WHAT IS WRONG WITH THE WASHINGTON CONSENSUS AND WHAT SHOULD WE DO ABOUT IT?

by

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I. The Washington Consensus: Classical vs. Post Keynesian Views

John Williamson coined the term "Washington Consensus" in 1989. This Washington Consensus term, however, means different things to different people[1] – and apparently even different things to John Williamson at different times. Williamson [2002] states that this consensus requires ten reforms:

"1. Fiscal Discipline. This was in the context of a region where almost all the countries had run large deficits that led to balance of payments crises and high inflation that hit mainly the poor because the rich could park their money abroad.

2. Reordering Public Expenditure Priorities.... from things like indiscriminate subsidies to basic health and education.

3. Tax reform. Constructing a tax system that would combine a broad tax base with moderate marginal tax rates.

4. Liberalizing Interest Rates. In retrospect I wish I had formulated this in a broader way as financial liberalization, and stressed that views differed on how fast it should be achieved[2].

5. A Competitive Exchange Rate. I fear I indulged in wishful thinking in asserting that there was a consensus in favor of ensuring that the exchange rate would be competitive, which implies an intermediate regime; in fact Washington was already beginning to subscribe to the two-corner doctrine. [William has championed the establishment of FEER (a Fundamental Equilibrium Exchange Rate) target zone for the exchange rate, i.e., a zone based on a fixed competitive rate plus or minus ten percent. Williamson has argued that FEER would simultaneously achieve internal and external balance[3]]

6. Trade Liberalization...

7. Liberalization of Inward Foreign Direct Investment...

8. Privatization...

9. Deregulation....

10. Property Rights....

The three big ideas" underlying these reforms are, according to Williamson, "macroeconomic discipline, a market economy, and openness to the world". "The first three reforms are, so far as I am aware, widely accepted among economists." (Williamson, 2002).

Developing from Keynes's General Theory (1936) and Bretton Woods writings (Keynes, 1980) Post Keynesian analysis (e.g., Davidson, 2002) can demonstrate that what most orthodox economists mean by a policy of fiscal discipline will neither (1) avoid the possibility of current account crises, nor (2) produce a fully employed economic system. Trying to implement the reforms with their emphasis on fiscal discipline, the liberalization of financial markets, and the free market competitive exchange rate has created some severe problems for Latin America

This does not mean all ten reforms are bad. The importance of property rights for the productive operation of the operation of an entrepreneurial economy can not denied. Regarding privatization, however, "It is not the ownership of the instruments of production that is important for the State to assume. If the State is able to determine the aggregate amount of resources devoted to augmenting the instruments and the basic rate of reward to those who own them, it will have accomplished all that is necessary"(Keynes, 1936, p. 378).

Why have intelligent economists such as John Williamson gone so wrong on their demand for fiscal discipline, financial liberalization, and actively pursuing a competitive exchange rate policy? The fundamental analytical framework underlying Williamson's views is the same as the foundation of neoliberalist and market fundamentalists arguments (Davidson, 1992-3). For example, in an article co-authored with Marcus Miller (1989), Williamson accepts the classical belief that, in the long run, a free market economy will always revert to the optimum allocation of resources at full employment. Williamson and Marcus (1989, p. 50), however, are impatient with the length of time it takes for the market to achieve this long-run equilibrium, and therefore they argue that the economy, prodded by intelligent authorities will show a greater "speed of adjustment" than the "automatic pilot" of a free market. In other words, the only analytical difference between Williamson and ideological Market Fundamentalists is the question of the length of time it requires for a free market to achieve a social optimum.

Those who profess a rational expectations approach can argue for immediate liberalization ─ shock therapy. The common sense of mainstream economists such as Williamson suggests that such "shock and awe" medicine might severely debilitate if not kill the patient. Thus Williamson tries to direct the discussion towards the speed at which governments liberalize markets and reduce the size of government. Nevertheless, all ten reforms of the Washington Consensus are founded on classical economic theory that supports the laissez-faire doctrine as necessary to solve all our economic problems.

The evidence of the last 10-20 years, however, has demonstrated that attempting to implement the ten reforms of the Washington Consensus has ultimately proven to be a disaster for developing nations. If the empirical evidence of the failure of the Washington Consensus under the existing rules of the game is so clear, why does the G-7, the World Bank and the IMF seek to tie aid for Latin American nations's economic problems to a demand for the nation to move towards full adoption of the 10 consensus reforms? The answer to this question is nested in the classical theory belief in the beneficence of free markets. This beneficence, however, can only be "proved" if one invokes three very restrictive classical axioms[4]. If these classical axioms are not applicable to the real world, then the characteristics of the Washington Consensus market vision of the economic system "happens not to be those of the economic society in which we actually live, with the result that its teaching is misleading and disastrous if we attempt to apply it to the facts of experience" (Keynes, 1934, p. 3).

When put in the context of an open economy, Keynes's General Theory analytical framework demonstrates that the theoretical foundation for some of the reforms advocated by the Washington Consensus are not applicable to the economy in which we live. In a passage that is particularly a propos to the Washington Consensus, Keynes noted that

> "in a society where there is no question of direct investment under the aegis of public authority [due to the need for fiscal discipline per se], the economic objects, with which it is reasonable for the government to be preoccupied, are the domestic interest rate and the balance of foreign trade"[Keynes, 1936, p. 335].

If, however, the government institutes reform #4 of the Washington Consensus and permits capital funds to freely move across national boundaries, then "the authorities had no direct control over the domestic rate of interest or the other inducements to home investment, [and] measures to increase the favorable balance of trade [are]...the only direct means at their disposal for increasing foreign investment" [Keynes, 1936, p. 336] and domestic employment.

The orthodox policy for improving a nation's trade balance is to make the domestic industries more competitive either (1) by forcing down nominal wages including fringe benefits (i.e., liberalizing or "freeing up" the nation's labor market) to reduce labor production costs and/or (2) by encouraging a decline in the nation's exchange rate[5] to a more competitive level[6]. Keynes (1936, p. 338) warned that the domestic employment advantage gained by pursuing a competitive exchange rate policy (reform #5) to encourage export-led economic growth "is liable to involve an equal disadvantage to some other country" . Whenever countries pursue an "immoderate policy" [Keynes, 1936, p. 338] of export-led growth by making domestic industries more competitive, this aggravates the unemployment problem for the competitor nations and may even create unemployment problems for the trading partners of the successful export-led growth country. Consequently these other nations are then forced to engage in some policy to make their industries more competitive and in so doing they engage in a "senseless international competition for a favorable balance which injures all alike" [Keynes, 1936, pp. 338-9].

Williamson's reform #5, requiring the establishment of a competitive exchange rate for each Latin American country, can only exacerbate the problem of exchange rate changes adversely affecting Latin American nations, as the recent experience of yo-yo exchange rates between Argentina and Brazil indicates. More importantly, attempts by many nations to obtain competitive gains by policies that will reduce the domestic monetary costs of labor and/or the exchange rate can only foster further global stagnation and recession as each nation attempts to regain a competitive edge induces similar depressionary policies in others.

Unlike the classical theorists of his day (and our day as well[7]) Keynes (1936, p. 345) recognized that "the mercantilists were aware of the fallacy of cheapness and the danger that excessive competition may turn the terms of trade against a country" thereby reducing domestic living standards in the country searching for a competitive exchange rate in a global economy. If <u>each</u> nation does not actively undertake a program for public <u>domestic</u> investment to generate <u>domestic</u> full employment, then the resulting laissez-faire system of prudent fiscal discipline in tandem with liberalized international financial markets that encourage speculative free international monetary flows creates a global environment where <u>each</u> nation independently sees significant national advantages in a policy of export-led growth even though pursuit of these policies simultaneously by many nations "injures all alike" (Keynes, pp. 338-9).

This warning of Keynes has gone virtually unnoticed as mainstream economists waxed enthusiastically about liberalized international financial markets and the export-led economic miracles of Japan, Germany in the 1980s and the economic miracles of the Pacific Rim Newly Industrialized Countries (NICS) in the early 1990s. These miracles, it was claimed, proved the validity of the Washington Consensus and was often used to justify the Washington Consensus reforms for Latin America.

As markets are liberalized and governments shrink, international finance and IMF loans flow into the nation. Normally this brings about a momentary improvement in economic growth and a feeling of euphoria. Only later does it become apparent that this inflow of funds ultimately saddles the nation with large, and difficult to sustain international debt service out-flows that often can only be met by a Ponzi-type financing via more loans from the IMF and international bankers.

To prevent indebted Latin American nations from defaulting on their international debts. the IMF makes additional loans — contingent on Latin American nations pursuing the ten reforms of the “one-size-fits-all” Washington Consensus. Latin American nations should not let the "inadequacy of the <u>theoretical</u> foundations of the <u>laissez-faire</u> doctrine" (Keynes, 1936, p. 339) and the oratory of Williamson and other "orthodox economists whose common sense has been insufficient to check their faulty logic" [Keynes, 1936, p.349] to convince them to swallow the bitter medicine of the consensus reforms to obtain additional international loans in the false hope that this new influx in funds will improve their economic position.

Keynes once said “If a man owes his banker 5 pounds its the man's problem but if he owes 500 pounds its the banker's problem”. This same moral is applicable to the outstanding debts of the Latin American nations. The problem is not Brazil's or Argentina's etc. and they should not let the pressure of their international bankers force them to adopt those reforms that will further depress their economies. They will be doing themselves and their international bankers a favor if they avoid the constraints imposed by the international bankers and the IMF and pursue an independent full employment policy while negotiating the restarting of debt service payments after the domestic economy is showing significant signs of improvement.

To break out of a global slow-growth or stagnating economic environment in which the global economy has become immersed, requires each nation to adopt a "policy of an autonomous rate of interest, unimpeded by international preoccupations, and a national investment programme directed to an optimum level of employment” (Keynes, 1936, p.349) If a nation adopts such an independent policy then it “is twice blessed in the sense that it helps ... [the nation and its] neighbors at the same time. And <u>it is the simultaneous pursuit of these policies by all countries together which is capable of restoring economic health and strength</u> internationally, whether we measure it by the level of domestic employment or by the volume of international trade" [Keynes, 1936, p. 349, emphasis added].

The liberalization of the market doctrine solution embedded in the Washington Consensus is analytically based on the aforementioned three classical postulates. These presumptions logically assure a global full employment result. In the real world, however, a globally full employment environment can be achieved only when each nation pursues expansionary fiscal and monetary policies that are shielded from international interference. Only after these independent nations approach full employment will free trade increase the global wealth of nations by reducing each nation's aggregate supply constraints through the law of comparative advantage. By assuming liberalized markets reforms <u>per se</u> assure global full employment, as, Keynes (1936, p. 339) pointed out, "the [orthodox] faculty of economists prove to have been guilty of presumptuous error". We live in a world where global unemployment and income inequality problems has been exacerbated by the mindless imposition of the Washington Consensus reforms by Washington Institutions.

Today powerful players are attempting to force all debtor nations (except perhaps the United States) to operate under the laissez-faire mentality that is the foundation of the Washington Consensus. In a passage that is amazingly prescient, Keynes warns that if these nations play by the rules of this game, then if any

> "country were to neglect the struggle for markets its prosperity would droop and fail. But if [all] nations can learn to provide themselves with full employment by their domestic policy...there need be no important economic forces calculated to set the interest of one country against that of its neighbors. There would still be room for the international division of labour and for international lending in appropriate conditions. But there would no longer be a pressing motive why one country need force its wares on another or repulse the offerings of its neighbor, not because this was necessary to enable it to pay for what it wished to purchase, but with the express object of upsetting equilibrium in the balance of payment so as to develop a balance of trade in its own favor [i.e., export-led growth policy]. <u>International trade would cease to be what it is, namely, a desperate expedient to maintain employment at home by forcing sales on foreign markets and</u>

restricting purchases, which, if successful, will merely shift the problem of unemployment to the neighbour which is worsted in the struggle, but a willing and unimpeded exchange of goods and services in conditions of mutual advantage" [Keynes, 1936, pp. 382-3 emphasis added].

II. The Washington Consensus and Income Inequality

Before presenting my suggestions for a Post Keynesian alternative to the Washington Consensus, let me indicate why I believe that even if the search for a competitive exchange rate (reform #5) was successful in allowing a Latin American nation to avoid persistent adverse trade balance problems, the result would tend to increase the global inequality of income.

Williamson is for a flexible "competitive" exchange rate system rather than a fixed exchange rate system. Under this policy approach if a Latin American country is suffering from a persistent trade payments deficit, then this is prima facie evidence that its domestic industries are not competitive[8]. Williamson would argue that it would be necessary and desirable for the nation to experience a decline in the exchange rate target to make the nation's industries competitive. Of course, for a decline in the exchange rate to reduce (eliminate) the trade payments deficit, the Marshall-Lerner conditions would have to be applicable.

Typically, however, a Latin American nation has a comparative advantage in exports whose income elasticity of demand for these exports exhibited by the rest of the world is lower than the nation's income elasticity of demand for imports from the rest of the world. Under these income elasticity conditions, even if there is no persistent trade payments imbalance, the demand for the LA nation's exports will tend to grow at a slower rate than the domestic market's demand for imports from the rest of the world. Thus, even if trade payments equilibrium could be maintained over time solely by globally pursuing Williamson's "competitive " exchange rate target system, the rich developed nations would experience a higher rate of growth of income earnings from sales to the Latin American nation than the growth in income earned by the Latin American nation from sales to the rest of the world. The result is a growing inequality of income. If, at the same time, population growth in the Latin American nation is greater than in the developed world, the income per capita in Latin America falls significantly relative to the income per capita of the developed nations.

Moreover, if initially the Latin American nation had been receiving an influx of direct foreign investment and/or an international financial flow of funds, then the decline to find a "competitive" target exchange rate would make the servicing of international out- payments on the already existing stock of international capital inflows more onerous in real terms. Almost inevitably this is will result in greater impoverishment of Latin America.

III. Conclusions Regarding The Washington Consensus

The Washington Consensus has created perverse incentives that set nation against nation in a process that perpetuates a world of slow growth (if not stagnation). Because the global economy is on a de facto dollar standard, the United States is the only nation that can benefit from the existing international payments system— at least as long as it ignores its own deficit balance of payments position[9] and continues to run the horrendous annual trade deficits that it has experienced since 1981. This continuing US trade deficit has been, in recent decades the primary (sole?) engine of growth for the rest of the global economy as the other nation's of the world focus on policies that promote export-led growth as a solution to each nation's unemployment rates and stagnating rates of growth.

Since 1982 the United States has been obtaining an annual "free lunch" from the rest of the world as the US consumes more than it earns internationally. Although residents of most other nations may resent the ability of the United States to use the present system to obtain this "free lunch", they are hesitant to change a system (1) that is heralded as the only mechanism that permits every one the freedom to choose, and (2) that provides, in the form of the U.S. economy's willingness to import more than it exports, the only visible engine of growth.. To be against the Washington consensus is considered to be anti-free market. To advocate governmental financial regulations (controls) of international capital flows and a larger government input into the domestic economy is a particularly unpopular position in these days when State planning has failed so spectacularly in Eastern Europe. In the absence of a complete collapse of the international monetary payments system, however, unless an attractive feasible alternative to the current system is put on the public agenda for discussion and development, the status quo will remain. It is an old adage in political science that "you can't beat somebody with nobody!"

Generalizing Keynes's General Theory to an open economy provides a rationale for designing an international payment system that rejects reforms 1, 4, 5, and 7 as more likely to cause problems than provide solutions. Any alternative must creates incentives for each nation to pursue domestic demand policies that ensure full employment without the fear of a balance of payments constraint or unbearable international debt service payments. Only under such an alternative to the Washington consensus will the gains from the law of comparative advantage become possible.

Nowhere is the difference between the Keynes view and the view of those Consensus advocates who believe that free capital markets efficiently allocate capital more evident than in regards to these questions of international capital movements and payments mechanisms and the desirability of using the exchange rate to make one's industries more competitive. Moreover, Keynes's General Theory analysis suggests that government monitoring and, when necessary, control of international capital flows is in all nations's interests. Capital controls are not an infringement on the freedom of economic agents right to move their wealth between countries whenever the spirit moves them any more than the making it illegal to shout "fire" in a crowded theater is an infringement of the individual's right of free speech.

Any suggestions for reforming the international payments mechanism should build on whatever advantages the current flawed system possesses, while providing rules to prevent any one nation from enjoying a free lunch -- unless a free lunch is available to all. If a new international system has a built-in expansionary bias that encourages all nations to operate closer to full employment than the existing system does, then it provide all nations with a free lunch by increasing the rates of global economic growth and global full employment with the same quantity of available resources..

In what follows I wish to focus primarily on the Washington Consensus fallacy of demanding reforms (1) that liberalize international capital markets and (2) urge changes in the exchange rate to make industries more competitive. It is , in my view, these two "reforms" that have been a primary cause of the failure of Latin American nations — and the global economy generally — to grow at a rate equal to their resource potential where such growth which would provide a greater economic prosperity for all the inhabitants of this planet.

IV. A Post Keynesian Proposal As An Alternative to the Washington Consensus

The following proposal for an international payments system builds on Keynes's Bretton Woods proposals[10] that, during the 1947-73 period, proved successful for producing a global expansionist pressure on world trade and development. Economic development expert Irma Adelman has declared this 1947-73 period "The Golden Age of Economic Development".

Our suggestion is aimed at obtaining an international agreement that does not require surrendering either monetary policy and national control of domestic banking systems, nor surrender of a nation's fiscal policies. Keynes provided a clear outline of what was needed when he wrote:

> "We need an instrument of international currency having general acceptability between nations .... We need an orderly and agreed upon method of determining the relative exchange values of national currency units.... We need a quantum of international currency... [which] is governed by the actual current [liquidity] requirements of world commerce, and is capable of deliberate expansion.... We need a method by which the surplus credit balances arising from international trade, which the recipient does not wish to employ can be set to work... without detriment to the liquidity of these balances" (Keynes, 1980, p. 168).

What is required is a <u>closed</u>, double-entry bookkeeping, clearing union institution to keep the payments score among the various trading regions plus some mutually agreed upon rules to create and reflux liquidity while maintaining the international purchasing power of the international currency. The eight provisions of the following Post Keynesian clearing system proposal meet the criteria laid down by Keynes. The rules of our proposed system are designed [1] to prevent a lack of global effective demand[11] due to any nation(s) either holding excessive idle reserves or draining reserves from the system, [2] to provide an automatic mechanism for placing a major burden of payments adjustments on the surplus nations, [3] to provide each nation with the ability to monitor and, if desired, to control movements of flight capital[12], and finally [4] to expand the quantity of the liquid asset of ultimate international redemption as global capacity warrants.

Some elements of such a clearing system would include:

1. The unit of account and ultimate reserve asset for international liquidity is the International Money Clearing Unit (IMCU). All IMCU's are held <u>only</u> by central banks, not by the public, in accounts on the books of the clearing union institution..

2. Each nation's or UMS's central bank is committed to guarantee one way convertibility from IMCU deposits at the clearing union to its domestic money. 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[13].

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

Proviso #2 permits a nation to institute capital inflow and outflow regulations or controls. The function of capital flow regulations is to prevent sharp changes in the bull-bear sentiment from overwhelming the market maker and inducing rapid changes in financial market price trends for such volatility 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 expenditure category basis. These controls 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. Mayer (1998, pp. 29-30) has argued that the 1997 East Asian currency problem was largely due to the interbank market that created the whirlpool of speculation and that what is needed is "a system for identifying...and policing interbank lending" <u>and</u> banks' contingent liabilities resulting from dealing in derivatives. Echoing the Post Keynesian theme that the economic financial system is not ergodic, Mayer (1998, p. 31) declared "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".

Other capital controls include (a) policies that make foreign exchange available but at different exchange rates for different types of transactions and (b) the imposition of taxes (or other opportunity costs) on <u>specific</u> 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 as suggested by Mayer.

The recent experience of the IMF, as lender of last resort in the East Asian currency crisis, imposing the same conditions on all nations requiring loans for international liquidity purposes should have taught us that in policy prescriptions one size does <u>not</u> fit all situations. Accordingly, the type of capital regulations a nation should chose from the spectrum of tools available at any time will differ depending on the specific circumstances involved. In this brief paper it would be presumptuous of me to catalog what capital regulations should be imposed for any nation under any given circumstances. Nevertheless, it should be stressed that regulating capital movements is a necessary but not a sufficient condition for promoting global prosperity.

3. The exchange rate between the domestic currency and the IMCU is set initially by each nation -- just as it would be if one instituted an international gold standard. Since enterprises that are already engaged in trade have international contractual commitments that would span the change-over interval, then, as a practical matter, one would expect that the existing exchange rate structure (with perhaps minor modifications) would provide the basis for initial rate setting.

Provisions #7 and #8 infra indicate when and how this nominal exchange rate between the national currency and the IMCU would be changed in the future.

4. Contracts between private individual's will continue to be denominated into what ever 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 announced commitment from the central bank (through private sector bankers) of the availability of foreign funds to meet such private contractual obligations.

5. An overdraft system to 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 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: (1) on the products of any other member of the clearing union, (2) on new direct foreign investment projects, and/or (3) to provide unilateral transfers (foreign aid) to deficit members. Spending by way of (1) forces the surplus nation to make the adjustment directly through the balance on goods and services. Spending by way of (3) permits adjustment directly by the current account balance; while (2) provides adjustment by the capital accounts (without setting up a contractual debt that will require reverse current account flows in the future).

Consequently, proviso #6 provides the surplus country with 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, however, permit the surplus nation to shift the burden to the deficit nation(s) through contractual requirements for debt service charges independent of what the deficit nation can afford[14]. The important thing is to make sure that continual oversaving[15] by surplus nations can not unleash depressionary forces and/or a building up of international debts so encumbering as to impoverish the global economy of the 21st century.

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 excess[16]. This last resort confiscatory action by the managers of the clearing agency would make a payments adjustment via unilateral transfer payments in the current accounts.

Under either a fixed or a flexible rate system, nations may experience persistent trade deficits merely because their trading partners are not living up to their means -- that is because other nations are continually hoarding a portion of their foreign export earnings (plus net unilateral transfers). By so doing, these oversavers are creating a lack of global effective demand. Under provision #6, deficit countries would no longer have to deflate their real economy merely to adjust their payment imbalance because others are oversaving. Instead, the system would seek to remedy the payment deficit by increasing opportunities for deficit nations to sell abroad.

Proviso #6 embodies Keynes's innovative idea that whenever there is a persistent (and/or large) imbalance in current account flows -- whether due to capital flight or a persistent trade imbalance --, there must be a built-in mechanism that induces the surplus nation(s) to bear a major responsibility for eliminating the imbalance. The surplus nation must accept this burden for it has the wherewithal to resolve the problem.

In the absence of #6, under any conventional system, whether it has fixed or flexible exchange rates and/or capital controls, .there can occur 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 of the surplus nation to act, on the other hand, promotes 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[17]. 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, even if a foreign government permits wage-price inflation to occur within its borders. Consequently, the rate between the local currency and the IMCU would change with inflation in the local money price of the domestic commodity basket.

If, however, increases in productivity lead to declining nominal production costs, 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 altering the exchange rate between local monies and the IMCU to offset the rate of domestic inflation, the IMCU's purchasing power is stabilized. 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 towards 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 (or deflation). Whether the nation is successful or not, the IMCU will never lose its international purchasing power. Moreover, the IMCU has the promise of gaining in purchasing power over time, if productivity grows rapidly 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 maintain the relative efficiency wage parities amongst nations. In such a system, the adjustability of nominal exchange rates will be primarily (but not always, see Provision #8) 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 can have significant permanent real costs, e.g., industries may abandon markets and the resulting idle existing plant and equipment may be 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, reductions in real production costs that are associated with a relative decline in efficiency wages is the main factor (with the exception of provision #8) justifying an adjustment in the real exchange rate.

Under provision #7 of our proposal the IMCU would provide its holders with an invariant international monetary standard no matter whether the domestic rates of inflation in the various nations converged (or not) or accelerated (or not).

Although provision #6 prevents any country from piling up persistent excessive surpluses this does not mean that it is impossible for one or more nations to run persistent deficits. Consequently proposal #8 infra provides a program for addressing the problem of persistent export-import deficits in any one nation.

8. If a country is at full employment and still has a tendency towards persistent international deficits on its current account, then this is prima facie evidence that it does not possess the productive capacity to maintain its current standard of living. If the deficit nation is a poor one, then surely there is a case for the richer nations who are in surplus to transfer some of their excess credit balances to support the poor nation[18]. If it is a relatively rich country, then the deficit nation must alter its standard of living by reducing its relative terms of trade with its major trading partners. Rules, agreed upon in advance, would require the trade deficit rich nation to devalue its exchange rate by stipulated increments per period until evidence becomes available to indicate that the export-import imbalance is eliminated without unleashing significant recessionary forces[19].

If, on the other hand, the payment deficit persists despite a continuous positive balance of trade in goods and services, then there is evidence that the deficit nation might be carrying too heavy an international debt service obligation. The pro bono officials of the clearing union should bring the debtor and creditors into negotiations to reduce annual debt service payments by [1] lengthening the payments period, [2] reducing the interest charges, and/or [3] debt forgiveness[20].

If any government objects to the idea that the IMCU provisions provide 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 regional currency union [UMS] and thereby assuring a free flow of funds among the residents of the currency union.

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. Global depression does not have to happen again if our policy makers have sufficient vision to develop this Post Keynesian approach. The health of the world's economic system will simply not permit us to muddle through.

APPENDIX: OTHER ALTERNATIVE PROPOSALS — PLUMBING SOLUTIONS

Despite their willingness to accept the "compelling logic" of efficient markets in classical theory, the common sense of Tobin and his New Keynesian followers regarding volatility in international financial markets can not help but break into their logical models-- with injury to their logical consistency. To solve today's international monetary problems, these "Keynesians" advocate a Tobin tax where governments attempt to constrain exchange rate market volatility by increasing the transactions costs on <u>all</u> international payments via a small ad valorem tax. Unfortunately though Tobin's assessment of the problem is correct, the empirical evidence is that any increase in the transactions costs significantly increases rather than decreases measured market volatility (Davidson, 1998). Moreover, a Tobin tax does not create a greater disincentive for short-term speculators as Tobin has claimed (Davidson, 1997) . Hence, the "Tobin tax"solution is the wrong tool to solve the growing international financial speculative market problem.

Since the Mexican peso crisis of 1994, pragmatic policy makers have advocated a lender-of-last-resort (LOLR) to stop international financial market liquidity hemorrhaging and to buy time to encourage international investors to reschedule existing debts and make fresh loans. In 1994, US Treasury Secretary Rubin encouraged President Clinton to play this LOLR role. The IMF stepped into this lender role when the 1997 Asian crisis and 1998 Russian default occurred. In 1999 IMF Director Stanley Fischer (1999) suggested that the G-7 nations provide additional funding for an international lender of last resort. Fischer's cry for a G7 collaborative funding 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 requires the LOLR to pour more liquidity into the market to put out the flames. The goal should be to produce a permanent fire prevention solution, not to rely on organizing larger and larger volunteer fire fighting companies after each new currency fire breaks out.

Finally, the man who "broke the Bank of England", George Soros, as well as some economists, have recommended a currency board solution. A currency board fixes the exchange rate so that the domestic money supply does not exceed the amount of foreign reserves a nation possesses. Thus, if and when investors panic and rush to exit from a nation, the currency board maintains the exchange rate by selling foreign reserves and reducing the domestic money supply by an equivalent sum. A currency board solution, therefore, is equivalent to the blood letting prescribed by 17th century doctors to cure a fever. Enough blood loss can, of course, always reduce the fever but often at a terrible cost to the body of the patient. Similarly, a currency board may douse the flames of a currency crisis but the result can be a moribund economy. The experience of the Argentine economy should certainly eliminate the idea of a currency board ― or its close relative - official dollarization of the nation's currency.

Friedman (1998) and many others have suggested a return to completely flexible exchange rates. Unfortunately whenever there is an persistent international payments imbalance, free market exchange rates flexibility can make the situation worse. For example, if a nation is suffering a tendency towards international current account deficits due to imports exceeding exports, then free market advocates argue that a decline in the market price will end the trade deficit. If, however, the Marshall-Lerner condition does not apply, then a declining market exchange rate worsens the situation by increasing the magnitude of the payments deficit[21].

If, the payments imbalance is due to capital flows, there is a similar perverse effect. If, for example, country A is attracting a rapid net inflow of capital because investors in the rest of the world think the profit rate is higher in A, then the exchange rate will rise. This rising exchange rate creates even higher profits for foreign investors and contrarily will encourage others to rush in with additional capital flows pushing the exchange rate even higher. If then suddenly there is a change in sentiment (often touched off by some ephemeral event), then a fast exit bandwagon will ensue pushing the exchange rate perversely down.

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ENDNOTES

1.Williamson [1999] claimed that the term Washington Consensus has developed into something different from that which he intended. The Washington Consensus concept had become what is often called “neoliberalism’ or “market fundamentalism”.Williamson points out that Bresser Perriera patiently explained to him that just because he invented the term he did not have intellectual property rights to control its meaning. [One could suggest to Williamson that just because Keynes invented The General Theory did not limit the perverse meaning that neoclassical synthesis Keynesians and New Keynesians gave to the meaning of Keynesian macroeconomics.]

2. Williamson (1999) indicated that he “long ago changed my description of the fourth element of the Washington Consensus to ‘financial liberalization’”. In other words Williamson believes that all regulations controlling international capital flows should be abolished.

3. The internal balance implied an unspecified low rate of inflation that would be associated with NAIRU, while external balance was associated defined as maintaining a current account balance that is “sustainable and appropriate” in the medium term.

4.An axiom is defined as a statement accepted as true and not necessary to be proved. The three restrictive classical axioms are (1) the ergodic axiom in stochastic models or the equivalent ordering axiom in deterministic models, (2) the ubiquitous gross substitution axiom, and the neutral money axiom (See Davidson [2002, chapter 3]).

5. For example, in 1977 the Carter Administration's attempted to "talk down the dollar". In the Spring of 1993, Secretary of Treasury Bentsen tried to talk up the yen. In January 1994, the New York Times quoted Secretary Bentsen as saying that "allowing the yen to decline would not be an acceptable way for Japan to try to escape from its recession".

6.Currently, given the jump in the unemployment rate and the loss of jobs since George W. Bush became President in 2001, many economists are applauding the fall in the dollar exchange rate as a means of making American industry more competitive and therefore increasing jobs by increasing exports.

7. Most mainstream economists were appalled by President Reagan's boasts of superiority regarding the higher dollar that was achieved in the early years of his Administration.

8. Under a Keynes-Post Keynesian view, the imbalance may be due to the oversaving of the nation's trading partners.

9.And does not allow proponents of fiscal discipline to shrink the size of government.

10. Though modified by Harry Dexter White's views on the role of the IMF and the World Bank, these proposals plus the Marshall Plan (which unintentionally followed one of Keynes's proposals) were the basis of the Post World War II global prosperity (see Davidson, 2002).

11. Williamson recognizes that when balance of payments "disequilibrium is due purely to excess or deficient demand", flexible exchange rates per se can not facilitate international payments adjustments. [Williamson, May 1987, pp. 200-204]

12. This provides as an added bonus by making tax-avoidance and profits from illegal trade more difficult to conceal.

13. 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 a foreign currency for domestic transactions and as a store of value (e.g., it is estimated that Argentineans held over $5 billion U.S. currency at the turn of the century), 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.

14. Some may fear that if a surplus nation is close to the trigger point it could short circuit the system by making loans to reduce its credit balance prior to setting off the trigger. Since preventing unreasonable debt service obligations is an important objective of this proposal, a mechanism which monitors and can restrict such pretrigger lending activities may be required.

One possible way of eliminating this trigger avoidance lending loophole is as follows: An initial agreement as to what constitutes sensible and flexible criteria for judging when debt servicing burdens become unreasonable is established. Given these criteria, the clearing union managers would have the responsibility for preventing additional loans which push debt burdens beyond reasonable servicing levels. In other words, loans that push debt burdens too far, could not be cleared though the clearing union, i.e., the managers would refuse to release the IMCU's for loan purposes from the surplus country's account. (I am indebted to Robert Blecker for suggesting this point.)

The managers would also be required to make periodic public reports on the level of credits being accumulated by surplus nations and to indicate how close these surpluses are to the trigger point. Such reports would provide an informational edge for debtor nations permitting them to bargain more successively regarding the terms of refinancing existing loans and/or new loans. All loans would still have to meet the clearing union's guidelines for reasonableness.

I do not discount the difficulties involved in setting up and getting agreement on criteria for establishing unreasonable debt service burdens. (For some suggestions, however, see the second paragraph of provision #8.) In the absence of cooperation and a spirit of goodwill that is necessary for the clearing union to provide a mechanism assuring the economic prosperity of all members, however, no progress can ever be made.

Moreover, as the current international debt problem of African and Latin American nations clearly demonstrates, creditors ultimately have to forgive some debt when they previously encourage excessive debt burdens. Under the current system, however, debt forgiveness is a last resort solution acceptable only after both debtor and creditor nations suffer from faltering economic growth. Surely a more intelligent option is to develop an institutional arrangement which prevents excessive debt servicing burdens from ever occurring.

15. Oversaving is defined as a nation persistently spending less on imports plus direct equity foreign investment than the nation's export earnings plus net unilateral transfers.

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

17. 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 this 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.

18. This is equivalent to a negative income tax for poor fully employed families within a nation.

19. Although relative prices of imports and exports would be altered by the change in the terms of trade, the adjustment is due to the resulting income effect, not a substitution effect. The deficit nation's real income will fall until its import surplus disappears.

20. The actual program adopted for debt service reduction will depend on many parameters including: the relative income and wealth of the debtor vis-a-vis the creditor, the ability of the debtor to increase its per capita real income, etc.

21. The Marshall-Lerner condition requires that the sum of the price elasticities for exports and imports exceed unity for a depreciating exchange rate to reduce the payments deficit. The textbook J-curve for a depreciating exchange rate recognizes that in the short run the payments deficit worsens (the downward part of the J-curve). The J-curve ultimately turns upward because it is assumed that in the long run, price elasticities are approximately infinite.