Towards the reform of the international financial and monetary systems in the context of global political authority: an appraisal

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The title of this paper reflects that of a note offered by the Pontifical Council for Justice and Peace (2011, hereafter 'the Note') to world leaders and the public at large as a reflection on the economic and financial crisis that began in 2008. The Note offers a diagnosis but only a limited number of policy prescriptions. Rather it presents a vision of how human institutions need to develop in the circumstances of the early 21st century if they are to foster human dignity and the common good. It is intended as a prophetic document so that the criticism that it is utopian is misplaced. The document seeks mainly to identify certain principles, based on the Roman Catholic Church's understanding of human nature and society, upon which future policy will need to be based if it is to succeed in the long term.

The purpose of this paper is to evaluate the Note from an economic perspective. The following section contains a precis of the statement before proceeding to analysis and evaluation. There are three principal themes in the Note: the inequality of global economic growth over the last century; the failings of economic liberalism as a guide for the conduct of policy; and the need for a degree of transfer of sovereignty from individual states to the global level in order to make progress, with particular reference to the international monetary system. The main contribution of this paper is to articulate the meaning of these themes in economic terms and to illustrate the nature of the changes in thought and practice that the Note considers necessary in the interests of achieving the common good.

SUMMARY OF THE NOTE

The Church is concerned with the common good and therefore about the material resources necessary to achieve it. The last 60 years have seen unprecedented global economic growth but widening inequality within and between countries. The current crisis has its origins in the excessive growth of the financial system since the 1970s culminating in the failure of Lehman, which led to the shattering of confidence and serious damage to the real economy, especially in the developing world.

The cause of this increasing inequality and of the crisis itself is an ideology of free markets and of opposition to appropriate regulation, particularly at the international level. Underpinning this ideology are a utilitarian philosophy and an individualist culture. One consequence is a technocratic, materialist outlook, which encourages the error that economic problems have merely technical solutions. The neglect of ethics and of social justice will lead to hostility and violence and threatens democracy. Successful policy will be based on an ethic of solidarity and the recognition that people are not commodities.

Pope John XXIII recognised in 1963 that an increasingly global society requires corresponding political structures in order to achieve the common good. The progress of economic globalization, together with concerns about security, human rights and the environment, has made more pressing the need for a renewed commitment to the reformation and extension of the scope of the United Nations in accordance with the principles of solidarity and subsidiarity. Although the road will be long and difficult, the world needs to set its course towards a global political Authority at the service of the common good.

In the sphere of economics and finance, two factors have been historically decisive: the loss by the Bretton Woods institutions of their central role in global governance and the deregulation of finance. In response, regional groupings and policy summits have emerged which largely exclude developing and emerging countries, although the expansion of the G7 to the G20 has been a positive step. G20 leaders recognised in 2009 the need to reform the global architecture and this calls for a process of reflection to identify creative and realistic ways forward.

Foremost is a need to renew the vision that led to Bretton Woods and return to a system of managed exchange rates with a global central bank. This could begin with existing institutions including the European Central Bank, yet requires a new set of political as well as economic and financial institutions. Indeed the primacy over economics and finance of a politics, grounded in the spiritual and ethical, needs to be restored so that markets and financial institutions may come to serve the human person and the common good. This restoration might lead, for example, to a financial transactions tax, an insistence on publicly funded banks serving the needs of industry and the separation of utility and investment banking. The building of the necessary consensus will take time and a higher education which recognises the ethical dimension.

Despite its immense productive potential, the modern world lacks solid ethical foundations and a sense of purpose. In the face of present uncertainties, we need vision and imagination in order to transform society for the better. Over the centuries, rival clans and kingdoms gave way to modern states and in a similar fashion the common good of peoples increasingly unified by globalization now requires, as a moral imperative, a gradual, balanced transfer of sovereignty to a world Authority. The image of the Tower of Babel warns against a superficial unity that fails to recognise the dignity and brotherhood of man. By contrast, the spirit of Pentecost holds out the prospect of a world united in truth as a single family.

PRELIMINARY OBSERVATIONS

THE NATURE OF THE DOCUMENT

This Note is prophetic, meaning that its principal aim is to tell the world certain truths about itself, based upon a deep reflection on human nature grounded in the Church's social teaching and its two millennia of experience of human affairs. As the Preface makes clear, the Church is not a candidate for the position of Global Political Authority. Although the document does suggest that certain policy ideas should be given further consideration by those competent to do so, it is not a pamphlet for the financial transactions (*aka* Robin Hood) tax, even if the publication supports that proposal and appears to have been timed to coincide with a meeting of the G20. Rather it provides something sorely needed at present, a hopeful vision of what the world might become together with some concrete principles for the direction it needs to take. Its authority derives not directly from Christian revelation but, in the tradition of natural law arguments, from an appeal to the values of human dignity and the common good.

RELATION TO ECONOMIC THOUGHT

It is striking that the Note singles out 'economic liberalism' for criticism. This term appears to refer not only to neoliberal ideology but to mainstream economic analysis itself. The criticism is not only of its tendency to favour free markets and discourage regulation, but more deeply of its methodological distinction between positive (economics) and normative (ethics) and its philosophical roots in utilitarianism. A particular criticism is that liberal economic thought is a form of 'a priorism' which derives its policy prescriptions from axiomatic principles without reference to reality, an essentially unscientific enterprise. It is important to note that the Church was equally critical of Marxist economic thought for this very reason, as set out by Leo XIII in *Rerum Novarum* and John Paul II in *Sollicitudo Rei Socialis*. It appears that Catholic thought on economic matters occupies quite distinct territory. Although both left and right have sought to appropriate them for their own policy agendas, the Church's insights cannot be reduced to those terms. It is interesting to note that commentators from the Catholic Right such as Weigel (2011), Booth (2011) and Gregg (2012), more accustomed to the Church's championing of the dignity and freedom of the human person, have greeted this latest Note with varying degrees of dismay.

The Note approaches economics at a meta-theoretical level, addressing the principles upon which economic thought and policy should be based. People are to be treated, not as commodities, but with the respect due to their intrinsic worth. Social and economic problems cannot be addressed in purely technical terms (an example might be "labour market flexibility"), without reference to ethics or culture. In an echo of the ancient teaching on usury, the purpose of finance is to be understood as the service of industry and not simply the pursuit of profit though the unbounded creation and trading of financial claims without reference to the proper needs of production, consumption and physical investment. The invisible hand cannot be relied upon to deliver the common good unaided by institutions other than the market and the minimal state. Without prudence, temperance and charity in the form of solidarity, at all levels of society from the individual to the state, the market will often deliver unjust outcomes that undermine the fabric of democracy and ultimately threaten the existence of the market itself.

Globalization

It is clear that the Church welcomes globalization on the right terms. Economic growth is good insofar as it provides the material resources needed for human flourishing. The Note credits globalization with the significant rise (nearly fivefold, IMF, 2000) in global income per capita between 1900 and 2000 while the world's population increased almost fourfold. Nevertheless these changes have been associated with increasing inequality both within and between countries. The Church finds this degree of inequality unjust and inconsistent with an authentic people-centred development. Citing the evidence of the IMF[1], increasing inequality is held to be the consequence of an inadequately managed process of globalization.

IMF (2000) provides an overview of global economic growth during the 20th century that confirms the sharp differences between countries and regions and the increase in inequality as measured by the Gini coefficient from 0.40 to 0.48 between 1900 and 2000. Apart from inequality, the Note finds to be a major failing of the process of globalization, since the breakdown of the Bretton Woods system in 1971, the series of financial crises beginning with the 1973 oil crisis, through the developing country debt crises of the 1980s, together with the long series of currency and banking crises suffered by individual countries and regions but culminating in the 2008 global crisis. These crises have caused hardship to untold millions. At the root of these crises the Note identifies the uncontrolled growth of the financial sector

[1] Although no reference to this can be found in the place actually cited in footnote 6 – IMF Annual Report 2007, p. 8 – this may be intended to refer to IMF (2000), p. 178.

consequent upon the liberalization of capital movements between countries and the deregulation of the banking sector. In both cases these reforms were justified by economic liberalism.

IMF (2000) highlights the close association between global institutional arrangements (including trade, finance and the monetary system) and economic growth, dividing the 20th century into four periods: 1900-1913, the pre-WWI gold standard and first era of globalization; 1913–1950, World Wars and deglobalization; 1950-1973, the Bretton Woods era; and 1973-2000, the neoliberal era. Average growth during the neoliberal era was less than half the 2.9% pa of the Bretton Woods era. The low growth of the interwar period corresponded to the raising of trade barriers and a fall in world trade by 69% between 1929 and 1933.

Association is not the same as causation. Although the IMF is able to explain the fall in growth between 1913–1950 in terms of the collapse in trade, this cannot account for the fall after 1973. It is another sign of the power of mainstream economic thought that even the IMF, at the centre of the Bretton Woods system, treats the slowdown in productivity as exogenous (2000, p. 169). Hampered by the supply-side orientation of economic liberalism, the IMF report fails to recognise the long-run link between productivity growth and effective (as opposed to aggregate) demand and the importance of the combination of trade and monetary arrangements for demand, both pre-1913 and from 1950-1973. In line with its competence, the Note does not offer such a technical explanation but merely asserts the causal link between multilateral institutions and growth.

Nevertheless there is a substantial body of economic thought outside the liberalist mainstream that supports this causal explanation.[2]

Thus the Church's message is at one level pragmatic. Multilateral co-operation has historically been good for growth and both autarky and liberalization much less so. Milanovic (2005, p. 87) also finds that on one relevant measure inequality fell between 1950-1973.[3] Nevertheless there were many development failures during the Bretton Woods era and the IMF system itself contained the seeds of its own destruction. It is not a question of going back to that particular regime but first of repudiating the doctrinaire rejection of such institutions by economic liberalism, itself often a thin veil for powerful vested interests. It is then necessary to consider why multilateral co-operation is so difficult and where the solutions may lie. This is where the Church's positive vision and discernment can contribute.

FIRST A WARNING

As though the inequality of income and the hardships suffered by the poor in the crises produced by the current economic order were not a sufficient motive for reform, the Note points to the threat posed by them to the world as a whole. Quoting Hobbes (1998 [1642], p. 3), who contrasts the solidarity between citizens with the enmity between their states, which 'prey upon each other like wolves', the Note warns that economic injustice creates a climate of growing hostility and violence and threatens to undermine democracy itself.

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[2] An introduction to the post-Keynesian theory of economic growth can be found in Thirlwall (2002).

[3] Weighted inter-national inequality of GDP per capita excluding China and India.

Although it is unlikely that many in authority are complacent about the current state of the world, the Note's target is the assumption of economic liberalism that the solutions lie with the global extension of competitive markets, without a corresponding recognition of the need for stronger institutions at the international level and, beyond, that a change of heart that makes human dignity and the common good the underlying principles guiding the design of all institutions, including the social infrastructure of markets. The Note warns that economic liberalism may ultimately destroy the very freedom upon which it is based.

Governance vs. Government

The Note calls upon the world to work towards the establishment of a global political authority, which is sufficient grounds for most, including the Archbishop of Canterbury (Williams, 2011), to judge the Note utopian. While prophetic is a better description, let us recall that utopia can mean either no place at all or the good place, and here the Note is clearly pointing to world government as a necessary condition of the good society. Difficult as this may be to achieve, the Church is offering the world the assurance that a good (or at least, better) society is possible and indicating the direction in which it is to be found. This aspect of Catholic Social Teaching originated with John XXIII's encyclical *Pacem in Terris* and has been developed by his successors. At root it is a simple proposition, that an increasingly globalized society requires corresponding political institutions if it is to fulfil its potential.

The Note here makes an important distinction between governance and government. The world has set up a number of instruments for governance in the form of multilateral agreements or associations at global and regional levels. It has so far proved very reluctant to create (or empower) global instruments of government with authority *super partes*, that is, to over-rule national interests and sovereignty. Yet this is what the Note calls for in the case especially of the financial and monetary systems.

The reform of the international monetary system

Why might world government of the monetary system be necessary and in the interests of the common good?

Economic liberalism advocates flexible exchange rates and the liberalization of capital, goods and labour markets. Free competition will, it is claimed, lead to full employment of all productive resources and the best of all possible worlds (at least in the sense of Pareto). Optimal currency areas are largely defined in terms of the territorial limits of the free movement of labour as well as political expediency, although in principle, with fully flexible prices and wages, the existence of national currencies is irrelevant. Industrial and financial corporations play no explicit role and are simply passive vehicles for the efficient allocation of the factors of production by markets. From this perspective, there is nothing to warrant the transfer of national sovereignty to a global, or even regional, level and indeed the role of the state within the national economy should be kept to the minimum required for markets to function smoothly.

The preceding paragraph demonstrates the meaning of the criticism that economic liberalism is a system of thought based on *a priori* reasoning in denial of reality. The absence of full employment is obvious, yet liberalism insists that most observed unemployment is voluntary, and therefore, not welfare-reducing. If wages and prices are not flexible, it is replied that this is the cause of any unemployment that is genuinely involuntary: the answer is more of the same medicine, more competition in the form of greater labour market flexibility. There is no recognition that employers create employment only when they expect profitable demand for their production.

There are sound theoretical reasons, following Keynes (1936), for rejecting the claims that competition alone can deliver full employment and for understanding the stickiness of money wages, not as the cause of unemployment, but as the necessary condition for the stability of the price level. The roots of underemployment and slow economic growth lie in the tendency of an advanced economy to run financial surpluses, internal and external, that are neither consumed nor invested in physical provision for the future. All this was well understood by earlier generations of economists before the return in the 1980s towards liberalism in mainstream economic thought. Thus the Note's criticism of economic liberalism is supported by a substantial body of technical economic analysis that has been pushed outside academic orthodoxy.

There is a shared recognition among economists of all schools that the trade imbalances between countries are a matter for concern but sharply diverging analyses as to why. Mainstream commentators tend to attribute trade imbalances either to profligacy (by the public or private sector) or allegedly protectionist practices, such as the pegging of the Chinese currency to the US dollar at too low a value. The normal prescriptions of thrift and free markets follow. By contrast, Keynesian economists emphasise the importance of long-run demand patterns in determining trade balances, the need for adjustments beyond changes in exchange rates and the absence of an easy tendency to balance of payments equilibrium. Thus the trade balance becomes a force in itself such that a trade deficit requires a corresponding deficit on the part of either the public or private sector. For example, in the case of Greece, its increasing trade deficit post-1999 was largely matched by government borrowing, whereas in Spain it was mainly offset by private capital flows into construction, often speculative. In the US it has been a mixture of both public and private deficits financing consumption.

Once the balance of payments is understood as a causal variable and indeed a potential constraint on demand and economic growth, economists can no longer be indifferent to the form in which the trade deficit is financed. Private capital flows into a country only in the expectation that the inflow will be reversed over time by more than the initial amount in order to cover the investor's profit. Therefore it matters how the private inflows are invested and, in particular, they are only in the national interest if they can be expected to generate a surplus over the cost of capital, not simply in monetary terms, but in terms of net exports. This applies whether or not the country has its own currency or is part of a monetary union such as the Eurozone. In the absence of such investment opportunities the country can in the long run correct its balance of payments deficit only by other, more direct methods of increasing net exports, including a reduction in the real exchange rate (whether by nominal devaluation or, much more difficult, by cuts in money-wages) but also by industrial and trade policy, both of which are anathema to economic liberalism. There is agreement that import restriction is generally to be regarded as a last resort because of its long run implications for world trade and competitiveness, yet such measures, preferably on a multilateral basis, play a valid role when targeted against countries running persistent trade surpluses and thereby reducing global demand.

The Bretton Woods system was created in response to this Keynesian understanding of the nature of the global market economy. Nevertheless the flaws in that system demonstrate the need for government, beyond governance. Three features stand out:

1. The logic of the system required gradual exchange rate adjustments in line with changes in domestic price levels so as to maintain real exchange rates and, when necessary, change them in order to take account of changes in the economic fundamentals governing the balance of payments. In practice, the intellectual legacy of the Gold Standard and the national interests of member states made them reluctant either to devalue or revalue and the system became rigid and brittle. While the IMF had some power, in the form of access to finance, to persuade deficit countries to accept devaluation, it had no authority to impose it and *a fortiori* no means either to persuade or compel surplus countries to accept a revaluation. Indeed the original IMF articles reversed the onus and required IMF *approval* for exchange rate changes proposed by members in order to avoid the competitive devaluations of the 1930s.[4]

2. Apart from the IMF's lack of authority to change the exchange rates, no sanctions or financial penalties were imposed on countries in balance of payments surplus. Although there was a 'scarce currency clause' allowing restrictions on imports from persistent surplus countries this was never invoked. Since the system as a whole had to balance, any tendency towards long-run surplus among some members forced corresponding deficits on others. For many years, the US was content to run a deficit in

[4] The Smithsonian agreement of December 1971 required the setting of parities by multilateral negotiation but by this time the system was unravelling. At no point was the IMF empowered to set the rate.

order to accommodate the surpluses of Germany, France and Japan but this was unsustainable (the 'Triffin dilemma').

3. The Bretton Woods system did not shake off the legacy of gold. As a gold exchange standard, growth in international reserves required the issue of US dollars or sterling against an obligation to redeem in gold at a fixed parity. While the US was content to run a deficit (then as now) in order to accommodate the growing demand for reserves this could not continue indefinitely without its liability exceeding the value of its gold reserves. This tendency was hastened by the creation of dollar liabilities offshore (Eurodollars) by the banking system. After the devaluation of sterling in 1967, leading to the eventual suspension of gold convertibility by the US in August 1971, the system was finished.

The Note calls for the creation of a world central bank as one condition of a stable international monetary regime. This would require addressing the major questions of the nature of the assets supporting the issue of a global reserve currency; the implications for the US dollar and other reserve currencies; and the implications for private capital flows. Although this is not the place to offer a blueprint for a new system, it seems likely that it would need to contain the following elements of government, as opposed to governance:

a. A reformed IMF would need the authority and the economic capacity to fix exchange rates on a smoothly adjusting (crawling) peg at the level it judged to be consistent with long-run equilibrium of the balance of payments between countries. This would be analogous to central bank independence at national level in fixing the interest rate.

b. Exchange rates would be pegged in the first instance against a new global currency (working title, the mondeo) issued by the IMF and backed by a basket of (say) 30 commodities in proportion to their significance in world trade and other criteria.[5] While some fiduciary element (i.e. loans to central banks denominated in mondeo) would be desirable, the commodity basket substitutes for the ability to impose taxation which ultimately supports national fiat currencies. The use of commodities to back the mondeo would produce a negative return of about 5% per annum, corresponding to the carrying costs of the physical goods. Although there might be ways of reducing this cost, notably by expanding the fiduciary element, it is the price of creating a reserve asset that is independent of the economic policies of any individual state, especially in relation to inflation, as under the gold standard. The recovery of these costs might be a suitable application of a Financial Transactions Tax that would overcome some of the objections to such a supra-national tax. The historical role of gold reflected its low carrying costs.

c. All foreign exchange reserves held by central banks would be converted to mondeos. This would be achieved by the issuing countries selling commodities to the IMF for mondeos to purchase the existing reserves (again a fiduciary element might be involved, at least as a transitional measure). A large proportion of these commodities may already be held in strategic reserves so that it becomes a matter of transferring title. Any shortfall would be met by production over a sufficient period (say 5 years), incidentally

[5] Ussher (2009) provides a comprehensive review of the economic case for this type of scheme.

providing an initial boost to global demand. The physical distribution of commodities in warehouses across countries could over time be adjusted to match approximately their holdings of mondeos in order to provide security against political risk. Any aggregate surplus of mondeos could be redeemed pro-rata for commodities.

d. Member states would need to accept measures to adjust their balance of payments where the IMF judged that exchange rate adjustments would be insufficient. This would apply to both deficit and surplus countries. In the latter case, the ultimate sanction might be compulsory loans (unremunerated and repayable only upon winding up) of the persistent surplus to multilateral development banks to finance productive, export-oriented investment in deficit countries. The negative return on mondeos would also help to discourage unnecessary reserve accumulation.

e. The corollary of the negative return and the provisions for surplus country adjustment is an irrevocable undertaking that each central bank would accept only the mondeo or its own national currency in settlement of balances due from other central banks or the IMF. Gold and other currencies would not be accepted (i.e. they would become demonetised for the purposes of international transactions). This would not prevent bilateral credits but by their nature such transactions would need to balance over time.

f. Although conversion would deal with official reserves, private holdings of foreign currency assets would remain. After 40 years of financial liberalization these balances dwarf official reserves and capital controls would be necessary to maintain the currency pegs. Provided that the new exchange rate regime were seen to

> be sustainable there would be little reason for a run on a currency, since the path of future exchange rates would be largely predictable and interest and capital repayments could continue to be made in line with economic fundamentals (which indeed is the only way such payments can ever be made, in aggregate). Speculation on currencies would become both less possible and less necessary and capital controls might be relaxed accordingly.

Thus, in summary, a world central bank would require the transfer of sovereignty, over exchange rates and over the imposition of adjustment on surplus countries, together with the acceptance by member states of a reserve currency with a negative return. Capital controls would remain a matter for member states and represent, as it were, a reclaiming of sovereignty from financial markets by the state. The main benefit would be a system of stable exchange rates and a semi-automatic mechanism to ensure that trade imbalances do not depress global employment. There would be a number of side-effects of particular benefit to developing countries, although this would not be the direct objective of the world central bank itself. That objective would be the provision of a stable and secure reserve asset in order to secure balance of payments equilibrium by methods consistent with full employment and economic growth.

It is not difficult to see why such a system would require states to subordinate their immediate short-term interests for the benefit of the common good. The demonetization and conversion of existing official exchange reserves would impose a loss of income relative to other assets and be perceived as a form of taxation of the holders, unless offset by another form of taxation such as a Financial Transactions Tax. Conversely the requirement on issuers of existing reserve currencies to deliver commodities would represent a real transfer of resources and a cancellation of the seignorage previously earned. The US in particular would lose the ability to borrow without limit from other central banks and become subject to the IMF. Both the US and the UK contain powerful interests that would oppose capital controls. There are therefore formidable political obstacles to any such proposals.

CONCLUSION

This paper has presented and analysed the content of the Vatican Note from an economic perspective. Its purpose has been first to articulate more fully the empirical evidence and technical analysis supporting the Note's criticisms of the inequitable nature of globalization and of mainstream economic thought and ideology. The Note's positive proposals for reform have then been examined with particular reference to the international monetary system. The principal claim of the Note, that there needs to be a move towards global authority, has been illustrated in concrete terms by spelling out some of the major issues that would be raised in any attempt to renew the Bretton Woods system in a durable and sustainable form.

There can be no doubt that such a renewal would require a degree of political vision and consensus that has rarely, if ever, been achieved. The value of the Note is that it offers hope and direction to a world lost in confusion and misled by market ideology. It does not forecast that the world will take this road, any more than that a benighted traveller will find a path through a swamp. The Note merely points out that, in the end, the only reliable solution is to drain the swamp.

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