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Rebuilding The International Monetary Order: The Responsibility of Europe, Japan and the United States

Reconstrucción del Orden Monetario Internacional: la responsabilidad de Europa, Japón y Estados Unidos

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Abstract

One of the principal conditions to assure the long-term development and success of the liberal international economic and political order is the return to a stable, equitable and rule-based international monetary order. This is in the interests of large and small, rich and poor and "emerging" countries alike. In fact, the absence since the 1970s of a universal monetary order and the prevailing monetary nationalism and regionalism at a time of globalization and global finance have been responsible for a lack of equitable adjustment mechanisms and of effective checks and balances on financial and fiscal excesses in the world economy. The recurring financial crises have been hurting the economies not only of the poorer but by now also of the richest economies. The task of designing, negotiating and implementing a new international monetary order is clearly a combined political and economic and security challenge. A possible approach for a new design could be inspired by the original "European Monetary System" (EMS). The responsibility for this initiative for an "Extended EMS" belongs first and foremost to the three principal market economies: the United States, the European Union and Japan. From the start this "Extended EMS" would benefit the entire world economy – including the major new powers such as Brazil, China and India, and the weaker economies that suffer the most from the recurring financial crises. In the long run it would also be open to new members in order to become a truly universal system. But it is only the commitment and active participation of the three main pillars of the liberal international economic order, the US, Europe and Japan could be the guaranty of success: the absence of either one of the three would inevitably lead to failure with dire consequences for the outlook for an integrated and prosperous world economy.

Keywords: International Monetary Order; Reform of International Monetary Order; European Monetary System (EMS); "Extended EMS"; United States; Europe; Japan; Multidisciplinarity; International Order; Emilio Fontela; Globalization; Global Finance.

Resumen

Una de las principales condiciones para asegurar el desarrollo a largo plazo y el éxito del orden económico y político liberal internacional es la vuelta a un orden monetario internacional estable y regulado. Ello puede beneficiar tanto a países grandes como a pequeños, ya sean desarrollados o en vías de desarrollo. De hecho, la ausencia de un orden monetario internacional desde 1970 y el regionalismo y nacionalismo monetario han provocado la inexistencia de mecanismos de ajuste equitativos y equilibradotes de los excesos de la economía mundial. Las crisis financieras recurrentes han dañado las economías no sólo de los países más pobres, sino también de los ricos. La tarea de diseñar, negociar e implantar un nuevo orden monetario internacional es un reto que combina aspectos económicos y políticos. Un posible acercamiento a este diseño puede estar inspirado por el Sistema Monetario Europeo (SME) original. La responsabilidad de llevar a cabo un "SME ampliado" corresponde principalmente a las tres economías de mercado más importantes: Estados Unidos, la Unión Europea y Japón. La implantación de este "SME ampliado" beneficiaría a toda la economía mundial –incluyendo las economías emergentes como Brasil, China e India, y otras más débiles que sufren principalmente los efectos de las crisis financieras recurrentes–. A largo plazo el sistema podría ampliarse a nuevos miembros, de modo que se convirtiera en un auténtico sistema universal. Pero únicamente el compromiso y la participación de las tres principales economías –Estados Unidos, la Unión Europea y Japón– podría garantizar su éxito. Es más, la ausencia de cualquiera de ellas conllevaría de forma inevitable el fracaso del sistema, con las consecuencias que ello implicaría para el desarrollo de una economía mundial integrada y próspera.

Palabras clave: Orden Monetario Internacional; Reforma del Orden Monetario Internacional; Sistema Monetario Europeo (SME); "SME ampliado"; Estados Unidos; Unión Europea; Japón; Multidisciplinariedad; Orden internacional; Emilio Fontela; Globalización; Finanzas globales.

JEL Classification: E52, E42, F02.

The goal is not that the United States and Japan should "join" the EMS or the European Monetary Union as such, but that they should negotiate with the European Union a monetary system that will have similar objectives and similar rules to those of the original EMS. (Hieronymi, 1993).

...Japan, even more than the United States, needs a system of multilateral rules rather than ad hoc, bilateral negotiations under mutual threats and accusations. (Toyoo Gyothen in Volker, P. and Gyothen, T., 1992).

1. Multidisciplinarity and Specialization

International monetary order ought to be a relatively simple concept so that its organizing principles, its rules and day-to-day functioning can be understood and respected by all actors from households, to companies, banks and other financial intermediaries and governments and central banks.

In reality the issue of "international monetary order" is an eminently complex and multidisciplinary one: economic, political, social, financial, institutional, technological and security issues are intimately linked, with domestic, regional and international dimensions playing an important role.

Also, one of the political and intellectual challenges of our age is how to reconcile, on the one hand, the growing complexity, interdependence and globalization of economic, political, social and technological developments that call for multi-disciplinary analyses and solutions, and, on the other hand, the specialization and the increasingly narrow and abstract approach of economics, political science and of the study of international relations. This becomes a major problem especially at times of crises and breaks in trend when there is a need, or even compulsion and an opportunity to innovate. If this dichotomy is not properly handled, the outcome is often improvisation rather than action based on an in-depth understanding of the complexity of issues and of a careful weighing of possible options and of their consequences. There are few areas in economics and politics where this has been more true than in the field of money and of domestic and international monetary reform.

The choice of the topic of the present article was motivated by the author's interest in the multiple aspects of European-Japanese-American relations[1], an interest shared during several decades with Emilio Fontela to whose memory the issue of this Journal is dedicated. This choice was also based on the belief in the relevance of this subject and on the experience of seeing long-discarded or minority views (right ones or wrong ones) replace conventional wisdom often at the most unexpected moments – an observation and experience also frequently shared with Fontela.

He knew that the task of decision-makers and the forecasters who help them is to look forward and the study of the lessons of the past is a tool and not an objective. One of the principal contributions of Emilio Fontela was the ability to address systematically the following three challenges and to develop and provide the tools for others for dealing with them:

First: Recognizing the complexity of the world and of the objects of our analysis and trying to break down the walls between the various disciplines relevant for problems and questions at hand.

Second: Addressing the issue of the interaction between, on the one hand, constant change, and, on the other hand, the weight of structures and trends, and emphasizing the role of innovation in economics, politics, technology, at all levels.

Third: Reminding researchers of their duty to be "relevant", and keeping them from discouragement even if their conclusions and recommendations are not followed by practitioners or accepted by fellow scholars, and even if this relevance becomes evident only with a long time lag.

2. Reform of the International Monetary System: A Renewed Call For an "Extended EMS"

There is no doubt that the current crisis has been as much the result of intellectual rigidity and dogmatism as of objective economic factors and interests. As long as these dogmas continue to prevail and prevent debate and innovation about the international monetary order, the chances of true reform will be small.

Since September 2008 there has been a multiplication of initiatives, speeches, conferences, proposals and analyses throughout the world dealing with the nature, the origins and consequences of the current international financial and banking crisis and with the need, beside short-term crisis management, for fundamental long-term reforms to avoid a recurrence of such a crisis.

In the ongoing debate about the current crisis, the principal concern in the US, Europe and in Japan – as well as in the rest of the world economy – is

[1] The present paper is part of an ongoing research project, started by the author in early 2009, under the title *Renewing the Western Community: the Challenge for the US, Europe and Japan*.

how to stop the contraction in the world economy and downward pressures that emanate from both the monetary sector and from the so-called "real economy".

These are legitimate preoccupations as the short-term, more than ever, is bound to have a major impact on the long-term trend of the world economy, both on the overall growth and on the relative positions of the "losers" and "winners". However, these short-term concerns and the policies they inspire (and the fallacy of the immediate effectiveness of fiscal or monetary measures) tend to distract both policy makers and the broader public from the potential consequences of the improvisation and of the excessive fiscal and monetary measures that have been the order of the day since the fourth quarter of 2008 in the majority of the OECD countries. "Who will pay the price?" is a rhetorical question that is often raised, but it is rarely defined what is mean by "the price" and what is meant by the "who".

2.1. A "Great Absent" in the Current Reform Debate

Yet, notwithstanding the breadth and width of the debate and the readiness by some of the most conservative organizations and decision makers to reverse direction on instant notice and to advocate and to adopt measures of fiscal and monetary largesse that go against all precedent and against the minimum of prudential fiscal and monetary policies and management – there is a "great absent" in this debate and activity. There is, in fact, little, if any reference to the issue of international monetary order, and to the need to rebuild a true international monetary order and to redefine the role and responsibilities of governments and central banks for international monetary stability. [2]

While from time to time there are vague allusions to a "need for a new Bretton Woods", most of them have nothing to do either with the actual meaning of "Bretton Woods" or with the current and future needs for a new international monetary order. In fact: there are no coherent proposals for the objectives, organizing principles, scope, rules and institutions of such a new order, nor for the clear definition of the division of labor and responsibilities between, official national and international institutions, on the one hand, and of various categories of private market participants,on the other hand.

The lack of awareness of this issue is striking not only in the case of the IMF (whose deafening silence on global international monetary order has been noted for decades), and other prominent international bodies such as the BIS, the OECD, the Group of 20, etc., but also from the most eloquent and fertile critics of the current system and proponents of wide-ranging reforms such as Joseph Stiglitz. It is no exaggeration that as of now – mid-2009 –

[2] Cf. for example Group of 20 (2 April 2009) *The Global Plan for Recovery and Reform*, London, 2 April 2009

international monetary reform (as distinguished from financial and banking oversight) is not on the intellectual, political and institutional reform agenda. The various suggestions to create "macro-prudential" oversight bodies at the European or broader international level fall far short of the requirements in terms of transparency, predictability and most importantly of rules that are binding for both large and small countries, of an international monetary system.

2.2. A Renewed Call For an "Extended EMS"

Fifteen years ago, the present writer launched an appeal for an "extended EMS":

"In the 1980s concerns about tensions and potential conflicts in the relations of Japan, EC and the United States seemed to be linked mainly to trade issues. In the early 1990s, however, the sharp differences in monetary policies between Germany and the United States led not only to tensions between the two sides of the Atlantic, but ultimately to a severe crisis within the EMS as well. No doubt, the success of the Uruguay-Round negotiations is of the utmost importance for prosperity in the coming decade in the industrialized and in the developing countries. Nevertheless, it is in the area of international monetary relations that a bold new initiative is the most urgently needed: an agreement similar to the European Monetary System (EMS), which would include beside the European Union, also Japan and the United States." Hieronymi (1995:61). Today the need for such an approach is even greater than in the 1990s. And the current crisis and the lessons of from the last fifteen years ought to increase the political chances for its becoming a reality.

3. International Monetary Reform: A Political and Economic Challenge

One of the key assumptions of the architects of the post-war liberal international economic order was the close link between trade liberalization, on the one hand, and a properly functioning international monetary system, on the other hand.

Yet, one of the principal economic and political paradoxes of the period since the 1970s has been the contrast between the absence of an effective international monetary order, on the one hand, and the growing "globalization" of trade, finance and investments.

This was caused by, and reinforced the belief that private financial agents and markets could replace the functions that used to be fulfilled but what used to go under the designation of "international monetary order". This "freed" governments and central banks of international responsibilities at a time when internationalization of finance became the dominant feature of the world economy. [3] The current monetary and banking crisis is a dramatic demonstration of the consequences of this dichotomy.

It is the central conclusion of the present article that the reform of the international monetary system is an essential task in order to maintain and strengthen a liberal international economic order. Without the rebuilding of a stable and equitable international monetary order there is little chance for a "soft landing" from the current crisis and for avoiding recurring new financial crises.

3.1. The Multiple Dimensions of International Order

The current and future challenge for international order can be summed up by the following quote: *"The quality of international order depends on the quality of the underlying organizing principles, on shared values and on their implementation. Globalization without freedom and democracy, without cooperation and solidarity and social progress, without subsidiarity and without effective checks on the abuse of power by governments or private actors, without a balanced division of tasks and responsibilities between the public and the private sectors, without peace and respect for human rights, cannot work. In order to assure the success and the benefits of globalization for all in the long run, there is a need for a new spirit and a new practice of federalism in the world."* [4] (Hieronymi, Bensky and Stoyanova, 2008). International order has multiple dimensions: the political and security dimensions, trade, money and finance, human rights and increasingly the environment. International monetary order is relevant not only from the point of view of economic order, but it is also closely connected with the political dimension and with international order as a whole. It is the quality of these various dimensions, their convergence or conflict that determine the nature and the stability or fragility of international order at any given time or in any region.

International order does not necessarily mean "universal order", although time and again the two concepts have been confused. The last hundred years in particular have seen systematic efforts to create or to impose a truly universal international order. Yet, the co-existence of parallel (regional) international orders has been the rule rather than the exception ever since 1914. Also, one can also distinguish between complete, fully operational international orders and "partial" or "incomplete" orders.

[3] On "global finance" see Chapter 1 in Hieronymi, Otto (Editor) (2009) *Globalization and the Reform of the International Banking and Monetary System*, Palgrave Macmillan, London 2009

[4] Hieronymi, Otto, Bensky, D. and Stoyanova, Toyoo (2008) "What Future Domestic and International Political Order for the World?" Spirali, Milano, Paul1. These conclusions, written in early 2008 have gained further relevance through the outbreak of the world wide crisis in the summer and fall of last year and through recognition of the need for both greater government responsibilities and international cooperation in order to uphold the open, democratic model at the national and international level.

In fact, more often than not, true international order is "regional" (and the term regional does not necessarily correspond to geographic definitions) than truly universal. For example this was the case during the "cold war" when there were three quite distinct "international orders" (or sub-orders) primarily defined by the domestic political orders of the various groups of countries and the relations within and between the members of these groups.

These three "sub-orders" were the "Western world", the "Communist world" and the "Third World". The United Nations represented an attempt at a universal order: it was, however, at best a partial or imperfect order, primarily because the communist countries as a whole and many of the so-called "third-world" countries individually and as a group refused to or were unable to fulfill some of the most basic principles and obligations defined in the UN Charter and other basic documents.

International order is the result essentially of three categories of factors: 1. a given structure and in particular the main actors and their behavior and the evolution of this structure and actors; 2. major, mostly unexpected events and breaks in trends (wars, revolutions, etc.); and importantly 3. explicit efforts, on the basis of shared values and interests, through agreements and institutions to create a new international order (peace treaties, pacts, conventions, international organizations, etc.).

3.2. Parameters of International Order

International order in its multiple dimensions depends on the characteristics of the issues and the "technical" nature of the subject matter covered (telecommunications, military security, etc.) and on politics in broadest sense of the word. Fundamentally, international order is always political. International order defines the conditions of the cross-border interaction of states and their agents as well of non-state actors (individuals, companies, etc.), but which are one way or another "citizens" of one or several states.

All international orders (like all political orders) have a number of key aspects or parameters. It is the "content" or the characteristics of these parameters, and their relative importance or hierarchy within a given order that will determine the nature of that order and distinguish it from other orders.

When one considers the different types or categories of international order (political, security, etc.) for each category or dimension one can identify a number of basic parameters – the contents or characteristics of which will determine the nature and the quality and the effectiveness of the particular aspect of international order. These parameters include: objectives, organizing principles, values, rules and customs, policies and institutions as well as power and resources.

Sometimes the parameters of the various aspects or categories of international order converge, at times there are important differences and dichotomies for different aspects of international order for a given group of countries. These differences may be intentional or accidental: they may or may not affect the overall cohesion of a given regional or global international order.

A classic example of such a divergence was the international telecommunications order prior to the dramatic revolution of deregulation, liberalization and privatization in what used to be a strictly monopolistic and heavily regulated sector even in the most open market economies. This dichotomy between trade liberalization in goods and services on the one hand (and essentially trade conducted by private companies), and telecommunications monopolies, price controls, subsidies and generally closed markets, on the other hand, led to revolutionary change in the international telecommunications order in the 1980s and 1990s.

The example of telecommunications is also a good illustration of the close connection between domestic and international order. Contrary to the views of the more extreme exponents of the so-called realist theory of international relations, who argue that there is and should be a clear distinction between domestic and international order, in fact, in the real world there is a close interdependence between the nature and the quality of domestic and of international order. Also, in most cases it is the domestic dimension that determines the international one rather than the other way around.

Of course, the most dramatic example of differences in the pace of liberalization and of evolving domestic and international regulations has been the contrast between finance and banking, on the one hand, and the trade in manufactured products, on the other hand. Following the Second World War, up until the 1970s international (and domestic) banking and finance were a highly regulated sector compared with the progress of liberalization of trade and the international integration through trade and direct investments by multinational companies of the "real sector". Banks had a hard time following their clients into the growing international markets. After the early 1970s, the growing momentum of financial and banking "deregulation" led not only to a "catching-up" with the "real" side of the economy, but finance (and increasingly short-term finance) became the engine of what is known today as "globalization".[5]

[5] Cf. the concern repeatedly expressed by Alexandre Lamfalussy, one of the leadig monetary statesmen of our time, about the combined effects of domestic financial and banking deregulation and liberalization of international capital movements cf. Lamfalussy, Alexandre (1987) "Current-Account Imbalances in the Industrial World: Why They Matter" Kenen, Peter B. (Editor) (1987) *International Monetary Cooperation: Essays in Honor of Henry C. Wallich*, Essays in International Finance, No. 169, December 1987, International Finance Section, Princeton University, Princeton, N.J. pp. 31-37 Lamfalussy, Alexandre: *Financial Markets in Emerging Markets. An Essay on Financial Globalisation and Fragility*, Yale University Press, New Haven and London, 2000. See also Otto Hieronymi "From Global Finance to the Crisis of Globalization", Chapter 1 in Hieronymi, Otto (Editor) (2009) *Globalization and the Reform of the International Banking and Monetary System*, Palgrave Macmillan, London 2009

3.3. Domestic and International Monetary Order: Rules vs. Markets

The principal functions of a domestic monetary order, in a liberal market economy can be summed up in the following points: 1. facilitating sustained and stable growth, 2. providing a basis for stability and predictability of values (prices) 3. help to avoid artificial (not market conform) redistribution of incomes and assets.

The questions that have occupied economists, political analysts as well as officials for many years include:

What should be the distribution of responsibilities for "money" among the various factors and actors; "rules" vs. "policies", "government policies" vs. markets; what should be the signals, indicators that should guide the decisions of officials and of market participants; what should be the weight of "domestic" and of "international" considerations; and finally, what factors (domestic price stability, asset price stability, external price stability, freedom of exchange, etc.) should be determinant?

Who is in charge? Money is probably the single most important element of a market economy. Without a properly working monetary system there could be no market economy. Also, one of the inherent weaknesses of the planned, socialist economies was their inability to deal with the functions of money in an efficient and equitable way. Although the communist system continued to use "money", in fact the true functions of money were corrupted, and the communists could find neither in theory nor in practice an adequate substitute for money.

The term "sound money" is no longer used in political discourse or in the economic literature. Yet, the concept remains a fundamental one: "fighting inflation", "inflation-targeting", etc. are contemporary (although more limited) expressions of the traditional concept of sound money. The links between "monetary crises" and "political crises" have been demonstrated in the last twenty years, just as well as in earlier decades or in past centuries.

To what extent is money a public responsibility and what is the role and responsibility of markets? For centuries money – definition and creation – was part of the exclusive responsibilities of the ruler. It was one of the principal aspects of sovereignty. He or she who had no sovereign power over money was not really a sovereign ruler. Coinage and the definition and imposition of "legal tender" – the money that all had to accept were essential elements of sovereign power. Refusing to accept "legal tender" in payment of debts or in other transactions, was punished by the law – just as counterfeiting was a capital crime. But money was also the most direct and tangible expression of trust or lack of trust in the sovereign. If there was no trust it took the most severe and oppressive measures by those in power to impose the legal tender as an effective money, i.e. fulfilling the traditional functions of money.

Some of the most systematic and cruel violations against basic human rights carried out by the Communist, national-socialist or other totalitarian regimes in the twentieth century was against their citizens accused of violating "monetary or currency regulations". The alleged justification of these regulations was to uphold the "common good", but in fact in most cases they were necessary to cover up the inefficient and arbitrary nature of these regimes and to cope with the basic lack of trust of the citizens in their own government.

Throughout most of history the "trust" that governments required in the currency over which they exercised sovereignty was based not only on the "honesty" or the "wisdom" of the government that has the monopoly power, but also on "objective" factors, beyond the political or physical control of governments, i.e. on the production and availability of "precious metals", i.e. gold and to a lesser extent silver.

The "gold standard", based on the link between money or currency defined by governments, on the one hand, and the amount of gold they (or their de facto agents) actually owned, on the other hand, was first and foremost a domestic system, and only in the second place an international standard or order. The existence of this "objective", material core, that created the basic trust and the illusion or reality of automaticity in responses to changes in the objective factors, i.e. official gold and later also of foreign exchange reserves. The gold standard, was never, and the "gold-exchange standard" even less, a fully automatic monetary standard[6].

Both the "gold-standard" and the "gold-exchange standard" were rule-based systems, with the rules being first and foremost domestic rules. While they were more or less strict and binding on the authorities, there was obviously scope for policy and not just an obligation to follow blindly rules.

When it is said that governments cannot be expected to accept binding rules because it would conflict with their "national sovereignty", people forget that the primary restriction of a "rule-based" monetary system is on the domestic dimension of sovereignty and not on the external one.

International monetary order, like domestic monetary order has multiple functions. The functions and the very concept of money have been subject to change as a result of political and economic as well as of technological factors. The last hundred years have been particularly rich in terms of both positive and negative monetary experiences. The dramatic history of the 20th century has demonstrated once more the close link between the quality of money, on the one hand, and the quality of political and economic systems, on the other hand.

The success of an international order depends on its inherent qualities and on the political will of the countries involved to uphold it. Developing and maintaining international order is never "automatic". One of the most common fallacies economics is the assumption that the "gold standard" was "automatic" and thus it was a-political and independent of the policies and interests of the states. As mentioned above, one of the fundamental assumptions of the architects of the post-war "Western" international order was the need for a

[6] Some of the most eminent writers contribute to the confusion when they do not distinguish in their texts between the "gold standard" and the "gold-exchange standard". See for example Bernanke, Ben S.: *Essays on the Great Depression*, Princeton University Press, Princeton, 2000.

convergence of the "international trade order" and of the "international monetary order".

3.4. Monetary Nationalism vs. Financial Globalization

The current financial and economic crisis is only the latest and so far the most severe in the series of international crises that occurred since the 1970s. The principal causes of these crises, including the present one have to do with the dichotomy between, on the one hand, growing monetary nationalism (or regionalism) by the major economic and financial powers, and, on the other hand, the rapidly advancing financial globalization in the world economy and the "privatization" of the precautionary functions of money and monetary policy.[7]

The central theme of the debate about international monetary order is to what extent and through what tools should the domestic economy (and in particular the financial and monetary sectors) be isolated from the rest of the world and to what extent external developments harmful or not for domestic conditions and in particular for the "freedom of action" of national treasuries and central banks and for private savers and financial intermediaries.

One of the essential roles of monetary order – both domestic and international – is to help avoid financial and fiscal excesses, both by government agents and by the private sector (including banks and other financial intermediaries). This is a "fourth element" – distinct but closely linked to the other three traditional functions that are: 1. facilitating trade (convertibility in the international area), 2. measure of value (avoiding distortions of relative prices in the domestic economy and internationally, and 3. providing a reliable store of value (i.e. avoiding erratic upward and downward fluctuations in asset prices).

The cause of the breakdown of Bretton Woods was the revival of monetary nationalism and floating exchange rates further exacerbated this trend. Monetary nationalism became the de facto global international standard when the attempts to replace the Bretton Woods system were abandoned in the 1970s with the Second Reform of the Articles of Agreement of the International Monetary Fund. The need for a return to a stable international monetary order has been pointed out ever since the 1970s by numerous economists and also political analysts. [8] The calls for reform were rejected

[7] Cf. Danthine, Jean-Pierre and Donaldson, John B. (2005) *Intermediate Financial Theory*, 2nd Edition, Elsevier Academic Press, Amsterdam, 2005.

[8] One of the most articulate and prolific advocates of a return to a rule-based international monetary order incorporating a system of stable exchange rates has been Professor Robert Mundell. Although he received the Nobel Prize in economics primarily for his early work on "optimum currency areas", over the last four decades he has consistently fought against the misuse of this concept to support monetary nationalism and floating exchange rates. Cf. Mundell, Robert: "Monetary Nationalism and Floating Exchange Rates", in Hieronymi, Otto (Editor): *The New Economic Nationalism*, Macmillan, London, 1980, pp. 34-50. See also Hieronymi, Otto (Editor) (1980) *The New Economic Nationalism*, Macmillan, London, 1980; Hieronymi, Otto (1982) "In Search of a New Economics for the 1980s: The Need for a Return to Fixed Exchange Rates'', in Hieronymi, Otto (Editor) *International Order: A View from*

using different political and economic arguments.

The new orthodoxy was based on a number of arguments: (1) the absence of a rule based system was unavoidable because domestic monetary and fiscal autonomy is a non-negotiable objective; (2) a rule-based system is not "enforceable" because it goes against market forces; (3) there is a conflict of national interests; (4) the world is not an optimum currency area; (5) floating exchange rates will help avoid fundamental balance-of-payments disequilibria; (6) monetary sovereignty is an absolute good; (7) the risks against currency fluctuations can be covered at a relatively low costs; (8) a stable system was in the interest of small countries and not so much for large countries, and in particular not of the United States.[9]

The "gold-exchange standard" under the Bretton Woods system was the expression of a strong political will to create a new and stable international order and to avoid the consequences of the monetary disorders of the 1930s.

It is symptomatic that the current conventional view among specialists of international and of monetary economics (the "revisionists" of yesterday) is that "international economic order" cannot be reconciled with the legitimate objectives of domestic politics and of domestic policy objectives.

Also, in their historical analyses they not only point out the generally recognized shortcomings of the both versions of the gold-exchange standard (the 1930s and the Bretton Woods version), but they also tend to argue that countries were better off without an international monetary standard. They do neglect to a significant extent to analyze the economic and political consequences of the breakdown and of the absence of an international monetary order.

The development of worldwide integration required both markets, dynamic private sector competition and effective government policies, and cooperation to bring about gradual liberalization and the reduction of obstacles to trade and payments and to provide the necessary regulatory framework at the national and international levels.

A multilateral system of trade liberalization and a stable international monetary order – both with binding rules and commitments – were the twin

Geneva, *Annals of International Studies* Institut Universitaire de Hautes Etudes Internationales,Volume 12, pp 107-126, Geneva, 1982; Hieronymi, Otto (1998) "Agenda for a New Monetary Reform", in *Futures*, Vol. 30, No.8 pp. 769-781, Pergamon, Elsevier Science Ltd., Hieronymi, Otto (Editor) (2009) *Globalization and the Reform of the International Banking and Monetary System*, Palgrave Macmillan, London 2009. On the issue of Mundell and "optimum currency areas" cf. Mundell, Robert A. (1997) "Optimum Currency Areas", Extended version of a luncheon speech presented at a *Conference on Optimum Currency Areas*, Tel-Aviv University, December 5, 1997, Mundell, Robert: *International Economics*, E-book Robert Mundell and Padoa-Schioppa, Tommaso (2004) *The Euro and Its Central Bank, Getting United After The Union*, The MIT Press, Cambridge, Mass., 2004, Paul12.

[9] The authors of a recent book found the apt term "monetary nationalism as a science" to characterize the conditions that have prevailed since the 1970s and the theories to justify them. While very critical of US policies, the authors stop far short of advocating a reform that would re-impose binding international rules on the United States. This would be too much for the current members of the prestigious Council on Foreign Relations. Steil, Benn and Hinds, Manuel (2009) *Money, Markets and Sovereignty*, A Council on Foreign Relations Book, Yale University Press, New Haven, Conn., 2009, Paul 137.

objectives and innovations in the ambitious plans for the postwar international economic order. They became the basis of the spectacular reconstruction of the war-torn societies, of the expansion of the world economy and not the least of the successful catching-up of Europe and Japan with the US economy.

3.5. Do We Need an International Monetary Order?

There is a sharp contrast between, on the one hand, the activism about the re-regulation and reform of the financial and banking system, and, on the other hand, the relative silence about the disequilibria and the need for reform in the international monetary system. There are oblique references to the issue of global imbalances and the size of the dollar holdings of some of the emerging countries, in particular China, but no plans for rebuilding the international monetary order or even a recognition that the excesses in the financial and banking area have been a direct consequence of the absence of a global international monetary order. There is also a contrast between the fear of the rise of protectionism (the failure to get the Doha Development Round off the ground had been a major warning sign just as the multiplication of bilateral and frankly discriminatory trade agreements throughout the world in open breach of the spirit of GATT-WTO) and the lack of concern about rampant monetary nationalism.

Some continue to ask the question: do we need at all an international monetary order? And in particular the big and the powerful such as the United States, the European Union or Japan, are they not better off without having to conform to the rules of an international monetary order? Is this not only a problem for small and weak countries – and these can tag on to the coattails of one of the powerful currencies (as this is witnessed by the cacophonic range of "exchange-rate regimes" followed by the 190 or so sovereign member states of the United Nations)? [10]

It ought to be clear by now not only to "laymen", but also to the experts and the private and public policy-makers in the most powerful universities, banks, treasuries and central banks who had been caught off guard, that without "monetary order", international banking and finance cannot adequately fulfill their functions in an integrated world economy. The cumulative impact on the "real economy" – trade, investments, competition and innovation – could lead to a significant slowdown in economic growth in the long term.

There have been many warnings about the consequences of the refusal since the 1970s to rebuild the international monetary system[11] after it broke down (or rather it was broken in the early 1970s not by private speculation, or the force of the markets, as the legend has it, but by government and central

[10] Cf. Sharma, Shalendra D.: *The Asian Financial Crisis. Crisis, Reform and Recovery*, Manchester University Press, Manchester, 2003

[11] Cf. Hieronimy, Otto (1998) "Agenda for a New Monetary Reform", in *Futures*, Vol. 30, No.8 pp. 769-781, Pergamon, Elsevier Science Ltd.; Hieronimy, Otto (Editor) (1980) *The New Economic Nationalism*, Macmillan, London, 1980

bank policies of some of the most powerful members of the international financial community: the United States, France, Germany and probably also Britain, Italy and Switzerland, with Japan standing on the sidelines).

The following is only a random quote, this time from Paul Volcker, who himself had been involved in the "end of Bretton Woods", but who had come to see and to regret its negative consequences: *"It is hard to see how business can effectively calculate lasting comparative advantage when relative costs and prices are subject to exchange rate swings of 25 to 50 percent or more. There is no sure or costless way of hedging against all uncertainties; the only sure beneficiaries are those manning the trading desks and inventing the myriad of new devices to reduce risks – or to facilitate speculation."* Volcker, Paul and Gyothen, Toyoo (1992). [12]Yet, even most of those who were outspoken advocates of a return to a rule-based international order tended to argue that this was the most important for small countries and that large countries (such as the United States) or large "optimum currency areas" (such as Western Europe) could better afford the lack of an international monetary order.

In fact, the present writer belonged for many years to a minority within a minority – that is to the relatively small group economists and students of politics who argued that in an integrated world economy it was as important or even more important for the large economies (in particular for the United States) to belong to a well-functioning international monetary order as for small or medium-sized economies.[13] This conclusion was derived from the theory of the various roles – economic and political – of domestic and international monetary order and from the analysis of the behavior of small and large country governments.

3.6. Whose Fault Is It?

The principal thesis of this article is that the United States, Europe and Japan – individually and collectively – have a major responsibility to cooperate closely in rebuilding, designing and implementing a new international monetary order. The United States, Western Europe and Japan – through sins of commission and sins of omission – share the responsibility for abandoning in the 1970s the efforts for an effective reform of the international monetary system and for not attempting ever since to rebuild a new international monetary order.

Without their joint efforts the other countries are unlikely to be willing or able to undertake a systematic effort to rebuild an international monetary order without the active participation of the three major market powers.

[12] Volcker, Paul and Gyothen, Toyoo (1992) *Changing Fortunes: The World's Money and the Threat to American Leadership*, Times Books, New York, 1992, Paul293.

[13] Hieronymi, Otto (1982) "In Search of a New Economics for the 1980s: The Need for a Return to Fixed Exchange Rates'', in Hieronimy, Otto (Editor) *International Order: A View from Geneva*, *Annals of International Studies* Institut Universitaire de Hautes Etudes Internationales,Volume 12, pp 107-126, Geneva, 1982.

This is in their own interests and in the interests of the international community as a whole. There are strong economic as well as political arguments supporting this conclusion. This is not a new idea, but it has never been really taken up in a systematic manner by any one of what we can call the three pillars of the liberal international economic and political order.[14]

4. The United States, Europe and Japan: The Three Pillars of the Liberal International Order

The "Western international order" built in the wake of World War II has been responsible for the emergence and consolidation of the most successful community of free nations in history, and has been responsible for permanent peace among its members, democracy and freedom and for unprecedented economic prosperity and social progress. This was and remains a community open to all countries respecting the three fundamental security, political and economic conditions: no war or threat of war among the members, respect for human rights and political freedom, and economic integration and market economy.

The three principal "pillars" of this liberal, democratic, "Western" Community were and remain: the United States, Europe and Japan. [15]

It is in the area of economic relations and of economic integration that the achievements of the Western countries have been the most spectacular and have had the most far-reaching impact also on the rest of the world.

The economic relations among the "three pillars" have been characterized by competition and convergence, by policy differences and often acrimonious arguments and by a solid consensus about the importance for each of them and for the world economy as a whole of maintaining a common framework for an open and liberal international economic order.

[14] Hieronymi, Otto (1995) "The Case for an 'Extended EMS': A New International Monetary Order to be Built by Europe, Japan and the United States", in Szabo-Pelsoeczy, Miklos (Editor): *The Global Monetary System After the Fall of the Soviet Empire*, (In Memoriam Robert Triffin – 1911-1993, Sixth Conference of the Robert Triffin-Szirăk Foundation, Szirăk, 1993), Averbury, Aldershot, 1995, pp. 57-67; "I therefore think it would be useful to create a kid of triumvirate of the United States, Japan and Europe, perhaps with Germany as the representative of Europe if that is what the Europeans wan Toyoo The central banks would of course have to be represented on this triumvirate because we are dealing with currencies, but the finance ministers must also be there because they represent the elected governments. They are able to speak about political dynamics but not much else; central bankers are good to talk about markets but not much else." Toyoo Gyothen in Volcker, Paul and Gyothen, Toyoo (1992) *Changing Fortunes: The World's Money and the Threat to American Leadership*, Times Books, New York, 1992 Paul 307.

[15] "The outstanding examples of successful community building in the 20th century were the Western Community and European integration following the Second World War. These ought to remain essential pillars also in the future of the liberal democratic international order. As already argued above, their emergence and working and general experience are highly relevant for the pattern of political communities in the democratic and globalized world of tomorrow." Hieronymi, Otto, Bensky, Daniela and Stoyanova, Teofana (2008) "What Future Domestic and International Political Order for the World?" Spirali, Milano.

The US, Europe and Japan saw the fight against protectionism – in times of both rapid growth and even more at times of recession – as both an economic and a political responsibility. Whatever the frictions, whatever the high-profile disagreements and elaborate negotiating tactics, there was a fundamental agreement that a return to protectionism would be a major threat not only to economic prosperity but also to security in the world.

The degree of integration – at the level of trade, technology, production and of financial and direct investments among these "three pillars" of the world economy have reached a degree that the most optimistic of the early architects of the post-war international economic order could have never imagined.

While GATT and subsequently WTO provided the global, multilateral framework for the international trade order, there was ample room for bilateral negotiations, tensions and tacit or open agreements. Without the long-term commitment to the principles of a liberal trading system by the US, Europe and Japan, today's globalized world economy would have never come about: there would be a lesser degree of economic integration, a lesser degree of technology diffusion and the so-called emerging economies of today and tomorrow would have had less of a chance or will have a lesser chance in the future, to enter on a successful path of growth and development. Without the combined efforts of the US, Europe and Japan over the decades in favor of an integrated, open world economy, the new "emerging economies" – China, India and Brazil, to mention only the three most important ones – would not have had a serious chance for catching up.

Today, as a result of the crisis in the international banking and financial system, the task of rebuilding the international monetary order is not only necessary but it ought to be also politically more feasible than any time since the 1990s. However, this can only happen if the US, Europe and Japan decide to work together and agree on rebuilding the international monetary system.

The first and most obvious argument why these three have to work together and why success or failure depends essentially on them, has to do with the size and weight of these market economies in the world economy and in the monetary system as a whole.

A perhaps even more important argument is that each of the three, the US, Europe and Japan are responsible for the fact that there has been no return to a global international monetary order in the last thirty-five years: all three of them incurred both sins of commission and sins of omission in this context over the decades.

According to conventional wisdom and to the prevailing dogma mentioned above this has been due to their "self-interest". According to this view the lack of initiative was motivated by their "diverging interests": the common assumption was that each three of them was better off under this situation.

4.1. The US Position: From Internationalism to Monetary Nationalism

If there has been no serious effort to rebuild a stable international monetary order since the early 1970s, this has been first and foremost due to the intellectual rigidity of the majority of the American academic establishment and the lack of leadership shown by the political elite on this issue and their lack of courage to go against the "conventional wisdom" spread by the "experts".

Over the last three-and-a-half decades there was a vicious circle: (1) economists argued that a new rule-based system would be politically unacceptable to the US government and Congress, even if such a system were in the long-term interests of the United States; (2) politicians refused to address this issue – despite the obvious problems caused by the over- and under-valuation of the dollar, the impact on employment and on the long-term competitive position of American industry, and on the monetary and fiscal imbalances linked to the official disinterest in the balance of payments – because they were told that "professional economists" do not support the idea international monetary reform.

The "experts" argued that there is no alternative to the non-system of wildly fluctuating exchange rates (the best one could hope was private hedging) and to the last minute they remained skeptical about the chances of the European countries to deal with this issue at the regional level. Political leaders remained passive, and at best bemoaned the instability in the US external accounts and the recurring international financial crises, but they simply took the "expert advice" coming from the most prestigious American Universities that nothing can and nothing should be done about it.

Ever since the Nobel Prize in Economics was established, American or US-based economists received an overwhelming number of these annual distinctions: virtually all of them (and not only Milton Friedman) were explicit advocates of monetary nationalism and of floating exchange rates. The two most notable exceptions were Robert Mundell and the late Friedrich Hayek – not only were they free market economists they were, and Mundell still is, true monetary internationalists. Hayek, who is best known even among professional economists, for his very important (and influential) pamphlet *The Road to Serfdom*, was also a very important monetary theorists[16], who profoundly disagreed with his fellow free-market advocate Milton Friedman about monetary theory and policy and in particular about relative-price distortions and fluctuations. As for Professor Robert Mundell, he probably spent more time in studying international monetary issues than all the pro-floating Nobel Prize winners put together.

It is also interesting to mention briefly here the position of the last three Chairmen of the US Federal Reserve Board on the issue of the international

[16] Cf. Hayek, Friedrich .A. (1937, 1964) *Monetary Nationalism and International Stability*, Augustus M. Kelley, Reprints of Economic Classics, New York, and Hieronymi, Otto (Editor) (2009) *Globalization and the Reform of the International Banking and Monetary System*, Palgrave Macmillan, London 2009 Chapter 1.

monetary order, whose tenure encompasses the last three decades – from the late 1970s to the present day: Paul Volcker, Alan Greenspan and the current incumbent Ben Bernanke.

Paul Volcker was without any doubt the most internationalist of the three. He did believe and continues to believe in the importance of a stable and equitable international monetary order and he does not believe in the virtues of freely floating exchange rates. Unfortunately, these views became more public knowledge after he left the Fed and had no longer direct policy responsibility and influence. Also unfortunately, once he retired and a "private citizen", he never took the political initiative to use his immense prestige in America and in the world for the cause of international monetary order. While his speeches and other writings show nostalgia for global international monetary order and for US leadership in restoring such an order – there has never been a "Volcker Plan" for international monetary reform, and so far there seems to be none today either despite his renewed prominence as one the leading monetary and financial advisers of President Barack Obama. [17]

As for Alan Greenspan, a powerful, long-serving and highly respected and influential Fed Chairman, he was both a "Ayn-Randian" market extremist and the ultimate monetary nationalist. For Greenspan, much focused (more in theory than in practice) on budget deficits, the balance of payments of the United States was of no concern for the American Administration or for the Federal Reserve. "Finance" – national and international being one and the same thing – was the business of markets (including speculators) and the idea of internationally monetary reform was not only useless – it was positively harmful. [18]In the light of developments in the last two years in the US and the world economy the reputation of Alan Greenspan as a wise central banker has been downgraded considerably, and not the least among his former admirers in the financial markets. Yet, on the issue of the international monetary system, too many American opinion leaders may still share his nationalistic and doctrinaire views.

Of course, among the three, the views of the current Chairman Ben Bernanke are the most relevant for the future of the American position on the issue of international monetary order. Not only does he hold his powerful office at a time of an unprecedented international financial crisis and at a time of equally unprecedented activism trying to fix the financial sector both through the injection of enormous amounts of central bank money and of government funds and through revising the "rules of the game" and changing the role and responsibilities of official bodies (including central banks) to guarantee the recovery and safe working of the financial sector. Chairman Bernanke was also

[17] CF. Volcker, Paul and Gyothen, Toyoo (1992) *Changing Fortunes: The World's Money and the Threat to American Leadership*, Times Books, New York, 1992; Volcker, Paul (December 1997) "Global Markets and the Emerging Economies", Lecture *in honor of* Fritz Leutwiler *at* The University of Zurich, December 15, 1997; Volcker, Paul (April 2001) "Globalization and the World of finance", The 2001 Hutchinson Lecture, University of Delaware, April 30, 2001.
[18] Greenspan, Alan (2005) "Remarks on the *Current account*", At Advancing Enterprise 2005 Conference, London, February 4, 2005, Federal Reserve Board .

caught off guard, like all the major monetary and financial decision-makers in the US and the world, by the magnitude and suddenness of the crisis. Yet,, once he realized the magnitude of the threats to the financial system, proved to be ready to turn his back on some of the most basic traditions of central bank policy, to adopt bold measures and to improvise solutions without worrying about what his former colleagues in the academic world, the "high priests of the monetary doctrine" will say.

At the same time, he has shown so far, at least in his actions and in his public statements, no readiness to question and even less to break with the forty-year old American academic and official tradition of monetary nationalism and suspicion of suggestions of a new rule-based international monetary system. In his earlier academic work Bernanke, while demonstrating the policy errors committed under the gold-exchange standard of the 1930s and that countries that turned to monetary nationalism were "better off", does not seem to have been interested in the intellectual and political challenge of building a better international system or order. In his pre-crisis statements already as a Governor of the Federal Reserve System he emphasized the primacy of monetary policy independence and the incompatibility of the objective of independent monetary policy with a rule-based international order. [19]

Monetary nationalism was not always the mantra of the US. In fact, during the last hundred years the American position with respect to international monetary order has been marked by a certain number of constants and as well as by dramatic swings.

Thus, the US was one of the driving forces behind attempts at international monetary cooperation in the decade following the First World War. Yet, it was also one of the major powers that through lack of insight and through economic nationalism contributed in the 1930s to the ultimate breakdown of the international monetary system based on the gold-exchange standard.

After the end of the Second World War the United States played an even more active and influential role in the attempts of creating a new liberal international order. International monetary order, based on an updated version of the gold-exchange standard was to be a central element of the new universal international order. Also, when re-establishing convertibility for the currencies of the war-torn economies (and for those countries that had not fallen under communist domination) proved to be a daunting, an apparently hopeless task, it was the United States that stepped in to help create and finance a regional temporary solution through the resources and institutions of the Marshall Plan. In doing so the United States also accepted an at least temporary discrimination – because of the apparent "dollar shortage" – against the dollar by the beneficiaries of American aid.

[19] Bernanke, Ben S.: *Essays on the Great Depression*, Princeton University Press, Princeton, 2000; Bernanke, Ben S. (2004) "Remarks", At the *Cato Institute 22nd Annual Monetary Conference*, Washington, D.C., October 14, 2004.

Under the Bretton Woods system the United States accepted important responsibilities. The so-called key-currency system imposed at least as important obligations and limitations on monetary sovereignty on the key-currency country as on the other members of the system. The two most obvious obligations had to do with the exchange rate of the dollar and with the promise to sell gold against dollar to any central bank that asked for it. The general obligation was: maintaining trust in the dollar. Obviously trust is an elusive concept and, as was pointed out by Professor Triffin, a difficult one to maintain at the time when the world was keen on increasing the supply of dollars (in order to have a greater cushion of international reserves) and that this could be achieved only through a deficit in the US balance of payments.

Governments and central banks of small economies, if they have experience and are blessed with common sense, are not likely to believe in "unlimited freedom" for domestic monetary and fiscal policies, even in a world of "perfect floating" or all-round exchange controls, the two most common tools of isolating the national economy from the outside world. They will also learn how to adjust their policies to the conditions in world markets and to the behavior of the "elephants" or the policies of the large powers out there, be these policies inflationary or deflationary, or simply erratic or even reckless. In fact, the monetary and financial record of "small open economies" such as Switzerland[20], is on the whole superior to that of the "economic great powers", not to mention the so-called "super-power", the United States.

It is one of the central theses of this article that in large economies the political need for external rules is as important (or even more) as in small ones. It is the leaders of "great powers" – responsible for "growth and prosperity" in their large domestic economy – that tend to fall victims of the temptation to ignore real or alleged external or "balance-of-payments" constraints. They believe that without the rules and constraints of an international monetary system they could have the full autonomy pursue their domestic policy goals, whether this be to fight inflation more efficiently or to stimulate their economies more effectively, or both. Yet, the de facto solidarity those "virtuous" (surplus) countries and the discipline that "profligate" (deficit) countries have to accept through the workings of a rule-based system are both in their domestic interest and among the principal functions of an international monetary system in an integrated, liberal world economy.

The illusions of "total domestic policy and market freedom" that befell the Federal Reserve and the American administrations from Johnson through early Carter, early Regan and then again late Clinton and the whole eight years of Bush junior, and the consequences of the strongly held views on the advantages of monetary nationalism not only by political leaders, but also by "world class

[20] It is symptomatic that the financial and monetary record and stability of Switzerland, a country that earned its well-deserved reputation through prudent private and public management, was not jeopardized by the monetary policies of the Swiss National Bank or the fiscal policies at the national, cantonal or local levels, but by private speculators and in particular by the ambitions and reckless policies of its largest private bank, UBS.

economists", on the US and the world economy, should be a telling lesson of the political and economic importance of the "external constraint" resulting from the rules of international monetary order.

The intellectual and political challenge is to dispel this fallacy and reorient both theory and practice towards international cooperation.

4.2. European Monetary Regionalism

It is the European countries that have followed the most determined approach to overcome the consequences of the international monetary disorders and of the emergence in the 1970s of a de facto regime of floating exchange rates. However, the position of the major European countries, including France and Germany, towards the international monetary system and towards international monetary reform has shown some major contradictions and dichotomies between the official interpretation of "national interests", on the one hand, and the actual interests of the German, respectively the French economy. In fact both Germany and France, in their own ways, contributed (along with the United States) to "ending Bretton Woods" and to preventing the return to a global international monetary system. In Europe also, it was the claims for "policy autonomy" by the large economies and the growing monetary and economic rift between Germany, France and Italy (and Britain) in the 1970s and in the early 1990s that threatened both the political and economic achievements of European economic integration and that led to the political insight that paved the way for EMS and ultimately for EMU and the Euro. The European Monetary System, and subsequently the European Monetary Union, had both an economic and political objective: it was, however, the political leadership in the major countries that made them become reality, despite the skepticism of a majority of academic economists about the desirability and the feasibility of these projects in both the "strong" and the "weak" currency countries. Without Helmut Schmidt and Giscard d'Estaing, and without François Mitterand and Helmut Kohl, monetary stability and monetary unification would been unattainable objectives.

It could be argued that: *"Increased monetary convergence and exchange rate stability were indispensable for overcoming "Europessimism" and for adopting the Single European Act. The EMS helped create the monetary conditions for "Europe 1992", for the Maastricht Treaty and for the plans of for the European Monetary Union and a common European currency. The lack of coordination with the US has been one of the main sources of the crisis of the EMS witnessed in 1992 and 1993. One of the principal shortcomings of the original "Delors Report" was that they completely ignored the worldwide dimensions of international stability."* [21]Hieronymi (1995:62). The regional approach may or

[21] Hieronymi, Otto (1995) "The Case for an 'Extended EMS': A New International Monetary Order to be Built by Europe, Japan and the United States", in Szabo-Pelsoeczy, Miklos (Editor): *The Global Monetary System After the Fall of the Soviet Empire*, (In Memoriam Robert Triffin – 1911-1993, Sixth Conference of the Robert Triffin-Szirâk Foundation, Szirâk, 1993), Averbury, Aldershot, 1995, Paul62

may not have been in the late 1970s and in the early 1990s the only realistic approach given the US lack of interest in systemic issues under the succeeding Democratic, Republican and again Democratic US Administrations.

Yet, the deliberate ignoring of the external dimension of the EMS and then of the EMU was short-sighted and reflected rearguard action of the academic and political advocates of floating. The agreement was that the European Central Bank should be modeled on the German Bundesbank: as the Bundesbank no longer had any exchange rate responsibilities, and in fact had become a principal bastion of "virtuous (i.e. anti-inflationary)" monetary nationalism, it was inconceivable that the ECB should ever be concerned about the exchange rate of the Euro. This was the political price to be paid for the creation of the EMU – and as the record shows a heavy price in terms of exchange rate stability towards the rest of the world and in terms of economic cohesion of the EMU and the economic performance of the individual members. Today, Monsieur Trichet, the President of the ECB and his colleagues on the Board, as well as most of the professional staff of the European Central Bank seem to be committed to the idea that external floating is the best "system" for Western Europe. A system that would include the EMU as a unit, with binding rules against monetary nationalism, is for them intellectual and political heresy, as it is for the majority of experts on the other side of the Atlantic.

In this context it is useful to remember that well into the 1990s professors and bankers, not only in Germany and in Switzerland and Britain were betting that the common European currency would never become a reality.

4.3. The Case of Japan

Why Japan? Why project a major role for Japan in restoring international monetary order? Why not China? Today, there is a regrettable tendency to underestimate the economic and political importance of Japan – both for its partners in the "Western Community" and for the international community and the world economy as a whole. This fallacy is the reverse of the one that could be observed in the 1970s and 1980s of overestimating the potential of Japan and the populist warnings against the danger of "Japanese economic domination".

Part of this tendency of "writing off" Japan has to do with country's tendency to keep a low profile in the international economic and monetary policy debate and its reluctance in particular to make international institutional initiatives or major reform proposals. This was and remains especially true in the international monetary and financial area – a field that has been of vital importance for the Japanese economy for many years.

As pointed out by a former Japanese Ministry of Finance official in the early 1990s: *"At the same time I have to admit that for most of this period Japan's posture in dealig with those international monetary issues was dominated by very strong features. One was clear passivity, in the sense that Japan was quite* *reluctant to play a role on the main stage. She wanted to mind her own business at home without being mixed up with others. There was also a very strong, almost overwhelming, preoccupation with the bilateral relationship with the United States."*[22] Gyothen (1992:17).The Japanese authorities and "opinion-leaders" bear a substantial share of the responsibility for the "marasm" that has befallen the Japanese economy since the early 1990s and for the series of international financial crises of the 1990s and of the 21st century. The continued passivity of the Japanese government and of the Japanese economists and opinion leaders towards the need for a reform of the international monetary and financial system even despite the evidence of the negative impact of the absence of a rule-based international system on the Japanese economy is truly astonishing. [23]

In the 1970s and 1980s the Japanese economy and policy making have been characterized by a strong performance and emphasis on the "real" aide of the economy and much less on monetary issues and financial and monetary reform. The main concern of Japanese policy makers and of Japanese companies was to avoid protectionist measures against Japanese exports – in particular in the United States and in Europe – and to counter upward pressures on the yen in the markets. For Japan Camp David and the Smithsonian meeting came as a true shock, yet Japanese companies could live with the higher yen in the 1970s.

The 1970s saw a veritable myth develop around the strength of Japanese economic policy making. The power of the Ministry of Finance and in particular the close ties between MITI and the leading industrial companies became the subject of countless studies. Also, the combination of flexibility and ability to adjust to changing conditions with an increasingly technology driven innovation made the Japanese economy the star performer in the 1970s and 1980s. A much admired feature of the Japanese policy mix was the emphasis on long-term economic and technological forecasting that allowed Japan not only to catch up in many areas with the United States and Europe, but also to achieve leadership in a number of important sectors.

In the case of Japan the consequences of passivity on the issue of the reform of international monetary order, on the one hand, and accepting American pressures for "financial liberalization and deregulation" in order to avoid American restrictions on Japanese exports, on the other hand, proved to backfire on both accounts.

The yen-dollar exchange rate was subject to wide swings of periods of overvaluation and under-valuation (this latter in particular during the first half of the 1980s) demonstrating the fallacy of the assumption that freely floating

[22] Toyoo Gyothen in Volcker, Paul and Gyothen, Toyoo (1992) *Changing Fortunes: The World's Money and the Threat to American Leadership*, Times Books, New York, 1992 Paul 17

[23] Shirakawa, Masaaki "Preventing the Next Crisis: the Nexus between Financial Markets, Financial Institutions and Central Banks" Speech at the London Stock Exchange by the Governor of the Bank of Japan, Bank of Japan, May 13, 2009.

exchange rates tend to converge towards "equilibrium" and accelerating direct investments by Japanese companies in their major export markets, and in particular in the United States.

The arguments of frustrated American negotiators during the Reagan and Bush Administrations was that if "Japanese consumers are not willing to buy enough American manufactured or agricultural products" to correct the trade imbalance, Japan should liberalize, deregulate and "modernize" its banking and financial sector on the American model – in order to create a "level-playing field" for the more "modern" and "competitive" American financial firms in Japan.

The effect was unexpected although not entirely unpredictable. There is no doubt that among all the OECD countries that introduced a rapid and massive "deregulation" of its banking and financial sector, Japan suffered the greatest and most lasting losses – at least until the current crisis as so far it is not possible to evaluate what the cumulative losses suffered by the American and European from the financial collapse of 2007-2009 will be. In Japan all the major actors – households, companies, banks and last but not least the public sector – ended up worse off in terms of both current income and long-term asset positions than they would have been with a more prudent approach to financial reform and liberalization.

5. Conclusions: The Prospects for a Joint Initiative by the US, Europe and Japan

5.1. The Purpose and Functions of An "Extended EMS"

The general argument in favor of reform is that that most of the arguments of the critics of the conditions prevailing since the 1970s turned out to be right and the arguments of the new orthodoxy were disproved by events. Exchange rate fluctuations have been more frequent and more erratic than the early defenders of floating had argued that they would be. The system of floating exchange rates has amplified exchange-rate and relative-price distortions and there has been no self-correcting tendency towards "equilibrium" exchange rates. Also the absence of rules has allowed the accumulation of major fundamental disequilibria and ultimately led to short-term speculation as the principal dimension of financial activity.

Without an appropriate international monetary order the world is a more uncertain and dangerous place, where power and monetary nationalism undermine and weaken the achievements of cooperation and the respect for common rules in other areas.

The issue is not only how to deal with exchange rate fluctuations but more broadly the issue of optimum policy mixes and of transparency and predictability and accountability.

The system has to be based on rules and policies. A system based purely on "consultations" and "policy coordination", without at least some key binding rules would be clearly insufficient. The rules have to apply to governments, central banks as well as private financial institutions. Without agreement on the objectives and organizing principles it is no use to argue about technical solutions or to claim that the best solutions are "politically unacceptable".

A successful reform is a long-term process, with a fair amount of trial and error and setbacks. The sequence has to be the following: 1. objectives, common values and basic organizing principles; 2. search for "technical solutions" and drafting of a concrete plan and program; 3. negotiations among a small group of major and like-minded actors; 4. implementation.

The approach proposed here – i.e. to start with a "regional approach" by the US, Europe and Japan, and then gradually extend its scope to all potential partners – is inspired by the sequence from regional to more global convertibility in the 1950s.

The actual features of the "extended EMS" will be the result of close negotiations and trial and error at several stages. However, from the start the principal functions and issues will have to include: (1) exchange rates; (2) balance-of-payments equilibrium; (3) international reserves; (4) monetary and fiscal discipline; (5) the role of central banks and (6) the division of tasks between markets and monetary authorities.

5.2. The Role and Interests of the US, Europe and Japan

Domestic and international instability are a threat to the market economy and ultimately also to democracy. According to Paul Volcker, recalling the success of the fight against inflation in the US and in other countries: "What will count in the end is credibility—a recognition that there is national interest in greater stabilization and a willingness to act. That credibility will require time to attain. I would argue it is attainable."[24]Volcker (2001).The US, Europe and Japan are the most complete and most highly developed and sophisticated democracies and market economies in the world. For them abandoning the market economy and international economic integration is neither an economic nor a political option. It is no exaggeration that the future of the market economy and of international economic integration depends to a significant extent on these three countries and areas and on their function as "role models" in the world economy.

International economic integration has played an essential role in the growth and prosperity of the United States, Europe and Japan in the last sixty years. Each one of them contributed to the expansion of world trade and at the same time benefited from the growing integration of the world economy.

[24] Volcker, Paul (April 2001) "Globalization and the World of finance", The 2001 Hutchinson Lecture, University of Delaware, April 30, 2001.

Their future prosperity will continue to depend on the stability and proper functioning of the international economic system. Despite their size, external shocks and systemic malfunctions can have a major impact on their overall economic performance and outlook.

Also, notwithstanding their size and large "domestic markets" and their weight in the world economy, neither one of the three can afford "to go it alone": neither the US, nor Europe, nor Japan could benefit from attempting a policy of "fortress Europe", "fortress Japan" of "fortress US" – in trade or in the monetary field.

In conclusions, the arguments for the US, Europe and Japan to seek to create an "extended EMS" can be summed up in the following three points:

1. Any approach to the reform of the international monetary system that would exclude one of the three "pillars" is bound to be incomplete and would lead to a more rather than a less fragmented monetary order. The futility of a bilateral approach "to the China problem" by the Secretary of Treasury in the Bush administration was evident even before it started and showed the lack of long-term thinking about international order and cooperation that had characterized the eight years of the Bush Administration.
2. Any agreement about monetary order – domestic or international – is and has to be first and foremost a political one. This is one of the major points on which both the skeptics and the optimists about international monetary reform tend to agree. Thus, if it is not possible to reach an agreement among the three major pillars of democracy and the market economy in the world, among those who during the last sixty years have developed a de facto community that has been responsible for both their security and prosperity, it is difficult to imagine that effective initial progress could be achieved in a more heterogeneous constellation (IMF, Group of 20, etc.).
3. The third argument is that from the start the new system has to be designed as an open and equitable monetary order, that would take into account the interests of all potential participants – including the so-called emerging markets. Thus, the success and growing weight of some of the new "emerging markets" such as China, India or Brazil is not a valid argument against closer cooperation and common initiatives of the "three pillars" of the liberal international economic order: they are rather an argument for greater responsibility. The emerging markets – large and small economies – as well as the least developed economies can only benefit if the three weightiest free market economies effectively cooperate to recreate a well-functioning international monetary order.

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