Is It Time to End the IMF and WTO?

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This year's Nobel Prize for Economics was co-won by Elinor Ostrom for her work showing that local solutions often work better than government regulation for solving problems as diverse as preventing over-fishing, conserving rainforests, and policing cities. Perhaps it is time to check whether local solutions can also work better with international trade.

We are now in the second year of the worldwide Great Recession partly caused by the inaction of the International Monetary Fund (IMF) and the inadequacy of the World Trade Organization (WTO). The problem is that countries found ways to exploit international rules to their own advantage. As a result, these two institutions allowed huge imbalances in international trade and international cash flow to destabilize the economy of the United States. Perhaps it is time for these institutions to fade into the sunset.

Primary Cause of the Great Recession

The primary cause of the current Great Recession was the trade imbalances among countries. In a nutshell, the Asian mercantilists (countries that pursue policies to maximize exports and minimize imports) brought about the Great Recession through their currency manipulations. For years, their central banks bought up the extra dollars that their exporters were earning in America, and used the proceeds to buy American financial assets. They did so in order to keep their currencies artificially weak. Through this strategy they were able to lower the price of their exports and raise the price of their imports, giving their industries a competitive advantage in international markets and giving American industry a competitive disadvantage.

Their strategy relied upon growing lending to the American consumer to fuel growing trade imbalances. But when America's house price bubble popped in 2006, followed by the subprime mortgage crisis in 2007, American consumers could not continue to borrow ever more money on their houses. As trade collapsed, so did the world economy, bringing about a worldwide recession. Balanced trade can grow forever, but a growing imbalance of trade eventually bankrupts the trade deficit countries, ruining the markets for the trade-surplus countries and for other trading nations.

Even though currency manipulations caused the Great Recession, the Asian nations are refusing to give them up. The Chinese have kept the yuan firmly pegged to the dollar for a year and a half, refusing to budge one iota. Recently other Asian central banks resumed their currency manipulations so that their industries would not lose out to Chinese industries. These continuing currency manipulations by the Asian central banks are preventing the needed adjustments that would assist the recovery.

Inaction of the IMF

The International Monetary Fund agreement should have prevented the very actions by central banks which caused and perpetuate the Great Recession. Specifically, Article IV of the IMF Articles of Agreement requires that countries "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members."

Yet the IMF never did anything to enforce the agreement. As late as August 20, 2008, economist Brad Setser reported that the IMF was beginning to consider the possibility of enforcing this provision in their agreement.

The IMF's inaction was even more on display two months later, when the banking crisis caused currencies to tumble worldwide while the IMF stood by. In country after country, businesses faced bankruptcy because their loans were denominated in dollars and their currencies were falling rapidly against the dollar.

On the other hand, bilateral agreements proved their effectiveness during the crisis. Quickly, Federal Reserve Chairman Ben Bernanke made bilateral agreements with fellow central banks to swap currencies. His currency swap with South Korea: (1) pulled the won out of its collapse; (2) restored liquidity to South Korean banks; and (3) strengthened the won, preventing South Korean automobiles from way-underselling American-produced automobiles in world markets. It was a win-win for both the American economy and the South Korean economy.

So what was the response of the world's largest countries to the IMF's multiple failures? Did they defund the IMF? Did they demand that the leadership of the IMF be fired? Did they withdraw their countries from the IMF? No. At their meeting on March 13-14 2009 in England, the G-20 agreed to give more money to the IMF, rewarding the IMF for its failures and inaction!

Inadequacy of the WTO

During World War II, British economist John Maynard Keynes anticipated that there would be a huge growth in trade after the war if trade could be kept in relative balance. Volume 25 of his collected writings is full of his plans for a post-war institution that would maintain trade balance. It would have had very different requirements for trade surplus and trade deficit countries, requiring that trade surplus countries do such things as stimulate their economies or take down their trade barriers, while letting trade deficit countries use export subsidies and tariff barriers to bring trade into balance.

Instead we got the WTO, which lets countries with large trade surpluses maintain high tariffs. The latest round of WTO negotiations (the Doha Round) broke down because China and India refused to reduce their high tariffs on "strategic" sectors, including vehicles, even though the trade deficit countries were offering to take down some agricultural protections in return.

And the Chinese government goes far beyond even the advantages that WTO rules give them. It bypasses WTO rules in order to artificially stimulate exports through currency manipulations and export subsidies. It places the same high tariffs it is allowed to place upon vehicles upon autoparts and mining equipment. And it uses non-tariff barriers to keep out many imports. For example, it fails to suppress widespread piracy of American PC games and DVD movies, while delaying the issuing of import licenses for the legitimate products.

In fairness to the WTO, there is a specific remedy within WTO rules for trade deficit countries: import restrictions. If the United States were to tie the value of American imports from China to the value of Chinese imports from the United States, as we recommend in our 2008 book Trading Away Our Future, the Chinese government would have to give up its mercantilist strategy. The result would be a U.S. economic boom. This particular remedy in the WTO rules states:

(A)ny contracting party, in order to safeguard its external financial position and its balance of payments, may restrict the quantity or value of merchandise permitted to be imported.

In short, the WTO has failed because the current applications of its rules have produced trade imbalances. In contrast, free trade agreements work. For example, Mexico and Canada, partners with the United States in the North American Free Trade Agreement (NAFTA), do not manipulate their currencies in order to run trade surpluses with the United States. During the first six months of this year, for example, they bought 91¢ of U.S. goods and services for every $1 that the U.S. spent on their products. China, on the other hand, only bought 27¢ from the U.S. for every $1 that we bought from them.

Reasons for These Failures

These institutions could possibly be made to work. The IMF could enforce its rules against currency manipulations. The WTO could enforce its rules against unfair Chinese trade practices. The United States could take advantage of a WTO provision for trade deficit countries. A new round of WTO negotiations could level the playing field.

But both organizations have consistently failed to take action against third-world socialist countries pursuing mercantilist trade policies. Both organizations rely to a large extent on U.S. financial support while tolerating and supporting anti-U.S. policies. They are standing in the way of the balanced trade that may be necessary in order to restore world prosperity.

Of course, these institutions do not deserve as much blame as do the American Presidents who, beginning with Clinton, have all permitted Asian mercantilism without taking adequate action. The U.S. is capable of looking after its own interests. Its foreign policies and its trade policies do not require international institutions as intermediaries.

Presidents Clinton, Bush, and Obama have intentionally ignored Asian mercantilism rather than deal with it. For example, on October 15, President Obama's Treasury Department issued a ludicrous report to Congress which claimed that China is not manipulating its currency. It concluded:

[This] report must consider whether any foreign economy manipulates its rate of exchange against the U.S. dollar to prevent effective balance of payments adjustments or to gain unfair competitive advantage in international trade. For the period covered in this Report, January 1, 2009 to June 30, 2009, Treasury has concluded that no major trading partner of the United States met the standards identified in Section 3004 of the Act. (p. 3)

While American presidents deserve most of the blame, these international institutions have also clearly failed. They have permitted the trade deficits that brought about the Great Recession, and they are doing nothing to promote the trade balancing that would assist the recovery.

The Bilateral Alternative

While no system of international rules ever works well, bilateral agreements have had a very good track record. Bilateral agreements, such as currency swaps and free trade agreements, must benefit both parties, or one or the other would pull out.

As social scientists have found using a game called "The Prisoner's Dilemma," each player in a bilateral agreement knows that if he or she cheats, the other player will respond, perhaps ending the agreement. As a result of such "Tit-for-Tat" play, bilateral agreements usually work.

In group versions of the prisoner's dilemma, however, it is much harder to sustain cooperation. If one player fails to cooperate, then other players can punish the defector only by failing to cooperate themselves. This prompts more defections, with little prospect for a return to cooperation. Cooperation in group prisoner's dilemma games can be sustained, however, when cooperators are able to specifically punish defectors.

The principle is simple. Big regulation, as represented by these institutions, does not work any more efficiently at the international level than it works at the national level. Countries will always find ways to get around any system of international rules. Unless the U.S. can find ways to effectively punish those taking advantage of the system, it is time to end the IMF and WTO and replace those institutions with bilateral agreements.

The authors maintain a blog at tradeandtaxes.blogspot.com, and co-authored the 2008 book, Trading Away Our Future: How to Fix Our Government-Driven Trade Deficits and Faulty Tax System Before it's Too Late, published by Ideal Taxes Association.