

Financial Meltdown and the Redesign of the International Financial Architecture

A Brief Note for the Meeting on 24 April 2009

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- (A) The Global economy has had an unprecedented fifteen years of growth of GDP along with a high degree of integration in the flows of capital, commodities and labour. This growth unlike earlier periods has enabled countries of Asia to emerge as economic powerhouses.
- (B) This growth ended in late 2007/early 2008. It is one of the deepest crisis because it is a dual crisis of the financial system and the real output/employment economy. The financial crisis has been caused by a collapse of asset prices which have been acquired against highly leveraged positions by the financial institutions. They face the double problem of liquidity and solvency. The problem in my view was not so much underpricing of risk as underpricing of credit, or as Wicksell said a hundred years ago having a market rate of interest below the natural rate. The resulting boom and collapse have been anticipated in the economics literature by Hayek in his 1930's work Profits Interest and Investment.
- (C) This financial crisis has made the application of standard Keynesian policies difficult as the problem is of under-saving, not over-saving. The under-saving in the OECD economies (broadly speaking) was financed by the global flows of excess savings of Asian and other economies. This flow from savers to consumers is one that happens all the time in national economies and the banking system facilitates it. In the global context, there being no truly global banking systems and no global currency either , the flows were intermediated through US Treasury Bills or generally through the US financial system. This gave the US a seigniorage gain and allowed unsustainable credit booms to be launched with the Central Banks not just watching, but applauding.
- (D) The urgent task at the national levels is to fight the output recession and recapitalise the banks. But at the global level we need to consider urgently the building of an international currency system which would insulate all national economies, especially the USA from seigniorage gains, which make the pursuit of sound financial systems difficult. The world needs an intermediary which recycles surplus savings to deserving borrowers in ways which can reduce excess volatility.
- (E) This is where the IMF could have a crucial role to play. The G20 has already assigned a large tranche of credit to augment its resources. This will help in the rescue operations of fragile banking systems in many economies. But as many surplus nation especially the Chinese have argued the need is also for creation of a reserve currency which can bear the burden of being a global asset. Keynes's ideas of the BANCOR are useful here. The central

point is that the reserve currency should be a combination of national currencies and also try to stabilise commodity prices whose volatility augmented the financial boom in its last stages and hastened the real output recession. (the oil price movements between September 2007 and July 2008 for example.)

- (F) The commodity price stabilisation need not be done by active bufferstock holdings but by judicious countercyclical intervention in the commodities futures markets. There has been a number of proposals by economists such Kaldor during the last commodities price boom/bust of the 1970's, These need to be re-examined,

- (G) This meeting should take up some of these issues for further development.