



**3 Jonathan Street
London SE11 5NH
United Kingdom
00 44 207 820 6300**

Jubilee Research at **nef (new economics foundation)**

Report to the Helsinki Process: Track II – Global Economic Agenda

Introduction

“The pattern of overall capital flows to developing countries did not change much in 2002 over 2001. *Developing countries in aggregate, were net lenders to developed countries (our italics).*”

World Bank, Global Development Finance: Striving for Stability in Development Finance, 2003, page 13.

“Most countries invest their foreign-exchange reserves in relatively safe, short-term assets, such as US Treasury bills. The yields on such instruments are currently very low – well below the interest rates that developing countries pay on their debt”

World Bank, Global Development Finance, 2003, page 12.

Reports by Jubilee Research at **nef** (new economics foundation), like those from its predecessor, Jubilee 2000 UK, have concentrated on the debts of the poorest countries; on the economic adjustments imposed on them by creditors; and on their loss of policy autonomy. In this report we turn our attention to the debts of the United States and Britain, governments, which until recently, were major creditors, but are now major debtors. By doing so, we hope to provide a more balanced picture of

global sovereign indebtedness – and to frame developing country debt in the context of global savings.

It is only in this context, we believe that the Helsinki Process can come forward with proposals for dealing with globalisation and democracy. If democracy is going to be strengthened in a world rendered extremely unbalanced, volatile and dangers by financial globalisation , then it will be vital to reform the international financial system. The purpose will be to end the international economic injustices outlined below, to distribute global savings more equally and more productively; and to provide financing for the Millennium Development Goals.

Above all it will be vital to reform the international financial system to allow governments to wrest key powers from invisible, unaccountable financial markets, and to regain autonomy over policy making.

We have prepared this report to illuminate five important developments:

- that the growing indebtedness of rich countries has been the driving force behind the phenomenon of financial globalisation;
- that a relative few in the rich countries are using up a much bigger share of the world's savings than billions in the poorest countries;
- that a system in which the richest countries have their excessive consumption financed by the poorest countries (through e.g the forced holdings (as reserves) of US Treasury bills - concessional loans to the US) is unjust and iniquitous;
- that the imbalances and injustices caused by this excessive consumption of the world's savings, are leading to increased tensions in the world, and to more frequent financial crises;
- that while the US relies increasingly on foreign creditors – the US government (thanks to its military power) continues to exercise policy autonomy. This is in stark contrast to poor sovereign debtors, who sacrifice such autonomy to anonymous “capital markets” on the one hand, and the IMF (acting as agent of all creditors) on the other.

The injustice of transfers from the poor to the rich through unfair terms of trade and through excessive consumption of natural resources by the rich has been widely explored in development literature. However, we do not believe that sufficient attention has been paid to financial transfers, which enable rich countries to extract resources from poor countries, and middle income countries which have many poor people (like China, India and Brazil). These transfers enable richer countries to live off poor countries, while avoiding unpleasant economic adjustment, and retaining policy autonomy.

Globalisation: the US deficit as the real driving force

Many argue that the phenomenon known as “globalisation” came about largely because of advances in new technology and communications. Walter Wriston, for example, has argued that:

“Today we are witnessing a galloping new system of international finance. Our new international financial regime differs radically from its precursors in that it was not built by politicians, economists, central bankers or finance ministers, nor did high-level international conferences produce a master plan. It was built by technology....by men and women who interconnected the planet with telecommunications and computers”.¹

Others, particularly anti-globalisation activists, agree with Wriston and hold strongly to the view that globalisation, (often broadened into “corporate globalisation”) was, or is, promoted by big, aggressive corporations, keen to expand their markets and brutal in promoting self-interest.²

We contest this view of the driving force behind financial globalisation – central to the whole globalisation project. On the contrary, we argue, democratic governments and their elected leaders have been the real driving force behind financial liberalisation. These leaders were motivated to embark on the “globalisation” project, as Eric Helleiner has cogently argued³, because of the steady expansion of the US trade deficit in the 1960’s and 70’s. This led to deliberate decisions by the US and UK governments to remove statutory controls over the movements of capital.

The US trade deficit had to be financed, and the US was determined to finance it without making any unpleasant adjustments, or without giving up its policy autonomy to foreign creditors. The City of London, backed by the UK government, was only too happy to broker financing for the US deficit - through the “stateless” Eurodollar market based in London - a market carefully created by elected representatives of two of the world’s most powerful states.

As Helleiner has argued

“ever since the first dollar crisis in late 1960, the (US) government had attempted to postpone adjustment measures by persuading foreign central banks to finance its external deficit through dollar holdings Taking an approach that would prevail throughout the 1970s and 1980s, Washington policymakers fostered a more liberal international financial system as a way of preserving their policy autonomy in the face of growing external constraints.”⁴

¹ Walter Wriston 1988, “Technology and Sovereignty” *Foreign Affairs* 67:63-75. Quoted in “States and the Reemergence of Global Finance” by Eric Helleiner, Ithaca, 1994.

² See, as examples of this thinking, David Korten, “When Corporations Rule the World” (1995) and Noemi Klein’s best-seller, “No Logo” (2001) in which she argues that; “At the heart of this convergence of anticorporate activism and research is the recognition that corporations are much more than the purveyors of the products we all want; they are also the most powerful political forces of our time..... We have read how a handful of powerful CEOs are writing the new rules for the global economy, engineering what Canadian writer, John Ralston Saul has called “a coup d’etat in slow motion”..... because corporations have become the ruling political bodies (our emphasis) of our era, setting the agenda of globalization. We must confront them, in other words, because that is where the power is”. Page 339-40.

³ Eric Helleiner, “The Reemergence of Global Finance”, 1994, pages 90-91.

⁴ *ibid*

The emergence of the Eurodollar market began the process of dismantling capital controls in the 1960s. But as Helleiner notes, the other

“advanced industrial states remained wary of international capital movements for the reason discussed at Bretton Woods: disequilibrating speculative capital movements could restrict their policy autonomy and disrupt both the Bretton Woods system of stable exchange rates and liberal trading relations.”

The removal of these capital controls, which gained terrific momentum as the US deficit ballooned, (see the graph below) was pushed by the US and the UK; and has been central to the process of “globalisation”. Today, the US deficit can only be sustained by mobilising a staggering \$4bn of foreign savings each day of the year.

It was not always thus.....

Back in 1944, as part of the Bretton Woods Agreement, the US had helped construct the post-war economic order with other western governments. The new order, which the IMF and the UN were tasked to defend, set out to

- prevent and limit the imbalances and disorder brought about by the capital liberalisation of the 1920s and 30s;
- restore policy autonomy to nation states (primarily by imposing controls on the movement of capital); while
- liberalising trade, which included challenging the UK’s protectionist policies for “imperial preferences”.

Twenty years after the Bretton Woods Agreement, the Eurodollar market represented the first attempt at bypassing the exchange controls of nation states, and enabled the US to mobilise additional finance from a foreign capital market. The existence of the Eurodollar market gradually led to the erosion of capital controls by all major western governments and finally, most developing country governments. This in turn laid the ground for a massive expansion in the role of finance capital in the global economy; and, as a consequence, for greater trade liberalisation.

Globalisation and its consequences.....

According to the US Congress, before 1970, 90 per cent of all international transactions were accounted for by trade, and only 10 per cent by capital flows. Today, despite a vast increase in global trade, that ratio has been reversed, with 90per cent of transactions accounted for by financial flows not directly related to trade in goods and services.⁵

⁵ In James. A. Kelly, East Asia’s Rolling Crises: Worries for the Year of the Tiger. Center for Strategic and International Studies (CSIS) Pacific Forum, Pacnet 1, Jan 2, 1998, quoted in “Asian Financial Crisis: An Analysis of US Foreign Policy Interests and Options”.

Most of these flows have taken the form of loans, highly volatile stocks and bonds; derivatives and other forms of financial betting, gambling and speculation; and short-term investment. McKinsey and Company reckon that the total financial stock reached US\$53 trillion by the year 2000 – “triple the economic output of the OECD economies”.⁶ In other words, the often unproductive lending, gambling and speculating of global creditors and financiers generates a financial stock which is probably worth more than three times the productive output of the OECD countries.

While many may castigate companies like McDonalds and Nike for their role in the global economy, at least they can claim to be producing actual goods, even though these may be inedible hamburgers and unaffordable trainers, produced in unsustainable ways. Their counterparts in banks and financial institutions are making money in the most unproductive way; by lending, gambling and speculating. In other words, thanks to financial liberalisation, it is easier now for these institutions to disengage from the productive economy, and make money from money.

These volatile and often unproductive flows, have led in turn, to imbalances and instability in the global financial system, and to periodic crises, which have impacted most adversely on developing countries or emerging markets. As governments lose policy autonomy, these imbalances are leading, in turn, to global tensions not unlike those experienced by countries in previous periods of “globalisation” – like the 1920s.

The poorest countries owe a total of US\$1,983 billion to the rest of the world.

The accumulated external debt of the world’s richest country, the US, is equal to at least US\$2.2 trillion. This is almost the exact amount owed by the whole of the developing world, including India, China and Brazil – US\$2.5 trillion.

- In other words, three hundred million people in the US owe as much to the rest of the world, as do five billion people in all of the developing countries.
- Or to put it differently, every American citizen owes the rest of the world US\$7,333 while every citizen of all the developing countries only owes the rest of the world US\$500.
- Moreover, while developing country economies are bled dry through debt service repayments totalling more than US\$300 billion per year, the US must only pay US\$20 billion per year to service an almost equivalent amount of debt.
- Americans have been engaged in a consumer binge, which has led to the largest current account deficit in history, a staggering US\$445 billion or 4 per cent of US GDP. This deficit has been increasing by 50 per cent a year in recent years, and economists predict it will rise to US\$730 billion by 2006.
- Given this daily deficit of up to £2 billion, plus capital outflow of US\$2 billion, the US in effect has to borrow US\$4 billion from the pool of world savings every day.

⁶ From William Greider, *One World, ready or not*, Simon and Shuster, 1997 page 232

How the US deficit is being financed by the poor of the world

The US deficit is financed by

- the thrifty savers of East Asia, in particular Japan, China and Singapore;

but also by

- surpluses built up by countries like France and Switzerland.

More disturbingly, the US deficit is financed by the poor through

- capital flight from poor countries and
- through the forced holdings of US dollar reserves.

Borrowing high and lending low

To build up reserves, poor countries are borrowing hard currency from the US at interest rates as high as 18 per cent; and lending this back to the US (in the form of interest on US Treasury Bonds) at 3 per cent. (“Most countries invest their foreign-exchange reserves in relatively safe, short-term assets, such as US Treasury bills. The yields on such instruments are currently very low – well below the interest rates that developing countries pay on their debt” World Bank Global Development Finance, 2003, page 12).

The costs of financial instability and volatility

Asian and African countries are forced, by the financial instability caused by globalisation, to maintain dollar reserves, at 14 per cent and 7 per cent of GDP respectively. The US in contrast holds only about 1.3 per cent of her GDP in reserves.

- The cumulative cost for developing countries of holding such high dollar reserves may be as much as 24 per cent of GDP over ten years; which represent a significant drag on growth rates.

Inflows of capital into the US and UK:

- help to lower interest rates and therefore borrowing costs for the people of these countries and
- inflate the value of their currencies by about 20 per cent. This enables rich countries, therefore, to purchase imports from the rest of the world 20 per cent cheaper than they would otherwise have been able to.

If it were not for capital flight at least 25 African countries would be net creditors, not debtors.

Countries like Argentina find that their governments are borrowing hard currency, only to find it promptly leaves the country (in the form of “capital flight”) for Wall St., London, Zurich or Madrid – a legitimate process under capital liberalisation.

However the poor in these countries are then saddled with huge public debts. Argentina’s total external debt of US\$150 billion is almost exactly equal to unrecorded “capital flight” of US\$130 billion.

Conclusion and Recommendations

To mobilise the resources needed to meet the Millennium Development Goals, we propose a series of measures. The most important of these are longer-term changes to the international financial system – to end the inherent injustice of financial flows from poor to rich.

We propose the following changes to the international financial system, to stabilise financial flows, reduce volatility and end the injustice of the poor financing the rich. In our view, these changes are necessary and additional to the mobilisation of the resources needed to achieve the Millennium Development Goals (MDG).

Governments should take action, as they did in 1944 to claw back from financial markets their right to policy autonomy. This must be done if democratic institutions are not to be hollowed out, and democratic representation made a sham. As things stand, most governments have given up vital power to manage investment, economic growth and employment. These are the powers to fix the exchange rates of their currencies, and to set interest rates for their economies. As these are both vital tools for the management of economies they should be in the hands of democratically elected governments, and not in the hands of the finance sector.

A starting point for such a transformation will be to reverse the most pernicious elements of the “globalisation” experiment. This will mean taming financial markets through

- the re-introduction of capital controls;
- restraints on the growth of credit, through increased regulation by Central Banks and governments;

Second, it will be vital to end the world’s dependency on the US dollar as a reserve currency. The US is able to run up enormous debts, and to pay these by printing the currency in which they are repaid. This is not a privilege enjoyed by other countries. When the debts become too large, the US can encourage the depreciation of the dollar, which in turn reduces the value of the debt, and of the dollar reserves all countries are effectively obliged to hold.

To ensure a more just international financial system, we recommend the establishment of an **International Clearing Agency** (see Jane D’Arista’s essay in attached Appendix Three) which will enable all countries to repay their debts in their own currencies, and for these to be “cleared” by an international agency.

Third, it will be vital in rich and poor countries to

- “Upsize the state” - empowering governments to respond to democratic mandates, by returning to governments and parliaments the power to allocate resources for pensions, health, clean water, public transport, the arts, public service broadcasting, energy and other resources for the vulnerable and the poor.
- “Downsize” the single global market, by introducing an international trading system based on the concept of “appropriate scale” (see the work of Andrew Simms at **nef** on “localisation”).

With reference to the MDGs it is our view that:

- Gordon Brown’s proposal for an increase in OECD aid by US\$50 billion per year will prove ineffectual in achieving the Millennium Development Goals in the HIPC countries unless there is also 100 per cent debt cancellation in these countries.
- We also have reservations about the proposal for an International Finance Facility (see below).
- In our report (enclosed) “The Unbreakable Link: Debt Relief and the Millennium Development Goals” we show that at least 39 of the 42 HIPC countries will not only need 100 per cent debt cancellation, but also an increase in aid from the current US\$15 billion to a total of US\$46 billion if the MDG of halving the proportion of people living in extreme poverty is to be met.
- Even if the first Goal (eradicating extreme poverty and hunger) is not achieved, meeting the other MDGs – which include achieving universal primary education, reducing child mortality; promoting gender equality and combating HIV/AIDS – would require additional expenditures. Using costings prepared by major international bodies such as the World Health Organisation and World Bank, we show that these expenditures alone will require total debt cancellation, plus additional aid of US\$16.5 billion.
- Even when all countries have fully passed through the HIPC process, total savings will only amount to about US\$1.7 billion per year. Even when relief is provided, research by Jubilee Research has shown that debt burdens remain unsustainable.
- In response to these concerns, some bilateral creditors, including the UK, have agreed to provide 100 per cent debt relief to all HIPCs when they reach decision point.
- But the biggest constraint to the broadening out of the HIPC initiative remains the World Bank and the IMF, who effectively act as judge, jury and plaintiff in their own case. These institutions are major creditors to the HIPCs, but also set the levels of debt sustainability ratios; (measured by debt to export or debt to revenue ratios), assess whether or not HIPC countries need debt relief, and how much they need.

- The international Jubilee movement is therefore calling for a new framework for the resolution of sovereign debt crises, based on Chapter 9 of the US Legal Code. The '**Jubilee Framework**' would operate under the key legal principles underlying all insolvency procedures. Namely that:
 - all processes should be based on the application of justice and reason;
 - that any process should protect the human rights and the human dignity of the debtor, as well as the rights of creditors; and
 - that neither creditors nor the debtor can decide on their own claims or payments.

- Under the **Jubilee Framework**, countries could declare themselves insolvent if it is clear that repayments of foreign debts are being made at a cost to the human rights or dignity of the people of that country. Debtor countries would then be able to negotiate with their creditors in front of an independent arbitration panel consisting of nominees from both debtors and creditors.

- There has been substantial support for some form of international insolvency process from the IMF and other key players such as the Bank of England. In 2001 the IMF proposed a **Sovereign Debt Re-structuring Mechanism (SDRM)**, which unfortunately placed the IMF at the centre of negotiations, a position we deemed unacceptable, because as a creditor the IMF could not be independent. In addition the IMF applied the SDRM only to middle income countries such as Argentina.

Note on the Proposed International Finance Facility

The UK Chancellor Gordon Brown has proposed a new scheme to double aid flows from US\$50 billion to US\$100 billion in order to meet the internationally agreed MDGs. The proposed “International Financing Facility” (IFF) would enable donor countries to borrow from the international capital markets in order to provide large increases in aid flows between now and 2015. The money borrowed in this way would be paid back up to around 2032 by the donor country out of its long term aid budget.

According to the UK Treasury the IFF “could also be used to help fund further debt relief for existing debts, which for some poor and indebted countries is a valuable instrument to help achieve the millennium development goals.”

Jubilee Research strongly welcomes some aspects of the proposal, including:

- The recognition that further debt relief is needed to meet the MDGs. This point, which has been frequently made by HIPC Finance Ministers, African Governments, the UN, and NGOs, has until now been given relatively short shrift by the UK Government.
- The recognition that meeting the internationally agreed MDGs will require substantial increases in resources, and that rich countries have an obligation to provide such resources;
- The commitment to long term, stable and predictable aid flows, and improved donor co-ordination, making it easier for poor countries to implement long term strategies and ensuring that they will be able to meet the recurrent costs of investments in poverty reduction;
- The acceptance that the bulk of the funding should go to countries in form of grants rather than loans, in order to prevent the build up of unsustainable debt burdens.

However, Jubilee Research has some concerns about the IFF as it currently stands

These include:

- The outlook for aid flows after 2015. According to the proposal, an increasing share of the aid budget after 2015 will be used to repay the IFF rather than going to poor countries. However, even if the MDGs are met, Jubilee Research believes that substantial volumes of aid will still be necessary. This is particularly true given that the AIDS pandemic in Africa looks set to continue to wreak havoc for many years to come. Furthermore, as climate change continues the effects of climatic disasters on many poor countries are likely to increase substantially.
- The IFF will also put in place conditions on liberalisation on trade and investment. Under the IFF each developing country would need to commit to the Doha development agenda, which involves 'a sequenced opening up of markets to global trade.' This is despite the very limited evidence that trade liberalisation benefits growth and poverty reduction in poor countries and the substantial evidence that it can be harmful.
- More broadly, the IFF seems set to reinforce the current system of aid delivery whereby countries must be on track with their IMF programmes in order to receive aid from other donors. This effectively gives the IMF, with its neo-liberal view of the world, monopoly power to impose its deflationary macroeconomic policies on developing countries. The IFF states explicitly that no country which is in arrears to the IMF will be able to receive funds from the IFF.
- The IFF, in appearing to provide 'the answer' to the problems of meeting the MDGs by 2015, may detract attention away from the need for fundamental changes in the global

economy, including in the control over and disciplining of international capital flows and the reversal of inequalities within the global trading system.⁷

⁷ For more information on in the International Financing Facility, see http://www.hm-treasury.gov.uk/documents/international_issues/int_gnd_intfinance.cfm

APPENDIX ONE

Debt Relief under the HIPC initiative: progress to date (March, 2004): a note from Jubilee Research at nef (15th March, 2004).

According to the original HIPC schedule, by this point 27 countries should have *fully* passed through the HIPC initiative and received total debt cancellation of approximately US\$34.7 billion in net present value terms.

In fact only 10 countries have jumped all the hurdles and hoops, and been granted US\$13.3 billion of *stock of debt* relief. (Benin, Bolivia, Burkina Faso, Guyana, Mali, Mauritania, Mozambique, Tanzania, Uganda and Nicaragua).

In addition a further 18 countries have reached “decision point” of the HIPC process and received US\$30.9 billion of *debt service* relief. These 18 countries must complete a further stage in order to have a proportion of the remaining US\$18 billion *stock of debt* cancelled. (Cameroon, Chad, Congo DR, Ethiopia, The Gambia, Ghana, Guinea, Guinea-Bissau, Honduras, Madagascar, Malawi, Nicaragua, Niger, Rwanda, Sao Tome, Senegal, Sierra Leone, Zambia).

In total, *US\$43.3 billion of debt relief has been granted to 28 countries*. This represents the achievement, so far, of the Jubilee 2000 campaign, which sought “the cancellation of the unpayable debts of 52 countries”.

A further 7 countries have been identified as eligible for debt service relief, on an outstanding US\$16 billion of debt. (Burundi, Central African Republic, Cote D’Ivoire, Comoros, Congo Rep. Myanmar and Togo).

8 Countries have had *no* promise of debt relief, even though they carry (in the view of Jubilee Research) unsustainable burdens of debt of US\$84 billion, with some emerging from conflict. They are: Angola, Kenya, Lao PDR, Liberia, Somalia, Sudan, Vietnam and Yemen).

APPENDIX TWO

The following essays are taken from the *Real* World Economic Outlook, edited by Ann Pettifor and published by the new economics foundation (**nef**) in 2003 by Palgrave Macmillan).

Financial architecture in the 20th century

by Ann Pettifor

The virtue of the free flow of international capital is normally presented as a self-evident truth. In reality, this ‘liberalization’ effected under Margaret Thatcher and Ronald Reagan is only one of a series of resolutions of a complex and still unsolved debate over the structure of international finance.

At the turn of the 20th century, the gold standard was the self-evident truth of the day. Capital markets were dominant, and free to invest where they saw fit. To protect the value of financial assets invested in the ‘emerging markets’ of that time (countries like South Africa, India, Argentina, and Brazil) governments of these countries were obliged to maintain the value of their currencies relative to gold. In other words, the economy (in particular the currency and domestic interest rates) was oriented towards the interests of foreign creditors, via ‘exchange rate stability’. Capital markets expected central banks to be independent of government, and so it was central bankers who maintained exchange rate stability via the all too familiar means of manipulating short-term interest rates. As a global system, the gold standard lasted about 30 years.

The breaking of the gold standard

However, the gold standard system buckled when war imposed extreme financial pressures on governments. In 1917 the British were forced to suspend their commitment to exchange sterling for gold. However, even before World War I drew to a close, committees of bankers and their allies from academia and the Civil Service were drawing up plans for an immediate return to gold, but this time important and informed voices were raised in protest. In Europe, the first was that of Reginald McKenna, the Liberal Chancellor of the Exchequer throughout the first coalition British Government from May 1915 to December 1916 and subsequently Chairman of Midland Bank. The second was economist John Maynard Keynes, already famous through his bitter opposition to the Treaty of Versailles in the *Economic Consequences of the Peace*. Both argued that developments in national banking systems meant that the gold standard was no longer relevant – Keynes called it a ‘barbarous relic’. Both argued that central banks should instead ‘manage’ domestic exchange rates through buying and selling currency between a fixed and pre-announced range of exchange parities, rather than supporting a single fixed rate through interest rate manipulations. Such arrangements required controls over capital.

While the Chancellor of the Exchequer Winston Churchill gave sympathetic hearing to their views, the overwhelming force of the financial establishment's pressure for maintenance of the gold standard could not be resisted. On 20 March 1925, Churchill announced his intention to take sterling back onto gold. Four and a half years later, the Wall Street Crash marked the start of the great depression.

Financial establishment versus the people

For everybody that lived through it, the great depression was irrefutable proof that the preferred policy and interests of the financial establishment were very much opposed to the interests of society at large. As the British Labour Party's 1944 policy document Full Employment and Financial Policy emphasizes: 'Blame for unemployment lies much more with finance than with industry. Mass unemployment is never the fault of the workers; often it is not the fault of the employers. All widespread trade depressions in modern times have financial causes, successive inflation and deflation, obstinate adherence to the gold standard, reckless speculation, and over-investment in particular industries.'

On 21 September 1931, Britain again suspended its membership. The following Sunday, Keynes wrote: 'There are few Englishmen who do not rejoice at the breaking of our golden fetters.' He was immediately co-opted into an advisory role to the Prime Minister, and shortly afterwards the new National Government took the advice Keynes and McKenna had been giving all along. The Budget of April 1932 announced the institution of the 'Exchange Equalization Account' to manage the sterling exchange. This arrangement included capital control, administered through approval of applications for foreign currency.

While the UK economy was gradually restored to life, on the international stage most other countries attempted to cling to gold whatever the cost in unemployment, committing deeds that Keynes later described as 'crucifying their countries in a struggle which is certain to prove futile'. However, on 20 April 1933, the newly elected Franklin Delano Roosevelt took the United States off gold. Keynes soon offered advice on the stabilization of dollar exchange policy, advice that Roosevelt accepted. At this point, the world was split between a 'gold block' and a 'managed block' led by the British Empire and the United States. The tensions reached their peak on 3 July 1933 at the World Economic Conference, called to bring order to international finance. Roosevelt firmly and famously rejected a proposal for the worldwide re-establishment of the gold standard, which he said, reflected the 'old fetishes of so-called international bankers'. The following day, Keynes responded in the Daily Mail, under the banner 'President Roosevelt is magnificently right'.

The final collapse of the gold block began on 26 September 1936, when the newly elected Leon Blum took France off gold. Non-gold countries all adopted exchange equalization type arrangements including capital control, and were brought close together through the US, British, and French governments' 'Tripartite Agreement' to aid each other with the management of their exchanges. Over the next months, Switzerland, The Netherlands, Greece, Latvia, and Turkey extended the membership of the new system.

A proposed international clearing union

World War II interrupted the evolution of this architecture, but provided policymakers with an opportunity to approach the global financial architecture problem as a whole. Nobody saw this more clearly than Roosevelt, who, in turn, encouraged Keynes to develop a ‘free, fertile economic policy for the post-war world excluding nothing in advance’.ⁱ The result was his plan for an international ‘Clearing Union’, published as a British Government Command Paper on 7 April 1943.

But the world was not ready to go so far. The Bretton Woods agreement was essentially a compromise policy between the British and the Americans. Nevertheless, while a compromise, the Bretton Woods agreement preserved the one feature that Keynes thought essential to prosperity: ‘In my view the whole management of the domestic economy depends upon being free to have the appropriate rate of interest without reference to the rates prevailing elsewhere in the world. Capital control is a corollary to this.’

Bretton Woods was unable to tolerate the exchange rate pressures created as a consequence of the Vietnam War. With ‘globalization’, the capital controls Keynes saw as so essential to preserving monetary policy autonomy were abandoned. The cost to prosperity is evident in most of the developing world; it is now increasingly so in the developed world itself.

APPENDIX THREE

The dollar bill: who picks up the tab

by Michael Hudson

By the early 1960s, it became clear that the United States was approaching the point at which its debts to foreign central banks would soon exceed the value of the Treasury's gold stock. This point was reached and passed in 1964, by which time the US payments deficit seemed to derive entirely from foreign military spending, mainly for the Vietnam War.

It would have required a change in national consciousness to reverse the military programs that had come to involve the United States in massive commitments abroad. The United States seemed to be succumbing to a European-style imperial syndrome, and was in danger of losing its dominant world position in much the way that Britain and other imperial powers had done, weighed down by the cost of maintaining its worldwide empire. And just as World Wars I and II had bankrupted Europe, so the Vietnam War threatened to bankrupt the United States.

If the United States had followed the creditor-oriented rules to which European governments had adhered after the two World Wars, it would have sacrificed its world position. Its gold would have flowed out and Americans would have been obliged to sell off their international investments to pay for military activities abroad. This was what the US officials had demanded of their allies in World Wars I and II, but the United States was unwilling to abide by such rules itself. Unlike earlier nations in a similar position, it continued to spend abroad, as well as at home, without regard for the balance-of-payments consequences. One result was a run on gold, whose attraction rose as America's military fortunes in Vietnam sagged. Foreign central banks, especially those of France and Germany, cashed in their surplus dollars for US gold reserves almost on a monthly basis.

Official reserves were sold to meet private demand and so hold down the price of gold. For a number of years, the United States had joined other governments to finance the London Gold Pool. But by March 1968, after a six-month run, America's gold stock fell to the \$10 billion floor beyond which the Treasury had let it be known that it would suspend further gold sales. The London Gold Pool was disbanded and informal agreement (diplomatic arm-twisting) was reached among the world's central banks to stop converting their dollar inflows into gold.

The creation of the dollar debt cycle

This broke the link between the dollar and the market price of gold. Two prices for gold emerged, a rising open-market price and the lower 'official' price of \$35 an ounce at which the world's central banks continued to value their monetary reserves.

Three years later, in August 1971, President Nixon made the gold embargo official. The key-currency standard, based on the dollar's convertibility into gold, was dead. The US Treasury bill standard – that is, the dollar-debt standard based on dollar inconvertibility – was inaugurated. Instead of being able to use their dollars to buy

American gold, foreign governments found themselves able to purchase only US Treasury obligations (and, to a much lesser extent, US corporate stocks and bonds).

As foreign central banks received dollars from their exporters and from commercial banks that preferred domestic currency, they had little choice but to lend these dollars to the US Government. Running a dollar surplus in their balance of payments became synonymous with lending this surplus to the US Treasury. The world's richest nation was enabled to borrow automatically from foreign central banks simply by running a payments deficit. The larger the US payments deficit grew, the more dollars ended up in foreign central banks, which then lent them to the US Government by investing them in Treasury obligations of varying degrees of liquidity and marketability.

The US federal budget moved deeper into deficit in response to the guns-and-butter economy, inflating a domestic spending stream that spilled over into spending on more imports and foreign investment and yet more foreign military spending to maintain the hegemonic system. But instead of US citizens and companies being taxed or US capital markets being obliged to finance the rising federal deficit, foreign economies were obliged to buy the new Treasury bonds being issued. America's Cold War spending thus became a tax on foreigners. It was their central banks who financed the costs of the war in Southeast Asia.

There was no real check to how far this circular flow could go. For understandable reasons, foreign central banks did not wish to go into the US stock market and buy Chrysler, Penn Central, or other corporate securities because this would have involved the kind of risk that central bankers are not supposed to take. Real estate was no more attractive. What central banks need are liquidity and security for their official reserves. This is why they had traditionally held gold as a means of settling their own deficits. To the extent that they began to accumulate surplus dollars, there was little alternative but to hold them in the form of US Treasury bills and notes without limit.

Economic rules turned on their head

This shift from asset money (gold) to debt money (US Government bonds) inverted the traditional relationships between the balance of payments and domestic monetary adjustment. Thanks to the \$50 billion cumulative US payments deficit between April 1968 and March 1973, foreign central banks found themselves obliged to buy all of the \$50 billion increase in US federal debt during this period. In effect, the United States was financing its domestic budget deficit by running an international payments deficit. As the St. Louis Federal Reserve Bank described the situation, foreign central banks were obliged 'to acquire increasing amounts of dollars as they attempted to maintain relatively fixed parities in exchange rates'.ⁱⁱ Failure to absorb these dollars would have led to the dollar's value to fall vis-à-vis foreign currencies, as the supply of dollars greatly exceeded the demand. A depreciating dollar would have provided US exporters with a competitive devaluation, and at the same time would have reduced the domestic currency value of foreign dollar holdings.

Foreign governments did not want to place their own exporters at a competitive disadvantage so they kept on buying dollars to support the exchange rate – and hence, the export prices – of Dollar Area economies. 'The greatly increased demand for short-term US Government securities by these foreign institutions resulted in lower

market yields on these securities relative to other marketable securities than had previously been the case,' explained the St. Louis Federal Reserve Bank. 'This development occurred in spite of the large US Government deficits that prevailed in this period.' Thanks to the extraordinary demand by central banks for government dollar-debt instruments, yields on US Government bonds fell relative to those of corporate securities, which central banks did not buy.

This inverted the classical balance-of-payments adjustment mechanism, which for centuries had obliged nations to raise interest rates to attract foreign capital to finance their deficits. In America's case, it was the balance-of-payments deficit that supplied the 'foreign' capital, as foreign central banks recycled the dollar outflows – that is, their own dollar inflows – into Treasury securities. US interest rates fell precisely because of the balance-of-payments deficit, not in spite of it. The larger the balance-of-payments deficit, the more dollars foreign governments were obliged to invest in US Treasury securities, financing simultaneously the balance-of-payments deficit and the domestic federal budget deficit.

Rest of the world finances America's boom

The stock and bond markets boomed as American banks and other investors moved out of government bonds into higher-yielding corporate bonds and mortgage loans, leaving the lower-yielding Treasury bonds for foreign governments to buy. US companies also began to buy up lucrative foreign businesses. The dollars they spent were turned over to foreign governments, which had little option but to reinvest them in US Treasury obligations at abnormally low interest rates. Foreign demand for these Treasury securities drove up their price, reducing their yields accordingly. This held down the US interest rates, spurring yet further capital outflows to Europe.

The US Government had little motivation to stop this dollar-debt spiral. It recognized that foreign central banks could hardly refuse to accept further dollars, lest the world monetary system break down. Not even Germany or the Allies had thought of making this threat in the 1920s or after World War II, and they were not prepared to do it in the 1960s and 1970s. It was generally felt that such a breakdown would hurt foreign countries more than the United States, thanks to the larger role played by foreign trade in their own economic life. US strategists recognized this, and insisted that US payments deficit was a foreign problem, not one for American citizens to worry about.

APPENDIX FOUR

Creating a new international monetary system

by Jane D'Arista

As the crises that erupted in the mid-1990s spread from Mexico to Asia, to Russia, and back to Latin America, the need for a new 'international financial architecture' became a frequent subject for discussion among a wide spectrum of academics and policymakers. However, most proposals that emerged offered changes in the current system but failed to question its underlying structure. None addressed the most basic component of any international system: how do the citizens of one country pay for the goods or financial assets they buy from another country? Are there rules that decide how these payments are made? If so, what are the rules and how do they work?

What might be reasonable objectives and institutional structures for an international monetary system in the 21st century? Which currency regime would be consistent with keeping international trade and investment open to all nations on equal terms? One objective that should be explored is the possibility of creating a system in which all currencies could be used in international as well as domestic transactions, regardless of the size of the economies in which they are issued. Equally important, the governing institutions in a new, more egalitarian system must be designed to give equal weight to both population and economic output in the decision-making process. And the international reserve asset itself must respond to the need for inclusiveness: its value must be based on a trade-weighted basket of currencies of all member countries.

Dollar dominance in the post-war world

The international monetary systems in use over the past two centuries have been constructed out of the failures of the systems that preceded them. The agreement to make international payments in gold – the gold standard so widely accepted in the 19th century – was finally abandoned in the 1930s as depression, deflation, and looming hostilities forced countries to hoard their limited supplies of gold. During the war that followed, the United States and United Kingdom created a new system – the gold/dollar exchange standard – that gave the US dollar a central role in the post-World War II world. Under this new (Bretton Woods) agreement, all countries other than the United States were encouraged to hold dollars as reserves and use them in trade, while the United States was committed to exchange dollars for gold at a fixed rate of \$35 an ounce.

The design of the Bretton Woods monetary agreement was appropriate for the hegemonic role the United States had to play in a war-ruined world. With 60 per cent of the world's output and most of its gold, only the United States could supply both the goods and the financial liquidity needed for reconstruction. Using the dollar as the primary international currency made it possible to revive trade among all nations and facilitated US efforts to rebuild other national economies by making grants of

unprecedented size – 2 per cent of its GDP annually for five years – under the Marshall Plan.

However, as the rapid recovery of Europe and Japan revived a more balanced distribution of economic strength, the dollar shortage of the 1950s turned into a dollar glut by the 1960s. Excess dollars held abroad were being cashed in for gold and US gold stocks were dwindling. In 1971, the United States unilaterally ended the Bretton Woods monetary agreement when President Richard Nixon ‘closed’ the gold window, declaring that the United States would no longer exchange dollars for gold.

This decision ushered in a new international monetary system – one in which international payments would be made by private banks in the national currencies of the so-called ‘strong’ currency industrial countries rather than exchanges of gold by central banks. Moreover, the value of the dollar – the currency used for most of these transactions – would no longer be fixed in relation to gold. Its value would ‘float’ in response to changes in the supply and demand for dollars.

Since 1973, the dollar has had its ups and downs: a substantial fall at the end of the 1970s, a big rise beginning in 1983, an engineered decline after 1985, and a period of steady strength from 1994 until 2002. By the 1990s, however, the dollar’s dominant role in the global economy was unchallenged. Measures of that dominance included the rising amount of dollar debt owed both to foreign and domestic creditors by borrowers in countries other than the United States, the share of dollar assets in international reserve holdings, the amount of US currency held and exchanged outside the United States by residents of other countries and the impact of changes in US interest rates and the value of the dollar on developments in other economies around the world.

Dollar dependency and the pressure to export

The product of little thought or planning, the current international monetary system has had important consequences for the global economy. It has been the driving force behind the export-led growth paradigm that has elevated trade surpluses to priority status as an objective of economic policy in all countries except for the one that can always pay for imports and foreign investments in its own currency. Most countries cannot, not least because, until recently, all OPEC countries demanded that oil be paid for in dollars. Non-dollar countries must ‘earn’ the dollars they cannot issue in their own economies by exporting more than they import. Moreover, if they are emerging economies that need to attract investment from abroad to finance development, they must borrow in dollars or other strong currencies – not in the money issued and earned at home. But if they have borrowed in dollars, their need to export intensifies, as they must acquire dollars both to pay for imports and to service debt.

Using strong currencies channeled through private financial institutions to fund development has been a major cause of the financial crises that have plagued emerging economies and the global financial system since the 1980s. In many cases, the evidence already strongly suggests, the build-up in debt and the share of export earnings required to service it ultimately reverse the faster rates of growth that borrowing initially produced. Moreover, capital inflows can themselves cause one of the problems – exchange rate appreciation followed by a rising trade deficit – that

induce foreign investors to flee. And when capital outflows occur, the falling exchange rate increases the value of debts denominated in strong currencies and reduces the value of all the real and financial assets denominated in the home currency.

To protect themselves against these recurring events, emerging economies have been urged to build up their stocks of foreign exchange reserves and they have done so. From 1990 through 2000, total foreign exchange reserves grew by 142 per cent and dollar reserves by 236 per cent. Most of the increase was in the reserves of emerging economies (up 268 per cent) and their share of the total rose from 39 to 60 per cent over the decade. But this constituted an immense and expanding transfer of wealth out of these economies, as they invested their foreign exchange earnings in United States and other strong currency countries' financial assets.

Such a system appears to confer significant advantages on those countries that issue currencies used by others in international transactions. As other countries invest their international reserves in credit instruments (government securities, bank deposits, and so on) issued in strong currency countries, their investments augment domestic savings, increase the availability of credit, and allow residents of a reserve-currency country to spend more and save less. However, the steady stream of capital inflows into a country that issues a reserve currency can only continue if that country remains willing to run the trade deficits that allow other countries to earn its currency.

America sucks in global savings

Throughout the 1990s, the dollar's role as a reserve currency had the effect of transferring a substantial amount of global savings to the United States. By the end of 2001, dollar reserves held in the United States constituted a stock of loans to the Treasury and private borrowers equal to 10 per cent of US GDP. Moreover, gross liabilities to all foreigners (\$9.2 trillion) had risen to 90 per cent of GDP and net liabilities (\$2.3 trillion) to 23 per cent. But the red ink was rising on the other side of the US balance-of-payments ledger, with annual trade deficits approaching 5 per cent of GDP. Clearly, the US economy's ability to absorb such substantial shares of both the world's goods and savings undermined traditional mercantilist expectations. Not only had the primary reserve currency country become the world's largest nominal debtor, it had become richer as a net importer than the major net exporting economies among its trading partners.

Now, however, growing US indebtedness has raised new concerns about the sustainability of its trade deficit and how a shift away from the dollar would affect the global economy. So far, the discussion has not led to calls for reform, partly because of a widespread assumption that, after a period of financial and economic turmoil, the euro will replace the dollar and a modified version of the current system will continue.

But Europe is unlikely to assume the US role of importer of last resort and, unless the primary reserve currency country (or area) is willing to run the trade deficits that provide the opportunity for other countries to earn its currency, a continuation of the international monetary system based on national currencies will not even achieve lift-off. Within the current decade, it will either be replaced by conscious planning or transformed by the effort to adapt to the ever-larger crises that will impact industrial as well as emerging economies.

Keynes and his international clearing agency

One way to achieve a rational replacement for the current system is to revive John Maynard Keynes' international clearing agency (ICA) concept as a basic structure for a new global payments system. For example, an importer in country A would pay for machinery from country B by writing a cheque on his bank account in his own currency. The seller in country B would deposit the cheque in his bank and receive credit in his own currency at the current rate of exchange between the two currencies. This would be possible because of the existence of an international clearing process that would route the cheque from the commercial bank to the central bank in country B and from there to the international clearing agency.

At the end of the day, the ICA would net all cheques exchanged between the two countries and pay the difference by debiting or crediting their reserve accounts. Meanwhile, the individual cheques would be returned to the countries of origin and paid in a similar fashion. In this example, the central bank would debit the reserve account of the bank in country A on which the cheque was written and the bank would deduct that amount from the buyer's account.

The process is simple but it does imply certain rules. It would require that all commercial banks receiving foreign payments exchange them for domestic currency deposits with their central banks. The central banks, in turn, would be required to

deposit all foreign payments with the ICA. The result would be that all international reserves would be held by the ICA and that the process of debiting and crediting payments against countries' reserve accounts would provide the means for determining changes in exchange rates. As in national systems where the level of required reserves is determined at weekly or bi-weekly intervals, such a structure would greatly reduce the exchange rate volatility that currently plagues the system.

Building an egalitarian monetary system

But it could do even more. If, like national central banks, the ICA held the government securities of its member countries as backing for international reserves, it could create liquidity by buying a country's securities and adding to its reserve holdings. By creating a true lender of last resort to replace the current ad hoc facilities that depend on taxpayer donations, the ICA would be able to contain damaging crises and maintain the financial stability needed for balanced growth in the global economy.

Although the ICA is only one possible means to address the flaws in the current system, it incorporates the still-valid objectives of the Bretton Woods Agreement for an open international trading system while reforming the institutional framework to promote more egalitarian participation by all countries in the global economy. I offer it in the hope of focusing attention on the need for reform as the world's economies continue to slide into slower growth.

ⁱ D. Moggridge (ed), *The Collected Writings of John Maynard Keynes*, Volume XIII, (London: The Macmillan Press Ltd, 1973) p.228.

ⁱⁱ Federal Reserve Bank of St. Louis (1973) 'Interest Rates end Monetary Growth', *Review*, January. See also 'Will Capital Inflows Reduce Domestic Interest Rate Changes?' in *ibid*, July 1972

Currency Intervention Wasting Japanese Resources

From the Korea Herald, March 16th, 2004.

By Richard Werner

Last year, the Japanese government spent 20 trillion yen worth of taxpayers' money on buying U.S. Treasury bonds. This was the biggest annual amount of official purchases of foreign currency assets by any country in history.

Since then, the Japanese appetite for U.S. government debt has really increased - this January alone, the government bought more than 7 trillion yen (about \$68 billion) worth of U.S. dollar assets, almost half of which was spent on Treasuries, breaking all records for such purchases during any one month.

As a result of these investments, the Japanese government has become the single most important buyer of newly issued U.S. government debt.

Some would argue that buying U.S. Treasuries may be a justifiable investment. Unlike stock investors, buyers of government bonds who hold on to the paper until maturity should not lose any money.

But this argument assumes that the Japanese government had the money in the first place. While the Singapore government, or the government of the Principality of Liechtenstein, may have no national debt, the same does not hold true for Japan.

Japan is a rich country and its gross domestic product is second only to that of the United States. But the Japanese national debt is not far behind the U.S. debt and the Japanese debt-income ratio is higher than that of the United States.

But does the Japanese government not own a lot of assets, the largest foreign exchange reserves in the world, to be precise? True. But these are almost entirely held in the said U.S. dollars. Thus it does not make sense to use these foreign exchange reserves to purchase U.S. Treasuries.

But if the Japanese government cannot use its foreign exchange reserves to buy U.S. Treasuries, how else can it pay for them? After all, for the better part of the past decade tax revenues have been far smaller than government expenditures. The ensuing fiscal deficits have increased national debt to record amounts.

The answer is that the Japanese government has been borrowing money in order to lend it to the U.S. government. Let's get this clear: Japan's government issues debt, such as government bonds, so that it can purchase the government bonds issued by the United States.

This raises a few questions. For instance: Does the Japanese government really need to buy more U.S. Treasuries, despite already owning the world's single biggest pile of them? Does it really make sense to borrow money, just to lend the money to another country that needs to borrow?

Here is how the experts have explained events to us in the media: The Japanese government is borrowing money to buy the debts of the U.S. government, because this will weaken the Japanese currency and that is a good thing for Japan's economy.

We can quickly test whether this story is true by simply verifying whether such official purchases of U.S. Treasuries have indeed weakened the yen.

There is no such evidence. In 1994, Japan conducted official foreign exchange intervention of more than \$30 billion. The yen strengthened to a record high of 79.75 yen per dollar by April 1995. In 1999, Japan set a new world record in official currency intervention, spending more than \$50 billion on weakening the yen. The yen responded by strengthening almost 20 percent by the end of that year.

The government has remained the sole competitor in the increasingly frantic bid to break its previous records in currency intervention. Despite the foreign exchange intervention of about \$200 billion in 2003 and the first few weeks of this year, the yen rose from about 120 yen per dollar to 105 yen.

There is no empirical evidence that the Japanese government is buying U.S. Treasuries to weaken the yen - quite the opposite. Also, it is not clear that a weaker yen would actually stimulate the economy, as it makes the badly needed imports of raw materials and intermediary inputs more expensive.

Instead of holding a world record of \$777 billion in foreign exchange assets, mostly in the form of U.S. government debt, the Japanese government could sell them and use the proceeds to pay back some of its own record-breaking debt mountain, or stop issuing new debt - Japanese foreign exchange reserves currently amount to about 86 trillion yen, which should pay for the annual budget deficit.

Yet, the policy of buying U.S. Treasuries must have some beneficiaries, otherwise it would probably not have been adopted.

It certainly has helped the U.S. government. The Japanese purchases of U.S. Treasuries in 2003 were almost enough to fund half of the U.S. government's annual fiscal deficit. Thanks to loyal Japanese support, the U.S. administration has been able to handle its rapidly expanding fiscal deficit with ease, ballooning military and paramilitary costs of running its empire notwithstanding.

What is harder to understand is why Japan, which has the highest debt-GDP ratio among industrialized countries, should go further into debt, just so that the already profligate U.S. government can fund its growing indebtedness.

In effect, Japanese taxpayers, already suffering from over a decade of recession, a collapsing pension system and record national debt, are being asked to also shoulder the debts of the U.S. government.

But is it in the Japanese interest? I think taxpayers have a right to demand that their money is spent more wisely and in their best interest.

The writer is an investment strategist and fund manager. He is author of "Princes of the Yen: Japan's Central Bankers and the Transformation of the Economy." - Ed.

By Richard Werner The Daily Yomiuri / Asia News Network

2004.03.17