The Transition Problem

I Introduction

This chapter identifies some points to be considered when the problem of transition from the existing situation to one in which the threat of instability no longer looms over the international financial system. Ideally, transition must be confronted collectively by a group of nations to fashion a medium-run set of policies (and “rules”) that will defuse the dangers of instability that derive from having a nearly exhausted dollar-reliant system. The transition must, then, be provided with a set of policies, principles and constraints (a system), which will facilitate those policies that the situation requires. The crucial aspect is that the vulnerability of the US dollar to financial crisis must be eliminated. To accomplish this, the United States must recognize the need for and be allowed to run current surpluses without reducing the value of the dollar to the point that it would activate the international trigger.

Once transition has been accomplished, it becomes possible to introduce a new long-run international macrofinancial architecture that does not have to concern itself with an immediate threat of instability. However, it is not possible to renounce the inherited, potentially unstable existing system and to convert immediately to a new long-run architecture. The latter will be path-dependent and will require international collaboration and agreement on principles.

II Preferential treatment for the exhausted hegemon?

One aspect of the exhaustion of a hegemon is that the erstwhile hegemon will have had both the reputation and the time to accumulate sufficient net liabilities to dig itself into a very deep hole. This aspect is
clearly applicable when the United States has managed to achieve a negative INW equal to about 23 percent of its GDP p. 13. If the transition system is to allow the United States to accept the reduction in its level of living and gradually to rebuild its INW (or to slow the rate of “excess absorption”) without generating a flight from the dollar, it is necessary to prevent the dollar from weakening excessively in foreign exchange markets. The inevitable expenditure-switch in the United States cannot, then, be achieved by a one-shot sweeping reduction in the dollar’s rate of exchange.3 In the same way, a too rapid but steady decline in the dollar over a long period would also be likely to trigger a financial crisis. A different expenditure-switch is needed. This goal can be achieved by renunciation of the level playing field in international transactions on current account during the medium-run transition period. Two possibilities are self-evident: either the United States can be permitted to subsidize exports or to levy special tariffs on imports of both goods and services. In practice a combination of the two would probably be necessary.

Recognition that protection and subsidy may be a necessary feature of the transitional system does not commit the post-transition system to the inclusion of some protectionism in the final, long-run international financial architecture.

In trying to eliminate a large obligation (to reduce substantially the size of its negative INW) over a period of years, the United States will be in a position comparable to Germany’s position in the 1920s when Germany needed to be allowed to export in order to fund the reparations payments instituted by the Treaty of Versailles. The United States must now be allowed to export to generate a surplus on current account. Some arrangement would undoubtedly require that a portion of the surplus would be earmarked for the reduction of non-resident claims.4

The combination of export subsidies and import duties may be an effective strategy always provided that a large required expenditure-reduction is imposed on the US economy. However, the subsidy/tariff measure need not match the estimated degree of dollar overvaluation. Such a rate of protection would be unnecessarily and unproductively high for many goods and services. This policy sacrifices the open global market system which the United States has pursued since the Second World War. It is testimony to the political sensitivity of such a strategy that, when the George W. Bush Administration imposed tariffs on imports of steel, the World Trade Organization found such tariffs to be illegal.5 This episode provides a prima facie case for recognizing that a great deal of the liberal features of the system in force in the very early