

The Necessity of Reforming the International Monetary System¹

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1. Introduction

The current international financial crisis is a crisis of globalised finance, meaning that a crisis in one specific segment of the financial system – specifically the United States subprime mortgage market – eventually spreads worldwide. The effects of such a crisis are not neutral in economic and social terms, added to which the benefits of financial globalization have come to be called seriously into question. While this crisis is associated with an absence of regulation, particularly by the State, it has been action by *Big Bank* and *Big Government*³ that has prevented it from developing into a depression. This chapter evaluates the present international financial crisis and interpretations of it, and indicates that surmounting it will depend on a series of post Keynesian type measures. To that end, it describes very briefly the origins of the crisis, and developments and lessons from it, then presents the conventional and post Keynesian views of foreign exchange and financial crises, especially as regards the present international financial crisis. Lastly, on the one hand, it sets out the main conventional and heterodox arguments for the necessity of restructuring the international monetary system and some proposals for reform of that system and, on the other hand, in the light of post Keynesian theory, following Davidson (2002), it presents a proposal for restructuring the international financial system. That proposal, in the author's view, is capable of preventing future foreign exchange and financial crises, while at the same time assuring the conditions for macroeconomic stability, understood as sustainable economic growth with full employment, price stabilization and external equilibrium.

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³ According to Minsky (1986, Chapter 13), the failures of capitalism can be solved only by creating the *Big Bank*, a lender-of-last-resort function, to avoid financial system collapse, and *Big Government*, to assure fiscal stimulus and State intervention to stabilize output and employment.

2. A brief analysis of the current international financial crisis: origins, consequences and lessons⁴

2.1. Origins

Internationalization of the financial system has substantially altered the nature and determinants of world economic dynamics: the combination of deregulated financial markets and the attendant emergence of financial innovations (such as securitization and derivatives), freely mobile capital and flexible and volatile foreign exchange and interest rates, on the one hand, have limited the action of domestic macroeconomic policies and, on the other, have been one cause of recurrent balance of payments and foreign exchange crises in emerging economies (particularly those that took place in the 1990s), crises of both liquidity and solvency, and the recent international financial crisis.

When markets are integrated to the point of creating a 'single' world money and credit market – under conditions where there are no stabilizing financial and foreign exchange rules and where traditional macroeconomic policy tools become increasingly insufficient to contain currency exchange and financial collapse at the world level – this process of financial globalization comes to result ultimately in crises of effective demand and unemployment.

The present international financial crisis – which incidentally originated from losses caused by mounting mortgage loan defaults on the United States subprime market (high-risk real estate finance market) and produced knock-on effects worldwide, because a large part of those mortgages has been securitized and distributed to investors on the global market – is above all a crisis in financial globalization understood as a tendency to create a global financial market and to intensify capital flows among countries. This process can be traced back to the 1970s crisis in the Bretton Woods international monetary system, to deregulation of financial markets in the course of the 1980s, and to the liberalization of foreign exchange markets and capital flows from the 1990s onwards.

As a result of the process of financial deregulation, foreign exchange market liberalization and capital mobility, "a strong trend towards 'financialization' and rent-

⁴ This Section is based, particularly, on Ferrari Filho and Paula (2009).

seeking started to take shape in capitalist economies”, where companies, financial institutions and consumers “began to subordinate their spending, investment and savings decisions to expectations about the pace of their respective financial ‘enrichment’” (Coutinho and Beluzzo, 2004: 60; the original quotation was translated by the author).

Meanwhile, competition could be seen to intensify among banking institutions, with a consequent decline in net interest margins and the associated response, a trend towards financial conglomeration through mergers and takeovers. In this connection, financial institutions have begun to explore different markets, including lower-income ones. On the securities market, for instance, encouraged by growth among institutional investors (hedge funds and pension funds, and so on), securitization mechanisms were developed where firms and banks financed themselves by ‘packaging’ receivable earnings. Accordingly, given that securitization allowed risks to be diluted on the market, financial institutions and institutional investors went on to increase their leverage on the assumption that market self-regulation mechanisms would be able to continue returning correct assessments of the risks inherent to these financial activities⁵.

Ultimately, the crisis on the subprime (high-risk mortgage finance) market laid bare all the contradictions of this process. The existing context of (i) low base interest rates set by the Federal Reserve Bank (Fed) in order to reanimate the United States economy following the collapse of the Nasdaq bubble in 2000 and the terrorist attacks on the twin towers of the World Trade Center in 2001 and (ii) weak financial system regulatory mechanisms – which incidentally even permitted a parallel financial system (institutional investors) to spring up – eventually resulted in a bubble in subprime mortgages (adjustable rate mortgages whose interest rates are reset periodically, starting out low and rising over time, according to a variety of indices). Because of their need to achieve ever greater scale, financial institutions began to take in lower and lower income earners in conditions of ‘financial

⁵ For an analysis of financial globalization trends see Dymski (2008) and Palley (2008). Cardim de Carvalho (2008) describes the chronological evolution of the subprime crisis and Eichengreen (2008) shows the origins and responses to the international crisis. Kregel (2008) presents an interesting analysis of the subprime crisis based on Minsky’s financial instability hypothesis.

exploitation', resulting in a process of financial strangulation for borrowers. Securitization was supposed to serve to dilute risks; in practice, it served to conceal them: securities backed by mortgages were issued by major financial institutions and ranked 'investment grade' by certain rating agencies. As a result of financial globalization, these assets were purchased in turn by investors of various different nationalities. New financial instruments were created in this way, but were not properly regulated by the authorities. Moreover, market self-regulation mechanisms proved faulty due to the pro-cyclic nature of risk taking, i.e. projects that had been regarded as poor risks during the economic slowdown came to be seen as good risks during the boom.

It is worth noting that the subprime crisis was initially diagnosed as being a problem restricted solely to the institutions that had involved themselves with high-risk mortgage loans. That diagnosis proved mistaken, however, because an injection of liquidity and lower interest rates⁶ were not enough to avert the fallout from the crisis. Now why was that? It was because, eventually, given the extensive, interconnected financial network that had been put in place at the global level by the process of 'financialization', the subprime crisis ended up turning into a systemic crisis – that is, a situation where the liquidity crisis comes to precipitate a crisis of confidence. In that regard, in a situation where no abrupt movements in asset prices had been expected – neither rising United States basic interest rates⁷ nor falling housing prices as a result of defaulting mortgage debtors – financial institutions became insolvent.

There could only ever have been one outcome: on the one hand, the systemic crisis meant that bank credit was cut off, because the financial system came to prefer liquidity and, on the other hand, the scarcity of credit came to constrain levels of consumption and investment, thereby impacting the 'real economy'.

⁶ Right after the onset of the crisis, the interest rates charged by the major central banks were reduced significantly. At the end of 2009, the base interest rates of the central banks of the United States, United Kingdom and Japan and the European Central Bank stood, respectively, at 0.25%, 0.5%, 0.1% and 1.0% per year.

⁷ In 2004, the base interest rate set by the Fed was 1.4%, yearly average, as against 2007 when it rose to a yearly average of 5.2%. Mean rates calculated by the author on the basis of IMF (2010).

2.2. Consequences⁸

The international financial crisis affected economic activity dramatically, both in the developed countries and in the emerging economies, casting doubt on the very notion of decoupling the emerging countries.

The developments from the crisis were observed not just in the financial system, but most importantly in the real realm of the economy. After a long period of prosperity in the world economy running from 2003 to 2007, the United States, the countries of the *Euro zone*, Japan and some of the leading emerging countries, such as Argentina, Brazil, Chile and Mexico, went into recession from the last quarter of 2008 onwards⁹. The scenario that unfolded from September 2008 onwards in terms of economic downturn, shrinking trade flows and asset deflation caused the world economy to go into collapse. In this connection, it is worth remembering that the International Monetary Fund (IMF)'s *World Economic Outlook* of October 2009 held out both a pessimistic forecast for world GDP in 2009 (that is, recession) and also the expectation of a period of slow recovery in the world economy starting in 2010¹⁰.

It should be stressed that the world recession expected for 2009 might have been much worse had it not been for the actions of the Monetary Authorities (MAs) of both the G-7 countries and the emerging countries: aware that the international financial crisis had stemmed from inaction by the State and not from its purported proactive role, as supposed by the theoreticians of neoliberalism, these countries' MAs took an active part in mitigating the impacts of the international financial crisis on the productive sphere of the economy. To that end, they implemented counter-cyclic fiscal policies and expansionist monetary policies, mainly through the activities of their central banks as lenders of last resort, in order to reverse the steadily deteriorating state of expectations among economic agents. In that regard,

⁸ The main arguments of this Section were, initially, presented in Ferrari Filho and Paula (2009).

⁹ Of the main emerging countries, only China and India did not fall into recession, although their quarterly growth rates were substantially reduced.

¹⁰ Corroborating the IMF's somber forecast for 2009, the growth rates for the United States and the Euro zone have recently been published for that year: -2.4% and -4.0%, respectively. Moreover, according to the World Trade Organization (2010) in 2009 the volume of world trade decreased 12.0%.

the injections of liquidity and substantial reductions in interest rates practiced by central banks, as well as fiscal incentives, along Keynesian lines, were important in reducing the impact of the crisis on the 'real economy' and seeking to restore agents' confidence in the workings of the markets¹¹.

In parallel, the governments of the G-7 and the main emerging countries in the group known as the G-20 met in April 2009 and proposed a total restructuring of the international monetary system grounded in greater transparency and regulation¹² and in international financial cooperation. On that occasion they also approved the creation of an emergency line of credit of about US\$1.1 trillion to boost the volume of funding by the IMF and multilateral development banks to finance world trade, in addition to which the governor of the People's Bank of China suggested replacing the US dollar as the universal reserve currency by creating a new global currency that would be sovereign and independent of the decisions of national central banks. In short, the G-20 proposed to avert any worsening of the world recession, to monitor and regulate the financial system and to negotiate a 'new architecture' for the international monetary system so that financial markets could return to performing their primary functions, which are to finance productive investment and consequently expand effective world demand.

Unfortunately, the conservatism and conflicts of interest among the participants have prevented any progress towards the possible restructuring of the international monetary system, at least for the present.

2.3. Lessons

The international financial crisis has left us some lessons¹³, which briefly are:

¹¹ As regards the synchronized actions of central banks around the world, whether in injecting liquidity into the financial system or reducing base interest rates, it is worth calling attention to the fact that were it not for action of a lender of last resort (Minsky's *Big Bank*), the systemic crisis in the financial system was likely to have led to meltdown in the system of payments and a run on the banks, similar to the Great Depression of the 1930s. In this particular, Eichengreen and O'Rourke (2009), for instance, present an interesting parallel between the Great Depression and the current international financial crisis.

¹² The G-20 proposed to regulate hedge funds, private equities and derivative markets, as well as putting an end to offshore tax havens.

¹³ Lessons 2 and 5 are explored by Gontijo and Oliveira (2009).

1. Financial (and currency exchange) crises are more and more recurrent in a context of financial deregulation and liberalization of foreign exchange and capital flows.
2. Markets, especially financial markets, are not efficient, self-regulating and self-balancing, as has been argued by conventional economists.
3. Financial crises are endogenous. On this point, drawing on Minsky (1986) and the idea of a 'financial instability hypothesis', a continuous and dynamic cycle of economic prosperity, such as occurred in the world economy between 2003 and 2007, lead the economy inevitably to instability, because in times of prosperity economic agents – consumers, firms and financial institutions – take decisions to consume, invest and lend and/or leverage themselves that are essentially speculative ('suicidal' attitudes). In other words, the boom makes the economy inherently unstable; therefore, financial (foreign exchange) crises are associated with the peaks of economic cycles.
4. In a globalized world, the economic and social implications of financial crises are far more dramatic.
5. Solutions to the problem of excessive financial wealth in relation to the 'real economy' usually come at a high price¹⁴.
6. Lastly, the present world international financial crisis occurred because of deficiency in the regulatory frameworks and excessive leverage in the financial system, dynamized globally by the development of derivatives contracts and credit 'securitization'. Accordingly, Lehman Brothers, Fannie Mae, Freddie Mac and American International Group, as well as other institutions, **propagated** the crisis, but **were not its origin**.

Utopically, if there were convergence among economists' ideas and world views, we might perhaps be able to add one more item to this list of lessons from the international financial crisis; that is, that eventually we all learn from our past errors. Unfortunately, however, for the conventional theorists, once the crisis has

¹⁴ For example, according to estimates by multilateral institutions, by the end of 2009 some US\$15.0 trillion had been injected in order to reduce the present international financial crisis, while the public deficits of the G-7 countries had expanded abruptly.

passed, the ‘invisible hand of the market’ will return to conduct the economy to its natural condition of overall equilibrium. On this point, as Keynes (1936/1964: viii) wrote in his *The General Theory of Employment, Interest and Money* (GT), “[t]he difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds”.

3. The conventional and post Keynesian views of financial crises¹⁵

3.1. The conventional theory

In general, the conventional theory presumes that financial (and foreign exchange) markets are efficient; that is to say, efficient market theory claims that economic agents analyze past and present market data, which means that price signals are presumed to provide enough information about forming rational expectations as a basis for making utility maximizing decisions. Thus, financial (foreign exchange rate) crises occur *only* if there is any sort of ‘market fundamental’ essentially associated with a current or foreseeable future deterioration in economic fundamentals.

Assuming an ergodic world¹⁶, in which market fundamentals determine the conditional probabilities of future outcomes, financial (exchange rate) crises are explained by the possibility of irrational behavior involving bandwagon effects. In other words, financial (exchange rate) crises are explained by ‘anomalies’ (i.e., inconsistent economic fundamentals). Moreover, using *ad hoc* micro-fundamentals to explain ‘irrational’ crises, conventional theory is always trying to find an *ex post* explanation for each ‘new’ financial or currency crisis.

With the foregoing ideas as their frame of reference, conventional economists uphold the arguments that financial (foreign exchange) crises occur because of random, external events (‘sunspots’) or because of ‘asymmetrical information, or

¹⁵ This Section is based mainly on Alves Jr., Ferrari Filho and Paula (1999-2000) and Ferrari Filho and Paula (2009).

¹⁶ In an ergodic world, according to Davidson (1994: 89) “future events are always [calculable] and predictable by using a probabilistic analysis of past and current outcomes”.

even for reasons of 'moral hazard' (Mishkin, 1992)¹⁷.

In this context, how does the conventional theory explain the current international financial crisis?

For example, a book written by John Taylor (2009) called *Getting off Track* seems to summarize the conventional theory's view of the international financial crisis. Taylor regards the crisis as having resulted, on the one hand, from the adoption of excessively lax monetary policy in the early 2000s, which he considers to have contributed to inflating real estate prices in the United States. According to Taylor, if between 2003 and 2005 the Fed had held short-term interest rates at levels suggested by "Taylor's Rule" – that is, at higher levels than it actually did – the expansion of the United States real estate market would have been far more moderate. On the other hand, still according to Taylor, the United States government's hesitant actions to tackle the crisis merely heightened agents' insecurity. In this connection, both the announcement of the "Paulson Plan", which suggested buying up the 'rotten' mortgage assets of financial institutions in difficulties, and the United States MAs' mistaken diagnosis of the crisis as simply a problem of liquidity, not perceiving the extent of the banks' solvency problems, contributed to aggravating the crisis. On this latter point, Taylor sees the failure of Lehman Brothers, and also the interventions in Bear Stearns, American International Group, Fannie Mae and Freddy Mac, along with other financial institutions, as just one more step in the confused strategy for dealing with the crisis, where the government's intervention actually worsened the situation, because it spread insecurity and the fear of bankruptcies on the financial market.

In an article published in the journal *Valor Económico*, Alan Greenspan (2009), former chairman of the Fed, developed a different interpretation of the crisis: the subprime crisis was not determined by the reduction in the Fed interest rates between 2002 and 2005, given that the correlation between the mortgage interest rate and the Fed rate was insignificant, but rather by the sizeable current

¹⁷ For instance, Rogoff and Reinhart (2008), analyzing eight centuries of international exchange rate and financial crashes in different countries, have a similar view about the origins of them. Moreover, they argue that, in general, economic crises are originated from financial markets with transmission through commodity price collapses.

account surpluses of various emerging countries, especially China, which ultimately pressured the long-term interest rate to steadily lower levels, thus contributing to a global housing price bubble. In other words, the creation of a kind of endogenous currency associated with international liquidity is regarded as having been decisive in the simultaneous drop in global interest rates.

Faithful to his liberal principles, however, Greenspan did not perceive permissive deregulation as one of the main causes of the international financial crisis. He thus provides an interesting explanation for why the housing bubble burst, but is unable to take a more comprehensive view of the crisis. Why after all should a real estate crisis in a secondary sector of the financial system (the subprime market) ultimately contaminate the overall system as a whole?

One critical aspect of Taylor's argument, going beyond the remarks offered by Greenspan, is to suggest that ultimately the propagation of the international financial crisis resulted from excessive, undue interference by the United States government, on the old liberal argument that action by the government, when all is said and done, tends to be ineffective. Now, that does not seem to be a convincing explanation for the international financial crisis, because it confuses relations of cause and effect.

Taylor and Greenspan share a common faith in the free workings of the market – regulated financial markets tend to be inefficient and not very innovative. Besides, for them, the financial system is unstable due to problems of asymmetric information.

Going in this direction, Gordon (2008) shows that the origin of the international financial crisis is related to the asymmetric information and how the risk was spread to the security and derivative markets

However, it has to be understood that financial systems, at the same time as they can help leverage growth, are inherently unstable (Keynes, 1964, Chapter 12).

In short, the conventional explanation for the international financial crisis is that (i) the low rates of interest practiced by the Fed in the early 2000s in order to mitigate the effects of deflating the "New Economy" bubble eventually gave rise to

the housing bubble and (ii) misplaced interventions in the financial market by United States MAs constituted problems of asymmetrical information and market irrationality, thus generating situations favorable to the actions of foolish ‘noise traders’. In other words, the international financial crisis resulted from exogenous economic variables.

3.2. The post Keynesian perspective

As we know, Keynes and post Keynesians reject the ergodic axiom of efficient market theory to explain financial (exchange rate) market behavior because, in an uncertain world, future market valuations are always uncertain since the future is subject to sudden and violent changes and fundamentals do not provide a reliable guide to the future¹⁸. As a consequence, economic decision making cannot predict the future based on any statistical analysis of past market information. In such a world, speculation is not an ‘anomaly’ but results from how financial (exchange rate) market operations actually work.

It is because uncertainty exists that economic agents, in both financial and exchange rate markets, have heterogeneous expectations, since whatever data sets exist today, they can never be expected to provide a reliable guide to future outcomes. In this light, the expectations that drive spot financial (exchange rate) markets are not rational, because conventional valuation based on psychological market forecasting cannot be held as statistically reliable.

Also, Keynes argues that the expectations of both investors and speculators are governed not by real long-term fundamentals relating to expected earnings from an investment over coming years, but rather by the value the market expects the asset will have in the future. In the words of Keynes (1964: 154-5),

Most of these persons are, in fact, largely concerned, not with making superior long-term forecasts of the probable yield of an investment over its whole life, but with foreseeing changes in the conventional basis of valuation a short time ahead of the general public. They are concerned, not with what an

¹⁸ See, for instance, Keynes (1964, Chapter 12) and Davidson (1997).

investment is worth to a man who buys it 'for keeps', but with what the market will value it at, under the influence of mass psychology, three months or a year hence.

Thus, speculation is forecasting the psychology of the market.

Keynes shows, in his GT (Chapter 12), that in an entrepreneurial economy – in a context under incalculable uncertainty, money can be held as a safety asset by virtue of its characteristics of transporting purchasing power over time¹⁹ –, the organization of financial markets faces a severe trade-off between liquidity and speculation: on the one hand, the financial market encourages the development of productive activity by making assets more liquid, thus freeing investors from the irreversibility of investment; on the other hand, it increases the possibilities of speculative gains. Thus, in establishing a connection between financial and real markets in the economy, Keynes (1964: 159) writes that “the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done”.

Echoing Keynes, the activities of present-day global players in markets that are increasingly deregulated and integrated reduce financial markets to a kind of vast global casino. Thus, in a global economy, speculation is by nature disruptive of not just domestic markets, but of whole countries, creating a kind of over-sized financial casino.

From a Keynesian standpoint, financial instability is not regarded as an 'anomaly', but as an outcome of the very way financial markets operate in a system where there is no safeguard structure to perform a global market-maker function. Thus, the specific institutional format of the financial markets determines the possibilities of there existing an environment in which speculation can flourish. Financial crises are not just “irrational” behavior by agents, but result from the very way deregulated global financial markets operate in a system without appropriate regulation (Alves Jr, Ferrari-Filho and Paula, 1999-2000).

¹⁹ Keynes' concept of an entrepreneur economy is developed in his article “The distinction between a co-operative economy and an entrepreneur economy” (Keynes, 1979: 76-87). See, also, Davidson (1994, Chapter 6).

Taking as its frame of reference the ideas of Keynes about how financial markets operate in monetary production economies, the post Keynesian approach regards the international financial crisis as a consequence of processes of financial deregulation, capital flow mobility and intensifying competition among financial institutions, which ultimately constitute a financially globalized world in which finances, instead of leveraging (creating funding) in favor of productive activity, come to increase essentially speculative operations, thus valuating the financial wealth derived from capital.

To sum up, according to Keynes and the post Keynesian approach, in a globalized economy and an uncertain world, financial (exchange rate) crises (i) are an endogenous phenomenon, (ii) stimulate economic agents' preference for liquidity and (iii) lead to a lack of effective demand, as a result increasing the rate of unemployment.

4. A post Keynesian proposal for reforming the international monetary system

The international financial crisis recommends reflection on two counts. In the first place, it calls into question the supposed concrete benefits of financial globalization with financial markets deregulated everywhere, including in the developed countries. In the second place, given the fiscal and monetary measures implemented by developed and emerging countries to mitigate the world recession, it prompts a rethinking of the very role of the State in the economy, as regards the need both to regulate domestic financial systems and to restructure the international monetary system.

On the first count, as deregulated financial markets are not efficient, in the absence of rules to stabilize such markets, speculative activities and the financial valuation of wealth eventually become routine, because the liberalization of financial markets and the existence of new financial instruments (such as derivatives) increase the likelihood that speculative activities will be pursued. In that connection, there is a need to regulate 'exotic' derivatives operations and the

other practices (excessive leverage by financial institutions) that made the ‘party’ for investors and banks.

On the second point, on the one hand, the key lesson from the international financial crisis is not only that State action is fundamental in preventing or remedying crises, but that, particularly at critical moments, it is important there be greater global coordination among the various different national policies, especially in the developed countries. In this regard, the role of the State is fundamental to restoring macroeconomic balance and to creating an ‘institutional environment’ favorable to ‘animal spirits’. As stated by Keynes (1964: 378), “I conceive (...) that a somewhat comprehensive socialisation of investment will prove the only means of securing an approximation to full employment”. For that purpose, Keynes suggests fiscal, monetary and income policies²⁰. In that direction, the macroeconomic policy of national economies should be coordinated in such a way as to (i) operationalize fiscal policies designed to expand effective demand and reduce social inequalities, (ii) make for more flexible monetary policy so as to galvanize levels of consumption and investment and (iii) coordinate and regulate financial and foreign exchange markets in order to stabilize capital flows and exchange rates. In short, taking up the idea of Minsky (1986), there is a need for State intervention and regulation through *Big Government* and *Big Bank*.

On the other hand, as regards the need to restructure the international monetary system, a degree of consensus can be said to exist among economists and policymakers as to what measures are indispensable to restoring stability to the system. Nonetheless, there is no consensus as to how the international monetary system is to be restructured²¹.

²⁰ Cardim de Carvalho (1992, Chapter 12) presents the policy instruments for stabilizing the economy, from a post Keynesian perspective.

²¹ Concerning this specific point, recently, two different views about the necessity of reforming the international monetary system were presented: on the one hand, some essays collected by Eichengreen and Baldwin (2008) argue that government intervention to stabilize and to create regulatory reforms to the financial market, as well as rethinking the financial architecture are essential; on the other hand, The Group of the Thirty (2008) presents a report addresses to policies related to redefining the structure of prudential regulation and improving the governance, the risk management, the transparency and the accounting practices of the financial system. In other words, the first one emphasizes a global action in terms of macroeconomic policy, while the second one explores the idea of reforming the microeconomic framework to stabilize the financial system.

To conventional economists, an efficient international monetary system is one made up of flexible currency exchange regimes, more capital mobility and greater financial liberalization on markets. According to Edison, Levine, Ricci and Slok (2002), the benefits of a flexible exchange rate, unregulated capital flows and financial liberalization to the world economy is that these 'policies' (i) reduce the sources of external vulnerability, (ii) increase the autonomy of monetary policy, (iii) allocate domestic and foreign savings efficiently, (iv) discipline macroeconomic policies and (v) improve economic growth performance.

Meanwhile, the need to preserve the autonomy of countries' fiscal and monetary policy – which are essential to assuring sustainable economic growth trajectories – has reinforced the Keynesian economists' point of view that it is necessary to introduce an international market maker in order to (i) ensure the international liquidity indispensable to enable the flow of world trade, (ii) stabilize the currency exchange regime and (iii) control short-term capital flows. Issues (ii) and (iii) are particularly important for developing countries, given that these countries suffer from more volatility than developed countries, and this contributes to recessions of longer duration (Hausmann, Pritchett, and Rodrik, 2004).

In terms of proposals, it should be noted that a number of ideas have been formalized in recent decades in the endeavor to signpost this restructuring of the international monetary system. These include: (i) 'Target Zones for Exchange Rates' (Williamson, 1987), the essence of which is to establish rules and goals that limit the fluctuation of nominal exchange rates, with a view thus to establish a relatively stable real rate of exchange which will permit internal and external balance²²; (ii) 'Fixed Nominal Purchasing Power Parity Exchange Rate System' (McKinnon, 1988), which consists of creating optimal monetary areas where the fixed rate of exchange rests on parity purchasing power among the main international currencies; (iii) the 'Tobin Tax', developed originally by Tobin (1978), the idea of which is to introduce a world tax on all – but especially short-term –

²² Internal balance, on the conventional theory, is understood as the situation where economic policy is framed by a non-accelerating inflation rate of unemployment, while external balance has to do with current transactions balance of payments stability compatible with the rate of expansion of economic activity.

exchange transactions, with a view to curbing the destabilizing action of financial speculation on currency exchange markets, and the resulting exchange crises it occasions; and (iv) 'International Money Clearing Union', a proposal presented by Davidson (2002), which will be explored further below²³.

Now, as seen in Section 2.2, at a time when counter-cyclic macroeconomic policies have come back into the picture and the G-20 and multilateral institutions, such as the IMF and the Bank for International Settlements are signaling the possibility of architecting a new international monetary system, Keynes' ideas on the operationalization of fiscal, monetary and currency exchange policies to stabilize world effective demand and his proposal for reform of the international monetary system should be reconsidered, because they are essential to surmounting the international financial crisis and, more importantly, to preventing other crises in the future.

What can then be done to prevent the instability of financial (or exchange rate) markets and thus address financial crises in the global economy? Keynes' revolutionary analysis provides us a starting point for designing a new international monetary system that may be able to reduce the current financial crisis and at the same time promote full employment and economic growth in the global economy. Accordingly, post Keynesian theory, basically in the work of Davidson (2002), builds on Keynes' ideas and proposals about an international monetary system²⁴ in order to offer a proposal for reforming the international monetary system.

In many of his writings, Keynes discussed and suggested schemes to reform the international monetary system, such as:

- In *A Tract on Monetary Reform* (1923/1971), he proposed abandoning the gold standard, due to the fact that "the gold standard is already a barbarous relic" (Keynes, 1971: 138). In Keynes' words (1971: 140), "since I feel no confidence that an old-fashioned gold standard will even give us the

²³ A summary of the main proposals and other contributions with regard to restructuring the international monetary system can be found in Eichengreen (1999, Chapter 6 and Chapter 7), Eatwell and Taylor (2000, Chapter 7), Davidson (2002, Chapter 14) and Isard (2005, Chapter 7 and Chapter 8).

²⁴ Markwell (2006, particularly Chapter 6) presents an interesting analysis of Keynes' thinking related to international relations.

modicum of stability that it used to give, I reject the policy of restoring the gold standard”²⁵.

- In *A Treatise on Money* (1930/1976: 399-400), Keynes proposed an arrangement set up in a

Supernational Bank (...) [in which] assets [of the central banks of the world] should consist of gold, securities and advances to central banks, and its liabilities of deposits by Central Banks (...) call Supernational Bank-money (SBM) (...) SBM should be purchasable for gold and encashable for gold at fixed prices (...) The Supernational Bank would establish a Bank-rate at which the adherent central banks could borrow (...) The Supernational Bank should also have a discretionary power to conduct open-market operations.

In other words, he outlined a proposal for operating a supranational central bank to maintain the stability of international price levels, to increase international asset liquidity and to expand effective demand.

- In *The Means to Prosperity* (1933/1972), he proposed an international monetary agreement ('gold-notes', under fixed, but alterable, exchange rates) to expand the elasticity of the international currency. According to Keynes (1972: 358), “[t]here should be set up an international authority for the issue of gold-notes [a maximum of \$ 5,000 million], of which the face value would be expressed in terms of the gold content of the U.S. dollar”.
- Finally, in his proposal for an International Clearing Union (1944/1980), Keynes developed a scheme based on an international currency, *bancor*.

However, it is Keynes’ revolutionary analysis in the International Clearing Union that deserves special attention.

Before examining the proposal Keynes set out in his International Clearing Union, it is important to emphasize that, as in Ferrari Filho (2006, Chapter 3),

²⁵ The reasons that led Keynes to propose a golden-exchange standard type of international monetary system were probably (a) the need to make international liquidity more flexible and enable monetary policy to work more actively in stabilizing price levels and galvanizing levels of income and employment, given that under the gold standard it was essentially passive and (b) his skepticism towards the gold standard’s automatic adjustment mechanism.

Keynes' proposals for restructuring the international monetary system have one common goal, which is, through an 'International Market Maker', to create an international reserve currency that cannot be hoarded by economic agents and whose prime function is to enable and encourage real and financial relations in the world economy. In other words, Keynes' proposals seem to converge to a project of 'institutionality' in which, as supposed by the universe of classical theory, currency is **neutral**.

The main idea of Keynes' International Clearing Union is "the substitution of an expansionist, in place of a contractionist, pressure on world trade" (Keynes, 1980: 176). Thus, Keynes (1980: 168-9, emphasis added) suggested a scheme set out in an international agreement as follows:

We need an instrument of international currency having general acceptability between nations (...) We need an orderly and agreed method of determining the relative exchange values of national currency units (...) We need a *quantum of international currency*, which is *neither determined in an unpredictable and irrelevant manner (...)* nor *subject to large variations depending on the gold reserve policies of individual countries*; but is governed by the actual current requirements of world commerce, and is also capable of deliberate expansion and contraction to offset deflationary and inflationary tendencies in effective world demand. We need a system possessed of an international stabilizing mechanism, by which pressure is exercised on any country whose *balance of payments* with the rest of the world is departing from *equilibrium in either position*, so as to prevent movements which must create for its neighbours an equal but opposite want of balance (...) We need a central institution (...) to aid and support other international institutions.

Keynes, moreover, with a view to reducing entrepreneurial uncertainties, proposed (1) an international agreement under a fixed, but alterable, exchange rate, and (2) control of capital movements. In his words:

The proposal is to establish a Currency Union, here designated an *International Clearing Union*, based on international bank money, called (let us say) *bancor*, fixed (but not unalterably) in terms of gold and accepted as the equivalent of gold (...) The central banks of all member states (and also non-members) would keep accounts with the International Clearing Union (1980: 170-1).

(...) control of capital movements, both inward and outward, should be a permanent feature of the post-war system (1980: 185).

The advocacy of a control of capital movements must not be taken to mean that the era of international investment should be brought to an end. On the contrary, the system contemplated should greatly facilitate the restoration of international credit for loan purposes (...) distinguishing (a) between movements of floating funds and genuine new investment for developing the world's resources; and between movements, which will help to maintain equilibrium, from surplus countries to deficiency countries, and speculative movements or flights out of deficiency countries or from one surplus country to another (1980: 186-7).

It is important to note that, as explained in Ferrari Filho (2006, Chapter 3), Keynes was aware that the organization of financial markets in monetary production economies poses the dilemma between liquidity and investment: such markets encourage the development of economic activity, but at the same time increase the likelihood of speculative gains. Accordingly, the central idea of Keynes' International Clearing Union was to guarantee the international liquidity necessary to expand world effective demand. To that end, the *bancor*, together

with a system of managed exchange rates and curbs on the destabilizing influence of capital flows, would reflect the conventions necessary to stabilize economic agents' expectations, which by reducing the degree of uncertainty as to the future behavior of the prices of assets and/or contracts, would be fundamental to enable them to make decisions to spend, whether on consumption or investment, as a result expanding economic activity and the level of employment.

In this direction, Davidson (2002: 231) presents “the theoretical foundations for comprehending the need for (a) reforming the world’s money in the twenty-first century and (b) update[s] Keynes’ original proposal for a postwar international monetary scheme”.

Like Keynes, Davidson argues that the international monetary system must be rooted in the following basic elements: a new international currency to assure the elasticity (quantity of international liquidity) to expand global effective demand, a stable exchange rate system to protect domestic currencies and the international currency from speculative activity, and an agreement clause to eliminate the balance-of-payments disequilibrium in either position.

After defining a specific taxonomy to explain the economic dynamism of an open unionized monetary system (UMS) and an open nonunionized monetary system (NUMS)²⁶, Davidson attempts to present eight provisions required to operate an international monetary agreement according to a UMS. The provisions are the following (2002: 232-236):

- The International Money Clearing Union (IMCU) would be the unit of account and reserve asset for international liquidity;
- Each nation’s central bank would have to guarantee one-way convertibility from IMCU deposits at the clearing union to its domestic money.
- Contracts between economic agents in the various different nations would be denominated in their domestic currency;

²⁶ According to Davidson (2002, Chapter 8), in an open unionized monetary system (UMS) the contracts are expressed in the same monetary system – i.e., the exchange rate is fixed – while in an open nonunionized monetary system (NUMS) the contracts are expressed in different currencies and, as a consequence, the exchange rate is flexible.

- The exchange rate between the domestic currency and the IMCU would be set by each nation's central bank;
- An overdraft system would be built into the clearing union rules, so as to finance the productive international transactions of countries who need short-term credit;
- A 'trigger mechanism' to put more pressure for balance-of-payments adjustments on the creditor countries than on the debtor countries;
- The exchange rate between domestic currencies and IMCU would be fixed to stabilize the long-term purchasing power of the IMCU;
- A creditor nation would be encouraged to spend its surplus credits in three ways: buying products from any other country in the international payment system, investing capital in deficit countries and providing foreign aid to deficit countries.

Provisions 1, 2 and 4 are preconditions to reduce and/or avoid people holding the international asset, IMCU, as a store of value. As a consequence, the IMCU would be used only for international financial and commercial transactions. Provision 3 and 7 are necessary conditions to stabilize the long-term purchasing power of IMCU. At the same time, they restrict private speculation regarding the IMCU; that is to say, there is no possibility of the IMCU losing its purchasing power. Finally, provisions 5, 6 and 8 are the main instruments to guarantee that "export-import imbalance is eliminated without unleashing significant recessionary forces" (Davidson, 2002: 236).

To sum up, Davison presents the rules required to operate an international monetary agreement according to a UMS to (i) avoid a lack of global effective demand, (ii) "induc[e] the surplus nation(s) to bear a major responsibility for eliminating the imbalance (Davidson, 2002: 237), (iii) provide nations with the ability to control movements of capital and (iv) expand the quantity of international liquidity.

The post Keynesian proposal can thus be seen to create the conditions necessary to alter the present logic of financial globalization – that is, for displacing the dynamics of international speculative capital in favor of the process of

international production – and, as a consequence, it can reduce the uncertainties facing entrepreneurs, which is necessary to expand global effective demand. As Keynes points out, an international monetary system built in such a way “could use its influence and its power to maintain stability of prices and to control the trade cycle” (Keynes, 1980: 190-1).

5. Conclusion

The globalization process has limited action by macroeconomic policies and nation-States to stimulate effective demand and consequently increase the level of employment. In addition, international speculative capital flows have created serious exchange rate and monetary and financial problems, such as the European exchange rate crisis in 1992-93, the Dow Jones Industrial “crash” in 1987, the Mexican peso crisis in 1994-95, the Asian exchange rate crisis in 1997, the Russian exchange rate crisis in 1998, the Brazilian real crisis in 1999, the Nasdaq crisis in 2000, the Argentinean peso crisis in 2001 and, recently, the subprime crisis, in 2008, leading to high rates of unemployment, recession, exchange rate imbalances, persistent balance-of-payments disequilibrium, and so on.

The present international financial crisis has come to have dramatic adverse effects on economic activity, on a larger scale in the developed countries, but also in the emerging economies. It has demonstrated that, on the one hand, the international institutions, such as the IMF, and *ex post* fiscal policies are insufficient to solve the financial problems and consequently avert crises of effective demand – *ex post* fiscal policies merely mitigate impacts of the crisis of effective demand. On the other hand, it has generated consensus as to the need to restructure the international monetary system, as a necessary condition for the world economy to see a return to periods of stability and rising levels of output and employment. In this regard, it raises the possibility of replacing the United States dollar as the 'universal currency' on the world stage, as proposed by the governor of the People's Bank of China at the G-20 meeting in April 2009.

One of the key principles of liberal capitalism – non-intervention by the State – was set aside in order to prevent the international financial crisis from developing

into a situation similar to the Great Depression of 1929. Now, given that the State has gone on to gesture towards a “socialization of investment” (through counter-cyclic fiscal and monetary policies and, going even further, its explicit intervention in the 'real economy' by taking control of both financial institutions and companies in order to pave the way for economic recovery), what can be expected from here on?

In this context, the question arises: is it possible that changes are under way in international financial markets?

If we accept that the liberalized, integrated market arrangements of the *global era* may be dangerous to economic stability and that they hinder sustained attainment of a full-employment economy, some sort of global institutional arrangement is necessary to exert control over capital flows in order to prevent the disruptive real effects of speculative whirlpools. Davidson (1997, p.672) writes: “what is necessary is to build permanent fireproofing rules and structures that prevent ‘beauty contest’ induced currency fires. *Crisis prevention rather than crises rescues must be the primary long-term objective*”.

Despite the fact that the international monetary problems we now face are more difficult than those faced in Keynes’ period, his revolutionary analysis regarding reform of the international monetary system can once again be deployed to help us understand the necessity of creating an international standard currency in order to promote full-employment economic growth, as well as to maintain long-run price stability.

In this direction, Davidson (2002) argues that, with a view to overcoming the problem of financial market volatility, market-maker institutions with sufficient resources to assure market price stability are necessary to prevent the volatility associated with bandwagon phenomena. For this purpose, it is socially desirable policy to build a buffer stock exchange rate market institution to fix price movements. In other words, to avert future balance-of-payments current account crises and financial crises, it is necessary to create the essential conditions for implementing a new global currency reserve system.

To conclude, efforts should concentrate on pursuing creative policy options to reduce the real disruptive outcomes deriving from speculative activity in financial markets. This is one of the key legacies of Keynes' ideas.

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