

**THE KEYNES PLAN, THE MARSHALL PLAN AND THE IMCU PLAN;
DESIGNING THE FUTURE INTERNATIONAL PAYMENTS SYSTEM USING THE
PAST PRINCIPLES OF KEYNES’S LIQUIDITY THEORY AND SOROS’S
REFLEXIVITY.**

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For more than three decades, orthodox economists, policy makers in government and central bankers and their economic advisors, using some variant of old classical economic theory [OCET], have insisted that (1) government regulations of markets and large government spending policies are the cause of all our economic problems and (2) ending big government and freeing markets, especially financial markets, from government regulatory controls is the solution to our economic problems, domestically and internationally.

In an amazing “mea culpa” testimony before Congress on October 23, 2008 Alan Greenspan admitted that he had overestimated the ability of free financial markets to self-correct and he had entirely missed the possibility that deregulation could unleash such a destructive force on the economy¹ Greenspan then admitted “I still do not fully understand why it happened, and obviously to the extent that I figure it happened and why, I shall change my views”¹

Greenspan, Bernanke and all OCET economists explain the 2007-2008 collapse of the investment banks and the shadow banking system to the “mispricing of [probabilistic] risk”. In the first decade of the 21 century the bankers were utilizing some variant of “risk management” models developed by Nobel Prize winning economists (as Greenspan noted in his testimony). –despite the fact that Nobel Laureate Scholes’ model had helped to create the collapse of Long Term Capital Management in the late 1990s. The “quants” on Wall Street just said we have to

develop better models , i.e., more sophisticated computer models that no one can understand, to better manage risk! Even today, the mainstream solution to our financial crisis is to let the bankers develop even better risk management models– which, as a Post Keynesian I would say–will result even in more catastrophic financial collapse sometime in the future.

This paper will explain to Greenspan and others who possess the OCET Panglossian belief that free markets produce socially optimum solutions why they are wrong and why Keynes’s liquidity theory and Soros’s reflexivity concept explains why laissez faire markets can never be efficient. As nations deregulated domestic and international markets events occurred which just cannot happen in a OCET world. For example (1) the United States continued to run a deficit in its trade balance since the 1970s, (2) countries that pursued export led growth policies to obtain persistent favorable trade balances which were used to accumulate huge foreign reserves are considered to be economic miracles (e.g., Japan in the 1980s, China in the 1990s and 2000s, etc), (3) US financial markets that supposedly efficiently allocate capital continually suffered from “bubbles”, e.g., the dot.com bubble of the 1990s and the real estate bubble in 2000s where a small-sub prime mortgage set of defaults in the US spreads globally to create a global banking, financial market and economic crisis, and (4) outsourcing created unemployment (and limits if not actually lower) real income for US workers in contrast to the gains that should accrue to labor under the conventional wisdom of the law of comparative advantage.

At best, COET would claim these events are merely short-run exogenous disturbances and in the long run if we maintain our laissez faire faith, then the economies of all nations will experience global full employment prosperity. Keynes [1936, p. 192] noted that OCET theorists

“offers us the supreme intellectual achievement ... of adopting a hypothetical world remote from experience as though it were the world of experience and then lived in it consistently”.

The fundamental principles underlying Keynes’s theory of liquidity and in his proposals presented at the 1944 Bretton Woods meeting (the “Keynes Plan”), can be used to explain why free trade, freely flexible exchange rates and free international capital funds mobility are ultimately incompatible with the economic goal of global full employment and rapid economic growth. Moreover, Keynes’s principles provide policy prescriptions to either completely prevent or at least quickly alleviate the distress caused by such real world experiences.

The basic OCET model is of an economic system where people make “real” decision and are not “fooled” by nominal values in their business and consumption decisions, i.e., a fundamental OCET axiom is that money is neutral. But if money is neutral, financial market crashes in nominal terms should have no effect on the real economy since the marginal physical productivity of the underlying real capital assets are unchanged and therefore their real productivity value should be unchanged².

Keynes [1936, p. 3] stated that the OCET’s fundamental postulates are applicable to a “special case....[that] happen[s] not to be those of the economic society in which we live with the result that its teaching is misleading and disastrous if we attempt to apply it to fact of experience”. This “special case” statement is even more applicable today, given the economic austerity discussions in Washington, the UK, Euroland, China, etc.

To replace OCET Keynes provided a new way of economic thinking which explains the operations of a monetary economy where entrepreneurs enter into nominal contracts in order to organize production and exchange activities³. The sanctity of money contracts is the essence of

the capitalist system and Keynes's analysis. In Keynes's analysis, liquidity, i.e., the ability to meet one's money contractual commitments domestically and internationally becomes an essential foundation for understanding the operation of an entrepreneurial economy.

Consequently, the primary function of well organized and orderly financial markets is to provide liquidity so that holders of financial assets traded on such markets "know" he/she can make a fast exit and liquify their portfolio at a price close to the previous market price at any time he/she fears something bad is going to happen. For business firms and households the maintenance of one's liquid position is of prime importance if bankruptcy is to be avoided. In our world, bankruptcy is the economic equivalent to a walk to the gallows.

Under the civil law of contracts money is that thing that a government decides will settle all legal contractual obligations. Accordingly this need for liquidity typically takes the form of making sure that each person maintains a positive balance in his/her checkbook over time so that all contractual obligations can be met as they come due. If, in any month, we write so many checks that we are close to overdrawing our account, we typically solve this problem by either:

(1) stop writing checks until next month's income is deposited into our account, or

(2) we arrange for a bank line of credit or

(3) we sell a liquid financial asset in our portfolio and use the money to replenish our bank account.

Obviously a negative check book balance is an economic disaster for all members of our capitalist economic system. But why should one desire to maintain a positive balance rather than a zero balance? Keynes's response to this query would be that since the future is uncertain, we never know when we might be suddenly faced with a payment obligation at a future date that we

did not, and could not, anticipate and that we could not meet out of the cash inflows expected at that future date. Or else we might find an expected cash inflow suddenly disappears for an unexpected reason; for example because of a reduction in pension income due to financial market value declines, or a loss of job, or the death of the breadwinner in the family, or an asset that we held in our portfolio that we thought could easily be sold suddenly becomes illiquid; for example, if this was a mortgage backed security that became a “troubled asset”.. Accordingly we have a precautionary liquidity motive for maintaining a positive bank balance in order to protect us from an unforeseen catastrophe. In our society, no one can either be too beautiful or too liquid. As long as the future is uncertain (rather than probabilistically risky), enhancing our liquidity position to cushion the blow of any unanticipated events that may occur is an understandable human activity. And similarly, in an international setting, the accumulation of foreign reserves are the indication that a country wants to be sure it has enough liquidity to meet all future international contractual obligations.

SAMUELSON VS. KEYNES AND SOROS

As I document in my 2009 book *THE KEYNES SOLUTION: THE PATH TO GLOBAL ECONOMIC PROSPERITY*, the founder of the American neoclassical synthesis Keynesian school, Nobel Prize winner Paul Samuelson, has admitted publically that he never understood Keynes’s theory. Samuelson states he found Keynes’s theory “unpalatable” and incomprehensible. Samuelson indicated that “The way I finally convinced myself was to just stop worrying about it [about understanding Keynes’s analysis]. ... I was content to assume that there was enough rigidity in relative prices and wages to make the Keynesian alternative to Walras operative” [Colander and Landreth, 1996, pp159-160]. In other words, Samuelson merely

assumed that Keynes's theory was just a "special case" of OCET⁴ where rigidity in wages, prices was the sole cause of unemployment and recession⁵. Samuelson successfully propagate this incorrect view⁶ across the economics profession after World War 2 so what has been taught as "Keynesianism" at prestigious universities and written up in most economics textbooks has nothing to do with Keynes's new economic thinking⁷.

Keynes [1936, p. 16] stated that classical economists

"resemble Euclidean Geometers in a non Euclidean world who, discovering that in experience straight lines apparently parallel often meet, rebuke the lines for not keeping straight – as the only remedy for the unfortunate collisions which are occurring. Yet in truth there is no remedy except to throw over the axiom of parallels and to work out a non Euclidean geometry. Something similar is required today in economics".

In this analogy comparing Euclidean geometry to OCET, Keynes was alluding to the fact that time is a device that prevents everything from happening at once while OCET presumes that the future is known and therefore free markets are efficient since they correctly allocate resources to produce full employment (the equivalent of the "parallel lines"). Yet significant and persistent unemployment (the "unfortunate collisions") occur in the real world. Accordingly, OCET rebuking the lines in the real world for not keeping straight is equivalent to blaming the victim workers for their unemployment problem because workers would not accept lower wages.

To create a nonEuclidean economics to explain why these unemployment "collisions" occur in the world of experience, Keynes had to deny ("throw over") three restrictive classical axioms. These were (1) the neutrality of money axiom, (2) the gross substitution axiom, and (3) the ergodic axiom.

In order to draw any statistical (risk) inferences regarding a universe, one should draw a sample from that universe. Since drawing a sample from the future is impossible, the ergodic

axiom assumes that the future is already predetermined and therefore a sample from the past is equivalent to drawing a sample from the future and calculating the probability distribution from past statistics is the same as calculating the risks from a future sample. This ergodic axiom is an essential foundation for all the risk management models developed by the “quants” on Wall Street.

Soros has explained why the efficient market theory is not applicable to real world financial markets with a slightly different terminology but conceptually in the same way. Soros (2008) wrote: “we must abandon the prevailing [efficient market] theory of market behavior. ”. Soros states that there is a direct connection “between market prices and the underlying reality [that] I [Soros] call reflexivity” What is this reflexivity? In a letter to the Editor published in the March 15-21, 1997 issue of The Economist Soros objects to Paul Samuelson insistence on applying the ergodic axiom to economics because Soros argues the ergodic hypothesis does not permit “the reflexive interaction between participants’ thinking and the actual state of affairs” that characterizes real world financial markets. In other words, the way people think about the market can affect and alter the future path the market takes. Soros’s concept of reflexivity, therefore, is the equivalent of Keynes’s throwing over of the ergodic axiom⁸. Reflexivity means peoples thoughts and actions create the future, while all the mathematical risk management models presume that using past market data the computer models discovers the future that has already been predetermined by existing market fundamentals.

In an uncertain world, by entering into money contracts, decision makers can gain some control over their future cash inflows and outflows. If individuals suddenly believe the future is more uncertain than it was yesterday, then they will try to reduce cash outflow payments for goods

and services today (save more) in order to increase their liquidity position so as to be better cope with the more feared uncertain adverse future events. If, however, many people suddenly think the future is more uncertain, then the cumulative effects of them all reducing their spending on the products of industry in order to become more liquid will create a significant market demand decline.. Faced with this reduction in market demand, businesses will reduce hiring of workers.

In the international sector, nations often have a fear of being unable to meet unknown future international commitments. Accordingly, such nations attempt to grow and accumulate foreign reserves to become more liquid by “making” their industries more competitive vis-a-vis foreign firms to increase exports more rapidly than any growth in imports. The result will be that the more competitive nation can accumulate foreign reserves and always be internationally liquid. Thus, as Keynes noted [1936, pp. 338-339], a system of free trade is likely to encourage policies to promote “an immoderate competition for a favorable balance which injures all alike”⁹. So just as oversaving by individuals in a closed economy can lead to economic depression, excessive accumulation of foreign reserves (nations’s savings) can depress the global economy.

In contrast, markets in the OCET world are efficient since households, business firms and nations have statistically reliable knowledge of the future including their commitments regarding all future contractual cash inflows and cash outflows. Self-interested efficient decision makers, therefore, would never enter into a contract that requires a future payment obligation that they could not meet¹⁰. No one in an OCET world would ever default on their contractual obligation. Consequently, there would never be a need for an additional liquidity cushion to meet an unexpected problem with one’s cash flow balances. Yet in the real world, households and business firms, and even local (sovereign) governments do default on contractual obligations.

Since efficient market theory, by assumption, eliminates the possibility of people defaulting on their contractual obligations, it should be obvious that OCET can neither logically explain what the relationship is between the sub prime mortgage problem and the global financial crisis that began in 2007. Nor can OCET any guidelines to resolve the problem, except to recommend leaving the problem to the free market and flexible exchange rates, and in the long run the economy will right itself. As changes in exchange rates make previously competitive industries uncompetitive and even unprofitable they may often go bankrupt merely because another nation partner has developed a policy to make its industries more competitive— perhaps by devaluing the exchange rate.. My good friend Alan Meltzer has often told me that “bankruptcies are good for the health of the capitalist system.”

RISK MANAGEMENT MODELS

If Keynes was alive today he would call the risk pricing computer models developed by “quants” in Wall Street “weapons of math destruction”. Yet, economist Robert Lucas [1981, p. 287] has boasted that the axioms underlying classical economics are “artificial, abstract, patently unreal”. But like Samuelson, Lucas insists such unreal assumptions are the only scientific method of doing economics. Lucas insists that “Progress in economic thinking means getting better and better abstract, analogue models, not better verbal observations about the real world” [Lucas, 1981, p. 276]. The rationale underlying this argument is that these unrealistic assumptions make the problem more tractable and, with the aid of a computer, the analyst can then predict the future. Never mind that the prediction might be disastrously wrong.

In the introduction to his book Against The Gods, a treatise that deals with the questions of relevance of risk management techniques on Wall Street, Peter L. Bernstein [1996, p. 6]

writes:

“The story that I have to tell is marked all the way through by a persistent tension between those who assert that the best decisions are based on quantification and numbers, determined by the [statistical] patterns of the past, and those who based their decisions on a more subjective degrees of belief about the uncertain future. This is a controversy that has never been resolved....to what degree should we rely on the patterns of the past to tell us what the future will be like?”

One would hope that the empirical evidence of the collapse of those “masters of the economic universe “ that have dominate Wall Street machinations for the last three decades has at least created doubt regarding the applicability of classical ergodic theory to our economic world. Even Alan Greenspan seems to be having second thoughts although he still has not completely changed his tune. Keynes’s ideas support Bernstein’s latter group.

In their book, Arrow and Hahn (1971, pp 256-7 emphasis added) wrote

"The terms in which contracts are made matter. In particular, if money is the goods in terms of which contracts are made, then the prices of goods in terms of money are of special significance. This is not the case if we consider an economy without a past or future. . . . if a serious monetary theory comes to be written, the fact that contracts are made in terms of money will be of considerable importance".

Thus intelligent OCET economists such as Arrow and Hahn ca not help but let their common sense intervene in their view of the economy – to the detriment of their logical consistency with their general equilibrium (Arrow-Debreu) OCET model.

Keynes’s liquidity theory provides a “serious monetary theory” for domestic and international transactions as a way of coping with an uncertain future .In the brief time I have here , since this is where Keynes presented his plan for the global monetary payments system 65 years ago, let me present my version of the 21st century international payment institutions that would follow Keynes’s principles to lead to a world of global economic prosperity.

First let me remind you of what Keynes said about trade and any international monetary

system that relied on laissez faire principles.:

(1), What is necessary for each nation to pursue a full employment prosperity policy is an autonomous rate of interest domestically set without any preoccupation to international complications. [Keynes, 1936, p. 349]

(2) Keynes declared that except for natural resources and climate related industries, the law of comparative advantage is not important. For “an increasingly wide range of industrial products....[e]xperience accumulates to prove that most mass production processes can be performed in most countries and climates with equal efficiency” [Keynes, 1933, p. 238]

. REFORMING THE WORLD’S MONEY

Too often economic discussions on the requirements for a good international payments system that will eliminate persistent trade and international payment imbalances have been limited to the question of the advantages and disadvantages of fixed vs. flexible exchange rates. US Treasury Secretary Geithner apparently believes if the Chinese would let the market decide the yuan-US dollar exchange rate, the problem of US running an unfavorable balance of trade would be resolved. In championing the argument for flexible exchange rates OCET assume that the price elasticities of the demand for imports and exports will meet the Marshall-Lerner condition, at least in the long run. For example in a book co-authored by Ben Bernanke [1992, p. 50, emphasis added] it is stated that “[a] fall in the exchange rate tends to reduce net exports in the short run....After consumers and firms have had more time....the Marshall-Lerner condition is likely to hold and a fall in the exchange rate is likely to lead to an increase in net exports.”

Although the question of whether the Marshall-Lerner condition is important in deciding whether a policy of permitting some flexibility in the exchange rate has anything to recommend it even in the long run, the facts of experience since the end of the Second World War plus Keynes's

revolutionary liquidity analysis indicates that more is required, if a mechanism is to be designed to positively resolve otherwise persistent trade and international payments imbalances while simultaneously promoting global full employment, rapid economic growth, and a long-run stable international standard of value.

Since the Second World War, the economies of the capitalist world has conducted experiments with the different types of exchange rate systems. For more than a quarter of a century (1947-1973) after the war, nations operated under the Bretton woods Agreement for a fixed, but adjustable, exchange rate system where, when necessary, nations could invoke widespread limitations on international financial movements (i.e., capital controls). Since 1973, the conventional wisdom of economists and politicians is that nations should liberalize all financial markets to permit unfettered international capital flows to operate under a freely flexible exchange rate system.

In contrast to the OCET view of the desirability of liberalized markets , Keynes's position at the Bretton Woods conference suggested an incompatibility thesis. Keynes argued that free trade, flexible exchange rates and free capital mobility across international borders will be incompatible with the economic goal of global full employment and rapid economic growth.

Between 1947 and 1973 policy makers in their actions implicitly recognized Keynes's 'incompatibility thesis'. This period was an "golden age" era of sustained economic growth in both developed and developing countries. The free world's economic performance in terms of both real growth rates and price level stability during this 1947-1973 period of fixed, but adjustable, exchange rates was historically unprecedented¹¹. Moreover, global economic growth rates during the earlier gold standard-fixed exchange rate period, although worse than this Bretton

Woods record, generally was better than the global experience during the post 1973 period where liberalizing exchange rate markets to achieve flexible exchange rates has been the conventional wisdom. The disappointing post-1973 experience of persistent high rates of unemployment in many nations, bouts of inflationary pressure and slow growth in many OECD countries, plus debt-burdened growth and/or stagnation (and even falling real GNP per capita) in developing countries and finally a rapid international financial collapse contrasts sharply with the experience during the Bretton Woods period.

The significantly superior performance of the free world's economies during the 1947-1973 fixed exchange rate period compared to the earlier gold standard fixed rate period suggests that there must have been an additional condition besides exchange rate fixity that contributed to the unprecedented growth during the 1947-73 period. That additional condition, as Keynes explained in developing his "Keynes Plan" required that any creditor nation that runs persistent favorable trade payments must accept the major responsibility for resolving these trade imbalances. The Marshall Plan (as explained below) was an instance where the creditor nation adopted the responsibility that Keynes had suggested was required.

THE KEYNES PLAN AND THE MARSHALL PLAN

To reduce entrepreneurial uncertainties and the possibility of massive currency misalignments in any fixed exchange rate system, Keynes recommended the adoption of a fixed, but adjustable, exchange rate system. More importantly, Keynes argued that the "main cause of failure" of any traditional international payments system -- whether based on fixed or flexible exchange rates-- was its inability to actively foster continuous global economic expansion whenever persistent trade payment imbalances occurred among trading partners. This failure, Keynes [1941, p. 27]

wrote,

"can be traced to a single characteristic. I ask close attention to this, because I shall argue that this provides a clue to the nature of any alternative which is to be successful.

It is characteristic of a freely convertible international standard that it throws the main burden of adjustment on the country which is the debtor position on the international balance of payments - that is, on the country which is (in this context) by hypothesis the weaker and above all the smaller in comparison with the other side of the scales which (for this purpose) is the rest of the world".

Accordingly, an essential improvement in designing any international payments system requires transferring the onus of adjustment from the debtor to the creditor position. This transfer would substitute an expansionist, in place of a contractionist, pressure on world trade [Keynes, 1941, pp. 29-30]. To achieve a golden era of economic development Keynes recommended combining a fixed, but adjustable, exchange rate system with a mechanism for requiring any nation persistently "enjoying" a favorable balance of trade to initiate most of the effort necessary to eliminate this imbalance, while "maintaining enough discipline in the debtor countries to prevent them from exploiting the new ease allowed them" [Keynes, 1941, p. 30].

After World War II, the war-torn capitalist nations in Europe did not have sufficient undamaged resources to produce enough to feed their population and rebuild their economies. Rebuilding would require the European nations to run huge import surpluses with the United States in order to meet their economic needs. To obtain the necessary imports from the United States, under a laissez-faire system, it would be necessary for European nations to receive enormous loans to finance the required U.S. export surplus to Europe. The resulting European indebtedness would be so burdensome that it was unlikely that, even in the long run, the European nations could ever service such debt obligations.

The Keynes Plan required the United States, as the obvious major creditor nation, to

accept the major responsibility for curing the international financial problems that would be associated with the post-war European nations need for U.S. imports. Keynes estimated that the European nations might need imports in excess of \$10 billion to rebuild their economies. The U.S. representative to the Bretton Woods Conference, Harry Dexter White, rejected the Keynes Plan. Dexter White argued that Congress would be willing to provide, at most, \$3 billion as the U.S. contribution to solving this post war international financial problem.

Instead, the White Plan created the International Monetary Fund (IMF) whose function it would be to provide short-term loans to nations running unfavorable balances of trade. These loans were suppose to give the debtor nation time to tighten its belt and get its economic house in order. The White Plan had the U.S. subscribing to a maximum of \$3 billion as its contribution to the IMF lending facilities. White's plan also developed another lending institution, now called the World Bank, that would borrow funds from the private sector. These funds would then be used to provide long-term loans for rebuilding capital facilities and making capital improvements initially in the war-torn nations and later in the less developed countries. White's plan was basically the institutional arrangements adopted at the Bretton Woods Conference.

To avoid the possibility that many European nations facing a desperate electorate that might opt for a communist system when faced with the dismal future of servicing huge loans that the IMF and World Bank might provide for European recovery, the United States produced the Marshall Plan to assure that Communism did not spread West from the Soviet Union. In essence, the United States accepted the most important Keynes Plan argument that it is in the best interest of all nations if the major creditor nation bear the major burden of reducing trade imbalances and international payments adjustments. As a result of the Marshall Plan and other foreign aid

programs, the U.S. and its major trading partners experienced unprecedented long run rates of real economic growth from the end of the second World War until the early 1970s. Despite White's argument that the U.S. would not be willing to give more than \$3 billion to solving this international payments problem, the Marshall Plan provided \$5 billion in foreign aid in 18 months and a total of \$13 billion in four years. The Marshall plan was essentially a four year gift of \$13 billion worth of U.S. exports to the war devastated nations

The Marshall plan gift gave the recipient nations claim to approximately 2 per cent of the Gross Domestic Product of the United States for four years from 1947 to 1951.. Despite Americans giving away 2 per cent of their income per annum, there was no real sacrifice for Americans associated with the Marshall Plan as the remaining per capita income was significantly greater than pre-war levels. The resulting U.S. exports that Marshall plan funds recipient nation's were able to purchase created significant increases in employment in U.S. export industries just as several million men and women were discharged from the U.S. armed forces and entered the U.S. labor force looking for jobs. For the first time in its history, the United States did not suffer from a severe recession immediately after the cessation of a major war. The U.S. and most of the rest of the world experienced an economic "free lunch" as both the potential debtor nations and the creditor nation experienced tremendous real economic gains resulting from the Marshall Plan.

By 1958, however, although the U.S. still had an annual goods and services export surplus of over \$5 billion, U.S. governmental foreign and military aid exceeded \$6 billion, while there was a net private capital outflow of \$1.6 billion.¹² The post-war U.S. potential surplus on international payments balance was at an end.

As the U.S. current international payments account swung into deficit in 1958 other

nations began to experience payments surpluses. These credit surplus nations did not spend their payments surpluses on foreign goods and services. Instead they used their annual dollar surpluses to accumulate international liquid assets in the form of gold reserves from the U.S. Federal Reserve System¹³. These trends accelerated in the 1960s, partly as a result of increased U.S. military and financial aid responses to the construction of the Berlin Wall in 1961 and later because of the U.S.'s increasing involvement in Vietnam. At the same time, a rebuilt Europe and Japan became important producers of exports so that the rest of the world became less dependent on the U.S. exports.

Still the United States maintained a positive merchandise trade balance until the first oil price shock in late 1973. More than offsetting this merchandise trade surplus during most of the 1960s, however, were foreign and military aid plus net capital outflows from the United States so that the United States experienced an annual unfavorable balance of international payments. The Bretton Woods system had no way of automatically forcing the emerging surplus nations to stop accumulating gold (dollar) foreign reserves and instead step into the creditor adjustment role that the U.S. had been playing since 1947. Instead the surplus nations continued to convert some portion of their annual dollar surpluses into calls on U.S. gold reserves. The seeds of the destruction of the Bretton Woods system and the golden age of economic development were being sown as surplus nations drained gold reserves from the United States.

When, in 1973, the U.S. withdrew from the Bretton Woods Agreement, the last vestiges of Keynes's enlightened monetary approach were lost, apparently without regret or regard as to [a] why the Bretton Woods system had been developed in the first place and [b] how well it had helped the free world to recover from a devastating war which had destroyed

much of the productive stock of capital in Europe and Asia.

Under any traditional international free trade system, any nation that attempts to improve its economic growth performance by pursuing Keynes's policies for increasing domestic effective demand via easy monetary and fiscal policies will almost immediately face an international payments problem. Expanding domestic aggregate demand will increase the demand for imports relative to the value of exports, thereby encouraging increased economic growth in the trading partners's export industries.

Since 1981 the United States has been the "engine of growth" for most of the rest of the world, as U.S. perpetually ran an unfavorable trade balance as U.S. imports tended to grow more rapidly than its exports. Accordingly, the United States has been saddled by increasing international deficits almost every year for its laudatory efforts..

CHANGING THE INTERNATIONAL PAYMENTS SYSTEM

The 1950-1973 global golden age of economic development required international institutions and U.S. government foreign aid policies that operated on principles inherent in the Keynes Plan. The formal Breton Woods agreement, however, did not require creditor nations to take such actions. Since 1973, the international payments system has been one where international payments considerations often impede any rapid economic growth of many of the developed nations of the world while severely constraining the growth of the least developed countries (LDCs).

Utilizing Keynes's principles, it is possible to update Keynes's original plan for a postwar international monetary scheme that will promote global economic prosperity. For "to suppose [as OCET does] that there exists some smoothly functioning automatic [free market] mechanism of adjustment which preserves equilibrium if only we trust to methods of laissez-faire is a doctrinaire

delusion which disregards the lessons of historical experience without having behind it the support of sound theory” [Keynes, 1941, pp. 21-2]

In the 21st century interdependent global economy, a substantial degree of economic cooperation among trading nations is essential. The original Keynes Plan for reforming the international payments system called for the creation of a single Supranational Central Bank. The clearing union institution suggested infra is a more modest proposal than the Keynes Plan, although it operates under the same economic principles laid down by Keynes. Our IMCU plan is aimed at obtaining an acceptable international agreement (given today’s political climate in most nations) that does not require any nation surrendering control of either local banking systems or domestic monetary and fiscal policies. Each nation will still be able to determine the economic destiny that is best for its citizens without fear of importing deflationary repercussions from their trading partners. Each nation, however, will not be able to export any domestic inflationary forces to their international neighbors.

What is required is a closed, double-entry bookkeeping clearing institution to keep the payments ‘score’ among the various trading nations plus some mutually agreed upon rules to create and reflux international liquidity while maintaining the purchasing power of the created international currency of the international clearing union. The eight provisions of the international clearing system suggested here meet the following criteria. The rules of the proposed system are designed

[1] to prevent a lack of global effective demand¹⁴ due to a liquidity problem arising whenever any nation(s) accumulate excessive idle reserves.

[2] to provide an automatic mechanism for placing a major burden of correcting

international payments imbalances on the surplus nations,

[3] to provide each nation with the ability to monitor and, if desired, to control movements of flight capital, tax evasion money movements, earnings from illegal activities, and even funds that finance terrorist operations¹⁵, and finally

[4] to expand the quantity of the liquid asset used in settling international contracts (the asset of ultimate redemption) as global capacity warrants while protecting the purchasing power of this asset.

There are eight major provisions in this clearing system proposal. They are:

1. The unit of account and ultimate reserve asset for international liquidity is the International Money Clearing Unit (IMCU). All IMCU's can be held only by the central banks of nations that abide by the rules of the clearing union system. IMCUs are not available to be held by the public.

2. Each nation's central bank or, in the case of a common currency (e.g., the Euro) a currency union's central bank, is committed to guarantee one way convertibility from IMCU deposits at the clearing union to its domestic money. Each central bank will set its own rules regarding making available foreign monies (through IMCU clearing transactions) to its own bankers and private sector residents¹⁶. Ultimately, all major private international transactions clear between central banks' accounts in the books of the international clearing institution.

The guarantee of only one-way convertibility permits each nation to institute controls and regulations on international capital fund flows if necessary. There is a spectrum of different capital controls available. Each nation is free to determine which capital controls is best for its residents

The IMF, as lender of last resort during the 1997 East Asian contagion crisis, imposed the

same conditions on all nations requiring loans for international liquidity purposes. The resulting worsening of the situation should have taught us that in policy prescriptions one size does not fit all situations. Accordingly, the type of capital regulation a nation should choose from the spectrum of tools available at any time will differ depending on the specific circumstances involved. It would be presumptuous to attempt to catalog what capital regulations should be imposed for any nation under any given circumstances. Nevertheless, it should be stressed that regulating capital movements may be a necessary but not a sufficient condition for promoting global prosperity. Much more is required.

3. Contracts between private individuals in different nations will continue to be denominated into whatever domestic currency permitted by local laws and agreed upon by the contracting parties. Contracts to be settled in terms of a foreign currency will therefore require some publically announced commitment from the central bank (through private sector bankers) of the availability of foreign funds to meet such private contractual obligations.

4. The exchange rate between the domestic currency and the IMCU is set initially by each nation's central bank-- just as it would be if one instituted an international gold standard. Since private enterprises that are already engaged in trade have international contractual commitments that would span the changeover interval from the current system, then, as a practical matter, one would expect, but not demand, that the existing exchange rate structure (with perhaps minor modifications) would provide the basis for initial rate setting.

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

5. An overdraft system should be built into the clearing union rules. Overdrafts should

make available short-term unused creditor balances at the Clearing House to finance the productive international transactions of others who need short-term credit. The terms will be determined by the pro bono publico clearing union managers.

6. A trigger mechanism to encourage any creditor nation to spend what is deemed (in advance) by agreement of the international community to be accumulated "excessive" credit balances.. These excessive credits can be spent in three ways: (1) on the products of any other member of the clearing union, (2) on new direct foreign investment projects, and/or (3) to provide unilateral transfers (foreign aid) to deficit members. Spending via (1) forces the surplus nation to make the adjustment directly by way of the trade balance on goods and services. Spending by way of (2) permits adjustment directly by the capital account balance, while (3) provides adjustment without setting up a contractual debt that will require reverse current account flows in the future.

These three spending alternatives force the surplus nation to accept a major responsibility for correcting the payments imbalance. Nevertheless this provision gives the surplus country considerable discretion in deciding how to accept the onus of adjustment in the way it believes is in its residents best interests. It does not permit the surplus nation to shift the burden to the deficit nation(s) via contractual requirements for debt service charges independent of what the deficit nation can afford. The important thing is to make sure that continual oversaving¹⁷ by the surplus nation in the form of international liquid reserves are not permitted to unleash depressionary forces and/or a building up of international debts so encumbering as to impoverish the global economy of the 21 century.

In the unlikely event that the surplus nation does not spend or give away these credits within a specified time, then the clearing agency would confiscate (and redistribute to debtor

members) the portion of credits deemed excessive¹⁸. This last resort confiscatory action (a 100% taxes on excessive liquidity holdings) would make a payments adjustment via unilateral transfer payments in the current accounts.

Under either a fixed or a flexible rate system with each nation free to decide on how much it will import, some nations will, at times, experience persistent trade deficits merely because their trading partners are not living up to their means -- that is because other nations are continually hoarding a portion of their foreign export earnings (plus net unilateral transfers). By so doing, these oversavers are creating a lack of global effective demand. Under provision #6, deficit countries would no longer have to deflate their real economy in an attempt to reduce imports and thereby reduce their payment imbalance because others are excessively oversaving. Instead, the system would seek to remedy the payment deficit by increasing opportunities for deficit nations to sell abroad and thereby work their way out of their deteriorating debtor position.

7. A system to stabilize the long-term purchasing power of the IMCU (in terms of each member nation's domestically produced market basket of goods) can be developed. This requires a system of fixed exchange rates between the local currency and the IMCU that changes only to reflect permanent increases in efficiency wages¹⁹. This assures each central bank that its holdings of IMCUs as the nation's foreign reserves will never lose purchasing power in terms of foreign produced goods. If a foreign government permits wage-price inflation to occur within its borders, then, the exchange rate between the local currency and the IMCU will be devalued to reflect the inflation in the local money price of the domestic commodity basket. For example, if the rate of domestic inflation was 5 cent, the exchange rate would change so that each unit of IMCU could purchase 5 per cent more of the nation's currency.

If, on the other hand, increases in productivity lead to declining production costs in terms of the domestic money, then the nation with this decline in efficiency wages [say of 5 per cent] would have the option of choosing either [a] to permit the IMCU to buy [up to 5 per cent] less units of domestic currency, thereby capturing all (or most of) the gains from productivity for its residents while maintaining the purchasing power of the IMCU, or [b] to keep the nominal exchange rate constant. In the latter case, the gain in productivity is shared with all trading partners. In exchange, the export industries in this productive nation will receive an increasing relative share of the world market.

By devaluing the exchange rate between local monies and the IMCU to offset the rate of domestic inflation, the IMCU's purchasing power is stabilized. By restricting use of IMCUs to Central Banks, private speculation regarding IMCUs as a hedge against inflation is avoided. Each nation's rate of inflation of the goods and services it produces is determined solely by (a) the local government's policy toward the level of domestic money wages and profit margins vis-a-vis productivity gains, i.e., the nation's efficiency wage. Each nation is therefore free to experiment with policies for stabilizing its efficiency wage to prevent inflation as long as these policies do not lead to a lack of global effective demand. Whether the nation is successful or not in preventing domestic goods price inflation, the IMCU will never lose its international purchasing power in terms of any domestic money. Moreover, the IMCU has the promise of gaining in purchasing power over time, if productivity grows more than money wages and each nation is willing to share any reduction in real production costs with its trading partners.

Provision #7 produces a system designed to, at least, maintain the relative efficiency wage parities amongst nations. In such a system, the adjustability of nominal exchange rates will be

primarily (but not always, see Provision #8) to offset changes in efficiency wages among trading partners. A beneficial effect that follows from this proviso is that it eliminates the possibility that a specific industry in any nation can be put at a competitive disadvantage (or secure a competitive advantage) against foreign producers solely because the nominal exchange rate changed independently of changes in efficiency wages and the real costs of production in each nation.

Consequently, nominal exchange rate variability can no longer create the problem of a loss of competitiveness due solely to the overvaluing of a currency as, for example, experienced by the industries in the American "rust belt" during the period 1982-85. Even if temporary, currency appreciation independent of changes in efficiency wages can have significant permanent real costs as domestic industries abandon export markets and lose domestic market business to foreign firms and the resultant existing excess plant and equipment is cast aside as too costly to maintain.

Proviso #7 also prevents any nation from engaging in a beggar-thy-neighbor, export-thy-unemployment policy by pursuing a real exchange rate devaluation that does not reflect changes in efficiency wages. Once the initial exchange rates are chosen and relative efficiency wages are locked in, reduction in real production costs which are associated with a relative decline in efficiency wages is the main factor (with the exception of provision #8) justifying an adjustment in the real exchange rate.

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

8. If a country is at full employment and still has a tendency toward persistent

international deficits on its current account, then this is prima facie evidence that it does not possess the productive capacity to maintain its current standard of living. If the deficit nation is a poor one, then surely there is a case for the richer nations who are in surplus to transfer some of their excess credit balances to support the poor nation²⁰. If the deficit nation is a relatively rich country, then the deficit nation must alter its standard of living by reducing its relative terms of trade with its major trading partners. Rules, agreed upon in advance, would require the trade deficit rich nation to devalue its exchange rate by stipulated increments per period until evidence becomes available to indicate that the export-import imbalance is eliminated without unleashing significant recessionary forces.

If, on the other hand, the payment deficit persists despite a continuous positive balance of trade in goods and services, then there is evidence that the deficit nation might be carrying too heavy an international debt service obligation. The pro bono officials of the clearing union should bring the debtor and creditors into negotiations to reduce annual debt service payments by [1] lengthening the payments period, [2] reducing the interest charges, and/or [3] debt forgiveness²¹.

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

In the absence of proviso #6, under any conventional system, whether it has fixed or flexible exchange rates and/or capital controls, there can ultimately be an international liquidity crisis (as any persistent current account deficit can deplete a nation's foreign reserves) that unleashes global

depressionary forces. Thus, proviso #6 is necessary to assure that the international payments system will not have a built-in depressionary bias. Ultimately then it is in the self-interest of the surplus nation to accept this responsibility, for its actions will create conditions for global economic expansion some of which must redound to its own residents. Failure to act, on the other hand, will promote global depressionary forces which will have some negative impact on its own residents.

NOTES

1. Greenspan stated: “This crisis, however, has turned out to be much broader than anything I could have imagined.... In recent decades, a vast risk management and pricing system has evolved, combining the best insights of mathematicians and finance experts supported by major advances in computer and communications technology. A Nobel Prize was awarded for the discovery of the [free market] pricing model that underpins much of the advance in [financial] derivatives markets. This modern risk management paradigm held sway for decades. The whole intellectual edifice, however, collapsed.”

2. Yet the Great Depression of the 1930s was preceded by a real estate monetary value market bubble and a stock market nominal bubble. Moreover, the Great Recession of 2007 - 2010 was preceded by a dot.com monetary bubble and a sub prime mortgage real estate bubble. How is this possible?

3. In mainstream macroeconomics, contracts are always made in real terms as no agent is suffering from “the money illusion”.

4. While Keynes explicitly stated that OCET including Walrasian theory was a “special case of his more general theory.

5. Later a fixity in interest rates (the liquidity trap where the demand for speculative balances becomes infinite at some low but positive price) became another price fixity that could lead to deficient affective demand. Keynes [1936, p.202], however, presents the speculative demand as a rectangular hyperbola - a mathematical system that can never exhibit an infinite elasticity of demand.

6. Thus most people believe that The General Theory deals only with a closed economy similar to a Walrasian one. Yet, as I indicate below, Keynes had several cogent things to say about the effect of international trade and money payments and how, under a laissez-faire philosophy, these could adversely affect a nation’s economy.

7. Apparently Samuelson never tried to comprehend Keynes's analytical foundation and framework. For in 1986 Samuelson was still claiming that "we [Keynesians] always assumed that the Keynesian underemployment equilibrium floated on a substructure of administered prices and imperfect competition" [C-L, 1996, p.160]. When pushed by Colander and Landreth as to whether this necessary requirement of rigidity of prices and/or wages for a Keynesian analysis was ever formalized in his work, Samuelson's response was "There was no need to" [C-L, 1996, p. 161]. Yet specifically in chapter 19 of The General Theory and even more directly in his published response to Dunlop and Tarshis, Keynes [1939] had already responded in the negative to this question of whether his analysis of underemployment equilibrium required imperfect competition, administered prices, and/or rigid wages.

8. In place of the rejected ergodic axiom Keynes argued that when crucial economic decisions had to be made, decision makers could not merely assume that the future can be reduced to quantifiable risks calculated from already existing market data.

For decisions that involved potential large spending outflows or possible large income inflows that span a significant length of time, people "know" that they do not know what the future will be. They do know that for these important decisions, making a mistake about the future can be very costly and therefore sometimes putting off a commitment today maybe the most judicious decision possible.

Our modern capitalist society has attempted to create an arrangement that will provide people with some control over their uncertain economic destinies. In capitalist economies the use of money and legally binding money contracts to organize production, sales and purchases of goods and services permits individuals to have some control over their cash inflows and outflows and therefore some control of their monetary economic future.

People and business firms willingly enter into nominal contracts because each party thinks it is in their best self interest to fulfill the terms of the contractual agreement. If, because of some unforeseen event, either party to a contract finds itself unable or unwilling to meet its contractual commitments, then the judicial branch of the government will enforce the contract and require the defaulting party to either meet its contractual obligations or pay a sum of money sufficient to reimburse the other party for damages and losses incurred. Thus, as the biographer of Keynes, Lord Robert Skidelsky has noted, for Keynes "injustice is a matter of uncertainty, justice a matter of contractual predictability". In other words, by entering into nominal contractual arrangements people assure themselves a measure of predictability in terms of their contractual cash inflows and outflows, even in a world of uncertainty.

9. President Obama has indicated that he would adopt policies to double US exports by the year 2014 by making US industries more competitive.. At whose expense?

10. Thus the Walrasian system presumes all spot and forward contracts are settled and paid for at the initial period of time and all spot and forward market prices are market clearing.

11. See Irma Adelman [1991]

12. Figures obtained from Statistical Abstract of the United States 1959, U.S. Bureau of Census, Washington, 1959, p. 870.

13. For example, in 1958, the U.S. lost over \$2 billion in gold reserves to foreign central banks.

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

15. This provides an added bonus by making tax-avoidance, profits from illegal trade, and funding terrorist operations more difficult to conceal.

16. Correspondent banking will have to operate through the International Clearing Agency, with each central bank regulating the international relations and operations of its domestic banking firms.

Small scale smuggling of currency across borders, etc., can never be completely eliminated. But such movement's are merely a flea on a dog's back -- a minor, but not debilitating, irritation. If, however, most of the residents of a nation hold and use (in violation of legal tender laws) a foreign currency for domestic transactions and as a store of value, this is evidence of a lack of confidence in the government and its monetary authority. Unless confidence is restored, all attempts to restore economic prosperity will fail.

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

18. Whatever "excessive" credit balances that are redistributed shall be apportioned among the debtor nations (perhaps based on a formula which is inversely related to each debtor's per capita income and directly related to the size of its international debt) to be used to reduce debit balances at the clearing union.

19. The efficiency wage is related to the money wage divided by the average product of labor; it is the unit labor cost modified by the profit mark-up in domestic money terms of domestically produced GNP. At the preliminary stage of this proposal, it would serve no useful purpose to decide whether the domestic market basket should include both tradeable and non-tradeable goods and services. (With the growth of tourism more and more nontradeable goods become potentially tradeable.) I personally prefer the wider concept of the domestic market basket, but it is not obvious that any essential principle is lost if a tradeable only concept is used, or if some nations use the wider concept while others the narrower one.

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

[See Davidson [1987-8].

21. The actual program adopted for debt service reduction will depend on many parameters including: the relative income and wealth of the debtor vis-a-vis the creditor, the ability of the

debtor to increase its per capita real income, etc.

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