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THE ROLE OF THE U.S. IN THE INTERDEPENDENT WORLD

－Advice to Americans－

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1. Triumph of American Capitalism

The end of the Cold War was, in economic sense, a triumph of market economy over centrally-planned economy. The collapse of the Soviet empire came at the end of the process of its gradual deterioration caused by many factors. Again in economic sense, the coup de grace was dealt by the inability of its economic system to cope with the new environment emerged in the global economy since the 1980's. The new environment was the advent of an irreversible trend of globalization and the revolutionary progress of informations and communications technology. In the new environment the competition became global, no government, no corporation and even no individual can successfully survive without winning competition waged in the global market place. Also the IT revolution brought about a sweeping change in the whole spectrum of economic activities. The introduction of universal, efficient and inexpensive means of communication has enabled millions of taxpayers, consumers, employees, and shareholders to make an access to the same information simultaneously and instantly. As the result, the treasure of information has become no longer a monopoly of those in power. It has to be shared by all concerned.

The market, which can be considered as the aggregate of all economic agents, became the ultimate judge who scrutinizes and evaluates the performance of policy makers of government and CEOs of corporations. In the new environment as such, transparency and accountability became the two most essential elements of the governance of governments and corporations. Governments and corporations have to convince the market, with satisfactory transparency and accountability, that they are competent players.

Equally important was that the IT revolution has created a far-reaching change in the whole process of economic activities. By using the enormously enhanced capability of computers, enlarged transmission capacity, and global use of internet service the process of planning, designing, manufacturing, inventory management, marketing and all other facets of economic activities were innovated and made more efficient. Productivity of labor and capital was significantly enhanced. The centrally-planned economy, because of its inherent rigidity, could not adapt itself quickly enough and adequately enough to fundamental changes as such and the battle was lost for them.

The American economy, on the other hand, was best positioned to capture the opportunity provided by the trend of globalization and IT revolution. Free and competitive market, risk-taking entrepreneurship, and the government policy which was generally market-friendly, have all supported the quick adaptation of the economy to the new environment thereby making it the most efficient, competitive and powerful in the global market place.

The point to be stressed is that the benefit of globalization and IT revolution was most conspicuous in the financial services industry. Triggered by oil price crises in the 1970's the global flow of capital has started to increase rapidly. The trend was encouraged and accelerated by factors such as the large imbalance of global trade account, the expansion of cross-border activities of corporations, and the accumulation of private financial asset mainly as a result of the aging of population in industrialized economies. Massive and rapid flow of capital became the dominant force in the global economic scene. Naturally, the financial services industry, which acts as the major intermediation of the capital flow, was given the best opportunity to capture the benefit. Also, since financial services are basically an operation dealing with numerals it is in a position to take the best advantage of the development of IT. The IT has enabled to develop a new and vast horizon for financial services industry. All sorts of new products and services were made available by use of sophisticated computer operation. The financial services industry, in a sense, has transformed itself into a computer industry. The technology of financial engineering became the most important ingredient of financial services.

The American financial services industry has successfully established the position as the indisputable forerunner in the global market. It was made possible because American institutions were stimulated by fierce sense of competition and were supported by ample human and technological resources. Thus, the American economy, led by its financial services industry, became the most competitive and dynamic economy on the globe by the 1990's. In the post-Cold War period of the world economy the American economy has played an almost hegemonic role. The American standard of corporate governance, which is characterized by such key words as competition, efficiency, and shareholder value, has almost became the global standard. All other economies are, more or less, forced to emulate the American way. No wonder Americans today, whether they admit or not, are triumphant.

The predominant role of the USA has been the most outstanding feature of the world economy in the post-Cold War period. It is quite natural that, in parallel with the expansion of American influence, the global concern was heightened about how the U. S. should play the role. The fortune of the world economy is very much dependent on policies and behaviors of the U. S. It is certainly arguable that the strength of American hegemony in the international financial arena and also the fact that the rest of the world has basically accepted the validity of American hegemony, have contributed to the stable development of world economy by providing a common framework of activity for all players. However, the problem was that the U.S., as a hegemon, has not always tried consciously to balance and harmonize the America's own interest and the interest of others. The negligence of the leadership role as such was made possible by obvious reasons. The first was America's naive presumptuousness to believe that anything which is good for America should be good for others as well. The presumptuousness is of course a direct product of the American triumphantlism. The second reason lies in the structure of the decision making process. In the domestic economic management the U.S government is constantly faced with conflicting interests of business and of consumer. The challenge for the economic policy maker is how to strike the best balance between them while achieving the greatest benefit for the national economy as a whole. In the international economic policy management, however, the consumer has much less interest in what the government does. Thus the interest of business tends to prevail. This is particularly the case in a country like the U.S. where the influence of big businesses over the government is relatively great. As the result, American international economic policy is prone to support and protect the interest of American business. As I argued the American financial industry today is the most globalized, aggressive and competitive industry. Its quest for the maximization of global business opportunity coincides with the American aspiration to spread out the American style of market economy based upon free competition. This is the clashing point between unilateralism and multilateralism. The American policy in the international financial arena is fundamentally motivated by the national interest. What makes the matter complicated is the fact that Americans do not view their unilateralism as something incompatible with multilateralism. As they strongly believe in the value of their market system and business model they consider their unilateralism does perfectly coincide with the idea of multilateralism. Indeed, if we look at the end result, we cannot deny that in many instances their naiveté is vouchered. Many companies, industries and economies have recorded remarkable success by consciously emulating the American model. What was good for America was good for others.

Having said that, I still have to argue that the world is not that ideal place. The American unilateralism in the global financial arena, no matter how bona fide it might have been, was sometimes implemented without due regard to the actualities and the needs in other economies. American unilateralism did run counter to the multilateral benefit. In my view, there are three areas where the American unilateralism was not compatible with multilateralism. They are 1) management of international capital flow, 2) stability of exchange rate of currencies, and 3) role of international financial institutions particularly the International Monetary Fund (IMF). Let me elaborate on each of them.

2. Management of International Capital Flow

As I discussed earlier the expansion of the cross-border capital flow since the 1970's has been simply phenomenal. Today the volume of financial resources moving across national borders everyday is more than fifty times of the volume of transaction in goods and services. In a way, the world today is a huge whirlpool of money. The development as such was prompted first by the accumulation of investible fund in the hands of investors such as pension fund, mutual fund, and hedge fund which move the fund internationally by way of portfolio investment and currency speculation seeking for higher return for their money. Secondly, business corporations, particularly big multinationals, expanded their activities globally by way of foreign direct investment and cross-border merger and acquisition. American corporations and funds, armed with their strong resources base and high competitiveness, are undoubtedly the dominant players in the international capital movement.

In order to enlarge the market for business American business corporations, investment banks, and institutional investors pressured other economies, particularly emerging and small economies, to open up their capital market for foreign participation. In many cases they were endorsed and encouraged by American official policy. They persuaded the recipients by arguing that the opening of capital market will facilitate the inflow of productive foreign capital into the economy thereby stimulating economic development and improving efficiency of the economy. In most cases the recipient countries accepted American advice and opened their capital market, sometimes willingly but sometimes reluctantly. Indeed, liberalization of capital control has encouraged vigorous foreign investment and stimulated the economic activity in the country in many cases. However, in spite of the seeming benefit of a greater foreign participation, there were cases where ill-managed capital liberalization has created currency crisis and caused serious dislocation of the economy. The tragedy of this kind did happen in small and emerging economies notably in Asia and Latin America.

Asian financial crisis erupted in Thailand and spread quickly to other East Asian economies in 1997. Contagion has hit Russia and Brazil and eventually the Wall Street. Numerous analyses were already made of the cause and the development of the crisis, and I am not going to dwell upon it. One thing is clear that the crisis was directly triggered by a massive international capital flow. It was, in fact, a capital account crisis quite different from classical crisis which was caused by the deterioration of current account. In most of the crisis-hit countries the macro-economic fundamentals such as current account, fiscal balance, and inflation were quite away from the state of desperate deterioration. Yet the massive inflow and rapid withdrawal of capital in and out of the economy has created an uncontrollable fluctuation of the exchange rate of currency and resulted in a serious dislocation of resources and a deterioration of welfare of the masses.

It should not be forgotten that, although the crisis might have been perceived as an unexpected natural calamity, the crisis-hit economies had serious vulnerabilities, which made them unable to prevent and cope with the crisis. At least three of them should be highlighted. The first is the weakness of financial system, notably the poor balance-sheet of banks and the faulty supervision of banks, the second is the inappropriate speed and sequencing of capital liberalization, and the third is the ill-designed exchange rate arrangement. In hindsight it is quite obvious that many banks in crisis-hit countries were poorly and unsoundly managed. Most of their assets were bad policy loans, and the management colluded with politicians. There was little transparency and accountability. The central bank and other supervisory apparatus were not functioning properly. They were not independent from political influence and there was no strict rule of laws and regulations. Capital liberalization was implemented without clear assessment of internal and external situations. More often than not it was motivated by the desire to attract foreign capital quickly. The hasty establishment of offshore market was just one example. Foreign direct investment flourished seeking the benefit of inexpensive labor, but when there was no real transfer of skills and technologies and when there was little effort made to develop wide-based supporting industries there was a serious risk that the foreign direct investment fails to contribute to the indigenous economic development. Also, inflexible exchange rate arrangement such as the dollar-peg system proved to be a dangerous proposition when surrounded by changeable environment. The dollar-peg system has indeed attracted a large amount of volatile foreign capital. However, when the tide has reversed, it inevitably cost an unsustainable loss on the country's reserves. The system was forced to collapse and the currency suffered unjustifiably large depreciation thus leaving a lasting damage on the country's economy.

All told, it is clear that crisis-hit countries have to bear the responsibility for most of their failures. However, one cannot be fair to them without asking the following question. Are those foreigners who preached the benefit of globalization to the developing countries and urged them to open their capital market totally immune from responsibility? When they were pressuring the developing countries, did they have accurate assessment of the real situation in those countries and did they try to advise what should be the prerequisite of a successful globalization? I do not believe that developed countries particularly the U.S., their governments and private businesses together, and the official international institutions, have no repentance. They acclaimed globalization and liberalization but they failed to remind what should be done first in order to achieve the real benefit of globalization and liberalization. In this respect I believe the responsibility of the U. S. is the greatest because the U. S. has played by far the most important role in championing the global crusade.

There may be rebuttal to my assertion arguing that the necessary reform in the developing country such as the strengthening of banking sector would never have happened without the pressure of market forces, therefore, the capital market opening, even if it was painful, was a necessary bitter pill for many emerging economies. I would not deny that a bitter pill was necessary in some cases. It was the fact though that those who provided the bitter pill were not motivated by the genuine desire to promote the best approach for the improvement of welfare of the emerging economy. In most cases they were driven by the prospect of expanding market and increasing profit. It was an act of sheer greed. The bottom line is that there are often conflicts between national interest of emerging economies and private business interest of developed economies. The best approach should be a joint effort by the emerging economy to expedite its own internal reform and by the private business of developed country to exercise prudence with due consideration to a stable development of the emerging economy. It is encouraging that, in the process of the international effort to rebuild the global financial architecture, there was a broad consensus on the need to tighten the supervision of speculative hedge fund, to contain the disturbing activity of offshore financial center, and to support the proper sequencing of capital liberalization. I have to stress that if private business of developed country fails to cooperate fully then it is the responsibility of their authorities to enforce necessary public regulation. I also repeat to stress that the U. S., as the biggest beneficiary of the stable growth of the international financial market, should take an active leading role in the effort to accomplish the joint endeavor. I dared to say this because there is widely-held suspicion that the U.S. is least enthusiastic to implement these measures in compulsory fashion. If the suspicion is correct then I have to argue that American unilateralism, which is preoccupied with the desire to protect the interest of its financial institutions, needs to be modified so that it pays greater attention to the actualities of vulnerable economies and approach the issue with the spirit of multilateralism.

3. Stability of Exchange Rate

Under the Bretton Woods regime, which was maintained for a quarter century after the Second World War, the world economy enjoyed a remarkable stability of exchange rate among major currencies. All major countries committed to maintain a fixed exchange rate between their currency and the U. S. dollar the value of which was in turn guaranteed by the free convertibility to gold at fixed price. In other words the international economic activities were freed from exchange risk. Under the favorable environment the world trade and investment expanded and the world economy on the whole achieved a remarkable reconstruction and development. In retrospect the success of the Bretton Woods regime was made possible by the supreme value of the U. S. dollar which in turn was supported by the overwhelming relative strength of the American economy vis-à -vis other major countries. Therefore, when the relative supremacy of the American economy was eroded, the Bretton Woods regime was bound to collapse. The demise was prompted by various factors such as the catch-up by other major economies, progressive overvaluation of the U. S. dollar, and the damage inflicted upon the American economy by Vietnam War. By 1973 the U. S. suspended the dollar's convertibility to gold and major currencies abandoned their parity with the dollar. The world currency regime entered the age of floating. It should be noted that, although the value of the U. S. dollar was no longer guaranteed by gold, the U. S. dollar continued to play the role of the international key currency. In other words, the world financial market continued to operate under de facto dollar standard. The big difference from the Bretton Woods regime was the recurrent wild fluctuation of dollar's exchange rate in the marketplace, which clearly added cost to a stable expansion of international trade and investment and, more often than not, caused misallocation of economic resources. Indeed, repeated efforts have been made at either bilateral or multilateral levels to restore an adequate degree of stability and predictability by eliminating excessive volatility and by preventing the prolonged misalignment of exchange rate. Monetary authorities of major currency countries conducted joint intervention in the currency market. They also tried to coordinate their domestic macro-economic policy so that the market would not be tempted to speculate on the disharmonized economic performance. On a different front, countries of Continental Europe have launched a historic endeavor to eliminate the risk and the cost of exchange between their respective currencies. They finally triumphed the success when the single European currency of euro was introduced at the beginning of 1999. Nevertheless, the volatility of exchange rate between the U. S. dollar and other major currencies persisted. The situation was even aggravated in a sense by the rapid increase of the volume and the speed of international capital flow as I have mentioned earlier. When the amount of international capital flow was relatively small compared with the volume of trade of goods and services the exchange rate used to be determined basically and in a long run by the performance of the current account transaction of respective country. There was a certain degree of predictability in the movement of exchange rate. However, trouble started when the size of capital flow overwhelmed the volume of current account transaction because of the sheer fact that the bulk of capital movement is not predictable. Large and rapid movement of capital can be triggered by sudden change of market sentiment which in turn was caused by all sort of informations, expectations, and speculative motives not all of which are accurate and valid. To make the situation more uncontrollable there is a strong tendency among market players to succumb to a herd mentality because they are fearful of missing the bandwagon. When the critical mass of market players fell the victim to the herd mentality the vector in the market, no matter how irrational it might be, transforms the movement into a self-fulfilling prophecy. They have to continue to run to the same direction until they crash.

In sum, in today's currency market which is dominated by capital movement, exchange rate is much more susceptible to irrational violent fluctuations. It poses a dilemma. While the situation calls for greater effort to restore stability the achievement of the goal has become extremely difficult. In any effort to influence the currency market there are two fundamental principles we should not forget. The one is that, since exchange rate is a relationship between two currencies, there must be always a close cooperation between two issuing countries. Effort made by a single country alone will not produce real effect. Secondly, since we are dealing with market which is an aggregate of judgment made by millions of players, we cannot possibly achieve the goal unless we succeed in changing their perception. We have to admit that the market is right in most cases. When the majority of market participants are inclined to sell a currency they do so because they detect something wrong with the currency. Even wolves will not approach unless they smell blood. In that case the fundamental problem of the issuing country's economy needs to be rectified. Market intervention alone cannot solve the problem. However, the market can also err. As I mentioned earlier, the market is often driven by herd mentality, which is not vindicated by fundamental economic fact. Most of so-called overshooting of exchange rate do occur in such circumstance, and the overshooting is what we must be concerned about most. In this case what is needed for currency authorities is to send a clear and strong message to the market telling the market it is wrong. The message can take the form of a massive and concerted market intervention or a strong and convincing statement. It will work as a bucketful of cold water thrown over a drunken head.

So far I talked about the exchange rate between major countries because it is relevant not only to their respective economies but also to the stability of the international financial market. Indeed the stability of exchange rate between major currencies is of critical importance for many smaller economies, which are vulnerable to the volatility of such exchange rate. The experience of the 1997 East Asian crises was a good case to demonstrate such importance. Before the crises many East Asian currencies were pegged to the U. S. dollar although in reality their international economic activities were diversified between the U. S. dollar zone and the Japanese yen zone. The steady weakening of the dollar vis-à -vis the yen until 1995 and a strong recovery thereafter brought about unintended shift in the price competitiveness of those East Asian countries and distorted their economic policies thus enhancing their vulnerability to volatile international capital flow. When they abandoned the dollar-peg policy under the ferocious attack by currency speculators the value of their currencies plummeted far below the level which was justifiable by economic fundamentals. It was a clear case of overshooting.

I stated earlier that since the onset of the floating age many attempts were made to reduce the volatility of exchange rate between major currencies but none of them materialized and there is no international agreement for that purpose today. The reason for the failure is obvious. There has never been a common understanding among major countries. When there were clear cases of overshooting countries concerned conducted joint market interventions on ad hoc basis. Some of them succeeded but others failed. The agreement on the framework of cooperation could not be established because countries took different views on the desirability of stable exchange rate although from time to time they admitted the detriment of volatility. I have to argue that the U. S. has been the one who was most reluctant to commit to the international cooperation on exchange rate. It is not without reason. The U. S. dollar is de facto international key currency, and for the U. S. most of its international transaction was carried out in its own currency. The U. S., compared with other countries, has relatively small amount of exchange risk. Also, it has to be pointed out that there was a lingering view in the U. S. that the exchange rate could be and should be used as a tool of economic diplomacy. When faced with the need to address its huge trade deficit problem the U. S. pressured its trading partners to increase the purchase of American goods and services using the threat of a dollar devaluation if they do not comply. The tactic of "talking dollar down" was employed intentionally. In recent years the U. S. has maintained a "strong dollar policy" because a strong dollar is indispensable for a steady inflow of foreign capital to finance its large current account deficit. Also there is a strong trait in the American thinking that the market should be left as free as possible. According to that view the market is always the best judge.

However, our experience tells us that exchange rate does overshoot and misalignment does happen, and they hurt the economy. It is a legitimate concern that there should be a workable framework of international cooperation with a view to preventing overshooting and rectifying misalignment. The lack of dependability of the U. S. policy on exchange rate is regrettable. It is too obvious that without the U. S. commitment the international cooperation will not be possible, but if the U. S. decide to take a lead the EU and Japan will certainly cooperate. The purpose of the international cooperation is not to maintain exchange rate at unrealistic level which is unacceptable to the market. Rather, the purpose is to prevent the irrational overshooting by the market and to try to keep the exchange rate within the range which is acceptable to the rational judgment of the market. The U. S. should recognize that the exchange rate is a matter of global concern and there is no unilateral solution of exchange rate instability. The stability of exchange rate can be achievable only through multilateral agreement and cooperation, and the firm commitment of the U.S. to the principle of multilateralism is the key to success.

4. Role of IMF

When the IMF was created in 1945 as the cornerstone of the Bretton Woods regime its mission was clear. It was to uphold the stable parity among currencies based upon dollar-gold standard, and to support member countries to abide by their obligation the IMF was empowered to provide short-term financing to member countries when necessary. The mission was accomplished successfully; the parity system was maintained for a quarter century. However, the Bretton Woods regime collapsed in 1973 and the parity system was virtually abandoned. The IMF lost original mission. In hindsight we should have tried to redefine the mission and reorganize the IMF so that it could have played a proper role in the age of floating exchange rate. Unfortunately, we wasted time trying vainly to fix the broken regime with some alterations. While we were fumbling with repair work the world economy was hit by oil price crises and recurrent currency turmoil. The international financial situation seemed to have become unstable and unpredictable. The world was preoccupied with addressing immediate problems. Major shareholders lost interest in the fundamental reform of the IMF and instead started to use the IMF as an adaptable lending facility. The bureaucracy of the IMF was not necessarily unhappy. The lending activity of the IMF was diversified and expanded from narrowly defined balance of payment financing to large-scale budget support and variety of long-term structural reform support. The demarcation line between the World Bank became very much blurred. The IMF became an all-purpose rescue team. Also, it was perceived that the U. S., as the largest shareholder with veto power, was using the IMF as its agent to pursue its global strategy. The IMF was criticized once in a while for its inappropriate diagnosis and prescription provided to borrowers.

There is no question that the world economic scene has changed greatly since Bretton Woods days. There are many more countries, large and small, which are in the process of development or restructuring. The role of private institutions in the international capital flow has become much more important than official institutions. Nature of financial crisis is more diverse now. Occurrence of crisis became frequent and contagion became severe. In other words, the world economy today is much more complicated than before and there is a serious need for us to be prepared to cope with various troubles in efficient and well-coordinated fashion. We need a set of multilateral financial institutions, each one of them should be provided with clearly defined objective, efficient management, and adequate resources. In my view, the IMF in this context should be given the role of a guardian of the stability of global financial market. The mainstay of its role will be prevention and management of financial crises. In order to carry out the role the IMF should be assigned to conduct the surveillance of macro economic policies, to coordinate international cooperation to improve exchange rate stability, and to provide short-term financing to countries on the verge of crisis. This financing needs to be bolstered by regional, or other-governmental, or private sources.

As I said earlier, the IMF was often criticized for its incompetence and inadequacy. In my view, however, the crux of the issue was in the lack of serious involvement by the home governments of major shareholders in the function of the IMF. Some of them were busy manipulating the selection of the Managing Director in a very opaque way, but they are not willing to supervise closely the activity of the IMF bureaucracy. In this respect, the responsibility of the U. S. as the largest shareholder is naturally the greatest. The policy of the U. S. towards the IMF has not always been unified. In many instances the U.S. was viewed as trying to use the IMF as a tool to accomplish its economic and political aim. There are many people who believe that the U.S. is more supportive to the IMF's large assistance to Latin America and other areas which are strategically important for the U.S. Yet, when in 1997 in the aftermath of the Asian crisis some Asian countries plotted to circumvent the IMF by creating an Asian Monetary Fund, the U.S. strongly objected. At the same time, there is a strong group in the U.S., particularly in the Congress, who is very critical about the IMF arguing that the IMF is not functioning well for the interest of American taxpayers. This is disturbing, because the IMF is an international institution designed to serve the purpose of global welfare. It is based upon a shared responsibility of all members. Any view on the activity of the IMF must be formulated on a global perspective, not by national interest. It is strongly hoped for that the U. S., its government and Congress alike, fully acknowledge the global value of the institution. The U.S. policy toward IMF should be firmly based upon multilateralism and not on unilateralism.

5. The Role of the U. S. in International Finance

As I argued at the outset the U. S. now enjoys almost a hegemonic status in the global economy. If one considers the vast resources it owns, particularly the unchallenged competitiveness of its financial services industry, it is likely that the predominance of the U. S. in the international finance will remain in the foreseeable future. However, one should not overlook that there are also risks in the U. S. economy. The most serious one is the shortage of saving, which is reflected in the huge current account deficit. It means that the U. S. needs a constant large inflow of outside capital to finance the shortage. Disruption of the flow will inflict upon the U. S. economy a serious damage. In other words, while the world economy depends on the U. S., the U. S. also depends on the rest to the world. It is this interdependence that the U. S. needs to fully recognize. The U. S. policies and actions in the arena of international finance must always be decided taking into consideration their impact on others. Unilateralism, if motivated by short-sighted national interest, will sooner or later invite backlash. I believe positive leadership role based upon the spirit of multilateralism on such key issues as I described should be the best option for the U. S.

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