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Can Reform of the International Financial Architecture Support Emerging Markets?

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The developed world's policy response to the recent financial crisis has produced complaints from Brazil of "currency wars" and calls from India for increased policy coordination and cooperation. Chinese officials have echoed the "exorbitant privilege" noted by de Gaulle in the 1960s, and Russia has joined China as a proponent of replacing the dollar with Special Drawing Rights. However, none of the proposed remedies are adequate to achieve the emerging market economies' objective of joining the ranks of industrialized, developed countries.

There is little historical evidence that policy coordination is in any way beneficial to the stability of the international system. Monetary policy coordination to ease the return of the pound sterling to the gold standard in the 1920s is widely believed to have created the stock market bubble and collapse that precipitated the Great Depression. Similar attempts led to the equity and property bubble in Japan that collapsed at the end of 1989, which produced a 25-year-long stagnation and the zero interest rate policies now lamented by emerging market economies.

Robert Triffin exposed the problems of using a national currency as the international reserve currency in place of gold. But John Maynard Keynes had earlier noted that such problems would be inherent in any independent international standard that "throws the main burden of adjustment on the country which is in the *debtor* position on the international balance of payments" (Keynes 1980, 27). Since, as Keynes observed, "the main effect of [any international standard] is to secure *uniformity* of movement in different countries—everyone must conform to the average behaviour of everyone else[—] . . . it hampers each central bank in tackling its own national problems" (Keynes 1971, 255–56). "It is, therefore, a serious question," he concluded, "whether it is right to adopt an international standard, which will allow an extreme mobility and sensitiveness of foreign lending, whilst the remaining elements of the economic complex remain exceedingly rigid" (1971, 300).

Keynes's proposal for the postwar international system sought to remedy the same problems currently facing emerging market economies. It was based on the simple idea that financial stability was predicated on a balance between imports and exports over time, with any divergence from balance providing automatic financing of the debit countries by the creditor countries via a global clearinghouse or settlement system for trade and payments on current account. This eliminated national currency payments for imports and exports; countries received credits or debits in a notional unit of account fixed to national currency. Since the unit of account could not be traded, bought, or sold, it would not be an international reserve currency. The implication was that there would be no need for a market for "foreign" currency or reserve balances, and thus no impact of volatile exchange rates on relative prices of international goods, or tradable and nontradable goods. Moreover, since the credits with the clearinghouse could only be used to offset debits by buying imports, and if not used for this purpose they would eventually be extinguished, the burden of adjustment was shared equally—credit generated by surpluses had to be used to buy imports from the countries with debit balances. Alternatively, they could be used to purchase foreign assets—foreign direct or portfolio investment—but the size of these purchases would be strictly limited by the size of the surplus country's credit balance with the clearinghouse. Once an agreed-upon limit for each country on the size of multilateral debits and credits was reached, penalties, in the form of interest charges, exchange rate adjustment, forfeiture, or exclusion from clearing, would be applied and the outstanding balances reduced. Interest charges on the credit and debit balances generated could be provided as additional credits to support the clearing accounts of developing (or as Keynes put it, "backward") countries (1980, 120).

Keynes's clearing union provides a blueprint that could meaningfully improve current emerging market proposals for regionally governed financial institutions. The creation of regional clearing unions with a notional unit of account could better address these countries' development needs while providing an alternative to the prevailing US-dominated institutions. This may represent a radical break from the current system, but it should not be forgotten that a regional clearing union has been established before, and with great success: in the aftermath of World War II, the European Payments Union was created as a complement to the Marshall Plan, and played an integral part in restoring multilateral trade and payments in Europe.

A more detailed discussion of the issues can be found at http://www.levyinstitute.org/publications/emerging-market-economies-and-reform-of-the-international-financial-architecture-back-to-the-future.

References

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