

# The Superbubble behind “The Great Moderation:” How the Brandt Report Foresaw Today’s Global Economic Crisis

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**Abstract:** The Brandt Commission Report, published in 1980, broke ground in vital areas. It was the first international body to develop such concepts as *interdependence*, *globalization*, *sustainable development*, and *alternative sources of development financing*. It grappled with the difficult problem of global monetary imbalances, not in a vacuum, but rather, situated in the Commission’s stance that reforms in poverty, aid, debt, armaments expenditures, environment, technology, trade, and finance will not effectively meet their goals until they are supported by a totally-restructured monetary system. Virtually all sustainable development initiatives since then have missed that need for restructuring.

The Brandt Report warrants this first treatment of a full political economic framing because the world continues to operate with those structural imbalances and faces a global economic crisis. Nations with current account deficits are required by the rules of the marketplace and international institutions to adjust their fiscal balances by paying off their loans. Yet nations with current account surpluses are not under similar obligation because there is no adjustment mechanism for recycling their trade surpluses and currency reserves. Compelling examples of this disequilibrium today are the current account imbalances between the surplus nations of China and other Asian states on the one hand, and deficit nations like the United States and United Kingdom on the other. A mitigating factor is the use of the dollar as the world’s reserve currency, which allows the US to avoid adjusting its deficits on a timely basis. A major global financial adjustment is needed to eliminate the financial and monetary superbubble that has been forming as a result of these deep contradictions in the international system. The Brandt Report anticipated that unless these global imbalances were corrected through coordinated international action, there would be a series of sovereign debt crises, resulting in an emergency monetary readjustment. Brandt also demonstrated that any international stimulus program to merge the development needs of the global South, the underused capacity of the global North, and the needs of the entire world for a low-carbon environment, must be directly linked to the restructuring of the international monetary regime, including a new global currency and reserve system.

A return to the principles and analyses spelled out in the Brandt Report is needed now to reform the global economic infrastructure. Brandt’s call for an international monetary conference to address these issues is even more pressing and salient today than it was 30 years ago.

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## Introduction<sup>2</sup>

I intend for this article to contribute in two ways to this special issue’s theme, “toward development of politics and the political.” On this 30<sup>th</sup> anniversary of the Brandt Commission’s seminal report, I have attempted to give its systemic insights the full political economic framing they have not been given before. In so doing, I aim to elevate the *import* of Brandt’s contribution to the level often attributed to John Maynard Keynes’ original—but rejected—proposals at the 1944 Bretton Woods conference for a reciprocal international economic adjustment process. I show how the Brandt Commission’s arguments for a new global monetary system have not only stood the test of time, but also how its predictions have been validated by national and international events in the ensuing decades. For the same reasons stressed in the Brandt Report, my selected focus is on international monetary policy and its relation to the current global economic crisis.

In particular, I establish how Brandt foresaw the structural existence and global implications of a burgeoning *superbubble*—recently given this name by George Soros—which continues to generate ever-larger global economic imbalances. I contend that during the 1982-2007 period of economic growth with low inflation—which Ben Bernanke has called “The Great Moderation”—Western society was lulled into a kind of complacency by free market ideology that obscured this underlying global disequilibrium. Eliminating the superbubble inherent in the global financial and monetary system starts with recognizing its origins, relationships, and impacts. My discussion traces these themes and weaves them and other meta relationships together through the lens of the Brandt Report.

Such recognitions relate to the second contribution of this article. The Brandt Commission’s systemic analyses and recommendations are as central to restructuring “the political” in economic and monetary policy terms as they are to integrating sustainable development into the global economic system. That integration will be essential in reconfiguring the politics of sustainability, climate change, economic growth, and global wealth disparity to meet the immense challenges of world society in the decades ahead. Thus, in Brandt we have a compendium of received wisdom long ignored yet still vital. I suggest that a return to the principles and analyses spelled out in the report is needed now to address the contradictions which are deeply embedded in the global economic infrastructure. As Brandt demonstrated, efforts to reform economic development will fail if they do not begin at the foundational level of the international monetary system. The structural flaws inherent in the Bretton Woods scheme since the 1940s have introduced incessant dysfunctions into the global political economy, which are reproduced at national and local levels. I show that this complex of interrelationships can be

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<sup>2</sup> *Editor’s note:* In formatting this article, we employed a hybrid of the journal’s traditional use of APA style and the author’s style to accommodate the nature of the material. We used footnoted citations and did not use block quotes.

transformed only by addressing the assumptions, principles, and mechanisms behind the current operating system.

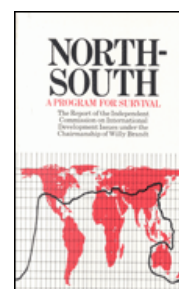
To provide a comprehensive overview of the problem of global economic imbalances and to establish linkages among its various elements, this article is organized into four major parts. The first part provides a general introduction to the Brandt Commission Report, including some of its tangible impacts to date and perennial challenges that remain unaddressed. The remainder follows a chronological trajectory. The second part summarizes the history of international development since 1944, along with critiques of structural inadequacies and explanations of the major monetary and financial influences on the praxis of international development. This includes the shortcomings of modern economic theories and the failure of central banks, policymakers, and analysts to generate realistic proposals that address the structural errors in the Bretton Woods institutions—and how the mandates of these decision makers keep the international monetary system in a state of perpetual disequilibrium. The work of the Brandt Commission and its monetary proposals are set in this historical context.

The third part focuses on present world conditions in three main areas: the exchange rate regime, balance of payments adjustments, and the reserve system. These monetary components, which are at the heart of today’s global economic crisis, are integrated with the Brandt Report’s analytical perspective, policy suggestions, and predictions. The final part takes a look ahead, with emphasis on the aforementioned superbubble, the US dollar crisis, and the vulnerability of the dollar’s status as a global reserve currency. It closes by iterating the Brandt Commission’s call for an international monetary conference and identifies key questions surrounding this world-changing event.

The article integrates historical conditions and the Brandt insights with the present crisis in the international economy and shows how they are all of one piece. It indicates why the challenges that Brandt tackled three decades ago remain the same challenges we face today, particularly if we are to create a new global economic system and avoid a systemic collapse and long period of global stagnation and depression. I’ve tried to show that these economic circumstances are also deeply political, since international discussions for restructuring the global economic system will require significant changes in the global political balance of power. Taken as a whole, the article is an argument for facing into and developing our political capacities at all scales to deploy recommendations like those that the Brandt Commission Report supplied thirty years ago. I also emphasize that these structural changes become only more painful the longer we postpone them.

## The Brandt Commission Report

International policy on economic development reached a new threshold three decades ago. Willy Brandt, the former West German Chancellor, began planning an Independent Commission on International Development Issues in January 1977. Humankind, Brandt observed, “already faces basic problems which cannot be solved purely at the national or even regional levels, such as security and peace, development goals, the monetary system, protection of the



environment, energy, and the control of space and ocean resources. The international community has begun to tackle these problems but, to date, very inadequately.”<sup>3</sup>

Brandt’s panel—comprised of twenty-two international political and economic leaders—deliberated on these global issues for the next three years. In January 1980, they issued a report, *North-South: A Program for Survival*. Its comprehensive strategy for restructuring the global economy, including an emergency program to end poverty in developing nations, was hailed by many international agencies, governments, business leaders and civil society groups across the world. The Brandt Report quickly became the best-selling book on international development in history.<sup>4</sup>

Many of the facts and statistics in the Brandt Report are outdated and of little interest now. Global markets have also grown much more sophisticated since the time of its publication. Yet the broad problems of the global economy have changed little in the intervening years and the strategic objectives and principles which were formulated by Brandt’s commission are still highly relevant. The Brandt Report pinpointed “not merely one, but several crises: the crisis of relentless inflation and increasing energy costs, the crisis of dwindling energy availability, the crisis resulting from mounting financial requirements, and the crisis posed by constraints on world trade and on the growth of export earnings to meet increased debt service commitments. Taken together, they threaten the whole structure of our political, industrial and financial institutions, unless we move urgently and adequately to deal with the basic causes” ... “to ensure a sustainable biological environment, and sustainable prosperity based on equitably shared resources.”<sup>5</sup>



Willy Brandt and the author at a press conference in 1980

As a publicist and adviser to the Brandt Commission during that period, I traveled across the world, consulting with many heads of state, legislators, business leaders, and civil society and media representatives. In 2000, some associates and I created a website aimed at updating the Brandt Report for the opening years of the 21<sup>st</sup> century.<sup>6</sup> Looking back from the perspective of the Millennium, it was clear that all of the basic problems that the Brandt Commission had initially addressed—food, aid, environment, energy, trade, finance and monetary reform, as well as global negotiations to find solutions to these issues—were still unresolved and had become only more urgent with

the passage of time. This is not to minimize the subsequent advances in many of the areas of international development that the Brandt Report had first proposed. Some of these later milestones include:

<sup>3</sup> Brandt Commission (1980, p. 267)

<sup>4</sup> Due to popular demand, an addendum to the report, *Common Crisis: North-South Cooperation for World Recovery*, was published in 1983.

<sup>5</sup> Brandt Commission (1980, p. 239, p. 124)

<sup>6</sup> Brandt 21 Forum (2000)

- Brundtland Commission (1987), which refined the concept of sustainable development;
- United Nations Conference on Environment and Development (1992), which launched a broad coalition of environmental and development groups;
- Commission on Global Governance (1995), which advanced the concept of a new multilateralism to support the objectives of sustainable development;
- Millennium Development Goals (2000), which set measurable, internationally affirmed objectives for sustainable development;
- Earth Charter (2000), which elaborated the principles and rights necessary for the transition to a global civilization based on sustainable development.

These initiatives and others have furthered our understanding and led to important policy reforms. Yet they have not been nearly enough. Many brilliant programs and projects have been launched, only to be compromised or co-opted by the commercial and strategic interests of businesses and nation-states. Rather than integrate sustainable development into the very structure of the system, policy makers and activists have sought to graft sustainable development onto the present economic system through public-private partnerships and capital incentives. Now that global pollution and climate change have escalated, and the gap between the global rich and poor continues to widen, it's become clear that sustainable development as it has been practiced will not create the transformation that is needed. Vital as they are, the various reforms of the past three decades have diverted attention away from the deeper systemic problems of the international economy.

The Brandt Report introduced the maxim that *reforms in poverty, aid, debt, armaments expenditures, environment, technology, trade, and finance will not effectively meet their goals until they are supported by a totally restructured monetary system*. This is the key point that virtually all of the sustainable development initiatives since the Brandt Report have missed. Simply put, sustainable development is a necessary condition for transforming world society—but not a sufficient condition. We cannot expect sustainable development to generate a new economy on its own: the price signals of the marketplace will not create sustainable development at the depth and scale that are needed. It will require new incentives emerging from purposeful institutional change to create a multilateral economic system with sustainable development at its core.

Now, on the thirtieth anniversary of its publication, I wish to underscore some of the major policy areas in which the Brandt Report still has something vital to say—proposals which have been largely forgotten but may yet have relevance to our present generation of politicians, economists, and global citizens. History would not be served if the significance of the Brandt Report were ignored, particularly since many of today's familiar trends and potential solutions had their origins in this book. It is not widely recognized, for example, that the Brandt Commission was the first international body to introduce the concepts of *interdependence, globalization, sustainable development, and alternative sources of development financing* in its report and supporting documents. Indeed, there are many dimensions of the Brandt Report that were ahead of their time—yet none as prescient as its proposals for *restructuring the international monetary system*.

The publication of the Brandt Report occurred at a crucial moment in the history of Western political economy. It was issued just after the political failure of Keynesian demand-side economics and just before the start of the Thatcher-Reagan supply-side era. Frankly, it must be said that in spite of its considerable international popularity, the Brandt Report had little impact on this turn of events.<sup>7</sup> Indeed, its demand-side proposals were the very opposite of the supply-side policies which were soon to become mainstream thinking. Nor did the Brandt Commission anticipate the lengthy period of asset appreciation with modest inflation from 1982-2007, which Ben Bernanke has called “The Great Moderation.”<sup>8</sup>

While the Brandt Commission did not know how long it would take, it was convinced that a continued economic emphasis on national production—rather than the stimulation of global effective demand—would lead to major structural distortions, disequilibrium, and crisis in the global economy. Brandt and his colleagues clearly recognized that without fundamental restructuring, sooner or later the global economy would have to reckon with what financier George Soros has recently called a *superbubble*—the ever-enlarging monetary asymmetry that underlies individual financial bubbles, like the subprime mortgage bubble that burst in 2007.<sup>9</sup>

Anticipating that the structural flaws in the international monetary system would ultimately lead to irreconcilable global economic imbalances in aid, trade, finance, and monetary exchange, Brandt’s team warned that “the problem of managing the international imbalances of payments is increasing the threat of grave crises in international finance. We have serious doubts as to whether the existing world machinery can cope with these imbalances and the management of world liquidity and debt.”<sup>10</sup> If nothing were done to correct these imbalances, Brandt predicted, a protracted series of financial shocks would result in a major public debt crisis, engulfing all nations. Indeed, the world has experienced the severe fallout from a series of credit-driven recessions over the past forty years, although the expected global fiscal debt crisis is only now beginning.<sup>11</sup>

Unfortunately, few politicians, bankers, or commentators seem prepared to look deeply into the structural causes of these breakdowns. We have been unwilling to see *the origins and buildup of the superbubble in the series of modifications to the global economic structure that have*

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<sup>7</sup> Translated into twenty different languages, the Brandt Report sold over a million copies around the world. But the political momentum behind supply-side economics was also very strong and the proposals of the Brandt Commission failed to capture the interest of Western policymakers.

<sup>8</sup> Bernanke (2004)

<sup>9</sup> Soros (2008). Soros contends that the superbubble started with the policies of financial deregulation and private investment in credit that were developed during the early Reagan-Thatcher era. My view is that the superbubble phenomenon was already well under way by that time. I suggest that the superbubble had its origins in the policies of monetary deregulation beginning in the early 1970s. The changes in economic policy that took place in the early 1980s merely gave political cover to—and greatly accelerated—the process of credit expansion and the development of asset bubbles which were unleashed when the US took the world off the gold standard in 1971. Many analysts have not explored the real implications of this connection: that the financial deregulation of the 1980s was the direct result of the monetary deregulation of the 1970s.

<sup>10</sup> Brandt Commission (1983, p. 2)

<sup>11</sup> The term “recession” is usually defined as a period in which there is a general decline in global GDP for two or more quarters.

*occurred over the past four decades. This includes the deregulation of the monetary system (1970s), the financial system (1980s), the trade system (1990s), and the philanthropic/foreign aid system (2000s).*

The monetary deregulation of 1971 (which launched this cascade of changes in international economic policy) was triggered by a foreign call on US gold but also had its roots in the rationalization that markets self-correct.<sup>12</sup> Given this underlying allegiance to laissez-faire ideology, a genuine appraisal of the world’s mounting imbalances has been obscured by the blind spot of “efficient markets” and “rational expectations” theory, leaving us unable to predict dangerous bubbles. Most people have been persuaded that money is just another commodity in the marketplace, its value determined by the prices of goods and services—which is why we tacitly support the policy commitments of the central banks to ensuring price stability and keeping inflation under control. This conviction has left policymakers and the public in denial about the familiar pattern of debt addiction and consumer spending that has resulted from their governments’ deficit spending and central banks’ oversupply of credit for the stabilization of financial markets—the very conditions which continue to inflate the superbubble.

Although modern society has learned to accept its boom-bust cycles as a fact of life, sooner or later we must face up to the essential problem that causes the economic system to create and recreate these financial crises. It’s time we recognize the entrenched pattern that has played out during every recession since the beginning of the era of international monetary deregulation.<sup>13</sup>

- Easy credit generates demand that pushes up the value of new financial products
- The distribution of these products is greatly expanded and generates high yields
- Greater numbers of people purchase these financial products
- The financial products are traded at inflated values
- Mispricing creates massive imbalances in trading between producers and investors
- A financial asset bubble builds
- The bubble bursts, resulting in heavy losses for investors, private banks, and financial institutions which have been over-leveraged
- Government treasuries or central banks rescue the affected private banks and financial institutions through fiscal or monetary bailouts (or both)
- A new round of financial speculation begins, since the private sector knows that the public sector will protect it from the downside risks of bad investment decisions through fiscal bailouts by taxpayers

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<sup>12</sup> Policy makers in the Richard Nixon White House, including Director of the Office of Management and Budget, George Schultz, decided to take the US and the world off the gold standard in 1971 partly out of economic necessity (as described below in “Bretton Woods I: 1944-1971”) and partly out of a deep ideological conviction in free market policies. The philosophical constructs behind the decision to deregulate the monetary system had their roots not only in the economic theories of Friedrich von Hayek and his followers, but also in the schools of behaviorism, logical positivism, linguistic determinism, and ultimately, post-modernism. A full treatment of the ideological underpinnings of the global deregulatory policies which were initiated in 1971 is beyond the scope of this discussion.

<sup>13</sup> This general pattern applies to any speculative bubble in history. Unlike earlier examples, however, most of the asset bubbles that have developed since 1971 have not been in commodities, but in financial assets.

- interest rate cuts for savers<sup>14</sup>
- benefits for unemployed workers
- Moral hazard—the asymmetric incentives of public sector guarantees for the private sector—results in the development of a new generation of financial products with a higher degree of opaqueness and leverage
- This encourages greater credit expansion and risk taking
- A new asset bubble is created over the ensuing years

If this pattern sounds familiar, it should. We have already suffered through a number of these cyclic recessions (including 1973-75, 1980-82, 1990-93, 1997-98, 2001-02 and 2007-09), each one becoming a little larger and more damaging. The monetary superbubble which has been amassing behind these individual recessions cannot be measured in terms of price inflation—which has been the primary focus of central banks during the era of deregulation, despite the obvious structural imbalances arising from easy credit, low interest rates and rising asset prices. Predicting speculative bubbles is not like predicting earthquakes, although this seems to be the philosophy adopted by central banks and policy makers: not much can be done until the destructive aftermath. By keeping the rate of consumer-price inflation low and stable, while ignoring asset inflation, central banks have studiously avoided pricking bubbles. Instead, they prefer to clean up the damage after bubbles burst through interest rate adjustments.<sup>15</sup>

While an array of critics across the world has observed that our recurring economic crises are caused by deep distortions in the Bretton Woods system, few realistic proposals have been put forward that would end the relentless surge of free-flowing credit and debt-financed consumption that results in asset bubbles, crashes, and economic pain. Current economic policies are still generating enormous trade imbalances, uneven growth, and misaligned exchange rates, while proposals to reduce these asymmetries through higher wages and purchasing power are seldom considered. If central banks continue to pursue an expansionary monetary policy and inflate the money supply, the likely result will be another huge asset bubble in the bond market and a public debt crisis, leading to depression and mass deflationary conditions.<sup>16</sup> In the meantime, global leaders do not appear to be discussing international coordination for deep structural changes in the monetary system, even though the superbubble that is now forming in the global equity and bond markets has clear monetary implications.

How did it come to this? And what can be done? The Brandt Report, which foresaw the superbubble of a long-term government debt crisis, offers many clues and lessons. Before analyzing present conditions and future possibilities, the monetary proposals of the Brandt Report should first be set in their historical context.

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<sup>14</sup> Interest rate cuts draw savers out of safer investments and into higher-yield investments.

<sup>15</sup> This was the policy of the Federal Reserve Board under the chairmanship of Alan Greenspan (1987-2006) and has been adopted by many other central banks. The idea that the central bank would come to the rescue of vulnerable private banks and financial institutions (by lowering interest rates and pumping liquidity back into the market) became known as the “Greenspan Put.” Instead of creating stability, these practices contributed to further speculation and continued to inflate the financial and monetary superbubble.

<sup>16</sup> At the government’s discretion, such deflationary conditions may be countered with hyperinflationary policies.



## Historical Background

### Bretton Woods I: 1944-1971

After the Second World War, many colonial nations achieved independence from their ruling countries. While this political liberation may have been genuine, economic freedom was another matter. These newly “developing” states still found themselves reliant on the world’s rich nations for economic assistance.

Meeting in Bretton Woods, New Hampshire, in 1944, the United States, the United Kingdom and forty-two other nations launched a multilateral system that promised to meet the needs of the world’s poor nations for economic development. The post-war economic system consisted of the International Monetary Fund (IMF) for crisis lending, the World Bank for development aid, and the International Trade Organization to negotiate and arbitrate the rules of international commerce and trade.<sup>17</sup> Along with the United Nations, which was established to create a new dimension of political security and peace in the post-war era, the Bretton Woods institutions were designed to create a new level of economic security across the world. For the first time in history, there would be an institutional framework for recycling international aid and credit in an orderly and stable way. Foreign assistance and loans would flow from rich nations to poor nations, and trade surplus and trade deficit nations would adjust their payments balances for mutual benefit. This new access to aid and credit, along with free competition, open trade, and private investment in the international marketplace, would be enough to lift the world’s poor nations out of poverty and guarantee economic prosperity for all.

These expectations were soon disappointed. In spite of the world’s new economic order, ex-colonial nations remained impoverished and marginalized, stuck with massive unemployment, low wages, and diminished purchasing power. The Cold War between the Soviet bloc and the West also created a complexity of barriers to international trade and financial flows. Still, the Bretton Woods economy had mixed success from the late 1940s through the early 1970s. Employment, economic growth, and living standards—especially for the industrialized countries of the North—improved at a rate unprecedented in history and in a climate of relative economic stability. Much of that achievement was due to the orderly and stable relationships between the different currencies of the international monetary system. The global economy was anchored by a system of sound money, supported by the US dollar serving as the dominant global reserve currency and the IMF facilitating the exchange rates between nations. Foreign central banks were allowed to redeem excess dollars at the fixed conversion rate of \$35 per ounce of gold, which encouraged the expansion of world trade and the predictability and security of financial investment. For its member states, this new economic system proved a welcome relief from the massive monetary instability resulting from the breakdown of the international gold standard between the First and Second World Wars. After the social pain and suffering caused by those political conflicts and the Great Depression, the liberalization of the international economy toward redistributing global credit and alleviating poverty was widely regarded as a major breakthrough.

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<sup>17</sup> In 1947, the International Trade Organization was replaced by the General Agreement on Tariffs and Trade (GATT), which itself was superseded in 1995 by the World Trade Organization (WTO).

Yet there was a flaw deeply built into the Bretton Woods framework from its inception, a fault which was obscured during most of the 1950s and 60s by the unrivaled strength of the United States as the world’s economic engine and currency guarantor-of-last-resort.<sup>18</sup> This structural error, which continues to plague the international monetary system today, is that *deficit nations are forced by the marketplace and the international institutions to adjust their fiscal balances,*<sup>19</sup> *while surplus nations have no real incentives to make reciprocal fiscal adjustments for the benefit of deficit nations or for the monetary system as a whole.*<sup>20</sup> These discrepancies have led to fractious differences among governments over the anticipated impact of interest rates on loans and investments. For nations in deficit, debts must be paid on a timely basis; but for nations in surplus, financial assets can accumulate without time constraint or requirement of redistribution.

The weaknesses of this asymmetrical structure came into focus in the late 1960s when the United States began inflating its money supply to accommodate growing fiscal strains. To fund its “War on Poverty” and the Vietnam War, the US borrowed from abroad. This forced other lending nations (many of which had little interest in the domestic spending of the US or didn’t approve of America’s foreign wars) to absorb some of the inflationary thrust of US expenditures through their own fixed-exchange rates with the dollar. Disagreements emerged between the United States and several member states in the Bretton Woods system, particularly with France, West Germany, and Switzerland.

Investors and multinational corporations, seeking to avoid losses through significant swings in exchange rates, embarked on a huge dollar selloff. As foreign holdings of US dollars increased, US gold reserves dwindled, and the anticipation of a dollar devaluation increased the private demand for gold across the world. Countries with balance of payments surpluses questioned the capacity of the United States, with its rapidly growing balance of payments deficit, to honor its obligation to convert dollars into gold. In these shifting circumstances, markets and central banks demanded to know where they stood. Was their money stable? Was the US dollar creditworthy? Was the Bretton Woods agreement coming to an end? With pressures mounting on the international monetary system, President Richard Nixon suspended the convertibility of the dollar into gold on August 15, 1971. By closing the gold window, the international system lost its monetary anchor and exchange rates were left to float. The international monetary system had been deregulated and a very different and uncertain era was beginning.

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<sup>18</sup> Eichengreen and Flandreau (2008). These authors would add that the underlying reason that the dollar dominated foreign exchange reserves in the post-war era was because the United States had liquid financial markets and no capital controls.

<sup>19</sup> The exception, of course, is the United States, which is not immediately forced to adjust its fiscal balances because of its reserve currency.

<sup>20</sup> I use the terms *deficit nations* and *surplus nations* to refer to countries with a deficit or surplus in their current account balance. A current account balance reflects the goods and services a nation imports against those that it exports, plus the net of foreign income, foreign aid, and transfer payments. A deficit nation earns less than it spends, while a surplus nation earns more than it spends. The implications of this for today’s economy are described in more detail below in “Balance of Payments Adjustments” and “The Superbubble and the Dollar Crisis.”

## Bretton Woods II: 1971 - Today

Under Bretton Woods I, capital could not flow freely from one country to another because of exchange controls. When the United States decoupled its dollar from gold, the abrupt change from fixed to floating exchange rates put pressure on governments to reduce capital controls and liberalize capital flows. The era of Bretton Woods II, which began with the collapse of the previous system of fixed exchange rates, resulted in loose monetary policy and an explosion in world reserves.<sup>21</sup> No longer bound by convertibility restrictions, central banks were free to create as much money as they wished.

This created major currency volatility for all nations, presenting them with new problems in the management of their exchange rates, balance of payments adjustments, and foreign reserves. Currency instability, in turn, contributed to inflation, slow growth, and unemployment in rich nations. These conditions intensified in 1973-74 when oil-producing nations quadrupled the price of oil. As double-digit inflation, interest rates, and unemployment soared, and exchange rate volatility continued, Keynesian countercyclical policies—based on fiscal intervention in slumping markets—were under challenge. Economists like Milton Friedman and political leaders such as Ronald Reagan and Margaret Thatcher promoted free trade, unrestricted private investment, and open capital markets, arguing that government bureaucrats could not rival the ability of private markets in allocating capital.<sup>22</sup> They believed that macroeconomic policy ought to be geared toward creating low inflation, rather than full employment.

The major recessions of the 1970s had also affected developing nations. They, too, were severely impacted by oil and commodity price inflation, as well as the rise of broader consumer prices. Their agricultural and mineral exports and domestic incomes slumped and unemployment escalated, making it difficult to build the industrial sector. As foreign investment in developing nations slowed, these countries suffered considerably.

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<sup>21</sup> Another school of thought contends that Bretton Woods II started about 2003, when the central banks of many emerging nations began to link their currencies formally or informally to the dollar, thus mimicking the system of fixed exchange rates during the period of Bretton Woods I. My view is that the Bretton Woods period did not simply end in 1971 and then restart in the early 2000s. I don't believe that Bretton Woods should be defined merely as a system of fixed exchange rates. In popular thought, the meaning of “Bretton Woods” is characterized mainly by its original institutions—the IMF and World Bank—which have continued to operate as the world's international economic institutions during the entire period since the 1940s, regardless of prevailing exchange rate policies.

<sup>22</sup> Although little recognized, much of the new political appeal of conservative economics in the late 1970s and early 1980s had its roots in the decision to close the gold window and liberalize the international monetary system. Floating exchange rates, loose monetary policy, the opening of markets, and the abolition of capital controls were all part of a policy continuum which set off an explosion of new credit instruments beginning in the early 1970s. This created the “stagflation” which, as is well known, helped to discredit Keynesian theory. But this new credit also made it easier for lenders to enter the home-loan market, and for homebuyers to obtain credit. This mass availability of credit had a major impact on Western politics, as conservative parties persuaded voters to shun higher taxes and reverse the redistributive policies of the social welfare state. As a result, popular conservative support for supply-side economics grew and national Keynesianism fell into political disrepute in the US, UK, Europe, Canada, Australia and elsewhere.

Under Bretton Woods I, the mission of the IMF had been to monitor the international economy and support the system of fixed exchange rates and stable money, which would promote free trade for the benefit of all nations. Under Bretton Woods II, the mission of the IMF was recalibrated for the era of floating exchange rates and monetary and financial deregulation. The IMF turned into a central planning authority, managing economic policy in developing nations by opening their economies to foreign capital as a condition for receiving cheap loans. But the IMF’s drastic conditionalities on lending—sharp reductions in public spending and domestic consumption, currency devaluations and higher taxes—“tended to impose unnecessary and unacceptable political burdens on the poorest, on occasion leading to IMF riots and even the downfall of governments.”<sup>23</sup>

By the early 1970s, it had become evident that many of the promises of the new international economic system had failed. Aid, loans, and investment were not ending world hunger and poverty—these conditions were growing only worse. A number of economists and policymakers began to call for a restructuring of the international economic system, particularly in the areas of trade, technology, finance, monetary policy, energy, commodities, food, and agriculture. By the late 1970s, many developing countries, disappointed with the prospects of socialism and communism, were looking to a new kind of “global Keynesianism” for answers. Many believed that a restructured international economic system was needed to generate an emergency relief program for developing nations and stimulate the global economy.<sup>24</sup>

Yet North-South discussions were at an impasse.<sup>25</sup> “Between the Bretton Woods and the United Nations institutions, each with their own language and assumptions, there remained a difference of orientation and power. The South had majority votes in the General Assembly which gave assurance of passing resolutions; but the North’s position in the World Bank and

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<sup>23</sup> Brandt Commission (1980, p. 216)

<sup>24</sup> In this view, rich nations would stimulate the global economy, not through economic policy within their own borders, but by enhancing the economic development of poor nations across the world. Helping these nations would also make them better trading partners for the world’s rich nations, thereby benefiting everyone.

<sup>25</sup> The “North-South” metaphor has never been an adequate framework for explaining global economic and social imbalances. Generally, the global North refers to the world’s richer, more developed nations, while the global South refers to the poorer, developing nations. Assigning regional sectors to these classes of economic development is obviously a gross generalization. Besides the problems of geographical anomalies (e.g., Australia as a developed nation in the South), the terms “North” and “South” do not reflect changing circumstances: many of today’s emerging nations, which were formerly developing nations, are still associated with the global South. Although “North-South” remains a useful shorthand for the broad distinction between the extremes of global development, economically and socially, the assumptions behind “developed” and “developing” nations need to be re-examined. (Perhaps a more empirical way of referring to the extremes of wealth is a terminology based on the national current account balance, i.e., “surplus” nations and “deficit” nations. I prefer this terminology because it goes right to the heart of the world’s structural imbalances without moralizing upon the meaning of the economic and social discrepancies, which often frame the world’s rich and poor as abusers and victims and reinforce historical barriers in the international dialogue on development. This is not to deny past injustices, but to suggest that the personal, social, and cultural differences in global economic and social development should find some new means of expression in the international negotiating framework. Recent research and activism involving the *global commons* has been headed in that direction.)

IMF gave it control over key areas of money and finance.”<sup>26</sup> As the dialogue on development faltered, Willy Brandt—the ex-chancellor of the Federal Republic of Germany who had won the Nobel Peace Prize in 1970 for his work in East-West relations—was asked by World Bank President Robert McNamara to lead a North-South commission to analyze the current conditions of world poverty and the prospects for international development.

Brandt’s group—comprised of high-level economists and politicians with a wide range of geographical and ideological perspectives—called for an international emergency relief program for developing nations, which was to be supported by a new international economic system. To lift the world economy out of recession in the short term and achieve lasting economic growth, the Brandt Commission advocated that rich nations provide a major stimulus of aid, loans, and technology to poor nations. “We insist,” the commission declared, “that longer-term measures of reform will be essential to the international financial and trading system, without which recovery and growth could not be sustained.”<sup>27</sup>

They argued that an expansion of markets in the global South would create more production, fairer prices for raw materials, higher wages, and a cleaner environment. In turn, this would benefit the global North by boosting employment through the expanded production of goods to sell to the markets of developing nations. “The large-scale transfers we will propose are seen therefore as measures both to support growth in developing countries directly and to permit a significant expansion of world trade. It is in this sense that we view them as contributing to growth and employment creation in the North as well as the South.”<sup>28</sup>

The idea of a “global stimulus” didn’t catch on until the past few years. During the period from 1982-2007—characterized by high production, stock market prosperity, and relatively low inflation in the North—few policymakers discussed ideas about boosting economic development in the South to rejuvenate the global economy. Particularly after the Cold War ended and the pace of globalization speeded up, most of the world’s non-aligned nations no longer had the political option of choosing neutrality from the rapidly globalizing economic system. Virtually all nations in Latin America, Asia, Africa, the Middle East, and Eastern Europe gravitated toward the global marketplace, not only for trade and finance, but as the primary means of fighting poverty and promoting international development.<sup>29</sup>

The span of years from 1982 to 2007 was a time of remarkable growth for many rich and emerging nations, yet the rate of global poverty, social inequality, environmental degradation, and climate change also continued to increase across the world. As the Great Moderation ended in the United States, both the Bush and Obama presidencies abandoned the supply-side ideology of the Reagan era. Each administration embraced old-fashioned national Keynesianism, fostering stimulus bills of \$152 bn in 2008 and \$787 bn in 2009 to generate effective demand. With the election of a Democratic Congress in 2008 and the increased attention on global warming before

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<sup>26</sup> Brandt Commission (1980, p. 38)

<sup>27</sup> Brandt Commission (1983, p. 13)

<sup>28</sup> Brandt Commission (1980, p. 68)

<sup>29</sup> As many of these nations industrialized and attained stable economic growth, they came to be seen as a kind of global middle class emerging from the lower class of developing nations. Hence, the terms “emerging markets” and “emerging nations” came into parlance in the early 1990s.

the 2009 United Nations Framework Convention on Climate Change in Copenhagen, the idea of Green Financing also became a popular platform in the sustainable development community, echoing proposals originally made by the Brandt Commission for “an orderly transition from a world economy and industry based on oil to one that can be sustained through renewable sources of energy.”<sup>30</sup>

The Brandt Report has often been viewed as a form of global Keynesian policy.<sup>31</sup> This is true to a large extent. The report was written just as national Keynesian policy was failing, and many of the Brandt Commission’s ideas were designed to recreate Keynesianism at the global level to make it more viable in sustaining international demand.<sup>32</sup> Since that time, however, the drawbacks of Keynesianism have become increasingly apparent. When he developed his economic philosophy during the 1920s-1940s, John Maynard Keynes was primarily addressing the needs of the world’s industrialized nations for increasing employment and consumption.<sup>33</sup> With the advent of globalization, industrialized economies are no longer as focused on their own domestic markets as they were in earlier years, which limits the effect of large-scale stimulus programs as multipliers of consumer spending for national economic recovery.

In addition, most proposals for global Keynesianism have failed to effectively address the problem of the overcapacity of production. Since the 1970s, global productive capacity has

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<sup>30</sup> Brandt Commission (1980, pp. 168-169). A “Green New Deal” between the global North and global South would mean that rich nations would reduce their production, consumption, and carbon emissions, while poor nations would receive credit, investment, and new technology while pursuing their economic development. At the same time, both North and South would reduce reliance on fossil fuels, implement energy efficiencies, create clean technologies, develop renewable energy, clean up natural systems, and establish a culture of sustainable growth.

<sup>31</sup> “The [Brandt] report’s simultaneous expansion and internationalism within a framework regulated by governments and international institutions made it a true successor to Keynes’ visionary schemes of the 1940s” (Newton, 2004, p. 118). What were these forward-looking plans envisioned by John Maynard Keynes? As part of the international exchange system discussed at the Bretton Woods conference, Keynes had proposed a new adjustment mechanism—a yearly fee or circulation charge which would encourage trade surplus nations to actively spend, invest, or loan their surpluses for the benefit of deficit nations, rather than hoard them. Although this proposal was rejected by the United States at Bretton Woods, there is much to be said in favor of Keynes’ essential concept of an International Clearing Union and negative interest rates, requiring nations with trade surpluses to recycle their excess. Since the Brandt Report did not broach this topic directly, however, it is best left for another occasion.

<sup>32</sup> Unlike other proposals for global Keynesianism, however, the Brandt Report combined economic stimulus for development with comprehensive monetary restructuring. Many recent proposals, like those for a Green New Deal, have focused primarily on financial stimulus without recognizing the necessity for changes in the global monetary system to support that stimulus. Few environmentalists, bankers, and policymakers have seemed to recognize that their goals would be better served by seeking “carbon value” through the currency system rather than a “carbon price” in the marketplace or a “carbon tax” through government policy. Several generations of policymakers and activists have now accepted the popular idea—promulgated by a few prominent twentieth century economists—that the value of money is simply a function of market prices. Brandt’s emphasis on a new monetary system as the underpinning of sustainable development would reverse this entrenched thinking.

<sup>33</sup> As David Martin (2009) notes, in focusing mainly on the volume of employment and consumption needed to achieve effective demand, Keynes did not adequately factor in the underlying wealth of labor and natural resources from which that demand arises.

outpaced the growth of effective demand, suppressing global wages, incomes, and purchasing power. The more that countries industrialize, the more acute this problem has become. The supply-side policies that produced the Great Moderation—deregulation, liberalization, and privatization—have deepened the crisis of overproduction through easy credit and rising asset prices. These asymmetries in productive capacity are the result of an ideological and political commitment to letting “market efficiency” and inflation reduction sort out the global imbalances between countries with payments surpluses and deficits.

## **Brandt’s Monetary Agenda**

While fighting price inflation may be good policy for ensuring stable economic growth, the post-Keynesian overemphasis on inflation has also been destabilizing. Since the early 1980s, when attempts to achieve price stability by controlling money were abandoned, inflation targeting became the new focus of central banks. Influenced by market polemics, many economists and bankers adopted the view that price inflation could be modeled and controlled without paying much attention to the value of money. Rather than meeting long-term monetary targets, central banks would use their own money to determine short-term interest rates and ensure a broad balance between overall supply and demand for the medium term (usually a few years). Thus, instead of seeking to control inflation indirectly, central banks began to aim expressly at price stability.

The fact that these monetary practices have now become mainstream policy does not validate them. Ultimately, the adjustment process should not be the task of either markets or central banks—it should be the task of the international system itself. Markets cannot protect against systemic risk; guarding against systemic risk is one of the main reasons that we have central banks. Yet through inflation targeting for the financial sector, central banks have actually contributed to systemic risk by allowing exchange rates to build up implicit monetary imbalances at the global level. While emphasizing price stability, central banks have also encouraged the huge surges of credit that lead to asset inflation, which is the real source of the underlying global imbalances in saving and investment. As the Brandt Report anticipated, without a way of stabilizing these major financial distortions and asymmetries internationally, the underlying superbubble will continue to build until it bursts and the entire system collapses.

The inherent tension between export-led and import-led economic development is not an easy matter of supply canceling out demand. It is extremely difficult to ensure global economic balance when the domestic economic infrastructure of one group of nations is geared primarily toward production, while the infrastructure of another set of nations is oriented largely toward consumption. What makes this imbalance particularly challenging is that the liquidity in the global economy is already skewed toward global supply and production capacity, which creates instability in the entire system. *A major international financial adjustment is needed to clear the superbubble that has resulted from the different incentives and timeframes in the balance of payment imperatives of surplus and deficit nations—which allows surplus nations to accumulate financial assets without recycling them, while requiring deficit nations to pay their debts and adjust their fiscal balances.*

It's clear that neither global poverty nor climate change are going to be tackled simply through a major stimulus package of aid, loans, trade, and investment from the global North to the global South. Certainly, a global stimulus can provide important short-term economic growth. Yet far more is needed. As the Brandt Report indicated, an effective global stimulus must also be accompanied and supported by a massive increase in income distribution, wage levels, and purchasing power through deep changes in social and monetary infrastructure: for “in the long run countries have to strengthen their capability to sustain development through structural transformation.”<sup>34</sup> The Brandt Commission stressed that *any international program to merge the developmental needs of the South, the underused capacity of the North, and the needs of the entire world for a low-carbon environment, must be directly linked to the restructuring of the international monetary system.*

The Great Recession of 2007-09 has focused the world's attention on the need for a new monetary system. China, Russia, Brazil, India, France, the United Nations Conference on Trade and Development, and the UN Conference on the World Financial and Economic Crisis—along with many other states and international agencies—have expressed apprehension about the world's widening trade imbalances, distorted growth, and misaligned exchange rates. These were the same concerns voiced by the Brandt Commission. “The current monetary disorder, together with the growing tides of protectionism and persistent inflation and recession, could have increasingly dangerous consequences for all countries,” said Brandt. “There is thus an urgent need to establish a mutually agreed international monetary order which would take into account the changes in the world environment since 1944.”<sup>35</sup>

It's clear that the path that the world embarked upon at the Bretton Woods conference hasn't worked and isn't going to work. It's time—past time, since these problems have been evident for decades—to think about creating a new international financial architecture, including a restructured currency scheme to reverse or eliminate the systemic errors in the present system. In this regard, Brandt's team of experts developed a monetary agenda that remains highly relevant today.

“The Commission believes that reform of the world monetary system is urgent and must address itself to the following issues: the *exchange rate regime*; the *reserve system* (the creation and distribution of the international means of payment or liquidity); and the [*balance of payments*] *adjustment mechanism* as it affects the countries using reserve currencies, surplus countries and deficit countries.”<sup>36</sup> The Brandt Commission also called on nations to re-examine the *international role of the dollar* and to prepare for a new *global monetary conference* to discuss all of these issues in a comprehensive way.<sup>37</sup>

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<sup>34</sup> Brandt Commission (1980, p. 63)

<sup>35</sup> Brandt Commission (1980, p. 206)

<sup>36</sup> Brandt Commission (1980, p. 207)

<sup>37</sup> Another proposal—closely related to these—is the Brandt Commission's call for automatic international financing, which continues to be the subject of much international discussion. Essentially, the Brandt Report called for a small surcharge or tax on income, production, consumption, or trade involving exchanges across international borders. New global programs and institutions for sustainable development could be financed through fees on international corporations, international investment, foreign exchange transactions, international trade, international airline tickets, maritime freight transport,



It is worth examining each of these topics now, thirty years after the publication of the Brandt Report, in light of the current state of the world economy.<sup>38</sup> The next section, “Present World Conditions,” will focus on the exchange rate regime, balance of payments adjustments, and the reserve system. The last section, “Looking Ahead,” will focus on the dollar crisis and the need for a global monetary conference.

## Present World Conditions

### Exchange Rate Regime

The exchange rate is a ratio between two currencies which indicates how much one is worth in terms of the other. It is the means by which one nation’s currency is valued against other national currencies for purposes of trading and exchange. The accounting of national monetary values was fairly straightforward under the system of fixed exchange rates. Since the 1970s, however, when exports and imports began to be invoiced in currencies with widely fluctuating values, differences between the real earnings from exports and the real cost of imports have frequently arisen. These discrepancies have created significant problems for producers and traders, as well as for central banks managing external debts.

Under the new system (or “non-system”) of floating exchange rates, government economists and politicians quickly realized that changes in the exchange rate could be used to manage the domestic trade balance for the benefit of the nation and its producers.<sup>39</sup> Hence, when central banks and governments buy and sell currency in foreign exchange markets, they are largely motivated by the same goals as those of primary exporting nations seeking price advantage in global commodity markets.<sup>40</sup>

All national currency is now *fiat*—created by central banks virtually out of nothing (since the costs of producing money are negligible).<sup>41</sup> Because currencies are a medium of exchange and not a commodity like wheat or iron ore, their “market” price essentially depends on the decisions

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ocean fishing, sea-bed mining, offshore oil and gas, international oil trading, satellite parking spaces, electromagnetic spectrum use, military spending and arms exports, toxic wastes, hydrocarbons and exhaustible resources, and energy consumption. The Brandt Commission believed that these measures were essential in funding a new international economic system. However, since these transborder fees are financial rather than monetary, I have not included them as part of Brandt’s monetary agenda. Rather than focus on the financial side, I’ve concentrated on the monetary conditions that will support the creation of measures for global financial stimulus and automatic global financing.

<sup>38</sup> For purposes of narrative flow, the topics of Brandt’s monetary agenda are arranged in a slightly different order in this article.

<sup>39</sup> A central bank’s interventions in foreign exchange markets to push exchange rates higher makes a country’s imports cheap but can lead to domestic demands for protection and subsidies; on the other hand, interventions to push exchange rates lower can create commercial and political pressures in other countries for trade discrimination and retaliatory measures.

<sup>40</sup> When the press reports on governments “cooperating” to influence exchange rates, what it really means is that their central banks are employing monetary strategies to manipulate foreign currency markets.

<sup>41</sup> *Fiat* is a Latin term for “let it be done.” Fiat currency is money decreed by a government to be legal tender.

of central banks as to how much money to print. Thus, in the era of floating exchange rates, neither exchange rates nor currency supplies are determined by market forces, as many people assume, but are strategically established by a cartel of central banks. When the world economy switched over to these floating exchange rates, central bank interventions in the currency markets seemed like a good way of substituting for the earlier stability of fixed rates. In theory, this manipulation of foreign currency exchange rates promised the kind of predictability and order that the gold standard had provided, but in practice this has not been the case. There are two reasons why the strategic manipulation of exchange rates is not working effectively and is actually contributing to global economic imbalances.

The first reason is financial. During the period of the Great Moderation, most bankers, investors, and policymakers assumed that the new era of credit was beneficial for the economy as a whole. Bankers were happy to extend new loans to investors, investors were profiting, and regulators were pleased to see the banks alleviating credit risk. But easy credit and financial innovation masked the symptoms of the emerging superbubble. Under the old system of fixed exchange rates, banking had been relatively simple. When banks extended loans, they kept them on their own books using rudimentary accounting measures. After the monetary deregulation of 1971, however, banks started selling their credit risk to off-book investors in the growing capital markets. The advent of computers and quantitative methods for managing credit risk also contributed to the proliferation of credit-based instruments using off-book accounting. Without a system of managed exchange rates, accounting standards were blurred and a great deal of ambiguity developed. Although exotic financial products were marketed as the latest form of free-market innovation, many of the new financial instruments such as collateralized debt obligations were never really traded in the marketplace at all. They were valued through the algorithms of complex theory rather than through actual market pricing. As banks lost track of their own *mark to market* accounting, regulators also lost track of the banks' capacity to trade and price assets in a credible way. Hence, exchange rates based on these calculations have also misrepresented the real value of assets.

The second reason for the failure of exchange rate manipulation is monetary. In the global exchange rate regime that emerged after 1971, some developing countries have chosen floating or “crawling” exchange rates, while most are linked to a major currency or to a basket of currencies. By pegging their currencies to the dollar, nations like China have to purchase more dollars to prevent their currencies from appreciating, which can lead to inflation. This arrangement is highly contradictory: although their currency values rise and fall with the value of the dollar, the export-driven incentives of nations with undervalued currencies are the very opposite of the import-led model of economic growth in nations like the US. This means that high-growth, producing countries which are pegged to the dollar must suffer the deflationary consequences of any drop in the dollar's value. If these countries are also running surpluses and accumulating savings, their investment and consumption is less than what it would otherwise be if their currencies weren't linked to the dollar.

In 1994, China's central bank fixed the yuan at an exchange rate about 8.28 to the dollar. Since China began generating a large surplus in its trade with the US, it's been widely argued that the yuan is “undervalued.” Critics say that China should allow its exchange rates to appreciate, which would reduce its trade surplus and allow it to consume more, while increasing

US exports and savings and lowering the US trade deficit. This logic is disputed, however. Some economists believe that an appreciation of the yuan against the dollar could actually cause investment in China to decline, increasing China’s net savings and trade surplus with the US. For its part, China does not think that its manipulation of exchange rates is the cause of global imbalances, which it says are largely the result of cheap money, inflated demand, and asset bubbles in the United States.

Although the large foreign financing of America’s negative current account has been grabbing the news headlines for several years, major global imbalances of this sort are not a recent problem. Over time, the scope of the economic distortions caused by the overextension of credit and the overcapacity of production has certainly broadened, but the issue is hardly new. For several decades, world demand has been in need of rebalancing, including deep changes in the pattern of national and global trade, finance, and monetary activity. The Brandt Commission advised in 1980 that greater international coordination was needed to prevent currency manipulation from resulting in exchange rate instability, distorted capital flows, and prolonged current account imbalances. It said that “key elements of monetary and fiscal policy should now be under urgent cooperative review by governments and central banks so that an appropriate pace of expansion can be agreed on and set in motion, and a better relation among exchange rates be maintained than has recently prevailed.”<sup>42</sup>

The failure of central banks to manage these imbalances through the exchange rate process brings up a broader question. Is the economic conflict today between China and the US simply a matter of resetting exchange rates between the yuan and the dollar? Or is it a larger matter of adjusting payments imbalances between the “surplus” saving of China and the saving “deficiency” of the US?<sup>43</sup>

## Balance of Payments Adjustments

A current account balance measures a nation’s income relative to its spending. All the trade flows of goods and services, charitable contributions, foreign aid, and other international payments are weighed in terms of what comes in and goes out of the country. Generally speaking, a nation’s current account indicates whether it is mostly saving or borrowing from abroad.

From a quick-glance standpoint, China and the US both appear to be thriving. By the measures of the Great Moderation, the economic relationship between these two superpowers has provided prosperity and economic growth with modest inflation for both nations and many of their trading partners. Yet this growth has resulted from a global economic system that is engineered to create and recreate asset bubbles and trade imbalances. As noted earlier, *there are different structural incentives for nations which have balance of payments deficits and surpluses. Through the enforcement mechanisms of the international economic system, deficit nations are required to make timely adjustments, while surplus nations are not required to make reciprocal*

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<sup>42</sup> Brandt Commission (1983, p. 42)

<sup>43</sup> I’m using the terms saving “surplus” and saving “deficiency” here in terms of the financing that is required for domestic investment.

*adjustments. Hence, poor nations are obligated to pay their debts or roll them over, but rich nations are not required to recycle any of their surpluses for the benefit of poor nations.*

The flaw built into the Bretton Woods system—that deficit and surplus nations must follow these different modalities—has led to two mutually-dependent models of economic development and growth. There is the model of export growth, over-saving, and underconsumption in many Asian nations like China and Japan, as well as Germany and the petrodollar states. And there is the model of cheap imports, low-cost foreign loans, and debt-financed consumption in nations like the United States and the United Kingdom.<sup>44</sup> These are two vastly different structures within a single global economy.<sup>45</sup> The question is, how did this imbalance occur? Why does Asia save and the US borrow? Let’s start with Asian thrift.<sup>46</sup>

Since the late 1960s, the terms on IMF lending had been very tough on developing nations. Typically, as a condition for receiving a new loan, a nation was forced to balance its budget, curb its money supply, cut subsidies, and readjust its exchange rates. In effect, poor nations were being penalized for their incapacity to produce tradable goods and services through austerity measures that further eroded their structural deficiencies. As the Brandt Commission observed, “in many cases these measures reduce domestic consumption without improving investment; productive capacity sometimes falls even more sharply than consumption. This is because many developing countries with deficits have a shortage of food or of basic consumer goods or cannot readily shift resources in line with their new needs.”<sup>47</sup>

Throughout the 1980s, Latin America and Africa experienced a lengthy debt crisis with periodic loan interventions from the IMF, although much of Asia was spared. Well into the 1990s, many nations in Southeast Asia had been enjoying heavy foreign capital investment, rising asset prices, and high economic growth rates. Yet these countries were also running large current account deficits while holding limited foreign reserves. In 1997, asset prices collapsed. International lenders lost their appetite for risk and quickly withdrew their funds. Capital flight began in Thailand and quickly spread to Indonesia, South Korea, Hong Kong, Malaysia, Laos, Singapore, Taiwan, and the Philippines, causing financial markets and economies to collapse throughout Southeast Asia and raising fears of a worldwide economic meltdown.<sup>48</sup> The IMF stepped in with bailouts totaling \$40 bn. These rescue packages were tied to drastic economic reforms—cutbacks in government spending, currency devaluations, forced bank failures, and higher interest rates.

Essentially, the IMF imposed draconian measures on these defaulting nations to restore the confidence of the international community in the stability of their currencies. As a result, many

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<sup>44</sup> This disequilibrium is expressed in the cliché that grew popular during the past decade: “Asians produce products, export, lend, and save; Americans import, consume, and borrow.”

<sup>45</sup> As globalization led to greater global economic integration, it also exacerbated the imbalances inherent in the Bretton Woods system. A primary example is the China-US relationship, which is not a case of mutually beneficial dependence, but of unequal co-dependence.

<sup>46</sup> The United States penchant for borrowing is analyzed below in “The Superbubble and the Dollar Crisis.”

<sup>47</sup> Brandt Commission (1980, p. 216)

<sup>48</sup> The financial contagion also spread to Brazil and Russia.

of these countries were forced to restructure politically and financially. The anger against the IMF’s harsh structural adjustment policies was strong and lasting. Chastened by a difficult debt crisis, many of these nations pledged to protect themselves against further speculative attacks and also from having to borrow from the IMF again. Over the next decade, Asian central banks began to increase their savings by accumulating foreign exchange reserves in dollar assets and building up large current account surpluses.

This imperative to save spread from Asia to other nations. In 1996, the year before the Asian financial crisis began, developing economies worldwide were running a combined current account deficit of \$78 bn. By 2008, this had turned into a surplus of \$4.7 trillion, or about 75% of the world’s \$6 trillion of foreign exchange reserves.<sup>49</sup> For some nations, such as the oil-producing Middle Eastern countries and Russia, this accumulation of assets reflects the surging price of commodities. In other cases, surplus nations are manipulating their exchange rates downward against the dollar to boost export growth and increase their currency reserves and current account positions. In both instances, the wealth is controlled by governments, either directly or through state-owned companies, rather than by individuals or companies.<sup>50</sup>

The Great Recession affected all countries. Asset prices and demand for goods and services declined and credit markets tightened. Both nations with current account surpluses, and nations with current account deficits, suffered declines in growth, although to varying degrees. To fight the recession in 2008-09, the central banks in many deficit nations cut interest rates (and some expanded their money supplies), while their governments created massive stimulus packages. These interventions were modestly successful in promoting domestic recovery. By borrowing and spending to raise demand for the world’s surplus output, deficit nations helped prevent the recession from spreading to surplus nations. But for surplus nations, the incentives to run big current account surpluses did not change as a result of the recession. In fact, China, Japan, and Germany ran huge current account surpluses from 2007-09 and seem intent on increasing their savings at the risk of suffering declines in domestic demand and increasing fiscal deficits. Despite (or because of) the stimulus packages created to fight the recession, the current account imbalances among national economies continue to widen and the underlying monetary disequilibrium has become much more pronounced.

Although the recession has dampened demand for its goods, the meager level of China’s 2009 government fiscal deficit and the strength of its massive surpluses indicate that China is set on revving up its exports, expecting a recovery in foreign demand. Other surplus countries also seem to be anticipating that export-led growth and external demand will moderate their withdrawal of domestic stimulus measures and drive their recoveries. But the credit bubble in the deficit nations has not been abated and the expected fiscal deterioration in these countries is still much greater than in the surplus countries. Although the US, UK and Spain spent less, saved more, and reduced their trade deficits between 2007-09, actually shifting their financial balances

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<sup>49</sup> Hale (2010)

<sup>50</sup> Ben Bernanke observed in 2005 that there appeared to be a “global saving glut” forming, particularly in fast-growing emerging economies and among oil exporters. (<http://www.federalreserve.gov/boarddocs/speeches/2005/200503102/default.htm>. From this angle, the central banks and sovereign funds of these nations were accumulating their reserve surpluses from excess US consumption.

toward surplus, the fiscal deficits in these nations are still much larger than in surplus nations. Rather than provide a source of global consumption as in the past, countries such as Spain, Greece, Portugal, and Ireland<sup>51</sup>—along with the US and UK—now represent increased credit risks following years of debt-driven expansion, lack of fiscal discipline, and structural deficiencies.

These internal government deficits—needed to offset chronic current account deficits and sharp declines in private spending—are not sustainable. In effect, surplus countries are still depending on the private sectors of deficit countries to do their borrowing for them. But nations with low rates of saving like the US and UK can no longer play the role of consumer-of-last-resort. Deficit countries simply can't absorb infrastructure spending or tax cuts that could generate economic growth because of the monetary interest payments on their debt.

Given their large surpluses and foreign currency holdings, surplus nations could provide the engine to get the global economy going again, whether by redistributing their surpluses to simulate demand abroad, or by stimulating demand at home. In the interests of global monetary adjustment, surplus countries like China and other Asian nations, Japan, Germany, and the oil-exporting states, need to expand their economies. This could be done by slashing taxes on consumption, increasing investment in infrastructure and the service sector, stimulating domestic demand, and adopting exchange rate regimes that are less geared toward saving and building up trade surpluses and currency reserves.

The massive monetary expansion engineered by the world's major economies to protect themselves from the effects of the financial crisis has temporarily reduced the economic pain, but only by deepening the underlying monetary imbalances of the superbubble. The US and European governments have delayed the rise in saving which they require, while China has poured more money into increased production. The undervaluation of Chinese currency—which increases tradable goods production within China—is not only driving trade imbalances with nations like the United States, it is also crowding out traded goods production in developing and emerging markets.<sup>52</sup> International measures for better regulation are important, but still represent an attempt to preserve the current system of unsustainable growth and overproduction, rather than finding a permanent cure for chronic global excess. Instead of facing the real structural challenge of monetary imbalances, governments insist on reinflating the next bubble, dealing with the symptoms of the illness but not the illness itself.

It is not enough now to ease the pressures on the global economy: the world needs a purposeful monetary design. Sooner or later, there has to be an international agreement for an adjustment process that rebalances the world economy and eliminates the superbubble. Part of the solution is in changing the policies of surplus countries. But it will also require reformulating the international monetary system—which has been responsible for this major misallocation of capital—so that the capital incentives of surplus and deficit nations are thoroughly transformed.

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<sup>51</sup> The fiscal deficits of these nations have been unsettling for the neighboring states of the European Union, as well as for the global economy. The risk of financial contagion from these countries rattled global markets in early 2010.

<sup>52</sup> Landler (2010). The yuan is undervalued somewhere between 25-40% relative to the dollar and other currencies, according to most estimates.

An international adjustment mechanism is required that will keep money circulating in a stable and predictable way so that it flows to where it is most needed. Because the world’s vast pool of excess savings and the inability to recycle them are at the heart of the global economic crisis, the Brandt Commission stressed that the adjustment process should be placed in the context of maintaining long-term economic and social development.<sup>53</sup> The need for economic and social development applies both to surplus nations, which often restrict their domestic spending on social services and infrastructure while boosting their savings and currency reserves; and also to deficit nations, which bear the burden of adjustment through reductions in employment and public spending while paying down their debts.

“A reformed international system must provide incentives and mechanisms for adjustment by both surplus and deficit countries. The world economy will always display payments imbalances. Since deficits have their counterpart in surpluses, a reformed system must ensure that both surplus and deficit countries have some obligation to adjust. In the past, it was only when deficit countries turned to the IMF for credit that adjustment mechanisms were internationally enforced. Means should therefore be devised, through the IMF or otherwise, to encourage countries in current account surpluses to make long-term loans to deficit countries that are undertaking needed adjustment.”<sup>54</sup>

## Reserve System

International reserves are the means of making international payments and managing liquidity. Reserves are generally authorized by central banks and held by treasuries as a stock of international purchasing power. Since 1944, the US dollar has been the world’s reserve currency, which individual nations may (or may not) choose to become part of their reserve assets.<sup>55</sup>

There is no automatic mechanism for keeping these reserves in balance on a global basis. Because of the structural error in the Bretton Woods system—that adjustment imperatives for balance of payments differ for deficit and surplus countries—internal reserves can be used either to finance balance of payments deficits or to store “surplus” savings. *When deficit countries turn to the International Monetary Fund for credit, the adjustment mechanism becomes operative and is internationally enforced. Deficit nations are required to make payments on their loans. Yet surplus countries are not under any similar international obligation because there is no adjustment mechanism for recycling their trade surpluses and currency reserves.* As long ago as 1980, the Brandt Commission had noted that the expansion of world liquidity was not helping the adjustment process because these reserves were being squandered by the world’s surplus

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<sup>53</sup> This is why the new global economic system must be centered on sustainable development, although many current advocates of sustainable development have not grasped the macroeconomic context that is needed to support it. New financing and new technology by themselves will not reduce climate change, create a low-carbon civilization, or meet the UN Millennium Development Goals.

<sup>54</sup> Brandt Commission (1980, pp. 213-214)

<sup>55</sup> As noted above in “Exchange Rate Regime,” a central bank often buys and sells international reserves to influence exchange rates and stabilize the value of its domestic currency. This enables a central bank using a flexible exchange rate regime to clear excess demand or supply by purchasing or selling a foreign currency. For a central bank that is pegging its exchange rates to the dollar, increases in demand for the currency will push its value higher, and decreases will lower its value.

nations. “Although the aggregate of world reserves has risen,” said Brandt, “their distribution has been highly concentrated and does not accord with any measure of reserve needs.”<sup>56</sup>

The dollar is now about 40% below its value from 1971.<sup>57</sup> At the moment, many countries like China are hoping to minimize the risk that the value of the dollar will decline further as the economy recovers, but they hesitate to sell high volumes of dollars for fear of triggering a fall in its value. In 2008, China expressed deep concern that the gaping US budget deficit could undermine the value of its huge dollar holdings. This has motivated China to call for a global currency to replace the use of the dollar as an international reserve.

Various proposals have been made for a new global currency. The idea has surfaced that the euro could replace the dollar, but several highly indebted states (Portugal, Ireland, Greece and Spain) have been undermining the confidence of global investors and central banks in the euro and in the political cohesion of the European Monetary System. Some pundits have nominated the yuan for the next global reserve currency and the Chinese government has taken some small steps toward internationalizing it, but China is a long way from developing the deep and open domestic markets necessary for capital convertibility. In the case of both the euro and the yuan, there are misgivings in nearly all countries about allowing a single bloc or nation to control global monetary policy again, as Great Britain and the United States have done previously. Historically, single-nation reserve currencies have encouraged distorted capital flows, misaligned exchange rates, and unstable balance of payments adjustments, contributing to major global economic imbalances.

The Brandt Commission called for a new global reserve currency to increase global liquidity and improve the adjustment mechanism. “It is in the international interest, indeed it is a purpose of the IMF” said Brandt, “that countries should be provided with adequate short-term resources so that they are not forced into measures which may be harmful not only to themselves but also to others by balance of payments pressures which are only temporary in their incidence. For this reason new reserves should be allocated to those countries which are most likely to experience balance of payments deficits and high domestic costs of adjustments, and least likely to be able to finance them from alternative sources. Many developing countries fit into these categories: a low level of development and a high concentration of primary production tend to increase both their export earnings instability and their costs of adjustment. At the same time, they have limited access to international capital markets, and relatively high opportunity costs of reserve acquisition. There is therefore a strong case based on efficiency as well as equity for a larger share of new unconditional reserves to be distributed to the developing countries than is achieved through allocations proportional to the IMF quota system. This is the underlying rationale for what is often referred to as an ‘SDR link.’”<sup>58</sup>

The SDR is a Special Drawing Right issued by the International Monetary Fund. SDRs were created in 1969 to meet the demands of central banks for an orderly increase in official reserves, a decreased dependence on the dollar, and a reduction of global imbalances in money and credit.

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<sup>56</sup> Brandt Commission (1980, p. 209)

<sup>57</sup> Norris (2007). The 40% decline in the value of the dollar since 1971 is a Federal Reserve Board estimate derived by periodically comparing the dollar with a basket of currencies.

<sup>58</sup> Brandt Commission (1980, p. 212)



As the Brandt Report explained, “An SDR is essentially a line of perpetual credit in the IMF on which member countries can draw, under certain conditions, to obtain the foreign currencies they need to settle their payments deficits. Its use is limited to central banks and treasuries, as well as the Bank for International Settlements. ... But an SDR has one outstanding feature: it is the only means of meeting international payments which has been established through international contract; for gold and reserve currencies as reserve assets are created by unilateral action (production and sale of the metal, US running balance of payments deficits) and their status is based primarily on custom. The SDR therefore represents a clear first step towards a stable and permanent international currency.”<sup>59</sup>

Although they are in only limited use, SDRs could be especially important in times of national economic volatility, since they allow for the international creation of money and the expansion of liquidity without adding to the global surplus of dollars. Presently, SDRs are denominated in four currencies which are included in a basket comprised of about 44% US dollars, 34% euros, 11% yen, and 11% pound sterling.<sup>60</sup> A full-scale SDR system would allow countries to share the costs and benefits of managing its reserves, as SDRs and domestic currencies are swapped between national treasuries and a substitution account at the IMF. Using a currency basket for an expanded distribution of SDRs would also mean that no single currency holds an unfair advantage.

Yet there are several challenges to the adoption of SDRs. While they have been available for over forty years, SDRs have become only a small addition to—not a substitute for—international reserve currency holdings. In 2008, US dollars made up 64% of the world’s foreign currency reserves, while SDRs comprised only about 4%. Therefore, a broader transition into SDRs—which has been possible since 1969—entails a willingness on the part of the international community to expand their use, which has been lacking. It also means that the IMF quotas governing the distribution of liquidity would have to be altered to create a more functional and equitable formula for SDR allocations.<sup>61</sup> Nor does the IMF presently have the authority, supervision, and independence necessary to function as a global central bank.

A second reason that SDRs may not be a viable alternative to US dollars as the global reserve currency is that SDRs can be held as reserves only by central banks and governments, which means that individuals and companies cannot use them, either in local or global trade. And since the average person could not borrow or spend in SDRs, they would not be an attractive source of liquidity for private markets, banks, and investors. SDRs are simply an accounting unit. While they may be a valuable currency for interbank and intergovernmental exchange trading, SDRs could never become a fully realized global currency since they function mainly as a store of value—not as a medium of exchange.

A third problem is the challenge of China. The yuan does not fully operate as a reserve currency since it is not freely convertible by other central banks that would use it to intervene in

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<sup>59</sup> Brandt Commission (1980, p. 209)

<sup>60</sup> The SDR is the weighted sum of these four currencies, valued in US dollars. Since the exchange rates of these currencies fluctuate, the value of the SDR is recalculated daily.

<sup>61</sup> Under current rules, 85% of IMF members must agree to an expansion of SDRs—a challenging threshold for official approval.

foreign exchange markets. Bringing China into the process of creating an equitable monetary system remains problematic.<sup>62</sup>

A fourth problem is the United States. America has resisted the expansion of SDRs from the time they were created. It's easy to see why. The widespread adoption of SDRs represents a threat to US dollar hegemony.<sup>63</sup> The US literally has a “vested interest” in not allowing an expansion of SDRs (or any other international reserve currency) to take away its privilege of trading in the same currency that it prints.

“The present reserve system is unsatisfactory,” the Brandt Report declared in 1980. “Expansion of world liquidity is erratic in both its volume and its distribution.”<sup>64</sup> Yet little has been done to correct these problems, and the monetary imbalances resulting from the

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<sup>62</sup> Through its massive purchases of US Treasury bonds, China has already demonstrated that it is interested in taking part in the global monetary system as an active player. But China may also be driving a hard bargain toward the creation of a new monetary system. Although it's still too early for China to play its hand, China's bargaining position is improving daily. If discussions to restructure the international monetary system were to begin during a time of monetary crisis rather than in advance of such a crisis, China could be in a position to emerge as a monetary hegemon. China has been buying a large amount of world gold supplies, leading some analysts to believe that China is emulating the same path that the United States did in the 1930s, when it purchased the majority of the world's gold and subsequently displaced Great Britain as the world's monetary guarantor at the global monetary conference of 1944. Its official rhetoric to the contrary, China must certainly see that appreciating the value of the yuan would help to correct world trade imbalances, and also that many nations—in the East and the West—are eagerly waiting for this to happen. If China promised to abandon its exchange rate to the dollar to alleviate international imbalances, while holding a majority of world gold supplies and making the yuan fully convertible into other currencies, it could attempt to broker an international deal to emerge as the world's currency guarantor. However, many in the international community do not see this as a desirable outcome, since there is a general sense that whatever currency replaces the dollar, it must not be controlled by a single country. In addition, there are many analysts who do not believe that the world will ever return to a gold standard (assuming that this is what China has in mind), or, for that matter, to any reserve standard that is based on a single commodity. The question is, does China intend to make the yuan a reserve currency? It's very likely. One possibility would be to issue its own bonds denominated in SDRs, which would enable China to foster a new market for a global reserve currency based on SDR liquidity. Another alternative is for China to slowly develop financial and trading markets for the yuan, gradually transforming it into a reserve currency. While it's probable that China will eventually create a reserve currency in one form or another, the challenge will be to transform its opaque financial infrastructure into deep and open domestic financial markets and banking institutions through greater transparency, supervision and regulation.

<sup>63</sup> The SDR was originally created to function alongside the US dollar in order to expand global liquidity when needed, although this possibility has never really been tested since the volume of SDRs has been limited. Some economists still believe that the US dollar could continue to operate as the world currency guarantor in parallel with expanded allocations of SDRs through the present IMF currency basket (of dollars, euros, yen and pound sterling), although this arrangement could have its own set of problems. Since the dollar is already one of the four currencies in the basket, when it receives dollars the IMF would have to decide to sell them and depress their value, or hold them and risk dollar depreciation. This could lead to a situation in which IMF liabilities were comprised of the four currencies, while IMF assets were primarily in dollars, exposing the IMF to dollar depreciation.

<sup>64</sup> Brandt Commission (1980, p. 209)

superbubble have continued to build. Now, three decades later, there is an emerging consensus that the present system, under which the dollar acts as the world’s reserve currency, should be subject to a thorough review and that new mechanisms must be established for creating and distributing an international currency to clear and settle outstanding balances between the central banks. Yet it is by no means obvious how to replace the dollar with a new global reserve currency. If the dollar is abandoned and there is no effective substitute for an international payments mechanism, nations may resort to settling their payments on a bilateral basis using their own currencies, as Brazil and China have announced they would do—which is hardly a stable or permanent solution.

An integrated international financial system requires an integrated monetary reserve system. Whatever new currency system is chosen, it should promote the non-inflationary expansion of liquidity and also assist the adjustment process of the monetary system by ensuring that surplus and deficit countries have a similar obligation to adjust.<sup>65</sup> Surplus countries that don’t need additional reserves must be able to direct their allocations to deficit nations which bear high adjustment burdens. A reciprocal adjustment process of this sort would transform the fatal flaw of the Bretton Woods system. But for that to happen, a new monetary architecture is required.

## Looking Ahead

### The Superbubble and the Dollar Crisis

Since 1944, America has been at the center of the world’s financial system. For over sixty years, most central banks have held the bulk of their foreign exchange reserves in dollars.<sup>66</sup> Because of foreign investors’ faith in the US economy and their seemingly unlimited desire to hold American dollars and bonds as a store of value, US government bonds have supported the value of the dollar, held domestic interest rates to a minimum, and allowed the US to finance its debt cheaply. By importing more than it exports, the United States sends its dollars to foreigners, who return them back to the US through the purchase of stock, bonds, companies, factories, and land. For many years, \$2 bn of global capital has flowed into the US each day from global investors seeking safety and stability, good deals, competitive returns, and high growth rates. By relying on foreigners to supply its finance, America has been able to run a huge balance of payments deficit and spend without regard for its debts. The more that foreigners have been willing to invest their dollars in US assets, the more that the US has been able to import cheap

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<sup>65</sup> It’s not certain how international discussions on a new currency will progress. Some analysts are proposing a G4 currency basket, comprised of the dollar, the euro, the yen, and perhaps the yuan. The G4 could also take another form, in which these same currencies are not placed in a basket but still share reserve status as independent currencies. Either way, a G4 reserve system is probably not enough to produce the deep changes in the monetary system that are now required. It’s unclear how a multiple currency system would eliminate the superbubble, bridge the imbalances between surplus and deficit nations, and provide for a smoother, more stable and equitable adjustment process. My view is that a multiple currency system would be only an interim solution until the world community is fully prepared to undertake a full-scale monetary adjustment through an integrated currency or currency basket.

<sup>66</sup> The notable exception is the Cold War period, 1947-1991, when the Soviet bloc operated its own economic exchange system, the Council for Mutual Economic Assistance (COMECON).

products, hold down inflation, enable consumers to keep buying, and fuel worldwide economic growth.

If any other country were to institutionalize its deficit spending as the US has done, the IMF would insist on structural adjustment measures, including government austerity or currency devaluation. Yet because of the dollar’s reserve status, the US has been able to avoid balance of payments problems by purchasing imports in its own currency. Even as far back as the late 1960s, French President Charles de Gaulle was commenting on the unfair advantage held by the United States. The US, he said, was using its position of reserve currency guarantor as a license to print money and finance its debt. As the Brandt Commission recalled, “Since the balance of payments deficits of the United States had become the principal source of growth in world liquidity ... it seemed to have, in General de Gaulle’s words, the ‘exorbitant privilege’ of continuing to finance its deficits through the provision of still more dollars.”<sup>67</sup>

Prior to this, when the US was running current account surpluses, the Bretton Woods nations had experienced little monetary volatility. America emerged from the Second World War with the world’s largest current account surplus and the global monetary system had been fairly stable until the US current account began to slump in the 1960s. When the US ran a negative current account balance in 1971, it was forced to end the gold backing of the dollar. With this deregulation of the international monetary system, the issuance of credit exploded, and the United States, as issuer of the world’s reserve currency, was its epicenter. The proliferation of credit resulted in a “hollowing out” of US industrial infrastructure. As manufacturing jobs left for overseas markets, the US gradually lost the basis of real economic growth. Consumption was now financed by credit, which had a profound impact on America’s current account balance. By 2009, America’s current account deficit was approaching \$800 bn, by far the largest in the world.<sup>68</sup>

Given the risks of this huge deficit, why are private foreign investors and central banks still investing heavily in the US? Some investors argue that the reserve status of the dollar will continue indefinitely because it is not affected by the US deficit. The dollar is highly liquid and convertible in both current and capital accounts, and nearly 2/3 of all foreign exchange holdings are in dollars. Since the predominance of world trade, finance, and foreign debt is also in dollars, creating a new currency system would be pointless and enormously disruptive. There is the feeling that, in spite of the recession, demand by overseas investors and central banks will remain steady, foreign investors will continue to look to the US for security, and the global economic system will remain strong. Because of its size, wealth, legal, and political stability—not to mention its highly credible track record for repayment on loans—many believe that there is no reason to fear a monetary meltdown in the US. Since the United States can simply print more money, foreign bond investors are certain they will be paid. While many investors acknowledge the risk, they do not believe that US politicians would let their deficits become uncontrollable. And indeed, the share of US bonds sold at auction has continued to grow.

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<sup>67</sup> Brandt Commission (1980, p. 204). Some analysts have attributed the term “exorbitant privilege” to Valéry Giscard d’Estaing, who was Minister of Finance under de Gaulle.

<sup>68</sup> Index Mundi (2009)

Yet even as the dollar continues to be accepted, the prospect of such a large and persistent deficit presents risks to global financial markets and the global economy. US external debt rose to \$3.5 trillion last year and is projected to increase by \$1 trillion each year for the next decade. Larger US deficits and higher interest rates are already increasing the global competition for savings and raising serious doubts about America’s capacity to repay its debts. Where is the US Treasury going to borrow this money? Given the rapid pace at which the US is taking on debt, how likely is it that China and other nations—with their own deficits to finance—will continue to underwrite half of the US debt for the next decade as they have in recent years?

If foreigners begin to question buying debts and other investments in the US, America may have to raise interest rates to sustain investment. But with high interest rates, foreign demand for dollar-based assets could slow dramatically. And if foreign investors were to stop funding the US current account deficit, the dollar would rapidly depreciate in value. This would require a further increase in interest rates, which would accelerate government debt, make imports and foreign debts more expensive, and severely impact the American economy.

When the value of the dollar was strong, the US economy attracted investment in spite of the US current account deficit. But without long-term fiscal prudence, international investors have started to ask whether the US can continue to maintain its reserve currency status by engineering low inflation without having to ratchet up interest rates to sustain capital flows. Ultimately, a dollar is just a piece of paper that has value because the government that issues it claims it does and the people who use it believe in it. But the institutions of the US government have been undermining that faith through careless fiscal policy. Now that the dollar is weakening, how long will foreign creditors allow the US to keep running the printing press for the world’s currency before demanding that the US obey the same rules of fiscal responsibility that apply to other countries?

As a result of the Great Recession, public deficits have increased dramatically in many countries. As private credit stagnated, governments were called upon to issue credit and restore the purchasing power that was lost. G20 governments took on the role of spender-of-last-resort, sinking \$17 trillion dollars into bailouts and fiscal stimulus to restore banks and financial institutions, which has sharply escalated the public debt. Soaring government debt may be typical during periods of war, but this recent spate of borrowing represents the largest public debt ever recorded in peacetime. Here’s the problem: even though state spending is underwriting private liabilities, these stimulus packages do not substitute for real income growth in nations such as the United States, where huge numbers of high-value production and jobs have already been exported.

In the US, stimulus spending has weakened the dollar, raised the possibility of inflation, and increased government debt to alarming levels.<sup>69</sup> In the past few years, debt burdens in several other countries—notably Greece, Portugal, Iceland, Ireland, United Kingdom, France, Spain, Japan and India—have also reached 80% or more of GDP, raising questions about the

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<sup>69</sup> Mackenzie and Tett (2010). In early 2010, Moody’s Investors Service, which rates the sovereign debt of nations, warned that the US triple A sovereign credit rating could soon be in jeopardy because of sluggish US economic growth and weak action in tackling the US budget deficit.

sustainability of their public debts and economic growth.<sup>70</sup> But the persistence of the debt-to-GDP ratio in the US is particularly challenging: US government debts are projected to grow faster than its economy for at least the next decade.<sup>71</sup> If the US maintains these huge fiscal deficits, government expenditure will be diverted from domestic public services and investments, and sent abroad in interest payments on America’s surging debt. During the recession, Americans realized that they could no longer take on new debt and personal spending slowed. Yet even if individual Americans continue to increase their savings and use it to pay down their existing debt, it will take at least a decade for US households to reduce their debt/income ratios to safe levels and balance the family budget.

The specter of sovereign debt is already haunting bond markets. Because they are denominated in dollars, even when bonds are rolled over into new debt they will never be fully repaid. This means that when the next recession arrives, the US may be unable to borrow the vast sums needed to cover their outstanding debts. And this puts the United States in a colossal bind. On the one hand, reducing its debt will slow economic growth. On the other hand, sustaining huge deficits by borrowing from abroad to maintain consumption and deficit spending at home will lead ultimately to bankruptcy or extreme currency devaluation.

Mounting government debt will likely trigger the next financial crisis, which would immediately impact the value of the dollar. And a US monetary crash would quickly become global in scope, since sovereign default entails a crisis in the reserve status of the dollar. At the global level, this would deeply impact other nations with current account imbalances and soaring government debt, placing the entire balance of payments system in jeopardy. It also means that the massive adjustment in exchange rates and current accounts—when it inevitably arrives—will be that much more severe.

So how will we unwind the superbubble? Do the US, G7, G20, central banks and the world’s financial institutions intend to create a new economic system before the present one collapses? Or will they leave it up to the marketplace and risk massive financial disaster? In the near-term, the burden of decision rests with the US. It has two choices, neither of which is very enticing. America can either make the tough choice to devalue its dollar—or dither around politically (as it has been doing) and suffer a default. At worst, default could mean debt repudiation; at best, it could involve the restructuring of the terms of loans and interest rates. There is no happy option. The Chinese have a compelling proverb for such a dilemma: “Drinking poisonous liquid to quench thirst.”<sup>72</sup>

## **Toward a Global Monetary Conference**

Why did the Brandt Commission call for an international monetary conference? Is this still necessary? Are there any indications of it happening soon? First, let’s briefly review how we got to this point.

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<sup>70</sup> The Economist (2010)

<sup>71</sup> Mankiw (2010)

<sup>72</sup> Qiao (2009)

There is a major flaw in global economic policy, a structural error built into the design of the Bretton Woods monetary system. Although free market ideology has obscured the problem from policymakers and analysts, it has never disappeared. This blind spot has not allowed us to see the period of relatively tame inflation from 1982-2007 for what it clearly was: a series of financial bubbles generated by policies geared toward an overcapacity of production. Our inability to reckon with this emerging superbubble has not allowed us to recognize its deeper structural roots; nor have policymakers and analysts fully realized that the tremors now shaking the pillars of the modern economic establishment are emanating from the long-term suppression of global demand.

Bretton Woods I ended in 1971 when the United States “closed the gold window,” ending the link between the world’s currencies and gold. In the absence of a monetary anchor, exchange rates have been left to float, leading to excessive credit expansion. Under Bretton Woods II (1971-today), the dollar standard has flooded the world with cheap money at a rate faster than the growth of world GDP, and successive bubbles have spread economic instability across the globe. The Latin American and African debt crises of the 1970s and 80s were followed by the Southeast Asian debt crisis of the 1990s. Each of these crises, and many others of lesser magnitude, were caused by a flood of dollars into developing regions from abroad, which overheated their economies and caused them to crash.

In spite of the obvious imbalances resulting from easy credit and high asset prices, central banks have pursued a policy of inflation-targeting rather than using monetary policy to curb rapidly rising asset prices. Efficient market theory—the idea that all participants in the market receive and act on all relevant information when it becomes available—has provided the rationale for these policies. From the perspective of developed nations, these theories seem to have worked. But the period of the Great Moderation, which was characterized by easy credit, low price-inflation, and steady growth, masked the symptoms of the superbubble which was forming within the global monetary and financial infrastructure. In setting interest rates between the extremes of high prices and recession, and ignoring the actual value of money and credit in the process, central banks have typically ignored the signs of asset bubbles until they burst, resulting in financial instability.

It’s one thing to simply say that higher savings in deficit countries and stronger demand in surplus countries will alleviate global imbalances—the reality is far more complicated. Modern states are driven by a global economic machine which runs on only two gears. A nation can create the structural capacity to produce tradable goods and services and generate credit, or, lacking this structural capacity, it can attempt to obtain credit by relying on other nations which primarily produce and trade. A system where credit growth generates economic growth inevitably creates overcapacity, suppresses consumer wages and demand, and allows financial bubbles to build. Market forces do not adjust these structural imbalances. As Milton Friedman observed, “Inflation is always and everywhere a monetary phenomenon.”<sup>73</sup>

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<sup>73</sup> Friedman and Schwartz (1963). It’s telling that many free market economists, who are otherwise disciples of Milton Friedman, have disregarded the master’s famous maxim. Mainstream policymakers and analysts continue to treat money as though it is a function of the marketplace.

The need for policy change has become evident as a result of the world’s economic integration during the past few decades. As financial markets became increasingly interdependent, international investors have, in effect, been setting asset prices on the basis of global monetary conditions. When asset bubbles are actually driving monetary policy, it’s pretty clear that the tail is wagging the dog. These dynamics must be reversed. Transparency and discipline must be restored. When asset prices rise and cause economic imbalances, even when inflation seems to be under control, monetary policy should be tightened. Central banks should increase short-term interest rates when there are clear signs of financial imbalances. The world needs a monetary regulator to anticipate excessive risk-taking and reinstate a firm link between monetary and credit growth on the one hand, and price and asset inflation on the other. This is necessary to ensure stability both in single countries and throughout the entire international economic system.<sup>74</sup>

Without such management, the asymmetric policies of the present international monetary system will continue to encourage surplus and deficit nations to assume different roles and responsibilities. Since many deficit nations lack the structural capacity to produce tradable goods and services, international institutions can put heavy pressure on them to revalue their currencies. Yet there is no corresponding international machinery to prevent nations such as Korea, Taiwan, Thailand, and China from keeping their currencies undervalued, running trade surpluses and accumulating foreign exchange, and putting this wealth into “investment funds” which are seldom economically invested.

The superbubble underlying these conditions is a result of the imperatives that the world economic system has bestowed upon deficit and surplus nations. Under the terms of the Bretton Woods agreement, *the IMF has the legal powers to ensure that deficit nations adjust their fiscal balances and pay their debts, but has no such ability to ensure that surplus nations accept responsibility for facilitating their own adjustment process and recycle their accumulated financial assets in an equitable and stable way.*<sup>75</sup> The IMF is unable to link global capacity with global demand. Instead, the global economy must depend on deficit nations to sustain their global demand for the surplus output of the rest of the world. It is evident that the world cannot continue to absorb the excess supply of surplus countries without ensuring greater effective demand.

The recession of 2007-09 demonstrated the weaknesses of the global financial system and the assumptions on which it was built. The dollar has been the dominant reserve currency for more than sixty years, during which period America went from being the largest surplus to the largest deficit nation in the world. With the US now mired in an enormous deficit, the dollar’s role as the strategic reserve currency is in question. It is apparent that the solution will have to be much more than the world’s central banks supporting the dollar through coordinated interventions in foreign exchange markets.

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<sup>74</sup> Traditional definitions of the monetary system also need to be expanded to include recent generations of ever-complex instruments and non-bank entities that impact monetary decision-making.

<sup>75</sup> Phillips (2007). Officially, the IMF is charged with “exchange rate surveillance,” but in practice it is allowed only to publicly identify countries that it believes are unfairly manipulating their currencies for competitive advantage. Thus, the IMF may have embarrassment powers, but it has no enforcement powers requiring violators to alter their currency policies.



The increasing interdependence of the global economy requires international policy coordination, but national interests are still determining international politics. Each national government discusses how a particular global policy will affect its own financial competitiveness and stakes out its position. Then, through the world’s different clubs—the UN, EU, G8 or G20—national representatives meet, discuss this policy, create a joint statement, and call it “policy coordination,” “international coherence,” or “regulatory harmonization.” At these meetings and in the press, world leaders agree on the need for global coordination but rarely commit to binding action and essentially do what they want when they return home.<sup>76</sup> Greater global political cohesion is necessary before a new global monetary system can be launched.<sup>77</sup> It is critical that surplus and deficit nations coordinate their policies—but as long as they are pursuing their own self-interests, they will not be able to address the world’s monetary and financial imbalances.

Even thirty years ago, the Brandt Commission was cautioning that the Bretton Woods system was designed for a different era. “The Bretton Woods international monetary system reflected the economic and political relations of the time. Since then much has changed—and the new system should reflect the changing political and economic circumstances of nations. The new international monetary system should have a pluralistic basis, in which no single political entity or small group of entities plays a predominant role.”<sup>78</sup> ... “We would like to see a more systematic and fully multilateral approach to countries in critical financial situations, rather than present ad hoc arrangements. This could include evolution of the IMF in the direction of carrying out some of the functions of an international central bank. For these and many other reasons, we welcome the many voices now added to our own calling for a review of the Bretton Woods institutions. We believe this should be an authoritative, international review which should lead to an international conference on their reform.”<sup>79</sup>

On the agenda of a new monetary conference should be the creation of a stable global currency and an international central bank that has the ability to manage that currency and also to monitor the fiscal solidity of member states. To this end, the Brandt Report called for an expanded decision-making process on international monetary policy. It declared that “a broad-based leadership should be established to manage the international monetary system, including provision for a growing role of the developing countries in the decision-making process. Such a collective leadership can be established if there are clear, fair, and explicit rules for managing the system—rules which will protect the interests of all members of the system including the weaker ones. Such rules must ensure that the Fund is not wholly administered on the basis of shareholding.”<sup>80</sup>

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<sup>76</sup> The world witnessed a recent example of globally influential decisions by individual nations that were not taken as part of a coordinated international policy. In 2008-09, politicians from the G20 nations created stimulus packages worth \$17 trillion geared for their own domestic constituents, while claiming that they were coordinating their efforts to address the imbalances in the global economy.

<sup>77</sup> The sovereign debt crises in the European Monetary System in 2010 are prime examples of why a certain degree of political union should precede monetary union. Europe has been pursuing the opposite course since it created the EMS in 1979: political cohesion has lagged behind monetary cohesion.

<sup>78</sup> Brandt Commission (1980, p. 218)

<sup>79</sup> Brandt Commission (1983, p. 95)

<sup>80</sup> Brandt Commission (1980, p. 218)

For the first time since the Brandt Report was published, there are indications of a trend in this direction. China, South Korea, India, Brazil, Mexico, and Turkey have been given small gains in voting power at the IMF, joining the G7 powers in decision-making roles.<sup>81</sup> Mervyn King, governor of the Bank of England, has proposed that the G20 become, in effect, a governing council of the IMF to help balance world growth and align global exchange rates.<sup>82</sup> French President Nicholas Sarkozy, who has been calling for a new monetary system, will be assuming the presidency of the G20 in 2011 and promises to open up the debate on the structure of a new Bretton Woods economic system.<sup>83</sup> A Financial Stability Forum has been created to help promote a new global regulatory regime.<sup>84</sup> China, Russia, Brazil, India, and other developing nations have also been calling for a new global reserve currency and monetary system.

The Brandt Commission proposed an international conference to discuss a new global monetary system. Thirty years later, it's no longer a question of if, but *when*. But what kind of monetary system is needed for the global political community now emerging and how will its responsibility be shared? Who is going to initiate this intergovernmental coordination? What changes in the balance of power will be required to represent the world's rich and poor economies in global economic decision-making? None of this is clear. What is clear is that the international monetary system is in chronic disequilibrium and needs to be readjusted through international collective action. The next round of currency volatility will very likely result in the collapse of the dollar, which will surely test its status as the world's reserve currency. If there is no effective system to replace it, the world could face a prolonged state of economic and political instability.<sup>85</sup>

Willy Brandt and his panel sounded the same note of caution in their report three decades ago. “The international community has made little headway in tackling its most serious problems—which begin in the strained system of international economic relations and result in additional burdens on many developing countries. Prospects for the future are alarming. Increased global uncertainties have reduced expectations of economic growth even more, and the problem of managing the international imbalances of payments is increasing the threat of grave crises in international finance. We have serious doubts as to whether the existing world machinery can cope with these imbalances and the management of world liquidity.”<sup>86</sup>

Yesterday's financial crisis is quickly becoming today's government debt crisis and tomorrow's international monetary crisis. A generation from now, we may all be astounded by the naive ideology and complacency which led us to think that these enormous global monetary and financial imbalances were natural and that markets could somehow adjust them. Even in 1980, the Brandt Commission was calling attention to the fact that international production was

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<sup>81</sup> Weisman (2010)

<sup>82</sup> Norman (2010)

<sup>83</sup> Bennhold (2010)

<sup>84</sup> Stiglitz (2010)

<sup>85</sup> The world community needs to plan and implement the new monetary system in advance of a global economic crisis. Otherwise, as history teaches, predatory forces could precipitate the crisis in order to manage the process and restructure the broken pieces according to their own ends.

<sup>86</sup> Brandt Commission (1983, p. 2)

outpacing the creation of a mass global market, and that this overcapacity in excess of human needs (expressed through effective demand at prevailing wages) was creating major structural imbalances and inequities. *While the adjustment mechanism of the IMF system requires deficit nations to make timely payments on their loans, Brandt insisted, surplus countries are not under any similar international obligation because there is no adjustment mechanism for recycling their trade surpluses and currency reserves.* A new global economic and legal framework is needed by which surplus nations are obliged to reduce tariffs, invest overseas, and revalue their currencies to increase demand for the exports of deficit countries and spend their surpluses back into these nations.

“Fundamentally,” said Brandt, “we require a set of measures which are designed to sustain effective demand in the world and promote an expansion of world trade. Such measures will help to ensure that deflation, balance of payments difficulties and default on debt are not widespread ... and thus help to ease bottlenecks, to create jobs through low-cost labor-intensive industry and to create the necessary social and economic infrastructure. It should provide special benefits to the low-income countries and be linked with the structural changes we propose in the international financial system.”<sup>87</sup>

Major changes in global economic institutions are needed to undertake this global rebalancing of demand and eliminate the superbubble in the global economic system. There must be a rules-based multilateral approach to adjustment which results in a greater redistribution of wealth, rather than the bilateral structural adjustment policies of the IMF which result in its maldistribution. *The Brandt Report was the first major international proposal to call for the management of world demand to generate economic output and employment through a global stimulus program for developing nations and a restructured global monetary system so that deficit nations could have access to global liquidity through an equitable, efficient, and stable process. This would require surplus nations to either revalue their currencies to increase domestic demand, or recycle some of their surpluses to increase growth in deficit countries.* The report also demonstrated how these policies would open up the means for the creation of automatic sources of international financing, reduce disparities in income, ensure adequate supplies of energy, and reverse environmental degradation.<sup>88</sup> These remain the same challenges today if we are to create a new global economic system and avoid a systemic collapse and long period of global stagnation or depression.

“We are convinced that the world community will have to be bold and imaginative in shaping that new order and it will have to be realistic in its endeavors,” Brandt asserted. “Change is inevitable. The question is whether the world community will take deliberate and decisive steps to bring it about, or whether change will be forced upon us all through an unfolding of events

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<sup>87</sup> Brandt Commission (1980, pp. 240-241)

<sup>88</sup> There was neither time nor space in this article to deal with all of the Brandt Report’s proposals for development, aid, trade, finance, alternative sources of finance, technology, energy, the environment, and the process of global negotiations. I’ve chosen to focus exclusively on the monetary dimensions of the Brandt Report because this guidance is needed now to support the changes necessary in these other important areas. Much more could be said on how a new monetary system would catalyze solutions across the entire range of sustainable development issues.

over which the international community has little control. It is the joint responsibility of all countries and people to act without further delay.”<sup>89</sup>

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