KOMMENTAR

Steps towards a New International Financial Architecture*

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"Even the longest journey begins with a small step".

Old Chinese Proverb

Let me begin with a historical episode. Britain, a much diminished industrial power after the First World War, returned hurriedly to the Gold Standard in 1925, pegging the British Pound at the old, pre-war gold parity rate. The act was symbolic of national pride, although this objective of a strong national currency in the interest of the *international* role of British finance capital and the City came to be counterposed against the objective of a high level of employment in domestic industries. Keynes opposed it. And, Winston Churchill observed, "the Governor (of the Bank of England) shows himself perfectly happy in the spectacle of Britain possessing the finest credit in the world simultaneously with a million and a quarter unemployed ... I would rather see Finance less proud and Industry more content".[1] And yet, the City needed badly that rating of the 'finest credit in the world' through creating the image of a strong and unfaltering sterling, although it undermined the international competitiveness of British industries. Only when Britain was forced to abandon the Gold Standard in 1931, the prestige of the City was sufficiently discredited at least temporarily, to make arguments in favour of domestic industry and employment more acceptable. Keynesian theory, in favour of *national* economic policies, designed to defend the level of employment in domestic industries against depressive influences of an over-valued national currency could find political acceptance in those circumstances. Kalecki, who discovered independently prior to Keynes, the essentials of the principle of effective demand, told Professor Josef Steindl in a conversation that the 'closed economy model' was chosen deliberately to emphasise the importance of industry over finance in the national economy in that particular historical context.[2]

Demand management in a closed economy focuses traditionally on private investment and public expenditure, including government budget deficit, as the main instruments of fiscal policy to maintain adequate demand for domestic industries. Monetary policy usually plays a secondary, supportive role, at least so long as the independence of the Central Bank is not insisted upon. The only link with the external sector is through export surplus or deficit. It acts as the base on which the 'foreign trade multiplier' operates to expand or contract the market for domestic industries. Export surplus and export-led expansion have a special attraction in this context, as they reconcile the objective of a 'healthy' national currency with the objective of stimulating aggregate demand. However, as a general strategy to be followed by

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all countries it has an obvious problem. It is a zero-sum game – one country's surplus is another country's deficit; and a fallacy of composition arises, if all countries try to achieve export surplus at the same time.

An important determinant, but not the only determinant, of export performance of a country is its relative unit cost of production of tradable goods vis-à-vis its trade rivals. It depends, in turn, on labour productivity and wage differentials, imported material cost, as well as on the exchange rate. However, by focussing exclusively on the unit cost differentials among countries, we tend to overlook that trade takes place not only in goods and services, but also in technology. And, not necessarily directly in technology, but indirectly through goods and services embodying new technology. From this point of view, many developing countries fail to achieve satisfactory export performance, because their technology is inadequate, especially for capturing international markets for a wider range of higher value-added products. Perhaps, the biggest 'gains from trade' over time accrues to a country through international learning about new technology which promotes not necessarily the cheaper production of the same range of exported goods, but a different range of goods typically with higher value addition. Too much attention to current unit cost, which is favoured by the ruling orthodoxy of the IMF variety, tends to reinforce the existing patterns of trade in goods and services at the cost of overlooking this more important source of gains from trade over time through international learning.[3] Moreover, in a tighter regime of intellectual property rights, it is far from certain that direct foreign investment, without effective national policies to absorb technologies can be adequate for exploiting the gains from trade from learning.

However, no matter how *relative* unit costs and international learning evolve through time, the fallacy of composition would not disappear. Some countries would still enjoy trade surplus with their counterparts in trade deficit countries. This not only calls for an international arrangement for settling payments as every banker recognizes, but more importantly it requires devising a settlement system which would not be detrimental to international trade and development. This is the problem which Keynes faced in the negotiations in Bretton Woods. He argued in favour of a new institutional arrangement which would maintain an adequate level of international aggregate demand. He recognized that this required a more *symmetrical* treatment of the surplus and deficit countries through (say) an International Clearing Union arrangement, rather than correcting unit cost differentials through the price mechanism and the exchange rate. Such an international payment mechanism requires the acceptance by the member states of an internationally agreed form of debt obligation (called 'bankor') transferred to their credit in the accounting books of the Clearing Union in settlement of balances due to them from other members. The practical soundness of the argument can be seen from its direct analogy with credit creation by the national banking system; just as "no depositor in a local bank suffers because of balances which he leaves idle, are employed to finance the business of someone else",[4] so would no surplus country suffer by accepting such 'bankor' to its credit.

Although the proposal to create an internationally agreed credit mechanism through the Clearing Union allows for sustaining aggregate demand in the world economy by permitting the deficit country not to undergo the depressive influences of negative income adjustment, while entitling the surplus country to use its accumulated credit of 'bankor' to finance its international payments at any time, it runs against 'economic nationalism' conducted through international financial diplomacy. Because, the command over financial claims and resources is left in the *general* pool of the Clearing Union as a supranational authority, instead of being hoarded in national currencies or gold by the individual central banks of the surplus countries. This limited severely the area of agreement after the Second World War, because the United States which had attained an unassailable position of economic and political hegemony over the rest of the capitalist world was in no mood to accept an international monetary system that could restrict her hegemonic role. Just as Britain in her hegemonic days had manipulated the Gold (or Gold Exchange) Standard to attribute to the British sterling the role of the international reserve currency, the United States modified the Keynes Plan to the point of actually defeating its purpose, so that the American dollar served in effect as the international reserve currency. The ultimate failure to create a genuine international credit mechanism delinked from any national currency in the final Agreements in Bretton Woods (1945), which also left the world economy without any mechanism for demand management, must therefore be traced back to hegemonic national interest.

The world economy has undergone significant structural changes since the original Agreement in Bretton Woods in 1945. Nevertheless, this old episode from the end of the Second World War still has an important message of great contemporary relevance. No serious progress can be made in managing international demand through macroeconomic policy co-ordination without having in place an internationally agreed mechanism for credit creation which treats the surplus and the deficit countries more symmetrically. The system of floating exchange rates was inspired by the idea that corrections in trade surpluses or deficits could be achieved through the price mechanism, operating through the flexibility of the exchange rates,[5] *without* necessitating significant adjustments in the levels of economic activity, income and employment either in the deficit or in the surplus countries. This, however, is a false start, typical of the current economic orthodoxy.

In several respects, the world economy, has undergone changes which make the impact of variations in the level of aggregate demand on income and employment perhaps stronger today. *First,* and most obviously, the increasing importance of international trade entails that the *relative importance of the external compared to the internal market* in the national economies is greater now. Consequently, trade surpluses and deficits are likely to impinge more heavily on the level of economic activity. *Second,* a main vehicle of international trade in goods and services is *intra-firm trade* among subsidiaries of the same multinational firm. In manufacturing, it is estimated at more than 40% of total trade. While this has delinked to a great extent trade among *nations* from trade among *firms* of transnational reach, national governments still remain politically accountable in terms of their performance regarding the balance of payments and economic activity level. This has been at least partly the reason for a 'race to the bottom' in terms of tax and fiscal policies to attract direct foreign investments and, for the creation of larger regional economic blocks. However, this has also meant lower control over the collection of government revenue, and a weaker link between private corporate investment which involves subsidiaries in different countries and its impact on aggregate demand in any particular country. *Third,* the overwhelming importance of private trade in foreign exchange, less than 5 per cent of which is now accounted for by trade in goods and services and direct foreign investment, makes short term private capital flows the leading determinant of exchange rates. The governments and central banks feel obliged to respect the 'sentiments' of the financial markets by focussing on inflation rate, and high interest rates, while their depressive consequences for the domestic level of economic activity are underplayed systematically in policy formulations. *Finally*, structural changes in favour of the service sector, especially in post-industrial societies have meant that many *non-storable services* embodied in high-skilled labour are lost irrevocably when their demand goes down. Moreover, to the extent it also entails lower purchasing power in the service sector, its transmission to lowering aggregate demand all round through the multiplier mechanism is likely to be more immediate and severe than in the case of lowering of demand for *storable* industrial goods in the form of unplanned inventory accumulation and labour hoarding at least on a temporary basis.[6]

It is against this background of a creeping paralysis of monetary and fiscal policies of the state which fails to stimulate demand either directly through its own expenditure or indirectly through private (especially multinational corporate) investment, that the contours of a new international financial architecture need to be found. In an ideal, 'one world', utopian programmes like a single currency to get rid of all currency speculations or coordination of centralised policies are less difficult to devise.[7] However, the real difficulties lie in finding a road map of politically feasible, small steps that lead to steadily improving arrangements of international finance. Defining this road map is more crucial than defining the final destination. With this in view, the following three policy suggestions are made.

First, interest rates are now mostly administered by the central banks, rather than reflecting simply demand and supply in the money market. Three major financial authorities – the Federal Reserve System, the European Central Bank and the Japanese monetary policy (a combination of Central Bank and the government) – set together the fundamental tone for interest rate policy around the world today. In this context, it is necessary to have explicit agreement about the synchronization of the interest rates at least in these three financial centres without a 'beggar-my-neighbour' interest rate policy, directed particularly at influencing short term capital flows. The false 'monetarist' stance that the main, if not the only, target of monetary policy is the rate of inflation needs to be avoided with greater attention paid to the target of employment and growth on a synchronized basis.

Second, while synchronization of interest rate policies would tend to exert a depressive influence on speculative, cross border capital flows, this might prove insufficient. The possibility of a Tobin-type cross-border tax on capital flows is worth being considered seriously as a part of the new international financial architecture for reducing speculation-driven fluctuation in exchange rates. As a concomitant policy, the IMF should learn to depart from its conventional wisdom, and encourage especially developing countries not to attempt current and/or capital account convertability prematurely, if necessary by imposing capital control or special taxes (e.g. in Chile, in Malaysia) for dealing with speculative, foot-loose capital flows. At the same time, the IMF must also take the transparent position of discouraging commercial banks and other financial institutions in advanced countries from 'pushing loans' for quick capital gains through exchange rate speculation in developing countries.

Finally, without a more symmetrical treatment of surplus and deficit countries that needs to be agreed internationally, e.g. along the lines suggested by the 'Keynes Plan', international demand management would always be in danger of being jeopardised. It is, therefore, essential to bring back this issue to the forefronts of international debates on a new financial architecture. The situation may be somewhat more conducive today than it was in the immediate aftermath of the Second World War, insofar as the biggest national economy in the world today, namely the United States, has been a deficit country in recent years. However, this will not solve the 'structural', i.e. persistent surplus or deficit problem. A possible start might be to permit persistent deficit countries to lower their interest rates from the synchronized level, and let them follow expansionary fiscal policy at the same time to raise their rates of economic growth. To the extent this combination allows the growth rate to exceed the interest rate, the basic condition for the longer-run viability of external debt would be satisfied.[8] In turn, this would allow otherwise persistent deficit countries to overcome their problems gradually over time through economic expansion rather than contraction. This is contrary to the ruling conventional wisdom on this issue and for that reason alone, needs to be discussed widely.

Endnotes

[1] Minute of 22 February, 1925.
[2] Cf. Bhaduri and Steindl (1983).
[3] Cf. Pasinetti (1981), especially 258-60.
[4] From Article 12 of the 'Proposals by British experts for an International Clearing Union', dated 18 April, 1943, reproduced in: United Nations Organization, Proceedings and Documents of the United Nations Monetary and Financial Conference (1948) 1548-73.
[5] The adjustment in the exchange rate could be in nominal or in real terms, in the latter case through comparative rates of inflation.
[6] This has a direct analogy with Keynes' explanation of the paradox of individual saving in a monetary economy in terms of 'a decision not to have dinner today' (Keynes (1936) 210-11), if the dinner in the restaurant today is considered a non-storable service.
[7] But as we also know from experience, centralized planning, however attractive theoretically, may degenerate more easily into bureaucratic planning without an adequate mechanism for self-correction.
[8] See, for example, Domar (1950), Auramovic et al. (1964), Solomon (1977) and Bhaduri (1987) for elaboration on this point.

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