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WHY THE IMF MEETINGS FAILED, AND THE COMING CAPITAL CONTROLS

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Coming events cast their shadows forward. —Goethe

What is to stop U.S. banks and their customers from "creating" $1 trillion, $10 trillion, or even $50 trillion with a few keystrokes and buying up all the bonds and stocks in the world, along with all the land and other assets for sale, in the hope of making capital gains and pocketing the arbitrage spreads by debt leveraging at less than 1 percent interest cost? This is the game that is being played today. The outflow of dollar credit into foreign markets in pursuit of this strategy has bid up asset prices and foreign currencies, enabling speculators to pay off their U.S. positions in cheaper dollars, keeping for themselves the exchange-rate gain from the currency shift as well as the arbitrage interest-rate margin. Finance has become the new mode of warfare—without military overhead costs and the expense of an unwanted occupation. It is a competition in global credit creation to buy real estate, natural resources, infrastructure, bonds, and corporate stock. Who needs an army when you can obtain monetary wealth and asset appropriation simply by financial means? Victory promises to go to the economy whose banking system can create the most credit, using an army of computer keyboards to appropriate the world's resources.

The main hurdle in this drive toward a financial Lebensraum is that it requires the central banks of targeted economies to accept electronic dollar credits of depreciating international

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worth in payment for national assets. U.S. officials demonize countries suffering these dollar inflows as aggressive "currency manipulators"—what Treasury Secretary Timothy Geithner calls "competitive nonappreciation," whereby countries "block their currencies from rising in value" (Chan 2010). Oscar Wilde would have struggled to find a more convoluted term to describe countries attempting to protect themselves from raiders intent on forcing the appreciation of their currencies in order to make enormous predatory fortunes. "Competitive nonappreciation" sounds like "conspiratorial nonsuicide."

The governments of targeted economies are simply trying to protect their own currencies from arbitrageurs and speculators who are flooding their financial markets with dollars and manipulating their currencies, extracting billions of dollars from their central banks in the process. The banks, in turn, are compelled to choose between letting these inflows push up their exchange rates (and pricing their exports out of foreign markets) or recycling them into U.S. Treasury bills (T-bills) that yield only 1 percent, in combination with a declining exchange value. (Longer-term bonds risk a price decline if U.S interest rates rise.)

The euphemism for flooding economies with credit is "quantitative easing." The Federal Reserve is pumping a tidal wave of liquidity and reserves into the U.S. financial system to reduce interest rates—ostensibly, to enable banks to "earn their way" out of negative equity resulting from bad loans made during the real estate bubble. This liquidity spills over to foreign economies and increases their currency exchange rates. Nobel economist Joseph Stiglitz recently acknowledged that the "flood of liquidity" from the Fed and the European Central Bank is causing "chaos" in foreign exchange markets: "The irony is that the Fed is creating all this liquidity with the hope that it will revive the American economy. . . . It's doing nothing for the American economy, but it's causing chaos over the rest of the world" (quoted in Brandimarte 2010).[1]

U.S. quantitative easing is driving the dollar down and other currencies up, much to the applause of currency speculators. In defense of this action, U.S. diplomats and bank lobbyists are threatening to derail the global financial system and plunge world trade into anarchy if other countries do not agree to reprising the 1985 Plaza Accord "as a possible framework for engineering an orderly decline in the dollar and avoiding potentially destabilizing trade fights" (Lauricella 2010).[2]

The Plaza Accord derailed Japan's economy by raising the yen exchange rate, lowering interest rates, and flooding the economy with enough credit to inflate a real estate bubble. International Monetary Fund (IMF) Managing Director Dominique Strauss-Kahn, speaking at a press briefing on the eve of the IMF meetings (October 8–10, 2010) in Washington, was more realistic: "I'm not sure the mood is to have a new Plaza or Louvre accord," he said. "We are in a different time today" (quoted in Beattie, Giles, and Nakamoto 2010). Acknowledging the need for "some element of capital controls [to] be put in place," he added that in view of U.S. insistence on open, unprotected capital markets, "The idea that there is an absolute need in a globalised world to work together may lose some steam" (see also Frangos 2010).

The issue is how long nations will succumb to the speculative dollar glut. Effectively, the world must choose between subordination to U.S. economic nationalism or interim financial anarchy. Nations are responding to this Faustian bargain by seeking to create an alternative global financial system and a fairer world economy, at the risk of a chaotic transition period.

Reinflating the financial bubble rather than writing down debts

The global financial system has seen one long, and unsuccessful, experiment in quantitative easing—Japan's carry trade. After the country's financial and real estate bubbles burst in 1990, the Bank of Japan sought to enable its banks to "earn their way out of negative equity" and to lend by supplying them with low-interest credit. With scant demand at home as a result of recession, the banks developed the carry trade: arbitrageurs borrowed at a low interest rate and bought higher-yielding securities (e.g., Iceland was then paying 15 percent). Thus, borrowed yen were converted into dollars, euros, kroner, and renminbi in order to buy government and private sector bonds, stocks, currency options, and other financial products. Not much funding was used to finance new capital formation. Its character was purely financial—extractive, not productive.

By 2006, the United States and Europe were experiencing their own financial and real estate bubbles. When the bubbles burst in 2008, they followed the lead of Japan's banks after 1990: the Fed flooded the U.S. economy with credit in an effort to provide banks with equity and subsequently increase lending to domestic borrowers. The economy was expected to "borrow its way out of debt" by reinflating asset prices (real estate, stocks, and bonds) in order to mitigate home foreclosures that were wiping out the collateral on bank balance sheets.

Quantitative easing subsidizes U.S. capital flight, pushing up nondollar currency exchange rates

Quantitative easing may not have set out to disrupt global trade and the international financial system, or to start a round of currency speculation; but the disruption and speculation can be attributed to the Fed's 2008 decision to reinflate U.S. real estate and financial markets by keeping high (insolvent) debts from defaulting. The government's aim was to rescue home ownerships from negative equities, as well as the banking system's balance sheets, and avoid a TARP II (which looked politically unattractive given the electorate's mood).

The government's objective is not being met because the banks are continuing to reduce their exposure to real estate (instead of increasing loans to consumers and businesses), and savings, in the form of debt reduction rather than cash reserves, are climbing (from zero to 3 percent of GDP). Debt repayment shrinks disposable income in the same way as hoarders who avoid spending on goods and services. Why would banks lend more under these conditions, when one-third of U.S. homes are experiencing negative equity and the U.S. economy is shrinking as a result of debt deflation?

Fed Chairman Ben Bernanke proposes to solve this problem by injecting another $1 trillion of liquidity over the coming year, on top of $2 trillion in new Federal Reserve credit created in 2009–10 that was sent mainly to the BRICs (Brazil, Russia, India, and China). "Recent research at the International Monetary Fund has shown conclusively that G4 monetary easing has in the past transferred itself almost completely to the emerging economies . . . since 1995, the stance of monetary policy in Asia has been almost entirely determined by the monetary stance of the G4—the US, eurozone, Japan and China—led by the Fed" (Davies 2010). According to the IMF, "Equity prices in Asia and Latin America generally rise when excess liquidity is transferred from the G4 to the emerging economies." This has led to a surge in gold prices and a move out of the dollar by investors since early September, prompting other nations to protect their economies.

Speculative credit from U.S., Japanese, and British banks to buy bonds, stocks, and currencies in the BRIC and Third World countries is a self-feeding expansion that pushes currencies, as well as asset prices, up. The central banks are left with dollars of falling value, as measured against the local currencies. U.S. officials claim that this is all part of the free market. "It is not good for the world for the burden of solving this broader problem . . . to rest on the shoulders of the United States," insisted Treasury Secretary Geithner on October 6 (quoted in Beattie 2010), as if the spillover from U.S. quantitative easing and deregulation was not promoting the speculative dollar glut.

So other countries are obliged to solve the problem on their own. Japan is holding its exchange rate down by selling yen and buying U.S. Treasury bonds in the face of unwinding its carry trade (as arbitrageurs pay back borrowed yen used to buy higher-yielding, but increasingly risky, sovereign debt from countries such as Greece). These paybacks have pushed up the yen's exchange rate against the dollar by 12 percent so far this year, prompting Bank of Japan Governor Masaaki Shirakawa to announce on October 5 that Japan had "no choice" but to "spend 5 trillion yen ($60 billion) to buy government bonds, corporate IOUs, real-estate investment trust funds and exchange-traded funds—the latter two a departure from past practice" (Fujikawa and Wessel 2010).

This "sterilization" of unwanted inflows by China has been criticized by the United States. China has tried to recycle its trade surplus in more normal ways by seeking out U.S. companies to buy. But Congress did not let the China National Offshore Oil Corporation acquire U.S. oil refinery capacity a few years ago, and now the Government of Canada is being pressured to block China's attempt to purchase potash resources. Such protectionism leaves China few options other than stabilizing currencies by purchasing U.S. and European government bonds.

The problem is that the global financial system, as presently structured, rewards speculation and makes it difficult for central banks to maintain stability without recycling dollar inflows to the U.S. government, which enjoys a near monopoly in providing reserves by running budget and balance-of-payment deficits. In the case of Brazil, the arbitrageurs' gain (as noted earlier) is twofold: the margin between Brazil's 12 percent yield on its long-term government bonds and the cost of U.S. credit (1 percent), *plus* the foreign-exchange gain as the demand for *reals*, pushed its exchange rate against the dollar up by some 30 percent—from R$2.50 at the start of 2009 to R$1.75 as of October 2010. Taking into account the ability to leverage $1 million of one's own equity investment to buy $100 million in foreign securities, the rate of return is 3,000 percent.

Brazil has been more a victim than a beneficiary of "capital inflows," as the appreciation of the *real* has eroded the competitiveness of Brazilian exports. To deter the currency's rise, the government imposed a 4 percent tax on foreign purchases

of bonds on October 4. “It’s not only a currency war,” Finance Minister Guido Mantega explained. “It tends to become a trade war and this is our concern” (quoted in Wheatley 2010). Thailand’s central bank director, Wongwatoo Potirat, warned that his country was considering similar taxes and currency trade restrictions to stem the baht’s rise. Subir Gokarn, deputy governor of the Reserve Bank of India, announced that his country was also reviewing defenses against the “potential threat” of capital inflows (Beattie, Chaffin, and Brown 2010).

Such “capital inflows” do not provide capital for tangible investment. Rather, they are predatory, causing currency fluctuations that disrupt trade patterns and create enormous profits for large financial institutions and their customers. Yet most pundits treat the balance of payments and exchange rates as if they were determined purely by commodity trades and “purchasing power parity,” as opposed to financial flows and military spending that dominate the balance of payments. The reality is that this financial interregnum—anarchic “free” markets prior to the initiation of monetary defenses—provides the arbitrage opportunity of the century. This is what bank lobbyists have been pressing for, and it has little to do with the welfare of workers.

The largest speculative prize promises to be an upward revaluation of China’s renminbi. The U.S. House Ways and Means Committee is demanding that China raise its exchange rate by 20 percent, as suggested by the Fed and Treasury. An upward revaluation of this magnitude would enable speculators to put 1 percent equity down—say, $1 million to borrow $99 million—and buy Chinese renminbi forward, for a 2,000 percent profit ($20 million). And banks can trade on much larger, nearly infinitely leveraged margins that mirror CDO (collateralized debt obligation) swaps and other derivative plays.

This kind of profit has been made by speculating on Brazilian, Indian, Chinese, and other national securities in response to a credit flight from the dollar, which has fallen 7 percent against a basket of currencies since early September, when the Fed floated the prospect of quantitative easing. During the week leading up to the IMF meetings in Washington, the Thai baht and Indian rupee soared in the anticipation that the United States and Britain would block any attempts to change the global financial system or curb the (disruptive) gambling on currencies.

As the Fed intended, capital outflow from the United States has indeed helped domestic banks rebuild their balance sheets. But in the process, the global financial system has been victimized. U.S. attempts to blame China for running a trade surplus were countered by Chinese officials’ remarks that U.S. financial aggression “risked bringing mutual destruction upon the great economic powers” (Beattie 2010).

From the gold-exchange standard to the Treasury-bill standard to “free credit” anarchy

Indeed, the standoff between the United States and other countries at the IMF meetings could result in the most serious rupture since the breakdown of the London Monetary and Economic Conference in 1933. The global financial system threatens to break apart once again, deranging trade and investment relationships, or taking a new form that could isolate the United States, along with its structural, long-term balance-of-payments deficit.

This crisis provides an opportunity—indeed, a need—to step back and review the *longue durée* of international-financial evolution to see where past trends are leading and what paths need to be retracked. For many centuries, nations settled their balance of payments in gold or silver. In 1767, Sir James Steuart called gold the “money of the world,” and it was the basis of domestic currencies. U.S. Federal Reserve notes were backed 25 percent by gold, valued at $35 an ounce, until 1971. To increase their money supply and facilitate general economic expansion, countries had to obtain gold by running trade and payment surpluses. When they ran trade deficits or undertook military campaigns, the central banks restricted the supply of domestic credit in order to raise interest rates and attract foreign investment. In addition, the banks would slash government spending, raise taxes on consumers, and slow the domestic economy in order to reduce imports. The international financial system operated fairly smoothly with the checks and balances of this system, albeit under “stop-go” policies when business expansions led to trade and payment deficits.

War spending destabilized this system; for example, such transactions spanning the two world wars enabled the United States to accumulate approximately 80 percent of the world’s monetary gold by 1950, making the dollar a virtual proxy for gold. But after the Korean War broke out, U.S. military spending accounted for the entire payments deficit during the 1950s, ’60s, and early ’70s, while private sector trade and investment were exactly in balance.

By August 1971, war spending in Vietnam and other countries forced the United States to suspend the dollar-gold fix (via the London Gold Pool). The central banks continued to settle their payments balances with U.S. Treasury securities, since no other asset was in sufficient supply to form the basis for monetary reserves. But replacing gold—a pure asset—with dollar-denominated Treasury debt transformed the global financial system from one that was asset-based to one that is debt-based. Geopolitically, the T-bill standard made the United States immune from traditional balance-of-payment and financial constraints, enabling U.S. capital markets to become highly debt-leveraged and "innovative." The T-bill standard also enabled the U.S. government to wage foreign policy and military campaigns without much regard for its balance of payments.

The problem is that the supply of dollar credits has become potentially infinite. The "dollar glut" has grown in proportion to the U.S. payments deficit. Growth in central bank reserves and sovereign funds has taken the form of recycling dollar inflows into Treasury securities, thereby making foreign central banks (and taxpayers) responsible for financing most of the U.S. federal budget deficit. The fact that this deficit is largely military in nature is particularly galling to many foreign taxpayers, so it is hardly a surprise that foreign governments are seeking an alternative arrangement.

Contrary to most public-media posturing, the U.S. payments deficit (and hence, other countries' payment surpluses) is not primarily a trade deficit. Foreign military spending has accelerated despite the dissolution of the Soviet Union and the end of the Cold War in 1991. But rising capital outflows from the United States are even more important than rising military spending. U.S. banks lent to Third World and other countries (to cover payment deficits), U.S. private borrowers (who bought foreign infrastructure, stocks, and bonds), and arbitrageurs.

The corollary is that balance-of-payment surpluses do not stem primarily from trade relations but from financial speculation and the spillover of U.S. military spending. Under these conditions, the maneuvering of banks and their (arbitrage) customers in pursuit of quick returns is distorting international exchange rates. "Quantitative easing" is perceived as a euphemism for a predatory financial attack by the United States on the rest of the world. Trade and currency stability are part of the "collateral damage" caused by the Fed and Treasury when they flooded the U.S. economy with liquidity to reinflate asset prices and "save" the banks from negative equity. In response, other countries are obliged to act as "currency manipulators" because financial speculation is destroying their "real" economies.

The coming capital controls

The global financial system is breaking as U.S. monetary officials alter the rules laid down a half century ago. Prior to abandoning the gold standard in 1971, nobody dreamed that a sovereign economy could create unlimited credit using computers and not expect its currency to plunge, but this happened under the T-bill standard. In order to prevent currencies from rising against the dollar, foreign countries can only (1) recycle dollar inflows into U.S. Treasury securities, (2) impose capital controls, or (3) avoid the dollar or any other currency used by financial speculators associated with economies that promote "quantitative easing."

Malaysia used capital controls during the 1997 Asian crisis to prevent short-sellers from covering their bets. This short-squeeze response created a loss for speculators such as George Soros. Now countries are trying to impose capital controls and protect themselves from the tsunami of credit that is being used to buy up their assets, including gold and other commodities that have become vehicles for speculation rather than actual production. Brazil took a modest step along this path recently when it used tax policy rather than outright capital controls to tax foreign buyers of Brazilian bonds.

If other nations take a similar path, they will reverse the policy of open and unprotected capital markets adopted after World War II. This trend threatens to lead to the kind of international monetary practice of the 1930s, '40s, and '50s: dual exchange rates, one for financial movements and another for trade. It probably means replacing the IMF, World Bank, and World Trade Organization with a new set of institutions with reduced representations from the United States, Britain, and the eurozone.

To defend itself, the IMF is proposing to act as a "central bank" by creating what in the late 1960s was called "paper gold"; that is, artificial credit in the form of special drawing rights. However, other countries have complained that voting control would still be dominated by the major promoters of arbitrage speculation (i.e., the United States, Britain, and the eurozone). Moreover, the IMF's Articles of Agreement prevent countries from protecting themselves, since that would "interfere" with "open capital markets." So the impasse in Washington appears

to be permanent. "There is only one obstacle," said a frustrated Strauss-Kahn, "which is the agreement of the members" (quoted in Giles and Beattie 2010). He added: "The language is ineffective."

Paul Martin, the former Canadian prime minister who helped create the G20 after the 1997–98 Asian financial crisis, noted that "the big powers were largely immune to being named and shamed." And in a *Financial Times* interview, Pravin Gordhan, the South African finance minister, said: "You have a burst pipe behind the wall and the water is coming out. You have to fix the pipe, not just patch the wall" (Beattie and Giles 2010).

In response, the BRIC countries are simply creating their own parallel system. In September, China supported a Russian proposal to start direct trading between the yuan and the ruble, and brokered a similar deal with Brazil. And on the eve of the IMF meetings in Washington, Premier Wen met with Turkish Prime Minister Recep Tayyip Erdogan in Istanbul, where they agreed to use their own currencies to triple Turkish-Chinese trade over the next five years—effectively excluding the U.S. dollar. "We are forming an economic strategic partnership," Erdogan said. "In all of our relations, we have agreed to use the lira and yuan" (quoted in Parkinson 2010).

The global financial breakdown is part of the price to be paid for the refusal of the Fed and Treasury to accept a prime axiom of banking: debts that cannot be paid, won't be. These U.S. government agencies tried to "save" the banking system from debt writedowns by keeping the debt overhead in place, while reinflating asset prices. In the face of the repayment burden that is shrinking the U.S. economy, the Fed's way of helping the banks "earn their way out of negative equity" actually provided opportunities for predatory finance, which led to excessive financial speculation. It is understandable that countries whose economies have been targeted by global speculators are seeking alternative arrangements. But it appears that these arrangements cannot be achieved via the IMF or any other international forum in ways that U.S. financial strategists will accept willingly.

Notes

1. Dirk Bezemer and Geoffrey Gardiner (2010) make clear that quantitative easing "provides bank customers, not banks, with loanable funds. Central Banks can supply commercial banks with liquidity that facilitates interbank payments and payments by customers and banks to the government, but what banks lend is their own debt, not that of the central bank. Whether the funds are lent for useful purposes will depend, not on the adequacy of the supply of fund, but on whether the environment is encouraging to real investment."
2. Edwin Truman, quoted in Lauricella 2010. Truman, a former U.S. Treasury official, is now a senior fellow at the Peterson Institute for International Economics.

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