Beyond North and South: The Second Coming of the World Economy

Jeremiah Novak

The world economy and international economic institutions are in trouble. That, at least, is the opinion in informed circles following the Conference on International Economic Cooperation (CIEC) held in Paris last spring. There is a growing realization that CIEC failed to grapple with the systemic problems the world economy faces, a failure that threatens developing and developed countries alike.

Despite Secretary of State Cyrus Vance's dramatic call for a "new international economic system," the Paris conference failed to address systemic issues. Instead, the developed nations of the North angled for a separation of the issues of energy from those of development; and the developing countries of the South closed ranks by linking the two. Consequently neither side truly debated the crushing problems of the world economy.

A number of issues that should have been settled at Paris, at least in principle, still remain: the slow recovery in the West; the increasing fragility of private international banks and the need to strengthen international institutions such as the International Monetary Fund; growing protectionism and increased use of exchange rates as a means of exporting both inflation and unemployment; a failure to examine the linkages between economic development and prosperity in the West; the incorporation of Eastern Europe and China into the world economy as full partners; and the structural problems related to the balance of payments surpluses of the newly rich OPEC nations.

Each of these fundamental or systemic issues is yet to be addressed. As a result many analysts regard the failure of CIEC to reach even a general agreement of principles on these issues, despite eighteen months of negotiations, as a distinct danger to the world economy. Throughout the autumn of 1977 the debate over these unanswered issues intensified. It is worth examining the full spectrum of perspectives in this debate before seeking signs of possible solution.

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In a remarkable speech presented to the U.S. senate on June 16 Senator Jacob Javits of New York, who had attended the CIEC conference, set the tone for many people who understand that behind the North-South confrontations in Paris was a deep concern about systemic relations. Javits said in "CIEC and the Spectre of the West": "I want to sound a note of alarm about the state of the international monetary system and the strains on that system which threaten the world with a deeper recession than 1974 or a full-scale depression in 1978-80."

To Javits more was at stake at CIEC than simple rhetorical demands by the Third World. In the senator's view what was important were basic issues that affect the prosperity of both North and South.

> To be sure it is self-interest which prompted the call for the new international economic order by the Third World. However, I have concluded that it is in our self-interest to take this call seriously, and also to look pragmatically at the state of the international monetary system, which has been in a state of disrepair since the breakdown of the Bretton Woods arrangement in 1971, and especially since the drastic OPEC price increases. I submit that if we do not do this, the recession or depression we are likely to experience will be brought about by many of the issues which are important to members of the developing world.

Noting that the issues being raised were not "irrational," Javits—who often voices the concern of major banks in New York—decried the "abyss of difference" between the North and South negotiators around such issues as trade, resource transfers, Third World debts, technological transfers, and commodity pricing. While recognizing that the Third World failed to make significant concessions in return for their demands, Javits said that four lessons had been learned at CIEC.

The *first* is that the Third World's dissatisfaction is deep and will not be eliminated either easily or quickly. The *second* is that Third World dissatisfaction has some

basis in reality, and that "we need to identify the real issues which in the final analysis threaten both the developed and developing world." *Third*, the Third World must place greater emphasis on self-help. And *fourth*, the Third World must clearly realize the contribution that private investment can make to development.

The lessons are not new. But the clear thrust of the senator's remarks delineates the linkages between the malfunctioning of the current monetary system and the present crisis and the need to focus on how our own prosperity depends on the stability and growth of developing world economies.

In an interview Javits spent a great deal of time on these linkages. He stressed that since the collapse of the world monetary system in 1971, when the system of stable exchange rates broke down, the world monetary system has undergone a period of vast structural changes in the way balance of payments surpluses must be financed. Prior to 1971 stable exchange rates placed maximum stress on financial discipline within nations and required international discussion before changes in exchange rates. Since March, 1973, the rates are "floating rates," not subject to control by the International Monetary Fund. Consequently some nations, such as Japan, have been accused of manipulating their exchange rates and of practicing beggar-thy-neighbor policies.

As a result of the breakdown in the system the IMF possessed neither the right nor the means to establish international surveillance over floating exchange rates. And this has led to an uncertain picture for world trade. Although in January, 1976, the IMF obtained the power to monitor exchange rates, by then the total structure of the world monetary system had changed and IMF power to influence events had diminished. What had happened between 1973 and 1976 was that the OPEC oil crisis had imposed a major tax on the world. Funds generated by this tax could not be cycled through the IMF because the institution had not been able to act as an intermediary in the crucial years of 1973-77. Instead, the private multinational banks filled the gap.

The role of the banks changed dramatically. They found themselves financing balance of payments deficits on an unprecedented scale. This new job was quite different from their original task of supplying credit to private investors. They soon found that in financing balance of payments deficits they were doing the job the IMF had been designed to do, but without the power the IMF once had. In effect the private banks filled a vacuum that the 1971-73 crisis made the IMF incapable of filling.

Today nearly 30 per cent of all external debt owed by nonoil-producing countries is financed by international banks, compared to less than 10 per cent in 1968. Official IMF-World Bank financing of Third World debts has *decreased* from 70 per cent in 1968 to 55 per cent today. This shift in the financing burden reflects the increased role of banks and the decreased role of the IMF in financing debt. As a result the prosperity of the banks, which have loaned $52 billion for balance of payments purposes, is now intimately tied to the growth and development of the poor nations.

Four aspects of this situation have caused concern in recent months. The first is that the banks and the IMF have often worked at cross purposes and often in ignorance of each other's policies. Under current rules the IMF is not allowed to share information with private banks about the financial condition of nations. As a result some loans have been made by the banks that the IMF would have denied.

Second, much of the money deposited in banks by oil countries is provided in short-term deposits. The banks in turn must lend this money at long-term, thus exposing themselves to the dangers of sudden withdrawals. Third, much, if not all, of the money is deposited in so-called Eurocurrency accounts or Eurobanks that operate outside the regulatory provinces of any national government. In the event of default the banks have no international regulation or even international reserve bank to step in and protect their interests.

Last, it is estimated that Third World countries (and the less rich among the industrialized nations—especially Spain, Italy, Turkey, and Greece) will continue to borrow large amounts of money from private banks. These loans have shorter maturities than IMF loans and higher interest rates, and many will come due in 1978-79, thus creating the need for increased financing if the system is not to be wracked by defaults.

Senator Javits believes the United States and our leading allies must totally revise the current IMF system, that the IMF needs greater funding to take the load off the private banks, and greater control over the system of exchange rates. He also believes the IMF should share data with the private banks so as to prevent the IMF and the banks from working at cross purposes. Finally, Javits believes there can be no long-term solution to the problem of increasing Third World debt unless efforts are made to help the Third World nations grow more rapidly so that they can pay the debts. Believing there is a link between Third World prosperity and the survival of the current international monetary system, Javits maintains that "we must do more to help them [developing nations] increase their earning power."

Similar sentiments are being expressed elsewhere. In August the Senate Foreign Relations Subcommittee on International Economics issued a report on Third World debt. Prepared under the leadership of Senator Frank Church, the report emphasized the exposed position of the banks and the need for action. It concluded: "The system has so far managed to cope with the shock administered by the OPEC cartel in 1973...due in large measure to the enormous lending power developed by the large multinational banks in the past 12 years which enabled them to play the leading role in recycling petrodollars...." But it also said that while the world is coping with the vast financial disequilibrium caused by OPEC, "this does not mean that it is coping with the ultimate economic, political and social consequences...which are only now being felt."

Members of the business press have also worried publicly about the present international economic system. Irving Kristol and Jude Winiewski of the *Wall Street Journal* and analysts at *Business Week*, for example, have issued warnings. Kristol noted at the end of the

first eight months of the Carter administration that it had enjoyed a tranquil period, untroubled by either a foreign or an economic crisis. Maintaining that the first such impending crisis would be economic, he added that his economist friends were less likely to dismiss his pessimism than they had been a few months earlier. "But they are still talking of a moderate slowdown in the rate of growth....The stock market suggests, however, that in the months ahead the prospect of calamity will become more real to them. By calamity I mean a worldwide economic recession—or worse."

Kristol asserted that the Carter administration is unable to see clearly that business is suffering from ten years of flat profitability, and that much of the Carter legislation, including the Energy and Social Security bills, are threatening to destroy business through higher taxes.

> It has taken extraordinary efforts by business to even achieve and maintain this level of profitability. By now the golden goose may well be too exhausted to continue its desperate fight for survival. And if the American economy staggers, the world economy would come close to collapse. International trade and investment...will dry up. Protectionism will become rampant. Many of the poorer countries will demand a moratorium on their debts. Bankers will become even more nervous than they are.

Winiewski said much the same thing recently: "Current theory deprives business of the freedom it needs. Business needs a free hand to develop and grow, both in the industrial countries in the West and in the developing countries."

Criticizing the IMF and its policies in a hard-hitting editorial, Winiewski said the IMF and its past policies encouraged the poor nations to borrow heavily beyond their means, largely from private banks. When the poor countries have trouble paying, he wrote, the IMF and bankers recommend "austerity" programs that in the end raise taxes and stifle private enterprise. Now that the banks are overexposed Winiewski believes that the banks (and Senator Javits) are calling for the U.S. taxpayer to bail them out through government contributions. He calls on the IMF to change its austerity measures and help developing countries by suggesting that they lower taxes and government expenditure and free private markets.

Both Kristol and Winiewski see a deep-seated systemic problem in the policy of the government and, in turn, of the IMF. Both believe that new markets must be opened up to prevent a world recession—and that without such steps there can be no real hope for the recovery so vitally needed. As Winiewski said, "CIEC didn't even address this issue."

Taking another tack, *Business Week* supplied its own gloomy assessment. It pointed out the following:

- The world economy, while increasingly fragmented, is in serious trouble.
- Germany and Japan, while committed to new economic stimulation, may provide very little.
- The U.S. economy is slowing down.
- World trade is slowing down from 11.5 per cent growth last year to 6 per cent in 1977, and only 5 per cent is projected for 1978.
- The world economy of floating rates—all world currencies were set afloat in 1973—worked well during the oil crisis; it no longer works in a recession-threatened world.

The systemic problems facing the world economy hung like a pall over the subdued and workmanlike IMF-World Bank meeting late last September. The general malaise in the world economy permeated the comments by representatives from both North and South. The IMF report issued before the meeting soberly discussed the lower-than-expected growth in the industrial world, the debt burden of the poor nations, growing protectionism, and the situation in exchange rates. Perhaps the most pointed remarks were made by Robert S. McNamara, president of the World Bank, who stated in his opening address:

> And yet beneath this immediate and short-term approvement in the global development scene—and practically obscured by it, lies a profound and troubling problem.
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> It is this:
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> A certain restive and uneasy interlude has followed on the international community's unsuccessful efforts to reach fundamental agreements....
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> The Seventh Special Session of the U.N. General Assembly, the UNCTAD IV meeting in Nairobi, the protracted North-South Dialogue have all come and gone.
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> And yet urgent issues remain largely unresolved....
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> It is evident that neither the developed nor developing countries are really satisfied with the outcome....
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> It is not a promising climate in which to achieve what is needed most of all: a basic understanding of development issues and how to solve them.

McNamara summarized the mood of the conference. He reiterated the call for a commission of leaders under the chairmanship of Willy Brandt to help resolve the impasse. The commission, he said, would be empowered to explore the cost and benefits, "the linkages" that exist between the welfare of the poor nations and the prosperity of the rich nations.

These voices raised in concert among a wide spectrum of observers—liberal and conservative, moderate and thoughtful—must be heeded. Essentially their conclusion is that the current international economic system needs at least to be reformed, if not restructured; that the new system must take into account the interdependence of rich and poor nations —must recognize that the problems of development must be solved if the recession in the West is to be abated. What they all understand is that the crux of any international economic reform hinges on dealing with the bonds that tie together the IMF, the World Bank,

GATT, and private multinational businesses. For these institutions and the financial apparatus of national governments represent the institutional matrix of the system.

It is doubtful that any American government in recent history has entered Washington as fully aware of these linkages as the Carter administration. Congressman Henry Reuss, chairman of the House Banking Committee, has said that "these are the most qualified men I've ever seen in the area of international finance."

Most thoughtful Americans are already aware that Jimmy Carter, Walter Mondale, Cyrus Vance, Zbigniew Brzezinski, and Michael Blumenthal were members of the prestigious Trilateral Commission that since 1973 has studied the international economy. What is not generally known is that there are other "Trilateralists" in the government, including Charles Schultz, chief economic advisor; Undersecretaries of State and Treasury Richard Cooper and Anthony Solomon; Assistant Secretaries of State Stephen Bosworth and Paul Boeker; Assistant Secretary of the Treasury C. Fred Bergsten; and trade negotiator Robert Strauss. Together these men comprise one of the most potent groups of thinkers and international economists ever assembled in Washington. Far from being unaware of the international economic issues at stake, they are out in front in many respects.

It was the thinking and planning of this group that inspired Secretary of State Vance's opening remarks at the Paris conference last May, when he said dramatically:

> At this meeting and at this moment I want the policy of this administration to be understood. There should be a new international system. In that system there must be equity; there must be growth; but above all, there must be justice. We are prepared to build that system.

Much of the program is already being discussed on a piecemeal basis. For example, the administration has called on the Soviet Union to take up its share of the burden in reconstructing the system. Robert Strauss is seeking a vast tariff reduction and more open trade. Anthony Solomon and Michael Blumenthal not only have called for the IMF and the international banks to share their resources and expertise but have been instrumental in helping to create the Witteveen Facility that gives the IMF new financial muscle and to increase IMF powers over "dirty" exchange rate policies.

Richard Cooper, perhaps the brightest economist in international affairs, has worked diligently to educate Congress and the public in the need for a new international system. His article, "A New International Economic Order for Mutual Gain," in the spring issue of *Foreign Policy*, will be seen in retrospect as a major turning point in U.S. thinking. And Ed Fried, a Carter-appointed director of the World Bank, who has proposed creation of a new world-development budget as part of the new World Development Report of the World Bank, wrote in a staff memo last spring that there are indeed linkages between Third World development and Western prosperity:

> Mounting debt (in the Third World) could soon threaten the continued flow of capital, with consequences coming close to a catastrophe for developing countries and private (multinational) institutions.
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> The only real solution is more rapid economic growth in the poor countries. In the meantime, much larger governmental lending (IMF, World Bank, OPEC oil credits, and other bilateral official loans) on sufficiently long term will be needed to place the developing countries in a credit worthy position, and thus avoid a disruptive curtailment in the flow of private capital.

Fried echoes the position of Richard Cooper. In testimony last March before the Senate Foreign Relations Committee relative to Third World debt, Cooper stressed the need for greater resource transfers through aid, through the World Bank, and through a recognition of the need to address the commodity issues raised by the Third World. In August Cooper told the Senate Subcommittee on International Finance that there is a "confluence of interests between debtors and creditors."

As to the creation of a new international system, Cooper and Ed Fried believe that there are political obstacles. "There is no consensus on what the new system will look like," Cooper points out. And Fried says that "many Americans are not aware that a new system is even needed." Cooper admits that, unlike Bretton Woods in 1944, when the postwar economic system was created, the United States cannot today impose its will. "We must work in concert with our major allies and with the Third World," he says. "Our ability to move quickly depends on them."

As a result the administration has taken a piecemeal approach, obtaining agreements whenever possible on aid, trade, commodities, and reform of international institutions. As one State Department aide declared: "If you add up the pieces you will see they form a mosaic." He referred to the fact that the administration has a vision of a new system but prefers to obtain agreement on substantial issues instead of announcing a grand design.

Senator Javits, on the other hand, feels that piecemealism offers too little, too late. "We need a bold voice to spell out reform. If the United States sets its policy clearly, others will follow." He does not doubt, however, that the administration is aware of the need for a new system.

Why the administration feels politically unable to lay out its card on the table for a new international system and take a leadership stance becomes clear in the report issued by Senators Abraham Ribicoff and Javits and Congressman Jonathan Bingham. The three authors had attended the CIEC as well as UNCTAD IV conferences, and they provided the Senate and House with their findings. What occurred, according to the report, was a rhetorical battle between rich and poor over "reform" versus "restructuring"—a definitional controversy. "It is time to put aside the question of when restructuring becomes a new order," the report said, "and deal with the real issues."