

## 7 The monetary-policy relevance of an international settlement institution

The Keynes plan 60 years later

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Keynes Vol. 25, p. 21

### Introduction

The constitution of a new international monetary and financial architecture has been debated for at least 60 years now, since the 1944 conference at Bretton Woods set up the 'twin institutions', that is, the International Monetary Fund and the International Bank for Reconstruction and Development. A number of important questions that were at stake at the Bretton Woods conference have not been answered yet. To cite only a few of them: can a national currency play the role of international money *essentially*? What are the basics for the creation of a truly international money? Which institution should issue it? What are the links between money and credit at the international level?

This chapter focuses on the need of a structural monetary reform of the international payment system in the spirit of Keynes. It analyses international money and credit from an endogenous-money perspective, showing that these issues need to be addressed, and solved, together to set up an institutional system that can avoid world monetary disorder as well as financial turmoil. The chapter also shows that the so-called incompatible triad of fully liberalized finance, monetary policy autonomy, and stable (though not fixed) exchange rates can be disposed of, if Keynes's message for a world monetary reform is elaborated today considering the financial issues *pari passu* with the monetary ones.

The approach we take is based on the idea, first advocated by Rueff (1979), that a key-currency country subjects its money to a process of duplication when it pays in national money for its net commercial imports. Duplication of the bank deposits owned by the rest of the world, then, creates an international, speculative capital that is crucial for explaining the observed, yet unpredictable, volatility on foreign exchange markets. The argument runs as follows. Suppose that a key-currency country, A, has to pay for its net commercial imports a given amount of money A to the rest of the world, R. In today's regime, country A transfers to R a financial claim on A's deposits in its banking system. The deposits themselves are recorded in A's banking system, in which they had been formed as a result of the working of the local monetary economy of production. These same bank deposits, however, are recorded – as a duplicate – also in the banking system of the rest of the world, which is a net commercial exporter in

this stylized example and, as such, is paid with an amount of money A that it enters – as foreign exchange reserves – on the assets side of its banking system's balance sheet. Now, these claims (a financial capital) circulate erratically, subjecting foreign exchange markets to erratic fluctuations that hamper the development of our capitalist economies, be they advanced, emerging, developing or in transition. In short, the present regime of international payments – which lacks an international standard *proprio sensu* – transforms national currencies from means of payment into objects of trade: their exchange rates vary thus according to their sales and purchases, and in this market speculation arises with a view to making capital gains from these variations. Indeed, this kind of speculation becomes the main cause of exchange rate fluctuations, which, in turn, become the main incentive to speculate on foreign exchange transactions.

The structure of this chapter is as follows. The next section recalls the backbone of the proposal for an International Clearing Union (ICU) that Keynes developed in the early 1940s and then submitted to the Bretton Woods conference. The third section focuses on a point that, to the best of our knowledge, has been neglected, or even ignored, in the endogenous-money literature so far, namely, the distinction between money and credit at the international level, where the International Clearing Bank (that is, the settlement institution for national central banks) would operate for the settlement of international transactions. The fourth section develops Keynes's proposal on modern grounds, and puts forward some structural changes to reform the current international monetary system along post-Keynesian lines. The fifth section concludes, illustrating some main benefits that result from the implementation of an international settlement institution and raising questions for further thought.

### Keynes's proposal: an overview

During the Second World War, Keynes was concerned with the negative effects that the war was likely to bring about in the United Kingdom, whose current account balance was in deficit as a result of the need for this country to import many commodities from the United States without being able to pay for them by an equivalent flow of commercial exports. In particular, the United Kingdom feared beggar-thy-neighbour policies from the United States. As a matter of fact, the US economy was in a very strong position in the early 1940s: its production system was not affected by the war, and its current account recorded huge surpluses as a result of the needs to reconstruct those European economies devastated by the war. Further, the United States had an enormous stock of gold in their reserves, and could thus guarantee convertibility of their currency into precious metal. As a result, the US dollar was in a strong position with respect to any other currency. Keynes was persuaded that the United Kingdom had to put forward a plan in order to limit the US domination – especially with respect to his own country. On 8 September 1941, he thus published two memoranda in which he called for a new international monetary order, and from which he started to develop his view about the new monetary architecture to be set up internationally.

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He namely put to the fore the idea to create a world central bank – for the creation of a truly international money – that in his own words ‘might become the pivot of the future economic government in the world’ (Keynes 1980: 189).

Keynes was indeed one of the first proponents of an international payment system in which a non-national book-entry money, instead of a commodity like precious metals, is used by participating countries to settle their trade imbalances – hence an international netting (or clearing) system, where settlements are made in real (barter) terms as long as foreign trade is balanced and all trade deficits are settled using an international bank money (instead of gold).<sup>1</sup> It remains true, however, that Keynes linked the international bank money, which he dubbed *bancor*, to gold, because in his plan the *bancor* ‘would be defined in terms of a weight of gold’ (ibid.: 85). Most importantly, in Keynes’s plan gold has still some bearing on international settlements, since member countries are entitled to obtain a credit in terms of *bancor* by paying in gold to the Clearing Union for the credit of their clearing account (ibid.: 175). According to Keynes, this would turn a stone (gold) into bread (ibid.: 177), in order for it to nourish economic growth (ibid.: 176).

In fact, the starting point of Keynes’s analysis relies on the merits of the (ideal) gold standard for the orderly working of the international settlement system that existed before the First World War. ‘Years ago, money was an international thing: if you had the money of one country you could change it into the money of another at a fixed rate, and you never had to think which currency you held’ (ibid.: 3). As a matter of fact, under the gold standard system there was an international standard, to wit, gold, which rendered the various national currencies homogeneous owing to the convertibility principle. Hence, Keynes’s proposal is to revert to the *structure* of the international gold standard system, which is ‘a means for trading goods against goods’ (ibid.: 12). To be sure, Keynes insisted on the importance of money as a means of payment at both the national and international levels. His argument, however, is that ‘[any] trading transaction must necessarily find its counterpart in another trading transaction sooner or later’ (ibid.: 18).

Let us recall Keynes’s line of reasoning. First of all, Keynes clearly distinguishes those transactions that only concern a country’s residents from those transactions that also concern countries themselves. The distinction between a country and its residents follows from the fact that any national currency loses its purchasing power when it trespasses the country’s borders, namely, the national payment system issuing it (see Guttman 1988: 255–6). In fact, no national currency can be a means of final payment in the international economy, hence play the role of international money, for in this environment it represents a debt of one of the trading partners (that is, a nation), and everybody knows that no one can finally pay by surrendering a debt. As Keynes pointed out with respect to the essence of international money:

We need an instrument of international currency having general acceptability *between nations* ... that is to say, an instrument of currency used by

each nation in its transactions with other nations, operating through whatever national organ, such as a Treasury or a central bank, is most appropriate, private individuals, businesses and banks other than central banks, each continuing to use their own national currency as heretofore.

(Keynes 1980: 168, emphasis added)

Indeed, Keynes’s goal was not the replacement of national currencies with a world currency: every local currency is a valid means of payment within the currency area where it is issued. Keynes’s aim was to give to international transactions a means of final payment that was, and still is, lacking in foreign trade.<sup>2</sup> In this respect, Keynes (1980: 33) suggested that ‘[w]ithin any member-country or currency unit the provision of foreign exchange [has] to be concentrated in the hands of its central bank which would deal with the public through the usual banks’. This means that to obtain foreign exchange, non-bank agents have to turn to banks, which in turn ask the central bank for it. Moreover, ‘[i]nternationally all transactions [have] to be cleared between central banks, operating on their accounts with an International Clearing Bank’ (ibid.: 34). Two characteristics of the international monetary order that Keynes proposes are thus plain: the bank to set up must act as a settlement institution, that is to say, it must imitate national central banks in their capacity of finally settling interbank debts (see Rossi 2005); and it must be an international bank, that is, the central bank of national central banks.<sup>3</sup> In Keynes’s own words:

the Clearing Union is set up, not for the transaction of daily business between individual traders or banks, but for the clearing and settlement of the ultimate outstanding balances between central banks (and certain other super-national institutions), such as would have been settled under the old gold standard by the shipment or earmarking of gold, and should not trespass unnecessarily beyond this field.

(Keynes 1980: 125)

As Keynes explains, the goal of his plan is ‘to set off transactions against one another so far as you can clear and then to deal with the resulting credit and debit balances as still off-setting one another in the same way they do in internal banking’ (ibid.: 210).

Keynes’s plan is clear. It aims to reproduce at the international level the monetary order that exists in any country, owing to the working of domestic settlement systems headed by a central bank. One cannot be clearer than Keynes himself:

The idea underlying my proposal for a Currency Union is simple, namely to generalise the essential principle of banking, as it is exhibited within any closed system, through the establishment of an International Clearing Bank. This principle is the necessary equality of credits and debits, of assets and liabilities.

(Keynes 1980: 44)

To reproduce at the international level the fundamental principles governing national payment systems, Keynes went as far as to claim that the proposed International Clearing Bank creates its own payment unit, the bancor, for any transaction it settles.

If no credits can be removed outside the banking system but only transferred within it, the Bank *itself* can never be in difficulties. It can with safety make what advances it wishes to any of its customers with the assurance that the proceeds can only be transferred to the bank account of another customer.

(Keynes 1980: 44)

We recognize here the loans-make-deposits causality on which the endogenous-money paradigm is based (see Gnos 1998). Yet, how does it actually work in Keynes's plan? Let us illustrate it with a stylized example.

Consider a trade imbalance between two countries, A and B, which participate in the ICU system as proposed by Keynes.

The central banks of all member states (and also of non-members) would keep accounts with the International Clearing Union through which they would be entitled to settle their exchange balances with one another at their par value as defined in terms of bancor.

(Keynes 1980: 171)

Suppose that country A has a trade deficit worth  $z$  bancor, which must be settled via the International Clearing Bank (ICB) to the benefit of country B. When this occurs, the former country obtains a credit of  $z$  bancor from the ICB, which owes an identical amount to the latter country (Table 7.1).<sup>4</sup> Owing to the banking principle that loans create deposits, the ICB accepts the granting of a credit to country A – for the payment of the trade imbalance – because the amount of bancor so created is mechanically deposited by country B and, as a result of the very mechanism of double-entry bookkeeping, no single bancor can leave the system. It is at this juncture that money and credit come to light in Keynes's plan.

### Money and credit in Keynes's plan

The Keynes plan for world monetary reform does not distinguish explicitly between money and credit in so far as the working of the ICB is concerned. In

Table 7.1 The result of an international payment in bancor in Keynes's plan

<i>International Clearing Bank</i>	
<i>Assets</i>	<i>Liabilities</i>
Country A + $z$ bancor	Country B + $z$ bancor

fact, were the plan implemented as Keynes suggested, it would solve the international monetary problem but would leave the credit problem unsolved.

Consider the example stylized in Table 7.1, which epitomizes any international payment in bancor according to the Keynes plan. As a result of the payment carried out in the ICB ledger, country B is entitled to a deposit in bancor for the amount of country A's trade deficit. Hence, as Lutz noted:

If this world bank grants a credit to country A by creating a bancor deposit in its favor, and country A then turns this deposit over, in payment for its deficit, to country B, which then keeps the deposit, it is of course country B which is really giving the credit to country A.

(Lutz 1963: 241)

It is precisely at this stage that Keynes's plan blends money and credit, allowing deficit countries to live beyond their income – up to some predetermined quota (see Keynes 1980: 173–6).

In fact, Keynes's analogy between domestic and international banking does not fully apply to his own plan. As argued by Schumacher:

The analogy with a national banking system, greatly emphasized in the Memorandum [Keynes's plan], is justified only as far as the *creation* of bancor quotas is concerned. They indeed, like bank credit, are created out of nothing. But once bancor quotas have been allotted and fixed, the analogy becomes confusing.

(Schumacher 1943b: 15)

In domestic banking and payment systems, as a matter of fact, money is issued by banks as a means of final payment between non-bank agents. It does not constitute an asset on its own for any agent, who must earn an income to have a purchasing power over produced output. By contrast, Keynes's bancor would be issued (in exchange for gold) as a reserve asset for the ICU participating countries,<sup>5</sup> which may use it in final settlement of international transactions and acquire thereby real goods and services. In other words, the bancor created by the ICB would be a liquid asset (a financial capital) for the country that would dispose of it in order to pay for its net commercial imports. Indeed, as Keynes (1980: 176) explains, his plan is to allow each country 'a certain margin of resources and a certain interval of time within which to effect a balance in its economic relations with the rest of the world'. This margin, according to Keynes, is to be provided by the ICB itself, and is intended as an 'initial reserve' (ibid.: 272). In his own words, '[t]he margin of resources provided by the Clearing Union must be substantial... This margin, though substantial, must be regarded solely as a reserve with which to meet temporary emergencies and to allow a breathing space' (ibid.: 272).

In sum, Keynes's bancor would be created with a purchasing power of its own, and would serve only for the payment of trade imbalances – as in a netting

system – and not for the payment of each single international transaction – as in gross settlement systems. Any country would be entitled to pay for its net imports of real goods and services by merely a stroke of the ICB pen, provided that its deficit does not exceed its predetermined quota (see Keynes 1980: 173). Under such a scheme, Keynes is therefore obliged to provide a series of measures, namely, a system of fines, to prevent the piling up of credit and debit balances without limit in the accounts that countries hold at the ICB (*ibid.*: 173–5). These measures are of an institutional order and depend on the good will of participating countries, whose behaviour may or may not abide by the system of regulations devised by Keynes. It is thus legitimate to ask whether these fines, and the other conditions stipulated by Keynes, are enough to exert pressure towards equilibrium in foreign trade. According to Schumacher:

the fines which under the [Keynes] Plan are to be imposed upon surplus countries must be viewed with a certain amount of doubt. They may help to achieve equilibrium, but will they exert an expansionist pressure? Not if the surplus countries react to them by cutting their exports, for then the result will be restriction and a contraction of world trade.

(Schumacher 1943b: 14)

Further, '[i]f it appears doubtful whether the treatment proposed for excessive surpluses will, in fact, lead to an expansion of world trade, it is almost certain that the treatment proposed for excessive debits will be a restrictive force' (*ibid.*: 15). At another level, Schumacher argues that it would not 'be wise to place much reliance upon the efficacy of persuasive efforts emanating from an international authority' (*ibid.*: 14). The regulations proposed in Keynes's plan are thus problematic on two counts, granted:

(1) that the suggested pressure by means mainly of fines and persuasion is quantitatively and qualitatively too weak to exert any measurable influence; and (2) that the expansionist effect which a penalization of surpluses might have (on special assumptions) may easily be neutralized, if not overcompensated, by the restrictive effect of the regulations applying to deficit countries.

(Schumacher 1943b: 15)

Yet, even on the assumption that countries are 'well behaved' and that the designed institutional measures of Keynes's plan function well, the implementation of this plan without any further elaboration might give rise to some inflationary pressures at the international level on the markets for produced goods, because it does not distinguish money from credit explicitly. In fact, to revert to the example stylized in Table 7.1, country A would be allowed to pay for its net commercial imports by becoming indebted to the ICB, that is, without disposing of an equivalent amount of financial claims. In other words, total demand for world output (that for expositional ease we limit to the output of countries A and

B) would be greater than total supply, owing to the purchasing power that Keynes's plan attributes to the bancor deposits in the accounts at the ICB and that adds to the purchasing power that exists in the form of bank deposits in national currencies (money A and money B in our example). In other words, owing to the fact that there is no production outside the countries, to wit, at the international level, the creation of bancor generates a stock of money with no corresponding output, so that a country is not finally (that is, really) paid until it spends its bancor deposit and obtains real goods and services in exchange for it. As noted by Schumacher (1943b: 17), '[t]he creation of bancor quotas, unlike the creation of gold, costs nothing; consequently, it produces no new incomes and no new spending'.

So, if we were to stop here, the Keynes plan would not solve the problem of how countries are to finance their trade deficit eventually. To be sure, each country must provide the real or financial backing of its net commercial imports for equity reasons. 'In simple terms, this means that a country must finance its net commercial imports by an equivalent amount of exports of goods, services or securities' (Cencini 2001: 13). To put it differently, if the bancor is not used for the payment of each international transaction, but only for the settlement of foreign trade imbalances, as in Keynes's netting scheme, then it remains a unit of account. No trade deficit, however, can be financed with a unit of account: a means of final payment is needed for that purpose (Schmitt 1985: 204–6).

The problem with Keynes's plan is that it applies the overdraft principle, which indeed functions very well in domestic banking systems, to the international economy.<sup>6</sup> As a matter of fact, as Guttman (1988: 273–4) notes, there exists an essential difference between national economies and the international economy: whereas the former are monetary economies of *production*, the latter involves *exchange* transactions only. The international monetary unit (Keynes's bancor), therefore, cannot be associated with an international output, because no international production exists in order to give to this money a purchasing power of its own, which in point of fact can only be derived from national currencies, and production. Overdrafts in the international economy have thus to be grounded on financial assets – to wit, claims on present or future production – that countries may exchange between them through the intermediation of the ICB.

### Keynes's proposal refined: the ICB as money purveyor and credit purveyor

In his speech before the House of Lords on 18 May 1943, Keynes (1980: 270) pointed out that the principal object of his plan is 'to provide that money earned by selling goods to one country can be spent on purchasing the products of any other country. In jargon, a system of multilateral clearing.' Now, settlement of international transactions on real goods and services in such a system means that:

The importer in country A pays for the goods he buys from country B by handing over to the Clearing Authority in his own country a sum of

A-money which is deemed to discharge his debt. The exporter in country B receives from the Clearing Authority in his country an equivalent sum of B-money which is deemed to satisfy his claim.

(Schumacher 1943a: 150)

In other words, multilateral clearing implies that every single international transaction has to be finally settled, in local currency within the countries concerned as well as in an international monetary unit, say bancor, between them.<sup>7</sup> In this framework, '[b]eing linked to equivalent payments by and to individuals in their respective currencies, [any international settlement in bancor] only transfers existing purchasing power from one country to another' (Guttman 1994: 433).

Let us elaborate on the example stylized in Table 7.1. Suppose that countries A and B participate in the ICU as suggested by Keynes, and that we aim to modernize and forge ahead in this section. Suppose also that country A has a trade deficit worth  $x$  units of money A (MA) or, equivalently,  $z$  bancor. For expositional ease, assume that country A's deficit is country B's surplus, as if the ICU were composed of two countries only. To refine Keynes's plan and make sure that the money-purveying and credit-purveying functions of the ICB are clearly separated, let us introduce a two-department bookkeeping in each national central bank involved (see Schmitt 1973 for an analogous proposal at the international level). In other words, let a country's central bank record any international transaction in two separate monies: its Domestic Department enters the payment in local currency, while its External Department enters it in international money, namely, in bancor. The result of the payment of the trade imbalance between countries A and B is shown in Table 7.2.

So far, the only difference with Keynes's (and Davidson's) proposals is the explicit departmentalization of monetary flows. In fact, the double entry in the ICB ledger is the same in Tables 7.1 and 7.2. So, as we noticed, if the settlement of the international transaction were stopped here, country A would be allowed finally to pay for its net commercial imports from country B without relinquishing an equivalent amount of securities (see the Domestic Department account of country A's central bank in Table 7.2). Country A would thus live beyond its income, because it could pay for its net commercial imports without exporting goods, services or securities for an equivalent amount.

If the ICB intervention were to stop at this stage, in fact, a deposit of  $z$  bancor would coexist alongside of a sum of bank deposits in money B (MB) worth the same amount (see Table 7.2). In other words, the number of money units existing as a result of a single payment would be twice ( $2x$ ) the value of the exchanged items ( $x$  MA) – recall that in our example  $x$  MA =  $z$  bancor =  $y$  MB. To make sure that the total sum of bank deposits corresponds to the value of the underlying transaction, the international payment system has to ensure that either one of the two sums of money worth  $y$  MB each – the deposit in the Domestic Department of country B's central bank and the deposit at the ICB –

Table 7.2 The result of an international payment in bancor: step I

Central bank of country A			
Domestic department		External department	
Assets	Liabilities	Assets	Liabilities
Bank B1 (importer) +x MA	External department +x MA	Domestic department +z bancor	International Clearing Bank +z bancor

International Clearing Bank	
Assets	Liabilities
Central bank of country A (External department) +z bancor	Central bank of country B (External department) +z bancor

Central bank of country B			
Domestic department		External department	
Assets	Liabilities	Assets	Liabilities
External department +y MB	Bank B2 (exporter) +y MB	International Clearing Bank +z bancor	Domestic department +z bancor

Note

$x$  MA =  $z$  bancor =  $y$  MB.

disappears as soon as it is formed. Only in this case will the ICB intervention, which is needed to finalize international payments, leave the money–output relationship unaltered worldwide.

At this stage, the recent advances made by domestic banking systems in the management of settlement risks can provide the missing element to forge ahead Keynes's plan. In short, it is possible to link together funds transfers and securities transfers at the international level to make sure that delivery of a financial asset occurs if, and only if, the corresponding final payment occurs, too (this is the delivery-versus-payment mechanism by means of which both actions take place at the same time; see Committee on Payment and Settlement Systems 2003: 492).

Let us illustrate this mechanism by referring to our stylized example. When the central bank of country B is informed that it is entitled to a deposit in international money at the ICB, it should decide whether to lend this amount directly to a deficit country (like A) or to spend it for buying securities in the

international financial market (see below). If country B lends its bancor deposit to country A voluntarily, this means that country A sells an equivalent amount of financial assets to country B. If so, then the book-entry situation after this financial transaction has taken place, and has been finally settled in bancor, is depicted in Table 7.3 (previous entries are shown in bold).

Table 7.3 shows that as a result of the international payment in bancor through the ICB no country has a *monetary* deficit, because all trade imbalances are finally settled by a transfer of eligible assets in a multilateral framework. In this setting, national as well as international monies are used in a purely circular way, that is, as a means – and not as an object – of payment. To be sure, country A ends up with a net *financial* outflow, since it sells an amount of securities to finance its final payment to country B (through the ICB). Needless to say, these securities, while they provide the means to finance the country's net commercial imports, are in no way the ultimate export of a deficit country: any trade deficit can only finally be paid by a net export of goods or services, thereby compensating over time a country's trade deficit with the same country's trade surplus. The sale of financial assets, nevertheless, provides a bridge between the present and the future, that is, between a trade deficit and a trade surplus recorded by the country considered (country A).

In other words, if country B spends the bancor deposit it received as a result of its trade surplus (worth  $z$  bancor) for purchasing the securities sold by country A, this allows the latter country to find in the international financial market the funds it needs to pay for its trade deficit and reimburse the overdraft obtained at the ICB. In the end, international money disappears as the reflux principle indicates (see the ICB balance sheet in Table 7.3), and hence no inflationary pressure can arise in the market for produced goods: a bank deposit of  $y$  MB exists (in country B) as a result of the international settlement of A's trade deficit (B's trade surplus). This bank deposit is backed by financial assets – as a collateral – which are transferred from country A to country B with the *monetary* intermediation of the ICB.

Now, although the most needed purpose of the ICB is that of providing participating countries with a means of final payment for the orderly working of the international monetary system, it would be wise to let the ICB act also as a *financial* intermediary, lending on a long-term basis the amounts saved by surplus countries. The ICB could, notably, lend to deficit countries the whole amount of bancor deposited by those surplus countries that spend it neither on the product nor on the financial markets around the world. Consider in this respect the ICB balance sheet in Table 7.3. From a circular-flow perspective, the two double-entries in the ICB ledger are the result of two distinct circuits of international money that occur in one and the same point of time. The first circuit concerns the payment in bancor of the trade imbalance between country A and country B. The second circuit concerns, by contrast, the payment in international money of a transaction on the financial market that has been induced by the former circuit (see above). The second circuit being induced by the first, we may analyse them together (Figure 7.1).

Table 7.3 The result of an international payment in bancor: step II

<i>Central bank of country A</i>			
<i>Domestic department</i>		<i>External department</i>	
<i>Assets</i>	<i>Liabilities</i>	<i>Assets</i>	<i>Liabilities</i>
<b>Bank B1 (importer)</b> +x MA	<b>External department</b> +x MA	<b>Domestic department</b> +z bancor	<b>International Clearing Bank</b> +z bancor
External department +x MA		International Clearing Bank +z bancor	Domestic department +z bancor
Financial assets (sold to country B) -x MA			
Bank B1 (importer) +x MA			
Financial assets (sold to country B) -x MA			
<i>International Clearing Bank</i>			
<i>Assets</i>		<i>Liabilities</i>	
<b>Central bank of country A (External department)</b> +z bancor		<b>Central bank of country B (External department)</b> +z bancor	
Central bank of country B (External department) +z bancor		Central bank of country A (External department) +z bancor	
<i>Central bank of country B</i>			
<i>Domestic department</i>		<i>External department</i>	
<i>Assets</i>	<i>Liabilities</i>	<i>Assets</i>	<i>Liabilities</i>
<b>External department</b> +y MB	<b>Bank B2 (exporter)</b> +y MB	<b>International Clearing Bank</b> +z bancor	<b>Domestic department</b> +z bancor
Financial assets (bought from country A) +y MB	External department +y MB	Domestic department +z bancor	International Clearing Bank +z bancor
Financial assets (bought from country A) +y MB	Bank B2 (exporter) +y MB		

Note

 $x$  MA =  $z$  bancor =  $y$  MB.

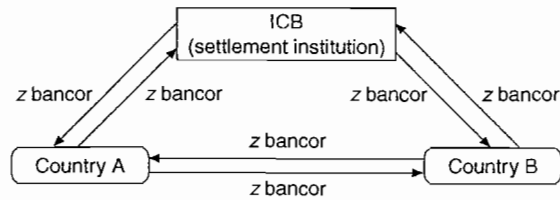


Figure 7.1 The two circuits of international money.

The goods-market circuit of international money, represented anticlockwise in Figure 7.1, is elicited by the money-purveying role of the ICB as regards international trade. Countries need to ask the ICB in order for their commercial transactions to be settled. By contrast, the financial-market circuit of international money, represented clockwise in Figure 7.1, is elicited by the fact that the first (anticlockwise) circuit alone would not be enough for the surplus country (B) to be finally paid: the monetary intervention of the ICB, in fact, would give rise to a mere promise to pay if it were not complemented by a reverse operation whereby the newly created international money is destroyed. This reverse operation amounts to a purchase of securities by country B, which in so doing spends the bancor deposit it is entitled to at the ICB as a result of the goods-market circuit of international money. On the whole, if country B is led to spend on the international financial market the amount of bancor it obtains from foreign trade, it contributes to ensure the orderly working of the international payment system, namely, the bancor standard system.

What happens, however, if country B does not spend its bancor deposit at the ICB to buy those securities sold by country A, which seeks to finance its trade imbalance? It is at this juncture that the credit-purveying function of the ICB acquires its full sense. As a matter of fact, instead of selling its securities to country B, country A may sell them to the ICB, which, in so doing, advances a payment that country A will benefit from when exporting real goods or services. If so, there may be two kinds of financial assets behind the entries in Table 7.3: country A's securities sold to the ICB, and the ICB's securities sold to country B. These securities may be denominated in either local currencies (MA, MB, or any third-country's currency) or bancor, the important point being that the final settlement of these financial transactions between countries occurs using international money as a vehicle, that is, a means of payment, whose load is the amount of securities transferred from the seller to the buyer.

By selling its own securities (or certificates) on the international financial market, the ICB would collect private as well as public capital and invest it in those countries most in need of a recovery and in which capital would otherwise not flow (see Kalecki and Schumacher 1943: 30–3 and Arestis and Sawyer 1997: 362–3). As Stamp (1963: 81) noted, '[t]he certificates would end up with the countries which are in over-all surplus – which, therefore, would have auto-

matically lent . . . that surplus to the rest of the world'. Needless to say, the ICB open-market and lending operations would have to be supervised and respect the principles of sound banking as well as international best practices. The ICB lending facilities are not to be granted *ad libitum*, but some limit must be provided, and an interest rate must be paid by those countries obtaining the ICB (unconditional) financial assistance. The interest rates paid by deficit countries on their borrowings, from either surplus countries or the ICB, would depend on the extent of their trade deficit, stock of foreign debt and capital account balance. A country recording a financial deficit, especially one elicited by capital outflows, is hardly in a position to issue new debt instruments at favourable terms. It must accept either the onus of paying higher rates of interest on new debt, or that of slowing down the national economy by a hike in domestic interest rates in the hope of attracting foreign capital (both short and long term). Alternatively, or additionally, the country might devalue, hoping thereby to boost exports and improve its trade balance in a not too distant future.<sup>8</sup>

In fact, the main objection against our plan is that it might invite abuse, and that the quality of the securities sold by deficit countries to the ICB (in its acting as long-term purveyor of funds) might not match the quality of the ICB's securities sold to surplus countries, so that the quality of the latter financial assets is likely to deteriorate over time too. In this respect, the ICB statutes need to provide some limit, say in terms of a percentage of either total foreign trade or GDP (for instance, calculated on a ten-year moving average), beyond which no country is allowed to finance its current account deficit by selling financial assets – namely, when the country's risk and stock of debt are already too high for this country to provide sound collateral – and it must thus cut back on its commercial imports and/or increase its exports of real goods and services (not least to pay for debt service, that is, interest on securities sold either to surplus countries or to the ICB to finance the country's trade deficit). To be sure, no creditor country would suffer from any credit risks under the proposed international settlement system: bancor balances would always be fully, and immediately, convertible into real goods and services sold by any member of the system, or into securities sold either by any (deficit) country or by the ICB acting as a financial intermediary between member countries.

## Conclusion

The creation of an International Clearing Bank as proposed by Keynes would not be enough to address the problem of funding the economic transactions between trading countries. This chapter shows that a structural monetary reform is needed to provide for final finance in the settlement of current account deficits. In fact, analysing international money and credit with the endogenous-money paradigm leads to the conclusion that these issues need to be addressed together, to set up an institutional system that can avoid world monetary disorder and financial turmoil.

The delivery-versus-payment protocol that we propose for the international settlement machinery guarantees that each monetary transaction between any two countries gives rise to both a transfer of funds via the ICB ledger and a transfer of securities between the countries involved by the final payment in bancor (or whatever the name of the international money will be). The first merit of our system would indeed consist in introducing a mechanism by means of which any surplus country spends its bancor balances as soon as it earns them, so that at the end of each settlement day no credit balances at the ICB would be held idle.<sup>9</sup> If the latter balances were not spent by surplus countries buying the securities sold by deficit countries, a protocol would make sure that end-of-day bancor balances are automatically spent by the same surplus countries for the purchase of ICB's securities.

If international settlements are carried out through the monetary and financial intermediation of the ICB, then each local currency will be instantaneously exchanged against itself through international money. In the example we analysed in the previous section, for instance,  $x$  units of MA are supplied (against  $z$  bancor) in the payment of country A's trade deficit, at the same time as  $x$  units of MA are demanded (against  $z$  bancor) in payment of the securities sold by country A. Similarly,  $y$  units of MB are demanded (against  $z$  bancor) in the payment of country B's trade surplus, at the same time as  $y$  units of MB are supplied (against  $z$  bancor) in payment of the securities bought by country B. Each currency being simultaneously supplied and demanded against an identical amount of bancor, its exchange rate can never be affected by international transactions – be they on product or financial markets. Hence, speculation cannot alter exchange rates in such a system. To be sure, even though there may still exist a 'cash' market for foreign exchange on which local currencies can be traded according to individual supply and demand conditions, arbitrage between this market and the structurally reformed international payment system makes sure that the former market prices will rapidly converge to official exchange rates: either one of the trading parties, in fact, will take advantage of the official exchange rate to carry out its foreign exchange transactions, so as to bring the 'cash' exchange rate in line with the official rate necessarily and before long.

This international payment machinery is particularly needed in today's world of free international capital flows and multi-currency international banking. To be sure, these are essential characteristics of modern open economies, be they advanced, emerging or in transition, and their importance has been growing in line with the emergence of globalized financial markets. In spite of highly integrated financial markets, however, the international infrastructure for the settlement of cross-border transactions is still fragmented, and one may even say cacophonous. This represents a major limitation of cross-border transactions, because they lack a sound monetary-institutional framework within which international payments can occur without generating destabilizing effects on exchange rates, current and capital accounts, interest rates, and thus affect economic performance negatively. As a matter of fact, the Continuous Linked Settlement (CLS) system operated by the New York based CLS Bank as from 9

September 2002 represents the private sector answer to globalized financial markets and the changed structure of the balance of payments, in which capital flows are now prominent. This system allows the settlement of foreign-exchange transactions in some major national currencies. In this system, various central banks provide accounts and some also offer settlement services for CLS participating banks. What is still lacking, however, is a settlement institution for central banks themselves, which would notably homogenize their national currencies by the emission of an international central bank money that would guarantee exchange rate stability – though not fixity.

Indeed, in the system we propose, any participating currency would have an exchange rate that is stable (although not fixed) in terms of bancor, hence also in terms of any other participating currency, in a framework of free capital movements,<sup>10</sup> without this being incompatible with a high degree of flexibility in policy making. In fact, our plan grants another major benefit to participating countries, because it increases their room for manoeuvre when gearing their economic policies (particularly an autonomous and independent monetary policy) to the needs of their domestic economies. The age-long conflict between domestic and external goals of a country's monetary policy would therefore be solved definitively, to the benefit of growth, employment and effective demand.

A number of questions, however, remain to be addressed and should be on the agenda of an international conference aiming to reform the international payment system in the spirit of Keynes. In the system we propose in this chapter, indeed, and up to some limit (see above):

no individual member State would be prevented from determining for itself to what extent it wished to allow its Current Account to be unbalanced. . . . Such a country might aim, for instance, at a drastic over-valuation of its own currency, thus being able to pay highly attractive prices for its imports and making its (potential) exports inordinately dear to the foreigner.

(Kalecki and Schumacher 1943: 30)

If so, then on what grounds should a country's policy makers determine the exchange rate of the local currency against the bancor, within the limits outlined in the previous section? The answer depends on the country's policy targets. A country might decide to have a current account surplus, to secure employment and have a positive amount of net investment abroad, or it might decide to have a current account deficit, to develop itself through foreign capital inflows.<sup>11</sup> In either case, the exchange rate (between the local currency and the bancor) has to be set at a level that allows the country to hit its external target. Further, a country may have an output/employment target that it may want to hit using (also) the exchange rate instrument. If so, then the exchange rate between its currency and the bancor should be set at a level compatible with this goal. Any other policy variable may be considered, of course, the important point being that the country concerned will be able to set, and modify (if necessary),<sup>12</sup> the exchange rate of its currency against the bancor, which would become the



standard of the structurally-reformed international monetary system. In such a system, monetary and exchange-rate policy decisions could be taken according to the real needs of increasingly-open market-economies – be they advanced, emerging, developing, or in transition.

### Acknowledgements

Earlier versions of this chapter were presented at the History of Economic Thought conference held at the University of Leeds, UK, on 3–5 September 2003, and at the European Society for the History of Economic Thought conference held at the University of Treviso, Italy, on 26–29 February 2004. The author would like to thank conference participants and an anonymous referee for their very helpful comments. Research and bibliographic assistance by Nunzio Canova and Dante Caprara is also gratefully acknowledged. The usual disclaimer applies.

### Notes

- 1 See also Schumacher (1943a and 1943b), Kalecki and Schumacher (1943) and Schumacher and Balogh (1944).
- 2 As recent central-bank literature indicates, a final payment is ‘the discharge of an obligation by a transfer of funds and a transfer of securities that have become irrevocable and unconditional’ (Committee on Payment and Settlement Systems 2003: 496). The fourth section elaborates on this point.
- 3 ‘Keynes observed that the logic of bank money implied the hierarchical structure of banking systems. Within countries inter-bank settlements are daily proceeded in central bank money after multilateral clearing of net bank exposure. Keynes thought that the same logic could be forwarded to international settlements, if a third stage was built in linking national banking systems together’ (Aglietta 2004: 52).
- 4 Davidson (2002: 232) calls for an analogous system, substituting the bancor with what he labels the International Money Clearing Unit (IMCU).
- 5 ‘The liability of this institution [Keynes’s ICB] would be the exclusive international reserve asset for national central banks’ (Aglietta 2004: 52). Davidson (2002: 232) argues in the same vein, considering the IMCU as ‘the unit of account and ultimate reserve asset for international liquidity’.
- 6 According to Schumacher (1943b: 16), ‘[t]he great merit of the [Keynes] Plan is that, by a mutual exchange of overdraft facilities, it restores the international liquidity of countries. It should not claim more than this. It should not claim (par. 12) that it amounts to “the substitution of a credit mechanism in place of hoarding.” It does not abolish international hoarding. On the contrary, it creates a new object for hoarding, bancor balances’.
- 7 This contrasts with netting systems, in which only the net position of each participant is settled with a money transfer on the accounts held at the settlement institution, ‘such as would have been settled under the old gold standard by the shipment or ear-marking of gold’ (Keynes 1980: 125).
- 8 The bancor standard is not a system of irrevocably fixed exchange rates. Generally speaking, ‘[c]hanges in parities can take place when money wages and profit margins relative to productivity are permanently out of line, or when countries experience chronic difficulties in their balance of payments for other reasons’ (Arestis and Sawyer 1997: 363).

- 9 International hoarding would thus be mechanically impossible. By way of contrast, see note 6.
- 10 Two-way convertibility between any participating currency and the bancor through the proposed two-department bookkeeping system in the national central banks (see Table 7.3) amounts to free capital flows across national borders. This contrasts with the one-way convertibility mechanism called for in the Davidson proposal (2002: 232), which permits each nation to control and regulate international capital movements, but which seems unrealistic in the current framework of full financial liberalization.
- 11 As argued by Kalecki and Schumacher (1943: 29), ‘[t]here is no merit in a general policy aiming at *Current Account equilibrium* for all countries, because different countries are at different stages of economic development, and a regular flow of investment from the more highly developed to the more backward regions of the world may redound to the benefit of all’.
- 12 The possibility of modifying the exchange rate is necessary to correct it in case of non-attainment of the relevant target (defined with respect to foreign trade, real growth, inflation or any other policy variable). In addition, the ICB may also be given the statutory power to require exchange rate changes if current account surpluses threaten economic growth in deficit countries, or if overvaluation of a currency’s exchange rate threatens financial stability.

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## 8 Price and prejudice

### The statics and dynamics of money-wage flexibility

*Annamaria Simonazzi and Fernando Vianello*

#### Introduction

In the last decade of the twentieth century concern over the havoc wrought by deflation in Japan and the threat of contagion of 'nipponitis' to other developed economies aroused new interest in deflation as a theoretical subject, but does not appear to have undermined the reassuring belief ('prejudice') that, as a rule, money-wage flexibility ('price') can be counted on to make the economic system self-adjusting.<sup>1</sup> To tell the story of how the above belief, peculiar to 'classical' economics, survived Keynes's critique is among the aims of the present chapter.

The idea put forward by Keynes in Chapter 19 of the *General Theory* – partly relying on his own and Irving Fisher's previous analyses of deflation – is that under money-wage flexibility any departure from full employment would trigger a cumulative fall in prices and aggregate demand. What makes the real-world economy stable is indeed, in his opinion, the circumstance that money wages *do not* fall without limit as long as labour supply exceeds labour demand.

Some aspects of Keynes's (1923) and Fisher's (1932 and 1933) analyses of deflation will be examined in the first section as a preliminary to the reconstruction – offered in the second section – of Keynes's (1936) treatment of money-wage flexibility. Fisher's and Keynes's approaches, it will be pointed out in the above sections, are dynamic in nature, in the sense that both authors are concerned with the fall in (money wages and) prices *as a process*.

In the third section we shall illustrate a scarcely noticed aspect of Keynes's position, namely, its open-endedness as far as the final outcome of the deflationary process is concerned. A critical appraisal of the subsequent rehabilitation of the static analysis of money-wage flexibility – with its accompanying 'closure' of the Keynesian system, and vindication of the economy's capacity for self-adjustment – will be provided in the fourth section.

Not even in static analysis, it will be contended in the following two sections, can money-wage flexibility be reckoned to bring about a rise in aggregate demand and employment. As is well-known, the logical basis of the decreasing relationship between the demand for capital (as a stock and as a flow) and the rate of interest has been shown to be flawed. From this it follows that what has