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## International economic organizations, developing country reforms, and trade

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<sup>3</sup> Weiler et al., *A Measure of Malpractice*, p. 137.

<sup>4</sup> F. A. Sloan, "Experience Rating: Does It Make Sense for Medical Malpractice Insurance?" *American Economic Review*, 80 (1990), pp. 128–33. However, physicians bear significant uninsured expenses in response to a malpractice claim, such as the value of time and emotional energy spent on legal defense (U.S. Congress, Office of Technology Assessment, *Impact of Legal Reforms on Medical Malpractice Costs*, OTA-BP-H-119, p. 7. Washington, D.C.: U.S. Government Printing Office, 1993).

<sup>5</sup> P. M. Danzon, *Medical Malpractice: Theory, Evidence, and Public Policy*. Cambridge, Mass.: Harvard University Press, 1985; D. P. Kessler and M. B. McClellan, "The Effects of Malpractice Pressure and Liability Reforms on Physicians' Perceptions of Medical Care," NBER Working Paper No. 6346, January 1998, and *Law and Contemporary Problems*, 60 (1997), pp. 81–106.

<sup>6</sup> D. P. Kessler and M. B. McClellan, "Do Doctors Practice Defensive Medicine?" NBER Working Paper No. 5466, February 1996, published in *Quarterly Journal of Economics*, 111 (1996), pp. 356–90.

<sup>7</sup> Recent work confirms that defensive practices exist in nonelderly populations. See, for example, L. Dubay, R. Kaestner, and T. Waidmann, "The Impact of Malpractice Fears on Cesarean Section Rates," *Journal of Health Economics*, 18 (1999), pp. 491–522.

<sup>8</sup> R. R. Bovbjerg, "Legislation on Medical Malpractice: Further Developments and a Preliminary Report Card," *University of California, Davis, Law Review*, 22 (1989), pp. 499–556.

<sup>9</sup> E. D. Kinney, "Malpractice Reform in the 1990s: Past Disappointments, Future Success?" *Journal of Health Politics, Policy, and Law*, 20 (1995), pp. 99–135.

<sup>10</sup> D. P. Kessler and M. B. McClellan, "How Liability Law Affects Medical Productivity," NBER Working Paper No. 7533, February 2000.

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## International Economic Organizations, Developing Country Reforms, and Trade

Anne O. Krueger\*

### International Economic Organizations

The three major international economic organizations are the World Bank, the International Monetary Fund (IMF), and the World Trade Organization (WTO). The WTO emerged out of the General Agreement on Tariffs and Trade (GATT) in 1995; it is an arrangement across countries that serves as a forum for negotiations on trading rules as well as a mechanism for dispute settlements in trade issues.<sup>1</sup> By contrast, the World Bank and IMF deal with

their member countries one at a time. They have little influence with industrial countries but can affect developing countries during times of economic crisis and when those countries seek additional foreign exchange resources. The origins and evolution of the three organizations are of considerable interest.<sup>2</sup> Perhaps even more important in light of the recent financial crises in Mexico, East Asia, and a few other countries, are the questions that arise about the current and future roles of the IMF and the World Bank.<sup>3</sup>

These questions cover a broad set of issues. A healthy open trading system is crucial for the progress of the international economy. It is particularly important in providing an environment in which developing countries can successfully reform their policies and achieve rapid economic growth and rising living standards for

all. I have been particularly interested in the relationship between preferential trading arrangements, such as the North American Free Trade Agreement (NAFTA), and the WTO.<sup>4</sup> The issue is simple: the WTO is based on the principle of open, nondiscriminatory trade among its members, while preferential trading arrangements are, by their nature, discriminatory. Under NAFTA, for example, goods originating in Mexico and Canada are not subject to duties when they enter the United States, yet the same goods from other countries are subject to U.S. duties. Assuring that preferential trading arrangements will not block progress in multilateral liberalization is important, and I am now completing a paper in which I analyze how much discrimination has been a factor under the first three years of NAFTA.

My other major concern regarding

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international economic organizations is closely related to the subject of developing countries' economic policy reforms. I want to know what the current and future roles of the World Bank and IMF will be in economic policy reform in developing countries. In the case of the World Bank, for example, to what extent will the Bank need to focus its resources on poor countries and the support of economic policy reforms, as opposed to tackling "new issues," such as gender and ethnicity (including treatment of minorities). Both the Bank and the IMF have been criticized by many in light of the Asian financial crises of 1997 and 1998.

## Economic Policy Reforms

That takes me immediately to my second set of issues of concern: the choice of exchange rate regime and its relationship to economic growth and the avoidance of crisis. Even before 1994 there was cause for concern about Mexico and other countries that adopted "nominal anchor" exchange rate policies: they deliberately kept their exchange rates from depreciating as rapidly as would have been warranted on the basis of the inflation differential between themselves and the rest of the world. These regimes enabled foreigners to invest very profitably in local markets (because they received the domestic interest rate and could convert it into their own currencies at the appreciated exchange rate) until investors realized that the debt-servicing obligations that were accumulating were too heavy.<sup>5</sup>

Moreover, as long as foreigners were willing to lend and invest, domestic credit could increase in these countries without strong inflationary pressures: the lending financed an excess of imports over exports. Investors appear to have been fooled: they did not observe fis-

cal deficits, but they also failed to recognize that under these exchange rate regimes, rapid expansion of domestic credit was equivalent to increasing the contingent liabilities of the government, with the same long-run implications for sustainability unless capital inflows financed highly productive investments.

An increasing body of evidence suggests that efforts to maintain nominal anchor exchange rates are very likely to be unsustainable: the appropriate exchange rate regime is probably either floating rates or one in which the currency is permanently and irrevocably tied to a major foreign currency.

Indeed, the rapid expansion of domestic credit in many countries meant that banks did not have an adequate staff of trained personnel who could appropriately evaluate the credit risks of their borrowers. As a result, nonperforming loans built up in the domestic banking systems and weakened the banking structure. Then, when the exchange rate regime was abandoned, the dollar- (or yen- or Deutsch mark-) denominated liabilities of domestic borrowers increased the difficulty with debt servicing, and threatened a major crisis in the domestic banking system.

One of the questions that has arisen as we are better understanding the events of 1997-8 (and the earlier Mexican difficulties) is: what are the appropriate reforms for financial systems so that banks will have improved incentives (attributable mostly to increased capital adequacy standards) and will operate in a regulatory framework that prevents the build-up of nonperforming loans (whose magnitude is further increased when devaluation must follow the end of the nominal anchor exchange rate regime)? Aaron Tornell and I<sup>6</sup> have analyzed the evolution of nonperforming loans in the Mexican banking system and the ways in which Mexico's policy responses to

the 1994-5 crisis enabled rapid recovery but failed to resolve some of the longer-term issues associated with restoring the health of the banks. The problem for policymakers is that recovery from crisis cannot occur until the banks are restored to health: that means that nonperforming loans must be removed from the banks' portfolios (as happened in Mexico).<sup>7</sup> But that must be done in ways that prevent a repetition of the build-up of nonperforming loans. Finding an appropriate mix of policy instruments is challenging, and many researchers continue to investigate this topic.

An interesting and related question is how the charges of "cronyism" relate to the other issues that have arisen in the East Asian crisis. I am currently studying the parallels between state-directed lending by banks to cronies under "crony capitalism" and public-sector deficits of state economic enterprises under more state-led development. The parallels are interesting and instructive: if cronies can be assured of access to bank credit, their budget constraints are "soft," just as are those of state-owned enterprises when their losses are automatically covered from the government's budget. And, for the same reason, each type of enterprise is likely to realize lower rates of return on investments than when there is a "hard" budget constraint.

Likewise, for state enterprises politicians normally select managers whose talents and skills lie elsewhere. Cronies are equally likely to not be the most qualified and trained managers. In each instance, there is likely to be a lack of competition (or an unfair playing field) that further reduces pressures for economically efficient production. In both instances, import barriers are likely to be used to assist domestic firms. In the case of crony capitalism, access to credit on favorable terms and other government favors can insulate

enterprises from competitive pressures. I am currently estimating real rates of return on investments in the various financial-crisis countries; preliminary data indicate that real rates of return fell dramatically for several decades as the relative importance of the crony-run enterprises increased.

## U.S. Trade Policy

The final area of research in which I have been involved in recent years is U.S. trade policy. The United States is so important in the world economy that its policies affect the functioning of the international economic system with at least as much force as does the WTO and other international economic organizations. Many aspects of U.S. trade policy are conducive to the efficient functioning of the international trading system, but there are questionable practices, too. While these practices clearly hurt U.S. consumers and producers, they have broader ramifications for the international economy because of the American leadership role. Particularly worrisome are American practices with respect to antidumping and countervailing duties: the law and the procedures followed in these cases bear little resemblance to the economist's case against predatory pricing.<sup>8</sup> Many other countries are now imitating American practices, and there is a serious risk that many of the gains achieved in liberalizing world trade under GATT and the WTO will be eroded as more and more countries resort to antidumping measures and procedures that penalize trade even when predatory pricing is not involved.

## EASE

All of these issues arise in connection with relations between East Asian countries and the United States. For the past ten years, Takatoshi Ito and I have been codirectors of the NBER's East Asian Seminar on Economics. Each year a conference has been held on a subject relating to mutual interdependence. Authors have then revised their papers based on discussion at the conference, and we have produced a volume published for the NBER by the University of Chicago. Cosponsoring institutions are the Chung-Hwa Institution for Economic Research in Taipei, the Japan Economic Research Center,<sup>9</sup> the Korea Development Institute, and the Hong Kong University of Science and Technology. The five cosponsors have rotated being the local host, while the NBER has maintained a lead role in supporting the logistics of the conference and in preparing the results for publication. The subject of the 1998 conference in Osaka was the microeconomic aspects of direct foreign investment. That volume is in press. The subject of the 1999 conference, hosted by the NBER in Hawaii, was macroeconomic aspects of direct foreign investment. The 2000 conference, to be held in Seoul, will have trade in services as its theme. Each seminar has proved highly stimulating in illuminating the many similarities that arise across the economies of East Asia and the United States. Researchers from the participating countries also benefit from the additional insights they achieve when contrasting the

circumstances in their own countries with those of others.

<sup>1</sup> See The WTO as an International Organization, A. O. Krueger, ed. Chicago: University of Chicago Press, 1998.

<sup>2</sup> See A. O. Krueger, "The Founding of the Bretton Woods Institutions: A View from the 1990s," in *The Political Economy of Comparative Development into the 21st Century*, G. Ranis, S.-C. Hu, and Y.-P. Chu, eds., pp. 335-4. Cheltenham, U.K.: Edward Elgar Publishing, 1999.

<sup>3</sup> See A. O. Krueger, "Whither the World Bank and the IMF?" *Journal of Economic Literature*, 4 (December 1998), pp. 1983-2020.

<sup>4</sup> A. O. Krueger, "Free Trade Agreements versus Customs Unions," *Journal of Development Economics*, 54 (October 1997), pp. 169-87.

<sup>5</sup> A. O. Krueger, "Nominal Anchor Exchange Rate Policies as a Domestic Distortion," in *Development, Duality, and the International Economic Regime*, G. Saxonhouse and T. N. Srinivasan, eds., pp. 375-97. Ann Arbor: University of Michigan Press, 1999.

<sup>6</sup> A. O. Krueger and A. Tornell, "The Role of Bank Restructuring in Recovering from Crises: Mexico, 1995-8," NBER Working Paper No. 7042, March 1999.

<sup>7</sup> A strong case can be made that it was the failure of the Japanese government to address the problem of nonperforming loans in the banking system early in the 1990s that led to a significant barrier to resumption of economic growth.

<sup>8</sup> See my *American Trade Policy: A Tragedy in the Making* (Washington, D.C.: Brookings Institution, 1995) and the NBER volume I edited, *The Political Economy of American Trade Policy* (Chicago: University of Chicago Press, 1996).

<sup>9</sup> We have received generous support from the Center for Global Partnership of the Japan Foundation for the past two NBER East Asian Seminars on Economics.