

# Time for Reorganization of the Monetary System

by Prof. Dr. Wilhelm Hankel

*Dr. Hankel is the former chief economist of Germany's Kreditanstalt für Wiederaufbau (Reconstruction Credit Agency). This paper, "Remarks on an Overdue Reorganization of the World Monetary System," was read on his behalf at an EIR seminar in Berlin on March 5. It has been translated from German by EIR.*

The whole world actually should be in agreement, that a new world financial architecture must be built. For a quarter of a century, more precisely since the blow-up of the Bretton Woods system at the beginning of the 1970s—first, the gradual decoupling of the U.S. dollar from gold (1968-71); then, the official rejection of fixed, central bank-based U.S. dollar exchange rates with national currencies (Spring 1973)—one regional currency crisis after another has broken out.

First it was Latin America, with the high point, or low point, reached by Mexico I (1982); then followed the crises in the post-communist reform countries; turbulence in the European Monetary System (EMS) at the beginning of 1992-93, after German reunification; and the German Bundesbank's imposition European-wide of interest rate escalation; the enduring crisis in Russia, Japan, and the developing sector; Mexico II; and the unexpected collapse of the, so far, most successful threshold countries of the globe, the Far Eastern Tigers of the first and second generation, from Korea to Indonesia, which began in 1997 and still has not ended. New crisis candidates emerge all the time, from Argentina to Turkey.

Even though it has been possible up to now, more or less to manage these partial crises, and to avoid a total collapse of the world economy, such as occurred after 1931, the situation is becoming more acute. In the economy and financial system of the United States, a brand new crisis is building up, which could have dramatic consequences for the world economy, and world financial and monetary system.

In recent years, astronomical sums of vagabond, highly mobile investment capital have concentrated on diminishing, supposedly safe-haven currencies, and so-called good addresses. The result was a permanent flight upward of the secure, supposedly hard world currencies, the U.S. dollar and the pound sterling, as well as the Swiss franc at the top—as well as an irrational overvaluation of the stock and financial markets in the leading centers of the world.

In 1929, one day before "Black Friday," the capital value

of the Dow Jones Index stocks reached 80% of the U.S. Gross National Product at the time. Now, the capital value of the Dow Jones represents 140% of today's GNP in the United States. As was the case then, all that is required is a small rise in interest rates or bond yields, and the whole house of cards of the bloated stock market will fall apart, with terrible results for the security of banks, currencies, investments, and jobs. In place of the wild stock-buyers of the 1920s, who speculated with credit, the equally wild hedge funds and traders of the international big banks, who also speculate with incredible credit leverage, have long since entered the scene.

No one can guarantee, that this time it will be easier than 70 years ago, to avoid a global depression, triggered by a stock market crash. And, as was the case then, it would be followed by a global political crisis, which could seriously endanger world peace.

The "old" Bretton Woods system broke apart as a result of its built-in inflationary mechanism. It forced the participating nations to import unwanted inflation, through purchase of dollars at a fixed rate. Thus the "old" Bretton Woods fell apart because of the opposite defect that its predecessor, the gold standard, had. The latter forced partners who were in deficit, and who were losing their gold reserves, into a deflationary adaptation, through tight money and rising interest rates—without taking into consideration their internal economic and employment situation.

The gold standard broke down due to its rigidity, and the Bretton Woods system, due to the weakness of its adaptation process. One had a deflationary bias, the other, an inflationary one.

The "non-system" of floating, market, or speculatively valued exchange rates, which has existed since the 1970s, has not achieved any of the goals proclaimed by its inventors or supporters. On the contrary: The flight into exchange-rate adjustments facilitated the maintenance of external current accounts as well as internal budget deficits, while monetary insecurity and escalating financial risks narrowed planning and investment horizons.

Never were so many goods ready to be traded worldwide, and never were so many national companies—even medium-sized and small—oriented to the world market. Yet, much more than the goods markets, it was the money and financial markets that were denationalized. The financial system, far more than the real economy, is "globalized." And the financial world is split: into a regulated sector at home and a deregulated one beyond the country and currency borders. There, a completely new and flourishing "duty-free finance capitalism" came into being, which gained its attractiveness and permanent power from all those crises, catastrophes, and currency risks somewhere, sometime, in the world.

The global financial economy in the last decades—because of its systemic instability—had produced a considerable arsenal of market and technical banking innovations to allocate financial risks of single companies or investors (roll-



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over and syndicated credits, futures contracts, derivatives, etc.). However, with this, the worldwide capital markets became even more short-term and volatile. The current “non-system” is, like any other money and credit system without a central bank, “inherently unstable” (Walter Eucken). That is, it may protect single protagonists, large and small investors who give up their individual risks, but only at comparatively high costs. Others pay the price for the overall risk — the uninsured, those who do not engage in capital flight, the less clever, those who trust the system, the country, and its policy. For them, global, deregulated finance capitalism does not grant any insurance. On the contrary: It socializes its losses!

In a certain sense, the union of worldwide stateless financial markets functions like a “privatized Bretton Woods,” with the U.S. dollar as its commercial leading currency—only it is more unpredictable and unregulated. The tough competition among the many creditors (banks, capital markets) for customers throughout the world, draws in the weak and deficit-ridden states as well: these in particular, since they are grateful customers, who usually pay extremely high interest and risk premiums (LIBOR-plus). The system misleads them into excessive (and much too short term) foreign indebtedness, instead of urging them to maintain current account and budget discipline. The bridge loans are, however, immediately cancelled, once early signs of macro- and microrisks appear in the debtor country. The debt crises chase one after another, and let one debtor nation after the other make a hard landing, with disastrous consequences for the living standards, social status, and future of the population. Yet, the crisis hits back, and does not let itself be localized in the interconnected world economy: Markets and customers fall away, exports and foreign investments stagnate; world trade is reduced to trade among the still wealthy and financially viable; competition takes on ruinous forms, and the world economy is transformed from a “welfare machine” (John Stuart Mill) into an industry eliminator and a job killer.

Seen in this light, privatized and deregulated financial globalism inherited the worst of the gold standard, as well as the worst of the “old” Bretton Woods. Financially unregulated globalism goes hand-in-hand with devastating impoverishment and income deflation in poor countries, and fully unjustified asset inflation in rich countries. What results from this is the following: capital flight out of all parts of the world, which concentrates on ostensibly “secure” currencies and asset investments, making of the next “Black Friday” only a question of the date.

## **Basic Points of a New Ordering of The World Monetary System**

In considering the reorganization and new ordering of the world financial and monetary systems, one must always keep in mind that the world monetary systems of the past were children of a catastrophe. The “father” of the gold standard was named Napoleon, since his European wars left behind monetary chaos. And one could say that the “father” of the Bretton Woods system, was named Hitler, since his Second World War led J.M. Keynes in 1941-43 to present his “Proposals” for the postwar period, characterized by a full employment government policy.

Keynes’s proposals for Bretton Woods still constitute a weighty contribution to the new ordering of world finance. He defined three “essentials” for the reliability of a globally composed and crisis-proof monetary and credit system:

1. A “clearinghouse” for all nations, which is the highest facility for refinancing the national central banks which have pooled their reserves with it, and have opened an account.
2. A monetary and accounting unit, reserved for the money transfers of the central banks with their highest facility, the “bancor,” which corresponds to today’s Special Drawing Rights (SDR). However, this inter-central bank money—as distinct from the euro—was not to replace any national currency, but was solely (as had been gold earlier) to serve as a reference basis and conversion factor for the exchange rates. Each country kept its own currency, interest rate, exchange rate, and central bank.
3. An adjustment process which was to be “symmetrical” for debtor and creditor nations, and equally binding. An international legal norm had to be created, which would accord all world economic nations, and especially the weakest among them, equal rights.

As Friedrich List rightly stressed, the priority must lie with the internal, domestic economic development of the participating nations. If one had respected these basic points, perhaps the “old” Bretton Woods would have survived.

It is at least as urgent to return to “ordered” world monetary relations, from national and European standpoints. Globalization means, essentially, that the unity of the state and monetary areas is broken—the monetary areas “outgrow” the

national (or soon, perhaps, even the European) state area. The global market withdraws from the national (or European) regulatory authority. Formally, politics still has its instruments, but they are truncated, or have lost all their power. What is exchange rate policy supposed to be, if the currency valuation follows the influence of subjectively steered capital movements and profit expectations? What are interest rate and economic policy supposed to be, if international interest rates determine national rates, and the international economic climate determines the national? Even the freedom of national budgeting tends to be nullified, if state deficit spending, aimed at economic and employment policy, is being countered through shifting portfolios (capital flight), through interest hikes and currency devaluation.

### **‘Solutions’ That Are Not Solutions**

The free and unregulated international or transnational financial market raises the constitutional question: How is the coexistence of a stateless global economy and nationally regulated economic systems still possible at all? Must the nation-state—with its democratic structure and legitimation—die out, because we neither have nor want to have a world state? If monetary areas and state areas—due to monetary policies—are separated, territorial regionalism offers itself as an apparently pragmatic solution: the perhaps not political, but economic and monetary integration of states that have become too small, into a “large” economic and monetary union. For example, the European Union and the euro.

Such proposals are more attractive on the drawing board than in reality. as the European Monetary Union (EMU) proves:

1. The European economy does not exist, but rather is constituted by 11 different state and fiscal areas, with varying productivity. The social state is “wedded” to the national territorial state, something it seems to have just now realized. Social systems, as well as wage policy, are defined as national, not European.

2. National fiscal autonomy—with neither existing nor desired interstate financial transfers—aggravates its alignment with the stability goals of common monetary policy. Fiscal policy is related to the nation, monetary policy to the community: The conflict is inherent in the system.

3. Any attempt to homogenize the politically and economically non-homogeneous, through monetary policy, undermines trust in the neutrality and technical competence of the monetary leadership.

Does a currency of a community of nations—the euro—in place of ten earlier currencies, make a contribution to the reform of an unpredictable financial globalism? The answer is negative.

Of the 190 currencies registered with the International Monetary Fund [if the euro replaces ten currencies], there will

be 180; out of theoretically 17,955 bilateral exchange rates, there will be 12,720! Both are too many. In a monetary system which rests on a monetary unit of account that combines all exchange rates, for example the SDR, one would end up with 189 or 179 exchange rates. The question of whether a “synthetic” accounting unit, like the SDR, or the dollar, or the euro, should be made the basis of the monetary system, is not a theoretical question, but is rather eminently political.

Two “living” currencies, like the dollar or the euro, enable the issuers (country or central bank) fabulous “seigniorage” profits: One prints savings for the whole world, and receives in return free capital and credits, at the lowest interest rates, to finance its own deficits. As a country, it plays the role of a world central bank and lives very well at the expense of other countries and populations!

It is clear, that the U.S. has greatly profited from this market privilege of its dollar, in the post-Bretton Woods era.

### **A Monetary Order for the 21st Century**

But the world monetary order in the 21st Century can no longer be secured in this way. Neither the dollar nor the euro can assume the role of a world accounting unit. It is rather a question of whether the world community finally will agree to a neutral unit of account, with all the world’s nations participating and serving—no national currency—in which all value their currencies, but do not abolish them in its favor. This unit of account has long been in existence, at least as a monetary dwarf, the SDR.

What would be gained from such an SDR standard? First, there would be more calm, stability, and reliability in the world monetary realm. For the SDR does not fluctuate, as do the dollar, euro, or other currencies traded on the market. Second, there would be greater justice in the capital flows of nations, since, in relation to the SDR as an exchange-rate measure (and modern gold substitute), all the currencies of the world are equal and none is “more equal” than the others.

There is no way around a global new monetary order. As soon as the “big” crisis hits, there remains only the choice between sacrificing the social market economy on the altar of globalization and giving up the welfare state, or decoupling from the world economy, in order to keep both going at the lowest level, as was the case after 1931. Even Europe cannot protect itself from this alternative. There is no alternative to taming globalization through a new world monetary system, adjusted to present problems and situations.

So, philosophers must step forward, to tell the kings what to do. And here, naturally, a catastrophe will help. There would never have been a consensus for Bretton Woods, if we had not had the catastrophe of the world economic crisis, as well as the two world wars.

People will move only when they are faced with a crisis. So, I fear, we again need a collapse, which I see coming, and then we would have the real chance for a new Bretton Woods.