What I learned at the world economic crisis.
The Insider

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Next week's meeting of the International Monetary Fund will bring to Washington, D.C., many of the same demonstrators who trashed the World Trade Organization in Seattle last fall. They'll say the IMF is arrogant. They'll say the IMF doesn't really listen to the developing countries it is supposed to help. They'll say the IMF is secretive and insulated from democratic accountability. They'll say the IMF's economic "remedies" often make things worse--turning slowdowns into recessions and recessions into depressions.

And they'll have a point. I was chief economist at the World Bank from 1996 until last November, during the gravest global economic crisis in a half-century. I saw how the IMF, in tandem with the U.S. Treasury Department, responded. And I was appalled.

The global economic crisis began in Thailand, on July 2, 1997. The countries of East Asia were coming off a miraculous three decades: incomes had soared, health had improved, poverty had fallen dramatically. Not only was literacy now universal, but, on international science and math tests, many of these countries outperformed the United States. Some had not suffered a single year of recession in 30 years.

<Picture: Photo by AP>But the seeds of calamity had already been planted. In the early '90s, East Asian countries had liberalized their financial and capital markets--not because they needed to attract more funds (savings rates were already 30 percent or more) but because of international pressure, including some from the U.S. Treasury Department. These changes provoked a flood of short-term capital--that is, the kind of capital that looks for the highest return in the next day, week, or month, as opposed to long-term investment in things like factories. In Thailand, this short-term capital helped fuel an unsustainable real estate boom. And, as people around the world (including Americans) have painfully learned, every real estate bubble eventually bursts, often with disastrous consequences. Just as suddenly as capital

flowed in, it flowed out. And, when everybody tries to pull their money out at the same time, it causes an economic problem. A big economic problem.

The last set of financial crises had occurred in Latin America in the 1980s, when bloated public deficits and loose monetary policies led to runaway inflation. There, the IMF had correctly imposed fiscal austerity (balanced budgets) and tighter monetary policies, demanding that governments pursue those policies as a precondition for receiving aid. So, in 1997 the IMF imposed the same demands on Thailand. Austerity, the fund's leaders said, would restore confidence in the Thai economy. As the crisis spread to other East Asian nations--and even as evidence of the policy's failure mounted--the IMF barely blinked, delivering the same medicine to each ailing nation that showed up on its doorstep.

I thought this was a mistake. For one thing, unlike the Latin American nations, the East Asian countries were already running budget surpluses. In Thailand, the government was running such large surpluses that it was actually starving the economy of much-needed investments in education and infrastructure, both essential to economic growth. And the East Asian nations already had tight monetary policies, as well: inflation was low and falling. (In South Korea, for example, inflation stood at a very respectable four percent.) The problem was not imprudent government, as in Latin America; the problem was an imprudent private sector--all those bankers and borrowers, for instance, who'd gambled on the real estate bubble.

Under such circumstances, I feared, austerity measures would not revive the economies of East Asia--it would plunge them into recession or even depression. High interest rates might devastate highly indebted East Asian firms, causing more bankruptcies and defaults. Reduced government expenditures would only shrink the economy further.

So I began lobbying to change the policy. I talked to Stanley Fischer, a distinguished former Massachusetts Institute of Technology economics professor and former chief economist of the World Bank, who had become the IMF's first deputy managing director. I met with fellow economists at the World Bank who might have contacts or influence within the IMF, encouraging them to do everything they could to move the IMF bureaucracy.

Convincing people at the World Bank of my analysis proved easy; changing minds at the IMF was virtually impossible. When I talked to senior officials at the IMF--explaining, for instance, how high interest rates might increase bankruptcies, thus making it even harder to restore confidence in East Asian economies--they would at

first resist. Then, after failing to come up with an effective counterargument, they would retreat to another response: if only I understood the pressure coming from the IMF board of executive directors--the body, appointed by finance ministers from the advanced industrial countries, that approves all the IMF's loans. Their meaning was clear. The board's inclination was to be even more severe; these people were actually a moderating influence. My friends who were executive directors said they were the ones getting pressured. It was maddening, not just because the IMF's inertia was so hard to stop but because, with everything going on behind closed doors, it was impossible to know who was the real obstacle to change. Was the staff pushing the executive directors, or were the executive directors pushing the staff? I still do not know for certain.

Of course, everybody at the IMF assured me they would be flexible: if their policies really turned out to be overly contractionary, forcing the East Asian economies into deeper recession than necessary, then they would reverse them. This sent shudders down my spine. One of the first lessons economists teach their graduate students is the importance of lags: it takes twelve to 18 months before a change in monetary policy (raising or lowering interest rates) shows its full effects. When I worked in the White House as chairman of the Council of Economic Advisers, we focused all our energy on forecasting where the economy would be in the future, so we could know what policies to recommend today. To play catch-up was the height of folly. And that was precisely what the IMF officials were proposing to do.

I shouldn't have been surprised. The IMF likes to go about its business without outsiders asking too many questions. In theory, the fund supports democratic institutions in the nations it assists. In practice, it undermines the democratic process by imposing policies. Officially, of course, the IMF doesn't "impose" anything. It "negotiates" the conditions for receiving aid. But all the power in the negotiations is on one side--the IMF's--and the fund rarely allows sufficient time for broad consensus-building or even widespread consultations with either parliaments or civil society. Sometimes the IMF dispenses with the pretense of openness altogether and negotiates secret covenants.

When the IMF decides to assist a country, it dispatches a "mission" of economists. These economists frequently lack extensive experience in the country; they are more likely to have firsthand knowledge of its five-star hotels than of the villages that dot its countryside. They work hard, poring over numbers deep into the night. But their task is impossible. In a period of days or, at most, weeks, they are charged with developing a coherent program sensitive to the needs of the country. Needless to say, a little number-crunching rarely provides adequate insights into the development

strategy for an entire nation. Even worse, the number-crunching isn't always that good. The mathematical models the IMF uses are frequently flawed or out-of-date. Critics accuse the institution of taking a cookie-cutter approach to economics, and they're right. Country teams have been known to compose draft reports before visiting. I heard stories of one unfortunate incident when team members copied large parts of the text for one country's report and transferred them wholesale to another. They might have gotten away with it, except the "search and replace" function on the word processor didn't work properly, leaving the original country's name in a few places. Oops.

It's not fair to say that IMF economists don't care about the citizens of developing nations. But the older men who staff the fund--and they are overwhelmingly older men--act as if they are shouldering Rudyard Kipling's white man's burden. IMF experts believe they are brighter, more educated, and less politically motivated than the economists in the countries they visit. In fact, the economic leaders from those countries are pretty good--in many cases brighter or better-educated than the IMF staff, which frequently consists of third-rank students from first-rate universities. (Trust me: I've taught at Oxford University, MIT, Stanford University, Yale University, and Princeton University, and the IMF almost never succeeded in recruiting any of the best students.) Last summer, I gave a seminar in China on competition policy in telecommunications. At least three Chinese economists in the audience asked questions as sophisticated as the best minds in the West would have asked.

As time passed, my frustration mounted. (One might have thought that since the World Bank was contributing literally billions of dollars to the rescue packages, its voice would be heard. But it was ignored almost as resolutely as the people in the affected countries.) The IMF claimed that all it was asking of the East Asian countries was that they balance their budgets at a time of recession. All? Hadn't the Clinton administration just fought a major battle with Congress to stave off a balanced-budget amendment in this country? And wasn't the administration's key argument that, in the face of recession, a little deficit spending might be necessary? This is what I and most other economists had been teaching our graduate students for 60 years. Quite frankly, a student who turned in the IMF's answer to the test question "What should be the fiscal stance of Thailand, facing an economic downturn?" would have gotten an F.

As the crisis spread to Indonesia, I became even more concerned. New research at the World Bank showed that recession in such an ethnically divided country could spark all kinds of social and political turmoil. So in late 1997, at a meeting of finance

ministers and central-bank governors in Kuala Lumpur, I issued a carefully prepared statement vetted by the World Bank: I suggested that the excessively contractionary monetary and fiscal program could lead to political and social turmoil in Indonesia. Again, the IMF stood its ground. The fund's managing director, Michel Camdessus, said there what he'd said in public: that East Asia simply had to grit it out, as Mexico had. He went on to note that, for all of the short-term pain, Mexico emerged from the experience stronger.

But this was an absurd analogy. Mexico hadn't recovered because the IMF forced it to strengthen its weak financial system, which remained weak years after the crisis. It recovered because of a surge of exports to the United States, which took off thanks to the U.S. economic boom, and because of nafta. By contrast, Indonesia's main trading partner was Japan--which was then, and still remains, mired in the doldrums. Furthermore, Indonesia was far more politically and socially explosive than Mexico, with a much deeper history of ethnic strife. And renewed strife would produce massive capital flight (made easy by relaxed currency-flow restrictions encouraged by the IMF). But none of these arguments mattered. The IMF pressed ahead, demanding reductions in government spending. And so subsidies for basic necessities like food and fuel were eliminated at the very time when contractionary policies made those subsidies more desperately needed than ever.

By January 1998, things had gotten so bad that the World Bank's vice president for East Asia, Jean Michel Severino, invoked the dreaded r-word ("recession") and d-word ("depression") in describing the economic calamity in Asia. Lawrence Summers, then deputy treasury secretary, railed against Severino for making things seem worse than they were, but what other way was there to describe what was happening? Output in some of the affected countries fell 16 percent or more. Half the businesses in Indonesia were in virtual bankruptcy or close to it, and, as a result, the country could not even take advantage of the export opportunities the lower exchange rates provided. Unemployment soared, increasing as much as tenfold, and real wages plummeted--in countries with basically no safety nets. Not only was the IMF not restoring economic confidence in East Asia, it was undermining the region's social fabric. And then, in the spring and summer of 1998, the crisis spread beyond East Asia to the most explosive country of all--Russia.

The calamity in Russia shared key characteristics with the calamity in East Asia--not least among them the role that IMF and U.S. Treasury policies played in abetting it. But, in Russia, the abetting began much earlier. Following the fall of the Berlin Wall, two schools of thought had emerged concerning Russia's transition to a market economy. One of these, to which I belonged, consisted of a melange of experts on the

region, Nobel Prize winners like Kenneth Arrow and others. This group emphasized the importance of the institutional infrastructure of a market economy--from legal structures that enforce contracts to regulatory structures that make a financial system work. Arrow and I had both been part of a National Academy of Sciences group that had, a decade earlier, discussed with the Chinese their transition strategy. We emphasized the importance of fostering competition--rather than just privatizing state-owned industries--and favored a more gradual transition to a market economy (although we agreed that occasional strong measures might be needed to combat hyperinflation).

The second group consisted largely of macroeconomists, whose faith in the market was unmatched by an appreciation of the subtleties of its underpinnings--that is, of the conditions required for it to work effectively. These economists typically had little knowledge of the history or details of the Russian economy and didn't believe they needed any. The great strength, and the ultimate weakness, of the economic doctrines upon which they relied is that the doctrines are--or are supposed to be--universal. Institutions, history, or even the distribution of income simply do not matter. Good economists know the universal truths and can look beyond the array of facts and details that obscure these truths. And the universal truth is that shock therapy works for countries in transition to a market economy: the stronger the medicine (and the more painful the reaction), the quicker the recovery. Or so the argument goes.

Unfortunately for Russia, the latter school won the debate in the Treasury Department and in the IMF. Or, to be more accurate, the Treasury Department and the IMF made sure there was no open debate and then proceeded blindly along the second route. Those who opposed this course were either not consulted or not consulted for long. On the Council of Economic Advisers, for example, there was a brilliant economist, Peter Orszag, who had served as a close adviser to the Russian government and had worked with many of the young economists who eventually assumed positions of influence there. He was just the sort of person whose expertise Treasury and the IMF needed. Yet, perhaps because he knew too much, they almost never consulted him.

We all know what happened next. In the December 1993 elections, Russian voters dealt the reformers a huge setback, a setback from which they have yet really to recover. Strobe Talbott, then in charge of the noneconomic aspects of Russia policy, admitted that Russia had experienced "too much shock and too little therapy." And all that shock hadn't moved Russia toward a real market economy at all. The rapid privatization urged upon Moscow by the IMF and the Treasury Department had

allowed a small group of oligarchs to gain control of state assets. The IMF and Treasury had rejiggered Russia's economic incentives, all right--but the wrong way. By paying insufficient attention to the institutional infrastructure that would allow a market economy to flourish--and by easing the flow of capital in and out of Russia--the IMF and Treasury had laid the groundwork for the oligarchs' plundering. While the government lacked the money to pay pensioners, the oligarchs were sending money obtained by stripping assets and selling the country's precious national resources into Cypriot and Swiss bank accounts.

The United States was implicated in these awful developments. In mid-1998, Summers, soon to be named Robert Rubin's successor as secretary of the treasury, actually made a public display of appearing with Anatoly Chubais, the chief architect of Russia's privatization. In so doing, the United States seemed to be aligning itself with the very forces impoverishing the Russian people. No wonder antiAmericanism spread like wildfire.

At first, Talbott's admission notwithstanding, the true believers at Treasury and the IMF continued to insist that the problem was not too much therapy but too little shock. But, through the mid-'90s, the Russian economy continued to implode. Output plummeted by half. While only two percent of the population had lived in poverty even at the end of the dismal Soviet period, "reform" saw poverty rates soar to almost 50 percent, with more than half of Russia's children living below the poverty line. Only recently have the IMF and Treasury conceded that therapy was undervalued--though they now insist they said so all along.

Today, Russia remains in desperate shape. High oil prices and the long-resisted ruble devaluation have helped it regain some footing. But standards of living remain far below where they were at the start of the transition. The nation is beset by enormous inequality, and most Russians, embittered by experience, have lost confidence in the free market. A significant fall in oil prices would almost certainly reverse what modest progress has been made.

East Asia is better off, though it still struggles, too. Close to 40 percent of Thailand's loans are still not performing; Indonesia remains deeply mired in recession. Unemployment rates remain far higher than they were before the crisis, even in East Asia's best-performing country, Korea. IMF boosters suggest that the recession's end is a testament to the effectiveness of the agency's policies. Nonsense. Every recession eventually ends. All the IMF did was make East Asia's recessions deeper, longer, and harder. Indeed, Thailand, which followed the IMF's prescriptions the most closely,

has performed worse than Malaysia and South Korea, which followed more independent courses.

I was often asked how smart--even brilliant--people could have created such bad policies. One reason is that these smart people were not using smart economics. Time and again, I was dismayed at how out-of-date--and how out-of-tune with reality--the models Washington economists employed were. For example, microeconomic phenomena such as bankruptcy and the fear of default were at the center of the East Asian crisis. But the macroeconomic models used to analyze these crises were not typically rooted in microfoundations, so they took no account of bankruptcy.

But bad economics was only a symptom of the real problem: secrecy. Smart people are more likely to do stupid things when they close themselves off from outside criticism and advice. If there's one thing I've learned in government, it's that openness is most essential in those realms where expertise seems to matter most. If the IMF and Treasury had invited greater scrutiny, their folly might have become much clearer, much earlier. Critics from the right, such as Martin Feldstein, chairman of Reagan's Council of Economic Advisers, and George Shultz, Reagan's secretary of state, joined Jeff Sachs, Paul Krugman, and me in condemning the policies. But, with the IMF insisting its policies were beyond reproach--and with no institutional structure to make it pay attention--our criticisms were of little use. More frightening, even internal critics, particularly those with direct democratic accountability, were kept in the dark. The Treasury Department is so arrogant about its economic analyses and prescriptions that it often keeps tight--much too tight--control over what even the president sees.

Open discussion would have raised profound questions that still receive very little attention in the American press: To what extent did the IMF and the Treasury Department push policies that actually contributed to the increased global economic volatility? (Treasury pushed liberalization in Korea in 1993 over the opposition of the Council of Economic Advisers. Treasury won the internal White House battle, but Korea, and the world, paid a high price.) Were some of the IMF's harsh criticisms of East Asia intended to detract attention from the agency's own culpability? Most importantly, did America--and the IMF--push policies because we, or they, believed the policies would help East Asia or because we believed they would benefit financial interests in the United States and the advanced industrial world? And, if we believed our policies were helping East Asia, where was the evidence? As a participant in these debates, I got to see the evidence. There was none.

Since the end of the cold war, tremendous power has flowed to the people entrusted to bring the gospel of the market to the far corners of the globe. These economists, bureaucrats, and officials act in the name of the United States and the other advanced industrial countries, and yet they speak a language that few average citizens understand and that few policymakers bother to translate. Economic policy is today perhaps the most important part of America's interaction with the rest of the world. And yet the culture of international economic policy in the world's most powerful democracy is not democratic.

This is what the demonstrators shouting outside the IMF next week will try to say. Of course, the streets are not the best place to discuss these highly complex issues. Some of the protesters are no more interested in open debate than the officials at the IMF are. And not everything the protesters say will be right. But, if the people we entrust to manage the global economy--in the IMF and in the Treasury Department--don't begin a dialogue and take their criticisms to heart, things will continue to go very, very wrong. I've seen it happen.

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Recently:
Paul Krugman explained how the U.S. worsened the Asia crash. Alexandra Starr investigated the arcane process the IMF used to select its new managing director. James Tobin and Gustav Ranis wrote about the IMF's misplaced priorities.

Currently (04.17.00 issue):
The Editors: Microsoft and the return of antitrust.
TRB: Andrew Sullivan on the gay conservatism of Allan Bloom.
The Hunted: John B. Judis on why the GOP hates moderates.
The Old New Thing: Jonathan Cohn on why Gore can't be a New Democrat.
Miami Dispatch: Jim Defede on Miami going insane--and Al Gore going with it.
Washington Diarist: Gregg Easterbrook on the Bills and other Buffalo landmarks.
Tomb of Their Own: Franklin Foer on Skull and Bones going p.c.
Alive and Kicking: Benjamin Soskis on why the death penalty isn't dead.
Backward March: Shawn Zeller explains why gay activists are opposing a gay march.

Stanley Kauffmann on Films: Joe Gould's Secret is the surprising story of a depressing man; the story of East-West is depressingly unsurprising.
Jed Perl on Art: The casual weirdness of Robert Gober.