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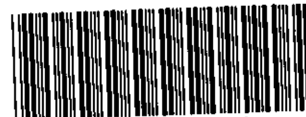
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FINANCE, CAPITAL MOBILITY AND MACROECONOMIC POLICY AFTER THE GOLDEN AGE

A CONVERSATION WITH GERALD EPSTEIN

Ian Bell

Money is a crucial power resource in the world political economy. Any monetary or financial regime fuses particular configurations of both collective and distributive power. Given the intimate relationship between money and power, the historical interpretation of monetary regimes is a matter of contestation in social analysis. Economic liberals are fond of the 19th century, especially the gold standard and the high levels of trade and capital market integration it facilitated in the latter part of the century and the years to 1914. They often term it the "Belle Epoque" or "Golden Age". They also stress the "automaticity" of the gold standard while neglecting the role of state power, and class and ideological struggles in its operation (Epstein 1989; Eichengreen 1990). Economic liberals remain divided, however, on the merits of fixed exchange-rate regimes and the overt state intervention in foreign exchange markets this entails. Many contend that floating is to be preferred for this allows private markets to set exchange-rates more efficiently (Campbell & Dougan 1986).

For elements of the political left, the interpretation of history is different. It is the Bretton Woods monetary system of fixed but flexible exchange-rates managed by active international institutions and the post-1945 Keynesian full employment regime they enabled which deserve the epithet "Golden Age" (Marglin & Schor 1990). As Gerald Epstein and James Crotty have noted, this was "the age of the 'social contract' or the capital-labour 'accord' (however, loaded in capital's favour these

arrangements might have been) under which the Keynesian state, with the acquiesence of capital, was to pursue full employment and build a stronger social safety network. Golden Age central banks fixed exchange rates and determined interest rates with only sporadic interference from a relatively small class of financial speculators" (Crotty & Epstein 1996:118).

It is now almost three decades since this "Golden Age" began to fail. A central feature of the new era of intensified liberalism has been the resurrection of floating exchange rates and successive rounds of financial liberalization which have given private finance space to grow exponentially once again. In 1995 the daily turnover in the foreign exchange markets was approximately $U.S.1.3 trillion, an amount perhaps sixty times the volume needed to finance trade (Crotty & Epstein 1996:132). At the end of 1997, the International Monetary Fund (I.M.F.) estimated that over $U.S.100 billion were available for short-term speculation, and these funds could be leveraged several times over. The exponential growth of private finance has enhanced the structural power of business enormously. In the case of national-level state elites, it is now commonplace to note that capital mobility leads to a trade-off between exchange-rate stability and monetary independence because monetary policy operates primarily via the exchange rate. A government can only ensure currency stability by giving up its principal instrument of monetary policy (Frieden 1994:83). To restore state capacities in the monetary sphere there has been an extensive debate over the desirability of, and scope for, policy coordination (Feldstein 1988; Cohen, 1993).

The wider politico-economic effects of accelerating capital mobility, however, run much deeper and have been largely neglected in current debates. Apart from central questions about the inherent stability of the new regime which have gained new force in the wake of the 1997-98 East Asian crisis, issues arise as to the policy and ideological priorities of private finance, the impact on long-term investment and innovation, the relationship between the real and financial sectors, the impact on state institutions, especially central banks, as well as the effects on electoral, coalitional, movement and class politics. For all these reasons new interpretations of the reorganising role of private finance in the contemporary world political economy are called for.

Gerald Epstein, professor of economics at the University of Massachusetts - Amherst, is a leading scholar in the political economy of money and finance. In April this year he recorded an interview for the radio series "After the Golden Age: the new capitalism in question" first broadcast on A.B.C. Radio National's "Saturday Eye" program in May. What follows is an edited version of that interview.

IB: Do you think the rise in economic integration has exacerbated the impact of exchange rates on economies?

GE: One would have expected so but economists are finding it difficult to pin down the increased impact of exchange-rate changes on the economy empirically. I think the main reason is that the private markets have really adjusted to exchange-rate fluctuations to some extent. There has been an increase in all kinds of financial instruments, hedging instruments and so on, which have allowed markets and exporters and importers to reduce the impacts on their businesses and profits. So the impacts of short-term fluctuations on economies are not as great as many economists expected. But the long-run impact of the misalignment of exchange-rates, that is, exchange rates that are undervalued or overvalued for quite a long period of time, has been shown to have quite significant effects on the competitiveness of economies, and on the sectoral structure of the economies - for example, manufacturing versus services. So it's the long-run impact most economists are concerned about.

IB: Given the nature of private financial markets, and the difficulties of the real sector in adjusting to financial changes, is the system more prone to sustained misalignments now?

GE: Yes, I think the system is more vulnerable now to sustained misalignments, as well as very intense short-term crises, than it has been for quite awhile. If you go back to the gold standard period of the nineteenth century, exchange-rates were fixed among the major industrialised economies, Britain and the United States, France and Germany as well as a number of countries on the periphery including your own, so in that situation it was much more difficult for exchange rates to get misaligned because nominal exchange rates by the gold standard and the prices of goods and wages were relatively flexible, so

they could adjust up or down to maintain competitiveness. In the 1920s and 1930s, there were floating exchange-rates and massive short-term capital flows, and that period is similar to the one that we have now where you can get quite serious misalignments for a very long period of time. The Bretton Woods system was somewhat in-between. You had stable exchange rates for quite long periods of time but then over a period of five or ten years, you could get quite serious misalignments as well.

IB: How would you summarise the effects of the move to floating in the early 1970s on the two key sets of actors involved: national governments and private finance?

GE: Well, it's hard to analyse the move to floating exchange-rates separate from the massive increases in short-term international capital. The move to floating exchange-rates in combination with the massive increases in short-term capital mobility has made governments much less in control of their own destinies. They have to pay much more attention, as they did in the 1920s and 1930s, to maintaining the "confidence" of short-term capital. If the financial markets start to lose confidence in the government's policies, they think the government might be running too large a budget deficit or its monetary policy may be too inflationary, then capital flight might get very large, very quickly and force the government to engage in excessive depreciation of their currency or turn around and tighten monetary policy and raise interest rates dramatically, all of which could have a negative impact on their economies. So the move to floating exchange-rates, in combination with rapid capital mobility has really constrained the sovereignty of most nations. Of course, this is more so for smaller, more open economies than for larger economies like the United States, which still have a fair degree of autonomy.

What these developments have done for finance is create enormous profit-making opportunities. Finance has been able to innovate and generate all kinds of new financial instruments like derivatives from which they have been able to make a great deal of profit. At the same time, finance has been able to speculate against currencies, betting on ups and downs, and been able to make a profit that way. So the move to floating exchange rates has been quite a boon to finance on the whole.

IB: Finance has always had considerable influence over governments through stock markets and bond markets. What are the new mechanisms which floating opens up for finance to influence government policies?

GE:- Well, interestingly, heretofore there has been quite a range of financial structures in different economies. For some what you say is true. For the United States, the United Kingdom and other countries that have had very large stock and bond markets, finance has always had influence. But for other countries, Germany for example, and other less developed countries where stock and bond markets have not been very large, finance traditionally has had much less impact. Now with the movement towards international capital mobility, and many countries integrating themselves into the world economy, that has created an avenue by which finance can influence governments, even those that did not have large capital markets before. The main way in which international finance influences and constrains governments is by affecting the exchange-rate and, with it being such an important price, it gives finance quite a big lever to influence government policy.

IB: Would you say that national governments have lost the battle to control financial markets, especially in relation to exchange rates?

GE: I would say that governments have given up the battle. It would be one thing if governments on the whole had decided, individually or together, to fight this battle at all costs but that has not been the case. I think governments have decided that this is not a battle they want to fight for the most part, and I think the reasons are many. One of the most important is the increased political power of finance in many parts of the world. This political power has both a real and material component, and it also has an ideological component. The real and material component is that finance offers a very large, very profitable sector to many economies, that generates a fair amount of employment in many cases, creates a lot of wealth and money which finance can use to contribute to politicians to get their support for liberalisation. All of these factors, in addition to the indirect one, where finance can veto a government's policy through an act of no-confidence through capital flight, has meant that governments have decided not to fight the battle.

The ideological component though is equally important, I think, or almost as important. Finance, and economists have played a big role in this as well, has convinced governments and other policy-makers that a free market in finance is for the best. The invisible hand, as Adam Smith put it, by which the market allocates resources in the area of international finance is the way to achieve maximum welfare for everybody. Through this ideological war, governments have not only decided it's too costly to rein in finance but many of them have believed that it's simply the wrong thing to do.

IB: Do you think that private international finance can be identified with a particular economic orthodoxy; that is, one which is zero inflationary and even deflationary in character?

GE: Most orthodox finance is very afraid of uncertainty with regard to inflation, the reason being that if they make a bet on a currency or a long-term security, the price of which fluctuates with movements in interest rates, then surprises, inflation surprises, can make them lose money. An increase in inflation over and above what they expected can lead to an increase in interest rates and a decline in the value of stocks or securities. So finance doesn't like those kind of surprises. As a result, for the most part, they would much prefer to have a very low and stable rate of inflation, and this makes them very afraid of government budget deficits. It makes them very afraid of democratically-controlled central banks that might make policy to reduce unemployment and lower interest rates. So in a sense, it makes them very conservative with regard to macroeconomic policy. There are exceptions. There are always financial people who have made a lot of money in the markets who see the danger of deflation. George Soros is one person who has argued against the dangers of deflation. But for the most part it's inflation that financiers are primarily concerned about.

IB: Would you say there is scope for a moderate, growth-oriented strategy that ran low to moderate inflation within the current system?

GE: Yes, particularly if it were led by the major industrialised economies. The smaller economies, unless they're willing to pay the costs of reining in private capital, have a much more difficult time pursuing an expansionary policy when the large economies - the United

States, Germany, and Japan - are pursuing a contractionary or less growth-oriented policy. If the larger economies are pursuing a policy of lower interest rates and more rapid economic growth that creates space for the smaller economies to lower their interest rates without fearing capital flight and to expand their exports to the larger, more rapidly growing economies. Through that kind of policy, a kind of locomotive strategy, which I know has a bad name but which is a sensible strategy, there is quite a bit of scope even with private finance to run a more expansionary policy on a global scale.

IB: Let's just return to the tools that are available to governments in their conflicts or potential conflicts with private international finance. Now the classic tools that come to mind are, on one hand, central bank intervention, especially coordinated central bank intervention in the short-run, and on the other, coordinated macroeconomic policy. Can you comment on those tools?

GE: Yes. Let's take central bank intervention first. There have been a lot of studies by economists, Jeff Frankel and others, about whether or not central bank intervention can be successful in stabilising exchange rates and allowing governments to pursue perhaps lower interest rate policies than they otherwise might be able to. Most of these studies show that the scope is rather limited; that is, if the major central banks do intervene in a coordinated fashion, they can manage exchange rates to some extent for a short period of time but it's very limited indeed. So that brings us to the second possibility, coordinated macroeconomic policy. As I said before, if the major economies do undertake a coordinated expansion, I think there is very little doubt, if it is of a responsible amount, that it can have a significant impact on not only those economies but on the smaller economies as well.

IB: You'd have to say that the history of coordinated macroeconomic policy through the G-7 summit process has been very mixed.

GE: Yes, in fact the successes have been quite limited. The example that people point to as successful was when they tried to talk down the dollar in 1985, that seemed to have worked quite well. But this has been, I think, more of a political than economic problem. States have different exchange-rate objectives. There's always going to be some conflict

between states over exchange-rates because exchange-rates affect competitiveness, and failure in the past has been primarily because of mercantilist conflicts. Now I think these kinds of conflicts could be reduced if there was an international institution with some clout that could twist the arms of these individual economies and help them overcome these collective action problems. So, for example, if the I.M.F. or some other international organisation had, as one of its major goals, the promotion of high employment policies, rather than the goal of financial liberalisation, and if the I.M.F. had some teeth, namely the availability of credit to pay good citizens, then I think it would be much more likely to overcome these collective action problems which have plagued these coordination efforts up until now.

The problem is that the international institutions we have don't have high employment as a primary goal. They'd rather have stable exchange rates and liberalised financial markets as primary goals. Employment is not really on their list of goals.

IB: Coordinated macroeconomic policy sounds like a good thing but, in fact, it's not surprising that it's difficult to pull off because there's so many different political, electoral and domestic coalitional interests which come into play.

GE: That's right. That's what I mean by political problems. So I'm afraid that we can't count on such coordinated policy in the absence of an international institution pushing it to solve these problems on a regular basis. We have to look elsewhere.

IB: Can we unpack those coalitional conflicts a little, because, with the rising power of finance within, as well as across, economies, it seems to be gaining more influence than manufacturing interests which might, for example, favour more expansionary policies?

GE: Well, that's a very good point. I think there has been a lot of discussion about whether or not there's really a distinction any more between finance and industry and whether, in fact, finance has gained the upper hand over industry itself. I think that is a very important point. If you look at the politics of the1950s and the1960s when high employment was a goal in many governments, what you saw was that finance had been discredited as a result of the disasters of the 1930s. The political

power of finance had been very strongly reined in as a result of those debacles of the 1930s. So what you saw more, I think, were coalitions between industry and labour, and in those coalitions they both had an interest in maintaining rapidly growing economies, high employment and the like. Now with finance gaining the upper hand, what you see is industry, even where it's more separate, joining forces with finance to a much greater extent, and labour has now been pushed aside as no longer even a coalition partner in many cases. As a result of that, I think you're correct to say that many governments don't have a large interest in promoting a high employment policy and therefore they're not even attempting to coordinate policy to allow them to do that.

IB: It is interesting that that shift in coalitions, towards a type of finance-industry complex if you like, is leading to changes in the structure of the state. For example, central bank independence and the financial arms of the state are being strengthened in their voice.

GE: That's correct. Independence of the central bank is one of the most important and most dramatic changes. Once again, let's look back to the future. If you look at the 1920s and the late nineteenth century, you saw independent central banks in many parts of the industrialised world: the Federal Reserve, the Bank of England and so forth. Then with the debacles of the 1930s, which were attributed by many to mistakes made by central banks, and mistakes made by "greedy finance", we saw a reining in of central banks. The Federal Reserve was put under the control of the government to a greater extent; the Bank of England, the same.

Now we're moving once again in the opposite direction. Finance is insisting that central banks be independent. Why? Because finance knows that when you have independent central banks, finance will have a much bigger say over central bank policy than they did when central banks were under the control of governments. Now central bank monetary policy is important to finance but equally important is regulatory policy. Now central banks have a very important say in regulatory policy, that is, how much control there is going to be over finance, and when you have an independent central bank, almost invariably, though there are exceptions, they'll take a relatively lax position with regard to most financial regulation. So I think that with the

move towards an independent central bank in Europe as part of the condition for joining the European Monetary Union, in less developed countries, in New Zealand and in many parts of the world, we're creating a monolithic voice where the central bank pipes up and says the same thing that finance has been saying. We're losing a diversity of voices in government.

IB: Well, simultaneously, we see a fragmenting in the power of labour and in fact the disappearance of an overt class politics.

GE: That's right. Partly that's because of the possibility of exit by corporations. Corporations can now threaten to leave either the province or the state or the entire country. They can threaten to leave and set up shop elsewhere and this, in combination with the other factors we've just been talking about, has silenced labour as an independent voice. In the United States, labour has a new political leadership which is finally trying to attack this head-on with the battle over NAFTA and the battle over the relationship of NAFTA to the rest of the hemisphere. Labour is standing up and saying no, we need to bring class back into politics and I think this is a hopeful sign. Luckily labour is finally seeing that it has to organise with labour in other parts of the world in order to fight the exit option that corporations have. So I'm glad to see that labour is making more attempts to organise on a cross-national basis than they have in the past.

IB: You'd have to say though, that the conditions for labour organisation are weakening with the move to more flexible production techniques.

GE: Yes, I think that's true, the move towards production flexible techniques is making it more difficult; but primarily, I think, the change has come about as a result of the politics of states. I know that in the United States, they've made it much more difficult for labour to organise; they've made it much harder for labour to win certification battles, for example. If there were a change in labour law in the United States which, for example, would make it impossible for companies to replace striking workers, which would make it necessary for companies to give a year or two notice to workers before they shut down a plant and moved away, if you had a change in national labour law, I think that would, to a large

extent, compensate for the difficulties flexible production and so forth have created for labour.

IB: Returning to the future of the international monetary system, economists like Fred Bergsten have argued for a target zone system which would combine elements of fixity and flexibility, and give more scope for national autonomy. What's your view of this proposal?

GE: The fundamental problem is whether or not there can be any kind of fixed exchange rates or managed exchange rates, given the high degree of international capital mobility. Barry Eichengreen, at the University of California, Berkeley, and now an I.M.F. adviser, has quite strongly made the argument that, with capital mobility as rapid as it is now, it's very difficult to maintain target zones or any other form of managed or fixed exchange rates. So while I would like to believe that Bergsten is correct, I think we've seen such problems in Europe in the 1992 crisis, and now in Asia, I'm becoming sceptical about the degree to which we can maintain fixity at all without doing something about capital mobility.

IB: Do you think then that the power of short-term private international finance, or so-called hot money, is now too great in the setting of currencies?

GE: I do think it's too great and I think many in government and industry are beginning to agree, especially now with the Asian financial crisis. After all, if you look at the 1930s, and what Keynes and the others tried to do in the Bretton Woods system, they tried to rein in private finance in order for international trade to really flower and flourish. They believed that international trade could be a mechanism for world economic growth and high employment, and they were worried that private finance would interfere with international trade and high employment. We've come full circle again now where private finance is, once again, jeopardising the possibilities for trade integration, high employment and rapid economic growth, so I think something must be done to rein it in.

The question is, of course, what can be done? Now, there have been proposals for what's called a Tobin Tax. This is a very small tax on all international foreign exchange transactions which would have the effect of making short-term foreign exchange transactions very costly while, at the same time, not raising the cost very much at all for long-term

investments. For example, somebody investing in a Korean bond for five years would not be taxed very heavily but somebody investing for a day or a couple of hours would be taxed quite a bit. I think this Tobin Tax is an excellent idea. It would raise the cost of such hot money and at the same time, it might generate quite a bit of revenue. There have been estimates of as much as $US300 to $500 billion dollars a year in revenue, which could be used for good purposes. For example, an international finance fund could be set up which could make loans or equity investments long-term for countries which need capital. So I think this Tobin Tax is an important, but unfortunately, only a small step in the right direction.

I think we need to do even more than that. During crisis periods, for instance, other types of short-term capital controls can work as well. Charles Wyplosz and Barry Eichengreen have argued for controls on bank deposits, and the I.M.F. itself has argued for some controls over the inflow of capital to try to prevent inflows of hot money which would then later on be an outflow of hot money. So even the I.M.F. is suggesting that this might be a good idea. Stanley Fischer, who is the Deputy Managing Director of the I.M.F., has floated this as a possibility. So I think these kinds of short-term capital controls can help for a limited period of time.

In the longer-term, what Keynes argued for was to have an international lender-of-last-resort which can provide credit to governments that want to pursue a high employment policy. This kind of credit from, say, the I.M.F or some other agency can substitute for the hot flows, so countries will not be so dependent on private finance to finance their real needs. So I would think that beefing up an international agency would be one way of doing it. We have such an agency now, the I.M.F., but the conditions that they insist on are exactly the wrong kinds. Rather than arguing for a government pursuing long-term investments in human capital and infrastructure, for example, as a condition for getting loans, they've been arguing for governments cutting back on public investment and budgetary expenditures. Rather than making it a condition for loans that governments should get more control over private finance, what the I.M.F. has done in Korea and the Philippines and elsewhere, is say, if you want credit from us, you have to liberalise your financial markets. So

the problem is that we currently have an international financial institution which can give a large sum of credit to countries in need but as conditions for that credit they're making these countries follow what, in my opinion, are rather destructive policies.

IB: What's the role of financial regulation in your approach?

GE: I think that what we need is a global regulatory institution with similar power and scope to the World Trade Organisation which can place all international financial institutions under a regulatory framework. Right now we have these hedge funds, for example, run by George Soros and others, which really don't fall under any strict regulatory apparatus, and indeed any regulatory apparatus to speak of at all. These hedge funds can move billions of dollars very rapidly in and out of currencies and can help to contribute to, if not bring on, crises like we see in Asia. I'm not saying these hedge funds caused the Asian crisis, which is more complicated than that, but they certainly have contributed to it. Now if we had an international regulatory institution which could bring all international financial institutions on to a level playing field, under similar regulations, then we could begin to provide the infrastructure which would allow us, I think, to bring finance under control.

IB: A proposal for a global regulatory agency is quite grand. It does get around the problem of competitive financial deregulation.

GE: That's correct and that's the problem that we face. Big countries like the United States could do a lot more to regulate finance. Japan, I think, is going in exactly the wrong direction, moving towards the Big Bang, as they're calling it now, which will lead to financial liberalisation. I'm afraid that they will be sorry that they have done this, looking back 10 or 15 years down the road. Large countries could still do more on their own but even there, there is going to be this competition between the United States, Japan, the United Kingdom and other financial centres to get to the lowest common denominator of financial regulation. Smaller financial centres, Singapore for example, don't have a chance to regulate on their own. So yes, I think, undermining this competition for the easiest, most lax regulation is one of the most important things that a global regulatory agency could prevent.

IB: One of the things that many liberal economists miss is the underlying role of the distribution of power between key states. We are moving into a multi-currency system, a system that seems to have several potential reserve currencies. One of the underlying problems in the current system is that the US dollar is in relative decline. Do you see the rise of the euro as offering an alternative to the role of the US dollar?

GE: Yes. I think the euro will definitely offer an alternative to the US dollar and, potentially, I think that is good. The reason is that, if you have a world economy that's dependent on only one currency and that currency is in decline, then that has the potential to lead that country to have excessively high interest rates and insufficiently expansionary macroeconomic policy in order to protect its currency. Take for example Britain towards the end of the nineteenth and early twentieth century when it provided the key currency - the pound sterling - and it was in decline. Britain pursued very restrictive policies in order to maintain its key currency role. So yes, I think it's potentially a good thing that the euro is going to be an alternative to the dollar. I think that that potential positive aspect will not be realised, however, unless the Europeans are willing to take a lead in pursuing more expansionary monetary policies; and I'm afraid that, with the Bundesbank at the helm of European monetary policy, that's simply not going to happen. I expect the Bundesbank is going to continue to pursue relatively restrictive, high interest policies and, as a result, the possible benefits of having a competitor to the dollar and another centre of financial power won't be realised.

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