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Policy Note 2002 / 1

KICK-START STRATEGY FAILS TO FIRE SPUTTERING U.S. ECONOMIC MOTOR

WYNNE GODLEY

There is a strategic need, if a "growth recession" is to be avoided, for a new motor to drive the economy, particularly if there is a further decline in private expenditure relative to income that could generate a further hole in aggregate demand.

IF SHARE PRICES ON WALL STREET are to be believed, recovery by the recession-hit U.S. economy will be under way by the second half of the year. But what exactly does "recovery" mean? "Recession" is defined as two consecutive quarters of negative growth, with the corollary that positive growth, however small, qualifies as a recovery. But there is no significant difference between a decline of 0.1 percent per annum and growth of 0.1 percent; both are so far below productive potential that they would be experienced as an increasingly severe recession if continued for any length of time. No growth rate much below 3 percent should be called "recovery" at all, since unemployment would be rising and profits and capacity utilization falling.

Public discussion is further distorted by Wall Street's obsession with the very short term. People who want to make money on the stock exchange try to predict what will happen during the next few months, but strategic policy formation, particularly with regard to fiscal policy, requires a time horizon several years ahead. "Fine tuning" has been decisively and permanently discredited.

Taking a strategic view, I believe that, in the absence of a substantial and continuously increasing fiscal stimulus, the U.S. recession will continue for several more years. At the least, this will take the form of seriously subnormal growth, although it is easy to imagine circumstances (a world slump or a stock market crash) that would cause the absolute decline to continue.

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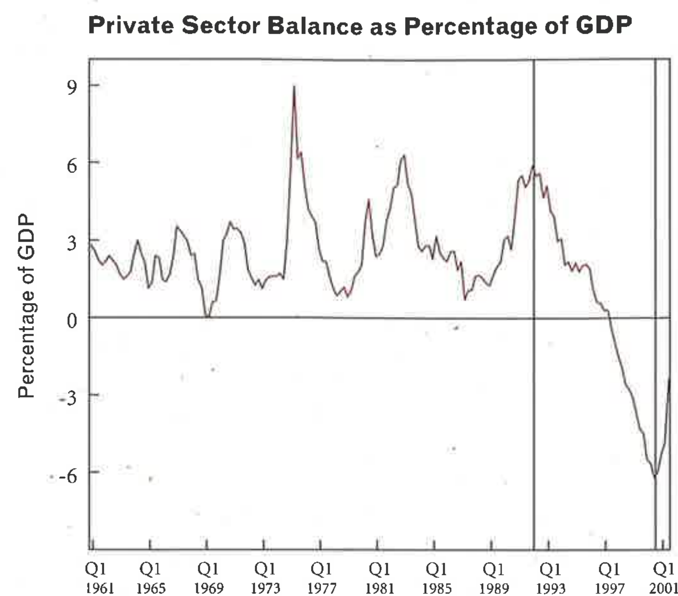

Source: National Income and Product Accounts, U.S. Department of Commerce

The 1990s expansion was powered uniquely and exceptionally by a huge fall in net saving by the private sector, the scale of which is illustrated in the chart above. Vertical lines ma[illegible] the first quarter of 1992, when the expansion really got going, and the third quarter of 2000, when the slowdown started. During this period the balance between the private sector's income and expenditure fell by 11.5 percent of GDP; in the third quarter of 2000, private expenditure exceeded income by an amount equal to 6.2 percent of GDP, having never exceeded it significantly during the previous 30 or more years. This could not have happened without a huge rise in borrowing, which made the private sector as a whole far more indebted than ever before.

The subsequent recession has clearly been associated with a reversal of this tendency. There has been a sharp fall in private expenditure relative to income since the third quarter of 2000. Yet, in the third quarter of 2001, the private sector deficit was still nearly 2.5 percent of GDP, much higher than in any earlier period and high enough to require so much borrowing that private debt relative to GDP rose to another peak. The private deficit will probably recover to its normal condition of surplus, implying a continued fall in private expenditure relative to income that will withdraw 4.5 to 5 percent—up to $500 billion—from aggregate demand. But even if the private deficit were not to recover at all, my main conclusion would still stand because the U.S. economy would remain deprived of the motor that drove it in the 1990s.

Total demand and output in the rest of the world is unusually stagnant, so net export demand may not rise at all, while the Congressional Budget Office's 2002 fiscal projections imply no stimulus beyond the injections under consideration.

A number of factors may combine to lift aggregate demand in the very short term. First, a tax rebate put $40 billion into the hands of U.S. consumers during the third quarter of 2001. (With GDP at about $10 trillion per annum, this has been written off as too small to count—but while the rebate is indeed less than half of 1 percent of a year's flow of GDP, it was 1.6 percent of GDP in the third quarter, quite enough to have a perceptible effect on spending.) Second, the huge fall in short-term interest rates has reduced mortgage rates to their lowest level in decades, lowering the interest burden on households and resulting in substantial withdrawals of equity from the housing market. Third, there is bound soon to be a recovery in inventory investment, which was heavily negative in the third quarter. And fourth, car buying has surged as a result of zero-interest credit inducements.

All of these influences will have a positive effect in the immediate future. However, some of them (the rebate, the equity withdrawal) will be "blips" in the sense that they occur only once and will in time cancel themselves out. Others (lower interest payments and the rise in inventory investment), while not self-canceling, are nevertheless one-time-only, while the car splurge is likely not to have an effect, since sales figures have been "stolen" from 2002.

There is a strategic need, if a "growth recession" is to be avoided, for a new motor to drive the economy. Such an engine must, by deduction, be driven by the public sector; my Levy Institute colleagues have made a number of suggestions for the particular forms the the stimulus might take (Galbraith 2001; Papadimitriou and Wray 2001, a, b; Wray 2001). Suffice [illegible]t to say that fiscal stimulus is necessary, particularly if there is a further decline in private expenditure relative to income that could generate a further hole in aggregate demand, rising toward $400 to $500 billion per annum.

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Policy Note 2002 / 2

THE BRAZILIAN SWINDLE AND THE LARGER INTERNATIONAL MONETARY PROBLEM

JAMES K. GALBRAITH

The postwar liberal trading framework has become hopelessly distorted during the past two decades by the hegemony of the U.S. dollar, high interest rates, debt deflation, and capital flight; the asymmetries of a world so structured are proving intolerable. The economist John Maynard Keynes recognized this issue with characteristic clarity in the design of the Bretton Woods institutions—the World Bank and International Monetary Fund—in 1944. Keynes favored free markets and liberal trading arrangements insofar as they could be made to work, but he was also well aware that free markets are inherently unstable and prone to collapse. Keynes also understood that the characteristic structure of unregulated international finance placed bankers and creditors in the dominant position, and so would inevitably force adjustment by debtors. But what was locally rational in a financial transaction would prove disastrous for the system as a whole. As individual debtors contracted their economies in order to meet their interest payments, their demand for imports would diminish, and so would the exports of their suppliers. The entire economic system would contract, and in the end no one would be further forward in their ability to pay their debts.

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THE INTERNATIONAL MONETARY FUND (IMF) has offered Brazil a $30 billion loan, most of it reserved for next year, on condition that the country continue to run a large primary surplus in the government budget. In this way the IMF maintains a strong arm over Brazil's next government, almost surely to be drawn from the left. Any significant move toward fiscal expansion would trigger revocation of the promised loan, followed by capital market chaos. Or so one is led to suppose.

Right now, Brazil is in the grip of recession. With declining demand for imports, the country has a surplus in its trade account (outflows less inflows of goods and services). It has, nevertheless, a substantial deficit in its current account (outflows less inflows of financial assets), most of which must be interest payments on external debts. These outflows are offset by capital inflows, which are not, however, mainly new investments—currently low, owing to the depressed state of internal demand—but operating loans to existing businesses and the sale of existing national assets to foreigners. In short, Brazil's external balance today is a matter of mortgaging or selling property to pay interest, meanwhile hoping that things will somehow get better.

Hence the loan represents no new money that would benefit Brazilians, except to the extent that wealthy Brazilian nationals also transfer their assets abroad, and that locals purchase durable imports while they can.

The IMF's requirement that Brazil maintain a primary budget surplus amounts to a prohibition against fighting recession by increasing domestic demand, an action that would raise domestic investment and move the trade balance back into deficit (and the current account even more so), which in turn would require that foreign investors be found who are actually willing to bankroll new activity. Of course, such investors do not exist. If they did, the IMF would not be in the picture.

Conversely, the pressure to maintain a trade surplus is a device for balancing the existing willingness of foreigners to buy Brazilian assets against the existing burden of debt service. In part because of the political climate, that willingness is eroding more rapidly than Brazil can manage by shrinking real activity and curtailing imports. Panic therefore threatens from day to day. The short-run purpose of the loan is merely to shift the *timing* of panic so that it occurs under the new government instead of the old. A report in the *New York Times* on August 21, 2002, makes this clear:

> American and European banks have all been scaling back their lending to Brazilian exporters and manufacturers in the last six months. Most are refusing to comment on their willingness to jump back into that market on the heels of the fund's big loan deal.

In the medium term, if the new government respects the conditions of the loan, the effect must be to finance a continuing reduction in private capital inflows, substituting debt to the

IMF for exposure to private external investors while maintaining external debt payments to satisfy older creditors. It is probably not accidental that the net IMF loan for next year is roughly the same size as the present surplus on the capital account.

Nothing here holds out any hope that Brazil's high indebtedness and interest obligations can be reduced. There is no amortization plan. Therefore, unless something does turn up (for instance, massive price increases for orange juice and coffee, which are not very likely), the outlook is for another IMF loan, and another, and another, into the indefinite future, until the private foreign sector is safely divested of its Brazilian holdings.

There is also nothing in the loan that holds out the prospect for economic progress in Brazil itself. Neither increased public spending nor increased imports can be financed from it. Hence the loan represents no new money that would benefit Brazilians, except to the extent that wealthy Brazilian nationals also transfer their assets abroad, and that locals purchase durable imports while they can. It is a standstill, not a progressive package, whose purpose is to keep the wheels of finance spinning, aimlessly, on the Brazilian beach.

The IMF promises, in effect, to help maintain an illusion of business as usual, during which interval the new government can occupy its offices in Brasilia and enjoy the perquisites of power, but only so long *as no actual changes of policy are made.*

Who benefits? In the first place, private holders of Brazilian assets, who have an opportunity to escape before a severe devaluation. In the second place, foreign bankers, whose loans will receive interest longer than would otherwise be the case. And in the third place, domestic political forces inside Brazil that oppose growth in public services and social reform.

What is *not* clear is why a Brazilian government of the left, elected with a mandate to rule in the interest of the working population, should sacrifice its freedom of maneuver to these interests. It would be one thing if the loan held out a prospect of an early return to net new borrowing in support of state policy and private activity, but this is not the case. Instead, the loan is more properly thought of as a form of blackmail. The IMF promises, in effect, to help maintain an illusion of business as usual, during which interval the new government can occupy its offices in Brasilia and enjoy the perquisites of power, but *only so long* as no actual changes of policy are made. The threatened alternative, if the terms are broken, is financial chaos, no doubt accompanied by concerted efforts to destabilize the new regime.

In particular, has Luiz Inacio Lula da Silva worked for so many decades to build the Workers Party only to govern on such diminished terms? Or is he prepared seriously to consider an alternative strategy? If so, of what should it consist? And although disapproval by the U.S. government is a foregone conclusion, what should be the attitude of the people of the United States to such an alternative approach?

The Myth of "Sound" Financial Policies

Brazil is a large, resource-rich, industrialized developing country with a history of interventionist policies in several industrial areas, including aerospace, computers, and energy. It is the economic center of gravity in Latin America. The country's notorious flaw lies in income and wealth inequalities higher than virtually anywhere on earth, and a ruling elite very much aligned with the sectarian interests of the wealthy. A weak regulatory regime persists, particularly with respect to newly privatized sectors. Taxes have never been raised sufficiently to finance satisfactory mass urbanization, and the country's vast national resources have not been protected or developed in a sustainable fashion. Capital, moreover, has been free to take flight whenever policy threatened to move in these directions.

A case could once have been made for capital market openness in Brazil on the grounds that the country was short of capital resources and that these could only be acquired abroad. But that case was valid for the extremely short period between 1973, when the old Bretton Woods institutions were dismantled, and 1982, when the resulting explosion of private debt culminated in economic collapse. During the oil shocks, Brazil did manage to finance growth and its import bill from abroad, but of course it could not do so on a sustainable basis. Since then, Brazil and the rest of Latin America have labored under the dead hand of past debt, unpayable except by selling off existing capital assets. There is no serious case to be made that airlines, roads, power grids, and telecommunications networks actually function better under foreign ownership. At present the entire case for privatization is financial: it raises resources to permit the continued servicing of past debt.

There is no serious case that airlines, roads, power grids, and telecommunications networks actually function better under foreign ownership. At present the entire case for privatization is financial: it raises resources to permit the continued servicing of past debt.

For what purpose? The rationalizing argument behind current IMF programs is that countries that follow "sound" financial policies—balanced budgets, tight money, deregulation, and privatization of capital assets—will be rewarded with a stamp of creditworthiness. They should then benefit by being able to borrow from private capital markets on favorable terms, relative to their own histories and the record of countries who are less responsible. In principle this should mean they can run deficits on their *trade* accounts, loan-finance the purchase of capital goods imports to support development, and maintain high levels of economic growth and job creation. They should be able to do all of this and still attract inflows of direct foreign capital investment.

It has been clear for several decades, however, that this argument is a myth, that the promised land it envisions is a mirage. If it were not, would Brazil be able to complain? The country has a trade surplus and a primary surplus on the government budget. The only source of deficits in both accounts relates to the payment of interest on past debt. To run a surplus on the current account—reducing imports by another $20 billion or so—would require massive further deflation of the real Brazilian economy. This would destroy the tax base and greatly worsen the public budget. Thus, there is no way to improve Brazil's accounts from their current position, short of an export boom—which depends on external demand, over which Brazil has no control—or a write-down of past debt. But of course the very purpose of Wall Street's interest in Brazil is to be paid as much as possible for the past loans.

The Brazilian particulars illustrate a general point. The running of "sound" policies does not translate into favorable treatment on Wall Street. Instead, private investor judgments are driven largely by considerations over which national policies in developing countries have no influence at all. Most notably, these considerations include conditions in other developing countries and in the United States.

Conditions in other developing countries periodically affect Brazil through contagion in financial markets. Upheaval and financial crisis in Russia in 1998 directly affected the risk exposure of many emerging markets funds. Forced to account for the rising risk in Russia, they reacted by reducing exposure in other "risky" markets, such as Brazil, even though there was no connection between the Brazilian and Russian economies at that time. Similarly, contagion from Argentina—itself only recently a "model country" from the standpoint of the IMF—is affecting Brazil now. Brazil is being punished by the financial markets because of the failure of the IMF's sound-money prescriptions as they were applied in Argentina—even though Brazil did not follow the Argentine road of full acquiescence to the IMF's neoliberal schemes. The irony is, well, Latin American.

The rationalizing argument behind current IMF programs is that countries that follow "sound" financial policies—balanced budgets, tight money, deregulation, and privatization of capital assets—will be rewarded with a stamp of creditworthiness. It has been clear for several decades, however, that this argument is a myth, that the promised land it envisions is a mirage.

U.S. policies and internal conditions affect Brazil through their influence on relative rates of return facing investors. In the late 1990s, with a "flight to quality" compounded by the bubble mentality of the technology sectors, capital flowed into the United States and away from developing economies such as Brazil. Now that the bubble has collapsed, so has the appetite for emerging-country risk, and perhaps also the capacity to purchase Brazilian assets. This too is beyond Brazilian control.

It follows that the only route available to Brazilian policymakers *acting on their own* to restore growth and expand public goods and services in the short run must involve a reduction of debt payments. The easiest way to achieve this is straightforwardly to cut back on payments while imposing strict controls over capital flight. Alongside these measures, the real would be devalued, and interest rates reduced to accommodate both exporters and

import substitution. This is the model followed by Russia in 1998, and the result was, in fact, a modest revival of domestic production after a terrible crash. Since that time, the crisis in Russia has eased, even though the vast damage done since the advent of shock therapy has not been overcome.

The case against a policy of debt reduction comes in two parts. One is specious, but the other must be taken more seriously. The specious argument holds that capital markets will punish Brazil for its defiance. The difficulty with this argument is straightforward: Brazil presently enjoys no benefit from its participation in world capital markets. Even the IMF package serves, from the standpoint of ordinary Brazilians, merely to keep up appearances. It is self-evident that to interrupt the recycling of IMF loans into debt service would change nothing in real terms, while the effective imposition of capital controls—if technically possible in Brazil's case—would slow the exit of private investors, and so the decline of domestic asset prices. It does no harm to a bankrupt entity to declare bankruptcy. The main effect is to halt the outflow of inside money. Although affected investors obviously do not welcome this sudden loss of freedom, there is no moral or ethical basis on which they can claim a greater "right to escape" than that of ordinary workers and other citizens to whom the market grants no such opportunities.

The running of "sound" policies does not translate into favorable treatment on Wall Street. Private investor judgments are driven largely by considerations over which national policies in developing countries have no influence at all.

The more serious objection is that Brazil's internal political stability may be threatened by a policy undertaken in the national interest. This is the danger of subversion from the outside. The interests of international finance protect themselves by the means at their disposal. There is a long history of this in Latin America, including Brazil in 1964 and extending to present-day Venezuela, where the complicity of the U.S. State Department and doubtless other services in recent and continuing events is clear. In the Russian case, such risks are much smaller because the government rests on the bedrock of its security services, whose defects are well-known but whose loyalties do not seem to be in question. How well a new Brazilian government may be able to meet this danger is a matter of internal politics on which a distant observer cannot speak with any authority. But it is there—in the "crisis of confidence"—and not in the supposed power of a market that the true danger lies.

Is There a Better Way?

Is there a better way, for Brazil and the world, than a complete rupture between countries in the North and South on financial matters? And are the national interests of the United States absolutely congruent with those of our leading financiers, so that policy with respect to

international development can be safely left to their judgment and in their hands? Or is it possible that, to borrow a phrase, another world is possible after all?

Surely it has to be. The liberal economic vision—with multilateral clearing, relatively free and open trade, easy flow of technology, travel, migration, and human learning—has a core of virtues. It has helped to create a far more open and attractive world, in many important respects, than could ever have been achieved under the previous regimes of colonialism and empire. The world is today safer from global war than it was in the first half of the last century. Trade and peace do go hand in hand—most of the time. There are reasons why the enduring success of such a system remains an ideal for many intelligent and well-meaning people.

At the same time, however, the world we inhabit fails to rise to the standard set by the liberal ideal. Particularly over the past two decades, the postwar trading framework has become hopelessly distorted by the hegemony of the U.S. dollar, unsustainably high interest rates, debt deflation, and capital flight. The asymmetries of a world so structured are intolerable, as they lead to unprecedented prosperity in the rich countries and deepening crisis for the poor. It is a minor miracle that they have not long since led to a full-scale revolt against U.S. global leadership. But the fact is, such a revolt may not be very far off. There already exists widespread rejection of American world leadership by the populations of developing countries worldwide, and the reputation once enjoyed by the United States as a pillar of multilateral order, having respect for differences and fair play, has long since been squandered. This cannot fail to translate into political terms sooner or later.

Particularly over the past two decades, the postwar trading framework has become hopelessly distorted by the hegemony of the U.S. dollar, unsustainably high interest rates, debt deflation, and capital flight. The asymmetries of a world so structured are intolerable.

The British economist John Maynard Keynes had already recognized this issue with his characteristic clarity in the design of the Bretton Woods institutions—the World Bank and the IMF—in 1944. Keynes, as the third volume of Robert Skidelsky's biography makes especially clear, was an economic and a political liberal. He favored free markets and liberal trading arrangements insofar as they could be made to work. But he also had not forgotten the fact, which the Depression had driven home to all observers, that free markets are inherently unstable and prone to collapse.

Keynes understood that the characteristic structure of unregulated international finance placed bankers and creditors in the dominant position, and so worked to force adjustment by debtors. This was locally rational in financial transactions, but disastrous for the system as a whole. Individual debtors would be forced to contract their economies in order to meet their interest payments. Their demand for imports would diminish, and so would the exports of their suppliers. In the end, the entire economic system would contract, and no nation would be further forward in its ability to pay its debts.

The purpose of the Bretton Woods institutions, in Keynes's plan, was to evade this trap. The substantial mechanism was to be a multilateral clearing union, with authority to issue overdrafts to debtors—in effect, to print international money. Under Keynes's scheme, it would be creditors who would have to adjust by expanding their domestic economies, their employment, and their absorption of imports until their consumption of imports rose to match their sale of exports. Otherwise, creditors would face legitimate discrimination against their exports. In this way, the system would balance at high levels of employment (and the principal economic risk, of course, would be international inflation rather than global slump). No member country would, in Keynes's vision, be required to contract domestic economic activity and forgo full employment simply in order to meet international clearing obligations or pay debt service to foreigners.

Keynes did not get his way in the negotiations. The American side, led by Harry Dexter White, insisted on a system dominated by lender interests. As a result, the Bretton Woods institutions contributed almost nothing to postwar reconstruction until calamity threatened in 1948 and the Marshall Plan was put in place to avert it. After that, development largely proceeded under the impetus of cold and hot wars; one in Korea, which jump-started the recovery of Japan, and one in Vietnam, which provided a similar service for Korea and much of southern Asia.

The IMF began developing its modern regimens of debtor adjustment—devaluation plus deflation—for imposition in Europe in the late 1960s. There followed a brief moment, in the aftermath of the oil shock of 1973–74, when the IMF might have emerged as the principal conduit for the recycling of petrodollars to the oil-importing countries of the developing world, but the Nixon administration blocked this. Instead, the job of financing development was turned back to the major commercial banks, along with their European and Japanese colleagues. They made the necessary loans on commercial terms and at variable interest rates keyed to the London Interbank Offer Rate (LIBOR). Development from that point forward was to proceed on commercial terms and "free market" principles, at interest rates determined after the fact by the monetary authorities of the United States.

These arrangements were doomed from the beginning. They collapsed even sooner than they might have otherwise, when Paul A. Volcker and the Federal Reserve pushed American interest rates past 20 percent in their 1981 campaign against inflation. The result was a global crisis of debt, insolvency, and perpetual debtor adjustment that afflicts the entire developing world (except for India, China, and a handful of south Asian city-states) to this day.

The original authors of the IMF and World Bank generally supposed that the United States would remain in its immediate postwar position as a strong surplus country and creditor to the rest of the world. Thus dollars could be "scarce" and, if they were, international liquidity would have to be issued in some other medium. This rather soon proved to be a colossal misjudgment. Instead, the United States went into deficit and eventually became the world's largest debtor. The world became so awash in dollars that the proposed international unit of account—originally the bancor and in its etiolated modern form, the Special Drawing Right—faded into insignificance. Today, the dollar is the world's reserve currency, and the international position of the United States depends on this.

So long as the world is willing to take and hold U.S. assets, including liquid dollars, this system works—and shamefully to the interest of Americans. The resulting high value of the dollar means that we consume comfortably, and in exchange for very little effort, the products of hard labor by poor people. We live on the interest skimmed from the meager living available to factory workers in São Paulo, in exchange for providing otherwise unavailable liquidity to the world system. (Our situation is akin to that of, say, Australia in the late 19th century when gold fields were discovered, except that, in our case, no actual effort is required to extract the gold.) And meanwhile, we are not obliged to invest unduly in maintaining our own industrial base, which has substantially eroded since the 1970s. We could afford to splurge on new technologies and telecommunications systems whose benefits were, to a very great extent, figments of the imagination. And even when the bubble burst in those sectors, life went on, for most Americans, substantially undisturbed—at least for now.

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But for how long will the system of dollar hegemony endure? There can be no definitive answer; the few economists who have worried about this issue are far from being in agreement. On one side, it is argued that the dominant currency holds a "lock-in advantage"; that is, there are economies associated with keeping all reserves in one basket. The United States in particular is in a strong position to oblige foreign central banks to absorb the dollars that private parties may not wish to hold, at least within elastic limits. Control of oil by U.S. allies and satellites will require other importers to buy dollars in order to buy oil, though it is not obvious that such control requires anyone to hold those dollars very long, except as a hedge against price increases or home-currency devaluations.

Against this, the question remains: Will foreigners be willing to add to their holdings of U.S. assets at a rate consistent with the U.S. current account deficit at full employment? The amount to be absorbed is in the range of half a trillion dollars per year. This was easily handled when asset prices were rising, but now that they are falling, dollar assets are not as safe as they once were. If foreigners are not willing to absorb them at the requisite rate, and if asset prices do not quickly fall to the point where stocks appear cheap, dollar dumping is, sooner or later, inevitable. Otherwise, the United States must slow the rate at which liquidity is issued by restricting its imports, which it can only do by holding down economic growth and keeping

incomes well below the full-employment level. In that situation—which may already have arrived—the United States joins Brazil and other developing nations as a country effectively constrained by its debts. Indeed, the world prognosis from that point forward becomes grim, since high levels of American demand have been just about the only motor of growth and development (outside, perhaps, of China and India) in recent years.

The United States as a Debtor Nation

There are economists who advocate dollar devaluation, believing that the richer countries of the world would quickly rally to purchase increasing quantities of made-in-America exports, thus reversing the manufacturing decline of the past 20 years. But this is very unlikely. Exports to the rich regions may not be very price-sensitive.

And exports to the developing regions are very sensitive to income and credit conditions, which would get worse. At least in the short and medium term, there is no foolproof adjustment process to be had by these means. Where a high dollar provides U.S. consumers with cheap imports and capital inflows to finance domestic activity, a falling dollar would have opposite effects. A falling dollar would raise the price of imports into the United States, especially from the richer countries. Meanwhile, a declining dollar would hit at the value of developing countries' reserves, and so work, on that account, to diminish their demand for our exports. The most likely outcome from a dollar devaluation is therefore a general deepening of the world slump, combined with pressure on American financial institutions as global investors seek safer havens in Europe.

This "elasticity pessimism" and the specter of financial vulnerability mean that for the United States, the combination of falling internal demand, falling asset prices, and a falling dollar represents a threat that can best be described as millennial.

This "elasticity pessimism" (very much shared by Keynes in his day) and the specter of financial vulnerability mean that for the United States, the combination of falling internal demand, falling asset prices, and a falling dollar represents a threat that can best be described as millennial. (My colleague Randall Wray has called it the "perfect fiscal storm.") The consequences at home would include deepening unemployment. There would be little recovery of privately financed investment, amid a continued unraveling of plans—both corporate and personal—that had been based on the delirious stock market valuations of the late 1990s. The center of the world banking industry would move, presumably to continental Europe. Over time, the United States could lose both its position as the principal world beneficiary of the financial order and its margin of maneuver on the domestic scene. This would be not unlike what happened to the United Kingdom from 1914 to 1950.

It is not obvious that senior financial policymakers in the United States have yet grasped this threat, or that there is any serious planning under way to cope with it—apart from a simpleminded view among certain strategic thinkers about the financial advantages of the control of oil. Instead it appears that the responsible officials are confining themselves to a very narrow range of debt management proposals, whose premises minimize the gravity of the issue and whose purpose is to keep the existing bonds of debt peonage in place as long as possible.

A paper issued this year by the Derivatives Study Center, a Washington-based study group, outlines three major proposals for dealing with the problems of sovereign debt. One of these is the work of Anne Krueger of the IMF; the second, Treasury Undersecretary John B. Taylor; and a third, a group of private economists associated with the global debt relief campaign headed by Kunibert Raffer.

The IMF and Taylor proposals provide alternative ways of addressing a very narrow issue in debt negotiations, namely the incentive for renegade creditors to resist a write-down of their own assets and so to hold out for full payment. This is a classic free-rider issue, since the possibility of paying off any one creditor at face value rises as other creditors accept smaller payments. The IMF would deal with this problem via a new formal restructuring mechanism that would bind all creditors to terms acceptable to a majority. The Taylor proposal would accomplish much the same thing (though in a much more distant future) by providing that new debt contracts carry a collective action clause permitting the will of the majority of creditors to bind the entire group.

Neither the IMF nor the Taylor proposal addresses the systemic problem of excess and unpayable debt. Their thrust is merely to prolong the present prebankruptcy stage of financial relations for as long as possible—shaving and stretching out debt repayments so as to match the ability to pay to the willingness of foreign capital to acquire developing-country assets through liberalization and privatization. In this way, they implicitly assume what has already proven to be impossible, namely, that private capital markets will eventually produce "development" to which poor countries aspire. Nothing in either protocol would protect the populations or the public programs of any developing country.

The Raffer proposal makes an effort along these lines by proposing the creation of an international adjustment mechanism akin to the municipal bankruptcy proceedings available under Chapter 9 of the U.S. bankruptcy code. This proposal for "restructuring with a human face" would give citizens of debtor countries a legal right to be heard in debt negotiations, and so would permit countries to protect some of their social services and core infrastructure investments from disruption in the restructuring process. This proposal has an undoubted claim to enlightened sympathy, and would very materially ease the burdens of adjustment on poor countries in debt restructurings. But no more than the other proposals does it address

the larger problem facing the world economy today, namely, the breakdown of a functiona finance in support of the development process.

But *if*, as a result of a widespread diversification away from the dollar as a reserve asset, the United States runs a risk within, say, a decade or two, of joining those countries for whom the discipline of the international monetary order means continuous debtor adjustment, a new element will enter the picture. It would become part of the national interest of the United States, if not necessarily that of its financial industry, to collaborate in the reconstruction of a global order that serves the interests of debtors at least as well as creditors. It will become the American interest to switch sides in the debt wars and join forces with the developing countries whose interests lie in rebuilding a multilateral international monetary structure, thus providing a safe path to the orderly liquidation of the dollar overhang and the restoration of autonomy to growth-oriented national development policies.

What would this mean in practice? In broad terms, it would mean that the negotiations antecedent to Bretton Woods, so admirably recounted by Skidelsky, would have to be recreated. But this time, the United States would have to take the role that Britain, anxious to protect its national autonomy in difficult financial conditions, took in 1944. (In that environment, Britain spoke for all the habitually indebted nations of the world in favor of a global order that would force creditors to bear the burden of adjustment.) The role played by the United States would be taken on by the world's emerging creditor power, the European Union.

There is every good reason to think that the outcome of such a revisited negotiatio would be more favorable to the world's beleaguered debtors than was the case in 1944. The United States remains today a dominant diplomatic and military force, which the European Union is not. And the U.S. economy is far more globalized, with more natural links of trade and investment to the developing countries, than are the Europeans. Should the United States one day switch sides in the global financial struggles, remarkable things might happen in a fairly short time.

Such a change is difficult to imagine today. The political processes of the United States would first have to be thoroughly overhauled—the money changers once again would have to flee their positions in the temple. But circumstances have a way of dictating political position, sooner or later. It has only been a bit more than a century since the U.S. did in fact stand as the world's premier representative of debtor nations. It was only some 70 years ago that Franklin Roosevelt inaugurated the Good Neighbor Policy, acknowledging the sovereign right of Latin American countries to escape from the burden of unpayable debts. It may not take that long before we come full circle once again, if motivated by practical necessity in the pursuit of full employment. Perhaps the oncoming clash between Brazil's people and the global financial order will help motivate ordinary Americans to rethink on which side we should now stand.

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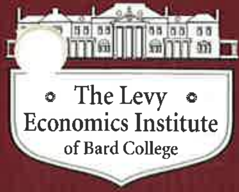

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Policy Note 2002 / 3

EUROPEAN INTEGRATION AND THE "EURO PROJECT"

PHILIP ARESTIS AND MALCOLM SAWYER

The introduction of the euro—in January 1999 as a "virtual" currency, and then in January 2002 as a "real" currency—has been a significant step in the integration of the economies of the countries that form the European Union (EU), and, more notably, for the 12 countries that have so far adopted the euro and created the Economic and Monetary Union (EMU). The adoption of the euro has not only meant that a single currency now prevails across the euro zone with reduced transactions costs for trade between member countries. It also has meant that the euro has become embedded in a particular set of institutional and policy arrangements that tell us much about the nature of economic integration occurring in the EU. In fact, the euro is a relatively *small* step along the path to further economic integration at the global level, and the neoliberal agenda of globalization can be clearly seen from the ways in which the euro has been introduced.

THE ADOPTION OF THE EURO CAN BE VIEWED AS A FURTHER STEP in a process of economic integration that began with the signing of the Treaty of Rome by the six founder member countries (Arestis, Brown, and Sawyer 2001, especially chapter 2). Proposals for a single currency began in earnest with the Werner report in 1970, which advocated the movement toward economic and monetary union by 1980. The European Monetary System (EMS), launched in March 1979, sought to establish monetary and exchange rate stability based on the introduction of the Exchange Rate Mechanism (ERM), which, in turn, focused on the European Currency Unit (ECU). In 1986 the EU amended the Treaty of Rome with the Single

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European Act and set the end of 1992 as a target date for the removal of all remaining barriers to the free flow of goods, services, and resources.

The countdown to the single currency started with the signing of the Maastricht Treaty (or Treaty on European Union, to give its full title). We begin with an analysis of the controversy surrounding the so-called convergence criteria, which were to determine whether a national currency would join the single-currency system, to provide some insights into the nature of the euro project. The introduction of the euro was also accompanied by the adoption of the Stability and Growth Pact; we continue with a discussion of the Pact and its accompanying constraints on fiscal policy. The creation of the European Central Bank (ECB) with a counterinflationary agenda and related matters are then introduced before we summarize and provide our conclusions.

The Maastricht Treaty and All That

The Maastricht Treaty defined the convergence criteria that each country had to meet in order for that country to become a member of the single-currency system. By implication, meeting the criteria is also required for member countries to become a part of the independent European System of Central Banks (ESCB) that comprise the ECB, and the national central banks of those countries that would belong to the EMU. The convergence criteria requires countries to

1. maintain a high degree of price stability, with an inflation rate within 1.5 percent of the three best-performing member states;
2. have "healthy" government finance, defined as a maximum government deficit-to-GDP ratio of 3 percent at market prices, and a maximum government debt-to-GDP ratio of 60 percent at market prices;
3. observe normal ERM fluctuation margins for at least two years without any devaluation among member-state currencies; and
4. support long-term interest rate levels that do not exceed two percentage points of the nominal long-term government bond rates of the three best-performing member states in terms of price stability.

Countries are also required to enact legislation for their central banks to become "independent." These criteria were to be applied to countries entering the euro at its creation, though many of the criteria were fudged (Arestis, Brown, and Sawyer 2001). In principle, these criteria would also be applied to countries seeking to join the euro in the future.

The Maastricht Treaty, which provides the institutional framework for the introduction of the single currency, was signed in late 1991, a time when political power in most EU countries was held by the right; the terms of the Treaty reflected the dominance of neoliberal ideas. Despite some electoral success by center-left parties (especially at the end of the 1990s), these neoliberal ideas still prevail. The neoliberal agenda therefore has been embedded in the institutional and policy arrangements surrounding the operation of the euro.

The general thrust of the convergence criteria was deflationary, as many countries were required to cut budget deficits, reduce public debt, and bring down inflation and interest rates to meet the criteria. The relatively poor economic performance of many of the EU economies during the 1990s may to some degree be attributable to the striving of countries to meet those criteria. From 1992 to 1999, the growth of national income averaged 1.7 percent per annum in the eurozone countries, compared with the 2.5 percent per annum averaged by the United Kingdom over the same time period. Moreover, the unemployment rate fell substantially in the United Kingdom (as well as in the United States and Canada), but tended to rise in the eurozone countries, most notably in France, Germany, and Italy. (The notable exception was Ireland, where unemployment fell dramatically.)

The relatively poor economic performance of many of the EU economies during the 1990s may to some degree be attributable to the striving of countries to meet [the Maastricht Treaty] criteria.

The convergence criteria affected what may be called nominal variables; that is, inflation rates, interest rate, and budget deficits. There is some rationale for concern about the convergence of inflation and interest rates if a single currency is to be formed, since a single currency area will have a single monetary policy (and hence a single, Central Bank interest rate). It is also unlikely that a single currency area could function with substantial differences in inflation rates within the area. However, any rationale for the inclusion of the convergence of budget deficits to less than 3 percent of GDP and for government debt to be less than 60 percent of GDP has been generally lacking. The adoption of these criteria not only brought a deflationary element to the Maastricht Treaty, but also reflected the general rejection of Keynesian economics and the use of fiscal policy to stimulate employment.

It is also evident that there is no reference to what may be termed real convergence; that is, the convergence of economic growth, unemployment levels, levels of national income per capita, business cycles, and the like. Indeed, massive differences remain in living standards and unemployment rates across the EU. The single currency is much more likely to operate effectively if there is some real convergence between participating economies, yet those concerns were dismissed (Arestis, Brown, and Sawyer 2001).

The institutional and theoretical background of the Maastricht Treaty and the EMU are embedded in the monetary policy operated by the ECB and in the Stability and Growth Pact

(hereafter SGP). The institutional macroeconomic policy framework, within which the euro was introduced and has begun to operate, has three key elements.

First, the ECB is the only effective federal economic institution. The ECB has the only policy instrument (the rate of interest, or "repo" rate) available to pursue the main objective of low inflation. The single monetary policy has an area-wide, euro perspective. A quantitative definition of price stability has been adopted in the form of, in effect, a 0–2 percent target for the annual increase in the Harmonised Index of Consumer Prices (HICP) for the euro area. The ECB has adopted a "two-pillar" monetary strategy to achieve this target through the policy instrument of interest rates. The "first pillar" is a commitment to analyze monetary developments for the information they contain about future price developments. This is the quantitative reference value for monetary growth, where a target of 4.5 percent (of the M3 definition of the money supply) has been imposed. The "second pillar" is a broadly based assessment of the outlook of price developments and the risks to price stability. This broad range of indicators includes the euro exchange rate; labor market indicators, such as wages and unit labor costs; fiscal policy indicators; and financial market indicators, such as asset prices.

Second, the ECB and the national central banks are linked into the European System of Central Banks (ESCB), with responsibility divided between them: the ECB has the responsibility for setting interest rates in pursuit of the inflation objective, and the national central banks have responsibility for regulatory matters.

Third, the ECB is intended to be independent of the EU Council and Parliament and of its member governments. Thus, there is a complete separation between the monetary authorities, in the form of the ESCB, and the fiscal authorities, in the shape of the national governments comprising the EMU. It follows that there can be little coordination of monetary and fiscal policies. Indeed, any attempt at coordination would be extremely difficult to implement. Apart from the separation of monetary and fiscal authorities, there also is the requirement that national governments (and, hence, the fiscal authorities) should not exert any influence on the ECB (and, hence, the monetary authorities). Strict interpretation of that edict would rule out any attempt to coordinate monetary and fiscal policies.

The Stability and Growth Pact

The SGP, alongside the Maastricht Treaty, creates four rules for economic policy. The four rules are that (1) the ECB is granted independence from political influence; (2) national governments cannot bail out government deficits; (3) monetary financing of government deficits is prohibited; and (4) member states must avoid "excessive" deficits (defined as more than 3 percent of GDP).

The core elements of the SGP with respect to fiscal policy are three: (1) to pursue the medium-term objectives of maintaining budgetary positions close to balance or in surplus; (2) to require member states to submit annual stability and convergence programs; and (3) to monitor the implementation of those programs. The main feature of the core elements is the requirement that a national budget deficit not exceed 3 percent of GDP; failure to meet the requirement could lead to a series of fines (depending on the degree to which the deficit exceeds 3 percent). According to the Resolution of the European Council on the Stability and Growth Pact (Amsterdam, June 17, 1997), it is also necessary for national budgetary policies to "support stability-oriented monetary policies. Adherence to the objective of sound budgetary positions close to balance or in surplus will allow all Member States to deal with normal cyclical fluctuations while keeping the government deficit within the reference value of 3% of GDP." Furthermore, "Member States commit themselves to respect the medium-term budgetary objective of positions close to balance or in surplus set out in their stability or convergence programmes and to take the corrective budgetary action they deem necessary to meet the objectives of their stability or convergence programmes, whenever they have information indicating actual or expected significant divergence from those objectives." The Council can impose penalties on a country that appears to be running "excessive" deficits, with some escape clauses in case of severe recessions.

The ECB is instructed to focus on inflation, while the fiscal authorities have a broader range of concerns; this makes the grounds for potential conflict considerable and suggests a need for the evolution of a body charged with the coordination of EMU monetary and fiscal policies.

Each year a country has to submit a stability program to the commission for scrutiny, containing, inter alia, information about the paths of their budget deficit-to-GDP and national debt-to-GDP ratios. If the stability program reveals that a country is significantly diverging from its medium-term budgetary objective, the council will recommend that the stability program be "strengthened"; that is, that public expenditure cuts and tax increases be imposed. If the situation persists, the member state will be judged to have breached the reference values. (The pact details "escape" clauses that allow member states with excessive deficits to avoid sanctions.)

The separation of the monetary authorities from the fiscal authorities, along with the decentralization of fiscal authorities, inevitably makes any coordination of fiscal and monetary policies difficult. The ECB is instructed to focus on inflation, while the fiscal authorities have a broader range of concerns; this makes the grounds for potential conflict considerable and suggests a need for the evolution of a body charged with the coordination of EMU monetary and fiscal policies. In the absence of such a body, tensions will emerge in the real sector when monetary policy and fiscal policies pull in different directions. But so far, the SGP has, in effect, resolved these issues by establishing the dominance of the monetary authorities (ECB) over the fiscal authorities (national governments).

Neoliberalism and the Euro

The policy rules governing the euro are based on a more general theoretical framework, the ingredients of which we identified elsewhere and termed new monetarism (Arestis and Sawyer 1998). The essential features of this theoretical framework (Duisenberg 1999; Arestis, Brown, and Sawyer 2001; Tsakalotos 2001) are as follows.

1. Politicians in particular, and the democratic process in general, cannot be trusted with economic policy formulation, as both politicians and voters have a tendency to make decisions that have stimulating short-term effects (that is, that reduce unemployment), but are detrimental in the longer term (notably, that raise inflation). In contrast, experts (in the form of central bankers) are not subject to political pressures to court short-term popularity, and can take a longer-term perspective when there is a conflict between the short term and the long term. The logic underpinning such reasoning mirrors that found in the debate over rules versus discretion. Policymakers' scope for using discretion should be curtailed and the possibility of negative spillovers from irresponsible fiscal policy reduced.
2. Inflation is a monetary phenomenon, so it can be controlled via monetary policy. The money supply is difficult, if not impossible to control directly, and the demand for money is thought to be highly unstable. However, the central bank can set the key interest rate (the repo rate) to influence monetary conditions, which in turn influence the future rate of inflation. Central banks have no discernible effect on the level or growth rate of output in the long run, but do determine the rate of inflation in the long run. Thus, inflation is still a monetary phenomenon, and ultimately it is central banks that determine the inflation rate.
3. The level of unemployment fluctuates around a supply-side-determined equilibrium rate, generally labelled the NAIRU, or nonaccelerating inflation rate of unemployment. The level of the NAIRU may be favorably affected by a "flexible" labor market, but is unaffected by the level of aggregate demand or by productive capacity.
4. Fiscal policy, primarily due to beliefs that it is inflationary and leads to the crowding out of private sector investment, is considered impotent in terms of its impact on real variables, and therefore should be subordinate to monetary policy in controlling inflation. It is recognized, though, that the government budget position will fluctuate during the course of the business cycle, but only in the context that fiscal policy is essentially passive.

The sole objective of the ECB is price stability, so decisions are made by a governing body composed of bankers and financial experts, with no involvement by other interest groups or democratic bodies.

The structure of the ECB clearly conforms to the first point. The sole objective of the ECB is price stability, so decisions are made by a governing body composed of bankers and financial experts, with no involvement by other interest groups or democratic bodies. The only EU-level policy for controlling inflation is monetary (interest-rate) policy, which presumes that monetary policy is a relevant and effective instrument for controlling inflation.

The implementation under the SGP of what is effectively a national-level, balanced-budget requirement (albeit balanced over the course of the cycle, rather than during any particular year), and the absence of fiscal policy at the eurozone level has eliminated the use of fiscal policy as an effective instrument for reducing unemployment (or, indeed, inflation). This approach to fiscal policy fits in very well with our fourth point listed above.

Inflation, Unemployment, and Inequality

The ECB is the only EU-level economic institution, and it operates with the objective of attaining low inflation. There are three points of note here. First, this key institution is undemocratic in nature (indeed, it is barred from taking instructions from democratic organizations) and operates in a secretive and nontransparent way. ECB decision makers are central bankers, who represent no other interests (such as those of industry or trade unions).

Second, the only objective addressed through macroeconomic policy (and only via monetary policy) at the EU level is price stability, and that policy—an inflation target of less than 2 percent—has been one that has been generally missed over the past two years. Employment targets have also been set by the EU. For example, the overall EU employment rate is currently targeted to be 67 percent and 57 percent for women, rising to 70 percent and 60 percent, respectively, by the year 2010. These objectives are part of the European Employment Strategy, and are to be achieved through measures such as increased labor market flexibility and lifelong learning. There is no macroeconomic policy based on fiscal or monetary policy designed to create high levels of employment. Indeed, the general tenor of macroeconomic policy runs counter to the creation of high levels of employment.

. . . monetary policy has become interest-rate policy, despite the evidence that the linkages between changes in interest rates and changes in inflation are at best weak, and at worst obscure.

Third, policy operates according to the notion that monetary policy is the relevant action for controlling inflation. Yet, monetary policy has become interest-rate policy, despite the evidence that the linkages between changes in interest rates and changes in inflation are at best weak, and at worst obscure (Arestis and Sawyer 2002). Any significant upswing in inflation

would reveal that the ECB is unable to control inflation or even possesses policy instruments that can effectively tackle it, leaving the eurozone bereft of any counterinflation policy.

The eurozone itself has no weapons with which to fight recession, as there is no significant government expenditure at the EU level; further, it has no ability to run a fiscal deficit. At the national level, the ability of a government to run budget deficits is severely constrained by the SGP.

The response of the ECB to the economic slowdown of 2001–02 is a worrisome one, in view of its argument that it is natural for an economic slowdown to have adverse effects on the budget positions of member countries. However, for countries with a budget position still not close to balance or in surplus, it is important to adhere to medium-term consolidation plans. Short-lived slowdowns should not significantly change the scope for reaching the targets set in the countries' stability programs. Further, "as adjustment needs are likely to become more visible in periods of less vigorous economic growth, policymakers must now step up the reforms rather than allowing efforts to abate" (ECB *Monthly Bulletin*, October 2001, p. 6). In this context, "reforms" mean further deregulation of labor markets. There is no fiscal policy in operation at the European level. The size of the European budget is relatively small—less than 1.2 percent of combined EU members' GDP in 1997—and is still dominated by the needs of the Common Agricultural Policy (about 50 percent). Yet, the MacDougall Report (1977) suggested that monetary union would not be viable without a sufficiently large community budget for fiscal policy (7.5 percent of members' GDP). It is also the case that the EU budget must be balanced. The interaction of those two elements means that there is no scope for active fiscal policy (or, indeed, for any fiscal policy), and that the EU budget is too small to operate as an effective stabilizer or to redistribute funds from richer regions to poorer ones in any significant manner.

The disparities of unemployment across the regions of the eurozone (and associated disparities in living standards and employment) present a major challenge and pose a considerable threat to the successful operation of the single currency.

The disparities of unemployment across the regions of the eurozone (and associated disparities in living standards and employment) present a major challenge and pose a considerable threat to the successful operation of the single currency. The disparities between the regions of the eurozone (which number 65) and the states within the U.S. may provide a reasonable basis for comparison. In the United States, unemployment rates ranged between 2.2 percent and 5.9 percent in 2000, and per capita disposable income from $18,467 (Mississippi) to $31,697 (Connecticut) in 1999. In the eurozone, unemployment rates ranged between 3 percent and 37 percent, and per capita GDP from 6,536 euros (Ipeiros, Greece) to 40,353 euros (Hamburg, Germany) in 1998, a factor of 1:6. But the SGP and associated policies contain no remedies for such disparities between these levels of unemployment and income.

The achievement of full employment does require an appropriately high level of aggregate demand, which in turn requires some combination of increased demand for exports, consumption, investment, and public expenditure. Whether such a level of aggregate demand would require a substantial budget deficit inevitably depends on what happens to the other sources of demand. But a high level of aggregate demand is only one condition, albeit a rather important one, to achieve full employment. In the context of the eurozone, there are two rather obvious and significant obstacles to such an achievement. First is a lack of productive capacity in many regions to provide high levels of employment. Current estimates by the OECD of the output gap—the difference between potential total output and actual output—place it around zero; that is, actual output is about equal to potential output despite the fact that unemployment is over 8 percent. In a similar vein, the OECD's estimates of the NAIRU average 8.8 percent for the eurozone (in 1999), which again is close to the current experience. Interpreting the NAIRU as an indicator of a capacity constraint suggests capacity problems. In this context, higher levels of aggregate demand would place pressure on capacity and could well have some inflationary consequences.

The second obstacle is the disparity of unemployment; a general increase in demand would push some regions to or even above full employment.

A major weakness of the present institutional arrangements is the separation between monetary policy (conducted by the ECB) and constrained fiscal policy (operated by national governments). There is clearly a requirement for economic policy to be coordinated across EU member countries, and for the emergence of appropriate institutional arrangements and policies at the European level. Economic policy at the EU level faces the additional issue of the disparities of economic performance in terms of employment and unemployment rates and the per capita level of GDP across the regions and countries of the EU.

Concluding Remarks

The establishment of the euro and the European Monetary Union has been undertaken within a specific institutional and policy framework (see Arestis, McCauley, and Sawyer 2001 for a proposal of an alternative policy framework for EMU). The institutional framework gives prominence in policy formulation to an undemocratic and unaccountable European Central Bank. It is a policy framework that emphasizes controlling inflation over reducing unemployment, although it provides only a weak instrument (monetary policy) for that control and generates macroeconomic policies that tend to increase rather than diminish the level and disparity of unemployment.

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