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EMERGING MARKET ECONOMIES AND THE REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE: BACK TO THE FUTURE

JAN KREGEL

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Preface

Emerging market economies are taking an ill-targeted and far too limited approach to addressing their ongoing problems with the international financial system, according to Senior Scholar Jan Kregel, director of the Monetary Policy and Financial Structure program. In this policy brief, he explains why only a wholesale reform of the international financial architecture can adequately address these countries' concerns. As a blueprint for reform, Kregel recommends a radical proposal advanced in the 1940s, most notably by John Maynard Keynes, that was ultimately put aside in the face of US opposition.

The unconventional monetary policies implemented by central banks in developed countries in the wake of the global financial crisis and Great Recession have occasioned a renewed effort on the part of some leaders of emerging market economies to seek alternatives to the prevailing international financial system. Yet the solutions put forth so far—such as greater multilateral policy coordination, the replacement of the US dollar as the international reserve currency (with, for instance, Strategic Drawing Rights), or the development of regionally governed financial institutions that would be more responsive to emerging market concerns—do not get to the heart of the matter. Although the last approach focused on the creation of alternative financial institutions is the most promising, Kregel writes, it remains incomplete. To modify this proposal so that it would more effectively serve emerging market needs, Kregel suggests we resuscitate Keynes's idea for a "clearing union."

In the 1940s, Keynes was among those who were developing proposals for shaping the post–World War II international financial system. His clearing union plan, itself inspired by Hjalmar Schacht's system of bilateral clearing agreements, would have effectively eliminated the need for an international reserve currency. Keynes maintained that reliance on a freely convertible international standard placed the bulk of the burden of adjustment on the countries least able to bear it and constrained national policy autonomy. As Kregel explains in this brief, the current push to replace the US dollar with some other national currency, or even with Strategic Drawing Rights, would not ultimately address these issues. For Keynes, it was the freely convertible international standard itself (whether gold, the US dollar, or some other replacement) that was the source of the problem.

Under Keynes's clearing union, trade and other international payments would be automatically facilitated through a global clearinghouse, using debits and credits denominated in a notional unit of account. The unit of account would have a fixed conversion rate to national currencies and could not be bought, sold, or traded, meaning no market for foreign currency would be required. Clearinghouse credits could only be used to offset debits by buying imports, and if not used within a specified period of time, the credits would be extinguished, giving export surplus countries an incentive to spend them. As Kregel points out, this would help support global demand and enable a shared adjustment burden.

Though Keynes's proposal was not specifically designed for emerging market economies, Kregel recommends combining this plan with current ideas for regionally governed institutions—to create, in other words, "regional clearing unions," building on existing swaps arrangements. Under such a system, emerging market economies would be able to pursue their development needs without reliance on the prevailing international financial architecture, in which their concerns are, at best, diluted. Moreover, Kregel explains, the regional clearing unions would mean the end of currency wars and exchange rate volatility, little concern regarding international capital flows, no need for an international lender or bank, and, above all, the preservation of policy autonomy for the governments of emerging market economies.

Dimitri B. Papadimitriou, *President*
February 2015

Recent Emerging Market Critiques of the International Financial Architecture[1]

The developed world's policy response to the recent financial crisis has produced a growing chorus of criticism of the operation of the international financial system by emerging market government officials. The former Brazilian finance minister has complained of the "currency wars" generated by the extraordinary monetary policies introduced by developed country central banks in response to the Great Recession. Criticism was equally sharp when a possible reversal of these policies was intimated and the resulting "taper tantrum" in May 2013 produced sharp volatility in exchange rates and capital flow reversals from emerging market economies.

The recently appointed governor of the Reserve Bank of India has joined in this criticism of the policies of developed country central banks, faulting them for failing to take into account the impact of their policies on emerging markets and calling for increased policy coordination and cooperation. Seeking a larger international role for the Chinese currency, Chinese officials have also called into question the dominant role of the US dollar—echoing a criticism of the "exorbitant privilege" first launched by French President de Gaulle in the 1960s.[2] And even before its current difficulties in managing the impact of the decline in oil prices on the ruble exchange rate, Russia joined China as a proponent of replacing the dollar with the SDR—the International Monetary Fund's Special Drawing Rights.

This policy brief suggests that John Maynard Keynes's clearing union proposal could provide a financial system capable of responding to the grievances of emerging market economies. If emerging markets are to achieve their objective of joining the ranks of industrialized, developed countries, they must use their economic and political influence to support radical change in the international financial system.

The Chimera of Increased Policy Coordination

In the aftermath of the US decision to break the dollar-gold parity and the collapse of the Smithsonian Agreements to preserve fixed exchange rates, virtually the only role that remained for the IMF was policy coordination. Initially carried out through Article IV assessments, this role has now been extended to consider more systemic interconnections of national monetary and fiscal policies in the form of what is called the "Spillover Report," which seeks to identify the cross-border impact of members' economic policies (IMF 2014). But it is instructive that the attempts to charge the IMF with increased power to impose policy coordination have produced skepticism among IMF staff (Blanchard, Ostry, and Ghosh 2013). Indeed, the major fora for coordination are now in the G-20 and the Financial Stability Forum, both also dominated by US policy preferences.

Even more important, there is little historical evidence that policy coordination is in any way beneficial to the stability of the international system. The best-known example of monetary policy coordination was the support provided by the governor of the Federal Reserve Bank of New York to ease the return of the pound sterling to the gold standard in the 1920s. This support is widely believed to have provided the basis for the euphoria in equity markets that led to the September 1929 market break.[3] And the collateral damage of this policy was an increasing flow of short-term funds to Germany, which exacerbated the problem of finding an equitable solution to inter-Allied debts and the German reparations that led to World War II.[4]

More recently, international cooperation provided the bulwark for the measures taken to resolve the dollar's overvaluation and then precipitous decline in the aftermath of the Plaza and Louvre Agreements. According to Toyoo Gyohten, the failure of these coordination efforts was the main cause of the October 19, 1987, equity market break known as Black Monday:

> The crash drew forth a multitude of explanations, but I am convinced that one fundamental cause was the failure to achieve real results in coordinating the macroeconomic policies of the seven major economic powers. (Volcker and Gyohten 1992, 268)

Subsequently, the need to allow the United States to lower rates without further depreciation of the dollar led to interest rate reductions by the Bank of Japan in the presence of a rampant equity and property bubble, which precipitated the break in the Japanese market at the end of 1989 that produced a 25-year stagnation and the birth of the zero interest rate policies now lamented by emerging market economies.

A clear problem facing coordination that is cited by both Gyohten and Paul Volcker is the fact that coordination has focused on monetary policy, while "whatever its economic merits, the flexible use of fiscal policy is politically difficult. This difficulty is what limits so sharply the potential for the international coordination of economic policies" (Volcker and Gyohten 1992,

292). These difficulties in fiscal policy coordination seem only to have increased after the response to the 2008 financial crisis.

Failed policy coordination appears to have been more the rule than the exception in the past, and there is little evidence that attempts to consider the impact of domestic monetary policies on other countries can ever be devised in such a way as to provide mutually beneficial results.

An International Reserve Currency

Since Robert Triffin's devastating critique of the Bretton Woods dollar-gold standard (Triffin 1960), the problems of using a national currency as the international reserve currency in a stable exchange rate system have been well known. But rather than providing an innovative solution to this problem, the current proposals to replace the dollar with an international reserve currency appear to be based on the belief that this could provide a system of implicit policy coordination similar to that which was supposed to have ruled under the freely convertible international gold standard. If each country were responsible for maintaining the gold content of its domestic currency unit, there would be no need for explicit international coordination; it would be imposed by the market adjustment of trade flows to changes in relative gold prices for traded and nontraded goods. However, it is difficult to see how an independent international currency would perform differently from the actual operation of the gold standard. Indeed, the Bretton Woods system was an attempt to escape from the instability of the British return to the gold standard in the 1920s.

Keynes's Critique of International Standards

As Keynes pointed out, the international coordination provided under the gold standard was neither equitable nor stabilizing: "The main cause of failure . . . of the freely convertible international metallic standard," he wrote, was "that it throws the main burden of adjustment on the country which is in the *debtor* position on the international balance of payments" (Keynes 1980, 27). "It has been an inherent characteristic of the automatic international metallic currency . . . to force adjustments in the direction most disruptive of social order, and to throw the burden on the countries least able to support it, making the poor poorer" (29).

Indeed, the historical performance of the gold standard confirms this assessment. When debtor countries are faced with adjustment via credit restriction and declining domestic prices, the pressure on the financial system leads to a suspension of the gold standard, while creditor countries resist the expansion of credit and rising prices by limiting convertibility and implementing counterinflationary policies.[5] Thus, while Keynes's insistence on symmetric adjustment is often explained by a desire to allow the UK to implement policies to maximize employment and prevent systemic deficiency of global demand, it has a more fundamental explanation related to the destabilizing nature of a system based on an international standard.

As Keynes observed,

> The main effect of [any international standard] is to secure *uniformity* of movement in different countries—everyone must conform to the average behaviour of everyone else. . . . The disadvantage is that it hampers each central bank in tackling its own national problems. (Keynes 1971, 255–56)

Thus, Keynes identified the existence of a freely convertible international standard, rather than the asymmetric adjustment, as the constraint on national policy autonomy. This point is just as relevant for a dollar standard as it is for a gold standard—as well as any other standard that might replace the dollar.

Keynes noted "a further defect" in the supposed automatic coordination of adjustment under the freely convertible international standard: "The remittance and acceptance of overseas capital funds for refugee, speculative or investment purposes" (1980, 30). And in contrast to earlier periods,[6] "capital funds flowed from countries of which the balance of trade was adverse into countries where it was favourable. This became, in the end, the major cause of instability" (31). His conclusion was that since "we have no security against a repetition of this after the present war . . . nothing is more certain than that the movement of capital funds must be regulated" (31).

This observation reprises Keynes's view of the variable speeds of adjustment of financial and real variables:

> It is, therefore, a serious question whether it is right to adopt an international standard, which will allow an extreme mobility and sensitiveness of foreign lending, whilst the remaining elements of the economic complex remain exceedingly rigid. If it were as easy to put wages up and down as it is to put bank rate up and

> down, well and good. But this is not the actual situation. A change in international financial conditions or in the wind and weather of speculative sentiment may alter the volume of foreign lending, if nothing is done to counteract it, by tens of millions in a few weeks. Yet there is no possibility of rapidly altering the balance of imports and exports to correspond. (1971, 300)

Indeed, a characteristic of the post-Smithsonian, Bretton Woods system has been the tendency for international capital to flow from debtor to creditor countries. This was first seen in Europe as speculative funds flowed to Germany, forcing repeated exchange rate adjustments, and in the global economy in the negative net flows of financial resources from developing to developed countries in the 1980s. Just as members of the euro area have not been spared financial instability with the single "interregional standard" replacing the deutsche mark, emerging market countries are not likely find a remedy to their complaints if the dollar is replaced with the SDR or an international reserve currency.

The Road to Radical International Reform not Taken

As Keynes noted in his proposals for postwar international monetary reform, the fact that

> the problem of maintaining equilibrium in the balance of payments between countries has never been solved, since methods of barter gave way to the use of money and bills of exchange . . . [,] has been a major cause of impoverishment and social discontent and even of wars and revolutions. (1980, 21)

His proposals for the post–World War II financial system sought a solution to the problem by avoiding the difficulties caused by the Treaty of Versailles, represented in his first popular book, *The Economic Consequences of the Peace* (1919). Indeed, it is difficult to understand any of the discussion of postwar international finance without reference to the financial problems of the Treaty of Versailles and the Dawes and Young Committees in dealing with German reparations and the debts of the Allies to the United States.

The problems caused by German reparations payments generated two fundamental principles: (1) that reparations could only be achieved through net exports of goods and services, not by fiscal surpluses and financial transfers; and (2) that this could only be achieved if the recipient country were willing to open its domestic markets and accept an external deficit. The formulation of proposals for the postwar system was dominated by the need to make sure that the absence of these two conditions, which had led to volatile international capital flows and exchange rates, should not be repeated.

As Keynes's thinking evolved, a third fundamental principle gained ascendancy, which Keynes called "the banking principle," and which he defined as "the necessary equality of debits and credits, of assets and liabilities. If no credits can be removed outside the banking system but only transferred within it, the Bank *itself* can never be in difficulties" (1980, 44). But this principle did not refer to credit creation via the creation of bank deposits. It was motivated by an application of his theory of liquidity preference and effective demand. He faulted the gold standard because saving by creditor countries in the form of holding gold stocks reduced global liquidity, and thus the ability to finance global demand.

The banking principle eventually became the centerpiece of Keynes's proposals for a clearing union in which credits were automatically made available to debtor countries to spend. This was of great advantage to the UK, since it meant that the financing of imports required for reconstruction would be automatically available without the need to accumulate dollar balances through export sales (or by borrowing from the United States). On the other hand, the States viewed it as an unlimited commitment to finance European reconstruction, making the proposal anathema to US negotiators.[7]

The reform plans that were discussed in the early 1940s were based on Hjalmar Schacht's "New Plan" of bilateral "Clearing Accounts." As economics minister, he applied the "very simple principle that Germany must refrain from buying more than she could pay for, in order to prevent an accumulation of foreign debt which would make a proper trade balance still more difficult to establish in the future" (Schacht 1949, 80). Given that the creditor countries' "system of import quotas had closed markets to German goods," Schacht sought

> to find countries which would be willing to sell their goods not against payment in their own currency, but against . . . German goods. . . . The best solution was the establishment of "clearing accounts." Foreign countries

selling goods to us would have the amount of our purchases credited to their account in German currency, and with this they could then buy anything they wanted in Germany. (1949, 80–1)

Since Germany was in bilateral deficit with most countries, this led to "blocked credit balances"[8] of Reichsmarks, or what were called "Sperrmarks," that could only be used for specific types of payments—either to foreign exporters or bondholders, leading to a demand for German exports to release them. As Johan Beyen notes, "[creditor] governments had to square the account with whatever Germany was prepared to deliver; and they were inclined to do so because the German purchases solved their unemployment problem" (Beyen 1951, 106–7).

It was Schacht's system of bilateral clearing agreements that provided "the germs of a good technical idea," as Keynes put it (1980, 23), and was the blueprint for both Keynes's and Harry Dexter White's plans for a stable international financial architecture. Keynes expressed these initial ideas for the postwar system in these terms: "The virtue of free trade depends on [it] being carried on by means of what is, in effect, *barter*. After the last war *laissez-faire* in foreign exchange led to chaos" (1980, 8). But Keynes assured his critics that this "does not mean that there would be direct barter of goods against goods, but that the one trading transaction must necessarily find its counterpart in another trading transaction sooner or later"(18).

Keynes's proposal was based on the simple idea that financial stability was predicated on a balance between imports and exports, with any divergence from balance providing automatic financing of the debit countries by the creditor countries via a global clearinghouse or settlement system for trade and payments on current account. This eliminated national currency payments for imports and exports; countries received credits or debits in a notional unit of account fixed to the national currency. Since the unit of account could not be traded, bought, or sold, it would not be an international reserve currency. The implication was that there would be no need for a market for "foreign" currency or reserve balances, and thus no impact of volatile exchange rates on relative prices of international goods, or tradable and nontradable goods. In addition, the automatic creation of credit meant that the UK would not be constrained by its nonexistent gold reserves or its nonexistent dollar balances in financing its reconstruction needs for imports.

Since the credits with the clearinghouse could only be used to offset debits by buying imports, and if not used for this purpose they would eventually be extinguished, the burden of adjustment was shared equally: credit generated by surpluses had to be used to buy imports from the countries with debit balances. Alternatively, they could be used to purchase foreign assets—foreign direct or portfolio investment—but the size of these purchases would be strictly limited by the size of the surplus country's credit balance with the clearinghouse. Once a limit on the size of multilateral debits and credits was agreed upon for each country—its "quota"—penalties, in the form of interest charges, exchange rate adjustment, forfeiture, or exclusion from clearing, would be applied and the outstanding balances would automatically be reduced. Although Keynes's initial proposals did not take developing countries into account, the subsequent drafts suggest that the interest charges on the credit and debit balances generated could be provided as additional credits to support the clearing accounts of developing ("backward") countries (1980, 120).

Another advantage that Keynes claimed for his plan was that it was multilateral in nature, by contrast with Schacht's bilateral clearing agreements. It also avoided the problem of blocked balances and multiple exchange rates for different types of balances and different countries, which had been prevalent within the exchanges under the bilateral agreements. Both of these attributes were considered to be primary objectives of any postwar arrangement and were also present in the US proposal and expressly included in the Final Act of the Bretton Woods agreements.

The Clearinghouse Proposals and the Problems of Emerging Market Economies

Given the historical experience of the negotiations and the performance of the structure launched at Bretton Woods, it would seem obvious that the aspects that emerging market economies find objectionable cannot be fixed by means of the policy proposals they have put forward. It is the structure that has to be changed; Keynes's clearing union idea would seem to meet the criticisms more directly.

Under these more radical proposals, there can be no currency wars, no wall of money, and no interest rate arbitrage. Foreign investment by any country is limited by its global current account position. Indeed, there would be no need for discussion over the efficacy of capital controls, or whether they should be on

inflows or outflows or monitored by the creditor country central bank or the debtor country central bank. As Keynes had envisaged in his original proposal, "international capital movements would be restricted so that they would only be allowed in the event of the country from which capital was moving having a favourable balance with the country to which they were being remitted" (1980, 16–17). Capital flows would extinguish foreign credits in the same way as imports, and thus would only be "allowed when they were feasible without upsetting the existing equilibrium" on external account (17).

Thus, replacing the dollar with a nonnational currency or the SDR will not eliminate the problems facing emerging markets; nor will increased multilateral cooperation, even if that could be achieved. The creation of financial institutions governed by regional or other restricted groupings represents the most promising possibility, but not in the form in which they are currently being discussed. The current proposals are primarily designed to escape the inadequate governance of the IMF and the World Bank and the dominance of the United States in both the theory and practices of these institutions. However, these proposals usually take the IMF as their template and at some level of financial commitment impose IMF program conditionality—and thus do not escape the indirect influence of the United States.

There is no reason why these institutions cannot be created on the template of the clearing unions, building on the swap agreements that many countries have already agreed to on a bilateral basis. Thus, the creation of a common currency for the members of the Bank of the South may not be the most sensible proposal, but the creation of a regional clearing union with a notional unit of account would provide a remedy to the problems faced by these countries. Indeed, Keynes had already considered this as a possibility:

> I would encourage customs unions and customs preferences covering groups of political and geographical units. . . . It would be preferable, if it were possible, that the members should, in some cases at least, be groups of countries rather than separate units. (1980, 55)

Thus, the currently proposed financial institutions could be cast in the form of regional clearing unions.

Indeed, there is already a historical precedent for the operation of a regional clearing union in the European Payments Union, which played an integral part in the restoration of intra-European trade and payments to complement the Marshall Plan.[9] This might provide a better template for the emerging markets initiatives than the IMF.

Stable Exchange Rates and Monetary Sovereignty

From the point of view of the current difficulties facing emerging market economies, the basic advantage of the clearing union schemes is that there is no need for an international reserve currency, no market exchange rates or exchange rate volatility, and no parity to be defended. Notional exchange rates can be adjusted to support development policy, and there is no need to restrict domestic activity to meet foreign claims. Indeed, there is no need for an international lender or bank, since debt balances can be managed within the clearing union. The external adjustment occurs by creating an incentive for export surplus countries to find outlets to spend their credits, which may be in support of developing countries. The system thus supports global demand. Since all payments and debts are expressed in national currency, independence in national policy actions and policy space are preserved. In modern terminology, countries retain monetary sovereignty within the constraint of external balance, which should correspond to full utilization of domestic resources.

Such a system would reflect Keynes's broader vision of the appropriate role for international financial flows:

> I sympathize, therefore, with those who would minimize, rather than with those who would maximise, economic entanglement between nations. Ideas, knowledge, science, hospitality, travel—these are the things which should of their nature be international. But let goods be homespun whenever it is reasonably and conveniently possible; and, above all, let finance be primarily national. (Keynes 1982, 236)

Notes

1. For an extended treatment of these issues, see Kregel (2015).
2. "The present monetary system consists in the exorbitant privilege enjoyed by the United States of being able to cover its balance of payments deficit with its own dollars" (February 4, 1965).
3. Stephen Clarke notes that "the basic instrument, as in 1924, was an easing of monetary policy which, in the light of the boom of the next two years and of the October 1929 crash, was to become one of the most controversial actions in the history of the Federal Reserve System" (Clarke 1967, 124).
4. Schacht explains that "it had not been possible to . . . pay the reparations debts out of export surplus. Not once in the course of the past five years had we achieved such a surplus. Rather, we had met all payments of reparations out of the loans made to us by other countries during those years, a system which could not possibly be continued for any length of time. The interest would increase our indebtedness year by year and the loans themselves would not always be forthcoming" (1955, 248).
5. The various measures used by central banks to manage the "automatic" gold standard adjustment process are detailed in Bloomfield (1959).
6. "During the nineteenth century and up to 1914 the flow of capital funds had been directed from the creditor to the debtor countries, which broadly corresponded to the older and the newer countries, and served at the same time to keep the balance of international payments in equilibrium and to develop resources in undeveloped lands" (Keynes 1980, 30). This is an assessment very similar to that of Raúl Prebisch concerning the impact of international capital flows on Latin American development in the 19th century.
7. Indeed, the private bankers' criticism of the plan was that it was bad banking, since the lending was automatic with no due diligence or credit assessment!
8. Without this background it is difficult to understand the amount of space given in the US proposal to such balances, and the concern of the UK for resolution of the sterling balances with its Commonwealth partners in any postwar scheme.
9. See Kaplan and Schleiminger (1989) for a political and analytical description of the operation of what was an integral part of the restoration of multilateral trade and payments in Europe.

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About the Author

Jan Kregel is a senior scholar at the Levy Economics Institute of Bard College and director of its Monetary Policy and Financial Structure program. He also holds the position of professor of development finance at Tallinn University of Technology. In 2009, Kregel served as Rapporteur of the President of the UN General Assembly's Commission on Reform of the International Financial System. He previously directed the Policy Analysis and Development Branch of the UN Financing for Development Office and was deputy secretary of the UN Committee of Experts on International Cooperation in Tax Matters. He is a former professor of political economy at the Università degli Studi di Bologna and a past professor of international economics at Johns Hopkins University's Paul Nitze School of Advanced International Studies, where he was also associate director of its Bologna Center from 1987 to 1990. Kregel has published extensively, contributing over 200 articles to edited volumes and scholarly journals, including the *Economic Journal*, *American Economic Review*, *Journal of Economic Literature*, *Journal of Post Keynesian Economics*, *Economie Appliquée*, and *Giornale degli Economisti*. His major works include a series of books on economic theory, among them, *Rate of Profit*, *Distribution and Growth: Two Views*, 1971; *The Theory of Economic Growth*, 1972; *Theory of Capital*, 1976; and *Origini e sviluppo dei mercati finanziari*, 1996. His most recent book is *Economic Development and Financial Instability: Selected Essays,* 2014.

In 2011, Kregel was elected to the Accademia Nazionale dei Lincei, also known as the Lincean Academy, the oldest honorific scientific organization in the world. Founded in 1603, the academy counts Galileo Galilei among its original members. It has remained an elite organization of only 540 members, with only 180 of those from outside Italy. Although the academy covers all scientific and literary fields, Kregel is a member of the division for moral, historical, and philological sciences; specifically, the social and political sciences. Robert Solow, Amartya Sen, the late Paul Samuelson, and fellow Levy Senior Scholar James K. Galbraith are among the other American economists who have been elected foreign members of the academy.

Kregel studied under Joan Robinson and Nicholas Kaldor at the University of Cambridge, and received his Ph.D. from Rutgers University under the chairmanship of Paul Davidson. He is a life fellow of the Royal Economic Society (UK) and an elected member of the Società Italiana degli Economisti. In 2010, he was awarded the prestigious Veblen-Commons Award by the Association for Evolutionary Economics for his many contributions to the economics field.