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DO THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEMS NEED MORE THAN SHORT-TERM COSMETICS REFORMS?

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Do the International Monetary and Financial Systems Need More Than Short-Term Cosmetics Reforms?

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Abstract

The storm that has rocked our world has opened an interesting debate among economists and policy makers concerning with the need of a new international monetary and financial architecture. The monetary and financial regime that has been in force since the collapse of Bretton Woods (B-W), encourages indeed the persistence of unsustainable dynamics which spawn increasingly serious crises and it is unable of imparting an acceptable macro-economic discipline device to the world's economy. It became apparent that the global role of a key currency along with the deregulation of financial markets (neo-liberal paradigm) have acted as underlying conditions for the US financial crisis up to present situation and the following contagion to Europe. In this paper I point out the inadequacy of the institutional arrangements underlying the international monetary and financial regimes and I outline the relevance to the current debate of Keynes original plan, suggested rightly 70 years ago, that never born.

Keywords: International Currency, International Financial Architecture, Global Imbalances, Keynes Plan

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"perhaps Utopian, in the sense not that it is impracticable, but that it assumes a higher degree of understanding of the spirit of bold innovation, and of international cooperation and trust that it is safe or reasonable to assume"

(J.M. Keynes, CW, vol. XXV, p. 33)

0. Foreword

The storm that has rocked our world has opened an interesting debate among economists and policy makers, concerning with the need of a new international monetary and financial architecture (cfr. Alessandrini-Fratianni, 2009, Mateos y Lago et al. 2009, Palley, 2008, 2009, 2011, Eichengreen, 2011).

The monetary and financial regime that has been in force since the collapse of Bretton Woods (B-W), encourages indeed the persistence of unsustainable dynamics which spawn increasingly serious crises and it is incapable of imparting an acceptable macro-economic discipline device to the world's economy. It became apparent that the global role of the "key currency" (i.e. the dollar) along with the deregulation of financial markets (i.e. neo-liberal paradigm) have acted as underlying conditions for the 2007 financial crisis up to present situation (cfr. Palley, 2009; Perelstein, 2009), with the following contagion to Europe and to the emerging markets.

The crisis would have been either averted or, at the very least, mitigated if the monetary and financial regimes have sounded the alarm bell and triggered an adjustment in time both from the perspective of US and in terms of global monetary and financial relations.

In this paper I also point out the inadequacy of the institutional arrangements underlying the international monetary and financial regimes and I outline the relevance to the current debate of Keynes' original plan suggested, rightly 70 years ago, at Bretton-Woods. As well-known that plan was unfortunately aborted. Despite in the first aftermath of recent crisis someone have believed[1] that the problems of the current reserve system could be eliminated by creating a true international reserve currency issued by a supranational bank, this intriguing theoretical topic

has later indeed turned into oblivion.
To try to get this aim and to renew the debate on the reforms needed, I have considered 3 sections: Section I looks back to the origins of Keynes Plan at Bretton Woods stressing the 'secular problem' of international imbalances and the solutions proposed by Keynes himself. Section II shows how the international monetary system, stemming after the collapse of B-W, along with the deregulation of financial markets fuelled current macroeconomic and financial imbalances, instability and crisis. Section III addresses the importance to strongly review the international monetary and financial architecture instead of suggesting "short-term cosmetics" reforms. Section IV get some conclusions.

1. From Bretton Woods to the current non-system.

As I pointed out in the foreword, if we are to consider the possible reforms which the monetary and financial systems might be subjected we may well begin by looking back to the Bretton Woods agreements of 1944. In fact, it is in the light of the themes involved in that debate that we can grasp the nature of the snags lying in the path that was to be followed up to present date. In a word, we need first to summarize the monetary and financial systems' history.
The conference saw the clash between the views of two heavyweight protagonists: Harry Dexter White (assistant to Morgenthau, secretary of the US treasury) and John Maynard Keynes (representing the British government). Apart from the idea common to both that the international monetary and financial system was subject to instability and inefficiency, calling for intervention by the international institutions, the positions taken by the two economists on the actual "agenda" of these institutions showed a marked divergence (Skidelsky, 2001; Sau, 2004; Piffaretti, 2008).
Keynes argued that the "secular international problem" of balance of payment imbalances, was characterized by a "single characteristic" that is: all the

international monetary settings used in the past five hundred years throw "the main burden of adjustment on the country which is in the debtor position on the international balance of payments" (CW, vol. XXV, p. 27).

He then suggested a new institutional framework: a thoroughgoing *International Clearing Union* (ICU) which, through the operation of an *International Clearing Bank* (ICB), would facilitate the re-equilibration of global imbalances. Clearing Union activity lay in generalizing the principle of national banking to international transactions, i.e. the necessary equality of credits and debits, of assets and liabilities" (CW, vol. XXV, p. 44). Thanks to this institution the states of debt or credit of the Union members resulting from economic-financial exchanges were to be regulated on the basis of a new unit of currency (*bancor)* which would circulate only between countries but not within them[2]. Bancor would be the liability of ICB not of any individual central banks. Then there would be no demand for any "key currency" both as a means of international payments and as means of a reserve in central banks' portfolios.

The central banks of all the countries that wish to trade with members would entertain relations with CU "through which they would be entitled to settle their exchange balances with one another at their par value as defined in terms of bancor. Countries having a favorable balance of payments with the rest of the world as a whole would find themselves in possession of a credit account with the CU and those having an unfavorable balance would have a debit account" (Keynes, CW, vol. XXV, p. 171). That is, Keynes Plan tried to reproduce the banking principle governing national payment system, at the global level[3].

The ICB could never be in difficulties since it may advance what any of its countries customers need, with the assurance that the proceeds can only be transferred to the bank account of another country. An implication of the Keynes's plan, useful for the purpose of this paper, is that even if the ICB was not primarily designed to be a lender of last resort, its power to issue an international currency could have afforded to grant emergency loans well beyond the quotas supplied by the member countries (Sau, 2004).

Furthermore Keynes suggested measures necessary to prevent the piling up of credit and debit balances without limit. Contrary to the past, he stressed the need of a symmetric rebalancing[4] which would involve both countries, in debtor and creditor position (cfr. Piffaretti, 2008; Constabile, 2009; Carabelli-Cedrini, 2010). Central to this idea was the treatment of creditor countries[5].

To avoid the contraction pressure against the world economy and, by repercussion, against the economy of the creditor country itself, Keynes argued that the chief initiative would rest on the country which finds itself in a creditor position against the rest of the world (see, CW, vol. XXV, p. 47).

Keynes also suggested that "a charge of 1% per annum shall be payable to the Reserve Fund of the clearing union on the amount of the excess of the average balance of a member state, whether it is a credit or a debit balance, above a quarter of its quota; a further charge of 1% on the excess of the average balance whether it is a credit or a debit balance, above a half of its quota[6].

Although, as over depicted, Keynes Plan had many hindsight that now we can say more courageous and more long-sighted compared with the American proposal, it was White who won the day with a plan that provided for the creation of a simple Stabilization Fund[7]. (subsequently christened the "International Monetary Fund" (IMF)). As to the monetary system it was the gold-exchange standard that prevail and bancor as a true international currency never born.

As already argued by Keynes in 1942 the White plan was different from his plan because it was not founded on banking principle and was not intended to provide the world with a means of international circulation[8].

The initial impact of the Bretton Woods agreements was positive, giving a prompt boost to international trade and guaranteeing stability. Subsequently, increasing trade also entailed the need for an increase in the quantity of dollars: America's official liabilities outstripped the country's gold reserves and saw the system steadily on the way to collapse (which came about in 1971). This argument has been pointed out particularly by Robert Triffin (1960) in his famous "paradox" or "dilemma" concerning with the international monetary system of his day[9].

Nevertheless, the ensuing solutions after Bretton Woods left, once again, Keynes's original proposal out of the picture and do not take into account Triffin's criticisms. The choice was, rather, to sever all links between currencies with gold or the dollar, and leave the individual countries free to decide on their foreign exchange.

As a result of the 1976 Jamaica agreements, the IMF saw its role yet further downsized, to become a mere organism for surveillance that retained the possibility to provide funding only conditional on the implementation of closely defined economic policies and supplied data on the state of the world economy.

At least three significant attempts at building a more consistent system had, in effect, been made and failed: the Committee of Twenty in 1972-74; the substitution account project in 1978-80; and the Plaza-Louvre Accord in 1986-87. As none of these attempts succeeded in rebuilding a consistent and universally accepted monetary regime, the global economy was simply left without any monetary order at all. It is worth noting that a timid direction by the IMF in 1963 suggested the introduction of Special Drawing Rights (SDRs). By the time of their first allocation (1970) however the "Bretton Woods System" was already crumbling. The global shortage of reserves that the SDRs were supposed to address never materialized, and, as I shall outline in section 3, the SDRs never managed to gain significance.

The post-Bretton Woods 'non-order' had indeed two features: first, it made the market responsible for determining exchange rates; second, it reinforced the dollar as the global standard in the absence a true new system. This latter aspect is particularly apparent considering the indifference displayed for such variables as the amount of international liquidity and the boom-bust cycles of asset prices confirming that the international currency and the global stance of monetary policy were no one's responsibility. These two features were not based on a body of economic research, nor they were introduced by international agreement's designs; rather they were both largely adopted by default.

Nevertheless most reserves continued to be invested in dollar-denominated assets; most prices of internationally traded goods are quoted and invoiced in dollars; and most managed currencies continued to be pegged to the dollar[10]. In some sense, "the

post-Bretton Woods era was marked by a fundamental shift in relations between money and the two entities to which it had been anchored from time immemorial: a commodity as intrinsic value, mainly gold, and the political power; the former anchor was relaxed while the latter was correspondingly strengthened" (cfr. Padoa-Schioppa, 2010, p. 7). Unfortunately new forms of financial instability raised in last decades, both domestically (inside the US) and globally.

As a matter of fact, flexibility in exchange rates is not stabilizing since it will not effectively enforce discipline on national economic policies and will not ensure the rapid correction of imbalances. Foreign exchange market is indeed incapable of governing interdependence because it is too slow in detecting the imbalances that require correction, and when it does detect them, it is incapable of enforcing decisions on the public players who are responsible for those imbalances.

In financial complex systems economic players themselves pay unequal attention to fundamentals, affording priority to only one of them at a time and alternating moments of over-estimation and under-estimation of the attendant risks (Sau, 2013). Imbalances tend to build up and to get worse over time, because the market considers them to be sustainable for too long and finances them accordingly, until it suddenly changes its mind and adopts sharp corrections (what is known in jargon as a 'sudden stop'). In contrast with the efficient market hypothesis (EMH), thus the market 'makes mistakes' too often and for too long time for it to be an effective and credible guide in the service of macro-economic stability.

The tumultuous globalization process continued to move forward for years in spite of the existing framework's shortcomings pending the arrival of better arrangements. Unfortunately up to present time both national and international financial authorities failed to build a new system: they simply struggled with the available tools, arrangements and institutions. In reality, the fact that so many of the functions of money were performed by a purely national currency like the dollar hampered and distorted the globalization process. Since then the international economic picture has undergone progressive change, above all due to the intensive process of liberalization of the financial markets (neo-liberal paradigm) and in

absence of a true "new order". As a consequence this "institutional vacuum" was overwhelmed by the forces of the free market and has generated one of the great financial crisis since 30s.

2. Macroeconomic imbalances, instability and crisis in the current international financial and monetary non-system

In this section I try to show how the current monetary and financial non-system, as it has been depicted in section 1, may be considered the main underline conditions both for macroeconomic imbalances, and for the present situation of global financial instability stemming after the sub-prime crisis.

Imbalances[11] are characterized, on one hand, by large current account deficits run by the US and, on the other, by high surpluses in emerging economies. It has been stressed that this situation is inequitable (cfr. Report by Nations Unions, 2009) since the U.S. has been the recipient of the world's savings, while emerging economies and developing countries have been the supplier, that is developing countries has financed the developed one.

As pointed out by Perelstein (2009), prior to the crisis there wasn't any other state than the U.S. having a higher level of current account deficit in the balance of payments. Simultaneously, this has happened with a record high fiscal deficit (twin deficits) by the US, financed by issuing new debt: China and Asia have primarily financed the U.S. national debt.[12] The idea that the U.S. is responsible for the global imbalances is contrasted by some economists who think that emerging economies (China is the most relevant), are to blame for saving too much without letting their currencies appreciate. That is, the "responsibility" of macro-imbalances is under scrutiny[13]. Indeed, as I shall argue later, macro imbalances are the results of current monetary and financial non-system along with the financial deregulation "paradigm" that promote excess elasticity in gross capital flows rather than to so-called savings glut. Furthermore, one thing is undeniable: "any other country

pursuing a strong expansion without worrying about the consequences that policy might have on its own currency's domestic spending power, would soon be called to order by the drop in its currency's value on the foreign markets, but this was not the case for US dollar" (cfr. Padoa-Schioppa, 2010, p. 9).

Let's see now why the international monetary non-order is the key structural feature that determine the dynamics of an international financial system that depends on U.S. trade deficits. The specifically monetary factors that triggered the financial turmoil are indeed of crucial importance and need to be afforded.

U.S. trade deficit, enable to inject reserves (cfr. Costabile, 2009) into the rest of the world financial system. While in the past the global growth was dependent on the mining of gold, today it is dependent on the creation of dollars[14].

That is, there is global dependence on the U.S. trade deficit as a means of maintaining liquidity in financial markets: if the U.S. reduces its deficit it might therefore have negative effects on the world economy through dollars shortage. Since the dollar is the international reserve currency, international debt is mostly denominated in dollars. Since World War II, the U.S. has been a leading superpower partly because the dollar, as the international reserve currency, has given asymmetric power[15] to the U.S. economy[16]. Much of the current account surplus has been built up in the aftermath of the East Asian financial crisis in 1997 and 1998 when some of these countries ran out of reserves (cfr. Palley, 2011). Many of these countries have been building up their reserves precisely in order to avoid another crisis in future due to outflows of domestic capital and "sudden stop" in capital inflows (i.e. self-insurance).

As already stated the scenario over depicted has both domestic and international consequences for the stability of the financial system. As to domestic ones the U.S. current account deficit, financed with foreign capital inflows, is unsustainable and might lead to disastrous consequences for the global economy[17]. Since the U.S. is running a current account deficit, it is building up debt to other countries, which is paid for by outflows in the financial account but these liabilities have to be paid back in the future. This argument is that if the U.S. external deficit is not drastically

reduced, it might lead to a speculative attack against the dollar and a flight in capital flows.[18] Many skeptical have worried about foreigners holding U.S. assets, in the form of debts, which then have to be repaid to them.[19]

Nevertheless despite the huge twin deficits in US, the monetary and financial regime has not sounded the warning and triggered an adjustment in time of these imbalances. For the global key currency, and for it alone, that call to order never came. As outlined by Padoa-Schioppa (2010, p. 12), "two crucial factors made it possible to protract this situation far beyond the point at which an adjustment could still have been painless: the fact that it was the world's leading economic and political power sailing that route; and the fact that that economy, being the world's "central banker", was exempted from any external monetary discipline".

In no other country in the world could we have seen start building up processes of over-indebtedness as easily and for so long without suffering the consequences of these actions. If nothing actually occurred, it is because the dollar was in demand as an international reserve currency.

This quotation by Jacques Rueff on the point referred to the dollar's exorbitant privilege as "key currency" is prescient: "If I have an agreement with my tailor that whatever money I pay him he returns to me the very same day as a loan, I would have no objection at all to ordering more suits from him." That is, "there is a tendency built in the system to confer the borrower/debtor position to the US" (cfr. Costabile, 2009, p.7).

Domestic analysis (focusing on the sustainability of financing for the US trade deficit) does not account well enough both for the demand-side inadequacies of the system (cfr. Palley, 2007; Perelstein, 2009) and for the global integration of capital markets. Is then necessary a more systematic view to analyze the relationship between the U.S. imbalances, the global economy and the financial markets. On one hand, if the high level of US foreign debt would lead to dollar crisis there would be much higher capital losses to foreign investors and a drop in emerging countries's foreign reserves than expected. On the other there are indeed negative aspects for other countries in the world of reducing the global trade imbalances by the US. One

cannot indeed consider the consequences of a reduction in the U.S. import-led growth without thinking through the consequences of export led-growth of other countries (cfr. Keynes's point on secular imbalances). The truth is that both the US and emerging countries get stuck in a sort of suboptimal equilibrium that has been rightly labeled as "balance of financial terror".

Most of the focus on the U.S. economy has emphasized the unsustainable situation ignoring the negative side for other countries in the world of reducing the global trade imbalances. Every time the U.S. goes into recession and reduces the level of imports, the rest of the world will suffer due to less demand for foreign export (i.e. huge negative spillovers to other countries). Some countries might handle this better than others, but when this problem is concerned to the heavily indebted countries this may generate negative effects that lead to a severe debt-crisis in these countries. As stressed by Perelstein (2009, p.9) "because there is a high degree of global financial integration, if the U.S. reduces its deficit it might therefore have negative effects on the world and lead to an outflow slowdown"[20]. Furthermore, when the U.S. deficit has been lowered previously, it has led to a depreciation of local currencies against the dollar, and the price of borrowed U.S. dollars has risen[21]. The US financial crisis and current global financial turmoil are then a consequence of the global imbalances over depicted along with the financial deregulation process inspired by the neo-liberal paradigm. The current monetary systems and the globalization of finance over depicted have indeed excessively prolonged the duration of unsustainable trends which a different system could have resolved far earlier and far more painlessly[22].

The transmission to the US financial markets goes indeed through the dollar credit balances since the latter are usual reinvested in dollar securities by surplus countries[23]. Capital flows from emerging countries to the US promoted "excess elasticity"[24] of the international monetary and financial system since financial innovation and deregulation processes fuelled the build-up of unsustainable credit and assets price booms. The booms in the collaterals, in turn, have positive influence on the credit constraints with pro-cyclical effects. Inflation in all dollar-

denominated assets markets, for example in the housing market, fuelled indeed an endogenous process of over-lending and over-borrowing in the private sector (Sau, 2013)[25]. The boom in the U.S. securities markets and the extensive deregulation process has led to the buying of all sorts of assets whose risks were unknown, for example the collateralized debt obligations (CDO) linked to subprime borrowing.

The U.S. subprime mortgage crisis in a deregulated international financial markets is then an example of how fast a problem in one part of the internationally integrated financial system can be passed on to other parts, and affect the real global economy (Perelstein, 2009; Palley, 2013; Soros, 2008). This will lead to the conclusion that: the financial crisis in 2007–08 is transmitted to the rest of the world through the macroeconomic imbalances; and there is a global monetary and financial dependence on the U.S. since the dollar is the key currency.

In this sense, macro-imbalances promoted financial imbalances. If it is the case, the over quoted “excess saving view” bears reconsideration since it was the “credit creation” that played a key role in this story, instead of the fashion idea that stressed the downward pressure on world interest rates promoted by the “saving glut”[26]. Indeed, from the perspective of the global economy, the crisis was the work of two false idols: the infallibility of the market and the self-sufficiency of US national monetary policy.

The first paradox link to the international financial turmoil is that Europeans were not responsible for the crisis, yet they have become its chief victims. The origin of the current European crisis indeed can be directly traced back to the US crisis of 2007–2009 over depicted which spilled over into a sovereign debt crisis in several euro area countries in early 2010.

Europe indeed has done very little to avoid contagion from the US. As outlined by Palley (2013, p. 2): “the crisis in the euro zone is link to a toxic neo-liberal economic policy cocktail”. In fact, well before the crisis stemmed, many euro countries exhibited striking similarities with US’s paradigm concerning with the financial system.

In many of these countries, government bailouts of banking systems contributed to

an increase in public debt. Conventional way of correcting bank balance sheet shifted problems from banks to government, but worsening government's balance sheet set in motion, in the euro zone, bad dynamics. Private debt became public debt, be it through banking crises or the burst of housing bubbles, leading to the sovereign crisis. The latter begin with Greece, but suddenly spread over some other countries of the euro zone like Portugal, Ireland, Italy and Spain (cfr. Toporowski, 2008a e 2008b).

The crisis in the euro-zone is often described as a sovereign debt crisis in fact, it is really a sequence of interactions between banking problems and sovereign problems (twin crisis) that present many aspects that are prone to instability and debt deflation processes.

In the monetary regime whose features and shortcomings I have just illustrated, any depreciation of the dollar's real exchange rate[27] would inevitably have the greatest impact on the euro and on other major currencies like the yen and the yuan rembimbi. Furthermore it is now more and more apparent that the global financial instability stemmed after the US financial crisis has open the door to the possibility of "currency war" between the main developed and developing countries[28].

A major drop in competitiveness due to this currencies turmoil has rapidly turned Europe into a fully fledged crisis zone in the global economy, into a source of instability, and into a factor of international tension. It became apparent that the world vitally needs a new global monetary and financial order (cfr. Wade, 2008).

3. On the need of a new monetary and financial architecture

There are several reasons that justify a call for a renewal of the international monetary and financial architecture: in previous sections, I tried to identify the global macroeconomic consequences of the shortcomings of the current international monetary non-system. Having stressing the urgency to put in place a more sustainable system, in this paragraph I outline why Keynes Plan offers, up to

date and in my opinion, a good plan and a right frame of mind to move beyond it. Unfortunately, as far as I know, current proposals are indeed characterized or by a substantial *status quo* approach[29] or, in the best case, they suggest some kind of short-term cosmetics reforms that do not consider the whole insights of Keynes Plan.

As to the so-called cosmetics reforms they consider and explore arrangements both on the demand side and on the supply side of the current non-system and, even if they contribute to the ongoing debate on strengthening the international monetary system (cfr. Mateos y Lago et al. 2009), they only address part of the problems and the solutions needed.

As previously discussed (cfr. section 1) the moving away from fixed exchange rate regimes has not implied a diminution in reserve accumulation since there are other reasons for holding reserves stemmed during recent time. This is particularly true for emerging countries: they accumulate indeed huge dollar reserves to buffer exchange rates adjustments or banking crisis in the face of shocks link to sudden stops in capital inflows as occurred in the 90s Asian crisis[30]. Since the problem comes from some kind of self-insurance the focus is put on the reduction of the precautionary demand for reserves. Among the measures emphasized by some authors, there are a more extensive role for the FMI. That is, the opportunity for emerging countries to borrow from FMI and to have access to a global lender of last resort (GLLR) able to rapidly intervention during financial and banking crisis.

Unfortunately conditional borrowing experiences[31] during the crisis, particularly the Asian's one in the late 90's (cfr. Sau, 2003, 2004), have not moved in this direction. As I shall try to show later a true GLLR need a radical reform both in the structure and in the governance of the FMI.

Short-term reforms are also suggested in the direction of looking for third-party insurance, that is: to encourage countries to make greater use of private sector hedging instruments. At this regard FMI might offer technical support, for example using surveillance to inform insurers on the risk profile of potential clients. This is of course a partial and very difficult response to implement since market failures

emerge at many levels particularly concerning the pricing of events such as financial crisis and connected phenomena of moral hazard, adverse selection, costs to underwriters for identifying risks and returns and, least but not last, the inability to diversify sovereign risks. Furthermore during a phase characterized by financial distress for both banks and firms it is difficult if not impossible to distinguish between insolvent or simply illiquid operators (Sau, 2004).

As to the supply side of the problem of current international monetary non-system, short-term reforms are looking for alternative currency system that could substitute the current one based on the dollar. The most stressed are: multiple or competing reserve currencies[32] with no one as a true "key"; and new SDR-based system that pools the main reserve currencies.

A multi-national currencies system is certainly better than the existing one, nevertheless the former depends on a host conditions that cannot be readily changed only by national policy. To compete with the dollar as reserve asset is possible only for economies with financial systems, international trade, and GDP that are comparable in size to those of the United States. Someone suggest the euro, the yen and the Chinese rembimbi. Nevertheless it is not sure that even fully substitutable currencies could overcome the problem of network externalities that push in the direction to converge to a dominant one. As to the euro it would be particularly problematic to become the key reserve currency since countries in the euro-zone are restrained in their monetary and fiscal policies for they would face difficulties in offsetting the adverse effects on national aggregate demand associated with trade deficits.

Furthermore it is not clear if a multi-currency system would be more stable than a reserve system dominated by a single national currency (allowing central banks shift the composition of their portfolios to optimize expected return) and in any case this system would not eliminate the problem of deflationary bias and resources transfers from emerging countries (cfr. Mateos y Lago, 2009).

As anticipated, suggestions are also concerned to move away from the dollar, reviving attention to the SDRs after a falling into near oblivion for decades[33] (Zhou,

2009; Mateo y Lago et al., 2009; Padoa Schioppa, 2010). Becoming the principle asset in the international monetary system, maintaining the network externalities that favor a single currency and being available as a composite product, SDRs may finally offer a convenient means of reserve diversification and stable store of value[34].

Nevertheless finding the players prepared to bear the initial cost of reaching a critical mass is unfortunately the crucial hurdle for the use of new-SDRs. Furthermore someone has outlined that the *condicio sine qua non* for SDRs to play a greater role in the international monetary system and to become a global standard is that they be able to circulate in the economy, that is to be used by a broad spectrum of public and private economic players[35].

This call for a deep and liquid market whereby banks and non-banks financial firms, as well governments issues and hold SDRs-based instruments. In a highly integrated global economy a basket containing the main currencies would be appealing in and of itself both for the denomination of assets and liabilities and for other purposes as well. Padoa-Schioppa (2010, p. 8) argued that "SDR's could play precisely that role[36]. Furthermore nothing would prevent SDR or an SDR market from being endowed with ordinary, properly functioning market infrastructures". This analysis is rather optimistic since the crucial question is this: would an SDR endowed with a well developed private market, and used as a store of value and unit of account by private and public players, help to correct the fundamental flaw in the present system? Yes it would, but only to the extent to which this proposal is better than the current system; beyond that limit, a global standard requires its 'own' policymaker mandated to pursue the global interest if it is to become a full fledged anchor of stability.

Emerging countries that will look for additional reserves for self-insurance motives do not have to run export surpluses, forgoing consumption in order to acquire them. This is also a way of limiting both the macroeconomic/financial imbalances and the exorbitant privilege of the country's reserve currency. But unfortunately, limiting is not the same as eliminating.

For the new-SDRs to become more like a global currency, the FMI would have to

become more like a global central bank and provider of emergency liquidity.[37] There is indeed no way to get round the requirement of a policy framework anchoring the global standard to an objective of global stability. As apparent in current times, only in theory a world of decentralized monetary policy decisions with the help of the institutional framework (by the IMF, the BIS, the G7 and the G20) may generate effective coordination among the main monetary areas and meet the requirement of stability. All past and recent experience suggests indeed that, in practice, coordination fails precisely when it is most needed, i.e. when policy preferences are most divergent!

Any removal of the perverse incentives which exist in the system today is likely to generate a more appropriate global monetary policy stance; in particular, the arrangement described would diminish the inequitable and 'exorbitant privilege' that allows the United States to run large external deficits while financing them with its own currency. The demand for dollar assets would be less elastic, and large US deficits would sooner rather than later cause a downward pressure on the dollar and an upward pressure on US interest rates.

But let me turn to my skepticism: this is based on the fact that Keynes's "international secular problem" (deflation bias) and Robert Triffin's 'general dilemma' would not simply disappear in the wake of the development, however successful, of the SDR's circulation and use. In the absence of an International Clearing Bank and of effective arrangements for adjustment in surplus countries one cannot produce the global public good of a stable monetary and financial architecture.

That is, in the absence of a policymaker supplying a sort of *global public good* which action could enhance both the efficiency and the stability of the ever more uncertain and volatile financial markets (to the advantage of both emerging and the more developed countries) a mere average of national economic policies cannot produce a stable monetary anchor on a global scale. Here is where the decisive role of public policy comes into play thus accommodating tools indexed to a unit clearly defined by the international institutions and starting issuing debts denominated on this

unit on a regular basis. On the other hand, the international institutions, working with national central banks, could foster the creation of a *clearing system*.

That is, the implementation of a new plan need to be more close to Keynes's original one at B-W (cfr. section 1). The latter had indeed the seeds for a true new-order, based on both a true international currency and on an international clearing bank (ICB), and today's current debate should include reshaping the international monetary and financial system in the 'spirit' of that plan.

To make the IMF a new-SDRs-based organization it is necessary to replace quotas with new-SDRs as the single source of funding for IMF and to permit to issue new-SDRs to itself on a regular basis, to be used in lending operations; that is, future challenge is to replace *exogenous* vs. *endogenous* creation of international liquidity. There would be "no backing" for the global currency except the commitment of central banks to accept it in exchange for their own currencies.

If it is the case new-SDRs issues were indeed no longer some kind of "helicopter money" subject to arduous and politically charged negotiations dominated by major industrial countries, neither it would be necessary to borrow from some of its members in order to lend to others. The new International currency certificates (labeled ICCs -as suggested by the 2009 commission of the United Nations-), like the original Bancor, as a true international currency could play a role as a store of value and a unit of account for exchange rate policies interventions, and the management of official reserves to provide stability.

Furthermore the current SDRs allocation is based on a particular "quota" system, that of the IMF, which continues to be subject to heated debate because richer countries, on average, get a large share of new allocations: this is the opposite to what a criterion based on need would suggest. By contrast the allocations could and should have built on incentives and/or penalties to discourage maintaining large surpluses as it was in original Keynes plan. Countries that maintain excessive surpluses could lose all or part of their quota allocations if they are not utilized in a timely manner to increase global demand. The emissions should have adjusted in a *countercyclical* way (to offset deflationary and inflationary tendencies in effective

world demand), with large emissions when global growth is below potential and restrictions in the opposite case. As well known, Polak (1996) suggested, in compliance with the spirit of Keynes plan, to provide all financing during crisis with loans in the international unit. This would generate emissions that would be automatically extinguished once loans are paid back and create a global equivalent to what the central banks of industrial countries have been doing on a massive scale during recent years.

I am fully aware that this need the creation of a mechanism that may remove the dollar overhang by allowing countries to replace their existing stocks of dollar reserves with new ICCs, without causing disruption in currency markets. This is in compliance with the proposal by the director of People Bank of China Mr. Zhou, concerning with a new substitution account: the FMI would set up an open-ended ICC-denominated fund allowing subscription and redemption in the existing reserve currencies by various investors as desired.

Those who reject the analysis that I have conducted hitherto claim that the current state can carry on the way it is today and cosmetics reforms -like the modest palliative of a revaluation of the renminbi at most, and a better governance inside the FMI- are necessary but sufficient for global stability. They also stressed that there are two greatest hurdles concerning with radical reforms: first of all, the absence of a consensus within the community on what a sustainable monetary and financial order should be[38] and second, the tireless resistance proffered by nation states (since they are convinced that they are the repositories of effective and untouchable sovereignty) against the creation of a supranational institution (i.e ICB) and of a new international and independent currency (i.e. ICC), that such an order demands.

But the idea of a real “International Bank” went beyond the proposal of an international clearing union, to become the financial core of the architecture of a system of global economic governance. The current financial turmoil has lead to the recognition that some kind of international/global lender of last resort (GLLR) is urgent. In the absence of a sounder global institutional grounding, and with

currencies, including the US dollar, the yuan and the euro, being left dangerously exposed to very strong fluctuations, the global monetary architecture is being left vulnerable to possible new chaotic unwinding of global macroeconomic and financial imbalances.

Conclusions

In this paper I try to envisage the post-crisis era in constructive terms to avoid other financial turmoil. At this regards, it is urgent to promote the reconstruction of a fully fledged international monetary and financial order in the spirit of the plan that Keynes suggested, rightly 70 years ago, at Bretton Woods.

In recent time there has been a marked increase in concerns about this topic, nevertheless many have stressed solutions that might be called "cosmetics": these are indeed characterized by short-termism and they are incomplete because they disregard and deal inadequately with the international aspect of money and with the globalization in financial markets. The demise of the Bretton Woods system stemmed in 1971, indeed was not accompanied by the adoption of any robust alternative tools or any shared rules for managing the global economy.

Current non-system is not able to defend the world against the constant and lethal dangers to which unsustainable macroeconomic dynamics expose the global economy. These disorders lies at the bottom of the crisis and no reform of the monetary system and of finance failing to remedy them, can provide a solid foundation for stability.

Nowadays, the international financial architecture is shaped by the regime of the "key currency", which structure it into a core (the US), and a periphery. As currently set, the system allows for international imbalances to continue build up, so long as the periphery supports the accumulation of dollars. Macroeconomic imbalances, in turn, are at the roots of financial imbalances, and subsequent crisis phenomena that spillover in Europe and promote huge negative real effects. That is the system is

unstable, inequitable and incompatible with global full employment.

I have argued that the fundamental weakness in the international monetary and financial system stem from the problem of "excess elasticity": the system lacks sufficiently strong anchors to prevent the build-up of unsustainable booms in credit and asset prices (financial imbalances) which lead to serious financial strains and may derail the world economy.

The elements that are helping to keep this disorder alive are economic interests but also, and above all, the inertia of the practices currently in use and, in some sense, widespread intellectual inertia. In 1944, Keynes assumed[39] a higher degree of understanding of bold innovation and international cooperation that it is reasonable to assume also today. An up-date of his thought, as I have expounded here, are an invitation to overcome that inertia.

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Notes

[1] See Ocampo, (2008) and the 2009 Report on Reforms of the International Monetary and Financial System by the Commission of Experts of the United Nations.

[2] The following quotations may be useful to the understanding of Keynes's project: "We need a quantum of international currency , which is neither determined in an unpredictable and irrelevant manner as, for example, by technical progress of the gold industry, nor subject to large variations depending on the gold reserve policies of individual countries; but is governed by the actual current requirements of world commerce and is also capable of deliberate expansion and contraction to offset *deflationary* and *inflationary* tendencies in effective world demand" (Keynes, CW, vol. XXV, p. 168-69).

[3] If it is the case, one may recognize the loans-make-deposits causality on which the *endogenous* money paradigm is based (see Gnos, 1998 in Rossi, p. 100). If, for

instance, a country A has a trade deficit to the benefit of country B amounting at x bancor worth, it may optain a loan from the ICB to settled its position. The amount of bancor so created is, on its turn, deposited by contry B to the ICB: no single bancor can leave the system.

[4] … "The principal object can be explained in a single sentence: to provide that money earned by selling goods to one country can be spent on purchasing the products of any other country. In jargon, a system of multilateral clearing. In English, a universal currency valid for trade transactions in all the world" (Keynes, CW, vol. XXV, p. 270).

[5] As Keynes puts it (idem p. 211): "the problems of the debtors can only arise if creditors are not choosing to make use of the purchasing power they have obtained".

[6] … if they are found acceptable they would be valuable and important inducements towards keeping a level balance, and a significant indication that the system looks on excessive credit balances with as critical an eye as on excessive debit balances, each being, indeed, the inevitable concomitant of the other (idem, CW, p. 173).

[7] The role of the stabilization fund was indeed: to intervene in order to keep exchange rates stable, granting loans to countries with temporary deficits, above all in the balance of trade (capital movements playing a decidedly minor role at the time),and within the limits of the deposits, calculated on the basis of the economic clout each member country enjoyed in international trade. Gold-exchange standard system wasn't a currency union since all currencies might be exchanged with the dollar and only the latter with the gold. Assessing these membership quotas meant determining not only the availability of credit obtainable but also the relative "weight" in voting.

[8] "Since the proposed Stabilization Fund is to perform clearing functions for its members, it might seem, at first sight, to have a closer resemblance to the Clearing Union than it is the case. In fact the principles underlying it are fundamentally different. For it makes no attempt to use the *banking principle* and *one-way gold convertibility* and is in fact not much more than a version of gold standard, which simply aims at multiplying the effective volume of the gold base. …The scheme is only helpful to those countries which have a gold reserve already and is only helpful to them in proportion to the amount of such gold reserve" (Keynes, 1973, p. 160).

[9] He explained that if the global currency is a national currency, there is an irremediable contradiction between the issuing country's internal domestic requirements and the external requirements of the world using it, that is: "what Triffin feared more than anything was the rarefaction of the global currency (shortage of dollars). What we might call "Triffin's 'general dilemma' can thus be expressed as follows: the stability requirements of the system as a whole are inconsistent with the pursuit of economic and monetary policy forged solely on the basis of domestic rationales in all monetary regimes devoid of some form of supra nationality. Almost 50 years ago, he shed light indeed on the flaws in that system based, as we have seen, on the dollar (i.e gold exchange standard) and on

fixed exchange rates" (cfr. Padoa-Schioppa, 2010, p. 13).

[10] This is true despite the USA declined its relative economic weight in the world economy, the reason is due (cfr. Eichengreeen, 2011) to the so-called advantages of incumbency. Nowadays the dollar dominate indeed international transactions since it is use in 85% of foreign exchange transactions, it still accounts for 62.2% of the foreign currency reserves (COFER-IMF data, 2012) despite the fact that US is only 20% of the world economy.

[11] As external positions of systematically important economies that reflect distortions or entail risks for the global economy. Then they "may be outward signs of inner disequilibria located in one or more of the large national economies whose behavior is of systemic relevance" (cfr. De Cecco, 2012, p. 30).

[12] Inflows were around two billion U.S. dollars every day during 2001-2007 (cfr. IMF, outlook, 2008). At present time the US fiscal debt is around 12.000 billion dollars.

[13] Bernanke (2007) for example emphasized "the global saving glut" hypothesis which underlines that increased savings and current account surpluses in developing countries have to be counterbalanced with deficits somewhere else. This is because the total saving in the world must equal investment, and the sum of national current account balances must be zero. He then suggested that the real fault lies not with the American deficit but with excessive savings in Asia. By contrast, Palley (2011) and De Cecco (2012) correctly reject the saving glut hypothesis.

[14] To understand the reserves injection process one can imagine that when, for example, Asian exporters receive the dollar balances, they need to sell their dollars for local currency in order to be able to spend the money domestically, for example to pay their workers, or make new investments. To avoid appreciation, which is not desirable the local banking system and the central bank will usually buy the dollar inflows.

[15] The dollar international status has been labeled as "exorbitant privilège" (cfr. Eichengreen, 2011)

[16] The U.S. dollar is, by far, the most important reserve currency in the world. Most of the current account surpluses and foreign exchange reserves are held by Asian countries which, prior to the crisis, hold 3.4 trillion dollars, or 59 percent of the world´s foreign reserves. China alone holds 1.3 trillion dollars, or 22 percent of the world´s total reserves.

[17] The academic debate has instead been centered on the question of whether the U.S. trade deficit is sustainable or not, with emphasis on domestic factors. As stressed by Perelstein (2009) however, neither of these positions offer a sufficient explanation of the present situation since they do not account well enough for the global integration of capital markets. In this context, a more systematic view will be used to analyze the relationship between the U.S. imbalances and the global financial markets. "This will lead to the conclusion that the financial crisis in 2007–08 is transmitted to the rest of the world through the U.S. trade deficit; that there is

a global financial dependence on the U.S. in addition to its political dominance; and that the U.S. macroeconomic imbalances cannot be resolved without affecting the rest of the world whose financial systems are dependent on dollars supplied by the U.S. through its current account deficit" (cfr. Perelstein, 2009 p. 5).

[18]Paul Krugman (2006) is one of the scholars who warned that the U.S. current account deficit might lead to a dollar crisis: in a worst case scenario, the dollar might then lose the important role it has had in the global economy until today.

[19] The level of the U.S. trade deficit has varied through the years, but increased rapidly in the first part of this decade, hitting a record level in 2006 when it accounted for 6.2 percent of GDP in the U.S. Prior to the crisis (2007) the U.S. balance of payments deficit amounted to 790 billion dollars, which makes the U.S. the world´s largest debtor state (FMI, 2008). For a long period every country trading with the U.S. runs a current account surplus with the U.S.

[20] The global risk is very high since the U.S. external deficit is creating an export stimulus demand close to 2 % of world GDP.

[21] This can be seen as part of the reason for the debt crisis in the 1980s and 1990s.

[22] It has become apparent that, what is known as the 'subprime crisis' has actually been a great deal more than simply the bursting of a typical speculative bubble: what was taking place was a structural and not yet finished upheaval.

[23] As well known, Particularly US Treasury Bond (cfr. International Financial Outlook, 2005-2008).

[24] Roughly speaking elasticity is defined as the degree to which monetary and financial regimes constraint the credit creation process and the availability of external funding. More generally: weak constraints imply a high elasticity.

[25] As well known, this process has been extensively investigated by Hyman Minsky in several works.

[26] On this point see again the critics by Palley (2009) and De Cecco (2012).

[27] The US quantitative easing policy and the currency policies adopted by the Chinese's government are indeed under scrutiny.

[28] This is particularly evident concerning with the US dollar, the yen and the yuan rembinbi.

[29] This is the case for the benign neglect thesis (cfr. Dooley et al. 2003) that argued that the current system behaves like the old Bretton Woods. Mutatis mutandis Asia and the oil-exporting countries are the new periphery of the system pursuing an export-led development strategy. In compliance with this approach there were no problems concerning with macro imbalances and the possibility of financial crisis.

[30] cfr. Sau (2003); Obstfeld et al. (2009) estimate that two thirds of current reserve holdings are for insurance motives.

[31] Supplemental reserve facility (SRF) and Contingent credit lines (CCL).

[32] At this regards Eichengreen (2009, p. 8) argued that: “the world for which we need to prepare is thus one in which several international currency coexist”.

[33] This happened despite the fact that the IMF is committed by its Articles of Agreement to ‘making the Special Drawing Right the principal reserve asset in the international system’.

[34] Their appeal is so strong that in the very temple of national central banks, the BIS (Bank for International Settlements), the SDR has been adopted as unit of account.

[35] As I pointed out in section 1, this was not the case for the Bancor in the Keynes Plan.

[36] Today, many of the countries that do not accept free floating, manage their currency with reference to a basket of other currencies that often reflects the composition of their trade. If SDR's were to become a genuine *reserve asset*, those countries would have an incentive to set or to manage their exchange rates with reference to a ready-made basket broadly representative of the composition of world trade.

[37]Eichengreen (2009, p. 141) at this regards is rather pessimist and trenchant: “ this is not something that is going to happen overnight. No global government, which means no central bank, means no global currency. Full stop!”

[38] cfr. Monetarist’s point of view and the new benign neglect on US trade balance (cfr. Perelstein, 2009).

[39] cfr. quotation in epigraph.