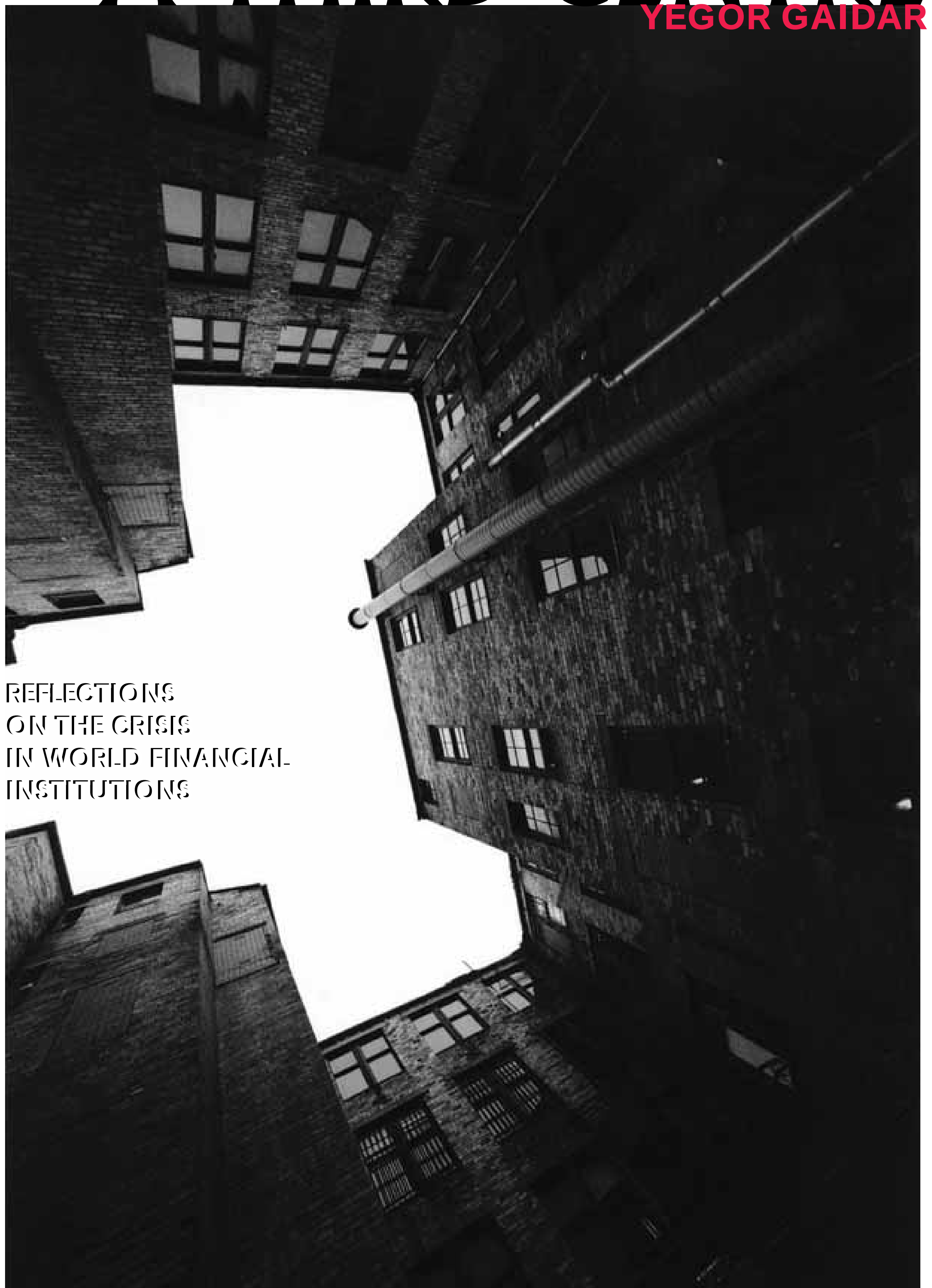
THE THIRD WORLD and A THIRD CENTRE

YEGOR GAIDAR



REFLECTIONS ON THE CRISIS IN WORLD FINANCIAL INSTITUTIONS

The modern set-up of the world's monetary system is perceived by many people (including those invested with power) as something immutable, almost God-given. But that's not how it really is. In historical terms, it has only begun to come together relatively recently — over the course of the last three centuries. During that time it has changed more than once, and only in the last fifty years has it acquired a more or less stable form.

Even this fundamental buttress of the status quo that has come about has been put in doubt by the rapidly changing nature of the modern world.

The highly complex and contradictory process which the economist S. Kuznets once aptly called "modern economic growth"[1] — the repeated acceleration of economic development in the countries of Western Europe, their colonies, and then of the world as a whole — was linked, alongside other factors, to the formation of stable monetary systems based on the gold standard. Without stable money there could be no stable growth. These systems made it possible to ensure the stability of financial contracts and a low inflation rate while allowing the monetary authorities to pursue a flexible monetary policy.

When countries' shares of world output and the price of goods are subject to wide fluctuation, the best way of ensuring predictable conditions for economic activity is for the authorities to support the stability of the monetary system. This has been the key issue in world finance in recent years.

For a long time the monetary system of the gold standard made it possible to address these issues. No matter how the configuration of the world monetary system changed, there remained the problem of how to combine the realities of a changing world with the stability of the monetary set-up. This was always the most important challenge facing those who were developing the world's monetary policy. When it proved impossible to reconcile reality and financial stability, serious economic problems arose, and sometimes even disasters such as the world wars and the Great Depression.

In recent years the world has once again found itself facing a similar challenge. It is the challenge of an economy that is global but still by no means unified, a challenge that requires completely new and substantive solutions. The conservative world of global finance cannot simply act according to precedent: the problems are unprecedented. Hence the pressing need for the world community to take appropriate decisions. Today this problem is no longer taboo in expert circles; it is being more and more actively discussed. Let us consider a few thoughts on this matter.

ON MONETARY STANDARDS

The gold standard was formulated in Britain in the eighteenth century. The French historian Fernand Braudel wrote, "The pound sterling, stabilised by Queen Elizabeth in 1560–1561, retained its true value right up to 1920, even up to 1931. The pound sterling, equivalent to four ounces of pure silver, traced a surprisingly straight line on the chart of European currencies for more than three centuries. The stability of the pound was a decisive element in Britain's greatness. Without a stable monetary measure there can be no easy credit, there can be no security for those who lend their money to the sovereign, there can be no contracts in which people can have confidence. And without credit there is no greatness, there is no financial supremacy." (F. Braudel, 'Material civilisation and capitalism in the fifteenth to eighteenth centuries', *Vremya Mira*, Moscow 2007, p. 378.)

This was one of the factors that made it possible for Britain to win wars that in many ways defined the configuration of the modern world.[2]

The idea that the gold standard was the key to stable development and economic stability became increasingly widespread in the eighteenth and nineteenth centuries.

In some cases states have rejected the gold standard and this was generally accepted practice during major wars. This was seen as a temporary measure to be used only in exceptional circumstances. Players in the market believed that after the war the gold standard and the pre-war currency exchange rate would be restored. This conviction was bolstered by the stability of the finances of Britain during the Napoleonic Wars, of the North American states during the Civil War, and of both Britain and America during the First World War.

The conviction that traditions which had been reinforced over centuries would continue to be observed in the monetary behaviour of economic players was of major importance. For this reason, at the end of the First World War, the British authorities tried to return to the pre-war exchange rate for the pound sterling.

In the 1920s the prevailing conditions for monetary policy were completely different from those after the end of the Napoleonic Wars in the nineteenth century. At that time, modern economic growth had barely started and the price Britain paid for its deflationary attempt to return to

[1] Kuznets S., *Economic Growth and Structure*, New York, W.W. Norton & Company, Inc, 1965.

[2] Kemmerer E.W., *Gold and the Gold Standard*, New York — London: McGraw-Hill Book Company, Inc, 1944, p. 49, Hawtrey R.G., *The Gold*

pre-war parity between the pound sterling and the rate of gold was a slowing-down of its economic growth. This did not, however, lead to economic disaster. The attempt to do the same thing at the beginning of the twentieth century, to restore the pre-war exchange rate of the leading world currencies in relation to gold, was one of the factors that paved the way for the Great Depression.[3]

The heart of the problem was simple: at the beginning of the eighteenth century the money supply was not strictly linked to the available quantity of gold. It wasn't a gold system, but a gold-currency system. The monetary authorities had instruments enabling them to control the money supply.

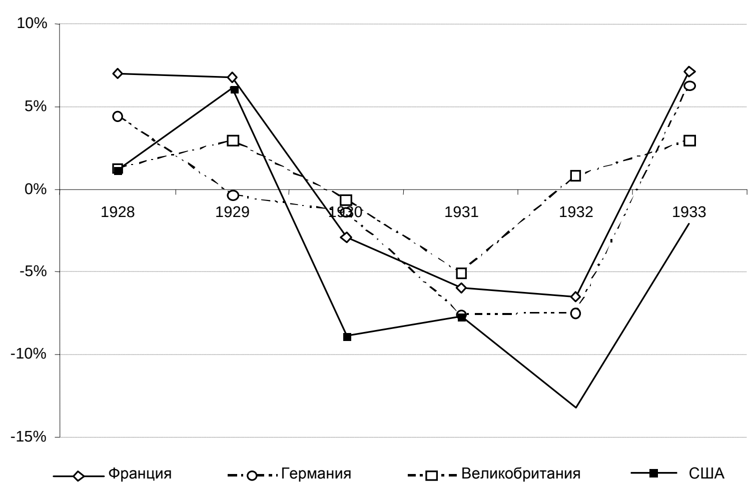
Nevertheless, one very important problem was that the rates of growth in gold extraction, the discovery of new deposits and the rates of world economic growth and demand for monetary resources were only weakly linked.

During the Great Depression the need for the leading world economies to reject the gold standard became obvious. The first to recognise this were the authorities of Great Britain in 1931. This was one of the reasons why the decline in GDP during the depression was on a lower scale in Great Britain than in other leading world economies (see Figure 1).

For the first time in many years the most developed economies in the world left the gold standard at a time when there wasn't a major war. This violated the idea of a stable financial system and created a situation of uncertainty. From the beginning of the 1930s limited convertibility of currencies for current and capital operations and the related wave of protectionism and a slow-down in the rates of world economic growth became a reality (see Figure 2).

The rejection of the gold standard made it necessary to create institutions which would make it possible to regulate world finances, to manage times of financial crisis and to ensure the predictability of exchange rates for the leading world currencies. The recognition of this fact paved the way for the Bretton Woods agreements. Without going into the technical detail of the talks associated with the signing of this agreement, the essence of the decisions taken was as follows: the United States of America (and to a lesser degree Western Europe) would assume responsibility for maintaining the stability of the monetary system, manage the institutions of the world financial infrastructure, and ensure the predictability of world currency exchange rates, low inflation and flexibility in monetary policy.

[3] Even before the Great Depression began, J. Keynes wrote: "In truth, the gold standard is already a barbarous relic... Advocates of the ancient standard do not observe how remote it now is from the spirit and the requirements of the age. A regulated non-metallic standard has slipped in unnoticed. It exists. [...]Therefore, since I regard the stability of prices, credit and employment as of paramount importance, and since I feel no confidence that an old-fashioned gold standard will even give us the modicum of stability that it used to give, I reject the policy of restoring the gold standard on pre-war lines." See Keynes, J.M., *A Tract on Monetary Reform*, vol. IV, London - Basingstoke: Macmillan Cambridge University Press, 1988, pp. 138, 140. He writes about the same issue in his classic work: "It is interesting to note that the very characteristic which traditionally made gold particularly suitable for fulfilling the function of a standard of value, and in particular its inelasticity, turned out to be the root of all the difficulties." See Keynes, J.M., *The General Theory of Employment, Interest and Money* Selection. Eksmo, Moscow, p. 226.



[Captions, L-R: France, Germany, Great Britain, USA]

Figure 1

Rates of decline in GDP, 1928–1933, in Great Britain, the USA, France and Germany, as a percentage of the preceding year

Source: Maddison A., *The World Economy: Historical Statistics,* August 2007.

The link that the two basic reserve currencies — the US dollar and the pound sterling — had with gold had weakened in comparison with the standards of the end of the nineteenth and beginning of the twentieth centuries, but was formally still the same. Central banks could exchange US dollars for gold. In a situation where more than 60% of gold reserves at the end of the 1940s and beginning of the 1950s were in the possession of the US financial authorities, this did not pose any serious problems.[4] But such a structure could only exist when the monetary policy of the country owning the reserve currency was responsible and conservative. The stability of the monetary system set up at the end of the 1940s depended on this. But it is not easy to separate monetary policy from other internal and external political problems. The US authorities in the period from the 1930s to the 1960s took on huge social obligations. The state expenditure connected with these grew many times. Opportunities to increase taxes were limited for internal political reasons. The expenditure on the war in Vietnam added to this. All these reasons led to a worsening in the condition of the USA's balance of payments and to an associated reduction in gold reserves (see Figure 3). The abandonment of the dollar's convertibility to gold became inevitable. The gold standard ceased to exist.

This was followed by an acceleration of inflation in the leading countries of modern economic growth (see Figure 4). Linked with this was an increase in the risk of financial crises in the emerging markets.[5] Such crises were difficult to predict. This applies both to the Mexican crisis of 1994[6] and to the 1997–1998 financial crisis in South-East Asia, which spread to the post-Soviet area and to Latin America.[7]

COUNTRIES AND INSTITUTIONS

The Bretton Woods system was set up at the end of the 1940s. It is named after the town of Bretton Woods in the USA, where in June 1944 an international conference on currency and financial issues took place under the chairmanship of US Treasury Secretary Morgenthau. The USSR was represented by a delegation headed by deputy minister for foreign trade M.S. Stepanov.

The conference took a decision to create the International Monetary Fund to support the stability of the exchange rates for the member countries' currencies, "by making resources available to even out their balance of payments". The fund was established with capital of 8,800 million dollars, the biggest quotas coming from the USA (2,750 million dollars), Great Britain (1,300), the USSR

[4] Bordo M.D., *The Gold Standard and Related Regimes: Collected Essays,* Cambridge University Press, 1999.

[5] The emerging markets are countries which are restructuring their own economies within the framework of the market model and are making effective use of the opportunities offered by foreign trade, acquiring technology and direct foreign investment. According to the World Bank, the five strongest emerging markets at present are China, India, Indonesia, Brazil and Russia. See Chuan Li, 'What are emerging markets?' http://www.uiowa.edu/ifdebook/faq/faq_docs/emerging_markets.shtml

[6] DeLong B., DeLong C., Robinson S. 'The case for Mexico's rescue: the Peso package looks even better now', *Foreign affairs*, May/June 1996. NY, Council on foreign relations. 1996.

[7] Weisbot M., 'Ten Years After: The Lasting Impact of the Asian Financial Crisis', Centre for Economic and Policy research, August 2007. http://www.cepr.net/documents/publications/asia_crisis_2007_08.pdf

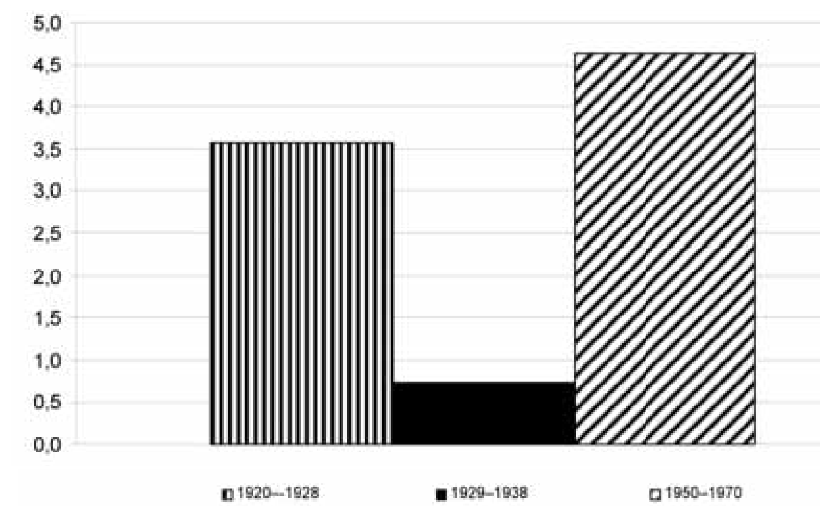


Figure 2

Average annual rates of world economic growth in 1920–1928, 1929–1938, 1950–1970

Source: Maddison A., *The World Economy: Historical Statistics,* 2008.

(1,200), China (550), France (450), India (400), Canada (300), Holland (275), Belgium (225) and Australia (200).

The contributions were expected to be in gold and in countries' own currencies. For settling the Fund's business, each country has 250 votes, plus one vote for every 100,000 dollars of its quota. The USA was to have 28% of the votes, Britain 13.4%, and the USSR 12.3%. The conference adopted draft regulations for the International Bank for Reconstruction and Development. The bank's capital was set at 10,000 million dollars. The USA's share was 3,175 million dollars, Britain's 1,300, the USSR's 1,200, China's 600 and France's 450.

"The majority of countries taking part in the Bretton Woods conference ratified the agreement on creating the International Monetary Fund and the Bank for Reconstruction and Development and these agreements came into force. The Soviet government did not ratify the agreements in question." *Diplomatic dictionary*, Moscow, 1948, p. 295.

Most importantly, it was now understood that the United States of America and Great Britain were assuming responsibility for financial stability and were willing and able to pursue a conservative monetary policy.

THE ROLE OF EUROPE

The important role of Europe and its colonies in the world economy, despite widely held assumptions, is a relatively new phenomenon in world economic history.

The relative shares of world GDP of India and China on the one hand and Western Europe on the other varied, but were comparable; right up to the eighteenth century this relationship was quite stable, and it was only then that the sharp increase in the share of Europe and the USA began. Life has refuted the arrogant and superficial idea that the East had fallen behind once and for all. The optimistic idea that Western Europe and the USA, having agreed the rules of the game, would henceforth define the parameters of the world's financial system and would be capable of fair and safe management of the world monetary system and of ensuring monetary stability, did not last long. It unravelled in 1971, when the USA discontinued the practice of exchanging dollars for gold in relationships between central banks. Since then, the US currency has been the basis of the stability of the whole world's monetary system. This is not an easy burden to bear. It increases the responsibility of the monetary and financial authorities. In the 1980s the USA had to pay a considerable amount to halt the wave of inflation and to restore financial order in the country.

Since the beginning of the 1970s the basis of the world's monetary system has been currencies, the exchange rates of which are not bound to gold. The leading world economies have open accounts for their capital operations. The relationship between the exchange rates of different currencies is difficult to predict.

RUSSIA AND THE REST OF THE WORLD

In such a situation countries which do not have reserve currencies but are integrated into the system of global financial markets are constantly running up against serious threats.[8] They do not possess world reserve currencies, they cannot manage monetary crises simply by a growth in credit and accumulating money, but at the same time they are closely integrated into the world economy, so they depend on it — and it depends on them. That's why it is vitally important for such countries (including Russia) to have effectively functioning world financial infrastructure institutions capable of fulfilling the functions of a world central bank.

In the short term, Russia has no problem with its current balance of payments and budget. But our country has experienced grave economic crises connected with the fall in prices for its most important export goods, and as before it is still dependent on the vagaries of the market for oil, oil products, gas and metals. That is why it has a particular interest in the stability of the world financial infrastructure.

On 29 September 2007, Dominique Strauss-Kahn, former finance minister of France and currently Managing Director of the International Monetary Fund, outlined in an article in the *Wall Street Journal* a programme of reforms necessary to ensure that the IMF is an organisation that represents the interests not just of the USA and Western Europe but of the whole world.

Russia's finance minister Alexei Kudrin replied in an article in the *Financial Times* (1 October 2007) that the Russian authorities are ready to support his initiatives.

However, it is customary in the financial world to pay attention in the first instance not to words but to actions. But the actions are such that a situation where the USA and Western Europe define how world finances are arranged and countries such as China, India, Russia, Brazil and Saudi Arabia are simply informed of the decisions that have been taken is not sustainable.

The world financial infrastructure put together in the 1940s was acceptable and reasonable while the United States of America and Western Europe dominated the world economy. But the situation is changing. The GDP growth rates of China, India, Russia and Brazil in recent years have been far higher than those of the European Union and the USA. And the share of these countries in world GDP is constantly growing.

In connection with this, voices are more and more frequently heard calling for the structure of bodies responsible for the stability of the monetary system[9] to be brought in line with the realities of the world economy.

THE NEW REALITY

At the beginning of the nineteenth century the obvious leader in contemporary economic growth was Great Britain. But it was not guaranteed this position for ever.

[8] Bordo M.D., *The Gold Standard and Related Regimes. Collected Essays,* Cambridge University Press, 1999.

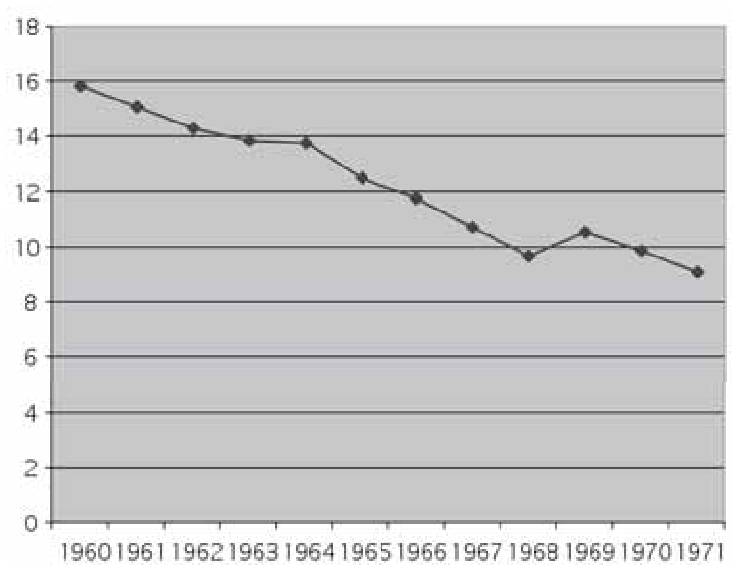


Figure 3

US gold reserves, 1960–1971 ('000 t.)

Source: IMF International Financial Statistics

[8] Bordo M.D., *The Gold Standard and Related Regimes. Collected Essays,* Cambridge University Press, 1999.

[9] One of the first to draw attention to this was Italy's former finance minister Giuliano Amato, in a speech in 2000: "The electoral system which allows the USA and Western Europe to agree between themselves on appointing people to the leading posts in the most important international financial institutions, leaving the rest of the world able only to passively observe the process, is not right and in the long term is unstable." See Kudrin A., 'The era of empires is over in the global economy', *The Financial Times,* 1 October 2007.

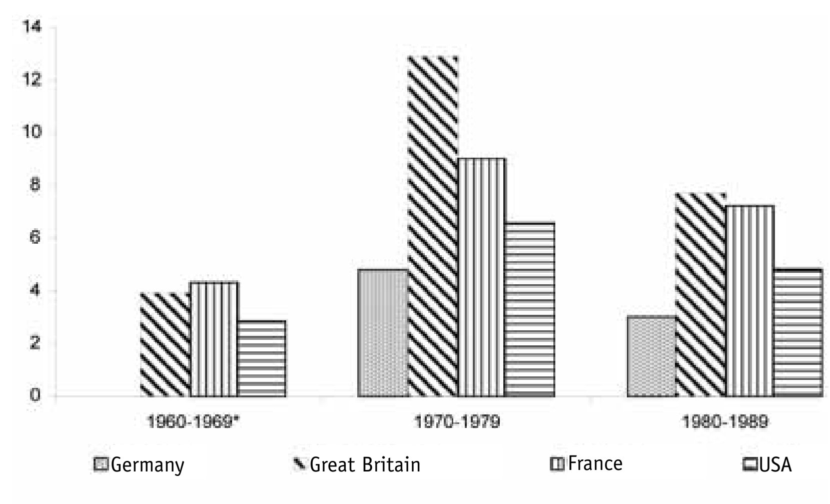


Figure 4

Average annual rates of inflation in Germany, Great Britain, France and the USA in the 1960s, 1970s and 1980s (%)

Source: World Development Indicators, 2008, World Bank

In the twentieth century the world paid dearly for the British authorities' inability to adapt to Germany's growing role in the world economy (see Figure 5).

The growth in the share of China and India in world GDP is a reality which other countries must come to terms with (see Figure 6).

If they ignore it, or try to hold on to a structure which belongs to a bygone era, it will increase the risk of a crisis and even the collapse of the world's financial infrastructure.

THE FINANCIAL AGENDA

Diplomats at all levels are now actively engaging with these issues. We won't go into the detail of their talks here. The essence of Russia's position, and that of many other countries, is simple. The IMF, the World Bank and many other influential organisations such as, for example, the FAO, should not be seen as immutable institutions enabling the monetary system and world food-production policy to be manipulated in the interests of a group of countries (or more precisely the USA and the EU). Otherwise the legitimacy and universality of world institutions are put under threat. And that promises danger for the whole world.

There are two indicators that reflect better than any other the place of any given country in the world economy. These are its share of world GDP according to currency exchange rates and its share calculated in terms of Purchasing Power Parity. The question of what should be the relationship between these indicators when working out the mechanisms of taking decisions in monetary policy is debatable. This is a matter for discussion, for seeking compromise.

THE CROUPIER PLAYS FOR THE CASINO

But these indicators are at least understandable. Any combination of them can be taken as rational by the world. When indicators whose essence is difficult to explain are included in the decision-making process, many people don't like it. For example, the rules currently in force and reinforced by recent decisions by the leading bodies of the IMF preserve an indicator such as "an open economy". What this means in the modern world is difficult to explain. What it means with regard to trade within the European Union is impossible to understand. How does trade between Luxembourg and Belgium differ from trade between the states of India or between the Ryazan and Tula regions in Russia? Nobody can answer this question. But it is precisely because of these kinds of indicator that the significance of the Benelux countries in decision-making on the important issues of world financial policy turns out to be greater than that of India and Russia together. To suppose that nobody notices this and that it suits everyone is a mistake.

In the changing world of the twenty-first century such technical inventions will not allow the situation to last in which Western Europe and the USA exert a monopolistic domination in the system for managing monetary policy. Everyone knows the croupier plays for the casino.

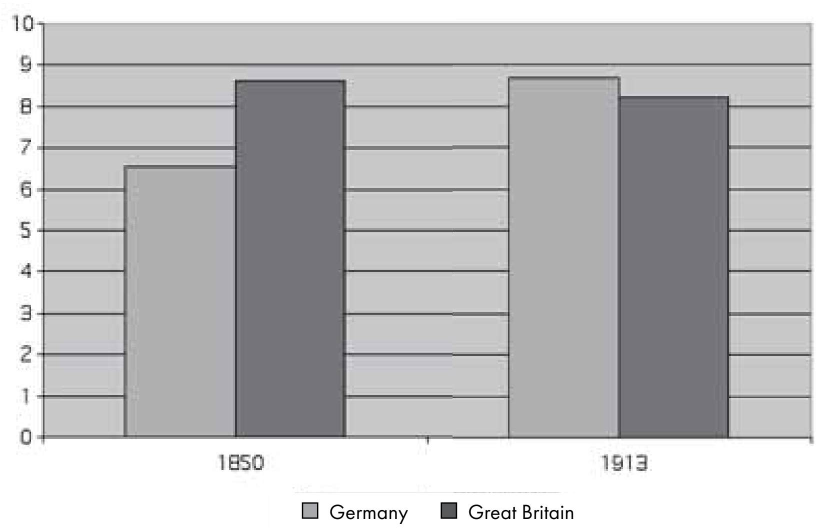


Figure 5

Great Britain and Germany's share in world GDP (as PPP) in 1850 and 1913 (%)

Source: Maddison A., *Contours of the World Economy: the Pace and Pattern of Change, 1-2030 AD*, Cambridge University Press, 2007.

Note: World GDP in 1850 was calculated on the basis of data for the main countries of Europe, North America, Latin America, Australia and the major countries of Asia.
These countries' GDP accounted for 80% of world GDP in 1950.

For us it's not even so important to know what Russia's quota in the IMF will be after the latest round of talks on reforming this organisation. There's something more important: the question of whether the system for managing world finances is perceived as just and in everyone's interests. If the answer is negative, in conditions of a serious financial crisis it will be found to be not fit for purpose.

That's why Russia was one of the countries that initiated a discussion about reform of the financial infrastructure. The heart of the Russian proposals is that there must be agreement in the end on transparent rules for the world's monetary policy. But so far it has not been possible to achieve serious progress in addressing this issue.

Many countries have begun to seek a way out of the deadlock. That is the reason why in May 2008 China, Japan, South Korea and ten other Asian states agreed to create a reserve bank, an alternative IMF, fulfilling similar functions. It was difficult for the leaders of the IMF and the American Treasury to object to the creation of such an Asian bank. The world has no lack of problems linked to the instability of financial markets. And if someone wants to share the burden of responsibility for solving them, it's difficult simply to announce that it's bad.

However, it must be understood that until recently the relative stability of the financial system was linked to its mono-centrism, the dominance of the dollar in the world reserve currencies system, and the existence of a single centre managing the world financial infrastructure.

The introduction of the euro as an alternative to the dollar as a world reserve currency changed the situation. The likely introduction of the convertible yuan for capital operations will be a further step towards a change in the monetary system which has formed since 1971.

All this confronts the countries which are not part of the American-European alliance (which controls the IMF and the World Bank) and have not been invited to join the Asian bank with a three-way choice:

to do nothing

to act in the role of junior partners in the new Asian financial centre

to create an alternative centre which would enable them to ensure the stability of their national currencies in the event of a crisis developing in the financial markets.

The words of Dmitry Medvedev, President of the Russian Federation, were highly topical when he spoke of the need to turn Russia into a country possessing one of the reserve currencies and to make Moscow one of the world's financial centres. They show that Russia is seeking a real answer to this challenge.[10]

Let us be realists, however. In the foreseeable future the rouble will not become a leading world currency like the dollar or the euro. However, with a responsible monetary and financial policy it would be possible to make it

[10] D. Medvedev. Speech at the 12th Petersburg international economic forum, 7 June 2008, St Petersburg. http://www.kremlin.ru/appears/2008/06/07/1200_type63377type82634type122346_202221.shtml

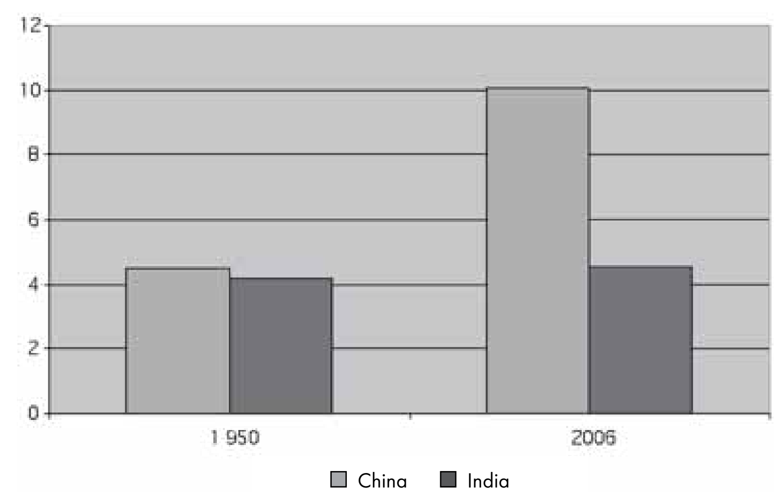


Figure 6

China and India's share in world GDP (as PPP) in 1950 and 2006 (%)

Source: Maddison A., *Contours of the World Economy: the Pace and Pattern of Change, 1-2030 AD*,
Cambridge University Press, 2007 (1950), World Bank WDI 2008 (data for 2006).

a second-level reserve currency, like the pound sterling or the Swedish krona (if we think in terms of a time frame up to 2020). This is not a simple task, but it is achievable. At the same time, even posing the question makes us reflect on Russia's position with regard to its attitude to the changes taking place in the world monetary system.

We shall not name the countries which could be participants in the creation of a third, alternative financial centre, if such a project were undertaken. The list is obvious. Such a development is not only in our national interests but also in the interests of the world community.

If we have not managed by means of talks to achieve a reorganisation of the unified financial infrastructure established in the 1940s, it would be better to have not two but three alternative centres. Perhaps then it would be easier to agree on how to coordinate monetary policy.

Of course, it would be possible, just as they did in the 1920s, to cling to the heritage of a financial system which has lost touch with changing realities. But such mistakes have to be paid for too dearly — and it is not those who make the mistakes who have to pay.

Russia has an interest in the stability of the world monetary system. Like other countries, we need authoritative and trustworthy international bodies which are capable of safe regulation at times of financial panic or a liquidity crisis, and which are prepared for constructive dialogue on the question of how to form a financial infrastructure that the world can trust. ■