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Towards a New Bretton Woods

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Introduction

The global economic and financial crisis, which started in August 2007 as disturbances on the American market of subprime loans and trickled down other markets and regions of the world, is probably not the last slump in the global economic activity. Apart from scale and persistence, it is exceptional in that it appeared after more than a decade of unprecedented growth of the global economy and its diverse components, threatening further existence of international cooperation and payments. A side effect of the global financial and economic crisis is shock and confusion on the ideological level, as it turned out that the neoliberal socio-economic doctrine based on the so-called Washington Consensus[2], prevalent since the times of Ronald Reagan and Margaret Thatcher is neither intellectually nor practically capable of facing the challenges of the overwhelming crisis. Indeed, it proved that the liberalisation of international finances does not necessarily reduce the need for clear, obligatorily observed rules and regulations governing activities on financial markets. One of the main causes of the ongoing crisis is undoubtedly the failure of countries and their organisations to ensure conditions of safe and efficient financial flow on the global scale as well as in individual countries. Lack of appropriate regulation and supervision over international financial operations can to some extent justify that in a dynamically diversifying group of countries conservative approaches were dominant ones, and focused mainly on the protection of their own vested interests.

The crisis, which has lasted for over a year and a half, painfully revealed lack of adaptation of the current financial architecture to contemporary requirements, in

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[2] Grzegorz W. Ko³odko offers a description and apt critique of the Washington Consensus, particularly in terms of post-socialist countries, in his book "Wêdruj¹cy œwiat" ["World on the Move"] Prószyñski i S-ka, Warsaw 2008, pp. 209-31.

particular the weakness of the mechanism for preventing liquidity problems or the insolvency of key players on the international market. Since the 1970s, when Bretton Woods system (called Bretton Woods I in relevant literature) collapsed, international finances have undergone a fundamental evolution, especially in functional and instrumental aspects. All these changes were far too inadequately reflected in the organisation and operation of the world's financial organisations established after World War II. These organisations urgently need a profound reform, for their ossification and non-representativeness to a large extent contributed to the outbreak of the current crisis.

Despite the unquestionable growth after 1971, there was no development of a new, consistent set of principles governing global finances. Partly based on inertia and not always conscious continuation, partly due to market forces, an inconsistent monetary and financial system emerged, which might rightly be called Bretton Woods Mark II[3]. The unique features of this not yet completely developed system largely contributed to the outbreak of the current financial and economic crisis, which in the fourth quarter of 2008 seriously infected production and exchange processes in leading countries of the world, and spread in the subsequent months to other countries [4]. In order to understand how such disorders may have arisen, let us briefly recall the rules behind the original Bretton Woods system. Consider how these rules were modified following 1971 and what it meant for the global economy and its components at the turn of the 20th century.

The post-war currency order lasting until 1971 was established by agreement of sovereign countries concluded in summer 1944[5] after almost two years of essential preparation. On the intellectual level, it stemmed from critical remarks on the interwar period, particularly the trauma of the Great Depression of 1929-1933. On

[3] Of course there is a temptation to call what emerged from the ruins of Bretton Woods I and lasts in the global finances today as Brenton Woods II, but considering transient nature of the accepted solutions and practically unchanged institutional system of international financial relations, Bretton Woods Mk II seems more appropriate.

[4] Curiously enough, the dominant globalisation doctrine made even expert circles believe that there would be no escalation of the crisis from the financial domain to the domain of the real economy and that the 'emerging markets' along with the eurozone states are immunized against American crisis (the so-called decoupling hypothesis).

[5] There were 44 signatories of the agreement: united nations fighting the 'Axis' countries and willing to build an effective mechanism of international cooperation.

political level, it reflected a new order on international arena which had been shaped as a result of World War II – a growing hegemony (primarily economic, political and military) of the United States and (especially) financial, political, military and even cultural degradation of Europe destroyed in the war, led by officially victorious Great Britain. The solutions accepted in that agreement were strongly based on compromise and at the same time their nature was makeshift, which harboured the germs of the future crisis and the collapse of the system. Nonetheless, the Bretton Woods agreement, successively joined by other countries, for almost a quarter of the century guaranteed the stability of currency rates and led to a gradual increase of their convertibility, thus creating grounds for rapid development of international trade and social prosperity. It was also a good example of relative effectiveness of international cooperation in a globally important financial and monetary domain.

International liquidity within the Bretton Woods I system.

From a purely technical point of view, Bretton Woods I was an international gold-currency exchange standard. Currency parities of the members of the International Monetary Fund (IMF), world's surrogate central bank, were specified in gold or in US dollars, convertible into gold in operations between central banks. Adjustments of monetary parities could only be made in the case of a fundamental disequilibrium of payment balance (which never has never been precisely defined)[6]. Due to lack of convertibility, or limited convertibility, of the currencies of most IMF member countries there was a sharp discrepancy between a rather orderly, gold-related circulation of international money, and the internal circulation of paper money, shaped quite freely in individual countries by domestic economic authorities. In other words, the need to stabilize the global monetary system was in contradiction with the priorities of sovereign economic policies, mainly with domestic monetary policies. Such contradiction is best proved by Great Britain's constantly recurring difficulties in maintaining internal and external economic balance throughout the post-war period.

[6] Changes of over 10% required consultation with the Fund's authorities.

Until the early 1970s, members of IMF were bound by the fixed rate rule, i.e. market rates of their currencies were allowed to fluctuate within a narrow bracket of +/-1% of the parity exchange rate. If the lower of upper limit was reached, national monetary authorities were obliged to intervene on the currency market, according to the notified range. Foreign exchange reserves of central banks included mainly monetary gold and increasingly the US dollar, which became the reserve currency of the system, used for equalling payment deficit. The fact that from 1934 the dollar was convertible into gold at the rate of $35 per troy ounce favoured the tendency for most central banks to locate their foreign exchange reserves in the dollar.

The dollar, as a key and fully convertible global currency, played a very important transactional role. It was backed by the reinforced American economy, a large supplier of consumer and investment goods for countries of Europe and Asia, which were picking up the pieces after the war. Little wonder that in the view of high demand for the American currency, several years immediately following the war are often referred to as the dollar gap. The shortage of dollars in the US's international circulation was counteracted by increasing returnable and non-returnable financial aid (e.g. as part of the Marshall Plan), military expenditure abroad and the export of capital. This situation lasted until the end of the 1950s, when, along with the completion of the post-war reconstruction of Western Europe and Japan, American exporters on the global market were faced by dangerous competitors from such countries as West Germany, the Netherlands, Sweden or Japan. These competitors had accumulated larger and larger dollar reserves due to growing trade surplus and started using various limits for the inflow of American capital.

In the 1960s, internal expenditure of the United States, mainly of military character, connected with the Vietnam war sky-rocketed, and the American demand for import grew sharply because of the expansive internal outlay policy. The administration attempted to halt the increasing lack of external balance by hindering the outflow of capital from the US (e.g. by introducing Regulation Q). From 1966 onwards, it became apparent that the USD reserves in foreign central banks were increasingly exceeding the value of monetary gold accumulated at Fort Knox, thus undermining the credibility and stability of the Bretton Woods system based on the link between gold and the US dollar. In this way, the second half of the 60s saw the vivid reappearance of the international liquidity problem[7]. This time it was caused by the surplus of the dollar in international circulation (the dollar glut) and was euphemistically dubbed ‘the dollar crisis.’ It was accompanied by a long-term depreciative trend in the American currency, lasting de facto until 2008. All this time the world deluded itself thinking that the United States of America will restore equilibrium in its payment balance, although this was not America’s economic or political interest in the long run.

As defined by prof. Stanisław Rączkowski[8], international liquidity is widely understood as sufficiency of world’s foreign exchange reserves for settling payment balances of all countries. By currency-gold standard, i.e. in a fixed rate system, with a fixed price of gold in dollars, a rapid growth of payment flow resulting from the acceleration of development processes on both global and national scale had to hit a wall of insufficient foreign exchange reserves composed of gold and US dollars. The production of the former rose too slowly, while increasing the supply of the latter involved the necessity to maintain growing and persistent payment deficits by the United States of America. The last solution was impossible to follow in the long run. On the one hand, it necessitated the approval of the countries with surplus to finance the soaring US deficit, on the other it carried the threat of a total depletion of the American gold reserves, and the resulting breakdown of the dollar-gold connection. Furthermore, any attempts at limiting or even eliminating the lack of proper payment balance of the US would mean that the rest of the world would be deprived of essential liquidity. The self-destructive mechanism outlined above, called the Triffin’s dilemma[9], was ingrained in the Bretton Woods system and sooner or later had to lead to its collapse. Serious symptoms of the system's crisis appeared already in the second half of the 60s as actual limitation of dollar’s convertibility into gold in transactions between central banks and the rise of a parallel private gold market with prices gradually departing from the official price of USD 35 per ounce.

There were attempts to counteract the international liquidity crisis by going back to the idea of creating an ‘artificial' international currency as a special ‘surrogate’ of gold[10]. Under the first amendment to the statute, which became effective in 1969, the International Monetary Fund started issuing its own currency – Special Drawing Rights (SDR). However, due to the obstructive policy of the United States, the volume of the issuance of SDRs was considerably limited and it would not significantly increase international liquidity even to this day.

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[7] This issue is discussed in a convincing way by George Cooper in *The Origin of Financial Crises*. Central banks, credit bubbles and the efficient market fallacy”, Harriman House, Petersfield 2008, pp. 65-9. Cf. also E. Caves, J. A. Frankel, R. W. Jones *World Trade and Finance*, HarperCollins 1997, pp. 507-8.

[8] See S. Rączkowski ”Międzynarodowe stosunki finansowe”, PWE, Warsaw 1984, p. 273.

[9] Cf. R. Triffin “Gold and Dollar Crisis”, Yale University Press, New Haven 1960.

[10] Note that J.M. Keynes, a representative of Great Britain was an ardent supporter of supporting the post-war monetary order on such currency during preparation for the Bretton Woods conference. He saw dangers of recognizing dollar’s absolute domination in international finances. Sadly, his idea of bankor was defeated with the plan of a US representative, H. D. White.

It is generally accepted that the terms of the Smithsonian Agreement of late 1971 concerning changes of exchange rate parities of leading currencies of the world and the extension of the range of permissible deviations from the parity (central) rate to +/-2.25% put an end to the Bretton Woods I system. Actually, entreaties to maintain a fixed-rate system lasted for more than ten subsequent months. There was even a long-lived conviction that exchange rates should still be based on fixed, but adjustable exchange rates. This was the stance of the Twenty Committee, appointed to suggest a reform of the failing system). However, in March 1973 the system underwent a definitive collapse together with the announcement of the second devaluation of the dollar. The scale of changes introduced under pressure of the escalating crisis was definitely too small to restore the convertibility of the dollar into gold. Instead, leading countries of the developed world one by one started to float their currencies, replacing the currency-gold standard with a multi-currency monetary standard. A process of gradual demonetization of gold began. Gold became a normal good, one of many metals in circulation. Money, not only in internal circulation of individual countries, but also in the international circulation became fiat currency, creating possibilities of unrestrained monetary expansion, exacerbation of inflation processes, increased rate variation and currency speculation, and thus to financial slumps and crises[11]. Although the gold market was made uniform in 1974 by introducing a single, free-market price of this metal, but there have been no attempts to reinstate the relationship between the volume of issued money and gold supply. Because of the clearly augmented global inflation throughout the 70s the price of gold in dollars rose twenty times.

Transient nature of Bretton Woods Mk II

The finale of the changes in the global monetary system in the 70s was the second amendment to the statute of the IMF, which became effective on April 1, 1978. It concerned the replacement of monetary gold with SDRs in the operations of the Fund

[11] Such cause-and-effect relation is stressed by George Cooper in the book previously referred to, disposing of a hypothesis of an effective, self-regulating financial market.

and introduced significant changes in the rate system, which involved the abolishing of the gold parity and enforcement of flexible exchange rates. Abolishing a single system of fixed currency rates for all IMF member countries was particularly eventful. Instead, a peculiar hybrid of floating (flexible) and fixed rates was created. The former have been preferred by developed countries[12], which perceive them as automatic regulators of their payment balance. The latter have been used by developing countries, especially those which based their development strategy on expanding export. In their situation, linking their currency with that of the main trading partner (usually the United States as the biggest importing market globally) by means of a fixed rate was supposed to ensure pricing competitiveness of the export and the progress of the national processing industry, including industrialisation. Such policy invariably leads to accumulating increasing amounts of foreign exchange reserves resulting from trade surplus.

Interestingly enough, in the amended statute of the Fund there is no possibility of full propagation of the floating exchange system, although a comeback to a single system of fixed currency rates is not excluded. Still, the rates would no longer be based on the gold parity. Such approach creates considerable opportunities for a broader use of SDRs, which in time would be a basis for global foreign exchange rates. The fact that this has not happened has to be blamed on the egoism of major players of the contemporary finances (mostly the US), but also attributed to qualitative changes which took place within the past 30 years.

First of all, fundamental transformations which have occurred in the institutional structure of international financial relations. Due to the rapidly progressing internationalisation (globalisation) and liberalisation of circulation, numerous private financial and non-financial institutions have appeared on the global arena, including international corporations whose capitals were frequently greater than those of small, but also middle-sized countries. In the light of the turbulent growth of markets there was an overall fall in the significance of international economic organisations in the

[12] An exception to this were countries forming the European Monetary System (EMS), which tried to stabilize exchange relations among their respective currencies to support the development of mutual trade as part of the European integration process.

financial circulation of countries and their groups[13] with a simultaneous increase of demand for their regulatory functions in terms of circulation efficiency and security. (The development of European integration process is the best example.)

A characteristic feature of the entire period following 1971 was a noticeable increase in the number of financial instruments in circulation (and a rise in their volatility) on most markets, which stemmed both from economic and systemic factors. The latter were directly linked to the conversion into fiat money both on the global and national scale, as well as the propagation of convertibility of currencies globally, with domination of flexible currency rates in developed countries. This was conducive to numerous financial innovations, especially the advent of derivatives, used for large-scale arbitration operations, hedging and speculative instruments. A widespread use of sometimes sophisticated financial engineering, including the increasingly overused debt securitization technique, leading to the dispersion of the associated risk, gave an illusory impression that transactions on derivative instruments were safe, which abruptly contributed to the increase of their volume.

A mechanism typical of the 1992-2007 period whereby large cash and capital surpluses appeared in some countries and entire regions, with the investment processes in the real world lagging behind the existing possibilities of financing them caused the continuous, overall excess liquidity in the global financial system. It was responsible for generally too low interest rates of financial instruments and a strong growth trend of prices of different assets, particularly for rapidly growing prices of real property practically on all markets during that period. With excess liquidity of financial markets and the diffused responsibility for the risk, it was fairly easy for a peculiar virtualisation of the financial world to happen, i.e. the separation of financial circulation from processes going on in real economy, which in fact involved a noticeable rise of the risk related to international financial operations. At the same time, the prosperous economic situation of the last decade and the associated decrease in the number, duration and gravity of financial disruptions led us to believe that the countries of the world had become less susceptible to various types of slumps and

[13] Some special exceptions include some integration associations (primarily the European Communities, the Paris Club or WTO/GATT).

even crises. Hence the popular astonishment of the international community at the scale and persistence of the current crisis.

In the 70s, the emergence of oil countries with their stock of petrodollars, which until then had been located mostly on the American market, was a very important event for the financial circulation of the last four decades. In the 80s, in conditions of international debt crisis, a conflict became sharply visible between the rich 'North', developed countries – creditors, and the poor 'South' – indebted developing countries. The conflict proved a difficult test of the efficiency and effectiveness of the IMF by the so-called stabilization and adaptation programmes. Since the beginning of the 90s, we have seen an accelerated development of 'emerging market' countries, which after the Asian crisis became real financial powers.

A basic drawback of the Bretton Woods system, that the currency of one country (the US dollar) was the main component of foreign exchange reserves of other countries and that increasing these reserves was possible only then the US reported payment deficit[14], was not definitely dealt with in the Bretton Woods Mk II, which was the decisive factor in its susceptibility to shock and its eventual transience. This particular weakness has been modified at least twice, which allowed the system to function for almost forty years.

Firstly, the role of the international reference currency, apart from the US dollar, was taken in the 70s, 80s and 90s by the German mark and the Japanese yen and, to a lesser extent, the British pound, French franc, Swiss franc and Dutch gulden[15]. This meant the crystallization of a multiple currency monetary system and was related to the liberalisation of currency circulation on the global scale, i.e. its globalisation (internationalisation). Remember that the US dollar has been the key currency of the world. The market of the dollar and assets contained within it is one of the biggest international markets in terms of the capitalisation of value and turnover. Considerable foreign exchange reserves are still kept in dollars (especially in Asian

[14] It was tantamount to these countries granting a loan the United States of America. Cf. S. Rączkowski "Międzynarodowe stosunki (…)", op. cit., pp. 277-8.

[15] Note, on the one hand, the minimum share in the global foreign exchange reserves of IMF's artificial currency – the SDR – and one the other hand, even several times higher share of the unofficial currency of the European Monetary System (1979-1998) – the ECU in the 90s.

countries)[16], it is also widely used to carry out international trade transactions and quote prices of important minerals and plants. At least for these reasons the United States bears the greatest responsibility for the condition of international finances, perhaps even more – the duty to reform them.

A part of the European monetary integration plan and the dollar's strongest competitor to the role of the world's most important currency, the uniform European currency euro appeared, with a comparable potential of integrating economy backing it[17]. Currently, almost 25% of global foreign exchange reserves is stored in euro. At the end of 2007, almost half of bonds in international circulation was denominated in the common European currency[18]. The euro is a more and more frequently use currency in international trade transactions. All of this gives the integrating Europe the right to call for a reform of the world's financial order on the international forum; a reform which would stabilize the conditions of trade and investment cooperation.

Secondly, the geographical characteristics of net capital flow on international markets have changed considerably. As a result of the oil crises of the 1970s, the group of countries reporting structural surplus such as Germany, Japan, Switzerland of the Netherlands was permanently joined by large producers and exporters of hydrocarbon fuels. Their joint foreign exchange surplus allowed them to finance not only American or British deficits, but also ambitious investment programmes of developing countries, both in the 70s and 90s. Speaking of the latter, both decades saw over-investment and the foreign debt trap – the international debt crisis of the 80s

[16] On a global scale, still around 2/3 of official foreign exchange reserves is kept in US dollars. According to International Financial Statistics, IMF, February 2009, pp. 33-34, world's foreign exchange reserves amounted to 4.049 bn SDR, as of the end of 2007, 967 bn of which was owned by continental China, i.e. 29%, 600 bn by Japan, i.e. 15%, 295 bn by Russia, i.e. 7%. In 2008 foreign exchange reserves calculated in SDRs increased globally by 12%, by as much as around 30% for continental China and 8.6% for Japan; in Russia they fell by approx. 7%.

[17] In this context, the development of the exchange rate of the euro to the dollar looks interesting. During the first three years of the European currency a strong appreciation of the dollar against the euro by over 25% occurred. From 2002, there was progressing depreciation of the dollar's exchange rate, which in the second half of 2007 and early 2008 significantly accelerated. On April 22, 2008 the European currency rate reached a historical maximum of 1.6 USD, only to fall by over 30 cents towards the end of January 2009 in the face of exacerbating crisis.

[18] Cf. A. Y. Kester "Euro Holdings Rise in Emerging Markets", IMF Survey Magazine, September 12, 2007. For the future of the euro as an international currency, see M. Chinn, J. Frankel "The Euro May Over the Next 15 Years Surpass the dollar as Leading International Currency", a paper for paper National Bank of Poland's conference *Common Currency and Its Future*: *Lessons for the New Member States*, October 2008, Warsaw.

and the Asian financial and economic crisis of 1997-8. The outcome of negative experience of developing countries, particularly from the circle of the so-called emerging markets, with the use of external financing, was their choice of the export-led development (the Japanese model), which in the last few years caused emerging markets to achieve large trade surpluses. The fact that such surpluses were maintained by the latter, and in addition by oil countries, has recently been overused by developed countries in their attempts to explain the causes of the current crisis.

It is argued that the excesses in the field of Western Europe and America's banking and finances and to the rise of deficit in structural budgets and current accounts in some economies of the developed world, primarily in America, were further fuelled by the accumulation of large foreign exchange reserves by developing countries, which in turn led to excess liquidity in the international circulation and too easy debt financing on the global scale. An abrupt growth of credit consumption in developed countries is allegedly attributed to the flooding of markets with cheap goods exported by developing countries, especially the 'emerging markets', whose excessive competitiveness is claimed to be based mainly on dishonest manufacturing and trade practices, including the continual lowering of their currency rates[19]. Although there might be a grain of truth that both internal and external deficits are easily achieved when there are no problems with their financing, it is hard to blame developing countries for the success of their expanding export[20]. First of all, export-led growth has proved in the last 25 years a very efficient development strategy, allowing many countries to survive their economic and civilization backwardness. It was a carbon copy of the earlier practices of countries today regarded as developed, which not only failed to condone such course of action but frequently encouraged it. Secondly, an reverse relation can be proved: it was the loose monetary and fiscal policy of the leading developed countries that made the way for the expanding export of developing ones. What is more, high pricing competitiveness of such export in the last decade saved the world form the escalation of inflation-related phenomena. It

[19] Cf. "When a flow becomes a flood", The Economist, January 24th-30th 2009, pp. 70-72.

[20] In the current situation of the global crisis, manifested e.g. by a general fall in external demand, a strong dependence of economic growth of on export may backfire on these countries. With regard to this issue, see "Asia's suffering" and "Troubled tigers", The Economist, January 31st-February 6th 2009.

may be also argued that the policy of export-led growth and accumulating large foreign exchange reserves by developing countries was their response to insufficiency of multilateral monetary and financial cooperation and an increasingly striking inadequacy of its main coordinator, the International Monetary Fund, since the early 1970s.

Trade surplus of oil countries and ‘emerging markets’ accumulated in substantial foreign exchange reserves are a powerful argument in favour of increasing their role in shaping the world’s financial order. This is especially true of the People’s Republic of China, whose foreign exchange reserves in excess of 2 trillion USD at the end of 2008 already allow them to achieve full convertibility of the renminbi and make it a serious competitor of the dollar and the euro as an international currency.

Only some countries are privileged to issue international currency[21]. They have a sufficiently strong and efficient (competitive) economy, a well-developed financial and banking system with globally recognised finance centres and display significant involvement in the global financial and capital flow. In order not to lose this privilege, issuers of international currency must follow a responsible and balanced economic policy, focusing not only on growth, but mainly on maintaining internal and external balance, which entails specific management efforts and costs. Such efforts and expenses are, however, worthwhile, since they give measurable benefits in the form of seigniorage and the possibility of maintaining relatively small foreign exchange reserves[22]. It is quite important it alleviates or even suspends the strict budget limit which in the case of market (capitalist) model should be binding upon all economic entities. As regards the latter, bear in mind that issuing an international currency quite easily gives rise to a temptation to abuse, a peculiar moral gambling. It involves living beyond one’s means (on credit) at the expense of other partners in

[21] These should be considered together with the IMF, which as a universal financial organisation obtained this privilege in early 1970s thanks to the consensus of its members confirmed by the approval of the first amendment to IMF statute.

[22] See A. Dorosz’s paper ”Participation in seigniorage from issuing international currency” for the Eight Conference of Public Affairs “Polska w Europie jutra” [”Poland in tomorrow’s Europe”], the Warsaw Academy of Finance, October 2008. According to International Financial Statistics, IMF, February 2009, p. 33, at the end of 2008 foreign exchange reserves calculated in SDRs were only 32.2 bn in the case of the US, 131.1 bn for the eurozone (including the CEB) and 27 bn for Great Britain, while Japan reported 651.6 bn. The latter, despite its impressive amount, were only a half of continental China’s foreign exchange reserves.

international economic cooperation, i.e. a tendency to incur excessive expenses in relation to income,which appears among the issuing country's economic entities: households, businesses, financial institutions and state treasury This phenomenon can largely be used to explain the continual high budget and current account deficits of such countries as the United States or the United Kingdom and their escalation in the last quarters among an increasing number of the European Economic and Monetary Union – the collective issuer of the euro[23].

In the current decade, the progress of the liberalisation and globalisation of monetary circulation, in particular the financial and capital flow, facilitate the financial flow not really from rich to poor countries, but from surplus-affected Third World countries to the deeply deficient United States of America and other developed, mainly European countries. Lucas's paradox, a situation typical of the last decade, in which a deep budgetary and payment balance deficit of the world's wealthiest economy, the US, and deficits in such countries as Spain, the UK, Australia, Italy and Greece are increasingly financed by much poorer countries of 'emerging markets'. The former became globally the biggest importer of capital, with the US alone accounting for half of the imported capital. For instance, in 2007 the ranking of biggest net importers of capital was headed by the US with almost half of world's imported capital (49.2%), followed by Spain (9.8%), Great Britain (8%), Australia (3.8%), Italy (3.5%) and Greece (3%). Net exporters of capital include China with as much as 21.3% of the overall outgoing capital, followed by Germany (14.5%), Japan (12.1%), Saudi Arabia (5.5%), Russia (4.4%), Switzerland (4.1%), Norway (3.4%) and the Netherlands (3%)[24].

Due to the escalation of the global financial crisis in the second half of the year 2008, there was a rapid increase of the US's share in the global net capital import. Financing the dramatically increasing deficit of the US has been strikingly unproblematic to date, which is facilitated by herd instinct of investors looking for a

[23] During the current crisis in the eurozone, we can see a growing diversification of budgetary and payment situation of individual member states. This tendency is a serious threat to the permanence of the European Economic and Monetary Union and the future of the uniform European currency, mainly due to the weakness of instruments and mechanisms regulating independent fiscal policies of its members.

[24] Cf. Global Financial Stability Report. Financial Stress and Deleveraging. Macro-financial Implications and Policy, October 2008, IMF, Washington, D.C., p.160. See also M. Wolf "Global imbalances threaten the survival of liberal trade", Financial Times, Dec. 3, 2008.

safe haven for their capital. However, an increased demand for American assets sooner or later will be satiated. The soaring foreign debt of the US may lead their external partners – quite understandably – to limit the dollar exposure, which may result in another fall in the rate and international position of the dollar. It is the interest of the US to gradually strive for the situation where, on the one hand, the internal demand will grow much less slowly than its GDP, and, on the other hand, the surplus-affected countries will demonstrate a reverse trend.

Looking for a new global financial and monetary order

The above discussed was intended to prove that in the international finance system developed after World War II there has so far been no effective way of preventing external (payment) imbalance on the level of a nation, group of nations or a region. Lack of an effective, widely accepted mechanism for preventing payment imbalance, and if the need be, equalisation of payment balance of various countries, has repeatedly been the underlying cause of periodical financial disruptions, shocks and crises, generally having a negative impact on the real domain of their economies. This is particularly noticeable in the fiat money system, which has been in effect since the early 70 and which does not guarantee a reliable mechanism forcing economic entities to balance the incurred expenses against the income in the long, but – first and foremost – in the short run. For this reason, with lack of sufficiently strong financial braking system, there are structurally deficient or surplus-affected countries constantly appearing within the framework of international financial relations. What is worse, it is the fundamental cause of the escalation of the global imbalance of payments. In the recent years, the amplitude of this imbalance has been increasing dangerously, giving rise to the current crisis. This inevitably raises questions as to the permanence of the entire global payment system and its future.

To overcome today's acute condition of the global lack of balance of payments within a short period, we need a sufficiently large supply of the world's payment system in funds and their appropriate distribution. An important problem appears here, namely the crowding out of weaker economies from access to funds by more powerful ones, particularly issuers of international currency[25]. This is demonstrated on the one hand by a significant rise in the cost of debt, which is sharply visible in the case of countries with lower credit rating, on the other – by physical lack of freely available funds on financial markets.

In the long term, a fundamental issue is not only ensuring international liquidity itself, but also developing a financial and monetary mechanism which would not allow the reappearance of excessive payment deficit or surplus on a global scale. The above consideration, coupled with an analysis of the global financial flow of the last several years, forces us to re-think the very problem of international liquidity. Current practical experience seems to dictate that international liquidity must not be linked with deficits of payment balance of the strongest participants in such flow, nor with limited resources of gold or other raw materials.

Theoretically, it is possible to search for partial solutions of improving the world's balance of payments by stabilising exchange relations of the most important currencies in international circulation or regional monetary integration. In practice, attempts at coordinating currency policy between countries preferring their own domestic interests prove difficult and fairly unreliable. On the other hand, creating regional monetary unions, despite indisputable benefits for their members, does not bring us any closer to the construction of a holistic, permanent system of international payments. Consequently, we believe the best solution to the payment flow balance problem is to introduce an artificial international currency. Such concept, in a fully fledged form, was suggested by J. M. Keynes and R. Triffin[26]. Incidentally, there is a need to give rise to a credible international institution which would issue the appropriate amounts of generally accepted international currency, hence the creation of a genuine central bank of the world. It should be equipped with extensive credit (supply), monetary and controlling (regulatory) functions. It could be built from scratch, as originally intended by lord Keynes in 1944, albeit allowing for today's

[25] It is estimated that in 2009 for the purpose of financing loan demands connected with deficit resulting manly from crisis-combating programmes, the United States will be forced to issue approx. USD 2 trillion worth of treasury bills. The eurozone countries will issue treasury bills on a similar scale.
[26] See S. Rączkowski "Międzynarodowe stosunki finansowe" ["International Financial Relations"], op. cit., pp. 282-3. For a broader discussion, see R. N. Cooper "The International Monetary System. Essays in World Economics", MIT Press, Cambridge, Mass., 1987.

conditions and requirements. Alternatively, a profound reform of the IMF, as advocated by professor Triffin in 1959 could be carried out. Still, one needs to be fully aware of the complexity difficulties associated with such venture.

So far, the attempts to reform the International Monetary Fund has been abortive despite all the anachronistic nature of decision-making, conditions of granting financial aid and the escalating leadership crisis, organisation model that has failed to reflect the current line-up in global finances, economy and trade, as well as the unjust distribution of SDRs[27]. Eradicating the main obstacle to necessary changes – the absolute domination of the well-developed countries of North America and Western Europe, headed by G7, in the Fund's authorities – may prove so difficult that as part of the programme of a fundamental conversion of the world's financial and monetary system, a new central institution managing international finances on the basis of different rules than the IMF, particularly in terms of representativeness, will be established, and its headquarters will probably be located in the Far East. One may not exclude the extreme case, in which it would be an organisation competing against the Fund. In the long run it is hard to imagine the coexistence of these two institutions managing the world's financial matters, which, all in all, constitute an inseparable whole. For this reason the most practical and desirable solution would be to transform the IMF in a way that would not squander its track record (e.g. in the area of convertibility or stabilising rates of currencies); a solution that would decidedly improve the management of the global financial flow.

Today the issue of managing international liquidity is especially important, since the current global economic and financial crisis ruthlessly revealed negligence and weaknesses of international cooperation in this field. With a follow-up in the US in the forthcoming months of the expansive monetary policy, it may soon turn out that the US dollar, main component of international foreign currency reserves, will not be able to fulfil its function of international currency due to its excess issuance damaging its value and no other currency (including the euro) will not be entirely capable of replacing the resultant gap. In the face of prevailing floating rates, an increase in the flexibility (fluctuations) of exchange rates between reserve currencies of the world

[27] Cf. M. Wolf "Why agreeing a New Bretton Woods is vital and so hard", Financial Times of 5 Nov. 2008.

will inevitably become another threat to the condition of international liquidity. Therefore, the need to create a new component of this liquidity is high on the agenda. Such component would replace the current reserve assets rather than supplement them. On the basis of current experiences concerning the operation of the global payment system we may conclude that there should be an additional mechanism stabilising exchange rate on a global scale.

The practices of the international finance sector over the last four decades provide two interesting attempts at far-reaching modifications of international liquidity: one in the form of special drawing rights (SDRs), the other in the form of the introduction of a common European monetary unit (ECU: European Currency Unit), which became the axis of the European Monetary System operating in the years 1979-1998.

Technically speaking, both SDR and ECU are forms of artificial currency, created by international financial organisations, the IMF and EMS, authorised by its members. They are basket currencies[28], i.e. their value fluctuates according to changes in the exchange rates of convertible currencies constituting the basket, whose structure is periodically altered on the basis of criteria accepted beforehand. Calculating the value of a given currency according to the basket has a stabilizing effect, since it averages the fluctuations in the rates of values which constitute the basket and the resulting monetary risk. However, there are significant differences between the two currencies. The most important one is that SDRs were created by the Fund *ex nihilo* by assigning them to member countries in proportion to the value of national quota shares, while the ECU was established as a settlement unit and started to function as reserve currency after the exchange of 20% of payment reserves of the European Monetary System countries for assets nominated in the ECU. More importantly, market for transactions in ECU soon followed, with ECU also as a bank currency. Loans and credits were granted in ECU and government bonds were issued. In contrast to the European currency unit, special drawing rights outside the Fund are characterised by low liquidity – so far the has been no developed transaction market

[28] Strictly speaking, SDR became basket value in July 1974. Prior to this, it was strictly linked to the US dollar, initially on par and then was revaluated against the dollar three times. Since the beginning of 2006, the SDR basket has been made up of four currencies, with 44% of its value assigned to the US dollar, 34% to the euro, and 11% for the Japanese yen and the British pound each.

or instruments nominated in SDRs. To a large extent it stems from small volume of their issuance and the fact that it occurred in the period when lack of liquidity ceased to be a problem for international financial relations. As a result of six allocations from the early 70s and 80s, the IMF member countries received a total of 21.4 bn SDRs, which today is much less than a half percent of the global reserves (without gold), equalling over 4.5 trillion SDRs as of the end of 2008.

A new international currency with a modified, less specialist name (e.g. a more universal and compact "global" or "mundial") could replace special drawing rights at a simple 1:1 ratio following the solution to the 6-year-long case of the assignation of the international currency to countries which did not participate in the first six SDR allocations, which should have taken place according to then applicable criteria and conditions. It is strongly recommended that while creating the new currency, good practices connected with the ECU should be followed. It is even possible to take a step further and make it both cash and cashless currency circulating in the global flow. Due to the requirement of maintaining maximum stability, the new currency would need to have basket form, composed of 10 currencies of most important issuers in the area of manufacturing and global trade. It is important for every country's currency to have a fixed central rate towards the new currency at the level ensuring payment balance. This means that, along with a significant change in the conditions of this balance, the central rate would have to be subjected to appropriate modification following a consent of the Fund.

In comparison to total allocation value of SDRs, the volume of the issue of new currency would be radically increased, which could happen step by step[29]. Because of its high stability, the new currency would surely become a competitive and widely accepted component of reserves, affecting the growth of payment discipline of the issuers of other reserve currencies. It could also enter the broad financial circulation, which would entail the involvement of the Fund's member countries and credible financial institutions of global range.

[29] The need to eradicate the crisis causes the financial circles to voice more and more demands for the general supplies of the IMF to be rapidly doubled or even tripled – z from as little as 250 to 500, or even 750 (and more) bn SDRs. See "Supersizing the fund", The Economist, February 7th-13th 2009, p. 67.

Last but not least, the new international currency should be used to create a New Bretton Woods – a global mechanism of finance and monetary cooperation based on a system of stabilized rates. To this end, the International Monetary Fund could make extensive use of the achievements of the European Monetary Cooperation Fund (EMCF, fr. FECOM), which together with central banks of EMS countries would administer the interventions on the monetary market, co-financing them as part of the stabilizing exchange rate mechanism (ERM).

A mechanism similar to ERM involving the stabilization of reciprocal exchange rates could be successfully used in reference to currencies included in the basket of the new international currency. Maintaining the reciprocal relations of convertible currencies of the basket to the extent of the accepted rate fluctuations would require strict cooperation between central banks – their issuers – and the IMF as well as joint interventions on monetary market. Such mechanism would force balance of payments of the most important participants of the global financial flow, preventing structural deficits and surplus of payment balances. With the assumption that countries with non-basket currencies would be obliged to link their values with a selected basket value by means of a fixed rate, the regulatory mechanism ensuring external balance could be extended over those countries as well. If necessary, they could benefit from the Fund's assistance by the logic of stabilising and adaptive programmes.

In the paper currency system the success of efforts aimed at reinforcing the security and efficiency of the global payment flow depends mainly on the quality of institutional solutions[30]. On the one hand, the objective is to achieve the highest possible credibility of international monetary authorities, which is derived from observance of the rules of representation and competence, and – on the other hand – to provide suitable measures. The former requires designing a far-reaching consensus of the IMF member countries. The latter will result from subsequent allocations of the new currency and the development of its relevant functions. One thing remains certain: failure to carry out a fundamental reform of the architecture of international

[30] Cf. W. H. Buiter ”Some suggestions for the G20 on November 15th” and R. Rajan ”Reforming global economic and financial governance” in: ”What G20 leaders must do to stabilise our economy and fix the financial system”, edited by B. Eichengreen and R. Baldwin, A VoxEU.org Publication, Centre for Economic Policy Research 2008, pp. 17-23.

finances will complicate and prolong the struggle with the global financial and economic crisis, and an attempt to continue the current mechanism of international monetary and financial relations will mean that the disorders will come back in the future.

The scale and pace of changes in international finances depends largely on the development of situation in world's still biggest and most important economy, the US. Economic policy of the American administration and monetary policy of the Federal Reserve System are of special importance in this area. A specially relaxed monetary policy of the Fed and the expansive budgetary policy of American administration in conditions of expanding recession create concerns for the future and questions as to whether the American economy is not threatened by 2-3 years of stagnation at a low activity level, with the eventual collapse of the dollar as the leading international currency. Paradoxically, such course of events may facilitate the implementation of the necessary changes, increasing the willingness of the decision-makers to carry them out. Apart from American involvement in a fundamental reform of the current system, its success will necessitate the consent and cooperation of other key players of global financial flow. It seems that currently the most appropriate forum for discussions and negotiations on new order in the world is the Group of Twenty (G20)[31], which includes not only the biggest developed countries and the European Union as the entire group, but also leading countries of the so-called emerging markets. Consequently, the above forum is at minimum as representative and predisposed to the acceptance of the new global order as countries which signed the agreement of 1944.

[31] For more information on this subject see: Briefing. The global economic summit. After the fall, The Economist, November 15th-21st 2008, pp. 27-29.

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