Reforming the International Financial System: Core and Periphery Issues and the Dollar Standard

The floating dollar standard was rooted in the aggressive pursuit of liberalized financial markets and the asymmetric integration of countries in the periphery into the international financial system. The mechanism of generating international liquidity was buttressed by the concerted advocacy of trade and financial liberalization of developing countries in the interests of preserving dollar dominance. This had enabled fragility to be exported to the periphery through two and a half decades of growing US deficits, while at the same time imparting greater elasticity to the adjustment mechanisms in the core. The debates and negotiations around refashioning the global financial architecture in the wake of the current global crisis need to take these core –periphery issues into account.

El patrón dólar flotante estaba basado en una búsqueda agresiva de la liberalización de los mercados financieros y en la integración asimétrica de los países periféricos en el sistema financiero internacional. El mecanismo de generación de liquidez internacional fue apuntalado por el apoyo coordinado de la liberalización comercial y financiera de los países en vías de desarrollo debido al interés por preservar la hegemonía del dólar. Esto ha permitido exportar la fragilidad financiera a la periferia durante dos décadas y media de déficit creciente de la balanza de pagos por cuenta corriente de EE.UU., a la vez que se confería mayor elasticidad al mecanismo de ajuste del centro. Los debates y negociaciones acerca de la modernización global de la arquitectura financiera internacional en la estela de la crisis actual necesitan tener en cuenta los asuntos centro-periferia.

Dolar flotatzailearen eredua finantza-merkatuen liberalizazioaren bilaketa oldarkorrean eta inguruko herrialdeak nazioarteko finantza-sisteman modu asimetrikoan sartzean zegoen oinarrituta. Nazioarteko likidezia sortzeko mekanismoa garapen-bidean dauden herrialdeetako merkataritza- eta finantza-liberalizazioaren babes koordinatuarekin zurkaiztu zen, dolarraren nagusitasuna babestu nahi zelako. Horri esker, finantza-hauskortasuna kanpoaldera esportatu ahal izan da AEBetako kontu korronteagatiko ordainketa-balantzak gero eta defizit handiagoa izan duen bi hamarkada eta erdiko aldian; gainera, aldi berean, malgutasun handiagoa eman zaio erdialdea doitzeko mekanismoari. Nazioarteko finantza-arkitekturaren modernizazio orokorrari buruzko eztabaida eta negoziazioek, gaur egungo krisiaren arrastoarekin, erdialdeko eta inguruko gaiak izan behar dituzte kontuan.

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INDEX

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1. REFORMING THE INTERNATIONAL FINANCIAL SYSTEM: CORE AND PERIPHERY ISSUES AND THE DOLLAR STANDARD

The financial crisis that has engulfed the global economy lays bare the contradictions of the international financial system where liquidity is generated through the growing debt of the key currency country –the floating dollar standard. It has at the same time reopened the debate of the reform of the international financial architecture and the possibility of a new Bretton Woods negotiation.

The shadow of the Great Depression and the debilitating trade wars and the volatile capital flows in the inter war period shaped the new financial system that was forged after the Second World War under the First Bretton Woods negotiations. Similarly the US response to the stagflationary crisis of seventies paved the way for the "floating dollar standard" after the Bretton Woods system was dismantled. The current crisis is, once again, a moment when the international monetary system is facing the possibility of far reaching changes. Specifically, it has raised the prospect of the end of floating dollar standard. The critical issue is what the contours of the new financial order that is erected on the debris of the current crisis would be. Does history provide us any lessons for shaping an outcome that fosters stability and development?

In this paper I shall argue that the floating dollar standard was rooted in the aggressive pursuit of liberalized financial markets and the asymmetric integration of countries in the periphery into the international financial system. The mechanism of generating international liquidity was buttressed by the concerted advocacy of trade and financial liberalization of developing countries in the interests of preserving dollar dominance. This had enabled fragility to be exported to the periphery through two and a half decades of growing US deficits, while at the same time imparting greater elasticity to the adjustment mechanisms in the core.

The debates and negotiations around refashioning the global financial architecture, in the wake of the global financial crisis, need to take this these core –periphery issues into account. More critically, the current conjuncture provides an opportunity to restructure the international payments mechanism so that developing countries have a greater scope to refashion the international payments system in a manner that is more conducive to independent development projects.

The next section explores the mechanisms underlying the floating dollar standard and highlights its basic contradictions. A broad overview of the impact of the implosion of the financial system on emerging markets is presented in the following section. In the final section some lessons are drawn for the agenda of reform of the international financial architecture.

2. THE CONTRADICTIONS OF THE FLOATING DOLLAR STANDARD

The US has been acting as the banker to the world under the floating dollar standard. The mechanisms of financial intermediation however depend on the triangular patterns of adjustment with the periphery that allows USA to borrow from surplus countries like China and pass the burden of deflationary adjustment shocks to peripheral debtor countries (Vasudevan 2008, 2010). In its role as a global financial intermediary the US has been imparting enormous liquidity to the international monetary system. Kindleberger (1981, 1996) and Desprez et al (2000) had argued that the cost of provision of this 'international public good' is borne by the lender of last resort – the source of offsetting countercyclical capital flows. One aspect of this cost might be the loss of international competitiveness and the emergence of trade deficits. These growing deficits need not precipitate deflationary adjustment in the hegemon, with consequent spiralling effects on other core countries. The historical evolution of the floating dollar standard has allowed the US to generate liquidity by passing the burden of adjustment to the developing countries in the periphery (Vasudevan 2008, 2010).

This includes surplus countries in the periphery (that are not competing with the dollar as international money) whose export led growth strategy weds its economy closely to the appetite for imports of the US economy. The newly industrialized economies of Asia (in particular China, Korea, Singapore and Taiwan), have in effect pegged their currency to the dollar, and are financing the bulk of the US deficit through active intervention. Foreign exchange risk arises out of the necessity of using dollars to denominate international trade and finance flows. The dilemma of "conflicted virtue" traps the central banks in these countries into continually intervening to buy dollars so as to prevent unwanted currency appreciation (Mckinnon 2005). This is the basis of what has been christened a 'Revived Bretton Woods' arrangement (Dooley et al 2004). The focus, in this argument, is on the impact of the portfolio choices of the central banks in the periphery in financing US's growing current account deficit.

However, the mechanisms of adjustment of the international monetary system, under the floating dollar standard cannot be explained solely on the basis of the dominance of official reserves holdings.

Private financial transactions have played, and continue to play, a significant role in the financing of the US deficit and in its net liability position (d'Arista, 2004). Debtor countries of the periphery are condemned by the "original sin" - the inability of a country to borrow abroad in its own currency- to bear the brunt of deflationary pressures and currency crisis with the reversal of capital flows at the end of the boom (Eichengreen, Hausmann and Panizza 2003 a, 2003b). The debtor countries are thus in a distinct structural position with respect to the mechanisms of financial intermediation that generate international liquidity. It can be demonstrated in a stock flow consistent framework (Vasudevan 2010) that shortfalls in the financing of the US deficit by the creditor country (through reserve accumulation) would generate an excess demand for debtor country assets generating a surge of private capital flows to these emerging markets.

In fact private capital flows to the US and to emerging markets have displayed a broadly countercyclical pattern since the seventies (Vasudevan 2009). The surge of flows to Latin America in the seventies was matched by an outflow from the US. The surge came to end with the debt crisis in 1982 when there was a net inflow to USA. The next surge in private flows to developing countries was launched after 1989, and continued till the Asian crisis in 1997. Private capital which had been flowing out of USA during the surge is drawn back into US markets. USA has been able to finance its growing deficits by generating private capital inflows in a cyclical manner. The initial phase of excess demand for emerging market assets fuels a bubble. The collapse of this bubble precipitates a shift from assets denominated in domestic currency to those denominated in dollars. Capital flight from these countries helps pre-empt speculative attacks on the dollar, performing the role of a safety valve for the floating dollar standard. In fact, the post Bretton Woods period has been marked not only by an increasing frequency of financial crises, but by a proportionately greater incidence of such crises in the emerging markets of the South (Bordo and Eichengreen, 2002).

The US can be seen to be at the apex of a pattern of triangular payments borrowing from surplus countries like Japan and China and recycling capital flows to (debtor) emerging markets of the periphery in Latin America and South East Asia (Vasudevan 2009, 2010). The proliferation of private capital flows globally, and the privileged position of the deep and liquid US financial markets at the center of the international financial system has buttressed the role of the dollar internationally. The asymmetric integration of countries in the periphery into the global financial system provides a pivotal mechanism of adjustment and helps sustain the growing global imbalances that characterises the current international economy. The International Monetary Fund and the World Bank have been instrumental in pushing this agenda of financial integration of developing countries through the conditionality associated with their support packages.

However, the mechanisms have been predicated on increasing 'financialization' and the resurgence of 'finance capital' (Dumenil and Levy, 2004). The pattern of financial intermediation has generated increasing fragility as the US is transformed not simply to a 'venture capitalist' (Gourinchas and Rey, 2005) but has in effect running a global Ponzi scheme. Instead of enabling a readjustment mechanism that redresses the growing imbalance created by the US deficits, the proliferation of finance is exacerbating these imbalances.

These imbalances have grown to the point where U.S.A. absorbed 34 % of global capital imports in 1995 and now absorbs 65% of global capital imports. US consumption spending has fuelled export demand globally. Developing countries have in turn begun supplying larger and larger shares of the US demand for commodities and manufactures and began to acquire current account surpluses by 2000. In 2000, they financed about 20% of the US current account deficit, but by 2007 their current account surplus accounted for 75% of the US deficit.

Three developments characterize the build up to the crisis in the context of the regional blocs of Latin America and East and South East Asia:

1. Both East and South East Asia and Latin America have turned from being current account deficit countries through the eighties and nineties to acquiring increasing surpluses since 2000 (Chart 1). Together the two regions accounted for about 40% of the US current account deficit.

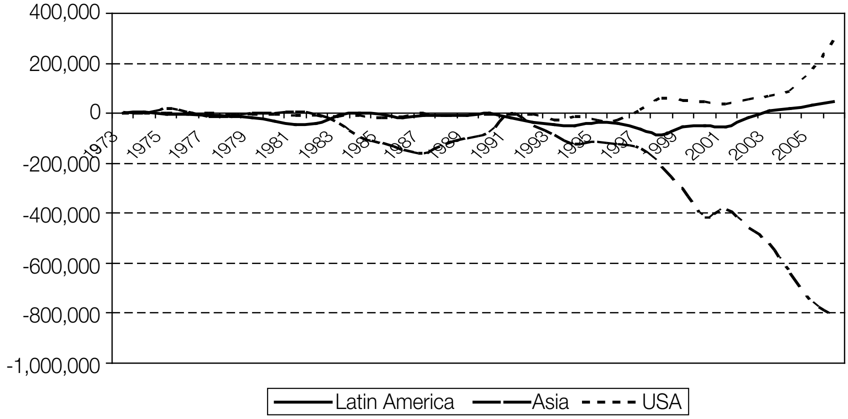
2. Both regions have hitched their economies increasingly to trade. Trade (Exports and Imports) as a share of GDP has grown significantly in both regions. In Asia the share of trade grew from 23% in 1982 to 52% in 2006. The share of trade in Latin America grew from 18% to 34% in the same period (Chart 2). The commodity boom of the past few years and the US appetite for cheap consumption goods gave a boost to the export led strategies of development. The regions have also been stockpiling reserves as a consequence of the export led strategy, and as a response to the experience of the Asian crisis. Reserves grew from 8% of GDP to 36 % of GDP in Asia between 1982 and 2006. Latin America also increased reserve holding from 5% to 11 % of GDP in this period (Chart 2). In effect resource flows were moving from the developing countries to the developed center. Reserves provide a larger cushion in dealing to capital flight fuelled currency crisis, but at the same time trade dependence leaves these regions susceptible to conditions in the export market.

3. The previous phases of inflows of private capital into the regions - the first in Latin America in between 1973-1982 and the second to both Latin America and Asia from 1989-1997 – were marked by an efflux of private capital from the US. The surge of private capital flows into Latin America and Asia after 2002 does not display this countercyclical pattern as flows to the US also surged in this period (Chart 3). This suggests that a critical mechanism sustaining the dollar standard was no longer in play. After the bursting of the dotcom bubble in 2002, speculative financial flows did not stoke bubbles in emerging markets instead they were recycled back to financial markets in the US to what Reinhardt and Rogoff (2008) characterized a developing economy that exists within the United States' own borders. This included the market for subprime mortgages which comprised the poorest and least credit worth borrowers within the United States.

Figure 1

Current Account Balances

($ millions)

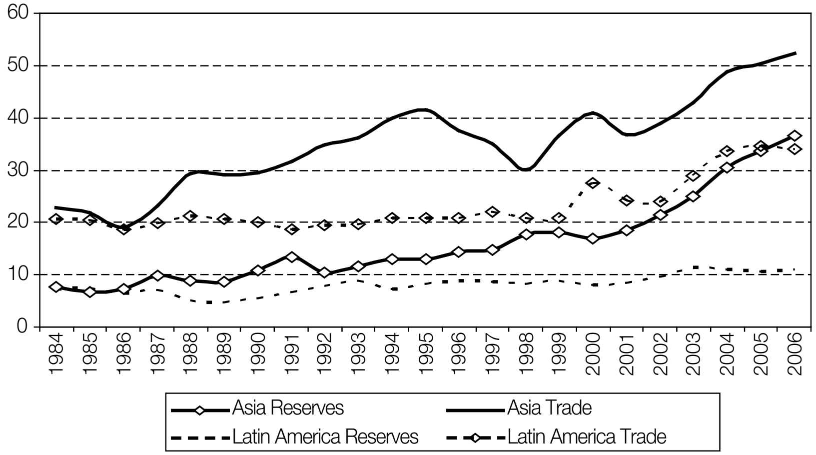


Source: GDF online.

Figure 2

Asia and Latin America: Trade and Reserve Holdings

(% of GDP)

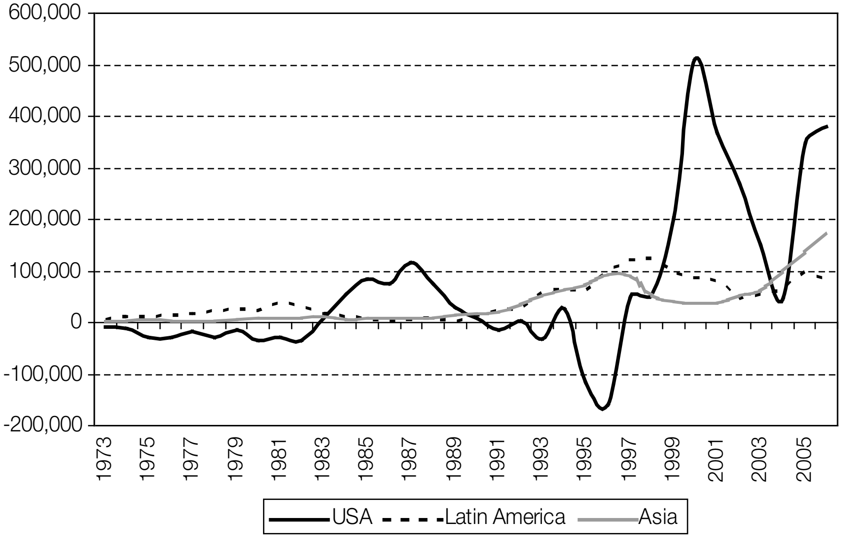


Source: GDF online.

Figure 3

Countercyclical Private Capital flows

(Thousands)



Source: GDF online.

What this suggests is that the collapse of the subprime market reflects mechanisms analogous to those that lead to the debt crisis in the eighties and the Asian meltdown in the nineties (Vasudevan 2009). As the subprime mortgage markets began unraveling, net inflows of private capital into the US dropped by about 38% from $380 billion in 2006 to $233 billion in 2008 precipitating a sharp depreciation of the dollar.

The crisis does reflect the contradictions of the mechanisms that sustained the floating dollar standard – specifically the increasing fragility engendered by the process of unfettered financialization has finally come home to financial center - the US markets. Paradoxically, the implosion of the financial system signaled by the collapse of Lehman in September 2008 sparked a flight to safety that boosted the demand for the safe and liquid US treasury bills. This sudden thirst for dollars highlights its pivotal role as "international money" precisely at the moment that the mechanisms that preserved the dollar's privileged status have begun to unravel. As the contagion effects of the crisis in the subprime mortgage markets spread across the financial system, the crisis which had initially appeared to be limited to the core of advanced capitalist countries came to engulf the developing countries. Even though emerging markets were relatively less exposed to the market for mortgage backed securities (though China for instance had begun to increase investments in agency bonds) they were deeply implicated in the integrated international financial system of the dollar standard. As the crisis engulfed USA and Europe, the surplus countries in the periphery have seen their reserves erode with the contraction in trade while deficit countries are facing the reversal of capital flows.

3. EMERGING MARKETS AND THE GLOBAL FINANCIAL CRISIS

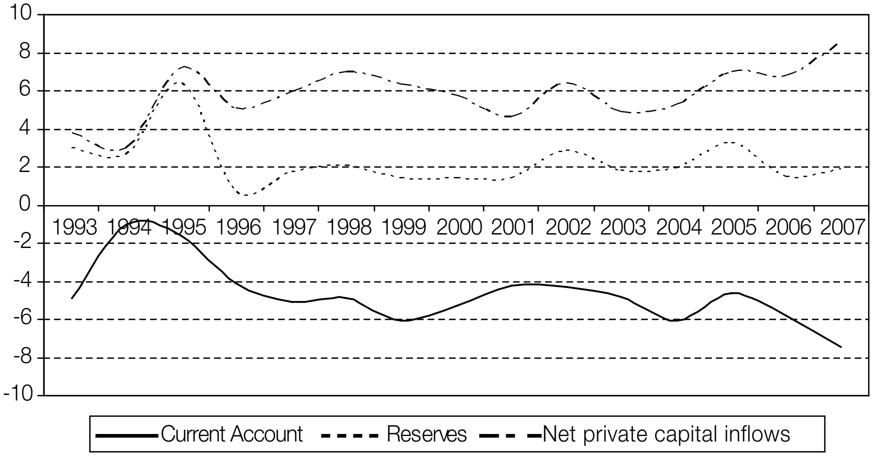
Even as capital flowed out of U.S.A. in the wake of the unraveling shadow banking system, capital flows to emerging markets had continued to rise and flows to developing countries surged in 2007 by about 40% from its 2006 level. But the seizure of the financial system after September 2008 dispelled any illusions that the emerging markets had decoupled from the advanced capitalist countries. The flight to safety (and the dollar) led to capital flight from emerging markets. Foreign investors who had continued to flock to emerging markets through 2007, turned risk averse and sought the safety of the dollar. The tightening of credit also forced US (and European) investors to deleverage their positions in emerging markets and repatriate the funds back to the domestic market. The Institute for International Finance (2009) estimates that net private capital flows to emerging markets have declined to $467 billion in 2008, half of their 2007 level. A further sharp decline to US$165 billion is forecast for 2009. Capital flight triggered currency crisis in many countries including Iceland, Hungary and Korea.

Iceland, which had a minimal exposure to subprime mortgage related markets, was one of the first countries to face the brunt of capital reversals. Iceland has seen the phenomenal growth of its banking sector as a result of liberalization and deregulation. Total assets of banking sector rose from 96% of GDP in 2000 to 800% of GDP in 2006. The majority of banks' revenues originate outside Iceland. Of the three large banks (Kaupthing, Landsbanki and Glitnir) that dominated the banking sector - - roughly half of Landsbanki's assets and two-thirds of the assets of Glitnir and Kaupthing were located outside of Iceland. Given that about 80% of all assets and 85% of all liabilities were denominated in foreign currency and that two thirds of their funding comes mainly from the international wholesale markets the sector was ripe for picking. The unfavorable current account balance (16% of GDP in 2007) and the significantly negative net international investment position (about 120% of GDP) compounded the fragility of the country (Baldurrsson and Portes, 2007; Buiter and Sibert 2008). The ripple effects of the credit crisis devastated the Icelandic banking sector, pushing the economy to the brink of collapse as the krona plummeted.

Eastern Europe was also vulnerable. While the region as whole had current account deficits amounting to about 7% of GDP, the current account deficit had widened to as much as 21 percent of GDP in 2006 in Latvia, and around 10–16 percent of GDP, in other Baltic countries and in Bulgaria, and Romania. Reserve holdings for the region have been around about 2% of GDP through the past few years (Chart 4). The region had also witnessed a huge inflow of private capital flows which grew from 5% of GDP to nearly 9% of GDP by 2006, as these transition economies boomed. The Baltic countries (Estonia, Latvia, Lithuania) had about 67% of their foreign exchange loans denominated in foreign currency while the share for

Figure 4

Eastern Europe: Current Account Balances, Reserves and Private Capital inflows

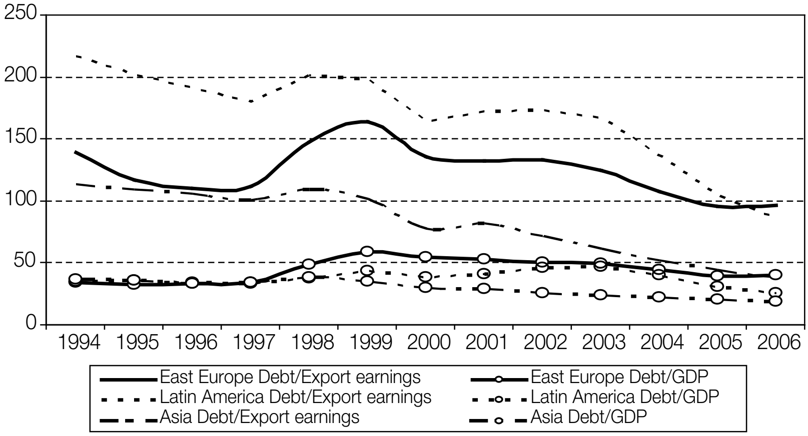


Source: WEO database.

Figure 5

External Debt: Latin America, Asia and Eastern Europe

(%)



Source: GDF online.

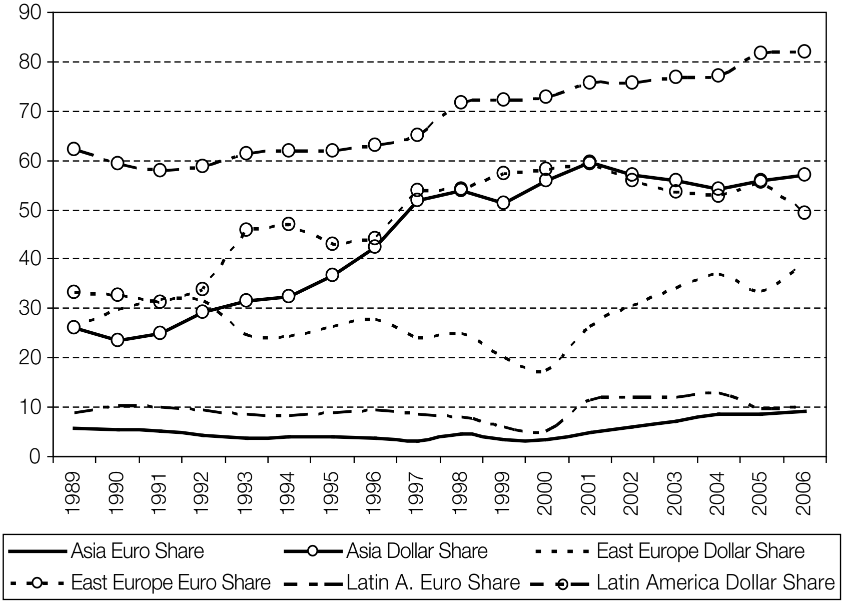
Central European countries ((Czech Republic, Hungary, Poland, Slovak) had 29% and that for the rest of Eastern Europe (Bulgaria, Croatia, Malta, Romania, and Turkey) was about 39% of their loans denominated in foreign currency (IMF 2007). Compared to Latin America (with 18% of loans denominated in foreign currency) and Asia (with 6% of loans denominated in foreign currency) the region was susceptible to capital flight and currency crisis. The debt indicators for the region were another warning sign. By 2006 the debt to export earnings ratio (96% of GDP) and the debt to GDP ratio (40%) had surpassed that of Asia and even Latin America (Chart 5).

Eastern Europe was in the classic position of the debtor emerging market that had been the safety valve of the floating dollar standard and parallels have been drawn to between the crisis unfolding in the region and the Asian crisis in 1997. However, the region is more closely connected to the European Union and the Euro Area compared to Latin America and Asia. While the share of dollar denominated debt in the region is still higher than that of euro denominated debt, the latter share is higher compared to Asia and Latin America (Chart 6). In 2006 the dollar share of long term debt for emerging Europe (49%) was much lower than that for developing

Figure 6

Currency Composition of Reserves

(%)



Source: COFER.

countries as a whole (62%) while the euro share of debt for the region (39%) was higher than that of developing countries (18%). The crisis has sparked talk of embracing the euro as a way of protecting the economies in this region. This does not imply the strengthening of the euro's challenge to dollar dominance. The European Union, which faced recession and the strains of diverging sovereign bond yields, initially balked at extending support to Eastern Europe. As the crisis sharpened, threatening over exposed banks in Western Europe, the EU finally agreed double the available bailout funds for non euro-zone countries in coordinated efforts with the IMF.

Iceland, Hungary, Ukraine, Pakistan, Romania, Belarus, Latvia and Serbia had to seek assistance from the International Monetary Fund (IMF) which had so far not played any significant role responding to the unfolding crisis. Turkey Estonia and Lithuania have also been negotiating loans. The IMF had by February 2009 extended support of about $ 55 billion to these countries tied to the familiar package of fiscal tightening and monetary austerity that involve freezing public sector wages, pensions and other social transfers ostensibly to improve government finances and attract foreign investors. Romania got about $26.9 billion in return for severe cuts in public spending and wages, Latvia has to cut its fiscal deficit from about 12% to 5% in return for the $2.4 billion IMF rescue. The $16.5 billion emergency lending to Ukraine imposed the binding condition of a balanced government budget The second tranche of the assistance has been delayed over these conditionalities and because of Ukraine's resistance to the IMF demand that it revokes the additional duty of 13% on " non critical" imports that the government recently instituted.

The unfolding crisis did not however leave the "surplus" countries in Asia and Latin America unscathed. Their economies were geared towards exports and they are not immune to speculative capital flows. The bursting of the commodity boom (after the Lehman collapse) and the buildup of recessionary forces in US and EU had a direct impact on the current account surpluses of primary good and manufacture exports of developing countries. Russia's reserve holdings for instance fell by 19 percent (to $485 billion) in the 12 weeks through Oct. 31, and were down to $427 billion in January 2009. Korea, Brazil, Singapore and Mexico all saw their reserves erode. China has faced a steep fall in its export earnings. The US extended its swap facilities to these countries to the tune of $30 billion. The IMF also announced (in November 2008) new Short-term Liquidity Facility that would provide "no strings loans", of as much as double the quotas for three months, to countries that were deemed to be "good performers" facing temporary shortfalls in liquidity. To qualify for such access, the fund said a nation would need to have low inflation, moderate levels of foreign debt, small current account deficits and sound public finances The changed situation of qualifying countries (especially those in Asia and Latin America that have suffered the stigma and stringent conditionality associated with IMF loans in the past) is evident in the fact that this special facility had no takers.

The IMF recently (March 2009) renamed this facility the Flexible Credit Line, extending the loan period to a year and removed the limits on the amount that can be borrowed in an overhaul of its lending framework. One plank of this revamping is use of pre-set qualification criteria (ex-ante conditionality) rather than on traditional (ex post) conditionality as the basis for providing countries access to the new Flexible Credit Line. At the heart of the qualification process is an assessment that the country has very sound economic fundamentals and institutional policy frameworks and a strong economic track record. However, the IMF has also been spurred by the growing strains in eastern Europe to double credit limits for economies with weaker "fundamentals". While reaffirming its commitment to "structural reforms" as integral to Fund-supported programs it will now monitor the implementation of structural policies in these programs in the context of program reviews, rather than through the use of structural performance criteria.

What the overhaul amounts to is a two tier lending framework with differential conditionality and terms. The "no string loans" target "strong performers" like Mexico, Peru, Chile, Brazil, Singapore, South Korea and Taiwan. The fact that relevant criteria for the purposes of assessing qualification this arrangement includes "a capital account position dominated by private flows and a track record of steady sovereign access to international capital markets at favorable terms" suggest that the basic neoliberal paradigm that was responsible for the asymmetric assimilation of these countries into the international financial system is not really being rethought in the wake of the crisis. The relaxation of conditionality for the group of countries that meets this neoliberal yardstick for sound fundamentals is an acknowledgement of their changed status. Conditionality would continue to be imposed on countries that do not yet meet this neoliberal yardstick and progress in implementing "structural measures" still remains critical to keeping the program on track.

The changed geopolitical landscape underscores a growing imperative to bring the stronger emerging economies into the governance structure. As the Anglo-Saxon model of financial capitalism is falling into disrepute the political leaders in developing countries have acquired a handle to negotiate a more democratic restructuring of the international financial system. The IMF has been hampered by its limited resources in playing a major role in the current crisis and is actively seeking to double its resources to about $ 500 billion with additional contributions from the EU, Japan and the US as part of this overhaul. The expansion of the resource base would hinge critically on contributions from China and Russia. This imperative has opened the debate on the structure of the IMF, in particular the concentration of voting rights with the US and Europe. If China and Russia are to contribute an augmented resource base for the IMF they would expect greater voting in the IMF. China is in a sense locked into dollar holdings by a "balance of financial terror" - selling off its mountain of treasuries would precipitate a crash of the dollar and a collapse of its (dollar) asset base. However, the growing debt burden of the US and the glut of treasury bills as a consequence of the financial rescue efforts of the US Federal Reserve- Treasury threatens to undermine this uneasy balance. The governor of the People's Bank of China (PBC), Zhou Xiaochuan,(2009) in a much publicized speech pointed to the urgent need for an international reserve currency that is disconnected from individual nations eliminates the inherent risks of credit-based sovereign currency, but also makes it possible to manage global liquidity.

The United Nations panel of experts on the reform of the international monetary system (United Nations 2009) on the other hand recognizes that the current crisis was fostered by a flawed understanding of the functioning of markets. This flawed understanding contributed to the drive towards financial deregulation and is the basis for the package of structural reforms that the IMF espouses. The UN panel points to the asymmetries in global economic policies—countercyclical policies are pursued by developed countries, while most developing countries are encouraged or induced to pursue pro-cyclical policies (United Nations, 2009).

Going beyond the overhaul of surveillance and regulatory mechanisms the UN panel also placed on the table a proposal for a new global reserve- based on an expanded SDR, with regular or cyclically adjusted emissions calibrated to the size of reserve accumulations as a means of addressing the contradictions of a single currency reserve system that fostered the growing global imbalances. The proposal of the UN panel and that of the chairman of the PBC both draw on the Keynes Plan – the proposal that Keynes put forward during the Bretton Woods negotiations. The deflationary spiral and the collapse of multilateral trade and capital flows in the wake of the credit crisis is reminiscent of the crisis of the inter war period that propelled the earlier negotiations. The debates of the sixties and seventies when the Bretton Wood System was unraveling are also relevant.

4. **LESSONS FOR REFORMS**

Keynes (1980) had argued that the gold standard was not a self adjusting system. It was vexed by an intrinsic deflationary bias arising from the fact that adjustment while being voluntary for the creditor or surplus country was compulsory for the deficit debtor country. Further, he argued that a deficit country was generally small and weak in relation to rest of world, so the adverse impact of deflationary adjustment was greater. The solution to the inherent deflationary bias of the mechanisms of international adjustment lay in finding a means of making the creditor countries take the chief initiative, and bear some of the burden for adjustment. His proposal for an International Clearing Union and the *bancor* sought to get around the perceived problems of the gold standard through a system of international credits, so that trade was not limited by the amount of gold, but regulated through an elastic supply of the *bancor*. The substitution of a “supranational” credit mechanism in place of hoarding in the international arena would fuel international expansion. Keyne’s conception was in essence a means to garner the benefits of the elasticity of a credit based international monetary system while at the same time transcending the narrow political constraints of a system based on the monetary liabilities of a single hegemonic country through the establishment of a supranational clearing union. This conception informed the plan Keynes put forward during the Bretton Woods negotiations.

The actual outcome of the Bretton Woods negotiation served to establish the dollar as a key currency (Helleiner 1994). Triffin (1968) had pointed to the inherent contradiction in this key currency system. The key currency country needed to sustain an external deficit in order to play it role in providing international liquidity but these excessive balance of payments deficits would precipitate a loss of confidence and a weakening in the key currency. By the sixties the tensions of the Bretton Woods arrangement were becoming evident as the overhang dollar liabilities with the rest of the world began to threaten the dollar-gold parity.

The solution Triffin (1968) advocated was a "true international standard, calling for concerted decisions and management by all participating countries". Such an international reserve would not be limited by the ability (and willingness) of the issuer of the key currency to sustain deficits. Triffin (1968) also sought to link the distributions of reserve creation to development finance in order to address the asymmetry of adjustment burdens for debtor countries in the periphery. Hart, Kaldor and Tinbergen (1964) on the other hand proposed a commodity reserve currency that linked the global reserve currency to a basket of 30 commodities through an International Commodity Fund. This International Commodity Fund was seen as a way of providing liquidity and stability without sacrificing autonomy of policy action for deficit countries. The Triffin proposal and the Hart-Kaldor-Tinbergen proposals both addressed a fundamental flaw of the defacto dollar standard of the Bretton Woods system in a context where international liquidity in this system was still largely created and recycled by the actions of Central Banks.

The dollar crisis did in fact pave the way for the creation of a new reserve asset - the Special Drawing Right (SDR) after the Rio agreement of 1967. While the creation of the SDRs did provide additional liquidity, stricter repayment provisions muted the expansionary potential of the device, and the SDR arrangements played only a marginal role without in anyway impinging on the dollar's international role (Block 1977; Helleiner 1994). The linking of SDRs to the IMF quotas further perpetuated core periphery asymmetry.

Kaldor's (1971, 1973 [1978]) analysis of the breakdown of the Bretton Woods system focussed on the progressive overvaluation of the dollar through the fifties and sixties as a result of 'consumer led' economic growth in the US that lead to cumulative divergences in productivity and competitiveness between US and its trading partners in a pattern of vicious cumulative causation. This process he argued presciently would transform "a nation of creative producers into a community of rentiers increasingly living on others seeking gratification in ever more useless consumption with the debilitating effects of the bread and circuses of Imperial Rome" (Kaldor 1971[1978], 64). The floating dollar standard that evolved after the collapse of the Bretton Woods system was, as we have seen, firmly entrenched in the burgeoning structure of private capital flows that preserved and extended the dollar's role as the key currency.

The fundamental paradox - the contradictory conditions enabling the functioning of a key currency system remained. A key currency has to be "weak" in the sense of the external deficit of the country issuing the currency, and "strong" in the sense of investor confidence in the currency (Hart, Kaldor and Tinbergen 1964). The dollar has in fact gone through cycles of appreciation and depreciation since

1973. These movements have not however undermined the dollar's status as a key currency.

Unregulated private capital flows came to act as a parallel monetary mechanism that allowed the US to draw on the surpluses of the OPEC Countries, Japan and more recently China while transmitting the financial shocks to the emerging markets in Latin America and South East Asia. This mechanism of parallel financial flows is in a sense a privatized form of the supranational credit creation mechanism that Keynes was seeking to forge – but paradoxically it buttressed the privileged position of USA in the structure of international financial relations. The problem of "creditor adjustment" found a perverse solution in the floating dollar standard, in that the key country generates liquidity by borrowing from surplus countries in the periphery. At the same time it has been able to pass on the burden of deflationary adjustment to debtor countries in the periphery (Vasudevan 2008). Financial liberalization and the asymmetric integration of developing countries into the international financial system were integral to the mechanisms of liquidity generation under this floating dollar standard.

The export of fragility to the periphery did enable USA to continue to finance its growing deficits without undermining confidence in the dollar. However the unwinding of this parallel financial system has exposed the contradictions of the floating dollar standard, and the growing global imbalance it generated. The flight to safety that has propped up the demand for the dollar, after the collapse of Lehman, suggests that the dollar need not be displaced immediately from its role as the dominant key currency. However, the fact that much of the inflows of capital to the US are into short term US treasury bills reflects a breakdown of the mechanisms of the unregulated private capital flows that sustained the dollar standard.

The above analysis draws two lessons for the debate around the reform of the international financial architecture. The first has to do with the asymmetry in adjustment between the core and the periphery. A pattern of countercyclical private capital flows provided an adjustment mechanism for the US deficit while precipitating financial fragility in the periphery. The asymmetry has been aggravated for developing countries by the curtailment of the space to pursue countercyclical policies. The changing geopolitical balance as a larger group of developing countries transform from being debtors to becoming creditors (in particular the changed situation of countries in Latin America and East Asia) does provide a basis for refashioning the international financial system in a manner that is less asymmetric, and allows developing countries greater autonomy and protection from the destabilizing capital flows. The expansion of the swap lines under the Chiang Mai initiative is a step in this direction. China is critical is to any reform initiative and Chinese official have expressed discomfort with the present dollar standard without taking any steps that might destabilize it. The new remnibi denominated loan lines with Argentina marks a move away from the prior practice of dollar denominated foreign investment. However the fundamental source of vulnerability lies in the foreign currency denominated debt. The revival of the proposals for a new global reserve currency seeks to address this source of fragility. The UN panel of experts (UN 2009) discusses an expanded role for

SDRS while Xiaochuan (2009) points to the advantages of such a commodity based reserve currency, disconnected from individual nations as a means transcending the pitfalls of a credit-based national currency standard.

However, the reforms advocated by Keynes, Triffin and Hart Kaldor Tinbergen were designed for systems where international private capital flows are circumscribed and international liquidity is predominantly created through official central bank actions (D'Arista 2004, 2008).

The second lesson to be drawn is that financialization has generated the parallel, unregulated private channels of liquidity creation of the floating dollar standard that helped pass the burden of adjustment to the periphery. While the collapse of finance in the current crisis might enable the reconstruction of a more regulated financial architecture, better prudential regulation and controls is not a sufficient framework to deal with the dominance of finance. This remains the fundamental challenge for any agenda of reform.

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