

THE MONETARY THREAT TO THE GLOBAL ECONOMY

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Much of the focus of crisis management policies so far have centered on resuscitating the financial system and injecting public spending. Neither policy objective directly addresses the main source of global deflation, which is that the global imbalances are no longer being recycled effectively. The US has lost much of its capacity to absorb and recycle trade surpluses because both its households and banks face the ongoing threat of insolvency. That in a nutshell is the driving force behind the global deflationary trend. Substituting *en-masse* public spending for private consumption and putting banks on life support are at best stop-gap measures that cannot bring back what is broken. That is true even under the best case scenario where the confidence in the dollar holds up and banks are effectively cleansed of troubled assets

In our view an effective policy against the crisis will have to address the main source of global deflation. The problem is not the global imbalances *per se*, but the unsustainable way in which they were absorbed and recycled. Thus new policies are needed that will pursue the following three objectives: one, the reassertion of public control over the credit creation process; two, being prepared in case the dollar tanks; and, three, ensuring the resumption of the recycling of trade surpluses before contraction begins to destroy them.

Put differently, the main challenge is to wane world demand of its dependence on US overspending given that the rising levels of both nonfinancial and financial debt has virtually destroyed its capacity to recycle global surpluses effectively. Moreover, getting from the first to the third objective without the US and the world economy getting stuck in a depression requires safeguarding the integrity of monetary reserves and thus the global monetary standard. That calls for a reform of the global monetary system. Meanwhile, the cost of trying to go back to business as usual can be prohibitive and the fiscal stimulus combined with the extreme quantitative easing in the US are liable to raise questions sooner or later about the viability of the dollar in financial

markets. If that were to trigger a protracted slide out of the dollar into gold the current slump could turn into a great depression worse than the last.

The Lesson of the Interwar Years

The interwar years offer a lesson on the dangers posed by a potential slide/rush into gold that could cause a massive monetary contraction. Though clearly nowhere as important as they have since become, foreign exchange (mainly British *consols* and US Treasury bonds) had then already figured significantly in countries' monetary reserves at a time when capital movements (from the US) financed similar chronic current account deficits (in Europe). Following the Fed's shift to tight money in 1928, the capital flow from the US to Europe began to reverse and the deficit countries were forced to deflate, increasing concerns about the overvaluation of sterling and eventually, the dollar as well. A destabilizing dynamic was thus set in motion – as confidence eroded, the fear of devaluation led countries to liquidate foreign exchange (sterling and dollar) in favor of gold in their reserves and the devaluation risk rose further. Moreover, the extinction of monetary reserves caused by the dwindling of foreign exchange assets led to a progressive contraction of national money supplies and credit, making the slump worse and further undermining confidence in the monetary system.

It is true that there are no fixed parities to defend today, whether against gold or between currencies, and the Fed is doing exactly the opposite of what it did then. However, there are also unmistakable parallels. Just as then, a process of deflation driven by the disruption of the recycling of trade surpluses poses a threat to global financial disintermediation. Moreover, the potential for an erosion of confidence could again cause a massive monetary contraction around the world in the period ahead similar to what happened then. This time around the stakes are even

higher and the room for maneuver less, given that the share of dollars in international reserves is incomparably larger now than it was in the late 1920s. This makes the challenge we face today more formidable.

Tracking the Development of the Current System [1]

In today's national economies and the current international monetary system, fiat currencies are the norm. With no backing other than the full faith and credit of their governments, the stronger currencies in the global system are used to settle trade and investment transactions by many countries other than those that issue them. Investments in assets denominated in those currencies now constitute the great majority of international reserves held by central banks and treasuries and the foreign exchange reserves of commercial banking systems throughout the world.

The mechanisms for settlement of foreign exchange holdings evolved throughout Europe with the development of financial markets and central banks. A government (treasury or central bank) bought and sold foreign exchange in transactions with its own private sector, becoming the creditor by drawing down or building up its own holdings of foreign exchange. This permitted the development of a larger role for the public sector in controlling international payments as these transactions replaced the earlier and less efficient transfers of gold reserves to net out holdings of bills of exchange between private banks in different countries [2]. Thus the addition of convertible currency assets as components of international reserves constituted a significant revision of the rules of the game in international payments that persisted until the collapse of Bretton Woods in 1971.

But the ability to “manage” the system was only possible for countries with developed financial markets. Countries without developed markets that lacked financial instruments denominated in their own currencies could not attract capital inflows and tended to experience the so-called “automatic” effects of the gold standard. Trade deficits had to be financed with outflows of gold and since commodity producers could only buffer price changes determined by developments in the industrializing countries by building up reserves when prices were high, the gold standard resulted in abrupt and often harsh changes in economic conditions in those countries and much default.

Breakdown of the Gold Standard

Very few countries had returned to the gold standard after World War I, the United States – by then a creditor rather than debtor nation – being a notable exception. Coping with economies damaged by war, rising prices, the movement of gold reserves to the US and a fall in gold production, European countries sought some means to regain currency convertibility and, in 1922, held a monetary conference in Genoa that recommended the use of foreign exchange reserves to economize on gold. Again, there was no international agreement involved but some countries acted legislatively on this recommendation at the national level and many others simply resumed the practice of buying foreign exchange from their own financial institutions. The Bank of England resumed gold convertibility in 1926 (at the pre-war rate) and was able to persuade some other European countries to do the same. Nevertheless, most industrial countries continued to rely on acquiring holdings of foreign exchange assets to build up their reserves and, by the end of the 1920s, foreign exchange reserves constituted about 42 percent of total reserves of 25 countries [3].

The rise in holdings of foreign exchange reserves became a critical channel for the transmission of economic collapse in the 1930s. Inflows into the US had climbed in the late 1920s with foreign funds attracted by returns on call loans during the stock market boom. Observing the shift in capital flows, John Maynard Keynes (1930) noted this change in the direction of capital flows as a shift to “financial circulation”. With the market’s collapse, losses by foreign investors affected their own national economies. But the collapse of reserves had an even greater impact. Between 1929 and 1931, foreign exchange reserves fell to 27 percent of total reserves and fell further to 8 percent by 1932.

France played a major role in initiating the extinction of reserves. Having undervalued the franc when it returned to convertibility in 1926, it ran large trade surpluses and amassed huge holdings of foreign exchange reserves, mostly in sterling and dollars. With legislators growing concerned about the size of these holdings, a law was passed in 1928 prohibiting further acquisitions of foreign exchange reserves. Germany was already in recession in 1928 and in 1929 – at the time of negotiations on reducing reparations under the Young Plan which France opposed – and France’s sales of its holding of Deutsch mark assets forced Germany to suspend convertibility. At the same time, French withdrawals of sterling drove up the Bank of England’s discount rate. The credit strain in London resulted in foreign loans being called and contributed to the \$120 million drop in call loans in New York in August 1929.

As economic conditions began to deteriorate world-wide, the Bank of France began to convert its existing stock of foreign exchange reserves into gold in 1931. Its sales of sterling set off sales by other countries that were required by law to hold only foreign exchange assets convertible into gold. These countries feared that France’s sales would force the UK to suspend convertibility and, after they had precipitated a run on the Bank of England, the UK did, in fact, suspend convertibility on September 21. Unable to dispose of sterling, many of these countries

converted sterling holdings into dollars and, even though the dollar remained convertible, they exchanged dollars for gold. From mid-September to the end of October, 1931, the Federal Reserve lost \$755 million of gold, \$350 million taken by France and the rest by Belgium, Switzerland and the Netherlands. The Fed responded by raising the discount rate from 1 ½ to 3 ½ percent - a move that is generally viewed as deepening the US depression and that of the rest of the world outside the sterling block [4].

By 1932, international monetary reserves had contracted by one-third. The loss of reserves put severe downward pressure on money stocks and credit in national economies and resulted in a sharp contraction in cross-border trade and investment. In the next several years, the contraction in reserves was offset to some degree by competitive devaluations (including the US in April 1933) that raised the value of gold reserves and permitted some re-expansion of money stocks. But it was more than a decade after the end of World War II before money stocks in Europe returned to previous levels. The great deflationary spiral from 1931 to 1933 effectively ended the multilateral world in which trade and investment had flourished. Germany imposed exchange controls and entered into bilateral trading arrangements that included barter as a way of bypassing the international monetary constraints that had blocked its access to international borrowing. Other European countries retreated into trading blocs enforced by tariffs and quotas [5].

In short, the global deflationary trend was the result of the disruption of the recycling of global surpluses. While the reversal of the capital flow into Europe was the initial impetus, the contraction of monetary reserves became its driving force. The experience of this period highlights the decisive role played by capital movements and central bank policy in adjustment in clear contrast to the kind of automaticity emphasized in the *price-specie flow* mechanism. Conceptually, interest rate management by central banks brought about two opposing effects on

aggregate demand. On the one hand, the higher (lower) discount rate in the deficit (surplus) country had a contractionary (expansionary) effect on spending and thus tended to lower prices. But, at the same time, incoming (outgoing) foreign lending augmented (diminished) reserves (the monetary base) and thus was potentially expansionary (contractionary). Stylistically, the strength of the contractionary effect depended on how high the interest rate rose and on the interest rate elasticity of spending, while that of the expansionary effect rested on how responsive the capital inflow was to the higher interest rate and the degree to which the credit supply expanded with the monetary base.

Clearly, an adjustment towards trade balance required a strong contractionary (expansionary) effect in the deficit (surplus) country. But that is exactly what often failed to happen during the interwar years, as well as in our neoliberal era since the early 1990s. During both periods, the two effects often canceled each other out, giving rise to the accumulation of chronic trade imbalances over time. Often, however, the expansionary (contractionary) effect in the deficit (surplus) country became stronger, causing the trade imbalance to worsen over time before eventually unraveling in crisis. Adjustment became increasingly capital account driven. As a result, creditors' perceptions of borrower creditworthiness and financial conditions rather than trade imbalances governed capital flows, and steadily rising debt, past a certain threshold, undermined the creditworthiness of the deficit country, bringing lending to a halt.

Once the capital inflow became disrupted, the *price-specie flow* mechanism began to work, forcing the deficit countries to deflate with all the attendant economic pain that entailed. The resulting adjustment toward trade balance however had little to do with any realignment of internal prices to their external levels on the basis of productivity and cost differences. It simply signified a breakdown of financial intermediation. It was this type of global maladjustment and

the instability it led to during the interwar years that the Bretton Woods System was supposed to fix.

The Bretton Woods System: A Failed Attempt

Much has been written about the competing British and American plans for the post-war system and the following is a brief account of these plans and the political and economic objectives they embodied. Given its large external debt accrued during the war to the colonies and dominions in the sterling bloc, a major concern for the UK was to protect sterling by gaining access to credit to fund its debt and prevent a run on its gold reserves. John Maynard Keynes and others in the UK Treasury saw exchange controls as necessary to curb speculative flights and while the US did not adopt controls, they were included in the final agreement and adopted by the UK and other European countries.

Keynes' International Clearing Union reflected his belief that the key problem in the international system was the lack of liquidity. He saw the need to construct a system that would favor expansion, not contraction, and one that would not restrain domestic policy. In addition, the ICU was structured to avoid creating a system that relied on one or more dominant currencies as reserve assets to minimize governmental influence and prevent a repetition of the collapse of foreign exchange reserves that had occurred in the period 1928-32. It was to be a multilateral system with automatic overdrafts based on the relative size of a country's trade. Foreign exchange reserves were to be concentrated in national central banks with purchases and sales of currencies among central banks only through accounts with the ICU that were to be denominated in "bancor". Both debtors and creditors would pay interest on their accounts so that the burden of adjustment would fall on both. Creditor countries would make deposits of current account

surpluses they did not wish to spend and thus create an additional supply of funds for debtor countries to borrow [6].

The original US proposal offered by Harry Dexter White was based on the structure of the exchange stabilization fund the US had created when it devalued gold in 1933. It proposed to use repurchase agreements to make swaps rather than loans to deficit countries [7]. Like Keynes, White saw the ability to provide liquidity as a major objective of the fund but he was more concerned than Keynes with exchange rate stability. Since US interests were more aligned with investment than with trade, White and others in the US Treasury were unwilling to be lenient about the right to devalue or accept currency fluctuations. He proposed a role for the dollar as the unit of account in the system but, unlike Keynes, designed an active rather than a passive role for the fund. In his view, subscriptions to the fund should be made in transferable securities rather than currencies which would allow it to conduct open market operations [8]

Neither of these plans was adopted and some of their more important benefits did not survive to be incorporated in the final structure of the monetary system and the International Monetary Fund that was to administer it. For example, a major advantage in the structure of the ICU compared with that of the International Monetary Fund was that the ICU could use the resources contributed by all surplus country depositors as well as the contributions to its capital base whereas the contribution of nonconvertible currencies to the Fund has limited its ability to lend and made it overly reliant on US dollar contributions. Another is that both Keynes and White agreed that policy conditions should only apply *ex post* - after a borrower's needs were met – and only if that borrower were unable to take appropriate action or were unable to repay. Their position on conditionality was, in fact, reflected in the initial framework for the IMF. It was only in the 1950s that the Executive Board of the IMF “introduced the conditional lending that gradually became standard practice” [9].

Also missing from the final agreement was the automaticity and apolitical structure that Keynes envisioned. It is likely that either his overdraft plan or White's swaps would have provided liquidity in a more timely fashion than the IMF's quota-based lending. But another serious loss was White's proposal for subscriptions of transferable securities to provide the framework for countercyclical open market operations. This would have made the International Stabilization Fund a true lender of last resort - unlike the IMF that depends on contributions of taxpayer funds and, like Keynes's ICU, plays an essentially passive role in international transactions.

The new system that emerged from the 1944 meetings at Bretton Woods originally envisioned the dollar's role as that of an international unit of account. That function for the dollar required that the dollar/gold exchange rate be fixed and unchangeable. But the absence of rival currencies convertible into gold ensured that the dollar would also emerge as an international medium of exchange used in transactions between third countries and an international store of value for private investment. A larger role for the dollar was inevitable given the reality of US economic power at the end of World War II. The US accounted for 60 percent of world output, owned 60 percent of the world's gold reserves, had modest import requirements and was able to produce much of what the rest of the world needed to resume economic growth [10]. Nevertheless – as necessary as this role was at the time – it required the US to subordinate fiscal and monetary policy to the objective of ensuring exchange rate stability. And, as proved to be the case, it was an objective that the US – or any other country - could not meet over time.

Moreover, there was real constraint on trade and investment during this period. Without convertibility, private financial institutions could not move funds across borders. All financial flows had to originate in the hegemon's national market and, initially, were largely government-

to-government flows. Subsequently, governments began raising funds from private institutions in the US national market, holding dollars as reserves to back the creation of domestic money to be allocated at home. Thus, in the period before 1958, the inability of the major industrial countries to participate in the international monetary system required governments to undertake the role of intermediaries in managing financial flows [11].

The Unraveling of Bretton Woods

The story of how the severe dollar shortages of the early post-WWII era quickly turned into rising US trade deficits and accumulation of excess dollars in European central banks by the 1960s is too well known to recount here. The US deficits were initially quite welcome as they were seen as means of reserve injections into a dollar starved Europe and beyond. However as the 1950s wore on they increasingly became a cause for concern and even alarm. By the early 1960s, US liabilities to foreigners exceeded its gold reserves, and questions began to emerge about the stability of the dollar.

At the time, Robert Triffin (1960) captured the gist of the problem posed by the dollar's reserve currency role. To avoid getting trapped in a deflationary spiral similar to that which occurred during the interwar years, the world needed an elastic money supply and thus its dollar holdings had to increase steadily to meet that need. But that required the world to run a trade surplus with the US. To put it differently, the US had to continue running ever larger trade deficits to enable the size of these dollar holdings overseas to expand. That, however, raised doubts about the dollar-gold parity, undermining confidence in the monetary standard. In a nutshell, this was what came to be called Triffin's dilemma. World growth and the prerequisite expansion of monetary reserves it depended on undermined the monetary standard that was the backbone of these reserves. Fine tuning the US policy mix could at best strike a balance between

the opposing scales and help buy time but not solve the problem. – that is, until the *strong-dollar* policy after the 1980s gave the dollar a second lease on life under much altered conditions.

The first dollar crisis erupted in 1960 with speculative sales of dollars for other currencies and some official demand for gold in expectation of devaluation. Despite the sudden turmoil the crisis created, the US would not be willing to devalue for another decade. Its attempts to counter pressure on the dollar included a monetary response known as “Operation Twist” in 1961 [12] followed by the inauguration of a series of capital controls as the decade progressed. The first of these, the interest equalization tax, taxed US residents’ holdings of foreign securities issued in the US to reflect the higher interest foreign issuers would have paid in their own countries. The effect of the tax was to move dollar issues offshore to the Eurobond market, reduce capital outflows and seemingly reduce pressure on the dollar [13].

The creation and expansion of the so-called Euromarkets in London and other financial centers was seen as a way to “manage” the dollar glut. Dollars (and other strong currencies) could be borrowed and loaned outside the US national market for transactions involving both US and non-US residents and would not appear as US transactions on its international balance sheet. What was not understood initially was that those offshore transactions would nevertheless affect the exchange rate for the dollar; that they would change the demand for dollars as effectively as transactions in the national market that involved capital flows and would tend to expand foreign holdings of dollars.

Overall, US efforts did not succeed in balancing its external accounts [14]. The second run on the dollar occurred in 1967, prompting the Fed to raise interest rates to attract foreign funds and dampen the economy. While capital controls were limiting outflows by banks, they responded to higher rates by bringing funds in from their foreign branches for lending in the US. But, as rates declined, US banks ignored the voluntary restraint program and moved funds back

to the Euromarket – a move that prompted the next dollar crisis in 1969 and what was called a monetary “jolt” as the French franc devalued by 10 percent and speculative flows pushed up the value of the Deutsch mark by 10 percent. The EEC countries responded to the renewed turmoil by imposing capital controls and recommending a revival of the automatic credit system. Finally, when sterling came under pressure in 1971 and the Bank of England asked the US to convert \$700 million into gold, President Nixon closed the gold window foreseeing a run on the dollar.

Potentially, the reserve shortages and convertibility problems could simultaneously be dealt with by raising the dollar price of gold while maintaining other currencies’ peg to the dollar. That would have simply amounted to devaluing all currencies together against gold which would raise the size of reserves by increasing the value of gold in them. In fact, the Bretton Woods’ Articles of Agreement had a provision for a universal reduction in par values that could have been used to that effect. But, such a measure was politically unattractive to the US because it would have rewarded countries who cashed in their dollars and penalized those who held onto them - in addition to being beneficial to South Africa and the Soviet Union, the largest producers of gold [15]. Thus, the US lent its support to the idea of developing a synthetic substitute for gold, giving impetus to the emergence of the IMF’s Special Drawing Rights (SDRs) [16].

Meanwhile, as the unsustainability of the dollar/gold exchange rate system became increasingly obvious in the 1960s, Robert Triffin led the way in calling attention to the need for a post-Bretton Woods system. His proposals were an integral part of the discussions that led to the Rio Agreement in 1967 that authorized the International Monetary Fund (IMF) to create and issue special drawing rights (SDRs). Although he was highly critical of the Rio Agreement, Triffin believed that its central achievement – the creation of new reserve assets to strengthen the balance of payments adjustment mechanism – was a first step in the right direction. Nevertheless, he warned that it would not constitute a viable reform effort if it failed to take a

more comprehensive approach in assigning roles to all three components of reserves – gold, foreign exchange and collectively created assets – especially since gold would certainly be demonetized internationally as it had been nationally since the 1930s.

In Triffin’s view, “...the alternative to the gold standard is not a dollar standard unilaterally run and managed by the United States alone, but a true international standard, calling for concerted decisions and management by all participating countries “ [17]. What Triffin called for was similar to the reserve asset Keynes called “bancor” in his 1940s proposal. Unlike Keynes, however, Triffin linked the distributions of reserve creation to development finance. But the major industrial countries with the majority of votes in the IMF linked the distribution of SDRs to the size of existing quotas. Triffin complained that this decision was “as indefensible economically as it [was] morally” – especially since two of the richest countries in the world (the US and the UK) were assigned about one-third of the total [18].

The Unilateral Dollar Standard

It is possible to read the history of the monetary system since the breakdown of Bretton Woods as a story of the protracted process by which a dollar standard unilaterally run by the US came into being - exactly what Triffin objected to - rather than the usual emphasis on the transition from fixed to floating exchange rates. The key issue was how the *strong dollar* policy became a viable option in reconstituting the dollar standard when, in the Bretton Woods era, it implied trade surpluses for the US and thus reserve shortages abroad. Under the altered conditions of the 1980s, however, it went hand in hand with ballooning US current account deficits. What made this change possible was first and foremost the political and monetary regime shift in the US.

A dollar standard without a gold anchor was successfully negotiated in the Smithsonian Conference in Washington D.C. right after the Nixon Administration terminated the dollar's convertibility to gold in July 1971. The US announced a devaluation of the dollar to \$38 to an ounce of gold, imposed a 10 percent tariff surcharge on Japanese imports and negotiated upward revaluations of the Deutsch mark, the yen and the Swiss franc. It also negotiated smaller revaluations of the Belgian franc and the Dutch guilder and even smaller revaluations of the pound, the Italian lira and the Swedish krone – ensuring the success of the negotiations by permitting these currencies to devalue relative to the mark, yen and Swiss franc even as they appreciated relative to the dollar. In addition, the G10 agreed that dollar reserves would be held in the US – not in the Euromarkets - as investments in US Treasury securities [19].

The Smithsonian Agreement however was short-lived. Another, much larger run against the dollar took place in February 1973 and prompted \$10 billion of intervention by central banks in an attempt to stabilize foreign exchange markets. Exchange markets were closed in March and the US took unilateral action, devaluing the dollar to \$42.50 for an ounce of gold, letting its currency float and, in 1974, ending capital controls. US officials and academics who had argued that the market should set the price of the dollar had prevailed [20].

There were several important byproducts of these years of monetary turmoil. First, intervention by major central banks to support the value of the dollar (or prevent the appreciation of their currencies) resulted in a massive increase in foreign exchange reserves in the period 1970-1974 (an increase of 65 percent in 1971 alone) [21]. The result was an equally massive increase in international liquidity that ignited ongoing inflation in the US and other countries throughout the 1970s. Second, and more importantly, public sector influence over international monetary developments was substantially eroded as control of the international payments system and balance-of-payments financing shifted from national central banks to transnational private

banks. The result was precipitous growth in the external (Euro) markets and a rising volume of cross-border capital flows that dwarfed the volume of trade.

From Failure to “Success”

Two general themes are often emphasized to explain why efforts at a reconstituted dollar standard failed. One is the idea of incompatibility of fixed exchange rates with international capital flows that were becoming increasingly *free* at a time when many of the earlier capital controls were being dismantled [22]. The other is the Europeans’ frustration at having to accommodate the turns and twists in US macroeconomic policy and their complaint about the inflationary impact of the weak dollar. The common European currency, it is often remarked, to a large degree owes its very inception to this sense of frustration on the part of the Europeans. Be that as it may, their own contributions to the massive increase in global liquidity that resulted from intervention in foreign exchange markets were ignored. Moreover, rather than US macroeconomic profligacy, many see the real source of the problem with inflation as the growing political strength of labor that gave rise to the wage-price spiral throughout the advanced capitalist countries. The lesson was also not lost on the world in the aftermath of Bretton Woods that it was next to impossible to discipline a superpower such as the US, let alone do it by anchoring the dollar to gold. The threat of inflation could be much better contained if the US led Europe in abrogating the post WWII social compact that made it hard to discipline labor.

The monetary tightening that started under Federal Reserve Chairman Paul Volcker was soon joined with a large dose of fiscal stimulus under the Reagan Administration, and the result was higher real interest rates, a much stronger dollar and ballooning trade deficits - just as the Mundell-Flemming model predicted. But, this time around, US trade deficits were no longer a source of chagrin for confidence in the dollar. The political reconfiguration that broke the back of

labor unions provided all the backing the dollar needed as the increased threat of unemployment proved a much more convincing anchor than gold for wealth owners around the world.

Nevertheless, it took about a decade for the unilateral dollar standard to come into its own as marked gyrations in major exchange rates and the domestic political backlash against the *strong dollar* in the US continued to pose a threat to the emerging monetary regime. By the 1990s, however, advancing globalization and the triumphalism that ensued after the fall of the Berlin Wall clinched the trend the changing political climate had set in motion earlier. As the *strong dollar* and trade deficits returned with a vengeance in the mid 1990s it became abundantly clear that there was no going back.

US trade deficits were once again the key to world growth. But now the majority of reserves were accumulating in the hands of a few successful exporters – first Japan and Germany, then China, the oil exporters and a few others – who ran increasing trade surpluses with the US which were then recycled to the rest of the world through the US financial system. The fact that exports became the sole safe source of demand stimulus helped contain the exchange rate volatility of the earlier decade. The appreciation of any currency against the dollar was self-limiting as any country whose currency appreciated was liable to experience falling exports and succumb to economic stagnation, which then curtailed the demand for its currency

Also, the trade imbalances were no longer deflationary for the deficit countries that could attract capital. *De facto*, less successful exporters in the periphery were given a choice between deflation and making themselves hospitable to foreign capital, and more often than not the hope of expansion on borrowed money won over deflation. It was as though a privatized version of Keynes' old International Clearing House idea was put into effect in the sense that the trade surpluses were now being effectively recycled. In fact, more than merely recycled, they were being multiplied at an increasing rate within the US financial system as they were in part

absorbed in the US and in part passed on to the rest of the world. On the one hand, with the Bank of Japan monetizing US debt at an increasing rate, an endogenous mechanism of speculative demand-led global money supply came into being [23].

On the other hand, getting rid of the last vestiges of financial regulation in the US gave impetus to a market based credit system that led to a record increase in household debt [24]. New financial instruments proliferated and were absorbed with rapidly increasing levels of leverage, raising the financial system's capacity to finance ever larger quantities of long-term illiquid assets with short-term liabilities [25]. Soon, the world was awash in liquidity.

The main recipients of these funds were the countries that could compete better than others in attracting capital. While some hardly received any inflows, others were drenched and the latter had only limited success in coping with the strongly procyclical nature of the capital inflow. Thus, the threat of deflation and exchange rate volatility was replaced by capital flow volatility, leading to capital-account driven boom and bust cycles that culminated in one currency crisis after another in the emerging economies throughout the 1990s.

The main point about the increased prevalence of sudden stops and abrupt capital flow reversals is that international adjustment in this period became once again capital account driven and increasingly *dysfunctional* in the sense of accentuating existing trade imbalances. The explosive expansion of financial liberalization in emerging economies in the 1990s made variable-price financial instruments the main conduits for capital inflows in contrast to the originally nonnegotiable fixed-price bank loans of the 1980s. As a result, speculative asset price expectations became an important driver of portfolio dynamics, giving rise to erratic capital flows [26]. The primacy of the capital inflow was such that even countries that ran sizable trade deficits quite often experienced rising real exchange rates and credit booms, culminating in even larger deficits – that is, until they were hit by a crisis.

The Asian crisis marked an important turning point. In its aftermath, the “savings glut” discussed by Bernanke became real, caused by the collapse of investment in Asia which was in part the result of growing competition from China [27] and in part the crisis itself. Foreign exchange reserves of emerging economies steadily increased as many of them began to run large current account surpluses. Contagion made it harder to finance consumption booms and even those countries that continued to run deficits began to accumulate reserves as net spending remained below the capital inflow. With spending either curtailed or harder to finance in many emerging economies, the epicentre of debt-financed credit booms shifted onto more developed economies with greater reservoirs of credibility, the US first and foremost among them. As we now know all too well, the Fed-engineered real estate bubble that gave the US consumption boom a second lease on life created a huge financial house of cards that collapsed when increasing debt finally caused risk aversion to return. Once investors pulled back, a self-reinforcing cycle of deleveraging forced a mass liquidation of assets, shaking the system to its very core.

6. Understanding the Current Crisis

Now that the system is broken, there are essentially two different ways of understanding what has happened, with very different implications as to whether policy should aim at repair or reform. According to the first view the problem was not with the market-based credit system that financial deregulation brought about *per se*, but the flaws in its regulation. The rating agencies were essentially misled by low default rates that were artificially kept low by the housing price bubble, and when falling housing prices made it difficult for the shadow banks to roll over debt, the inherent liquidity risk in the system became exposed. A run on the shadow banks then triggered a process of deleveraging, driving asset prices further down which in turn caused

further forced sales of assets and thereby set in motion a vicious cycle. Past a certain threshold banks also became exposed, and eventually much of their capital got wiped out.

From this point of view, the fall in asset prices is now as excessive as their initial rise before the crisis - the result of all financial sector firms trying simultaneously to shrink their balance sheets. Thus, a compensating expansion of the public sector's balance sheet, whether it is that of the Treasury, the Fed or the government sponsored enterprises (GSEs), is seen as the only backstop to this runaway bleeding in asset prices. It is thought that when investors realize that asset prices have bottomed out, private capital will return to the market to recapitalize banks and the system will begin to function normally. Once private credit begins to flow again, the recession will be on the mend and the financial system can at that point be repaired by revamping its regulatory oversight functions. It is fair to say that both the initial Paulson and the current Geithner-Summers plans basically share this view of the crisis whatever their differences are otherwise.

The alternative view holds that falling asset prices are not just a symptom of temporarily malfunctioning asset markets but, as others have pointed out, the result of banks that are now insolvent. Banks in turn became insolvent mainly because they enabled households to consume way beyond their means, causing the build up of an unsustainable amount of debt. Yet, it is not often recognized that the US credit boom that brought this about was at the same time perversely functional in recycling global trade surpluses. It was the means by which the ever expanding dollar reserves overseas could be loaned out in the US and, through US financial markets, to emerging economies and the rest of the world. However, as credit-induced investment/consumption booms could not be sustained for long in emerging economies, US households came to absorb an ever larger part of these global surpluses over time and thus became the epicentre of debt build up. This provided the fodder for financial innovation which

only compounded the excessive credit growth that eventually wrecked households' balance sheets and bankrupted banks. The excesses of US banks and financiers and shortcomings of their regulators, while important in their own right, have to be understood against this background. The speculative boom in its financial system with all its sins helped the US recycle global imbalances for as long as that could last. But that is a recycling mechanism that can not be revived.

Thus, according to this point of view, trying to shore up the US capacity to borrow and continue to finance overspending by substituting sovereign for private credit is not going to work. What needs to be done instead is to revive the recycling of global imbalances on sound footing, by using development finance rather than consumption booms as the target of credit expansion. That however requires reversing the privatization of credit at the global level that evolved after the breakdown of Bretton Woods. It requires that the focus of policy be reform rather than repair. The objective should be the reassertion of public scrutiny over the credit creation process so that credit can be revived without stimulating the creation of onerous debt. We argue that such a process might be the only way to revive the recycling of global surpluses and thus reverse the global deflationary trend.

The safe transitioning to a new global credit system can however be complicated by a possible collapse of the dollar and the fragmentation of world trade that would surely follow if that were to happen. That is, in our view, one of the main lessons of the interwar years. Given that the current US policy of extreme quantitative easing amounts to fighting deflation by trying to destabilize the monetary standard by inducing inflation, the viability of the dollar is liable to become an issue sooner or later. To be able to resume the recycling of surpluses, however, the integrity of global monetary reserves must be preserved and that in turn presupposes that a precipitous fall in the value of the dollar will not occur. The recent calls to rethink the dollar's role as the reserve currency need not be a cause for alarm provided that they prove to be a

catalyst for reforming the international monetary system in ways that can potentially benefit everyone.

Clearly, as long as the dollar remains the key currency for cross-border transactions, countries will be compelled to rely on promoting exports and shape their economies to ensure that they can earn or borrow dollars to conduct external trade and investment transactions. It also means that the US has to continue to import more than it exports to meet the demand for its currency and to accept the resulting current account deficits and build-up in debt. Ideally, the currency system should be such that countries could engage in trade and borrow in their own currency. This was the gist of the idea behind Keynes' proposal at Bretton Woods to create an international clearing union (ICU). Time might be ripe to revisit such ideas.

For example, an institutional setup based on the concepts and functions of a clearing agency would meet the critical goals needed to revive a functional system for recycling global imbalances. Such an international agency would clear transactions denominated in members' own currencies by crediting and debiting their clearing accounts. These clearing accounts would, in fact, constitute the international reserves of the system, held for the member countries by the International Clearing Agency (ICA) and valued using a trade-weighted basket of all members' currencies. Thus the clearing process would change the ownership of reserves and reinstate the original intent of the Bretton Woods Agreement to maintain public control of international payments.

A revised ICA proposal could also reintroduce former US Undersecretary of the Treasury Harry Dexter White's Bretton Woods proposal to authorize the International Monetary Fund to engage in open market operations, permitting the new clearing agency to acquire government securities of its member countries as backing for their reserve holdings. This would give the ICA means and authority to conduct open market operations at the international level, enabling it to help national authorities correct imbalances, carry out exchange rate adjustments and promote stability by

altering holdings of international reserves relative to national central bank reserves invested in domestic assets. More importantly, the ICA's money creating powers would also allow it to operate as a true lender-of-last resort – a role the IMF cannot play given its dependence on taxpayer contributions [28].

Conclusion

The speculative credit boom in the US was successful in recycling global imbalances, and thus perversely functional. Reversing the global deflationary trend today would require that ways be found to revive credit flows so that surpluses can be recycled again. However, this cannot be done by the privatized international payments system that has evolved since the collapse of Bretton Woods. It has given rise to boom and bust cycles and unsustainable accumulations of private and public debt both in the US and the rest of the world. Thus the reassertion of public control of both national and international payments and credit systems [29] would make countercyclical monetary policy possible once again and ensure that credit flows without giving rise to destabilizing imbalances. That in our view is the only sound way to restore world growth.

Notes

1. Much of the historical discussion in this and subsequent sections is drawn from J. D'Arista, "The evolving international monetary system", *Cambridge Journal of Economics*, 33: 633-652.
2. H. G. Grubel, *International Economics* (Homewood IL: Richard D. Irwin).
3. H. G. Grubel, *op. cit*

4. D. Gisselquist, *The Political Economics of International Bank Lending* (New York: Praeger Publishers); H. G. Grubel, *op. cit.*; C. P. Kindleberger, *op. cit.*
5. D. Gisselquist, *op. cit.*; H. G. Grubel, *op. cit.*
6. R. Skidelsky, *John Maynard Keynes. Volume Three: Fighting for Freedom* (New York: Viking); K. W. Dam, *The Rules of the Game* (Chicago: University of Chicago Press).; D. Gisselquist, *op. cit.*
7. Using repurchase agreements was a way of supplying liquidity without creating debt and was (and is) used by the Federal Reserve to support primary dealers in US government securities. In the White plan, a surplus country would swap its currency for that of a deficit country. When the agreement expired, the deficit country would repay the swap, buying back its currency with the currency of the surplus country.
8. J. M. Boughton, “American in the Shadows: Harry Dexter White and the Design of the International Monetary Fund”, Working Paper no. 06/6 (Washington, DC: International Monetary Fund).
9. J. M. Boughton, *op. cit.*, 11.
10. D. Gisselquist, *op. cit.*
11. D. Gisselquist, *op. cit.* A variation on this pattern was developed in the 1970s by many developing countries because their currencies were not readily convertible in the private foreign exchange markets that had developed after the collapse of Bretton Woods and could not be used in international transactions. Governments in these countries borrowed dollars and other hard currencies from private financial intermediaries in industrial countries or offshore centers and used the proceeds to allocate or guarantee foreign currency loans to their domestic public enterprises, to build foreign exchange reserves, to make foreign exchange available to private

domestic exporters in exchange for domestic currency, and as backing for expansions of domestic credit. It was a pattern that inevitably led to the buildup of external debt.

12. Operation Twist was an attempt to use monetary policy to shift the slope of the yield curve. The Federal Reserve bought long-term securities to depress their yield and raise the yield on short-term securities. The objective was to attract foreign investment into dollars to counter speculative sales but to do so without harming housing and business borrowing in long-term markets. It was a program initiated by the Treasury, reluctantly accepted by the Fed and not a great success (D. Gisselquist, *op. cit.*).

13. The 1965 voluntary foreign credit restraint program was an agreement by US banks to reduce their foreign lending by limiting them to the amount loaned in 1965. The 1968 foreign direct investment program restrained borrowing in the US by US corporations for overseas investment or transactions with overseas subsidiaries and was not voluntary. M. Moffitt, *The World's Money* (New York: Simon & Schuster).

14. Among the impediments was slow growth in the US relative to other major countries that had rebuilt their industrial bases in the aftermath of the war and become more productive as well as the fiscal drain of the Vietnam War.

15. R. Mundell, "The International Monetary System: The Missing Factor", *Journal of Policy Modeling* 17(5).

16. Unlike the first gold guaranteed SDRs, these were valued in relation to a basket of currencies and became the unit of account in which all IMF transactions and obligations are denominated. They can be exchanged for another country's currency at the direction of the Fund or by mutual agreement, or used in swaps, loans and to settle financial obligations among member countries and between members and the Fund.

17. R. Triffin, *Our International Monetary System; Yesterday, Today and Tomorrow* (New York: Random House) 187.

18. R. Triffin, *op. cit.*, 194. Some argue, however, that monetary turmoil and the increasingly limited supply of gold relative to the growth in foreign exchange reserves was seen as posing a threat to the convertibility of key currencies (notably the dollar and the pound) that could precipitate a contraction of world reserves like that in the period 1928-32. In their view, it was this concern that led to the decision to give the lion's share of SDRs to the US and other major industrial countries (Gisselquist, *op. cit.*).

19. K. W. Dam, *op.cit.*

20. K. W. Dam, *op. cit.*

21. K. W. Dam, *op. cit.*

22. This is similar to the *bi-polarization* thesis that gained currency by the end of the 1990s, which holds that the exchange rate mechanism has to be either a hard-peg or a full float to be viable.

23. J. D'Arista and S. Griffith Jones. "The Dilemmas and Dangers of the Build-up of U.S. Debt: Proposals for Policy Responses", in J.J. Teunissen and A. Akkerman (eds.), *Global Imbalances and the U.S. Debt Problem: Should Developing Countries Support the U.S. Dollar?*, (The Hague: Forum on Debt and Development); G. Schnabl and A. Hoffman, "Monetary Policy, Vagabonding Liquidity and Bursting Bubbles in New and Emerging Markets: an Overinvestment View", *World Economy*, 31(9).

24. J. D'Arista, "Rebuilding the Transmission System for Monetary Policy", *Financial Markets and Society* (Howardsville, VA: Financial Markets Center); K. Erturk and G. Ozgur, "The Decline of Traditional Banking and Endogenous Money", Working Paper 2009-2, Schwartz Center for Economic Policy Analysis.

25. J. Crotty, “Structural Flows in Deregulated Financial Markets Caused the Current Crisis: A Critical Evaluation of the ‘New Financial Architecture’”, mimeograph, University of Massachusetts/Amherst; J. Kregel, “Changes in the US Financial System and the Subprime Crisis”, Working Paper No. 50, The Levy Economics Institute.
26. K. Erturk, “On the Changing Nature of Currency Crises” in P. Arestis, J. Ferreiro and F. Serrano (eds.), *Financial Developments in National and International Markets*, Palgrave Macmillan. (New York: Palgrave Macmillan).
27. K. Erturk, “Overcapacity and the East Asian Crisis”, *Journal of Post Keynesian Economics*, 24(2).
28. For details of the ICA proposal, see J. D’Arista, “Reforming the Privatized International Monetary and Financial Architecture”, *Challenge*, 43(3) (May-June 2000).
29. For a discussion of the need for a reassertion of public control of the credit and payments system in the US, see J. D’Arista, “Setting the Agenda for Monetary Reform”, Working Paper No. 190, Political Economy Research Institute (PERI), University of Massachusetts/Amherst; W. Greider. “Fixing the Fed”, *The Nation*, March 30, 2009.

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