

## The financial crisis

### Part III

# Reforming the world's international money

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The last two lines of the original manuscript of my book *John Maynard Keynes* (Palgrave, 2007) was written in July 2006. In those lines I noted that:

“when, not if, the next Great Depression hits the global economy, then perhaps economists will rediscover Keynes’s . . . analytical system that contributed the golden age of the post World War II. For Keynes, however, it will be a pyrrhic victory”.

The winter of 2007-2008 will prove to be the winter of economic discontent and the beginning of the end of the classical theory of the efficiency of global financial markets. For more than three decades mainstream economists have preached, and politicians accepted, the myth of the efficiency of markets, while burying any thoughts of Keynes’s analysis of domestic financial markets and their connection via the international payments system.

Those who do not study the lessons of history are bound to repeat its errors. Economists forgot the events of the world-wide Great Depression and the collapse of unfettered financial markets that followed the “Roaring Twenties” prosperity. For history has repeated itself with the growth of deregulated financial markets and the prosperity of the 1990s and early 21st century ending up in 2008 with the greatest financial market crisis since the Great Depression.

Within a few months, the so called U.S. sub prime mortgage problem that started in 2007 developed from a small blip on the economic radar screen to a situation that has caused the collapse of financial markets and threatened the viability of financial institutions world wide as the contagion spread quickly via the existing international payments system. If we are to prevent a global Great Depression, it is time to restore Keynes’s vision of how the international payments system should work to permit each country to promote a national full employment policy without having to fear balance of payments problems or financial events occurring in other countries from infecting the domestic banking and financial system.

### 1. A lesson from the early post World War II history

In *The General Theory*, Keynes argued that if an economy was operating at less than full employment, then the nation’s central bank, while maintaining the stability of financial markets, should focus on providing all the liquidity that the economy can absorb in order to reach full employment. For more than a quarter century after following World War II, the major central banks around the world tried to meet the role that Keynes had prescribed for them in his *General Theory*.

From the end of the war until the early 1970s most central banks tended to provide increases in the money supply in response to any domestic or international increase in

demand for the nation's money, while maintaining interest rates at historic lows for prosperous times. This endogenous increase in the money supply tended to support expansion of aggregate demand that resulted in a golden age of economic growth and development for both developed and less developed capitalist economies.

While exchange rates were fixed under the Bretton Woods Agreement, in the early years after the Second World War the United States avoided amassing surplus international reserves by providing grants to the war torn nations, initially via the Marshall Plan and then via other foreign aid programs. In essence, the United States accepted the Keynes Plan suggestion that it is in the best interest of all nations if the major creditor nation bear the major burden of reducing trade imbalances and international payments adjustments. As a result of the Marshall Plan, for the first time in modern history, a post war depression was avoided. The U.S. and its major trading partners experienced unprecedented long run rates of real economic growth from the end of the second World War until the early 1970s.

When, in 1973, the U.S. withdrew from the Bretton Woods Agreement, the last vestiges of Keynes's enlightened monetary approach were lost, apparently without regret or regard as to:

[a] why the Bretton Woods system had been developed in the first place and

[b] how well it had helped the free world to recover from a devastating war which had destroyed much of the productive stock of capital in Europe and Asia.

In the decades since the breakdown of Bretton Woods, the world's economic performance has been unable to match what became almost routine economic success in the quarter century since the end of World War II in terms of low rates of global inflation accompanied by high rates of employment and real growth. Since 1973, however, international economic problems have multiplied, while significantly high rates of unemployment in many nations has again become the norm.

Under any traditional international free trade system, any nation that attempts to improve its economic growth performance by pursuing Keynes's policies for increasing domestic effective demand via easy monetary and fiscal policies will almost immediately face an international payments problem. Expanding domestic aggregate demand will increase the demand for imports relative to the value of exports. When a nation's imports persistently exceed its exports, the nation typically requires foreign loans to finance this import surplus that is encouraging increased economic growth in the trading partners's export industries.

Since 1981 the United States has been the "engine of growth" for most of the rest of the world, as U.S. ran an unfavorable trade balance as U.S. imports tended to grow more rapidly than its exports. In so doing, the United States has been saddled by increasing international deficits almost every year for its laudatory efforts.

## **2. The Bretton Woods experience and the Marshall Plan**

Too often economic discussions on the requirements for a good international payments system that would eliminate persistent trade and international payment imbalances have been limited to the question of the advantages and disadvantages of fixed vs. flexible

exchange rates. As suggested in Davidson [pp. 139-144, 2007] those who champion the argument for flexible exchange rates most mainstream economists merely assume that the price elasticities of the demand for imports and exports will meet the Marshall-Lerner condition. Although the question of whether the Marshall-Lerner condition is important in deciding whether a policy of permitting some flexibility in the exchange rate has anything to recommend it, the facts of experience since the end of the Second World War plus Keynes's revolutionary liquidity analysis indicates that more is required, if a mechanism is to be designed to resolve persistent trade and international payments imbalances, prevent contagion of financial markets globally, and simultaneously promoting global full employment, rapid economic growth, and a long-run stable international standard of value.

Since the second World War, the economies of the capitalist world has conducted experiments with the different types of exchange rate systems. For more than a quarter of a century (1947-1973) after the war, nations operated under the Bretton woods Agreement for a fixed, but adjustable, exchange rate system where, when necessary, nations could invoke widespread limitations on international financial movements (i.e., capital controls). Since 1973, the conventional wisdom of economists and politicians is that nations should liberalize all financial markets to permit unfettered international capital flows to operate under a freely flexible exchange rate system. The current international financial market crisis is a result of permitting unconstrained international financial flows.

In contrast to the classical view of the desirability of liberalized markets , Keynes's position at the 1944 Bretton Woods conference suggested an *incompatibility thesis*. Keynes argued that free trade, flexible exchange rates and free capital mobility across international borders can be incompatible with the economic goal of global full employment and rapid economic growth.

Between 1947 and 1973 policy makers in their actions implicitly recognized Keynes's incompatibility thesis. This period was, as already noted, an era of sustained economic growth in both developed and developing countries. Moreover, during this period, there was "a much better overall record of price level stability" with very high levels of employment compared to either the post-1973 period or the earlier gold standard era of fixed exchange rates (1879 - 1914) [McKinnon, 1990, p. 10].

The free world's economic performance in terms of both real growth and price level stability during the Bretton Woods period of fixed, but adjustable, exchange rates was unprecedented. Moreover, economic growth rates during the earlier gold standard fixed exchange rate period, although worse than the Bretton Woods record, was better, on average, than the global experience during the post 1973 period where liberalizing exchange rate and financial markets to achieve more flexibility exchange rates has been the conventional wisdom. The disappointing post-1973 experience of persistent high rates of unemployment in many nations, bouts of inflationary pressure and slow growth in many OECD countries, plus debt-burdened growth and/or stagnation (and even falling real GNP per capita) in developing countries contrasts sharply with the experience during the Bretton Woods period. Finally in the era of ease of electronic transmission of funds globally, individual investors and institutions such as pension funds,, local governments, banks, etc., looking for a slightly greater return on their money than they could obtain from holding domestic safe investments , reached across national boundaries to purchase foreign assets that they did not understand – but which were represented as being “as good as cash”.

The significantly superior performance of the free world's economies during the Bretton Woods fixed rate period compared to the earlier gold standard fixed rate period suggests that there must have been an additional condition besides exchange rate fixity that contributed to the unprecedented growth during the 1947-73 period. That additional condition, as Keynes explained in developing his proposal for the Bretton Woods Conference, required that any creditor nation that runs persistent favorable trade payments must accept the major responsibility for resolving these trade imbalances. The post war Marshall Plan (see *infra*) was an instance where the creditor nation adopted the responsibility that Keynes had suggested was required.

### **3. Keynes, free trade and an international payments system**

To reduce entrepreneurial uncertainties and the possibility of massive currency misalignments in any fixed exchange rate system, Keynes recommended the adoption of a fixed, but adjustable, exchange rate system. More importantly, Keynes argued that the "main cause of failure" of any traditional international payments system – whether based on fixed or flexible exchange rates-- was its inability to actively foster continuous global economic expansion whenever persistent trade payment imbalances occurred among trading partners. This failure, Keynes [1941, p. 27] wrote,

"can be traced to a single characteristic. I ask close attention to this, because I shall argue that this provides a clue to the nature of any alternative which is to be successful.

It is characteristic of a freely convertible international standard that it throws the main burden of adjustment on the country which is the debtor position on the international balance of payments - that is, on the country which is (in this context) by hypothesis the weaker and above all the smaller in comparison with the other side of the scales which (for this purpose) is the rest of the world".

Keynes concluded that an essential improvement in designing any international payments system requires transferring the onus of adjustment from the debtor to the creditor position. This transfer would substitute an expansionist, in place of a contractionist, pressure on world trade [Keynes, 1941, pp. 29-30]. To achieve a golden era of economic development Keynes recommended combining a fixed, but adjustable, exchange rate system with a mechanism for requiring the nation "enjoying" a favourable balance of trade to initiate most of the effort necessary to eliminate this imbalance, while "maintaining enough discipline in the debtor countries to prevent them from exploiting the new ease allowed them" [Keynes, 1941, p. 30].

After World War II, the war-torn capitalist nations in Europe did not have sufficient undamaged resources available to produce enough to feed its population and rebuild its economy. Economic rebuilding would require the European nations to run huge import surpluses with the United States in order to meet their economic needs for recovery. During the war, the European nations had run down their foreign reserves to extremely low levels. To obtain the necessary imports from the United States, under a *laissez-faire* system, it would be necessary for the United States to provide enormous loans to finance the required U.S. export surplus to Europe. The resulting European indebtedness would be so burdensome that it was

unlikely that, even in the long run, the European nations could ever service such debt obligations.

Private lenders in the United States were mindful that German reparation payments to the victorious Allied nations after World War I were often financed by U.S. investors lending to Germany (e.g., the Dawes Plan). Germany never repaid these loans. Given this history and existing circumstances it was obvious that private lending facilities could not be expected to provide the credits necessary for European recovery after World War II.

The Keynes Plan, presented at the 1944 Bretton Woods conference, would require the United States, as the obvious major creditor nation, to accept the major responsibility for curing the international financial problems that would be associated with the post-war European nations need for U.S. imports. Keynes estimated that the European nations might require imports in excess of \$10 billion to rebuild their economies. The U.S. representative to the Bretton Woods Conference, Harry Dexter White, rejected the Keynes Plan. Dexter White argued that Congress would be willing to provide, at most, \$3 billion as the U.S. contribution to solving this post war international financial problem.

The White Plan created the International Monetary Fund (IMF) whose function it would be to provide short-term loans to nations running unfavorable balances of trade. These loans were suppose to give the debtor nation time to get its economic house in order. The White Plan had the U.S. subscribing to a maximum of \$3 billion as its contribution to the IMF lending facilities. White's plan also developed another lending institution, now called the World Bank, that would borrow funds from the private sector. These funds would then be used to provide long-term loans for rebuilding capital facilities and making capital improvements initially in the war-torn nations and later in the less developed countries. White's plan was basically the institutional arrangements adopted at the Bretton Woods Conference.

Under the White Plan, international loans from the IMF or the World Bank were the only available sources for financing the huge volume of U.S. imports that the wartorn nations would require immediately after the war. This would result in a huge international indebtedness of these nations. Even if the nations could obtain a sufficient volume of loans to finance their import necessities for rebuilding, servicing the resultant immense debt of these nations would require them to accept the main burden of adjustment by "tightening their belt". To tighten the nation's belt is a catch phrase to indicate that the debtor nations have to reduce dramatically their need for imports. The ultimate result would be a significant decline in the standard of living in these countries which probably would have led to political and social unrest in these nations..

Even if the debtor nations had abandoned the Bretton Woods fixed exchange rate mechanism and opted for a depreciating currency under a flexible exchange rate system to force the European residents to "tighten their belts", the result would have reduced the Europeans to almost a starvation level of income. Accordingly, any conventional free market solution available to the European nations after World War II to obtain U.S. imports for rebuilding their economy would have so depressed the standard of living as to possibly induce political revolutions in most of Western Europe.

To avoid the possibility of many European nations facing a desperate electorate that might opt for a communist system when faced with the dismal future that the conventional

Bretton Woods system offered, the United States produced the Marshall Plan and other foreign grants and aid programs to assure that Communism did not spread West from the Soviet Union. Despite White's argument that the U.S. would not be willing to give more than \$3 billion to solving this international payments problem, the Marshall Plan provided \$5 billion in foreign aid in 18 months and a total of \$13 billion in four years. (Adjusted for inflation, this sum is equivalent to approximately \$135 billion in 2007 dollars.) The Marshall plan was essentially a four year gift of \$13 billion worth of U.S. exports to the war devastated nations.

The Marshall plan gift gave the recipient nations claim to approximately 2 per cent of the total output (Gross Domestic Product) of the United States for four years from 1947 to 1951.. Yet no U.S. resident felt deprived of goods and services even as the Marshall Plan recipients essentially siphoned off \$2 out of every \$100 worth of goods produced in the United States. Real gross national income (GNP) per capita in the United States (a measure of the U.S. standard of living) during the first year of the Marshall Plan was still 25% larger than it had been in the last peacetime year of 1940. Per capita GNP continued to grow throughout the 1950s.

Despite Americans giving away 2 per cent of their income per annum, there was no real sacrifice for Americans associated with the Marshall Plan as the remaining income was significantly greater than pre-war levels. The resulting U.S. exports that Marshall plan funds recipient nation's were able to purchase created significant increases in employment in U.S. export industries just as the federal government severely reduced its spending while several million men and women were discharged from the U.S. armed forces and entered the U.S. labor force looking for jobs. For the first time in its history, the United States did not suffer from a severe recession immediately after the cessation of a major war. The U.S. and most of the rest of the world experienced an economic "free lunch" as both the potential debtor nations and the creditor nation experienced tremendous real economic gains resulting from the Marshall Plan and other foreign aid give aways.

By 1958, however, although the U.S. still had an annual goods and services export surplus of over \$5 billion, U.S. governmental foreign and military aid exceeded \$6 billion, while there was a net private capital outflow of \$1.6 billion. The post-war U.S. potential surplus on international payments balance was at an end.

As the U.S. current international payments account swung into deficit in 1958 other nations began to experience payments surpluses. These credit surplus nations did not spend their entire payments surpluses. Instead they used a portion of their annual dollar surpluses to purchase international liquid assets in the form of gold reserves from the U.S. Federal Reserve System. For example, in 1958, the U.S. lost over \$2 billion in gold reserves to foreign central banks. These trends accelerated in the 1960s, partly as a result of increased U.S. military and financial aid responses to the construction of the Berlin Wall in 1961 and later because of the U.S.'s increasing involvement in Vietnam. At the same time, a rebuilt Europe and Japan became important producers of exports so that the rest of the world became less dependent on the U.S. exports.

Still the United States maintained a positive merchandise trade balance until the first oil price shock in 1973. More than offsetting this merchandise trade surplus during most of the 1960s, however, were foreign and military aid plus net capital outflows from the United States so that the United States experienced an annual unfavorable balance of international payments. The Bretton Woods system had no way of automatically forcing the emerging

surplus nations to stop accumulating dollar surplus and instead step into the creditor adjustment role that the U.S. had been playing since 1947. Instead the surplus nations continued to convert some portion of their annual dollar surpluses into calls on U.S. gold reserves. The seeds of the destruction of the Bretton Woods system and the golden age of economic development were being sown as surplus nations drained gold reserves from the United States.

When the U.S. closed the gold window and unilaterally withdrew from Bretton Woods in 1971, the last vestige of Keynes's enlightened international monetary approach was lost.

#### **4. Changing the international payments system**

The 1950-1973 global golden age of economic development required international institutions and U.S. government foreign aid policies that operated on principles inherent in the Keynes Plan with the creditor nation accepting the major responsibility for solving international payments imbalance. The formal Bretton Woods agreement, however, did not require creditor nations to take such actions. Since 1973, the international payments system has been one where international payments considerations often impede any rapid economic growth of many of the developed nations of the world while severely constraining the growth of the least developed countries (LDCs).

Utilizing Keynes's general theory principles, it is possible to update Keynes's original plan for a postwar international monetary scheme that will promote global economic prosperity. For "to suppose [as the conventional wisdom does] that there exists some smoothly functioning automatic [free market] mechanism of adjustment which preserves equilibrium if only we trust to methods of *laissez-faire* is a doctrinaire delusion which disregards the lessons of historical experience without having behind it the support of sound theory" [Keynes, 1941, pp. 21-2]

In the 21st century interdependent global economy, a substantial degree of economic cooperation among trading nations is essential. The original Keynes Plan for reforming the international payments system called for the creation of a single Supranational Central Bank. The clearing union institution suggested *infra* is a more modest proposal than the Keynes Plan, although it operates under the same economic principles laid down by Keynes. Our proposal is aimed at obtaining an acceptable international agreement (given today's political climate in most nations) that does not require surrendering national control of either local banking systems or domestic monetary and fiscal policies. Each nation will still be able to determine the economic destiny that is best for its citizens without fear of importing deflationary repercussions and financial disruptions from their trading partners. Each nation, however, will not be able to export any domestic inflationary forces to their international neighbors.

What is required is a closed, double-entry bookkeeping clearing institution to keep the payments 'score' among the various trading nations plus some mutually agreed upon rules to create and reflux international liquidity while maintaining the purchasing power of the created international currency of the international clearing union. The eight provisions of the international clearing system suggested in this paper meet the following criteria. The rules of the proposed system are designed:

[1] to prevent a lack of global effective demand either due to a liquidity problem arising whenever any nation(s) holds either excessive idle reserves or drain reserves from the system, or a financial crisis occurring in any nation's banking and asset marketing system spilling over to create liquidity and insolvency problems for residents and financial institutions in other nations.

[2] to provide an automatic mechanism for placing a major burden of correcting international payments imbalances on the surplus nations,

[3] to provide each nation with the ability to monitor and, if desired, to control international movements of funds to prevent contagion from financial problems occurring in other nations, tax evasion money movements, earnings from illegal activities, and even funds that finance terrorist operations, and finally

[4] to expand the quantity of the liquid asset used in settling international contracts (the asset of ultimate redemption) as global capacity warrants while protecting the purchasing power of this asset.

## **5. There are eight major provisions in this clearing system proposal.**

### Provision One

The unit of account and ultimate reserve asset for international liquidity is the International Money Clearing Unit (IMCU). All IMCU's can be held only by the central banks of nations that abide by the rules of the clearing union system. IMCUs are not available to be held by the public.

### Provision Two

Each nation's central bank or, in the case of a common currency (e.g., the Euro) a currency union's central bank, is committed to guarantee one way convertibility from IMCU deposits at the clearing union to its domestic money. Each central bank will set its own rules regarding making available foreign monies (through IMCU clearing transactions) to its own bankers and private sector residents.

Since Central Banks agree to sell their own liabilities (one-way convertibility) against the IMCU only to other Central Bankers via the International Clearing Union while they simultaneously hold only IMCUs as liquid reserve assets for international financial transactions, there can be no draining of reserves from the international payments system. Ultimately, all major private international transactions clear between central banks' accounts in the books of the international clearing institution.

The guarantee of only one-way convertibility permits each nation to institute controls and regulations on international capital fund flows if necessary. The primary economic function of these international capital flow controls and regulations is to prevent rapid changes in the bull-bear sentiment from overwhelming the market maker and inducing dramatic changes in international financial market price trends that can have devastating real consequences.



There is a spectrum of different capital controls available. At one end of the spectrum are controls that primarily impose administrative constraints either on a case-by-case basis or an expenditure category basis. Such controls may include administrative oversight and control of individual transactions for payments to foreign residents (or banks) often via oversight of international transactions by banks or their customers. Other capital controls might include the imposition of taxes (or other opportunity costs) on *specific* international financial transactions, e.g., the 1960s United States Interest Equalization Tax.

Finally there can be many forms of monetary policy decisions undertaken to affect net international financial flows, e.g., raising the interest rate to slow capital outflows, raising bank reserve ratios, limiting the ability of banks to finance purchases of foreign securities, and regulating interbank activity.

The IMF, as lender of last resort during the 1997 East Asian contagion crisis, imposed the same conditions on all nations requiring loans for international liquidity purposes. The resulting worsening of the situation should have taught us that in policy prescriptions one size does not fit all situations. Accordingly, the type of capital regulation a nation should choose from the spectrum of tools available at any time will differ depending on the specific circumstances involved. It would be presumptuous to attempt to catalog what capital regulations should be imposed for any nation under any given circumstances. Nevertheless, it should be stressed that regulating capital movements may be a necessary *but not a sufficient* condition for promoting global prosperity. Much more is required.

If any government objects to the idea that the IMCU Provision two provides governments with the ability to limit the free movement of "capital" funds, then this nation is free to join other nations of similar attitude in forming a regional currency union and thereby assuring a free flow of funds among the residents of the currency union.

#### Provision Three

Contracts between private individuals in different nations will continue to be denominated into whatever domestic currency permitted by local laws and agreed upon by the contracting parties. Contracts to be settled in terms of a foreign currency will therefore require some publically announced commitment from the central bank (through private sector bankers) of the availability of foreign funds to meet such private contractual obligations.

#### Provision Four

The exchange rate between the domestic currency and the IMCU is set initially by each nation or currency union's central bank -- just as it would be if one instituted an international gold standard. Since private enterprises that are already engaged in trade have international contractual commitments that would span the changeover interval from the current system, then, as a practical matter, one would expect, but not demand, that the existing exchange rate structure (with perhaps minor modifications) would provide the basis for initial rate setting.

Provisions 7 and 8 *infra* indicate when and how this nominal exchange rate between the national currency and the IMCU would be changed in the future.

#### Provision Five

An overdraft system should be built into the clearing union rules. Overdrafts should make available short-term unused creditor balances at the Clearing House to finance the productive international transactions of others who need short-term credit. The terms will be determined by the *pro bono publico* clearing union managers.

#### Provision Six

A trigger mechanism to encourage any creditor nation to spend what is deemed (in advance) by agreement of the international community to be "excessive" credit balances accumulated by running current account surpluses. These excessive credits can be spent in three ways: (1) on the products of any other member of the clearing union, (2) on new direct foreign investment projects, and/or (3) to provide unilateral transfers (foreign aid) to deficit members. Spending via (1) forces the surplus nation to make the adjustment directly by way of the trade balance on goods and services. Spending by way of (3) permits adjustment directly by the capital account balance, while (2) provides adjustment by the capital accounts (without setting up a contractual debt that will require reverse current account flows in the future).

These three spending alternatives force the surplus nation to accept a major responsibility for correcting the payments imbalance. Nevertheless this provision gives the surplus country considerable discretion in deciding how to accept the onus of adjustment in the way it believes is in its residents best interests. It does not permit the surplus nation to shift the burden to the deficit nation(s) via contractual requirements for debt service charges independent of what the deficit nation can afford. The important thing is to make sure that continual oversaving by the surplus nation in the form of international liquid reserves are not permitted to unleash depressionary forces and/or a building up of international debts so encumbering as to impoverish the global economy of the 21st century.

In the unlikely event that the surplus nation does not spend or give away these credits within a specified time, then the clearing agency would confiscate (and redistribute to debtor members) the portion of credits deemed excessive. This last resort confiscatory action (a 100% taxes on excessive liquidity holdings) would make a payments adjustment via unilateral transfer payments in the current accounts.

Under either a fixed or a flexible rate system with each nation free to decide on how much it will import, some nations will, at times, experience persistent trade deficits merely because their trading partners are not living up to their means -- that is because other nations are continually hoarding a portion of their foreign export earnings (plus net unilateral transfers). By so doing, these oversavers are creating a lack of global effective demand. Under Provision 6, deficit countries would no longer have to deflate their real economy in an attempt to reduce imports and thereby reduce their payment imbalance because others are excessively oversaving. Instead, the system would seek to remedy the payment deficit by increasing opportunities for deficit nations to sell abroad and thereby work their way out of their deteriorating debtor position.

### Provision Seven

A system to stabilize the long-term purchasing power of the IMCU (in terms of each member nation's domestically produced market basket of goods) can be developed. This requires a system of fixed exchange rates between the local currency and the IMCU that changes only to reflect permanent increases in efficiency wages. This assures each central bank that its holdings of IMCUs as the nation's foreign reserves will never lose purchasing power in terms of foreign produced goods. If a foreign government permits wage-price inflation to occur within its borders, then, the exchange rate between the local currency and the IMCU will be devalued to reflect the inflation in the local money price of the domestic commodity basket. For example, if the rate of domestic inflation was 5 cent, the exchange rate would change so that each unit of IMCU could purchase 5 per cent more of the nation's currency.

If, on the other hand, increases in productivity lead to declining production costs in terms of the domestic money, then the nation with this decline in efficiency wages [say of 5 per cent] would have the option of choosing either [a] to permit the IMCU to buy [up to 5 per cent] less units of domestic currency, thereby capturing all (or most of) the gains from productivity for its residents while maintaining the purchasing power of the IMCU, or [b] to keep the nominal exchange rate constant. In the latter case, the gain in productivity is shared with all trading partners. In exchange, the export industries in this productive nation will receive an increasing relative share of the world market.

By devaluing the exchange rate between local monies and the IMCU to offset the rate of domestic inflation, the IMCU's purchasing power is stabilized. By restricting use of IMCUs to Central Banks, private speculation regarding IMCUs as a hedge against inflation is avoided. Each nation's rate of inflation of the goods and services it produces is determined solely by (a) the local government's policy toward the level of domestic money wages and profit margins vis-a-vis productivity gains, i.e., the nation's efficiency wage. Each nation is therefore free to experiment with policies for stabilizing its efficiency wage to prevent inflation as long as these policies do not lead to a lack of global effective demand. Whether the nation is successful or not in preventing domestic goods price inflation, the IMCU will never lose its international purchasing power in terms of any domestic money. Moreover, the IMCU has the promise of gaining in purchasing power over time, if productivity grows more than money wages and each nation is willing to share any reduction in real production costs with its trading partners.

Provision 7 produces a system designed to, at least, maintain the relative efficiency wage parities amongst nations. In such a system, the adjustability of nominal exchange rates will be primarily (but not always, see Provision 8) to offset changes in efficiency wages among trading partners. A beneficial effect that follows from this proviso is that it eliminates the possibility that a specific industry in any nation can be put at a competitive disadvantage (or secure a competitive advantage) against foreign producers solely because the nominal exchange rate changed independently of changes in efficiency wages and the real costs of production in each nation.

Consequently, nominal exchange rate variability can no longer create the problem of a loss of competitiveness due solely to the overvaluing of a currency as, for example, experienced by the industries in the American "rust belt" during the period 1982-85. Even if temporary, currency appreciation independent of changes in efficiency wages can have

significant permanent real costs as domestic industries abandon export markets and lose domestic market business to foreign firms and the resultant existing excess plant and equipment is cast aside as too costly to maintain.

Provision 7 also prevents any nation from engaging in a beggar-thy-neighbor, export-thy-unemployment policy by pursuing a real exchange rate devaluation that does not reflect changes in efficiency wages. Once the initial exchange rates are chosen and relative efficiency wages are locked in, reduction in real production costs which are associated with a relative decline in efficiency wages is the main factor (with the exception of Provision 8) justifying an adjustment in the real exchange rate. Although Provision 6 prevents any country from piling up persistent excessive surpluses, this does not mean that it is impossible for one or more nations to run persistent deficits. Consequently Provision 8 infra provides a program for addressing the problem of persistent international payment deficits in any one nation.

#### Provision Eight

If a country is at full employment and still has a tendency toward persistent international deficits on its current account, then this is *prima facie* evidence that it does not possess the productive capacity to maintain its current standard of living. If the deficit nation is a poor one, then surely there is a case for the richer nations who are in surplus to transfer some of their excess credit balances to support the poor nation. (This is equivalent to a negative income tax concept.) If the deficit nation is a relatively rich country, then the deficit nation must alter its standard of living by reducing its relative terms of trade with its major trading partners. Rules, agreed upon in advance, would require the trade deficit rich nation to devalue its exchange rate by stipulated increments per period until evidence becomes available to indicate that the export-import imbalance is eliminated without unleashing significant recessionary forces.

If, on the other hand, the payment deficit persists despite a continuous positive balance of trade in goods and services, then there is evidence that the deficit nation might be carrying too heavy an international debt service obligation. The *pro bono* officials of the clearing union should bring the debtor and creditors into negotiations to reduce annual debt service payments by [1] lengthening the payments period, [2] reducing the interest charges, and/or [3] debt forgiveness.

It should be noted that Provision 6 embodies Keynes's innovative idea that whenever there is a persistent (and/or large) imbalance in current account flows, whether due to capital flight or a persistent trade imbalance, there must be a built-in mechanism that induces the surplus nation(s) to bear a major responsibility for eliminating the imbalance. The surplus nation must accept this burden for it has the wherewithal to resolve the problem.

In the absence of Provision 6, under any conventional system, whether it has fixed or flexible exchange rates and/or capital controls, there can ultimately be an international liquidity crisis (as any persistent current account deficit can deplete a nation's foreign reserves) that unleashes global depressionary forces. Thus, Provision 6 is necessary to assure that the international payments system will not have a built-in depressionary bias. Ultimately then it is in the self-interest of the surplus nation to accept this responsibility, for its actions will create conditions for global economic expansion some of which must redound to its own residents. Failure to act, on the other hand, will promote global depressionary forces which will have some negative impact on its own residents

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