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Created 4/6/1998

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Trying to Deal with Globalization

Comment on Robert Pollin, "Can Domestic Expansionary Policy Succeed in a Globally Integrated Environment?"

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April 1998

Back in the old days--the 1960s--there was a powerful strand of thought that argued that the world economy constrained domestic economic policy in only one way: through the--fixed--exchange rate. Let the exchange rate float, argued economists as far left as John Kenneth Galbraith and as far right as Milton Friedman, and then domestic policy will be free and unconstrained--and can be as stimulative (if the outside world should happen to be deflationary) or as committed to price stability (if the outside world should happen to be inflationary) as domestic politicans wish.

All agreed that under fixed exchange rates the global economy placed sharp constraints on domestic macroeconomic policy: a high-pressure economy would run a trade deficit, eventually exhaust its reserves, and be forced into deflation and high unemployment. But all these constraints were supposed to vanish once the exchange rate was set free to float. Then changes in the exterior global economy would show up as fluctuations in the exchange rate, but not as constraints on domestic economic policy. And so a country on a fixed exchange-rate standard that suddenly found the constraints placed on their economy by the global economy irksome could end these constraints simply and easily, by floating their currency.

It is now a quarter century since the collapse of the Bretton Woods fixed exchange rate system. For twenty-five years floating exchange rates have been the rule rather than the exception. And over these twenty-five years we have learned that it is not the case that floating exchange rates allow domestic macroeconomic policy to escape global constraints and to focus on achieving optimum internal balance alone.

Let me try to give this theoretical point--which is Robert Pollin's theoretical point--empirical substance. And let me focus on Mexico in 1994-1995, because it shows not only how brutal the limits placed on domestic expansionary policy by the integration of the world's financial market can be, but also how to at least mitigate the damage.

Neoliberal Development Strategy

In the late 1980s, the authoritarian PRI party ruling Mexico shifted its economic policies in a "neoliberal" direction. Instead of extremely tight restrictions on imports (even imports of the capital goods that serve as one of the major channels of technology transfer to the third world), they adopted policies of freer trade. Instead of the high-inflation high-deficit high-spending mix that had characterized Mexico's fiscal and monetary policies in the past, they sought monetary stability and balanced budgets. Instead of expansion of the publicly-owned sector (both to channel income and wealth to politically favored groups, and to try to make sure that windfall profits were not skimmed off by foreign elites), they sought "privatization" to attract capital from abroad, to try to give organizations incentives to improve their productive (as opposed to their political) efficiency, and to give some of their friends a chance to make a fortune.

The hope was that such a shift to "neoliberal" policies would pay benefits in a number of directions.

First, the privatization program might--it was hoped--lead to sharp increases in productivity in the formerly publicly-owned sector. Firms whose principal goals had been to transfer money to favored clients of the PRI oligarchy would find themselves, instead, with the principal goal of earning profits--and satisfying consumers as a step toward earning profits. Second, the liberalization of domestic financial markets might--it was hoped--shift the allocation of investment. Instead of access to capital being limited to those who knew the right people, it might become open to those who could see how to profitably and productively satisfy a strong consumer demand. Third, the reduction in government deficits might--it was hoped--boost the social rate of investment, and thus boost the rate of productivity and real income growth.

Fourth, freedom to buy imports would raise middle-class standards of living, and *might* make Mexico's upper middle class happier with the PRI. Fifth, a shift to "neoliberal" policies might attract large enough capital inflows to allow Mexican investment to outpace domestic savings, further boosting the rate of productivity and real income growth. Sixth, a shift to "neoliberal" policies would make high Mexican officials heroes in the world financial governance community--boost their reputations abroad at least.

Seventh, privatization would make the privatizees--those who found an opportunity to snatch up ownership of large chunks of capital at what they hoped was a bargain-basement price--very grateful to the privatizers.

Thus Mexico's steps toward "neoliberal" policies were taken for a bunch of reasons: some good, some bad, some naive, some subtle.

I happen to think that the policy shift toward neoliberalism was not a bad thing, or not the worst thing. Put it this way: it was perhaps the best of a number of bad options, certainly not the worst--bet for a Mexican government to have undertaken in the late 1980s. It appeared likely to have led to somewhat faster aggregate economic growth than many other alternatives. It seemed likely to impose significant social costs as well. For example, Mexico's subsistence agriculture sector seemed likely to wither under the force of competition from Iowa. But the social cost *could* be kept small with appropriate redistributional programs, and the PRI would have every incentive to keep the social cost small.

Were there preferred alternatives? The East Asian "developmental state" model is very attractive: it promises a relatively egalitarian distribution of income, rapid productivity and production growth, rapid transformation from a comparative advantage based on cheap labor to one based on mastery of manufacturing technologies, increasing democratization, and a government able to make the redistributions and carry out the infrastructure investments to diminish the social costs of industrialization. The East Asian model is relatively attractive even given the 1997-1998 financial crisis in East Asia, which appears much more likely to be a short interruption than a watershed trend-break in East Asian economic growth.

But as Lant Pritchett has observed, there are few things worse than state-led development carried out by an antidevelopmental--a parasitic--state. It seems clear that the PRI government in Mexico lacked that relative autonomy and bureaucratic capability found in East Asia; it seems clear to me that even the U.S. government lacks the relative autonomy and bureaucratic capability to successfully carry out the tasks of the "developmental state" model; it seems likely today that even the Japanese government has lost the relative autonomy and bureaucratic capability to be a successful developmental state.

Thus it seems possible that a neoliberal development strategy is the best of bad alaternatives, the best way to play the bad hand held by those whose governments lack the prerequisites to follow in the footsteps of the East Asian miracle. But I am not sure. Perhaps the PRI made a mistake in opting for a "neoliberal" rather than a "developmental" policy mix--perhaps a policy of state-led development and East Asia-style export subsidies combined with rapid increases in social welfare spending would have led to a better result all around.

A Step Away from Neoliberal Orthodoxy

In 1994 Mexico took a policy step away from neoliberal orthodoxy.

Mexico took a step away from neoliberal orthodoxy for a number of reasons. First, there was the forthcoming "election"--which there is good reason to hope was the last Mexican "election" that has to be enclosed in quotation marks. Second, aggregate economic growth had been disappointing over the previous several years: as Rudi Dornbusch and Alejandro Werner put it, Mexico had wound up with "reform, stabilization, and no growth". In part for these and in part for other reasons, the Mexican government shifted its monetary policies in a strongly expansionary direction in early 1994.

Some (for example, Calvo, Leiderman, and Rinehart; Dornbusch and Werner) saw this step away as dangerous. In the view of Calvo *et al.,* the tightening of monetary policy in the industrial core that took place in 1994 required not a loosening but a sharp tightening of monetary policy in Mexico in order to avoid a substantial devaluation, and the consequent loss of confidence and spiral of renewed inflation. In Dornbusch and Werner's view, the exchange rates that the Mexican government had set in the early 1980s left the peso overvalued: in spite of propaganda to the contrary, Mexico was not attractive enough as an export platform for the U.S. market. In their view, the sooner the devaluation came, the better for Mexico.

Yet there were others who held that Mexico's step away from neoliberal orthodoxy in economic policy in early 1994 was unlikely to be an event with major consequences.

Capital flows into Mexico had put pressure pushing the peso upward, not downward, in 1993. There was reason to hope that the shift to neoliberal policies and the implementation of NAFTA would excite strong capital inflows over the following decade. Such strong capital inflows would help finance Mexico's industrial revolution: if even a small portion of Mexico's export manufacturing sector could use foreign-financed capital to invest and attain the productivity found in, say, Hermosillo then Mexico's economic growth future looked very bright. And rapid manufacturing production growth would provide the best circumstances for Mexican industrial workers to push for substantial real wage increases.

The neoliberal consensus view was (i) that Mexican economic policies had made it attractive to global capital; (ii) at this attraction was based on a sober and likely prediction of Mexico as a productive and profitable platform for exports to the U.S. market (iii); that these fundamentals were working in Mexico's favor--boosting investment, strengthening the peso--and (iv) that given these strong fundamentals a minor deviation from neoliberal orthodoxy like the loosening of monetary policy in an election year (a loosening that appeared likely to be temporary should the PRI retain or the PAN attain control of the presidency, and that was not large in absolute magnitude) should have little if any effect on the Mexican economy.

Mexico should have been able to get away with a short, temporary, election-year driven deviation from monetary orthodoxy in the direction of extra Keynesian stimulation.

After all, growth would continue as long as foreign investors continued to have confidence in Mexico as an export platform. Confidence in Mexico might be undermined by large, repeated fiscal deficits funded by money-printing. But there was no reason for it to be undermined by the more-or-less standard election-year operation of the political business cycle.

Mexico's Crash

Yet this neoliberal consensus view was very wrong.

Monetary expansion in 1994--coupled with political assassinations and guerrilla rebellions--put downward pressure first on Mexico's stock of reserves, and then on the exchange rate. The Mexican government paid out some $20 billion or so in eight months trying to defend the peso.

December 1994 saw a devaluation--a small devaluation. It seemed to those who modeled the Mexican economy that this small devaluation of 20-30 percent or so, the size recommended by Dornbusch and Werner, would be sufficient to contain the effects of the monetary expansion and the political instability of 1994. If Mexico had been a profitable export platform at the higher exchange rate, it was an even more profitable export platform at the lower. If foreign investors had been eager to pour capital into Mexico when keen-eyed observers like Dornbusch, Calvo, and their co-authors saw devaluation as likely, they would be even more eager to pour capital into Mexico now that no one was arguing that the peso was overvalued.

Wrong.

A classic liquidity panic followed. Never mind that to an investor interested in Mexico over the long term, Mexico post-1994 (with its lower real exchange rate) would appear a better bet than Mexico pre-1994. Never mind that everything that had been said in the early 1990s remained true. The Mexican economy had guaranteed access to the largest consumer market in the world. Politics had shifted in a pro-market pro-capitalism direction. Mexico had become a very attractive export platform for any kind of manufacturing where technology is sufficiently routinized to be transferrable out of the industrial core.

But in spite of "fundamentals" stronger in 1995 than in 1993, the dominant forces governing financier decision-making in early 1995 were (a) let's get out of Mexico so that I no longer have to explain what it's doing in my portfolio, and (b) let's get out of Mexico before everyone else's running for the exit brings on a Great Depression in Mexico.

You could point out that those investors with long enough horizons to avoid the panic selling would avoid much of the losses from the crisis (albeit at the cost of running enormous risk). You could point out that those willing to be "contrarian" and put money into Mexico would (if Mexican politics did not degenerate into near-anarchy) realize very high returns. You could point out that an investor who thought that in terms of long-run fundamentals Mexico was a good deal in 1993 could not think that Mexico was a bad deal in 1995 without violating the canons of consistency and rationality in financial decision making.

So much the worse for consistency and rationality in financial decision making.

A lot of money was left on the table by investors in New York, London, Frankfurt, and Tokyo who folded and withdrew from the Mexican part of the global financial poker-game-cum-casino. Large expected profits (accompanied by enormous risks) were earned and are being earned by those who stayed in the game. In the fall of 1996 U.S. Vice President Al Gore defended U.S. support for the peso in terms of the high ex-post returns earned by the U.S. Treasury--never mind that the point of international lender-of-last-resort operations is supposed to be to reduce unemployment in the lendee country, not to make profits for the lender's Treasury.

But that didn't help Mexico, which saw real output fall by seven percent between 1994 and 1995.

The Reason Why

The most likely explanation is that investors, fund managers, and financiers lack the sophistication that economic theorists believe they ought to possess in assessing the financial effects of macroeconomic policies. Economists focus on "structural" and "primary" deficits as indicators of whether countries' public finances are or are not in long-run balance, and whether or not countries will ultimately have to resort either to massive inflation or to massive tax increases to fund their spending. But financial markets appear to pay much more attention to *reported* deficits--and to fail to comprehend or pay attention to the more sophisticated measures.

Economists focus on the determinants of the money supply process--not only whether the central bank is allowing the money stock to grow, but why the central bank is allowing the money stock to grow and what the money stock will do in the future. Thus they make a sharp distinction between *temporary* increases in money growth (as in, for example, an election year) and *permanent* increases (as when a central bank trying to keep interest rates low monetizes large persistent government budget deficits): the second should be inflationary; the first should not. Yet financiers and fund managers appear to examine the news with a much less sophisticated, much more knee-jerk model--in which all deviations from financial orthodoxy are equally sinful, no matter whether economists' models classify them as mortal or as only venial sins.

An Old Story

In some ways this is an old story. Few recall 19th century financier Jay Cooke, without whose fundraising and bond selling skills Sherman's armies would never have gotten to Atlanta and Grant's armies would never have gotten to Richmond. He went spectacularly bankrupt in 1873, having played double-or-nothing with his, his bank's, and his clients' money one time too many while trying to build the Northern Pacific Railroad.

After the Jay Cooke bankruptcy British investors fled the United States. And perhaps one in ten nonfarm jobs in the American economy vanished as a result of the collapse in railroad construction alone. To rely on foreign capital inflows to finance one's industrialization was an extremely risky development strategy for the U.S. in the 1870s. It is an extremely risky development strategy in the 1990s as well.

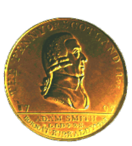
So why run the risks? Why not simply close off all capital flows--except for a small selection? Because the temptation is enormous: when foreign investors are willing to finance domestic industrialization, extraordinary gains in productivity--private *and* public--are possible at a very low cost. Capital is cheap in the first world. Capital is expensive in the third world. There is every temptation for those searching for means to fund industrialization in the third world to try to tap the cheap capital of the first.

So what is to be done? Let me propose three steps:

- Recognize that openness to capital inflows in boom times amplifies recessions when international finance turns cautious and panicky. International finance will turn cautious and panicky: it always has in the past, it always will in the future. Countries need to have *someone*--whether the IMF, Japan, the United States, or some other consortium--standing behind them. **Someone must be ready to make large-scale exchange-stabilization loans** when the wheel turns and it is their turn to suffer not-very-irrational capital flight.
- If even the minor sins against the Monetarist Gods committed by Mexico's PRI government in 1994 can trigger a disaster, then governments that accept the free use of foreign investment on a large scale to finance domestic industrialization have little choice but to **strain every nerve to keep foreign investors calm**: they need not just to *be* orthodox, but to *appear* to be orthodox. Thus governments need to very carefully weigh the benefits of accepting large-scale foreign investment. For an inevitable cost is that then they risk disaster by even very minor deviations from financial orthodoxy. Which is worth more: cheap capital during booms from the industrial core, or the constraints placed on policy by the necessity of appearing orthodox? All need to weigh this trade-off carefully.
- **Accept "cold" and reject "hot" money:** try to obtain all of the benefits of capital mobility by allowing long-term investors interested in financing industrialization to come in, and try to avoid all the costs of expectational volatility by keeping short-term investors subject to irrational fads and fashions in expectations out. Some obvious steps include: taxes on short-term investments that are liquidated in less than a year; penalties on banks (and corporations) that borrow abroad in major international reserve currencies like the dollar, the mark, the yen; and surtaxes on foreign holdings of domestic financial assets but not on direct investments by foreigners.

Without these three steps to try to widen running room, the lesson from East Asia 1997-98, Mexico 1994-95, and the European Monetary System 1992 is clear. If developing countries want to draw on global capital to finance industrialization, then they have very very little running room in terms of their freedom to tune their macroeconomic policy ito domestic conditions. Even with these three steps, the running room regained is small.

The world is not fair.



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