Debtor nations need a financial system that allows them to work their way to prosperity

Paul DavidsonMonday December 1, 2003The Guardian

The global economy is at a crossroads. We can try to muddle through with the existing defective international financial system, while hoping that minor tinkering will quarantine the devastating depressionary forces experienced by developing nations and avoid contagion spilling over to developed nations. Or we can produce a new financial architecture that not only protects all nations from experiencing the devastation of currency crises but also eliminates the persistent global depressionary pressures of the current system and therefore makes possible the potential of global full employment.

All prudent nations (except the United States) desire a surplus of exports over imports to obtain a net positive financial savings position on their internationally earned income. This surplus is added to the nation's foreign reserves. Since the global economy is on a dollar standard, additions to a nation's foreign reserves are held primarily in the form of US treasuries.

The effect of all nations attempting to accumulate foreign reserves is to create persistent high rates of unemployment, and liquidity problems for the global economy - and this is true whether the global economy is on either a fixed or a flexible exchange rate system. In essence, when any nation runs persistent export surpluses to accumulate foreign reserves, it is playing a game of Old Maid and passing the Black Queen of unemployment and indebtedness to its trading partners.

Any nation stuck with the Black Queen must use a combination of previously saved foreign reserves and/or additional international loans to pay for their current excess of imports and service existing international debts. As foreign reserves dwindle and international indebtedness increases, a deficit nation finds it increasingly difficult, if not impossible, to service its outstanding international debt obligations.

To prevent default, the International Monetary Fund can make new loans to the indebted nation allowing it to meet current obligations by increasing future debt service obligations.

These IMF loans require deficit nations to adopt "Washington Consensus" reforms where (1) all domestic financial, labour and product markets must be freed of institutional rigidities (including a government social safety net), and (2) the nation must tighten its belt, by running a primary fiscal surplus and high interest monetary policies.

Belt tightening depresses the nation's economy, forcing impoverished residents to reduce their purchases of all goods and services including imports. Belt tightening also tends to depress the export industries of its trading partners, creating unemployment abroad.

Any decline in the deficit nation's exchange rate encourages domestic residents and foreign investors to move their funds to a safe haven in another country. Almost inevitably, the indebted nation cannot free itself from the increasing weight of its hard currency international debts except by default. The result is a moribund economy, for example, Argentina in 2002.

The main failure of the international financial system is its inability to foster continuous global expansion.

The main burden of adjustment to an export-import imbalance is always on the deficit nation.

Nevertheless because the major trading nations have accepted a dollar standard, the US can print dollars with abandon and avoid this burden.

Since the 1980s the US has happily neglected its huge annual import surpluses, which creates as much as $500bn (££290bn) in demand for the export industries of its trading partners.

America's benign neglect of its annual import surplus has prevented the global economy collapsing into a great depression. Can the rest of the world rely on the world's greatest debtor to continue to promote demand for other nation's export industries?

If the global economy abandons the dollar and adopts a euro standard, global aggregate demand would fall by more than $500bn. The US could no longer avoid reducing its import demand to a level of export earnings as creditor nations no longer extend credit by adding additional US treasuries to their foreign reserves.

The cure lies in creating new international financial architecture, as President Clinton called for after the 1998 Russian debt default.

A big financial architectural change will require developing a system where the creditor nations accept a large share of the responsibility for making adjustments by spending their excessive reserve holdings on imports or direct foreign in vestment. This will allow the debtor nations to sell more abroad and thereby work their way out of their debtor position.

In my recent book, Financial Markets, Money and the Real World, I have proposed the creation an international clearing union that is designed (1) to prevent a lack of global effective demand due to nations oversaving liquid foreign reserves (2) to induce the surplus nation to contribute to resolving the import-export imbalance, since the surplus nation has the economic wherewithal and is in the better economic position and [3] to encourage debtor nations to work their way out of debt rather than await handouts or bailouts, or to default on their international obligations.

Some think that this clearing union plan, like Keynes's bancor plan a half century earlier, is utopian.

But if we start with the defeatist attitude that it is too difficult to change the awkward system in which we are trapped, then no progress will be made.

The health of the world's economic system will simply not permit us to muddle through.

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