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Policy Options and Constraints

I Introduction

Part IV introduces the analysis to a new world of uncharted phenomena and uncertainty. For these reasons, conclusions and proposals are tentative. This lead-in chapter addresses possible approaches to the creation of a new international financial architecture and identifies some of the constraints on both policies and the structural elements of the system. Chapter 9 will address very briefly the problems of transition from the moribund system left over from the last century and the establishment of a transitional international financial architecture. Chapter 10 will offer a possible “broad brush” design for a new long-term architecture as a basis for discussion.

The evidence in support of Propositions One and Two allowed Chapter 6 strongly to support the need for international co-operation to create a new transitional system as quickly as possible. Its task will be to avert or restrain macrofinancial disruption. The development of the international financial system for the transition period is the more important task and has the shorter period of grace. It may be assumed that the long-term architecture will evolve from the transitional system in the light of the degree of dislocation that will have been experienced. It seems efficient, therefore, to start with the same group of conferees if only because members will have developed some expertise. The fact that the United States will, inevitably, have been given some preferential treatment in the transitional system, see Chapter 9, suggests that there will be a broad-based incentive quickly to develop and to confirm the new long-term architecture.

The delegates to the conclave will face problems whose scope and scale exceed any experience from a previous time. The magnitude of the
undertaking must be explicit. If crisis is to be avoided and the high degree of interdependence between the two triggers constitutes an ominous attribute of the present reality, a patchwork solution will be of no avail.\textsuperscript{1} The transitional architecture must be created almost from scratch and, to the extent that they are not derivative from the transitional architecture, so must the details and institutions of the long-term system.

The policy goal must be to eliminate the overhang of instability brought about by the threatened exhaustion of the dollar and to facilitate a crisis-free transition from the vulnerable present state of affairs to a more resilient, longer-lasting system. The transition system is essentially required to put US international transactions on an “even keel” so that both the country’s negative INW and its rate of international dissaving would be reduced to levels at which they would no longer constitute potential sources of instability. These levels would continue to be negative but of a much smaller size so that the main task of the transition period is to ensure that the United States is committed to and allowed to make positive international saving without allowing the dollar’s rate of exchange to weaken so much that foreign owners stampede to unload dollar-denominated financial assets. The critical sizes of the two imbalances are not knowable \textit{ex ante}.

Section II addresses the political economy of working towards global welfare when the necessary policies can inflict short-run damage on individual national economies. Section III considers the limits of unilateral action by the exhausted hegemon and, indirectly, the absolute need for international co-operation. Section IV addresses the need for a flexible, non-dogmatic approach to the problem of creating a new long-term architecture.\textsuperscript{2} These topics must be understood by the participants of any co-operative effort to redesign the system.

II The current dilemma

The degree of fragility of the global macrofinancial economy derives not only from the size of the US imbalances and the complete lack of experience in dealing with an exhausted hegemon, but also from the sheer lack of awareness and concern of world leaders and the potentially damaging policies, which they currently follow. The difficulty facing elected leaders of imposing harsh economic conditions on the electorate is understandable but the alternatives are very serious.

The faith of the Bush Administration in “the strong dollar policy” is based, in part at least, on a complete lack of awareness that the country’s much-prized military and scientific advantages (Kissinger, 2001) are vulnerable to a financial Achilles heel. At the same time, US economic