George Soros, Chairman of Soros Fund Management gave a testimony to the U. S. House Committee on Banking and Financial Services. The following article was adapted from his testimony by ***The Wall Street Journal.***

THE CRISIS OF GLOBAL CAPITALISM

George Soros

The global capitalist system that has been responsible for America's remarkable prosperity is coming apart at the seams. The current decline in the U.S. stock market is only a symptom, and a belated symptom at that, of the more profound problems that afflict the world economy.

Some Asian stock markets have suffered worse declines than Wall Street's crash of 1929, and their tumble has been followed by economic collapse. In Indonesia, most of the gains in living standards that accumulated during the 30 years of Suharto's regime have disappeared. Japan, the world's second-largest economy, just reported an annualized 3.35 decline in economic activity for the second quarter. Russia has undergone a total financial meltdown. It is a scary spectacle, and it will have incalculable human and political consequences.

It would be regrettable if America remained complacent just because most of the trouble is occurring beyond its borders. We are all part of the global capitalist system, which involves not only free trade but, even more importantly, the free movement of capital. The system is very favorable to financial capital that is free to choose where to go, and it has led to the rapid growth of global financial markets. Picture it as a gigantic circulatory system, sucking up capital from the financial markets and institutions at the center and then pumping it out to the periphery.

...there comes a point when distress at the periphery cannot be good for the center.

Until the Thai crisis in July 1997, the center was both sucking in and pumping out money vigorously, financial markets were growing in size, and countries at the periphery could obtain an ample supply of capital from the center by opening up their capital markets. In this global boom, emerging markets fared especially well. At one point in 1994, more than half the total inflow into U.S. mutual funds went into emerging-market funds.

Fleeing the Periphery

The Asian crisis reversed the direction of the flow. Capital started fleeing the periphery. At first, the reversal benefited the financial markets at the center. The U.S. economy enjoyed the best of all possible worlds, with cheap imports keeping inflation in check and sending the stock market to new heights. Yet there comes a point when distress at the periphery cannot be good for the center. With the meltdown of Russia, I believe that we have reached that point, for three major reasons.

First, the Russian meltdown has revealed certain flaws in the international banking system that hitherto had been disregarded. In addition to the exposure on their balance sheets, banks also engage in swaps, forward transactions and derivative trades among one another and with their clients. These transactions do not show up in their balance sheets. They are constantly revalued, with any difference between cost and market made up by cash transfers, which is supposed to eliminate the risk of default. The transactions form a daisy chain in which each intermediary has an obligation to his counterparts without knowing who else is involved.

This sophisticated system received a bad jolt when the Russian banking system collapsed. Russian banks defaulted on their obligations, but the banks remained on the hook to their own clients. There was no way to offset the obligations of one bank against those of another. A similar situation arose subsequently, when Malaysia shut own its financial markets to foreigners. These events led most market participants to reduce their exposure all round. As a result, bank stocks have plummeted, and a global credit crunch is in the making.

Second, the pain at the periphery has become so intense that individual countries have begun to opt out of the global capitalist system, or simply fall by the wayside. First Indonesia, then Russia suffered an almost complete breakdown. But their collapse was unintended, whereas Malaysia opted out deliberately. It managed to inflict considerable damage on foreign investors and speculators. It also managed to obtain some temporary relief by being able to lower interest rates and pump up the stock market. But the relief is bound to be temporary, because borders are porous and money will leave the country illegally.

The third major factor working for the disintegration of the global capitalist system is the evident inability of the international monetary authorities to hold it together. IMF programs do not seem to be working. The response of the Group of Seven industrialized countries to the Russian crisis was woefully inadequate, and the loss of control quite scary. Financial markets are rather peculiar in this respect. They resent any kind of government interference, but they hold a belief that if conditions get rough, the authorities will step in. This belief has now been shaken.

These three factors are working together to reinforce the reverse flow of capital from the periphery to the center. The flight of capital has now spread to Brazil and put the rest of Latin America at risk.

Forecasts for global economic growth are being steadily scaled down, and will probably end up in negative territory. If and when the decline spreads to the U.S. economy, it may become much less willing to keep its trade barriers low, which may lead to a breakdown in international free trade.

This course of events can be prevented only by the intervention of the international financial authorities. The prospects are dim, because the G-7 governments have just failed to intervene in Russia, but the consequences of that failure may serve as a wake-up call. There is an urgent need to recognize that financial markets, far from tending toward equilibrium, are inherently unstable. A boom/bust sequence can easily spiral out of control, knocking over one economy after another. Thus, in finding a remedy, "market discipline" may not be enough. There is also a need to maintain stability in financial markets.

This principle has already been implemented on a national scale in the U.S. in the form of the Federal Reserve. But similar financial organizations are lacking in the international arena. The International Monetary Fund and the World Bank have tried valiantly to adapt to such a role, but additional institutions may be necessary. Earlier this year I proposed establishing an International Credit Insurance Corp., but at that time it was not yet clear that the reverse flow of capital would become such a serious problem, and my proposal fell flat. I believe its time has now come. We shall have to establish some kind of international supervision over the national supervisory authorities.

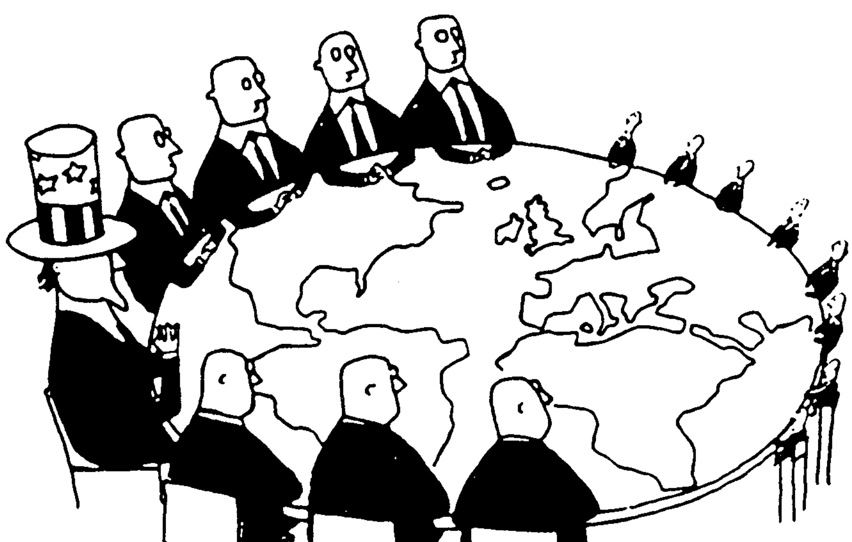
At the same time, there remains the urgent need for the U.S. Congress to authorize an increase in the capital of the IME. In doing so, lawmakers must disregard the influential testimony given by former U.S. Secretary of State George Shultz opposing an increase.

Moral Hazard

Among his other arguments, Mr. Shultz inveighed against the moral hazard of bailing out irresponsible investors. Here he has a valid point. Bailouts did encourage foolish behavior by banks and other lenders, which could count on the IMF when a country got into difficulties. But the moral hazard now operates in the opposite direction, in not enabling the IMF to do its work when it is most needed. Countries like Moldova and Romania have no one else to turn to but the IMF is perfectly capable of assisting them. It would be tragic if it were to run out of resources.

Replenishing the capital of the IMF, however, will not be sufficient to resolve the global financial crisis. A way has to be found to provide liquidity not only at the center but also at the periphery. I believe there is an urgent need for the creation of Special Drawing Rights that can be used to guarantee the rollover of the already existing debt of countries that receive the IMF's seal of approval. If there is no reward for good behavior, meltdowns and defections will multiply. But such radical ideas cannot even be considered until the U.S. Congress changes its attitude toward international institutions in general and the IMF in particular. ■

GLOBAL CAPITALISM



Making it work