

After the Crisis: Macro Imbalance, Credibility and Reserve-Currency

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In the last three or four decades, a view of what constitutes good macroeconomic policy - the best way to conduct monetary, fiscal e foreign exchange policies – was consolidated. What may be called a macroeconomic consensus, seemed to have brought about, if not the final end to the economic cycle, at least its considerable moderation. The historic alternation between good and bad times seemed to have been replaced by a horizon of continuous growth. The specter of recession and unemployment was repelled. Policy makers, central banks in particular, seemed as if they had finally mastered the technology to avoid great recessions and extraordinary unemployment. For the countries of the centre, it seemed that the traditional macroeconomic limits - external and internal - had been pushed far enough as to no longer represent bidding restrictions to sustainable growth.¹ The capacity to grow without exhausting the sources of external finance and without awakening the inflationary dragon seemed guaranteed.

For emerging countries, where the confidence of investors was still conditional, this never applied as demonstrated by the recurring crises they suffered. The fact that emerging economies had not reached the nirvana of the great macroeconomic moderation, but were still subjected to recurrent crises, was seen as sign of the need for institutional reforms and for additional time to consolidate them. To the countries of emerging economies, consolidation of external confidence was the main objective. When a crisis started, despite the halt of capital flows, the economic disruption and the rise of unemployment, macroeconomic policy was necessarily geared towards confidence rebuilding. Restrictive monetary and fiscal policies, in order to regain external confidence, are especially perverse when the economy dives into recession, the health of banking system is in danger and unemployment increases. For emerging economies, however, there has never been

¹ For a detailed analysis of this argument, see A.Lara Resende, *Em Plena Crise: Uma Tentativa de Reconstituição Analítica*, IEPE/CDG, December 2008.

condescension: in case of crisis, economic policy could not be anti-cyclical, in order to attenuate its impact; it had to be perversely pro-cyclical, to rebuild confidence.

While first world economies had the impression that the limits of the possible had vanished and no longer represented constraints to growth, emerging market countries took painful lessons about the risks of approaching the stubborn limits of the external restriction. The crisis in Russia, Latin America and Asia, represented a clear message: if emerging market countries wanted to participate in the global economic integration, if they wanted to benefit from the expansion of international trade and investment, they had to beware against the possibility of currency crises. The consequences would otherwise be painful and, unless they chose the road to isolation, they would not be allowed to conduct compensatory macroeconomic policies to reduce the social costs of the crisis.

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In the last three decades, the functioning of the world economy could be schematically described as follows. First world countries, issuers of reserve-currencies - mainly the USA, but also Japan, the euro area and, to a lesser extent, the United Kingdom and Switzerland – with guaranteed confidence and free of the specter of inflation, had no limits to growth, except those given by the ability to create domestic demand. The domestic production function would be indefinitely complemented by the capacity to finance external deficits. The ability to create domestic demand differed considerably amongst them. At one end, the USA, the most dynamic world economy, fueled by an aggressive consumerist mentality, driven by the technological and financial innovations of the last decades, convinced of its endless capacity to adapt and to reinvent itself. At the other end, Japan, that after the bursting of its real estate bubble in the early nineties, with an insolvent banking system and a traumatized private sector, became unable to respond to policy incentives to increase domestic expenditures and to reduce savings. Also amongst countries of the European Union, there were remarkable differences with respect to expenditure and growth. At one end, the dynamism of Spain and Ireland, at the other, Germany, by nature conservative, and for a long while engaged in the digestion of its reunification. Nevertheless, on the whole, first world countries, issuers of reserve-currencies, were the locomotives of world consumption. They remained unwary of the rapid increase in

domestic private indebtedness and of the scale of the external deficits. Japan, unable to reignite private domestic consumption, adopted an aggressively expansionary fiscal and monetary policy. Japan's lax monetary policy –through the popular “carry-trade” practice - ultimately helped to finance the voracious consumption of other first-world countries. Even when incapable of stimulating domestic demand through expansionary monetary policy, first-world countries, issuers of reserve-currencies, were still able to finance the external consumption of their commercial partners in and thus expand their own exports.

Emerging market countries, traumatized by the recurring crises, came to understand that the adoption of the macroeconomic policy consensus was not enough to guarantee investor confidence. They were not allowed to benefit directly from the euphoric expansion of world credit. To avoid being repeatedly knocked down by a sudden lack of investor confidence, when going too far in their dependence on foreign capital, emerging market countries adopted a cautious attitude. They understood that in order to benefit from the world's financial and commercial expansion, it was necessary to adopt a supportive role and to be towed by the dynamism of the first-world economies. Domestic growth had to be always conditional to the growth of the external demand. The export sector should lead economic growth, even though - as is the case for emerging economies - given all sorts of unsatisfied needs, domestic demand had a great potential for dynamism. Growth of emerging economies has relied on exports to cater to the consumption of the central economies, while domestic consumption was repressed. This explains why Brazil, faced once again with a balance of payments crisis in 1999, when its chronic inflation had already been controlled, has opted to adopt since then, a monetary policy that, at first sight, seems excessively conservative. High interest rates in Brazil are an insurance against the stubborn insecurity of investors. Emerging countries, that have only a conditional credibility, do not have room to turn domestic consumption into the engine of growth. Any attempt to mobilize internal consumption as an autonomous factor of growth increases the risk of running against the external restriction. The result could be a major and disruptive currency devaluation, after which there will be no room to conduct anti-cyclical policies. Restrictive monetary and fiscal policies will be mandatory in order to rebuild the shattered confidence of investors.

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Since the beginning of this century, after the recurring crises endured by the emerging economies, it became clear that commercial and financial integration to the world economy was conditional on the adoption of a subordinate posture. Integration had to be achieved through the expansion of the export basis and growth had to be kept within the limits established by a sustainable surplus in the external accounts. The accumulation of a robust cushion of international reserves was a condition for sustainable integration. The level of international reserves kept by emerging countries is far superior to what would be reasonable if the international capital market were anywhere close to the competitive market. Emerging countries had only two options: either a subordinate insertion or to remain at the margin of the world economy. In Latin America, the Venezuela of Hugo Chavez leads the attempt to create an alternative circuit, which includes Ecuador, Bolivia and Argentina. Brazil, Mexico, Chile and Colombia are amongst those who chose a subordinate insertion. Ideological questions aside, the result is unequivocal: integration into the world economy, even if in subordinate position, has been an alternative far superior to the one taken by club of the excluded. Apparently this did not escape the Chinese leadership. Aware of the risks of an unconditional integration into the globalized economy, through the crises that reached its Asian neighbors, China has kept an extremely conservative posture. It went for integration, but with an exporter stance, with mercantilist connotations. Its objective has since been to benefit from the strength of the demand of the first-world economies but with the guarantee of an expressive trade surplus. Only after the accumulation of an extraordinary cushion of international reserves, China started gradually to reduce obstacles to the growth of internal demand. Even then, until the start of the present crisis, China kept its role of only a secondary engine to the world economy. It has been the main source of demand for primary products, exported basically by emerging economies, as long as its exports and its trade surplus were guaranteed by the strong pace of consumption of first-world economies. China's internal consumption has always been repressed, by economic policy, as well as by direct control of the access of rural populations to urban areas.

High rates of growth, based on the increase in consumption of the mature economies of first-world countries, cannot be sustained for a prolonged period. First-world countries have low or no demographic growth, an inverted demographic pyramid and an already very high standard of living. The maintenance of a high rate of consumption growth depends, both on the creation of new consumption needs and on the permanent expansion of credit to families with ever higher levels of debt. The rich central countries consume, financed by ever higher levels of debt, in order to satisfy ever more artificial needs, with products made in China, which controls its labor costs and buys raw materials from emerging countries. No need of a profound analysis to conclude that in the long run this model is unsustainable.

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There are two currents of interpretation of the present crisis. The first emphasizes a deficiency of the regulatory framework. It argues that it was such deficiency that ultimately led to the excess of leverage in the financial system. The explosion of ingenuity that followed the development of contingent contracts, the so called “derivatives”, and the securitization of credits transformed the financial system from a relationship oriented system into a market transaction oriented system. It should have been more and better regulated in order to avoid the resulting excesses. The second current emphasizes the presence of large international macroeconomic imbalances. Obviously both interpretations are at least partially correct, but they are above all complementary. The macroeconomic imbalance would not have been so deep and persistent without the extraordinary development of the financial market. Indebtedness and leverage would not have reached such extremes in the world without the international macroeconomic imbalance. To accept that both interpretations are complementary does not necessarily lead to the conclusion that to redesign the regulatory framework is as important as to find a way to reverse the international macroeconomic imbalance. If promoted in a hurry and under the emotional impact provoked by the need to inject public money to limit the damage of recent excesses, a new regulation framework carries the risk of being too repressive, geared to avoid errors of the past and not necessarily able to cope with the challenges of the future. It is easier to restrict and to prohibit than to adapt the regulatory framework to the impending

challenges.² The design of a new financial regulatory framework, as important as it is, at this present moment, would not be able either to unlock the financial system, or to help the recovery of the world economy. The central question today is how to give a new dynamism to the world economy based on factors different from those that lead to the imbalances of the last decades. Which would the institutional framework capable to guarantee a sustainable dynamism to the world economy without resuming and deepening the imbalances of the last decade?

5

Over a year and half after the first signs of trouble surfaced in August 2007, no doubt remains about the depth and the global extension of the crisis. The most serious since the Great Depression of 1929 - as repeatedly heard. The American policy reaction seems to be driven by the determination not to repeat the errors of the Thirties. Where do we stand in the unfolding of the crisis and what to expect from the economic policy reaction?

The busting of the residential real estate bubble in the US was the trigger factor. As later became evident, the bubble in the housing market in the US was only the most critical aspect of the exhaustion of a larger cycle: the consumption cum debt cycle of central countries, fueled by apparently infinite ingenuity of a global financing sector, that lead to ever higher level of indebtedness of the private sector. Once the cycle came to an end, after a few months of collapsing asset prices, it became clear that the financial system was insolvent and consumers unable to repay their debts. Monetary policy reaction, at the beginning mainly in the US and soon after also in Europe, was geared to make sure that the mistakes of 1929 would not be repeated. Central banks were decided to provide liquidity to the system at any cost and made use of all forms - from the most conventional to the most heterodox - to expand money and credit. The aim was to interrupt the sharp fall in asset prices, real estate and other, before the financial system turned insolvent. The aggressive stance of the Fed, since the failure of Lehman Brothers in September 2008, was not enough to reverse the situation. The speed of the deterioration of the value of assets in bank portfolios remained higher than the capacity of government agencies to provide them

² See A. Lara Resende, "A Crise e o Desenho do Sistema Financeiro", in E.; Bacha and I. Goldfajn (orgs.), *Como Reagir à Crise*, Imago Ed. 2009.

capital through public funds and simultaneously absorb their troubled assets. The extraordinary liquidity injection into the financial system, from the start of 2008 until April 2009, meant an increase of almost US\$1.2 trillion in the Fed's asset. This represents approximately 10% of the American GDP. Given that a large part of the assets acquired by the Fed, financed by the monetary expansion of its asset, are irrecoverable, it results in the transformation of private debt into public debt. The justification to commit public funds in such a scale is to try to avoid the collapse of the banking system and to make it reassume lending. So far with no success; and it will probably remain unsuccessful, as long as the private sector remains over-indebted.

6

The recipe of John Maynard Keynes, as presented in his *General Theory of Money and Employment*, of 1936, remains the best way to reanimate a stagnant economy after a great recession. The seminal work of Keynes, later systematized as the foundation of modern macroeconomics, continues to be today, even though with profound revisions, the basis for the formulation of monetary and fiscal policies. Keynes argued that, in times of recession and deflation, monetary policy may become incapable of stimulating aggregate demand. Only fiscal policy, through an increase in public spending and investments, could work as a magnet to make a stagnant economy recover. A Keynesian fiscal policy expands current public spending, and in particular public investment, in order to create aggregate demand and reignite private demand through what is known as the "Keynesian multiplier". When the Fed expands its assets to acquire trouble assets, even if there is an embodied fiscal component because of the likely increase of public debt, it is still conducting monetary policy. It is unconventional monetary policy - with a likely direct impact on public debt, given that it will be unable to recover entirely the value of these assets - but still monetary policy. Even if this is not the classical monetary policy analyzed by Keynes, it is equally incapable of stimulating the economy in the present circumstances. The reason is that even if implemented to the point at which the financial system, less leveraged and recapitalized, will be willing to lend again, there will be no borrowers. As long as the non-financial private sector has excessive debt and remains willing to save in order to reduce its indebtedness, the only likely borrowers are precisely those who are unable to repay their debts. Only those who cannot honor their previous commitments will be willing to take

additional loans to roll over their debt. The reduction of the leverage exclusively in the financial sector is not sufficient to restore the normal activity of the financial system. It is also necessary to reduce the indebtedness in the non-financial private sectors. Firms and households have to reduce their over indebtedness before the system can function again. It is not enough to restore the willingness of banks to offer credit, it is also necessary to have creditworthy individuals willing to borrow.

There is a major difference between the present conditions and those prevailing at the time Keynes elaborated his theses. The General Theory is of 1936. Before that, from 1932 on, sketches of the argument could be found in his essays.³ In 1932, the economy was still in profound depression, but – as known today – due in a large extent to the errors of monetary policy, the excess of debt of the private sector had been eliminated by the collapse of the financial system. The generalized bankruptcy of banks and firms solved the problem of excessive indebtedness. Banks, enterprises and households were broken, but with no debts. The costs were dramatic, but the excess of debt disappeared. The fact that the mistakes of 1929 have not been repeated, lead to circumstances far different from those of 1932. Financial collapse was avoided and despite the severity of the recession, we are still far from the thorough disorganization of the economy and massive unemployment - close to 30% of the labor force - of the Great Depression. The economy, however, almost two years after the beginning of the crisis, continues to be, overwhelmed by unredeemable debts. As long as households and firms continue to bear the brunt of excessive debt, they will try to reduce expenditures and increase savings. Until debt is reduced to levels which are perceived as reasonable, the private sector expenditure will be exceptionally low. After the Great Depression, in the early thirties, there was a lack of demand because there was no economic activity and no income. Today, the lack of demand is the result of the exceptionally high rate of savings required to bring back private debt to reasonable levels. These are very different situations.

The American economic condition of today has more similarity with the Japanese economy after the real estate and banking crisis of the nineties. In Japan, the government avoided the bankruptcy of the financial system. Monetary and fiscal policy became aggressively expansionist, interest rates approached zero and, nevertheless, the economy

³ J.M. Keynes, *Essays on Persuasion*, 1934

remained virtually stagnant for more than a decade. A faint economy, but with no debt, can be jump-started through an increase in public spending. Once reanimated, an exceptionally high percentage of the generated income is no longer saved in order to reduce debt, but spent in order to rebuild firms and households standards of living. It thus creates demand and gives rise to the virtuous circle of recovery. In an economy paralyzed by the excess of debt - as it is the case of Japan since the early nineties and as it is now the case of the US - neither monetary policy nor fiscal policy can reactivate the economy. A large proportion of the income generated by the increase in public spending is saved by the private sector in order to diminish its debt. The virtuous circle of the Keynesian expenditure multiplier is thus interrupted.

It was not Keynes, but Irving Fisher, the American economist who lived between 1867 and 1947, who did the most insightful analysis of economies in deflation, paralyzed by excess debt. Keynes' analysis dealt with how to reactivate an economy where debts had been decimated by the depression. Keynes, at least the one of the *General Theory*, is the economist of the post-depression period. Fischer is the great analyst of depressive periods in themselves, when the question of excessive debt and deflation prevails.⁴ Fischer studied the depressions of 1837 and 1873, as well as the one from 1929 to 1933. He argued that neither monetary policy nor fiscal policy is able to stimulate the economy while excessive debt remains present. An idea of the relative dimensions of the current debt problem can be grasped by the fact that, in 1929, the total of American debt was 300% of GDP; it reached almost 360% of GDP at the end of 2008, after staying between 130% and 160% from the beginning of the fifties to the end of the eighties. Ben Bernanke, the Fed' chairman and an academic with relevant contribution to the understanding of depression periods, is well aware of the difficulties to escape from the deflation trap. When visiting Japan some years ago, he remarked that the best way to get out of deflation is not to get into it.⁵

7

There is symmetry between inflationary and deflationary conditions. The inflationary condition to be contrasted with deflation is not the one of small inflations,

⁴ I. Fischer, Debt-Deflation Theory of Great Depressions, in *Econometrica*, 1933.

⁵ B. Bernanke, Deflation: Making Sure it Doesn't Happen Here, www.federalreserve.gov 2002.

always present in a healthy economy. It is also not even the inflation that, given circumstantial pressures, might reach two digit annual rates. The inflationary condition that should be compared to deflation is the one of great chronic inflations, as those encountered in the Brazilian economy, from the seventies until the Real Plan in the nineties. While chronic inflation is essentially a question of excessive debt of the public sector, deflation is essentially a question of excessive debt of the private sector.

Behind chronic inflation is the lack of inter-temporal compatibility for the budget constraint of the public sector, independent of the tax function to be adopted. It is usually the consequence of the government having abused to such an extent its capacity to extract resources, be it from present generations – via taxes as well as via the so called “inflationary tax” -, be it from future generations – through indebtedness -, that its credibility is in the end exhausted. Public debt is then perceived as irrecoverable and the national currency is replaced by parallel currencies. The end of great inflations requires necessarily the reduction of public debt, either through the socially costly hyperinflation or, instead, through some form of default. In the case of Brazil, the Collor Plan, despite its failure to stabilize inflation, may be understood as a complex - and probably even more aggressive than a negotiated default - way to reduce the public debt. Without the significant reduction in the Brazilian public debt it implied, the sophisticated de-indexation of the Real Plan would have had less chance success.

Behind deflation is an inter-temporal lack of compatibility of the budget constraint of the private sector. After a certain point, the private sector debt can only be perceived as sustainable, as long as asset prices are perceived to be in continuous growth. Since the rise of asset prices is fueled by rising indebtedness, from a certain point onwards, the process acquires a pure speculative character.⁶ When the rise in asset prices is interrupted, the private sector discovers it is insolvent. Real estate speculative bubbles, especially residential real estate bubbles, being a speculative process based in assets of a wider ownership, are the ones that more damage cause when exhausted. The option not to throw public resources to rescue an insolvent private sector in a deflationary situation is the symmetric equivalent of letting the economy slide into open hyperinflation in a chronic

⁶ For an analysis of the speculative instability inherent in the economy, see Hyman P. Minsky, *Stabilizing an Unstable Economy*, 1986.

inflation environment. It was the choice made in 1929. The insistence on fiscal balance and on the maintenance of the gold standard led to the Great Depression. The result, the same as with open hyperinflation, was to have the ground cleared, so to say, through generalized bankruptcy. No need to stress how absurd the costs are of solving excessive indebtedness – be it public, via hyperinflation, be it private, via depression – through such an economic disruption that nothing survives.

The experience of 1929 taught us that to stick to orthodoxy and to refuse to throw public resources to avoid the collapse of to an insolvent economy is an error no to be repeated. Unfortunately, as known since Keynes, monetary policy is incapable of stimulating the economy in these circumstances. It could have avoided its collapse, as learned from subsequent studies by Milton Friedman and Anna Schwartz⁷. Yet the decision to use monetary policy to keep alive an economy drowning in debt, turns also fiscal policy incapable of stimulating the economy, as noted by Irving Fisher. As long as excessive debt is not digested, both monetary and fiscal policies are inefficient. There is alternative. Either to let the economy collapse, in order to reduce debts, and then use fiscal policy to revive it, or inundate the insolvent economy with public credit, to avoid the collapse, and loose the ability of fiscal policy to pull it out of a prolonged lethargy. Either a horrible end or an endless horror.

8

The US will most likely face a long period of stagnation. The option for an aggressive and heterodox monetary policy should avoid a depression like the one the thirties, when GDP fell nearly 50% and unemployment reached more than 30% of the labor force. There is however a trade-off: the digestion of excessive debt of the private sector will take several years. Since the excess of debt is something relative to income and GDP, the lower the rate of growth, the longer the required period of digestion. Or inversely, the stronger is aggregate demand, the higher the growth rate and the faster is the digestion of the excessive debt. This explains for the paradox trying to stimulate consumption when the economy faces a monumental crisis provoked exactly by excessive debt and excessive

⁷ M. Friedman and A. Schwartz, *A Monetary History of the United States*, 1963.

consumption. A cartoon line best captured the spirit of it: “country addicted to speculative bubbles desperately searches a new bubble to invest in. “

Doubts about what is the correct attitude in the present circumstances - to spend or to save - seems to confound everybody. To save seems to be the most indicated attitude, but as long as the others spend. And who are “the others”, from a macroeconomic perspective? The answer comes from an elementary identity of national accounts: the others are the foreigners who buy our exports and the government who draws on future generations. Keynes demonstrated that even if the government were to finance its increase in expenditures with a correspondent increase in taxation, the net result would be an increase in aggregate demand, since taxes come partially from savings. In current circumstances, it is out of question to finance higher public expenditures with higher taxes. It is expected to be entirely financed through the expansion of public debt. It is therefore clear that the larger the stimulus to domestic demand coming from exports, the lower the burden of public debt left to future generations. While exports are an external contribution to the recovery of demand, imports are a drain on internal demand. In an open economy, part of the effort to increase public expenditure is leaked via imports. The eternal protectionist temptation finds a renewed appeal.

9

Let us resume the argument. The roots of the crisis are major international macroeconomic imbalances. Despite the fact that the excesses of the financial system were instrumental to lead these imbalances further than otherwise possible, insufficient regulation should not be viewed as the main factor behind the crisis. The expenditure of central countries, turbinated by all sort of financial innovations created by a globalized financial system, was the engine of world growth. When debt become clearly excessive in central countries and the debt financed expenditure cycle come to an end, the ensuing crisis paralyzed the world economy. With the lesson of 1929 well assimilated, American monetary policy become aggressively expansionist. The Fed inundated the economy with money and credit, in the attempt to avoid a deep depression. Even if successful, the American economies as well as those of other central countries, given the burden of excessive debt, are likely to remain stagnant under the threat of deflation for the coming years. The assumption of troubled assets by the public sector, in order to avoid the collapse

of the financial system, might succeed, but at the cost of a major increase in public debt. Fiscal policy is not efficient to restart the economy when the private sector remains paralyzed by excessive debt. Even if a coordinated effort to increase public expenditure is successful, the central economies will remain stagnant for as long as the excessive indebtedness of the private sector persists. The period of digestion of excess debt will be longer than the usual recessive cycle. Since imports represent a drain in the effort to reanimate domestic demand through public expenditure, while exports, on the contrary, contribute to the recovery of internal demand, the temptation to central economies to also adopt a protectionist stance will be strong.

In the horizon of the coming years no domestic fiscal policy will be capable of revitalizing the central economies. It would be an ideal opportunity to reverse the imbalance of the last decades. Global recovery should be led by a more aggressive expenditure stance in the emerging economies. Besides contributing to the recovery of central economies, it would alleviate all kinds of repressed, both consumption and investment, needs in the emerging countries. It happens though that the emerging countries, traumatized by the dire consequences of any attempt to become an autonomous agent of pressure on world demand, adopted a conservative mercantilist stance, which shall be hard to modify. This conservative stance was stimulated, if not imposed on them even in extreme recessive conditions, in order to gain credibility. The conservative policy of emerging countries is understandable, but it shall aggravate the irritation in the central countries and is likely to fuel nationalist and protectionist tendencies, which are always stronger in moments of crisis.

The crisis bared clear the anachronistic character of the world's political and institutional framework. It did not accompany the speed of the technological revolution that brought economic integration and globalization. It is clearly not suited to deal with the threat of a synchronized world recession. The crisis of the thirties led, in 1944, to the Bretton Woods Conference. It was the first attempt to create a world monetary order and international economic and financial institutions. More than six decades, many crises and several revisions past, the system is definitely out of date. The attempt to incorporate the new actors in the world scene will not be sufficient to give revitalize institutions which have been created in the environment of the end of II World War. International

coordination seems to be today the magic formula. It is indeed necessary, to coordinate the efforts of monetary and fiscal policy, to avoid the protectionist temptation - both in finance and in trade -, to discuss a harmonic financial regulation and, last but not least, to reverse the macroeconomic imbalances of the last decades. Without an adequate institutional framework, coordination cannot but aim at declarations of good intentions, as those from the recent G20 meeting in London.

The question of a world reserve-currency was recently brought up by the president of the Chinese central bank. At first, this could be interpreted as nothing more than a retaliation to the repeated declarations of American authorities that China has been manipulating its currency. The article of Zhou Xiaochuan, president of China's central bank, is however sensible and well reasoned.⁸ A supra-national reserve-currency is probably the most important element in the search for a more balanced world. The imbalance of the last decades is due, on the one side, to the unrestricted expansion of expenditures and indebtedness in the central countries and, on the other side, by a conservative export led stance, geared to the accumulation of foreign reserves, in the emerging countries. The issue of credibility, the ultimate determinant of the asymmetry between countries issuing reserve-currencies and all others, is at the root of the two types of behavior.

Modern money is purely fiduciary. It relies only on the credibility of the issuer. Credibility depends, above all, on the perception of economic and financial soundness of the issuer. It also requires a sense of responsibility from the issuer; responsibility for not abusing the privilege bestowed on it. But this does not exhaust the question of credibility. The credibility of a currency is based on the perception of an overall economic soundness of the issuer, but mainly its political, legal and institutional framework. A currency does not acquire the right of being a reserve-currency, to be used in international transactions, without the perception of economic, political, legal and institutional soundness of its issuer. The US dollar, according to these criteria, was a far better alternative than any other, since Bretton Woods. The resounding failure of the attempt to transform the artificial currency of the IMF, the Special Drawing Rights, into a world currency is thus understandable.

⁸ Zhou Xiaochuan, Reform de International Monetary System, March 2009.

In the last decades, the persistent and growing imbalance in the American external accounts generated suspicion regarding the ever so dominant position of the dollar as the currency in which international transactions are conducted. Current account deficits of the magnitude of the American deficit would have provoked the collapse of any other currency. Some uneasiness was already present concerning the dollar as world reserve-currency in the years before the crisis. Increased risk aversion once the crisis started proved that there is yet no viable alternative. The dollar confirmed its condition of safe heaven and appreciated in relation to all currencies. The signs of uneasiness are now evident. A feeling that the dollar is no longer the safe harbor it was once, with its reserve currency status kept only by the force of habit and the lack of alternatives. The aggressive policy adopted by the Fed in order to avoid the collapse of its financial system has added to the sentiment of discomfort with respect to de dollar. It may be of interest to the US, in order to avoid a deep depression, to adopt an aggressive heterodox monetary policy and to inundate the market with dollars, but its credibility as issuer of a reserve-currency is inevitably stained. The possibility that hence the American excess of money and public debt might cause inflation and a sudden devaluation of the dollar is nowadays a concern that cannot be dismissed. As long as kept under control, both inflation and the devaluation of the dollar are in the interest of the US. Both would contribute to the reduction of the real value of debts and simultaneously stimulate the economy. It is thus understandable that China, the largest withholder of American public debt bonds, does not feel comfortable and proposes the creation of a supra-national reserve-currency.

Inflation and the devaluation of the dollar, presently, are not a concrete threat in a world on the verge of deflation. It's potentially disrupting impact, on commercial and financial, as well as political relations should, however, not be underestimated. The creation of a true supra-national reserve-currency would reduce the impact of an eventual devaluation of the dollar. It would also be a fundamental tool to reverse the asymmetry behind the large macroeconomic imbalances of the last decades. A world currency would require a credible supra-national issuer. The economic and cultural globalization, on the wake of technological progress, does not seem to be a reversible process, unless the progress of humanity is seriously interrupted. Economy and culture are ever more globalized, but politics is still constrained within the geographical limits of the national

state. Today's relevant issues have a global character. The creation of a supra-national jurisdiction, the harmonization of institutions and regulations, is the only way to deal with the challenges of a globalized world, whose limits are becoming narrower by the day. It would be naïf to believe in the rapid advance towards the construction of a new supra-national legal and institutional framework. Its need is obvious, but there is a long road before it. The comprehension that the macro imbalances that brought us to the present crisis, and also hamper its resolution, can only be corrected within a new global institutional framework should give a sense of urgency to the agenda.