should not affect manufacturing price-based competitiveness measures and it is less likely to be the case in an environment where unemployment is high and rising and the current account is deteriorating.

What are sustainable rates of real appreciation or of current account deficits and what invites a crisis? Because of such issues as lasting improvements in capital market access, persistent terms of trade improvements and productivity growth, emerging economies can experience trend real appreciation; they certainly can expect to finance on an ongoing basis some deficit/GDP ratio. It is safe to say, however, that a rapid -- say over 2 or 3 years-- real appreciation amounting to 25 percent and more and an increase in the current account deficit to exceed 4 percent of GDP, without prospect of correction, take a country into the red zone.

Example: Mexico with its recurrent end of sexennio currency collapses is an example where the exchange rate and the current account are in the foreground and where concern about the possibility of a devaluation (or the fact of a small devaluation) triggers massive capital flight. Because devaluation is postponed by shortening and dollarizing debt (the

Tesobonos issue, see below) the balance sheet issues triggered by the currency depreciation are huge..

Consider next a balance sheet with substantial nonperforming loans. If interest rates are lowered, the currency comes under attack. If interest rates are raised, the loan portfolio goes even further under water. This is a common situation leading up to a crisis.

Example: Thailand and Malaysia in 1997 had substantial nonperforming loans; in Thailand they were in real estate and consumer finance, in Malaysia they included stock market loans that had financed a market boom. Protracted unwillingness to raise mandated lending rates brought about a "carry trade", the currency under pressure, created an offshore market and ultimately led to crisis.

A large budget deficit or a large short-term public debt are factors of vulnerability. A change in the growth prospects undermines the sustainability of debt as does an increase in world interest rates and thus undermines the willingness to hold and add to portfolios of lenders. The same is true for a perception that the willingness to service the debt is impaired. The result is a flight from public debt and that flight, invariably, is into foreign assets. The resulting funding crisis translates into increased interest rates, which further worsen the fiscal situation and thus act in a destabilizing fashion.

Example: Brazil's crisis was centered on a large short-term debt part of which was dollar-linked; depreciation prospects put debt service into the express lane and actual depreciation completed the picture.

Argentina in late 2000 is a case in point. A deteriorated growth outlook put in question the financing of budget deficits and the rollover of the public debt by external creditors. Interest rates shot up and the prospect of a massive capital flight was in the air. A massive IMF postponed the fiscal crisis until further notice.

If the exchange rate is fixed, reserves are being depleted and that process increasingly adds currency risk to the equation. If the rate is flexible, depreciation ensues and increasing depreciation is projected. That, in turn may spread risks to foreign exchange-denominated parts of the balance sheet and aggravate capital flight.

Banking problems are a frequently part and possibly the initiating factor of a currency crisis. When creditors of short-term inter-bank lines, or depositors, withdraw from suspect banks, the resulting flows tend to go offshore and hence translate into reserve losses and or depreciation. The situation is more likely to become a banking and foreign exchange crisis, the worse the nonperforming loan situation, the larger the maturity mismatching in the balance sheet and the more significant the mismatching of denominations on the asset and liability side.

It is invariably important to look behind the balance sheet of the banking system to look at the underlying exposure generated by the banks' loan customers. While the banks' balance sheets may look proper, the loan customers may have the mismatching on their books and hence shift it to the banking system if and when they run into trouble.

It is also important to recognize that a banking system's situation can change in a major way in a very short time period. This easily happens in a situation where a concentration of liabilities (say real estate loans) becomes bad or a spell of high interest rates causes a general deterioration of a loan portfolio that had been just a bit above marginal. If the banking system's funding is short term, the makings of a crisis come on very fast.

Example: The Turkish crisis of December 2000 is a great example. In a situation of a large number of bad banks (not the major part of the banking system though), a withdrawal of credit lines triggered a banking crisis; the central bank financed the run on the banks by pumping in credit only to repurchase the liquidity in selling foreign exchange. Reserve depletion within days threatened the maintenance of an IMF-supported exchange-rate based stabilization program.

The corporate sector, just as the banking system, has balance sheets that are vulnerable to mismatch issues both of maturity and denomination. The larger the corporate sector's short-term debt in the national balance sheet, the more vulnerable the country to a funding crisis which then becomes a currency crisis. Once again, when credit to a particular sector is withdrawn, in emerging markets, that means a capital outflow and not a substitution into other assets. For that reason balance sheet problems become currency crisis issues.
Example: Indonesia and Korea are examples where formidably bad balance sheets -- huge debt equity ratios and large foreign exchange exposure-- were a major part of the crisis situation. Typically it takes weeks to even figure out just how large the external exposure is. Creditors will be reluctant to take haircuts, debtors are under no pressure to yield. The protracted debt problem overshadows post-crisis credit normalization.

Whenever capital flight emerges, the question of the exchange rate regime is immediate. Under fixed rates that means how much reserves the central bank has and is willing to commit; under managed or flexible rates it mans how far and fast the rate will depreciate. Either way the question is how urgent is it to bring money out; once that question emerges, very urgent is the answer. Reserves are almost never enough to withstand a balance sheet attack and often they are less than reported.

Vulnerability can, at least conceptually, be expressed in terms of a value at risk exercise; what are the relevant shocks, what are the exposure areas, how large a deterioration of the balance sheet would result. Mismatches are the key triggers of extreme vulnerability. And the worse the risk in part of the balance sheet, the more likely that it will spread to all of it if only because, in case of doubt, creditors want recovery and asset holders hold off lending.

Example: The Asian economies which experienced crises had bad corporate financial structures (high debt, high foreign exchange debt) relative to equity and a high ratio of short-term external liabilities to reserves. The combination made for fireworks.

Table 1 Critical Indicators: 1996 (%)		
	Corporate Debt/Equity	Short-term External Debt/Reserves
Indonesia	310	177
Korea	518	193
Malaysia	150	41
Philippines	160	80
Thailand	250	100
Source: World Bank		

III. Timing

There is no hard rule about the timing of crises. It is surprising how long basically unsustainable situations can be given extra lives, notably if an election is in sight. With an election on the horizon, creditors are willing to believe that much or anything will be done to hold off a crisis or a corrective devaluation. Governments will do anything, including high interest rates or preferably a shortening of maturities and re-denomination into foreign exchange of claims. As a result, crises happen after elections, not before. This is akin to the myopic political business cycle but no less real. It is clear that the more the crisis is postponed, the worse the balance sheet and the larger the fallout once it does happen.

Example: Mexico always postpones crises until after the election, so did Brazil and Korea. So did Russia. The post-election discovery of a Taiwan banking problem, and crisis, is another instance.

(2) Bad balance sheets -- as opposed to significant overvaluation, escalating current account deficits or vanishing growth-- in principle can last for almost ever provided net inflows cover up the hole and transparency is absent ("clear water, no fish" as the Chinese saying goes). As a result, the proverbial straw that broke the camel's back story can easily be the trigger. A relatively minor event might break a precarious refinancing scheme, or a suspicion arising anywhere else in the world might cause creditors to kick the tires somewhere else. Importantly, changes in the relative attractiveness of domestic and foreign assets or a change in the growth scenario can bring suddenly the test of the balance sheet and with it the move to crisis. If the balance sheet is bad enough, as a rule, quite small events are sufficient to undermine the funding scenario and precipitate the crisis.

Example: Turkey had forever been on the short list for a crisis but somehow got by. The failure of a Rumanian subsidiary of a bad Turkish bank, in an environment of political agitation about a sleazy banking system, got the stone rolling and within days reached the prospect of immediate currency collapse.

Contamination easily fits the pattern of balance sheets bad enough to be waiting for an accident. When that is the case, in time the right circumstances will materialize. It takes longer than you think but then it happens faster than you would have thought. A shift in the external environment – G3 exchange rates, Fed interest rates, a slump in new commodity exports all can work as triggers.

Example: The spread of crisis in Asia fits this pattern.

IV. *Good Balance Sheets, No Crisis*

Do countries with good balance sheets and a currency that is not vastly misaligned face crisis risks? Of course, there is the trivial answer that for any exchange rate or any balance sheet there is a shock large enough to make it unviable. But the striking fact of the past 20 years of crises is surely this: well-managed emerging market economies have suffered slowdowns in growth, high interest rates and currency depreciation. But they have not suffered crises. Moreover, the better the balance sheets, the better the ability to absorb shocks to capital flows and trade without outsized adjustments in exchange rates or interest rats.

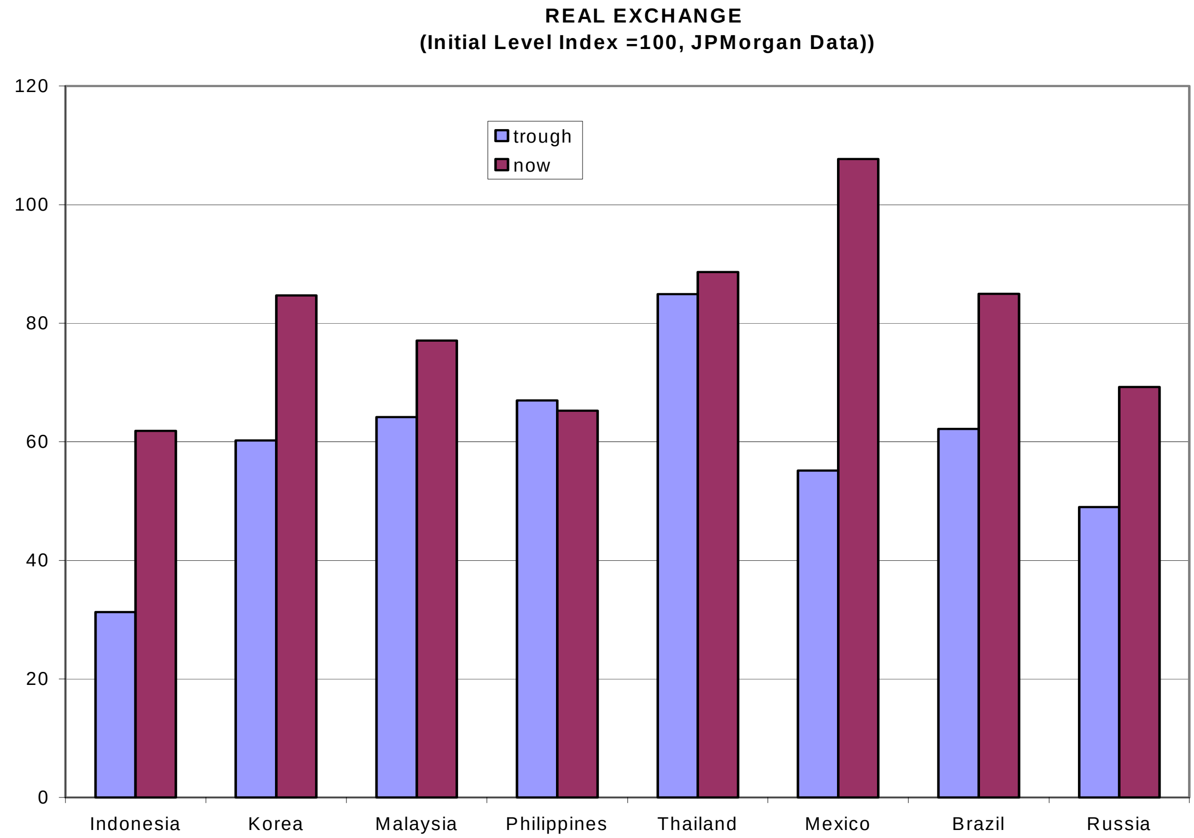
The proposition "good balance sheets, no crisis" risks being circular; but pending a good counter example, let it strand.

Example: The good balance sheets of banks in Singapore, Hong Kong and Argentina are a large part of why these countries while surely affected were not pushed under by the crises of Mexico or Russia-Brazil.

IV. *Why are Collapses so Large?*

Currency collapses are large for two reasons: value at risk is extraordinarily large because of the interaction of mismatch factors and because of the difficulty of governments, once a meltdown is underway, to establish their willingness and ability to engage in an uncompromising stabilization effort. In this environment, the IMF's role is to restore credibility and hence credit.[12]

[12] For the Asian economies the initial level is January 99; for Mexico January 94, for Brazil and Russia Jan 98. The most recent data are for December 2000.



The interaction of mismatch factors produces an instability in the response of asset holders: the more the exchange rate goes, the more bankrupt the balance sheet and hence the more reason to deny credit and get out. The higher the maturity mismatch, the more liquid the creditors and the more easily the debtor is moved to the gray zone between illiquidity and insolvency. The interaction of depreciation and illiquidity causes markets to cease functioning and hence record interest rates and initially a vast overshooting of exchange rates are the rule.

The crisis itself weakens the government politically and makes it doubtful whether it is willing to stick with a policy that dries up credit and hence starves off capital flight; the absence of effective property rights and the total absence of transparency renders the possibility of bottom fishing very hazardous. Hence there are no capital inflows, no stabilizing speculation and just a one-way downward pressure on asset prices, the currency and the balance sheets.

Example: Indonesia, with a political collapse and an ongoing struggle about who will pay the debts and who will gain offers a clear case of an unresolved crisis.

Disorganization in the *Blanchard-Kremer* sense becomes a dramatic issue when creditworthiness collapses, bankruptcy spreads and from that side attacks the real economy. The real economy is a complex layer of relationship in two ways: first there are input-output relationship that can be disrupted at any point in the chain because a critical supply or demand link disappears and hence impairs or brings down the whole chain. Second, there is often a credit relationship, rather than cash & carry, and this is sensitive to creditworthiness suspicions and can become the disruptive factor. Disorganization is an important part of the output collapse.

The IMF's role in reversing the dramatic immediate events is twofold. First it offers a commitment device for governments to underwrite a stabilization strategy that is known to work. Second, it offers temporary credits and debt reorganization, including lock-up of short term credits commercial bank creditors, and thus helps stem the outflows.

High interest rates may hurt growth and the balance sheets but they definitely stem the depreciation of the currency. Ultimately that is the single most important beachhead of the stabilization program. As long as the currency melts, there is no prospect of stabilization. (We discuss below an alternative of controls).

Example: In the collapse phase currencies depreciate formidably relative to any current account-based view of what is necessary for adjustment. They are driven by the capital account. When a credible program is put in place, there is a rapid normalization as in Korea or Brazil.

The adoption of an IMF strategy, and demonstrated adherence soon shut off the hemorrhage and turn around into a path of currency recovery and a decline in interest rates. The combination of post-collapse over-depreciated exchange rates and a credible credit program provides for appreciating exchange and declining interest rates. A virtuous circle is entered. Wavering commitment, by contrast, remains reflected in volatile currency and high interest rates.

V. Costs

Currency crises are formidably expensive; even more so is a history of recurrent crises. The costs arise in three ways: a substantial increase in public debt associated with the crisis, a loss of output and disruption, and the possibility of socially controversial redistribution of income and wealth.

In a currency crisis, because the government will bail out banks and often-even companies, public debt increases substantially and with that future tax liabilities. The deterioration in public finance also arises from a period of high interest rates in the run-up to the crisis and in the stabilization phase. It will also arise from the fall in output and hence tax revenues in the crisis period. Moreover, the increases in debt may itself bear the seeds of future crisis if it occurs in a situation where the government dos not have the ability to meet the higher debt service burden by taxation or reduction in spending.

The numbers can be staggeringly large. It is easy to have the government burden 20 or even 30 percent and more of GDP from a bank bail out. In addition, there is easily a 10 or 15 percent increase in debt from high interest rates applied to a large debt and from recession-induced tax losses.

There is also always a large loss of reserves, which are sacrificed during the defense part of the crisis. To some extent these may be captured by the private sector and hence merely amount to a transfer but often they are the counterpart of a bet the government makes with the rest of the world and loses.

To the extent that a crisis experience deteriorates a country's credit rating, there is also a lasting cost in terms of a higher international cost of capital.

A currency crisis redistributes wealth and income. It is said that more money was made in the few years of collapse of the Holy Roman Empire than in the long years of its existence. The same is true of crises that enrich those who can be in time in foreign exchange or can get the government to assume their debt while keeping the assets That is routine. The striking regularity, of course, is the dramatic fall in real wages and employment as well as the bankruptcy of small debtors.

Periods of recurrent currency crises translate into poor growth performance, short horizons, slow increases in the standard of living, a deteriorating social and economic infrastructure. Major asset sales along the way, or increases in external debt, and spurts of reform can obscure the degradation of the productive economy at any one time. But ultimately medium term growth rates, far from reflecting catch-up, reflect the costs of persistently poor finance.

Table 2 Latin American Growth Per Capita	
1980-90	1990-99
-0.3	1.7

VI. The Alternative Medicine Controversy

There are two areas of controversy. The first involves capital controls and the second surrounds the appropriateness of IMF programs. On both issues the controversy is alive and conducted with great vehemence.

The appropriateness of IMF programs is quite obviously questioned because it seems, at least on the surface, to make a bad situation worse. Raising interest rates at a time where balance sheets are already under water makes a bad debt situation worse. Raising interest rates and tightening fiscal policy at a time where the economy is already in steep decline seems to be outright counter productive.

What are the alternatives? The capital flight will certainly continue as long as the central bank pumps in credit at unchanged interest rates. The reason is obviously that the immediate gains from borrowing in a depreciating currency far outweigh the cost of borrowing. Hence borrowing and capital flight remain active, depreciation deepens, balance sheet problems widen -- there is no obvious end to the process.

There are, of course, two ways of trying to reconcile unchanging interest rates-- rather than extraordinary short run levels of 100 or 1000 percent p.a. -- with an end to capital outflows. One possibility is credit allocation controls and the other is capital control and best both combined. There are obvious questions of effectiveness of controls but even if hat is accepted, there is also the issue of efficiency. If controls were temporary that might not be an issue, if they are lasting then suspending the capital market is much more of an issue. For the system at large the presumption that controls are the response to outflows will reduce the perception of liquidity and hence translate into a higher cost of capital and more trigger-happy investors.

Surely there is agreement that the better strategy is to reduce the risks of a crisis situation, including by predetermined limits on liquidity and profitability, but that leaves open the question of what to do in the midst of a crisis: IMF or controls. The debate continues.

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