

## Financial Statecraft Excerpts

### Chapter 1: What is Financial Statecraft?

. . . trade is not the only way in which nations interact with each other economically. Although influencing international trade flows has long been and continues to be an important political objective and tool, another form of international economic exchange has risen to a level of much greater macroeconomic significance and political concern over the past two decades. This is the purchase and sale of financial assets—such as bonds, stocks, and derivative contracts—across borders, an activity whose growth has vastly outpaced that of traditional trade. Nearly \$2 trillion worth of currency now moves cross-border everyday, roughly 90 percent of which is accounted for by financial flows unrelated to trade in goods and services—a stunning inversion of the figures in 1970, when 90 percent of international transactions were accounted for by trade.

The relative importance of trade in goods and services, on the one hand, and trade in financial assets, on the other, is clearly illustrated in the U.S. balance of payments figures. If we chart the sum of American imports and exports (current account items) side by side with the sum of American foreign securities purchases and domestic securities sales to foreigners (capital account items), we see dramatically more rapid growth in the latter since the mid-1980s.

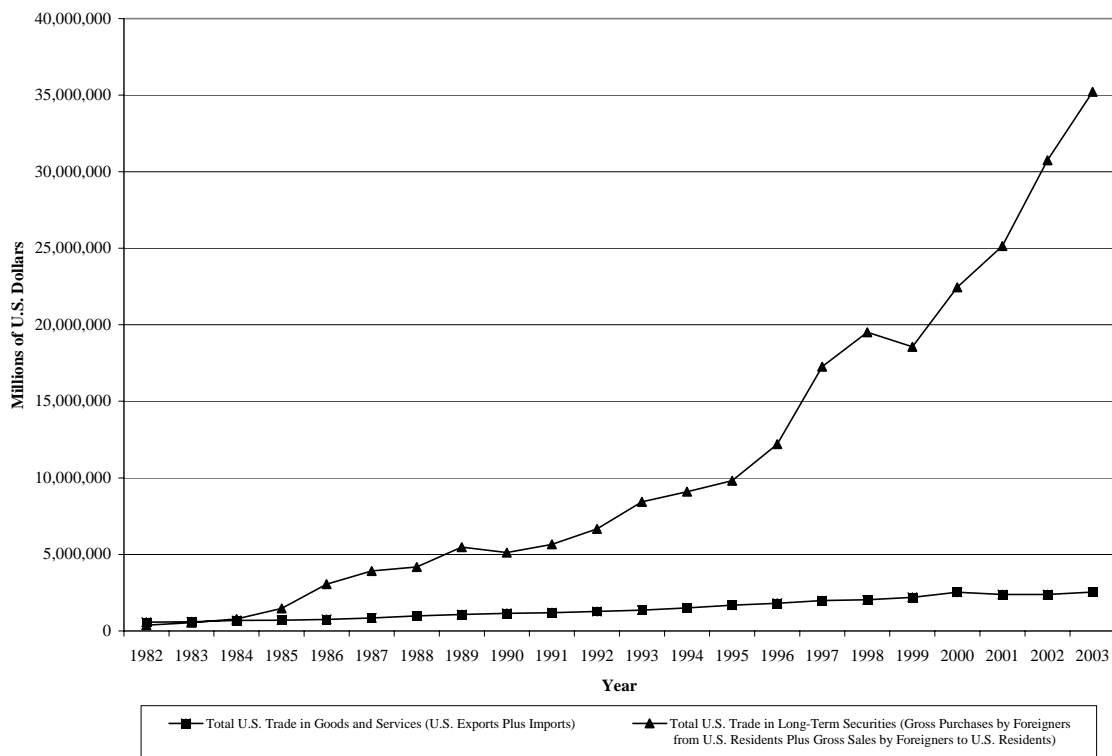


Figure 1. Total Trade in Goods and Services vs. Total Trade in Long-Term Securities

The answer to the question, “Why did Willie Sutton rob banks?”—because that’s where the money is—captures precisely why governments have increasingly turned to banks and other financial institutions as objects and instruments of foreign policy. In the mid-1990s, after the customary lag required for politics to catch up with economics, the arsenal of economic statecraft began expanding in response to the growing importance of financial flows. Both the Clinton Administration and its Republican opponents in Congress began to focus on how control of financial market institutions, instruments, and practices could be applied in the service of foreign policy—with the two sides often reaching very different conclusions.

## Chapter 2: Banking and Foreign Policy

As we will see in this and the subsequent chapter, banks continue to this day to be used by governments as a tool to fight wars and pursue foreign policy. And in the 1980s and 1990s, as banking became a truly global business, banks became *objects* of foreign policy, through the development of international financial regulations to promote prudence in risk taking, vigilance in customer monitoring, and a semblance of parity in cross-border competition. At the same time, governments have frequently deferred to or sought to promote the narrow interests of banks (and other financial institutions) in international regulatory and trade initiatives. The results have been decidedly mixed . . .

In sum, what began as a subtle effort by the U.S. government to harness U.S. banks in helping to “save the world economy” in the mid-1970s became by the end of the 1980s an effort by the U.S. government to force those banks to recognize their excesses. The focus had shifted dramatically from promoting foreign lending to restraining it . . .

Though it was widely lauded by many commentators and rich-country banks at the time, the Basel Capital Accord was, in fact, deeply flawed. At best, it proved to be irrelevant when really needed. At worst, it led to some perverse results.

The first problem did not take long to surface. Shortly after the Basel standards were finalized in late 1988, the United States and other countries fell into recession. Even without the Accord, banks would have adopted more cautious lending policies in that economic climate. Under the new Accord, the banks’ caution in lending bordered on the ridiculous. The problem was that the new risk-based formulae required banks to hold no capital against government bonds in their portfolios, but 4 percent “Tier 1” capital against most loans. Reacting, in part, to these conditions, U.S. banks reduced their loans while increasing their holdings of Treasury bonds by nearly 50 percent between 1989 and 1992. The result was a credit crunch.

Other problems with the Basel standards were even more fundamental . . .

It is clear from these anecdotes that the Basel Accord serves at the convenience of its member countries. To this day, members make their own decisions about enforcement, and no member country is penalized for failing to enforce the Accord’s stated capital standards. Although it has perhaps contributed to greater consciousness of the useful role of regulatory capital among bankers and their observers in industry, media, and government, it has proven toothless and, more important, has not achieved one of its fundamental goals: leveling the playing field in international banking . . .

The Basel process has dramatically demonstrated how a once simple set of standards can become highly complicated over time—the agreement is now more than 400 pages in length and riddled with mathematical formulae. But there is still no objective way to demonstrate whether the proposed new standards will be any more effective in discouraging imprudent risk taking. In fact, the opposite may be true.

Thus, one concern over the new accord is that it might actually allow most large banks to hold *less capital* than they do now . . .

Despite the accord's serious flaws and de facto irrelevance, bank regulators in the member countries continue to worship at the altar of Basel. Banks also pay homage to the accord, if for no other reason than not to offend their regulators. Too much time and political capital have been invested in the process of refining the accord for the key players to abandon it.

Although the effort started with laudable objectives—to raise and internationalize bank capital standards—countries like the United States have found the unilateral route more effective. Nonetheless, there is a way to make the accord truly effective, and to do so in a way that also comes close to the accord's objective of leveling the playing field for banks from different countries. The simple solution is to mandate that all large banks back a fixed percentage of their assets with subordinated debt . . .

Trade and investment policy is an area in which what may be good for certain financial institutions in the United States and elsewhere in the rich world may not be good for the economic health of developing countries with weak monetary systems and underdeveloped, poorly regulated banking and financial systems. Ultimately, it may not even be in the wider interests of the United States, for, as we shall see in chapter 5, financial crises abroad create security as well as economic risks at home. As the world's financial system becomes ever more integrated globally, so grows the need for better international regulatory coordination to reduce the risks of weaknesses in one country spreading problems to others. But the lessons of the Basel process's failings need to be heeded on many levels, as we will see in our analysis of financial crises in chapter 6: problems of institutional weakness, poor incentives, and inadequate monitoring are most effectively addressed by harnessing the natural driving forces of the market itself . . .

### **Chapter 3: Finance and “The War on Terror”**

Only days after the terrorist attacks of September 11, 2001, President George W. Bush announced a far-reaching “war on terror.” He not only signed legislation to strengthen law enforcement tools against actual and would-be terrorists, but also embraced the Clinton administration's campaign to dry up the financial flows to terrorists. The latter step was a striking about-face. Only months before, two top economic officials, then-Treasury Secretary Paul O'Neill and chief economic adviser Lawrence Lindsey, had questioned the wisdom of the Clinton administration's anti-money laundering effort.

That governments can fight the post-9/11 war on terror by stopping the flow of money to terrorists seems like a reasonable proposition on its face. After all, if it were possible to deny terrorists access to sources of finance—and specifically access to financial institutions—then it might be possible either to keep them from engaging in their nefarious activities, or at least to raise the cost of such activities significantly and thereby interrupt some of them. But even if the

efforts to track and seize the finances of terrorists failed to impede them, mounting a financial war on terrorists might help law enforcement officials and the military locate, apprehend, or even kill them before they strike again.

How might such a war be carried out? . . .

All of these efforts at regulation are limited even further by a third factor: acts of terror are cheap to carry out. The truck bomb used at the World Trade Center in February 1993 cost \$400. The cost of training and support of the 19 individuals who participated in the 9/11 airline hijackings is estimated at only \$500,000. Terrorist operations since 9/11 have been even cheaper: the October 2002 Indonesia bombings cost \$50,000; the November 2003 Istanbul attacks cost less than \$40,000; and the March 2004 Madrid bombings, carried out with dynamite and cell phones, cost less than \$10,000. As Defense Secretary Donald Rumsfeld admitted in a memorandum leaked to the press in October 2003, “The cost-benefit ratio is against us! Our cost is billions against the terrorist cost of millions.”

These limitations cast doubt on the effectiveness of the financial war on terror. Some policymakers have recognized this. While the *9/11 Commission Report*, for instance, asserts that efforts to track terrorist financing should remain “front and center in U.S. counterterrorism efforts,” it also acknowledges that asset freezing will diminish in effectiveness as terrorists find more ways to go around the system. As we have seen, the same can be said for AML regulation. In light of these doubts, we need to take a more rigorous look at the costs and benefits of the AML campaign . . .

The upshot of this assessment is that America is spending at least \$7 billion a year on unproven initiatives to fight a financial war on terror. To put this finding in some meaningful perspective, there is a host of compelling homeland security initiatives that are in dire need of that kind of money. For instance, we currently have no effective system for monitoring and verifying the contents of the world’s 90 million container shipments per year. As a consequence, any one of those containers could contain an explosive, possibly nuclear, device. If loaded onto one of the 8 million containers that pass through U.S. ports each year, the device’s detonation could shut down all shipments into and out of the United States for several weeks or even months, thereby causing an economic disaster. What would it cost to implement an effective worldwide container security system? Stephen Flynn, a leading expert on homeland security, estimates it would cost roughly \$40 to \$80 per shipment, or \$4 to \$7 billion per year. In other words, for the same amount of money that is spent domestically on possibly fruitless AML initiatives, we could institute a global security system that would significantly reduce the risk of a crippling shutdown of the international commerce network.

In light of the clear opportunity costs of America’s spending on antiterrorism financial regulation, we must ask whether we have fully encompassed the reasons for it in our discussion. The answer may be that we have left out an important public diplomacy dimension to such spending. As the terrorism expert Paul Pillar suggests, by mounting a financial war on terrorism the United States signals to other countries the seriousness with which it takes the terrorist threat, and may thereby be able to influence other governments to take the matter seriously as well. A government that condemns terrorism and demands that other countries make political and financial sacrifices in order to stop it cannot afford to appear to be allowing its financial institutions to abet terrorist financing with impunity. Seen in this light, the financial war on terror is a necessary component of a wider initiative to draw nations with disparate interests into visible cooperation against a threat which is widely felt but often difficult to combat, for political reasons, through more aggressive means . . .

## Chapter 4: Capital Markets Sanctions

Approach a medieval European city, and the importance of religious authority is immediately apparent in the cathedral dominating the skyline. In a seventeenth-century city, it is the secular authority that is elevated, literally and metaphorically, through the towering presence of the political palace. In a modern city, it is the power of the commercial sector, and particularly its financial institutions, that is reflected in the gleaming skyscrapers.

Buildings are metaphors for emergent centers of power. Politics provides such metaphors as well. In international affairs, the granting or withholding of trade “privileges” has taken on great symbolic meaning since the end of the Cold War. America, as the national embodiment of the emergent global power of international commerce and finance, bestows free-trade agreements on nations that aid her in the war on terrorism. (Pakistan was so blessed by the Bush administration in 2001, even though Congress declined to convert the metaphor into actual commerce.) America also punishes with economic sanctions those who oppose her. For those large enough to be particularly irksome in their opposition, such as China and Russia, the ultimate surrogate for traditional warfare has become capital markets sanctions. How did capital markets assume center stage in the emerging drama of financial statecraft? . . .

A new logic had been proffered in a major, congressionally mandated report that could be used to compel the U.S. government to harness the power of the capital markets, despised by groups on the right and left of the political spectrum, in the service of any manner of Great Cause. The logic was that since foreign companies doing wrong might be hit by American government punishment in consequence, American investors in such companies must receive government warnings of such companies’ behavior, presumably in a manner such that they would be deterred from investing.

Tellingly, however, the logic was not deemed two-sided or universal. That is, first, activities designated as being bad by activists could only be assumed to be bad for investors, never good, despite the fact that the companies engaging in them do so to make a profit for their owners. Second, no disclosures of *other countries’ sanctions* or potential sanctions would be required; the fact that other countries might choose to punish American companies, and thereby also hurt American investors, could just be ignored.

Many groups, as we shall see, have subsequently organized to pressure the SEC into expanding the definition of “material risks” which public companies must disclose to investors, in order to encompass religious, labor, and environmental concerns, and thereby dramatically expand the scope of legal liability which such companies face. The primary targets have been Chinese firms, but Russian firms have also proven popular . . .

In the late 1990s, two cases involving Russian and Chinese oil companies raising capital in the United States brought the issue of capital markets sanctions to the political fore, both in America and abroad. What raised these particular cases to such prominence was the heady mix of large oil firms from countries considered major nemeses by some and partners by others doing business in third countries already subject to highly controversial unilateral U.S. economic sanctions. The cases therefore managed to mobilize politicians, industrial and financial interests, and activists of all stripes in a very public campaign over the merits and feasibility of using the American capital markets as a lever of coercive diplomacy. The campaigns would be celebrated as successes, but the facts bear out a different story . . .

The notion that CNPC would have sacrificed its huge Sudan business for an NYSE listing is ludicrous. Using data from JPMorgan's ADR.com, we calculated that as of August 2003 the value of U.S. institutional holdings in PetroChina stock was *twice as large in Hong Kong as it was in New York*. In other words, not only was PetroChina *capable* of attracting U.S. capital through the Hong Kong Stock Exchange, but it actually proved *more successful* in attracting it through Hong Kong than New York. Warren Buffett, not normally considered to be a naive investor, controls nearly 14 percent of publicly traded PetroChina shares, and 95 percent of his stake is held through purchases on the Hong Kong Stock Exchange. The Casey Institute finds it "difficult to imagine U.S. investors flocking to the stock of a targeted firm in the event that company lists overseas." Yet this is precisely what happened.

With the exception of union and politically controlled funds, fund managers, who are hired and fired based on financial performance, seek stocks with the highest expected returns and seek to buy them where they are cheapest. In the case of Hong Kong—listed stocks, fund managers told us that it was almost invariably cheapest to buy there because of the critical liquidity from the Asian investor base.

The best way to understand the significance of this finding is to consider that the savings to CNPC's cost of capital owing to its NYSE listing amounts to mere pocket change, particularly when viewed side by side with the cash flow deriving from its Sudan business. Now, actually to imagine that the United States could persuade the regime in Khartoum to cease actions it considers vital to holding power by barring a Chinese oil firm from listing on the NYSE is to elevate imagination well beyond any legitimate role it should play in foreign policy formulation.

The image of religious freedom watchdogs, China hawks, Tibetan independence advocates, unionists, and environmentalists all joining hands—"the Sudan Community," as the Caseyites call this eclectic kumbaya collection—to oppose foreign investment in Sudan is both misleading and disingenuous. Prominent human rights advocates *actually living in Sudan* had been extremely critical of a June 2001 House bill (an embryonic version of the 2002 Sudan Peace Act) aimed at punishing foreign oil companies doing business in the country . . .

It is important to recognize that if Congress wishes to bar Americans from making certain investments it has it within its power to do so directly—by passing legislation. Congress could also try to persuade the White House to issue executive orders. The fact that Congressman Wolf and others choose instead to pursue their agenda through the SEC represents a dangerous misuse of that agency in the service of an agenda they could not persuade their fellow elected officials to enact . . .

In July 2001, the large Russian oil company Lukoil reacted to the Unger letter by withdrawing its planned share listing on the NYSE, choosing to move it instead to the London Stock Exchange, citing the "political risk" now associated with an American listing. The relentless badgering of the SEC to politicize its disclosure requirements, under the guise of informing investors of "political risk" in foreign investments, had succeeded in *creating* political risk in American listings, driving capital-seeking companies outside the SEC's jurisdiction entirely, where they continue to access U.S. as well as foreign capital. Indeed, every major U.S. investment bank is a member of the London Stock Exchange, which operates electronically and can receive and execute trading orders from around the world almost as fast as a trader can blink.

Lukoil's decision was nonetheless celebrated by Frank Gaffney in a *Washington Times* op ed as a "development of momentous significance." Of far greater significance is the dangerous level of ignorance within parts of the U.S. defense and intelligence establishment as to the

workings of the capital markets, given that some of their notables have been turning to the most foolish possible forms of market regulation as a substitute for real foreign policy . . .

Supporters of capital markets sanctions deliberately conflate investment risk with “risks” related to such matters as weapons proliferation, religious persecution, labor exploitation, and environmental degradation in order to co-opt securities law and regulation in the service of narrow foreign policy agendas for which they cannot muster legislative or executive branch support. The danger is that they will succeed—not in achieving their foreign policy aims, but in politicizing American capital market regulation to the point where it is irrelevant to foreign firms, as the activity will have migrated to London and other nonpoliticized jurisdictions . . .

The notion that American capital is “domiciled in New York City” is dangerously naïve. American capital may be owned by Americans, but it is effectively undomiciled.

Studying JP Morgan ADR.com data for 2003, we found that for 122 EU-based firms listing ADRs on the NYSE, U.S. institutional investors held, on average for each company, 7.7 times as much of the underlying stock listed in Europe as they did of the ADRs. For mainland Chinese firms, the ratio of U.S. institutional holdings in Hong Kong to holdings on the NYSE is 5.8.

The clear message from these data is that *U.S. investors go abroad to invest*. They do not sit in New York City waiting for the world to come to them . . . Critically, American capital markets sanctions can only accelerate this trend. If foreign firms are barred or discouraged from raising American capital within America’s legal jurisdiction, they will simply raise it outside—as Lukoil and Gazprom did. The only effective way to bar foreign companies from accessing American capital is to bar American investors from providing it . . .

Transparency is wonderful. But we do not ask the Pentagon to educate the American public on the environmental costs of war, or the Environmental Protection Agency to preach on the benefits to the drug war of defoliating Latin America. Likewise, the SEC’s role is not to inform Americans about the putative social, environmental, security, health, and other nonpecuniary costs and benefits that may attach to the activities of foreign companies.

Does this mean that Americans should not, or will not, be informed about the activities of foreign companies? Hardly. Members of Congress, the AFL-CIO, the Casey Institute, newspaper columnists, and the like all did their part to ensure widespread publicity for the debate over PetroChina’s business. Forcing the SEC to put a government health warning on corporate disclosure statements, which are generally read only by professional analysts, would not have lent any more transparency to the issue; on the contrary, it would have obfuscated it by sending a deliberately muddy message about the U.S. government’s true intentions . . .

Supporters of capital markets sanctions see them as much more than a tactic in a battle to achieve certain foreign policy ends. Whether on the right or the left, they tend to see capital market institutions such as the NYSE as the centerpiece of an amoral, international “neo-liberal regime” which undermines national interests and “traditional” social orders. They mirror the right and left wings of the antiglobalization movement, which accord almost mythic political powers to the three Bretton Woods institutions—the IMF, the World Bank, and the WTO. This accounts for much of the naive triumphalism which surrounds the epic sanction tales of Gazprom and PetroChina—rank failures in terms of achieving foreign policy aims, but heroic in the fight itself.

Rarely has so powerful a force been harnessed by so many interests with such passion to so little positive effect. Yet unless the failure of capital markets sanctions as a foreign policy tool becomes far more widely understood, their political seductiveness is such that this no-cost, feel-good diplomatic toy gun will be wielded with ever greater frequency, undermining both the credibility of America's foreign policy as well as the attractiveness of its capital markets.

## Chapter 5: The Security Dimensions of Currency Crises

In 1972, President Nixon, upon hearing that the Fed chairman was concerned about speculation against the Italian lira, responded, "Well, I don't give a \*\*\*\* about the lira." Today, if an American president is warned about possible speculation against the Thai baht, he is far more likely to give one.

The LDC debt crisis of the 1980s, as we discussed in chapter 2, galvanized economic policymakers in the United States, who were determined to ensure that the American banking system would not be destabilized by risky lending abroad. Despite the problems we identified with the capital standards regime that became the centerpiece of this strategy, the heightened focus on risk management among bank management, investors, and the financial press clearly began paying dividends in the 1990s, as debt crises hit Latin America, Asia, and Russia with the U.S. banking sector remaining relatively robust throughout.

What U.S. policymakers were not prepared for, however, was the geopolitical impact of foreign financial crises. It turns out that it wasn't just the economy, stupid. Financial crises were increasingly figuring into State Department, Pentagon, and National Security Council foreign policy concerns relating to matters such as political instability, defense cooperation, nuclear proliferation, drug trafficking, transnational organized crime, and terrorism. By the late 1990s, financial crises around the globe had become sufficiently frequent, widespread, and severe that they had made their way into American presidential State of the Union addresses. In his January 1998 address, President Clinton talked about the crisis in Asia and emphasized the connection between economic stability abroad and American national security.

Yet whereas the economic effects of financial crises in Asia, Russia, and Latin America have been subjected to much official quantification and commensurate lamentation, shockingly little has been written about how they actually relate to U.S. foreign policy and national security concerns. Former Secretary of State Henry Kissinger dedicates nearly an entire chapter to the Asia crisis in a recent book, *Does America Need a Foreign Policy?*, while observing a demure silence as to its actual *relevance* to American foreign policy.

In this chapter we discuss the U.S. national security issues emerging from the foreign financial crises of the past eight years . . .

The period since the presidency of Bush père in the late 1980s has been notable for the unprecedented consistent, constructive engagement that has marked American policy toward Latin America. This approach was reciprocated by a remarkable surge in pro-American sentiment in the region—at least through the first half of the 1990s. The second half brought an end to this honeymoon.

The late 1990s witnessed a severe economic downturn in Latin America that culminated in financial collapse in Argentina and crisis in Brazil. Economic growth slowed from an annual average of 4.2 percent in the first half of the decade to only 2 percent in the second, turning negative after 2000. Unemployment in 2003 reached its highest level in over two decades, and poverty has been on the rise. Private savings have flown out of the region, such holdings having

reached about \$700 billion. Economic troubles were accompanied by a revival of traditionally hostile attitudes toward private enterprise and market forces. The political effect was unsurprising: the ouster of all the region's political leaders who backed Washington's economic reform agenda and the rise of populist politicians who, to varying degrees, have halted or reversed their policies.

From the Potomac perspective, U.S. foreign policy is no less benign and supportive toward Latin America now than it was in the late 1980s. But south of the border, economic troubles are seen as being intimately connected with U.S. foreign policy . . .

IMF conditionality on loans to ward off or mitigate currency collapse and default was widely seen in Argentina as U.S.-inspired blackmail to support American commercial interests. For example, IMF demands for the repeal of Argentine laws supporting debt-laden domestic enterprises were popularly interpreted as a cynical plot to help American creditors take over major Argentine media and farming conglomerates. Leading newsmagazines published cover stories on speculation that Washington was seeking to deepen Argentina's crisis so as to topple the president, further undermine the peso, and assist American companies in snatching up the best farmland in Pampas. Opposition politicians railed against U.S. interests they alleged to be exploiting the crisis to buy up more of the country . . .

A 2002 UN Development Program survey found, disturbingly, that a majority of Latin Americans would prefer authoritarian rule if it would improve their lives economically. Democracy, a report based on the survey concluded, was suffering a "profound crisis of confidence" throughout the region. Essential to ensuring that Latin Americans do not come indelibly to associate democratization with impoverishment is to protect their savings from the ravishment of further bouts of inflation and devaluation. Failure to do so will also threaten to drag U.S.-Latin America relations back into the dark ages of the 1970s and 1980s, when Washington's diplomatic choices were frequently limited to tolerating anti-American leftist regimes or supporting authoritarian right wing ones . . .

## **Chapter 6: The Economics of Currency Crises**

Almost every major national financial crisis over the past decade has had currency mismatch at its root. As we shall see as well, such crises are brutally difficult to contain and resolve. No one—certainly not the IMF, the U.S. Treasury, or Wall Street seers—knows in any given case precisely what economic medicine or how much of it is needed in the midst of a crisis to persuade a country's citizens and its outside investors and creditors that it is in their interests to stop selling local currency. High interest rates may staunch the selling but may also push thousands of firms needing financing into bankruptcy. Keeping them low, however, may fuel the selling and thereby bankrupt the dollar borrowers as well as their lenders. This is why it is so vitally important to focus on preventative measures . . .

It is a convenient but inaccurate shorthand to lay the blame for these financial crises at the door of currency-market volatility. But measures of currency-market volatility are, in fact, poor indicators of financial crises. Furthermore, the favored snake oil of the "antiglobalization" movement, a "Tobin tax" on currency transactions, would have had precisely no effect in preventing the Asia crisis. These countries were not laid low by day-trading. Their foreign currency liabilities were built up over years, while the financial sector reforms necessary to manage them safely were

never undertaken. These liabilities accrued despite the fact that transaction spreads in those markets were generally on the order of 50 times higher than a 0.1 percent Tobin Tax, which was itself supposed to deter capital flows. And once the prospect of 30 percent devaluations became real, an exit tax this minuscule was hardly going to be a deterrent to capital flight . . .

Are high levels of capital inflows inherently dangerous? Not on their own. Between 1870 and 1890, Argentina imported capital equivalent to 18.7 percent of GDP, compared with barely over 2 percent in 1990–96, the years prior to a major currency crisis. Indeed, international capital flows for twelve major trading nations were roughly 60 percent higher as a percentage of GDP from 1870 to 1890 than they were in the 1990s. There is proportionately less capital crossing borders today than there was a century ago.

Consider too that capital today flows freely, instantaneously, and often massively within countries. During the 1990s tech boom, billions of dollars were raised in New York and invested in California. When the tech bubble finally burst with the dawning of the new millennium, both the California and New York economies were hit hard, as companies and their investors suffered the grim aftermath of irrational exuberance. Yet through the highs and the lows, there were no capital account crises, no speculative currency attacks, no cessations of credit, no interest rate spikes, no bank runs, no IMF missions, no violent protests, and no political upheavals.

We know of no economist who questions the wisdom of free capital flows between the continental United States and the commonwealth of Puerto Rico; or dollarized Panama, Ecuador, and El Salvador, for that matter. While the evils of “hot money” rushing into and out of emerging markets are widely proclaimed, the condemnation is reserved exclusively for dollars sweeping through states whose governments restrict their use or refuse to use them in dealings with their citizens. In other words, it is not the movement of money between the rich and poor parts of the world that is damned, but the movement of dollars in and out of countries whose governments don’t want their citizens to use them. The political presumption on the part of capital-flow critics is in favor of the governments, and therefore the solution is always to stop citizens from importing or exporting capital . . .

Being a country means having a sovereign currency. And therein lies the source of so much immiseration and international hostility that the only wonder is how it came to be seen so widely as a natural and immutable state of affairs . . .

The textbook case for floating a national currency is founded on the stabilizing effects of using the exchange rate to keep domestic interest rates from being whipsawed by movements in foreign rates, and the ability to lower rates to counteract recessions (and raise them to moderate booms). Yet the evidence is precisely the opposite: that under floating regimes, domestic interest rates are more sensitive to foreign rates, and, perversely, are more likely to go up than down during a recession. Indeed, in developing countries a procyclical interest rate policy has clearly replaced foreign exchange intervention as the preferred means of taming currency movements. These findings on their own cannot, of course, tell us whether developing country monetary authorities are incompetent or merely ineffective, but they do suggest clearly that they are unable to do what we know they must do if they are to derive any benefit out of monetary independence.

Calvo and Reinhart (2000) have termed the unwillingness of governments to leave determination of exchange rates to the market “fear of floating.” Fear it may be, but in a world in which large and sudden exchange rate movements frequently wreak havoc with economic stability, even exchange rate paranoids must reckon with enemies . . .

The Asian crisis shattered what had become a near orthodoxy in developing country monetary policy: that low inflation and capital-market integration could be installed overnight through pegged exchange rate regimes. Argentina showed that even currency boards were dangerously vulnerable unless dollar reserves were sufficient to cover not only the monetary base but the private sector's net dollar liabilities. Essentially, exchange rate promises are worthless. A peso is not a dollar, and never was. Even in the boom times, Argentine banks had to pay a premium of about two percentage points in order to attract peso rather than dollar deposits.

Crisis in the peg church has led to a schism among the following. Most have abandoned faith in the dollar and have called for an existential float. These disillusioned souls have decided that the spark of the divine resides within each country, in the form of the domestic inflation rate. Target it faithfully and exclusively, and all will be well.

Dollarizers, on the other side, have condemned the floaters as idolaters, worshiping at the altar of false graven monies. Only a dollar is a dollar, and the people need dollars. Local currencies keep the people isolated from the global capital market and give them a false sense of economic security. Inflation targeting without guidance from the dollar is a chimera, monetary independence a dangerous myth . . .

The globalization phenomenon of the late twentieth century was built on the voluntary and uncoordinated acceptance of the dollar as a global medium of exchange, just as its predecessor of the late nineteenth century was built on the pound sterling and gold. Globalization's Achilles' heel has been the fatal association of national monetary autonomy with national sovereignty, which has led to a proliferation of unwanted currencies in the international marketplace, each of which is tied to the dollar by nothing more than serially discredited promises of instantaneous convertibility at fixed or semifixed values.

This state of affairs is not the result of policy decisions. It is, rather, a reflection of the fact that monetary sovereignty in international transactions lies with individuals and private entities which determine for themselves what money shall be considered an acceptable store of value . . .

The loss of an independent monetary policy is the most widely invoked objection to dollarization. But since the Holy Grail of monetary policy is to get interest rates down to the lowest level consistent with low and stable inflation, this argument is, for most of the world, frivolous. How many Latin American central banks can cut interest rates below those in New York? The average *real* (inflation-adjusted) lending rate in Latin America is about 20 percent. In Brazil, it averaged 60 percent between 1999 and 2003. Naturally, rates this high cripple business investment and worsen fiscal deficits. Meanwhile, the dollarized country in Latin America with the *highest* real lending rate is Ecuador, at a miniscule 4.4 percent in 2003.

One must therefore ask what possible net gain to the national economy developing country central banks can hope to achieve from the ability to guide nominal local rates up and down on a discretionary basis. It is like choosing a Hyundai with manual transmission over a Lexus with automatic. The former gives the driver more control, but at the cost of inferior performance under any condition . . .

Opponents of dollarization often argue that it substitutes banking crises for currency crises. It is true that the elimination of the national currency precludes the central bank from printing money to bail out domestic banks. Yet designing a monetary regime on this basis is like building a house with removable supporting beams, under the logic that they might conveniently be used to prop up a sofa when fat guests visit.

The track record on bank bailouts in Latin America, southeast Asia, and, most recently, Turkey, is awful. They put confidence in the foundation of economic activity, the currency, at direct risk. The very possibility of bank bailouts not backed by foreign reserves represents a dangerous public underwriting of bank lending behavior, thereby making the systemic crisis which a lender of last resort is supposed to manage far more likely to materialize. Studies do, in fact, suggest strongly that the presence of a domestic lender of last resort is itself a *cause* of excess volatility in emerging financial markets as well as currency crises. Bank bailout mechanisms should be financed transparently through risk-adjusted deposit insurance premia paid for by the banks themselves, and not after the fact by surreptitiously creating new public debt on the books of the central bank.

It is furthermore critical to note that the entire intellectual apparatus of a lender of last resort premised on printing money is a nonsense in an open economy. A central bank printing money in excess of demand for it will trigger an outflow of funds, generally through the capital account, which leads directly to depletion of the central bank's dollar reserves. This has been well documented in the case of Brazil between 1998 and 2003, where the central bank's dollar reserves fell in line with monetary expansion and rose with contraction. As the Brazilian central bank cannot actually print reais without losing dollar reserves, its lender of last resort powers are illusory. This was further illustrated during the Ukrainian election chaos in December 2004: central bank dollar reserves plummeted as depositors pulled their money out of banks and immediately converted them to dollars.

A central bank faced with a financial crisis needs *dollars*. Thus, as Guillermo Calvo astutely noted, central banks are no longer lenders of last resort. They are *borrowers* of last resort . . .

Is dollarization in any sense undemocratic, a violation of popular sovereignty? Certainly not. In fact, most policymaking in democracies involves institutions designed specifically to insulate it from popular pressure. Dollarization is akin to constitutional laws barring certain actions by government officials, such as property seizure.

In more mundane terms, imagine a referendum posing the following simple question: Would you rather be paid in dollars or pesos? (assuming a national currency called the peso). If the majority would answer "dollars," there is no case grounded in democratic principle for maintaining the peso. For to say, "I wish to be paid in dollars, but to keep the peso" is to say, "I wish debts to me to be paid in dollars, but my debts to others to be paid in pesos." Such a shaft-thy-neighbor principle cannot be translated into sound public policy . . .

The IMF was created after World War II specifically to support a dollar-centered world, not a world of over a hundred autarkic currencies. The simple idea was that the Fund could assist countries in maintaining a fixed rate to the dollar with limited short-term financing to ease temporary balance of payments problems.

Over the past two decades, this world has changed beyond recognition and has placed demands on the Fund it cannot possibly meet. The Bretton Woods system of fixed exchange rates enabled countries to control their interest rates while keeping their currency rate locked to the dollar (and gold) only because capital flows were restricted. Yet as governments and private institutions in developing countries began seeking international capital in the 1980s, many of their central banks and treasuries sought simultaneously to maintain both low domestic interest rates and a stable dollar exchange rate, with disastrous results for their economies.

This put the IMF in an impossible position, from which it has been struggling unsuccessfully to adapt or to extricate itself ever since . . .

. . . the Fund's existential crisis will not end. The attractions of international capital will only increase as the financial services industry continues to expand, increase efficiency, and reduce global capital costs. Developed country supply of investable dollars and developing country demand for them will inevitably increase, to the clear net benefit of both. But it is also inevitable that in such a world, ever more financially integrated, but in which 98 percent of the currencies are unmarketable across borders, ever more severe currency mismatches will afflict ever more national balance sheets. Many more governments will throw off the shackles of capital controls, and most of those will prosper for most of the time. But financial crises will continue to emerge so long as governments continue to inject autarkic national currencies into internationally integrated national economies. In such an environment, there is every prospect that demands on IMF lending facilities will not only overstrain its lending capacity, but fatally undermine its political legitimacy on both the left and right.

Given such a bleak vision of the IMF's future, we see a saving grace in this jarringly modest comment from Stanley Fischer in May 2000, when he was still the Fund's first deputy managing director: "When you get right down to it, the benefits of having your own currency are much smaller than we used to think, especially for countries that already to a considerable extent are using the dollar." We would add only that the costs are also much greater . . .

## **Chapter 7: Global Capital Flows and U.S. Foreign Policy**

So much is at stake for the United States in finding a way to prevent the next wave of currency crises while resurrecting popular support for a world based on economic interdependence and openness. If the governments of nations perched precariously between authoritarianism and liberal democracy come to see their own legitimacy enhanced through the wealth-generating effects of foreign trade and investment, they will likewise develop a stake in conflict avoidance and stability in international affairs. If, on the other hand, they come to see domestic social chaos as the inevitable result of liberalization, they will seek to ground their legitimacy in confrontation with an emergent American-led international order. As critical as American military power may be to protecting a way of life that has made American citizenship so coveted globally, the soft power projected through the internationalization of norms supporting peaceful conflict resolution among governments and free economic exchange among people is eminently more effective and reliable over the long term. And there is no greater threat to this soft power than a sense among the vast populace of the world's poorer nations that such norms serve to enrich America *at their expense*. Preventing the recurrent collapse of currencies upon which national economies are, however unfortunately, currently built is central to the task of legitimizing a liberal international economic order among this skeptical populace . . .

A foreign financial crisis does not always present the United States with a clearly defined problem. Where was the locus of the national interest in the Asia crisis? Was it fundamentally about politics or economics? Would the strategy be the same if approached from the perspective of protecting American security interests in a region dotted with potential flashpoints, such as the Korean peninsula and the Taiwan straits, as it would be if approached from the perspective of protecting American economic interests in a region which took 30 percent of U.S. exports? The political and economic questions, even taken in isolation, were extremely complex. In the case of Indonesia, should the political objective have been preventing regime change, managing it, or encouraging it? The proper answer may well depend on the timeframe: immediate regime change may not be desirable, but an orderly regime change a year hence may be. As for the economic

objective, should it have been preventing widespread default or minimizing its impact domestically and abroad? And would the answer to this question be the same regardless of whether the strategy needed to implement it would make financial crises more likely or less manageable in the future? . . .

If Washington isn't quite master of the IMF puppet, it is an open secret that it controls most of the strings during a crisis. Paradoxically, this may harm American foreign policy interests in the long run. If large fund bailouts are more likely to be directed to key Washington allies, this may well induce risky overlending to precisely those countries for which Washington most fears the impact of default . . .

In the cases of Mexico, Argentina, and Turkey the evidence of moral hazard bets may be less clear, but the evidence of U.S. foreign policy rather than internal fund analysis driving intervention is not. Over time, it is only prudent to expect overlending to countries blessed to be a clear and present security concern for the United States. For this reason, it is imperative for Washington to implement policies now to restrain the compulsion, as well as the need, for large-scale crisis lending in the future . . .

"It would be close to impossible for a country to do what Thailand or South Korea or, earlier, Mexico did and hide its true reserve position," according to former Secretary Rubin. We disagree. The use of sophisticated derivatives among governments will inevitably saturate the developing world, providing them with the same tools that rogue companies and governments in the rich world have used to disguise red ink. G-7 member Italy appears to have used swap contracts in the late 1990s much the way Enron did, to fudge its books. Yen-lira swaps struck at a seemingly bizarre exchange rate served artificially to lower the Italian budget deficit figure in the run-up to its fiscal qualification exam for eurozone membership. In short, we cheer on the IMF and all others who encourage ever more prudent economic management in the developing world. At the same time, we harbor no illusions as to the perfectibility of IMF advice or the judgment and probity of the governments receiving it . . .

Perhaps the best that can be hoped for politically is that the United States will come to see itself as Ulysses, best tied to the mast to hold forth against the siren's call for bailing out friendly insolvents. Limitations on the ability of IMF directors to approve lending unsupported by IMF staff analysis would go some way toward achieving this goal. Unsound IMF lending to Argentina over the period 2001–03 would at least have been considerably reduced in the absence of official U.S. support, whereas the United States could not have been blamed for withholding such support had the directors been unable to override the staff's much more critical economic judgment. Those who argue that such political self-abnegation is impossible would likely have said the same thing about independent central banks three decades ago—and they would have been wrong. An American administration crying, "Stop me before I lend again!" might even endear itself to Congress.

Just as diners expecting to split a restaurant bill will overorder, so IMF directors sharing the lending tab will overlend. Power reserved for the IMF managing director to reject lending unsupported by staff economic analysis would assist in enforcing stricter and more consistent criteria for IMF loans, thus ensuring more prudence and less moral hazard in such lending. It would not bar the United States or its G-7 allies from leading bailouts on their own, without IMF political cover or funds. The United States supplemented IMF lending with considerable bilateral funds in the cases of Mexico and Turkey. But it would place far more political constraints—

legitimate, democratic constraints—on the use of bailout funds and oblige prospective G-7 lenders to clarify their criteria before their legislatures and the general public . . .

The destabilization of enemy money has been a staple of warfare for hundreds of years. The Milanese duke Galeazzo Sforza counterfeited Venetian currency in 1470 to undermine the economy of his enemies in Venice. The British began counterfeiting colonial American currencies in 1775 to undermine the American rebellion. Germany counterfeited an astounding \$7 billion, at today's value, of British pounds during the Second World War in an attempt to damage the British economy. The United States even counterfeited Cuban pesos during the Bay of Pigs invasion in 1961.

Destabilizing a nation's money unsettles its political and legal structures and undermines the state's ability to maintain internal order and security against external threats. Stabilizing a nation's money, on the other hand, can have a mirror-image effect: promoting social cohesiveness, buttressing the rule of law, and bringing credibility and consistency to foreign policy.

Yet it matters not one iota whether that money is manufactured or managed domestically. The British government has appointed foreigners to its Monetary Policy Committee, albeit with a wholly British domestic remit. The French government has gone much further, ceding all monetary authority to a European Central Bank in Frankfurt, run by independent appointees from throughout Europe pledged to act in the interests of the twelve-nation eurozone as a whole. And, critically, the French government ceded such powers with clear *political* motivations: to enhance the security of the French state and its influence in world affairs. In central America, Ecuador in 2000 and El Salvador in 2001 relinquished the prerogative to impose a national money even without sharing in the control of the money to be used within their borders, dollarizing their economies, as Panama did a century ago, and Guatemala and Nicaragua are seriously considering the option. It is clearly in America's national interest to support this trend . . .

The proposed International Monetary Stability Act needs to be revived. The concerns laid out in the July 2000 Summers letter notwithstanding, the *actual* "political, economic, foreign policy and budget issues" involved in repeated U.S. (and U.S.-led IMF) bailouts of allies with collapsed currencies over the past decade should have been far more worrisome. These interventions put tens of billions of U.S. taxpayer dollars at direct risk, while the conditions imposed ostensibly to limit default risk frequently strained U.S. relations with crisis governments severely. Presidential discretion to suspend seigniorage rebates owing to national security concerns can and should be accommodated in the act, but failure to pass it only makes such concerns more likely to materialize . . .

America is currently importing about \$2 billion of foreign capital a day. As policy initiatives to motivate an increase in private saving have failed over many decades, the only safe, effective, and responsible way for the country to reduce its external deficit is to raise public savings, meaning to cut the budget deficit. If, instead, the Bush administration continues to project an image of insouciance over the fate of the dollar, this will undermine the currency's hard-earned role as the world's preeminent standard of value, reduce America's influence over the setting of global norms in international commerce, and undermine the further march of dollarization . . .

Euroization of Europe to, and perhaps eventually beyond, Russia's borders might seem to clash with an American dollarization drive, but as a practical matter it would complement it. The central and eastern European economies are better off euro-based, and their prosperity can only

be an economic and political plus for the United States. Provided America continues to control inflation effectively and does not let its current fiscal profligacy get out of hand, this would not pose a challenge to the dollar's dominant international role. Washington should therefore be supportive of euroization. The big question is whether Brussels will be.

Official American neutrality on dollarization illustrates an unfortunate inertia in Treasury's conduct of international monetary affairs. Official EU *hostility* to euroization, on the other hand, illustrates an almost pathological insularity in the Franco-German-led drive for European integration. Indeed, it is difficult to imagine a matter on which the official EU stance is more antithetical to the interests of its most ardent supporters.

Although non-EU members Kosovo and Montenegro have euroized unilaterally, with neither assistance nor obstruction from the EU, the European Council of Ministers and the European Commission have stated clearly and repeatedly that such action is undesirable and, indeed, impermissible. According to one council document, "It should be made clear that any unilateral adoption of the single currency by means of 'euroisation' would run counter to the underlying economic reasoning of [European Monetary Union] in the Treaty, which foresees the eventual adoption of the euro as the endpoint of a structured convergence process within a multilateral framework. Therefore, unilateral 'euroisation' would not be a way to circumvent the stages foreseen by the Treaty for the adoption of the euro."

As a matter of economics, this statement is illogical. As a matter of legality, it is dubious. And as a matter of political principle, it is foolish . . .

We assume that the EU will always do the right thing, at least after exhausting every other option. So it is only a matter of time now before its political leaders come to see that assisting, rather than opposing, euroization is in the EU's strong self-interest. It will increase trade and investment flows among an expanding number of euroized nations. It will increase the role of the euro as an international reserve currency. It will reduce the risk of de-euroization by EU member states in the future. And it will contribute to the creation of a durable European political identity which, after all, was the driving force behind European monetary union in the first place . . .

## **Chapter 8: The Future of Financial Statecraft**

Financial statecraft, we have argued, is becoming an increasingly significant political phenomenon with potentially important economic and political implications. The two parts of this book express very different sentiments on the prospects for financial statecraft in the American diplomatic arsenal. Consistent with our view that financial markets are powerful vehicles for expanding prosperity as well as tremendously adaptable in the face of efforts to direct them (whether for good or for ill), we are, when looking out to the future of financial statecraft, macro-enthusiasts and micro-skeptics. On the one hand, we believe that far more fundamental reforms can and should be undertaken to make capital flows from the northern to the southern hemisphere as safe and productive as capital flows from the east to the west coast of the United States. And there are serious consequences to not undertaking such reforms. On the other hand, we believe that the growing enthusiasm for fighting foreign evils—from terrorism to weapons proliferation to human rights abuses—through bank and stock exchange regulation needs to be nipped in the bud. The emerging vanguard of economic warriors overstates both the importance of money to their foreign policy aims as well as our capacity to control its movements . . .

“Economic warfare” is a phrase now bandied about with great enthusiasm in Washington, as it implies that America has the capability of punishing her enemies effectively with little effort and no loss of life. Capital markets sanctions have become the centerpiece of coercive financial statecraft. Frequently the agendas are multiple, such as when the stated foreign policy target is a genocidal regime in Sudan while the sanctions target is a Chinese oil company. But as we have yet to see a case in which either companies or regimes were moved to behave in the way supporters of capital markets sanctions wished them to, it is clearly time to rethink the role of such sanctions in the foreign policy arsenal. Even when motivated by noble ambitions, applying toy gun tactics can mislead both responsible policymakers and the wider public that America is doing something meaningful when it is not, undermine America’s diplomatic credibility abroad, and produce significant collateral economic damage by driving financial activities outside the scope of America’s legal jurisdiction . . .

The LDC debt crisis of the early 1980s marked the emergence of capital flows as an economic phenomenon meriting the political attention previously reserved for trade flows, and much more. It marked an epochal transition from the “age of the current account” to the “age of the capital account,” with capital flows taking on rapidly growing geopolitical significance. As we saw in chapter 5, foreign financial crises produce American security problems. Yet American financial statecraft has yet to adapt effectively.

The Mexican, Asian, and Russian crises during the two Clinton administrations brought home just how intimately economics and foreign policy have become interwoven. Geoeconomics has emerged as a policy area in its own right. Its growing importance will require that the next generation of American foreign and security policy analysts have the experience and intellectual wherewithal to make sense of the way in which economic and financial market forces are acting to reshape the diplomatic landscape, while both constraining some strategic options and expanding others . . .

Having a national money is not only becoming less and less useful as the world becomes more and more interconnected economically and financially, but it is becoming more and more destabilizing. Collapsed currencies leave poverty, fear, anger, and insecurity in their wake. National monies have become the Achilles’ Heel of globalization. The Asian, Russian, and Latin American currency crises not only immiserated millions in the affected countries, but created or exacerbated significant security threats for the United States.

The recent unilateral adoption of the dollar in Ecuador and El Salvador and of the euro in Kosovo and Montenegro can and should presage a global denationalization of money. In the case of Latin America and the Balkans, governments ditching their national currencies would represent no more than an accommodation of ever more deeply entrenched local practices: saving in a trusted external money, concluding contracts in such a money, and measuring value in it. The United States has a compelling national interest in dollarization beyond its borders and needs to resurrect the enlightened efforts of the 106th Congress to accommodate and assist it. Even more urgently, it must reverse its present course of fiscal profligacy and insouciance toward the fate of the dollar. If the Bush administration does not move credibly and robustly to reverse the worrying long-term budget deficit trend, it will undermine global confidence in the dollar as a store of value and stop dollarization dead in its tracks. The fact that neither the euro nor any other currency is yet in a position to step into the dollar’s global role should provide no consolation. A setback to dollarization means a setback on the path to currency consolidation generally, with all that implies for further crises and more antiglobalization sentiment. And as Martin Wolf has so persuasively argued, “The world needs more globalization, not less.”

An enlightened American financial statecraft will always be consistent with this principle. America's long-term prosperity and security are intimately bound up with a liberal, rules-based international economic and political order to which people around the globe aspire to be attached. Given the nature of money and securities in the digital age, financial markets are an exceptionally important part of that order. They adapt to and arbitrage rules across jurisdictions in ways and at speeds which policymakers too often fail to appreciate fully. It has been our aim in this book to further this appreciation in the service of promoting a wiser and more effective financial statecraft in the future.