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**Title of the paper:** Globalization and an International Monetary Clearing Union

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**Abstract**

What is required today is a modern day variant of the "Keynes Plan" that was presented at Bretton Woods-- but was vetoed by Harry Dexter White , the leader of the US delegation to Bretton Woods. This paper provides the economic explanation of why the principles behind the "Keynes Plan" are essential to improve the international payment and financial system and then describes how a 21 century International monetary Clearing Union would operate.

**Keywords**

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Keynes's general theory explains that increases in spending on goods and services creates additional profit opportunities for business firms. It follows that the managers of these business firms would be encouraged to hire additional workers whenever additional profit opportunities exist. In the closed economy model of most textbooks where all transactions are among residents of the same national economy, it is implicitly assumed that the additional spending would come from domestic households, domestic business firms and/or federal, state or local governments to be spent to purchase the output produced by enterprises located in the domestic economy.

Once the analysis is placed into a globalized market system involving many separate nations things change somewhat. For example, spending by United States households, business firms, and/or government to purchase products produced in foreign nations (i.e., imports), creates profit opportunities and jobs in the foreign nation and not in the domestic economy. On the other hand, demand by foreigners for the products of domestically located business firms (i.e., exports) creates profits and jobs for workers in the domestic economy.

If, in any year, exports from the United States approximately equals the imports into the United States, then the foreign job creating effects of United States imports and domestic job creation in United States export industries will approximately offset each other. If, however, the United States imports significantly more than it exports to foreigners, then American spending on imports will support more profit opportunities and jobs in foreign nations than foreigner's spending on U.S. imports creates profit and job opportunities in the United States.. In this latter case, American factories's profits and jobs will be less than if either the total imports equaled the same level of exports or if all the United States excess demand for imports over exports had been

diverted to a market demand for these same products produced by domestically located production facilities.

For example in 2008 the United States imported \$709 billion more of goods and services from foreign nations than it exported to foreign markets. If that \$709 billion that Americans spent for imports over exports had been spent in 2008 on goods and services produced in the United States, it would have a big stimulus impact to the American economy that was then suffering from what some people called the Great Recession. This \$709 billion was equal to approximately 95 per cent of the amount of additional federal government spending and tax cuts provided for in the economic stimulus bill that President Obama signed in February 2009 . This stimulus bill that was supposed to end the Great Recession and restore jobs to several million US workers who had lost their jobs in this Great Recession.

Similarly suppose the Chinese, Japanese and other trading partners who experience exports to the US greater than imports from the U.S. had spent their 2008 total dollar earnings derived from their selling goods and services to people in the United States on exports from the United States instead of savings \$709 billion of their export earnings. This additional \$709 billion spending on United States exports also would have been approximately 95 per cent equivalent to the effect of the US federal government stimulus bill enacted in 2008 to alleviate the effects of the Great Recession. Accordingly, if a nation spend more on imports than it receives in exports, then the net effect is to reduce total market demand for the output from domestic industries and therefore to contribute to the market force causing domestic unemployment while encouraging greater employment and profits abroad.

Since 1976, the United States has been consistently importing more than its has been

exporting, thereby creating more profit opportunities and jobs in foreign nations than foreigners have been creating in the United States export industries. The result has been that the United States has acted as the major engine for stimulus and economic growth for the rest of the world's industries for more than three decades. The impressive economic growth rates displayed by countries like Japan in the 1980s and China and India in the early years of the 21<sup>st</sup> century owe that prosperity in large part to the United States increases in spending on exports from these nations.

A simple example will illustrate this situation. Let us assume that in any one year the United States spends \$10 billion more on Chinese imports (say toys) and therefore \$10 billion less on domestically produced toys. Assume that China does not increase spending on United States exports and therefore the United States trade deficit with China has increased by \$10 billion. The effect is that this \$10 billion spent on imports from China has created profits and jobs in the Chinese toy industry, while United States residents who have diverted their spending on domestically produced toys to foreign produced toys has, in essence, destroyed profits and jobs in the United States toy industry.

In this hypothetical example, China has earned \$10 billion more dollars on its international trade payments account. It is further assumed that China did not spend this on buying \$10 billion worth of more products from the United States. Instead, this hypothetical example has assumed China has "saved" \$10 billion out of its international earnings. Since in the Keynes - Post Keynesian analysis "a penny saved is a penny that can not be earned" by anyone else, then in this hypothetical example the \$10 billion the Chinese saved is \$10 billion that can not be earned by businesses and workers located in the United States. Former Federal Reserve chairman, Ben Bernanke, spoke of this foreign nations' hoarding of earnings from exports to the USA as a "glut of

savings overseas”.

When imports exceed exports for a nation, there is a deficit in the trade balance of that nation that economists call an “unfavorable balance of trade”. In our hypothetical example of \$10 billion that Chinese saved, this unfavorable balance of trade results in a deficit in the United States’ balance of payments with the rest of the world as the United States pays out more for its imports than it receives in payments for its exports.

Any nation experiencing a deficit in its international balance of payments must finance this deficit by either (1) the deficit nation drawing down its previous savings on international earnings (these savings are called the nation’s “foreign reserves”) to pay for its excess of imports over exports, or (2) by the deficit nation borrowing funds from the foreigners in the rest of the world to pay for the difference between the value of imports and the value of exports.

Since the United States imports have exceeded exports every year since 1974, the United States, for many years, has borrowed from foreigners in order to finance its excess of imports over exports. The result has been that the United States has moved from being the world’s largest creditor nation to being the largest debtor nation in terms of debt owed to the rest of the world.

To continue with our previous illustrative example, we might ask what do the Chinese do with the \$10 billion savings on its international earnings? Like all savers the Chinese look for liquid assets to move their saved (unused) international contractual settlement (purchasing) power to the future. For the most part the Chinese have used their international savings to purchase United States Treasury securities and other debt obligations of U.S.. government sponsored corporations. This indicates that the Chinese believe the United States dollar is the safest harbor for storing their unused international contractual settlement power. This savings by the Chinese have

led many classical theory “experts” to say that the Chinese have been financing the American consumer shopping spree and the resulting growth of United States international debt. These “experts” have warned that if nations such as China stops buying United States securities with their annual international savings out of earnings from exports to the United State, then American consumers could no longer afford to buy as many imports and they would have to reduce their purchases of Chinese made goods at retail outlets like Walmart.

If Americans did stop buying Chinese imports, just think how this will devastate the profits of Chinese firms and threaten the jobs of Chinese workers. The result could even cause political unrest in China. The Chinese Communist party enjoys popular support as long as it not only protects the nation from foreign enemies but also as long as it continues to support economic actions that result in substantial improvement in employment and living conditions for all Chinese citizens. If Chinese exports were to decline, then Chinese unemployment might increase and living standards decline. That could induce demonstrations and political unrest in China. In other words politically as well as economically it is unlikely to be in China’s interest to stop financing Americans huge imports over exports from China.

If, in our simple illustration, suppose the Chinese did not use their international savings to buy United States Treasury bonds. Instead assume the Chinese spent the \$10 billion on the products of American domestically located industries. The result would be that

(1) in China there would be more products from American producers, perhaps such as meat, corn and wheat. If more of these food products were available in China they would strongly embellish and improve the standard food diet of the average Chinese worker.

(2) American businesses and their workers would earn more income and therefore not have to

borrow from the Chinese to finance their large import purchases of Chinese goods.

The morale of this illustration is that if the Chinese bought goods from the United States instead of buying United States Treasury bonds, then the Chinese government would make available goods that could improve Chinese real living standards while American workers would have more employment and enough income to afford all the Chinese imports they bought without having to go into debt to the Chinese.

This simple illustration suggests that one engine of growth that a nation might try is to expand its exports to the rest of the world. If successful such an export expansion led growth policy will result in increasing profits for domestic firms, creating jobs for domestic workers. Moreover, the nation becoming a creditor to other countries as it runs a favorable balance of trade. If, however, one country runs a favorable balance of trade, then other nation(s) must run an unfavorable balance of trade, resulting in a tendency to lose jobs and profits to the nation pursuing an export led growth policy. Thus, as Keynes noted, if each nation tries to stimulate its economy by running a favorable balance of trade to increase domestic profit opportunities and employment then this “may lead to a senseless international competition for a favorable balance of trade which injures all alike”<sup>1</sup>.

Keynes and his Post Keynesian followers have developed a solution for preventing a competition among nations to stimulate their economy via attempting to maintain a favorable balance of trade. This solution will end persistent trade imbalances that cause the nation(s) with an unfavorable balance of trade to lose profit and job opportunities while incurring huge international debts. What is required is some form of an institutional arrangement that prevents any trade imbalance among nations to persist.

In contrast, the classical efficient market theory solution to this trade imbalance problem is

that the debtor nation must reduce its imports relative to its exports. One way this can occur is to have a free market in currency exchanges to solve the problem. The classical theory maintains that if the Chinese currency (the renminbi) was traded in a free flexible foreign exchange market, and if the United States ran an unfavorable balance of trade with the Chinese then the demand for the Chinese currency would substantially increase in value relative to the US dollar. As a result, the retail dollar price in the United States of Chinese goods would rise. American consumers would find that Chinese goods were so expensive in terms of dollars that they could no longer afford to buy very much from the Chinese. The rise in the consumer price level would adversely affect the real income and living standards of the average employed American worker. Thus Chinese imports to the United States would decline significantly.

In China, on the other hand, with the appreciation of the Chinese currency relative to the dollar, the Chinese would experience a decline in the renminbi price of United States imports and therefore they would buy more imports from the United States<sup>2</sup> as their real income and living standard improved.

If, however, the value of the US dollar declined relative to the Chinese currency, then as the retail dollar price of Chinese imports increases then the rate of inflation in the United States as measured by the consumer price index would rise as such imports are a significant portion of the American consumer budget<sup>3</sup>.

If the Federal Reserve believes that its primary obligation is to fight inflation, then the Federal Reserve's might ramp up its anti-inflationary policy and increase the domestic interest rate. A rise in interest rates in the United States would destroy some existing profit opportunities for American business firms and increase unemployment in the United States. The goal of the Federal

Reserve's anti-inflation monetary policy would be to reduce the incomes of Americans sufficiently so that American household's reduce their purchases of all goods and services including imports from China as well as products from American factories. In other words, the Federal Reserve's policy would try to dampen economic activity globally. If the Federal Reserve's anti-inflation policy is successful, then the decline in market demand will act as a break as Americans bought less goods (both domestically produced and imports) in the market. This reduction in imports would probably slow the appreciation of the yuan relative to the dollar and thereby have some impact on reducing the measured rate of inflation over time.

In this depressing scenario, as Americans buy fewer Chinese imports, profits and jobs in China's export industries would be reduced creating unemployment and potential political unrest in China. With lower incomes in China, the Chinese market demand for United States exports should decline resulting less profit opportunities in American export industries made possible by the ongoing devaluation of the dollar. Clearly such a possible scenario is neither good for the American or Chinese workers and business firms.

Classical theory avoids this possible unpleasant scenario by assuming that with free efficient markets there will always be full employment of capital and labor in all trading nations no matter what changes occur in the exchange rate of currencies between nations. In other words, classical theory merely assumes away the possible unemployment problem that could occur in both America and China if the free market permits the United States dollar to be devalued relative to the renminbi in order to end the United States' unfavorable balance of trade. In the long run, classical theory asserts, as a matter of faith rather than as empirical evidence, there must always be full employment in all nations<sup>4</sup>.

Thus by loading the classical model with sufficient but unrealistic assumptions, classical theory resolves any potential trade deficit problem by merely invoking the magic of free markets for foreign exchange of currencies, in a world where the future is known-- at least in the long run.

Some more pragmatic economists have noted that historically when exchange rates have been permitted to change relatively freely in the market the results have often been devastating for the nation. Consequently some experts have advocated a foreign exchange market where a market maker actually fixes the exchange rate at some pre-announced level. As a result, very often economic discussions on the requirements for a good international payments system have been limited to this question of the advantages and disadvantages of fixed vs. flexible exchange rates.

The facts of experience since the end of the Second World War, however, plus Keynes's revolutionary liquidity analysis indicates that more is required than merely deciding whether exchange rates should be fixed or freely flexible. A mechanism must be designed to adequately resolve any persistent trade and international payments imbalances that could occur whether the exchange rates are fixed or flexible. The mechanism should be designed not only to resolve these imbalance problems but also to simultaneously promote global full employment—rather than just assume global full employment will always occur. Such a mechanism is embedded in the Keynes Plan for international trade and payment imbalances.

### **The Bretton Woods Solution**

In 1944, as the Second World War was winding down, the victorious Allied nations organized a conference at Bretton Woods, New Hampshire. The purpose of this Bretton Woods conference was to design a post war international payments system. Keynes was the chief representative of the United Kingdom delegation. In contrast to the classical view of the desirability

of free exchange rate markets, Keynes's position was that there is an incompatibility thesis in the classical theory approach to international trade and finance. Keynes argued that permitting free trade, flexible exchange rates and free capital mobility across international borders can be incompatible with the economic goal of global full employment and rapid economic growth.

Keynes offered an alternative analysis to the classical approach to the problem. This alternative was the "Keynes Plan" solution, an arrangement that would make international trade and financial flow arrangement compatible with global full employment and vigorous economic growth while, when necessary, permitting nations to introduce controls on any flow of capital funds that was being sent across national boundaries.

Keynes argued that the "main cause of failure" of any traditional international payments system -- whether based on fixed or flexible exchange rates-- was its inability to actively foster continuous global economic expansion whenever persistent trade payment imbalances occurred among trading nations. This failure, Keynes wrote,

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

It is characteristic of a freely convertible international standard that it throws the main burden of adjustment on the country which is in the debtor position on the international balance of payments - that is, on the country which is (in this context) by hypothesis the weaker and above all the smaller in comparison with the other side of the scales which (for this purpose) is the rest of the world"<sup>5</sup>.

Keynes concluded that an essential improvement in designing any international payments system requires transferring the major onus of adjustment from the debtor to the creditor nation

when any persistent international payments imbalance develops. This transfer of responsibility for ending persistent international imbalances to those nations that experience exports that exceed their imports and are therefore in the creditor position would, Keynes explained, substitute an expansionist, in place of a contractionist, pressure on world trade. To achieve a golden era of economic development Keynes recommended combining a fixed, but adjustable, exchange rate system with a mechanism for requiring the nation “enjoying” a favorable balance of trade to initiate most of the effort necessary to eliminate this trade imbalance, while “maintaining enough discipline in the debtor countries to prevent them from exploiting the new ease allowed them”<sup>6</sup>.

During the Second World War , millions of people had been killed or wounded. Industrial and residential centers in most of Europe lay in ruins. Europe was on the brink of famine as agricultural production had been disrupted by the war. Transportation infrastructure was in shambles. The war-torn capitalist nations in Europe did not have sufficient undamaged productive resources available to produce enough to feed their populations and much less to rebuild their economies.

The only major economic power in the world that was not significantly damaged by the war was the United States. European rebuilding would require the European nations to run huge import surpluses with the United States in order to meet their economic needs for recovery. The European nations had very little foreign reserves. (At the time the major foreign reserves were in the form of the asset gold that European war-devastated nations could readily sell to the United States for dollars that they could then use to buy imports from the only post-war nation that had enough productivity capacity to produce for exports – the United States.)

The European nations had insufficient foreign reserves to obtain the necessary large

volume of imports from the United States necessary to restore their economies. The only alternative, under a free market laissez-faire system, would be for Europeans to obtain an enormous volume of loans from the United States to finance the purchase of required United States exports needed to feed the European population and rebuild their economies. Private sector lenders in the United States, however, were mindful that German reparation payments to the victorious Allied nations after World War I were primarily financed by American private investors lending to Germany (the so-called Dawes Plan). Germany never repaid these Dawes plan loans. Given this history of nations defaulting on international debt repayments and the existing circumstances immediately after the Second World War, it was obvious that private lending facilities in the United States could not be expected to provide the loans necessary for European recovery after the war.

The Keynes Plan, presented at the 1944 Bretton Woods conference, would require the United States, as the obvious major creditor nation, to accept the major responsibility for curing the post war trade imbalance where a tremendous amount of goods from the United States would be necessary to feed the populations in Europe while simultaneously rebuilding the factories and infrastructure necessary to reestablish viable European economies.

Where were the Europeans going to get the finance to purchase all the necessary goods from the United States? Keynes estimated that the European nations might require in excess of \$10 billion to purchase United States exports for such a post-war rebuilding of the European economies. The Keynes Plan had an operational system that would have the United States simply provide these funds to the Europeans. The United States representative to the Bretton Woods Conference, Harry Dexter White, stated that the US Congress would never provide the \$10 billion that Keynes

estimated was the minimum required funding. Instead, White argued, Congress might be willing to provide, at most, \$3 billion as the United States contribution to solving this post war international financial problem for rebuilding European economies..

The United States delegation at the Bretton Woods conference was the most important participant. It was clear that nothing could be done unless the United States delegation agreed to any plan that was developed at the conference. White had the US delegation veto the Keynes Plan. Instead, White provided a plan that set up the International Monetary Fund (IMF) and what we now call the World Bank.

The White plan envisioned the International Monetary Fund (IMF) providing short-term loans to nations running unfavorable balances of trade. These loans were suppose to give the debtor nation time to rebuild its economic structure and then stop importing more than it was exporting. Then these debtor nations were to pay off their debt to the IMF by earnings from their exports exceeding their import purchases. Under the White Plan, the United States would subscribe a maximum of \$3 billion as its contribution to the IMF lending facilities

The World Bank would borrow funds from the free market. These World Bank funds would then be used to provide long-term loans for rebuilding capital facilities and making capital improvements initially in the war-torn nations and later in the less developed countries. When the new facilities were in place, it was assumed that sufficiently more goods could be produced and sold profitably. Then the nation would use the new income earned from the new facilities to pay off the World Bank loans. This White plan suggested by the US delegation was basically the institutional arrangements adopted at the Bretton Woods Conference.

Under this White plan, international loans from the IMF or the World Bank were the only

available sources for financing the huge volume of imports from the United States that the war-torn nations would require immediately after the Second World War. It turned out, however, that the IMF and World Bank together did not have sufficient funds to make loans of the magnitude needed by the European nations. But even if the IMF and the World Bank could have provided loans sufficient to meet the needs of the war-torn nations, the result would have been a huge international indebtedness of these nations. Paying off this immense debt obligations would require the European population to accept the main burden of adjustment by them being willing to “tighten their belts”.

This belt-tightening statement is a euphemism to indicate that the debtor nations would have to dramatically reduce their consumption spending for imports and even goods produced domestically. Such a plan could be put into effect only by reducing the income of the residents of European nations so they will buy less output from both foreign and domestic enterprises in order to pay the annual debt servicing charges. This suggested no significant improvement in the standard of living of Europeans for years to come. The result would so depress Europeans as to possibly inducing political revolutions in most of Western Europe. Not inconsequentially, the tighten your belt policies also would have limited Europe as a possible large profitable market in the future for American exporters.

To avoid the possibility of many European nations facing a desperate electorate that might opt for a communist system when faced with the dismal future the White Plan offered, the United States, developed an alternative plan in the hope that Communism did not spread west from the Soviet Union to the democratic European nations.. In 1948, President Truman recommended Congress accept the Marshall Plan. Despite White’s argument that the United States. would not be

willing to give more than \$3 billion to solving this international payments problem, the Congress approved the Marshall Plan which provided \$5 billion in foreign aid in 18 months and a total of \$13 billion in four years. (Adjusted for inflation, this \$13 billion sum is equivalent to approximately \$160 billion in 2014 dollars.) The Marshall plan was essentially a four year gift of \$13 billion worth of American exports to the war devastated nations. The Marshall Plan required no repayment by the recipients of these funds – and hence no “belt tightening”..

The 1948 Marshall plan gifts gave the recipient nations a sufficient number of dollars to buy approximately 2 per cent of the total annual output (Gross Domestic Product) of the United States each year for four years . Despite Americans giving away 2 per cent of their national income per annum, there was no real sacrifice for American households associated with the Marshall Plan as the remaining income was significantly greater than pre-war levels. The United States standard of living during the first year of the Marshall Plan was still 25% larger than it had been in the last peacetime year of 1940. American household income continued to grow throughout the Marshall Plan period.

. The Marshall plan funds created profit opportunities for American firms and jobs for US workers. Full employment was readily sustained. Immediately after the war ended, despite government military spending being significantly reduced, which by itself might have created some post-war unemployment problems. Partially offsetting this reduction in government military spending was the Marshall plan funds spending that created significant increases in employment in United States export industries just as several million men and women were discharged from the United States armed forces and entered the United States civilian labor force looking for jobs.

For the first time in its history, the United States did not suffer from a severe recession due

to a lack of spending immediately following the cessation of a major war and a reduction in military spending by the federal government. The United States and most of the rest of the world experienced an economic "free lunch" as both the potential debtor nations and the creditor nation experienced tremendous real economic gains resulting from the Marshall Plan and other foreign aid give aways. Despite the growth in output from foreign factories, however, the United States maintained a surplus merchandise trade balance of exports over imports until the first oil price shock in 1973.

By 1958, however, although the United States still had an annual goods and services export surplus of over \$5 billion, the post war United States potential international payments surplus was at an end. By that time United States governmental foreign and military aid exceeded \$6 billion while there was a net private capital outflow of \$1.6 billion from the United State that financed United States companies investing in productive facilities abroad This total of \$7.6 outflow of funds offset the earnings of the \$5 billion export surplus by \$2.6 billion.. In other words by 1958, the international payments account of the United States saw a net outflow of \$2.6 billion despite export earnings exceeding spending on imports by \$5 billion. The post war international payments surplus of the United States was at an end.

As the United States total international payments account swung into deficit in 1958 other nations began to experience international payments surpluses. These credit surplus nations did not spend their payments surpluses on additional imports from the United States. Instead the nations used a portion of their annual dollar surpluses to purchase international liquid assets in the form of gold reserves from the United States. For example, in 1958, the United States sold over \$2 billion in gold reserves to foreign central banks.

These trends accelerated in the 1960s, partly as a result of increased United States military and financial aid in response to the construction of the Berlin Wall in 1961 and later because of the U.S.'s increasing military involvement in Vietnam. At the same time, a rebuilt Europe and Japan became important producers of exports so that the rest of the world became less dependent on purchasing products solely from United States export industries.

Still the United States maintained a surplus merchandise trade balance of exports over imports until the first oil price shock in 1973. More than offsetting this merchandise trade surplus during most of the 1960s, however, were foreign and military aid dollar outflows to other nations plus net capital outflows from the United States that financed United States companies investing in facilities abroad. Consequently during the 1960's years the United States experienced an annual unfavorable total balance of international payments.

The Bretton Woods system had no way of automatically forcing the emerging creditor nations experiencing a payments surplus to step in and accept the responsibility for resolving the persistent international payments imbalances – a creditor adjustment role that contributed so wonderfully to global economic growth. A creditor role that the United States had started playing in 1948 with the Marshall Plan. Instead during the 1960s the surplus nations continued to converted some portion of their annual dollar international payment receipt surpluses into demands on United States gold reserves to be stored as a liquid asset for savings that could be used anytime in the future to meet international payments. As surplus nations in the 1960s drained gold reserves from the United States, the seeds of the destruction of the Bretton Woods system and the golden age of economic development were being sown.

In 1971, President Richard Nixon closed the gold window. Nixon stated that the United

States government would no longer sell gold to foreign nations who had earned dollars and wanted to use these dollars to buy gold from the United States rather than buy produced goods and services from American business firms. Nixon's closing of the gold window had, in essence, indicated that the United States had unilaterally withdrawn from any Bretton Woods agreement. At that point of time, the last vestiges of Keynes's enlightened international monetary approach where the creditor nation accepts a large responsibility for correcting persistent trade imbalances was on its way to be forgotten.

### **Reforming the International Payments System**

The post Second World War global golden age of economic development required international institutions and United States government foreign aid policies that operated on principles inherent in the Keynes Plan where the creditor nation accepting the major responsibility for solving any persistent international payments imbalance. The formal Breton Woods agreement, however, did not require creditor nations to take such actions. Since Nixon's closing of the gold window in 1971, the onus has been on nations with deficits in their trade and international payments balances to solve their own international deficit payments problems. The result has been that since 1971 the international payments system often impedes rapid economic growth and even induce recession for many nations of the world.

Utilizing the ideas Keynes presented at Bretton Woods, it is possible to update the Keynes Plan for a 21<sup>st</sup> century international monetary payments scheme that would eliminate persistent unfavorable payments imbalances, promote global economic prosperity and still meet the political realities of today without bowing one's knee to efficient market advocates. For, as Keynes wrote:

“to suppose [as the classical theory does] that there exists some smoothly functioning automatic [free market] mechanism of adjustment which preserves equilibrium if only we trust to methods of laissez-faire is a doctrinaire delusion which disregards the lessons of historical experience

without having behind it the support of sound theory”<sup>7</sup>

Since the 1990s, there has been several international finance crises. In 1994 when the Mexican government was faced with difficulties in trying to service its international debt repayments, some pragmatic policy makers recognized that free markets do not provide a system that automatically prevents a crisis in the international payments sector. In some cases, instead of relying on the market to solve the problem, these pragmatists advocated the creation of some sort of crisis manager to stop international financial market liquidity hemorrhaging and to "bail-out" the international investors. In 1994, for example, United States Treasury Secretary Robert Rubin encouraged President Clinton to use American funds to lend to Mexico to solve its financial crisis and thereby save the wealth of international buyers of Mexican bonds. This solved the problem.

In other cases, when the solution was left to the free market severe economic problems developed.. In 1997, for example, Thailand, Malaysia, and other East Asian nations experienced an international currency crisis that battered their economies. In 1998 the Russian debt default caused another international financial crisis that lead to the collapse of the Long Term Capital Management (LTCM) hedge fund which, except for quick action by pragmatists at the New York Federal Reserve Bank, could have induced a significant drop in American equity markets. (We should note that among the principals of LTCM was Nobel Prize economist winner Myron Scholes, who won his Nobel Prize for discovering the formula for “properly” pricing risk in an efficient financial market environment. Scholes formula, however, could not save LTCM from its after-the-fact recognized investment blunder into Russian bonds by not correctly pricing the risks involved in such an investment.)

At the time of the Russian debt default and the LTCM collapse, President Clinton called for

a “new financial architecture” for international financial market transactions. The then International Monetary Fund Director Stanley Fischer (who in 2014 Obama appointed as Vice Chair of the Federal Reserve) recognized that the IMF did not have sufficient funds to stem the international financial crises that was occurring. Fisher suggested that the major nations of the world, the so called G-7 nations, make a temporary arrangement where they would provide additional financing to help provide funds to any nation suffering from deficits in its international payments imbalances until such nations could get their economic house in order.

Fisher's cry for a G7 temporary collaboration to provide funds to deficit nations is equivalent to recruiting a volunteer fire department to douse the flames after someone has cried fire in a crowded theater. Even if the fire is ultimately extinguished there will be a lot of innocent casualties. Moreover, every new currency fire would require the G-7 voluntary fire department to pour more liquidity into the market to put out the flames. Clearly a more desirable goal would be to produce a permanent fire prevention system, and not to rely on organizing larger and larger volunteer fire fighting companies with each new currency crisis. In other words, crisis prevention rather than crisis management should be the policy goal.

President Clinton's clarion call for a new international financial architecture implicitly recognized the need for a permanent prevention institutional arrangement in the existing international payments system, Unfortunately, President Clinton's call was not taken up as the international community managed to muddle through the experience although some nations and its residents suffered severe economic pains.

Beginning in 2007 the global economic system again experienced a crisis of the international financial system – a crisis of much larger proportions than those in the 1990s. The US

sub prime mortgage derivatives problem created a contagious disease that caused havoc with banking systems in many other countries including Germany, the United Kingdom , France, Spain, Greece and others. The contagion caused the almost complete collapse of the Icelandic banking system and even the Swiss banking system – usually considered a paragon of financial stability – appeared for a while to be in severe economic trouble. The need for a “new international financial architecture” is clearly more urgent than ever.

. In the 21<sup>st</sup> century interdependent global economy, a substantial degree of economic cooperation among trading nations is essential. The original Keynes Plan for reforming the international payments system called for the creation of a single Supranational Central Bank. Given the problems Europe has suffered despite it possessing a Supranational central bank suggests that perhaps an institutional arrangement that avoids such a Supranational central bank may be more desirable in that it permits participating nations to still manage their own monetary policy in the way the government thinks is in the best interests of its residents..

### **REFORMING THE INTERNATIONAL PAYMENTS SYSTEM**

A international financial architecture system to deal with persistent trade imbalances and any international financial crisis can be developed to operate under the same economic principles laid down by Keynes at Bretton Woods. But this system does not require the establishment of a supranational central bank of the world as Keynes suggested in his “Keynes Plan” at Bretton Woods.. Instead, this new international payment system is aimed at obtaining a more acceptable international agreement (given today’s political climate in most nations) that does not require any nation to surrender the nation’s control of either its domestic banking system or the operation of its domestic monetary and fiscal policies to a supranational authority. Each nation will still be able to use monetary and fiscal policies to determine the domestic economic destiny that is best for its citizens as long as it does not

detrimentally affect employment and income earning opportunities in other trading partner nations.

What is required is a closed, double-entry bookkeeping clearing institution to keep the international payments 'score' among the various trading nations plus some mutually agreed upon rules to solve the problems of persistent trade and international payment imbalances. It will also require an international agreement and a method to prevent international financial market transactions that can cause a financial market crisis that would be disruptive to the stability of any nation's economy as well as a threat to the global economy.

The new international institution to be set up under this plan could be labeled the International Monetary Clearing Union (IMCU). The IMCU would require all international payments between nations whether for imports or financial funds crossing national borders to go through this International Monetary Clearing Union. Each nation's central bank will set up a deposit account with the IMCU. Then any payments of a resident entity in nation A made to a resident entity in nation B will have to clear through each nation central bank deposit at the IMCU. A payment from a resident in A to a resident in B when cleared through the IMCU would appear as a credit for nation's B central bank account at the IMCU and as debit to nation's A central bank's account at the IMCU. Although this may seem to be a complicated process to the average layperson, it is merely an international version of how checks are cleared when a residents of one region of the United States, say California, pays other entities in another region, say New York. The checks clear thru the clearing house mechanism set up by the United States Federal Reserve. System

This IMCU is a 21<sup>st</sup> century variant of the Keynes Plan. To operate it would require at least seven technical proposals for dealing with all types of international financial problems that we have already indicated may occur. These technical proposals are presented in the Appendix to this chapter. At this point, rather than letting the exposition getting bogged down in technical details, it is more

appropriate to indicate how and why this IMCU proposal works to end the possibility of persistent trade imbalances and, disruptive flows of financial funds across national borders. Simultaneously this IMCU would be encouraging global full employment and economic growth.

The object of this International Monetary Clearing Union is

(1)] to prevent a lack of global effective market demand for the products of industry occurring due to liquidity problems whenever any nation(s) holds either excessive idle foreign reserves by saving (i.e., not spending on products) too much of its internationally earned income. In other words this IMCU would encourage sufficient spending globally to produce enough profit incentives in export industries of nations to help assure global full employment,

(2) to provide an automatic mechanism for placing a major burden of correcting international trade imbalances on the nation running persistent export surpluses,

(3) to provide each nation with the ability to monitor and, if desired, to control movements out of the nation of (a) flight financial funds, as well as money moved across national borders in order to avoid paying taxes on such funds, (b) of earnings from illegal activities leaving the nation, and © to prevent funds that cross borders to finance terrorist operations, and

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

The IMCU system would have a built-in mechanism to encourage any nation that runs persistent trade surpluses of exports over imports to spend what is deemed (in advance) by agreement of the international community to be "excessive" credit balances (savings) of foreign liquid reserve assets that have been deposited in the nation's deposit account at the IMCU. These accumulated credits (saving out of international earned income) represent funds that the creditor nation could have used to

buy the products of foreign industries but instead used to increase its foreign reserves in terms of its deposit at the IMCU. When a nation holds excessive credits in its deposit account at the IMCU, it would mean that these excess credits are creating unemployment problems and the lack of profitable opportunities for business enterprises somewhere in the global economy.

The Keynes principle involved in this situation is to recognize that if the creditor nation spends its excessive credits, this spending will increase profit opportunities and the hiring of workers around the globe and thereby promote global full employment. The Keynes solution would encourage the creditor nation to spend these excessive credits in three possible ways.— all beneficial to the global economy. These three ways are:

- (1) on the products (exports) of any other member nation of the IMCU,
- (2) on new direct foreign investment projects in other IMCU member nations, and/or
- (3) to provide foreign aid, similar to the Marshall Plan, to deficit IMCU members.

The credit nation is free to choose any combination of the above three ways to spend its excessive credit at the IMCU but it must spend its excessive credits.

If the creditor nation spends its excessive credits on imports from foreign producers, the result will be that the surplus nation's trade imbalance will be reduced while it is creating additional profits opportunities and labor hiring in other nations. This means more income for people and businesses in the nations previously experiencing unfavorable balances of trade and who were borrowing from foreigners to buy their excess of imports over exports. In essence this excess credit spending on imports gives the deficit nations the opportunity to work their way out of international debt by earning additional income by selling additional exports to their creditors.

Direct foreign investment spending requires the nation with excess credits in its account at the IMCU to build plant and equipment in the deficit nation, thereby immediately increasing profits, jobs

and income in the construction industries in the deficit nation and then creating jobs opportunities in manning the new plant and equipment when construction is completed. If the nation receiving this direct foreign investment is a less developed country, then this foreign direct investment spending helps to build the facilities of this less developed country up to 21<sup>st</sup> century standards.

Foreign aid spending provides the deficit nation with a “gift” that it can use to reduce its debt obligations and/or buy additional products from foreign producers without going further into debt.

These three spending alternatives encourage the surplus nation to accept a major responsibility for correcting trade and international payments imbalances. Nevertheless this provision gives the trade surplus country considerable discretion in deciding how to accept the onus of adjustment in the way it believes is in its residents best interests. It does not permit, however, the surplus nation to shift the burden to the deficit nation(s) by lending the deficit nation or nations more and therefore imposing on any deficit nation additional contractual debt repayments obligations independent of what the deficit nation can afford.

The important thing is to make sure that continual oversaving by the surplus nation in the form of international liquid reserves are not permitted to unleash depressionary economic forces on other nations and/or to build up of international debts so encumbering as to impoverish the global economy of the 21 century.

In the event that the surplus nation does not spend or give away the credits that are deemed “excessive” within a specified time, then the IMCU managers would confiscate (and redistribute to debtor members) the portion of credits deemed excessive. This last resort is the equivalent of a 100% taxes on a nation’s liquidity holdings that the international community has already agreed are excessive. Since continual excessive liquidity holdings implies continuing and excessive unemployment in one or more nations running trade deficits, if the surplus nation does not spend its excessive surplus, then

confiscating these excessive credits and providing them to debtor nations will not only benefit the debtors but improve the global employment rate and output. Of course the nation with excessive credits will recognize that these credits are subject to a 100 per cent tax if not spent. It is therefore highly unlikely that this confiscatory tax will ever have to be enforced.

Under either a fixed or a flexible rate system with each nation free to decide how much it will import, some nations will, at times, experience persistent trade deficits merely because their trading partners are not living up to their means -- that is because other nations are continually saving (hoarding) a portion of their foreign export earnings rather than spending it on the products of foreign workers and enterprises. . By so doing, these oversavers are creating a lack of global market demand for the products that global industries can produce.

Under the Keynes principle requiring creditor nations to spend excessive credits, deficit countries would no longer have to have to tighten the belts and reducing the income of their residents in an attempt to reduce imports and thereby reduce their payment imbalance because others are excessively oversaving. Instead, the system would seek to remedy the payment deficit by increasing opportunities for deficit nations to sell products profitably abroad and thereby work their way out of their otherwise deteriorating debtor position.

As the 2007-8 global financial crisis deepened, some recognized that merely attempting to tinker with the existing system by perhaps upgrading the power of the IMF and the World Bank or encouraging the G-7 to again act as a volunteer fire department did not solve the international trade and financial payments problems. For years now the international system has been running into trouble while patches to the existing IMF and World Bank system were applied in a vain attempt to end these global trade and payments problems. The world lost a great opportunity in 1944 when the United States vetoed the Keynes Plan at Bretton Woods. Let us hope we do not squander this opportunity again.

When the 2009 Obama recovery plan took effect, whatever economic recovery that the American economy experienced again placed the United States as the engine of growth for China and many other less developed nations. It tend to aggravate the United States international payments imbalance problem as, after 2009, the United States began again to increase its imports by a greater amount than it's increasing volume of exports. If this result continues, then, under the existing international payments system, the result may be to create an atmosphere where many fear the status of the dollar as the most liquid safe harbor foreign reserve asset. Such fears can only roil global financial markets and plunge the global economy into further crisis and recession.

If this were to occur, it should be even more obvious that a reform of the international trade and payments system is necessary if we are not to further aggravate any global economic crisis.. Hopefully, the leaders of the major nations will recognize the need to adopt some form of the Keynes Plan such as the IMCU if the global economy is ever to reinstate prosperous times for all the nations on earth..

### **The Case For Capital Controls**

Since the future is uncertain, at any moment of time some event (ephemeral or not) may occur which can make residents of a nation feel more uncertain about the prospects of their economy. Under a system of free exchange markets, residents of the nation that fear the future can remove their savings from the domestic banking system and transfer them to another nation's banking and financial system where they believe the latter is a safe harbor to store their savings. The funds used in any attempt to find a safe haven in another nation is called "flight capital". If enough people try at the same time to move their funds from the domestic economy to this presumed safe harbor, the effect is similar to a run on a domestic bank that causes the bank to collapse.

In the case of bank runs, a policy of insuring deposits is usually sufficient to stopping bank runs. Unfortunately, a cascade of flight capital fund movements out of a nation to a safe harbor in another nation can not be stopped by merely insuring the deposits at domestic banks. Instead this flight of funds if large enough can bring about the collapse of the domestic economy, as more and more people stop buying domestically produced goods to increase their holdings of foreign liquid assets. This creates significant recessionary pressures on the domestic economy thereby making it more difficult for the government to undertake economic policies to stabilize the nation's economy and prevent it from falling into recession or depression.

Since under the IMCU proposal all movement of funds across borders must go through the nation's central bank deposit at the IMCU, any nation can, if it desires, monitor and stop any cross border financial fund movements by merely refusing to allow the cross border banking transactions to be processed though the central bank's deposit on the IMCU's books. In other words each nation can institute an effective policy to limit fund outflows from its country if, for any reason, the government deems it in the best interest of the nation's economy to prevent such fund outflows.

Thus, for example, if such a system was in place, the United States government could via a Security Exchange Commission ruling prohibit the creation of domestic financial asset markets—such as mortgage backed derivatives - that are organized by investment bankers but do not have a reliable market maker institution to insure orderliness and liquidity. Under this capital control provision, the American financial services industries would not have to fear loss of customers and profits to foreign financial services firms who do not follow SEC rules when the SEC prohibited certain financial market activities by American financial services firms. The flow of funds could

occur only if the foreign financial service firms agreed to all the SEC rules required of domestic financial service firms. Thus the playing field would be level.

Finally, all movements of funds gained from illegal activities, or funds being moved from a country to another nation in order to avoid the domestic country's tax collector, or funds raised in one country that is being funneled to other countries to finance international terrorist activities must also flow through the nation's central bank to the IMCU. Consequently, each nation has the facility, if it wishes to monitor and if necessary stop such cross border money flow transactions from occurring. Clearly this is an important aspect of the IMCU plan for it permits each nation to assure its citizens that others can not take advantage of the international trading system to avoid paying one's fair share of taxes, and to constrain the international financing of terrorist organizations, as well as to permit the government to undermine the profitability of any international illegal drug trade.

**APPENDIX: THE TECHNICAL REQUIREMENTS FOR CREATING AN IMCU TO REFORM THE INTERNATIONAL PAYMENTS SYSTEM**

There are seven major technical provisions in this IMCU system proposal. They are:

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

2. Each nation's central bank or, in the case of a common currency (e.g., the Euro) a currency union's central bank, is committed to guarantee one way convertibility from IMCU

deposits at the clearing union to its domestic money to be used for the purchase of goods and services provided by domestic producers . Each central bank will set its own rules regarding making available foreign monies (through IMCU clearing transactions) to its own bankers and private sector residents<sup>8</sup>.

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

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

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

Finally there can be many forms of monetary policy decisions undertaken to affect net international financial flows, e.g., raising the interest rate to slow capital outflows, raising bank reserve ratios, limiting the ability of banks to finance purchases of foreign securities, and regulating interbank activity. It has been argued that the 1997 East Asian currency contagion problem that almost brought down the global financial system was due to the interbank market that created the whirlpool of speculation. Mayer has stated that what was needed was “a system for identifying . . . and policing interbank lending”<sup>9</sup> including banks’ contingent liabilities resulting from dealing in derivatives. Recognizing the inability of economic models to correctly price risk in a nonergodic economic system, Mayer stated: “The mathematical models of price movements and covariance underlying the construction of these [contingent] liabilities simply collapsed as actual prices departed so far from ‘normal’ probabilities”<sup>10</sup>.

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

If any government objects to the idea that the IMCU proviso #2 provides governments with the ability to limit the free movement of "capital" funds, then this nation is free to join other nations of similar attitude in forming a currency union and thereby assuring a free flow of funds among the residents of the currency union.

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

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

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

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

6. A trigger mechanism to encourage any creditor nation to spend what is deemed (in advance) by agreement of the international community to be "excessive" credit balances accumulated by running current account surpluses. These excessive credits can be spent in three ways: (a) on the products of any other member of the clearing union, (b) on new direct foreign investment projects, and/or © to provide unilateral transfers (foreign aid) to deficit members.

Spending via (a) forces the surplus nation to make the adjustment directly by way of the trade balance on goods and services. Spending by way of © permits adjustment directly by the capital account balance, while (b) provides adjustment by the capital accounts (without setting up a contractual debt that will require reverse current account flows in the future).

In the unlikely event that the surplus nation does not spend or give away these credits within a specified time, then the clearing agency would confiscate (and redistribute to debtor members) the portion of credits deemed excessive<sup>11</sup>. This last resort confiscatory action (a 100% taxes on excessive liquidity holdings) would make a payments adjustment via unilateral transfer payments in the current accounts.

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

7. A system to stabilize the long-term purchasing power of the IMCU (in terms of each member nation's domestically produced market basket of goods) can be developed. This requires a system of fixed exchange rates between the local currency and the IMCU that changes only to reflect permanent increases in efficiency wages<sup>12</sup>. This assures each central bank that its holdings of IMCUs as the nation's foreign reserves will never lose purchasing power in terms of foreign

produced goods. If a foreign government permits wage-price inflation to occur within its borders, then, the exchange rate between the local currency and the IMCU will be devalued to reflect the inflation in the local money price of the domestic produced goods and services. For example, if this rate of domestic inflation was 5 cent, the exchange rate would change so that each unit of IMCU could purchase 5 per cent more of the nation's currency.

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

By devaluing the exchange rate between local monies and the IMCU to offset the rate of domestic inflation, the IMCU's purchasing power is stabilized and inflation in one nation can not be exported to another via the price of the first nation's exports.

By restricting use of IMCUs to Central Banks, private speculation regarding IMCUs as a hedge against inflation is avoided. Each nation's rate of inflation of the goods and services it produces is determined solely by (a) the local government's policy toward the level of domestic money wages and profit margins vis-a-vis productivity gains, i.e., the nation's efficiency wage. Each nation is therefore free to experiment with policies for stabilizing its efficiency wage to prevent inflation as long as these policies do not lead to a lack of global effective demand. Whether

the nation is successful or not in preventing domestic goods price inflation, the IMCU will never lose its international purchasing power in terms of any domestic money. Moreover, the IMCU has the promise of gaining in purchasing power over time, if productivity grows more than money wages and each nation is willing to share any reduction in real production costs with its trading partners.

Provision #7 produces a system designed to, at least, maintain the relative efficiency wage parities amongst nations. In such a system, the adjustability of nominal exchange rates will be primarily to offset changes in efficiency wages among trading partners. A beneficial effect that follows from this proviso is that it eliminates the possibility that a specific industry in any nation can be put at a competitive disadvantage (or secure a competitive advantage) against foreign producers solely because the nominal exchange rate changed independently of changes in efficiency wages and the real costs of production in each nation.

Consequently, nominal exchange rate variability can no longer create the problem of a loss of competitiveness due solely to the overvaluing of a currency as, for example, experienced by the industries in the American "rust belt" during the period 1982-85. Even if temporary, currency appreciation independent of changes in efficiency wages can have significant permanent real costs as domestic industries abandon export markets and lose domestic market business to foreign firms and the resultant existing excess plant and equipment is cast aside as too costly to maintain.

Proviso #7 also prevents any nation from engaging in a beggar-thy-neighbor, export-thy-unemployment policy by pursuing a real exchange rate devaluation that does not reflect changes in efficiency wages. Once the initial exchange rates are chosen and relative efficiency wages are locked in, reduction in real production costs which are associated with a relative decline in

efficiency wages is the main factor justifying an adjustment in the real exchange rate.

## ENDNOTES

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1. J. M. Keynes, The General Theory of Employment, interest and Money (London, Macmillan, 1936) pp. 338-339.

2. For technical reasons (known as when the Marshall-Lerner conditions are not applicable) that we need not discuss here, it is possible that even with a decline in the value of the United States dollar relative to the Chinese yuan, the value of the trade imbalance between China and the United States would not disappear and - in the worse case scenario- the trade imbalance between China and the United States could actually worsen. We will ignore this possible real world complication in the following discussion to illustrate other possible deleterious effects of this classical theory solution to trade imbalances where free markets are suppose always to solve any trade imbalance problem by devaluing the currency of the country experiencing an unfavorable balance of trade.

3.If money wages of American workers did not increase, then the result of this classical theory solution would be to lower the standard of living of the average American worker until it approached the standard of living of Chinese workers

4.And as endnote #2 indicates, mainstream economists assume away all possible economic problems.

5. J. M. Keynes, The Collected Writings of John Maynard Keynes, 25, edited by D. Moggridge, (Macmillan, London, 1980) p. 27.

6. Op. Cit., p. 176.

7. J. M. Keynes (1941), "Post War Currency Policy" printed in The Collected Writings of John Maynard Keynes, 25, edited by D. Moggridge (Macmillan, London, 1980) pp.21-22.

8. Correspondent banking will have to operate through the International Clearing Agency, with each central bank regulating the international relations and operations of its domestic banking firms.

Small scale smuggling of currency across borders, etc., can never be completely eliminated. But such movement's are merely a flea on a dog's back -- a minor, but not debilitating, irritation. If, however, most of the residents of a nation hold and use (in violation of legal tender laws) a foreign currency for domestic transactions and as a store of value, this is evidence of a lack of confidence in the government and its monetary authority. Unless confidence is restored, all attempts to restore economic prosperity will fail.

9. M. Mayer, "The Asian Disease: Plausible Diagnoses, Possible Remedies", Levy Institute Public Policy Brief No. 44, 1998, pp. 29-30.

10. Ibid, p.31.

11. Whatever "excessive" credit balances that are redistributed shall be apportioned among the debtor nations (perhaps based on a formula which is inversely related to each debtor's per capita

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income and directly related to the size of its international debt) to be used to reduce debit balances at the clearing union.

12. The efficiency wage is related to the money wage divided by the average product of labor; it is the unit labor cost modified by the profit mark-up in domestic money terms of domestically produced GNP. At the preliminary stage of this proposal, it would serve no useful purpose to decide whether the domestic market basket should include both tradeable and non-tradeable goods and services. (With the growth of tourism more and more nontradeable goods become potentially tradeable.) I personally prefer the wider concept of the domestic market basket, but it is not obvious that any essential principle is lost if a tradeable only concept is used, or if some nations use the wider concept while others the narrower one.