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Abstract

The 2007-2008 financial crisis caused not only a dramatic fall in global output and employment but also a serious deterioration of public indebtedness for many governments, forced to rescue the banking system from failure. The crisis showed that national governments are not able to regulate the global market by means of the traditional instruments of political economy. The aim of this article is to identify new supranational instruments of economic policy. As a first step, to avoid a new financial crisis, it is necessary to understand the intimate connection between the international monetary system, founded on the dollar as key currency, and the international financial system. Only some economists were able to see the causes of the recent crisis as a by-product of an asymmetric monetary system. In this article, after having discussed the monetary roots of the financial crisis, the discussion is focused on monetary sovereignty, financial sovereignty, and fiscal sovereignty as the main economic responsibilities of a national government, to show that, today, a supranational economic government should have similar powers. An appendix (disposable on the website of the author) on "Global imbalances: A false objective of economic policy" shows how the balance of payments imposes wrong goals to national economic policies. The discussion is focused on (a) the neo-Ricardian theory of economic integration, (b) financial capital flows, and (c) the Keynesian equations of an open economy.

Keywords

international economics, international finance, international money, international political economy, international relations, political economy

The Need for a New Macroeconomic Theory

The financial crisis of 2008 cannot be considered as a traditional business cycle that the capitalist economy produces from time to time. The crisis provoked a dramatic fall in world international trade, world output, world employment, and a serious deterioration of public indebtedness for many governments, forced to rescue their banking system from bankruptcy. Charles Kindleberger (1973) considers the great depression, following the crash of 1929, as caused by the difficult transition from an international economic order led by Great Britain to a new international economic order led by the United States. The present crisis is of the same order of magnitude, but its evolution and outcome will be different because although the world leadership of the United States is declining, no other super-superpowers can replace it. The international institutions (United Nations [UN], International Monetary Fund [IMF], General Agreement on Tariffs and Trade–World Trade Organization [GATT-WTO], etc.),

created on the initiative of the United States after the Second World War, worked sufficiently well during the cold war and the two decades following the breakdown of the Union of Soviet Socialist Republics, but the international political system has now changed profoundly. Not only are new big powers, like China, India, and Brazil, willing to share with the old industrialized countries—the United States, Russia, Europe, and Japan—the power to lead the world economy but also new dramatic challenges, such as the risk of an ecological collapse of the biosphere, need to be faced. A new multipolar world is taking shape. A new political and economic thinking is required.

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Because the epicenter of the financial crisis has been located in the United States, many studies and essays deal with the U.S. economy and suggest reforms, which should be adopted by the U.S. government to avoid a new crisis and guarantee sustainable development. The implicit assumption is that the recovery of the U.S. economy will give a substantial contribution to the recovery and stability of the world economy; in other words, the United States is regarded as the stabilizer of global economy. Indeed, in the old hegemonic system, this was more or less the role of the United States—but that is the past. The financial crisis of 2008 marks a turning point: In the new multipolar world, no single country, not even the United States, will have the hegemonic power to lead the world. National reforms are not enough. We need a new world political and economic order. Only within the framework of a cooperative multipolar order, national reforms can be conceived and can be successful.

It is encouraging that some leading American economists understand the new role that the United States should play in international politics. For instance, Joseph Stiglitz, after having reconstructed the events causing the financial crisis with great accuracy, criticizes market fundamentalism—the notion that unfettered markets by themselves can ensure economic prosperity and growth—as the main cause of the United States's wrong policy and supports the idea that a better balance between the market and government should be found. Stiglitz (2010) says,

Enhancing economic performance requires improving both markets and government. There is no basis to the argument that because governments sometimes fail, they should not intervene in markets when the markets fail—just as there is no basis to the converse argument that because markets sometimes fail they should be abandoned. (p. 245)

Moreover, Stiglitz (2010) recognizes that the United States cannot promote the recovery alone but should cooperate with other countries to build a new international order, founded on a new reserve currency, as the Special Drawing Rights (SDRs) issued by the IMF, because the dollar can no longer play the role of key currency for the international monetary system. Even Fred Bergsten (2009) is very clear about the link between internal and external reforms, which should be conceived as a new “global rebalancing strategy.” Bergsten says,

By reducing the systemic role of the dollar and building up the international position of other currencies and SDRs, the United States would increase its own incentives to limit its deficits and enable other countries to add to their reserves without running surpluses. The cumulative effect would be greater prospects for international monetary stability and a reduced likelihood of future crises. (p. 36)

Nevertheless, the most explicit acknowledgment of the need for a new macroeconomic theory is put forward by Jeffrey Sachs (2009), who says, “Sustained and widespread future prosperity will require basic reforms in global macroeconomic governance and in macroeconomic science” (p. 1). The United States and all other industrialized countries should approve economic policies to increase their saving—by imposing new taxes, like the carbon tax—and invest in critical public goods, to face the challenges of climate change, higher education, public health, and world poverty. “A new strategy of economic governance, one that is structural and global is now needed, and a new science of macroeconomics must supersede the stale debate of Keynesian and rational expectations theories.” The new macroeconomic science, Sachs correctly affirms, is necessary because “bridging the divide of macroeconomics and global governance is exactly the challenge we face, both in policy and scientific terms” (Sachs, 2009, p. 8).

In dealing with these problems, I share two points of view. As a world citizen born in Europe, I consider European integration as a workshop for world integration too because the European Union (EU) is the first experiment of supranational integration. The second point of view is that of an economist trained in studying classical political economy during the years subsequent to the publication of Sraffa's *Production of Commodities by Means of Commodities*: It was the discovery and exploration of a new paradigm, alternative to the dominant neoclassical economic theory. But very soon I realized how difficult it was to understand the problems of European integration in the theoretical framework of classical political economy. It is true that in Adam Smith and Ricardo, we can find some very useful principles, such as the principle of comparative costs, to analyze the international economy. But these principles are insufficient to understand the European experience, which consisted mainly of building supranational institutions and supranational public goods, like the Common Market and the European Monetary Union (EMU). Afterward, it became clear to me that not only classical political economy but also the modern theory of international economics did not consider the problem of supranational institutions prominent. For instance, international monetary problems are analyzed as the choice between fixed and flexible rates of exchanges. The third way of a monetary union was not taken seriously into consideration until the creation of the EMU.

To find the appropriate means for the government of the global economy, the most promising starting point is Keynes's macroeconomic theory. It is true that the *General Theory* was conceived for a closed economy, but Keynes himself was obliged to work out an international institutional framework of his system, an International Monetary Union, on the occasion of the Bretton Woods conference. The challenge, for today's economists, is to renovate the *General Theory* for the government of the global economy. The challenge is twofold. We need to shape not only new theoretical instruments for a

global economic policy but also new institutions. In Keynes's *General Theory*, the institutions of the nation state—a national money and a national budget—were not even discussed; they were a common accepted heritage of the 19th century.

The Monetary Roots of the Financial Crisis

Because the financial crisis of 2008 was not followed by a dollar crisis, many economists focus their attention on the dysfunction of the American financial system. Of course, these dysfunctions exist, are serious, and should be eliminated by better regulation. But the roots of the crisis remain in the international monetary system, built at Bretton Woods as a gold-exchange standard and, after the declaration of the inconvertibility of the dollar, transformed in a dollar standard. One of the features of the international utilization of the dollar as the key currency for international transactions is that the United States can pay their imports with their national money. Therefore, the United States is not obliged to maintain the balance of payment in equilibrium and to keep a reserve currency. These privileges of the dollar caused an enormous increase in the international reserves, which rose 20 times from 1969 to 2000. They rose only 1.5 times from 1949 to 1969 (Duncan, 2005). If international reserves can be considered an index of international liquidity, it is reasonable to say that the dollar standard caused an excess of liquidity in the world because total exports increased only 5 times in volume, but 25 times in value, during the same period—from 1969 to 2000 world gross domestic product (GDP) increased 2.7 times (WTO–International Trade Statistics, 1950–2008, Appendix 1a).

Some economists were able to foresee the negative effects of the dollar standard well in advance. Robert Triffin, who in 1960 showed the inconsistencies of the gold-exchange standard and its inevitable breakdown, in 1992 labeled the dollar standard “International Monetary Scandal,” because it could “easily degenerate into a self-feeding spiral of inflationary reserve increases, since these are reinvested in the reserve centres and increase the ability of their leaders—official and private—to pursue inflationary policies” (Triffin 1992, p. 14). Triffin's (1992) analysis embodied the main causes of the present financial crisis. Indeed, we can read the recent analysis of Richard Duncan, *The Dollar Crisis* (2003, 2005), as a restatement of Triffin's point of view. According to Duncan, the Japanese crisis of 1990 and the Asian crisis of 1997 should be considered a by-product of the dollar standard. During the 1960s, Japan was able to base its industrial production and growth on its capacity to export. But during the 1980s, Japan's trade surplus increased so much that the country was obliged to accumulate international reserves (they increased by 260% between 1985 and 1988). In the same period, the internal money supply increased sharply and so did the credit supply, causing a boom in the house market and stock exchange.

All credit bubbles ultimately end in deflation because the purchasing power of the public does not increase quickly enough to absorb the surge in production that results from extended periods of easy credit. In other words, the ability of the public to buy does not increase in line with the capacity of industry to produce. When product prices begin to fall, debtors find they are no longer able to pay interest on their debt. Bankruptcies follow, credit contracts, and the economy enters recession. The Japanese bubble ended the same way. (Duncan, 2005, p. 31)

The Asian crisis of 1997 was different from the Japanese one only in some details, but the general trend was the same. In Thailand, the crisis was not caused by a trade surplus but by the surplus in financial account. Foreign capitals entered as direct foreign investments, portfolio investments in the stock market, and deposits placed in the Thai financial system. But even in Thailand, we can detect an increase in foreign reserves, in money supply and credit, and a bubble in the house market and the stock exchange. The explosion of the bubble economy was followed by a flight of capitals, a foreign exchange crisis, and a dramatic fall in GDP (about 35%, from 1997 to 2003). A similar pattern was followed in South Korea, Malaysia, and Indonesia (whose GDP fell by 55%, from 1997 to 2003).

For the United States, the increase of world reserves cannot be a direct cause of the crisis. But the excess of international liquidity worked as a boomerang for the U.S. economy, which was considered, before the crisis, the borrower and spender of last resort of the world economy (Wolf, 2009). During the last decade, the U.S. economy exploited the chance of importing very cheap goods from developing countries, mainly from China, which contributed to the mitigation of prices and wage demand. The gross domestic purchases, in the 1993–2004 period, rose by 53%, whereas GDP grew only by 46%, so that a huge current account deficit (6% of GDP, in 2006) was inevitable. The external deficit was covered by an inflow of foreign capitals coming mainly from surplus countries, especially China. The inflow of capitals helped the Federal Reserve System (FED) to maintain the low interest rate, which stimulated the boom in residential property market. Indeed, the United States

successfully absorbed much of the excess savings of the rest of the world. It has done so by promoting rapid growth of demand and, in particular, of consumption. The household sector has been principally responsible for the excess of spending over incomes. (Wolf, 2009, p. 106)

Therefore, without entering in a precise description of the financial crisis, we can understand well the remark of the UN report, according to which

The sub-prime crisis, which led to a wider crisis in credit markets, was partly engendered by an “excess” supply of liquidity and the failure of the Central Bank in the United States and some other advanced industrial countries to act to restrain liquidity and dampen the speculative increases in housing prices. (Report of UN, 2009, p. 17)

If we consider the monetary policy of the FED in the wider context of the international economy, it is easy to understand why, as Triffin said, for the U.S. policy makers it was reasonable to favor a world liquidity spree.

After the financial crisis of 2008, how can a world recovery be stimulated? It is unlikely that the United States can work again as the “borrower and spender of last resort,” and the European economy is certainly not able to replace the United States as the world engine of growth. Moreover, to avoid the collapse of the banking system, the governments of the United States and the EU were obliged to bail out some financial institutions and launch “Keynesian” plans to support internal demand and employment. The debt of the United States increased from 64.6% of GDP in 2005 to 98.1% in 2010; in EU-27, the total debt increased from 61.6% of GDP in 2008 to 73.6% in 2009 (in Eurozone from 69.4% in 2008 to 78.7% in 2009). In both economies, the rate of unemployment is well above the average of the years preceding the crisis. In 2009, world production fell by nearly 2%; the world productive capacity is underutilized. But to affirm that the world economy is depressed is dubious because China, India, Brazil, and other emerging economies are experiencing a rapid rate of growth. The index of world exports, which was 120 in July 2008, fell to 70 in January 2009 and is recovering toward the level of 100 (WTO data). The concept of effective world demand can be questioned because there are as many effective demands as there are national moneys and their sum is meaningless (to sum a depressed economy and a booming economy does not result in a full employment economy). In any case, because the problem of governing the global economy exists, it is necessary to clarify what we mean by an effective global demand policy.

We can split the problem of effective global demand into two parts. For industrialized countries (United States, Europe, and Japan) the main problem is a noninflationary recovery. Until now, the emergency plans adopted by governments were based mainly on supporting consumption demand. We agree with Sachs that, today, there is the need to support investment plans to promote social and ecological sustainable development. The age of consumerism is over. For emerging economies, one of the main obstacles to their development is the abnormal need for external reserves. As the UN Report says,

While it is rational for individual countries to “insure” against another crisis through the build-up of external surpluses and foreign reserves, doing so weakens

aggregate demand. . . . It is possible that when many countries simultaneously attempt to build up reserves the global economy will suffer from generalised insufficiency of aggregate demand—a global version of the well-known paradox of thrift. (Report of the UN, 2009, p. 21)

In the following pages, we try to single out the main economic institutions required to regulate effective global demand. Our point of view is that some of the economic institutions built within the nation state are becoming today ineffective in a global economy. Therefore, we examine the problems of monetary sovereignty, financial sovereignty, and fiscal sovereignty because some important public goods—like monetary and financial stability, international justice, and sustainable development—can be supplied only by appropriate supranational institutions. For this research, the European experience of integration can represent a useful model, even if the EMU is a very imperfect construction as far as financial and fiscal sovereignties are concerned (Defraigne, 2010).

Monetary Sovereignty

The three sovereignties are interconnected. In a closed economy, the central government is usually responsible for these three policies. In open economies, the question is more complicated. The EU is the only case in which monetary sovereignty belongs to European authorities, while financial and fiscal sovereignties belong to national authorities. The Maastricht treaty stated that the European Central Bank (ECB) has the primary duty to guarantee price stability. Monetary stability and low interest rates were considered the basis for sound national financial policies and growth. Moreover, to pursue these objectives in an interdependent economy, the EU chose a flexible rate of exchange for the euro. The financial crisis showed how fragile this construction is. The flexible rate of exchange was not a strong-enough bulwark to isolate the EU economy from the 2008 turmoil because the European banks were strictly involved in the global financial system. Now, the EMU is entering a phase of radical reforms.

These interrelationships also exist in the global economy. The international monetary system, as we saw in the previous paragraph, is the vector of international finance. Whoever holds the reins of international money and international liquidity has some objective advantage, without having the correlative duties (world monetary stability). Indeed, it is exactly this asymmetry which was brought into light by the governor of the People’s Bank of China before the G20 of April 2009. Zhou Xiaochuan (2009) affirms that the country issuing a reserve currency is “constantly confronted with the dilemma between achieving their domestic monetary goals and meeting the other countries’ demand for reserve currency . . . the Triffin dilemma . . . still exists.” For this reason, Zhou proposed to substitute the dollar as a reserve currency with

SDRs issued by the IMF. Because the reform of the international monetary system is on the agenda of the G20, the debate is open and many scholars have already put forward proposals for reforms (Cooper, 2009; Kenen, 2010; Kregel, 2009; Mateos y Lago, Duttgupta, & Goyal, 2009; Williamson, 2009). Here, let us consider the straightforward proposal of a world monetary union. Usually, the reforms of the international monetary system are discussed without clarifying this implicit point of arrival. On the contrary, at Bretton Woods, both Keynes and White, in their original plan, envisaged a world money for the future. Let us now consider the cost and benefits of a world monetary union. In the final paragraph, a transitory step is suggested.

The world has experimented long phases of stability and growth by means of a system of fixed exchange rates during the gold standard of the 19th century and the gold-exchange standard of the last century. But, as the economic theory explains, with capital mobility, a system of fixed exchange rates cannot survive. A country cannot simultaneously choose an independent monetary policy, fixed exchange rates, and free capital movements. The alternative is a system of floating exchange rates. But the experience of the last decades shows that only big economies, with important internal markets, like the United States and the EU, can afford the vagaries of a system in which, daily, capital movements are hundred of times bigger than trade transactions. For underdeveloped economies, this system is devastating. They need monetary and financial stability, to spur industrial development. A certain “fear of floating” is understandable; in some cases, “dollarization” was preferred to monetary instability. Therefore, the creation of a world monetary union is crucial for the stability of the world economy and the development of poor countries.

Of course, this decision has also some transitory costs, which should be dealt with. A monetary union involves, in the last resort, the free movement of commodities and capitals. Concerning this point, Friedrich List’s critique to free trade is well known: The German agricultural economy was supposed to protect its “infant industry” until fair competition with industrialized Great Britain became feasible. Competition is fair only among countries with the same degree of development, but in the 21st century, it is not difficult to provide sensible replies to these understandable fears (Frankman, 2002). The United States and the EU have found many policies to face internal regional problems; in the world monetary union, trade and capital mobility among countries should be considered regional problems. They can be solved if a minimum degree of solidarity exists among industrialized and emerging peoples. For instance, as far as trade is concerned, some stabilization funds, like Stabex and Sysmin created by the EU in the framework of the Lomé Convention to stabilize the incomes of African, Caribbean, and Pacific countries, can also be created within the UN. Of course, these funds should be financed by a UN budget, which at present does not exist. As far as capital mobility is

concerned, the real problem is not to avoid geographical mobility, but to regulate the behavior of foreign direct investment and multinational firms in hosting countries, to abide by local law, including minimum wages and taxation. A world monetary union can represent the starting point for a more equal distribution of income among poor and rich peoples and for the curtailing of the exorbitant power of financial capitals, today free to go into the most convenient “fiscal paradise.”

Now, let us examine the problem of global imbalances. In the world’s balance of payments, the total of surplus and deficits should be zero. If we take the 2006 accounts into consideration, just before the crisis, we can see that the EU, including the United Kingdom, was more or less in balance, the Asian countries (Japan and China included) and the oil-exporting countries showed a big surplus, while the U.S. deficit counterbalanced the total surplus. China’s surplus was 9.5% of GDP, and non-Asian emerging countries had a surplus of 5.2% of GDP. This picture confirms the role of the United States as the borrower and consumer of last resort and of emerging economies as savers and lenders of last resort—exactly the opposite of what should happen among rich and poor countries. It is the real side of Triffin’s international monetary scandal.

There is a lively debate on the causes and impacts of global imbalances (for a survey, ECB, 2010). Here, our aim is simply to show how a world monetary union could help to “rebalance” the world economy. In a single monetary area, nobody cares about the balance of payments of a city, a province, or a region. Everyday economic life shows that some regions are more developed than others, some regions offer more opportunities for investments and jobs than others, and so on. An integrated economy involves an endless improvement in the division of labor within the firms and the market; geographical imbalances are the rule, not the exception. A world monetary union, by itself, can contribute to rebalancing the world economy by eliminating the need for international reserves. If every country utilizes the same currency, as in the EMU, there is no need for foreign reserves because liquidity is supplied to the banking system, in the last resort, by the common central bank. This means that the balance of payments can no longer be exploited for political reasons. Let us consider the present imbalance between China and the United States. In 2009, China had almost half of the total reserves of the emerging economies. The United States feared a sudden stop of the reinvestment of Chinese reserves in U.S. Treasury bonds. China feared a sudden devaluation of the dollar. It is difficult to say who will win this game, which is also connected to military and power politics. In any case, the adoption of a common currency will eliminate any possibility to exploit the balance of payment for political reasons. In a world monetary union, a surplus country, like China, has no particular advantage in having a surplus in its current account; the only problem is to sell Chinese commodities in the world market. Of course, if Chinese commodities are

sold in foreign markets, “foreign money” will flow into the Chinese banking system. In the past, foreign reserves (in dollars) were an instrument of power in the hand of the central government. But if this instrument evaporates, the best way to utilize the incoming money is to use it to increase the people’s standard of living. Today, China saves 50% to 60% of its GDP. Private savings are high, even if the main share comes from corporate saving and government. Households receive a little share of total production. The share of consumption in GDP declined from 46% in 2000 to 36% in 2009. Today, the main problem of the Chinese economy is to increase the share of consumption at a rate greater than the rate of growth. That will cause a reduction in investments and the surplus of the current account (Pettis, 2010). This radical change in economic policy is certainly difficult, but it is time, for the Chinese government, to let the wage rate increase quickly and to provide better social services, even if the competitive advantages of Chinese commodities in the global market are eroded.

For the United States, a deficit country, the creation of a world monetary union is a major change. After the financial crisis, the U.S. monetary policy has to face Triffin’s dilemma anew. The recovery requires very low rates of interest, to favor home investments and consumptions, and, thanks to a devaluation of the dollar, an increase in exports. But a too strong devaluation of the dollar will lower the value of the dollar reserves held by emerging economies, which could decide to substitute the dollar with the euro or some other currency. A flight from the dollar could cause a new global crisis with dramatic consequences for the world economy. A world monetary union would eliminate Triffin’s dilemma from the roots. Not only can the dollar no longer be devalued against other currencies but also the rate of interest would be fixed, in the world market, by world monetary authorities (as explained in the last paragraph). These changes would help the federal government to spur the reforms that the American economy needs. The household rate of saving was only 2% of GDP before the crisis; during the crisis, consumption decreased, but “the rapid rise in household saving was offset by an even more rapid rise in public borrowing” (Stiglitz, 2010, p. 189). The money borrowed by the government—required to support internal demand—came mainly from abroad. The U.S. economy cannot live forever consuming more than its income. In a world monetary union nobody needs dollars as international reserve and the U.S. government cannot rely forever on surplus countries to finance its Treasury bonds. Of course, the American financial market will remain for years to come the strongest market of the world, and many capitals will look for investments in the American market. But the U.S. Treasury bonds should compete with other public bonds in the world financial market, where the risk of sudden devaluation is removed. Therefore, the U.S. budget should be rebalanced and should respect, more or less, the same rules of the European Growth and Stability Pact.

Contrary to what is commonly believed, the loss of national monetary policy is not a tragedy. The European governments are learning that they should spend the money collected by taxing their citizens more carefully. It is a problem not only of public morality but also of utilizing the public budget to promote the investments and the infrastructures the society and market need. The American economy must face the challenge of a new model of development. The American economy consumes too much energy and pollutes the atmosphere too much. In the past, the negative American stance on the occasion of the UN conferences on climate change was one of the main causes of their failure. Because citizens’ consumption models change slowly, the government should favor more social investments with appropriate reforms.

Of course, a full discussion on global imbalances requires much more space. A monetary union can sometimes increase imbalances, as in the case of regional congestion. An appropriate fiscal policy can become necessary. Nevertheless, in the appendix we try to show that instead of looking for ingenious policies to rebalance international economy, without discussing the crucial problem of world money, it is best to cut the Gordian knot.

Financial Sovereignty

According to Hyman Minsky, the capitalist system is structurally unstable, mainly because “over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system” (Minsky, 1992). The global financial crisis showed that Minsky’s view of financial markets is more correct than that of market fundamentalists. The problem to face, now, is how to avoid a new crisis. If Minsky’s financial instability hypothesis is correct, a permanent solution to capitalism instability is impossible, but we can find some reforms to diminish the risks of instability. Appropriate institutions increase security and stability.

Financial crises are usually followed by sovereign debt crises (Reinhard & Rogoff, 2009), as the case of Greece in the EMU showed. In this paragraph, we deal with the first problem only. The 2008 crisis showed that, in the United States and Europe, the governments were caught between bailing out some ailing banks and letting them fail, with catastrophic consequences for the banking and financial system. The governments decided to avoid a systemic crisis, but the cost was a huge increase in public debt. The banking sector is a special industry; to function properly, it needs strict public supervision and regulation, such as deposit insurance and reserve requirements. The governments’ decision to bail out some banks has successfully restored confidence but has also increased the risk of moral hazard. There is now a category of banks “too-big-to-fail,” which can behave outside the prudential rules established for the banking system; because they do not fear bankruptcy, they can assume disproportionate

risks. Without new rules, the banking system privatizes its gains and socializes its losses.

The debate on the dilemma—either bail-it-out or let-it-fail—shows that there is a third way: the creation of a resolution authority. On one hand, there is the need to change banking and financial rules concerning credit for mortgages, trade finance, and corporate investments. On these issues, the Basel committee proposes new rules on bank governance. On the other hand, one of the causes of the crisis was the official supervisor authorities' incapacity, central banks included, to diagnose the malfunctioning of the financial market and to intervene. The official authority should intervene *ex-ante* and not *ex-post*, to declare bankruptcy, as happened with Lehman brothers. A new institution is required. The

resolution authority may decide to seize the bank when it is still functioning, take control and separate or sell certain parts or assets of the bank, remove its management, freeze the rights of shareholders and creditors and reorganize or wind down the bank. It may agree on deals with the bank's counterparties, etcetera. All this will reduce the disorder and damage in the financial markets and result in orderly liquidation or merger. (Ruding, 2010, p. 3)

The United States and the EU are reforming their banking and financial system. Of course, the reforms take the different features of the two economies into consideration. For instance, the banking sector is more important in Europe, compared with the financial system, than in the United States; in 2007, bank loans were 145% of the euro-area GDP and only 63% in the United States. But the real difference is the institutional system: fully federal in the United States and semifederal in the EU. Indeed, in 2010, the United States approved a law embedding the so-called Volker rule, which prohibits a bank from engaging in proprietary trading and from owning or investing in hedge funds as well as limiting the liabilities that the largest banks could hold. The purpose is to reduce banking activities and their size, in view of resolving the too-big-to-fail dilemma. Moreover, the law includes new government powers to break up any company that becomes so big that its failure could threaten the economy. All in all, the U.S. law includes the principle of a resolution authority.

The EU is following another path. The EU has a federal monetary system but no federal fiscal system and no federal government. The proposals of the EU Commission are very cautious. It proposes a European Systemic Risk Board (ESRB) that would be responsible for macroprudential oversight of the financial system but without binding powers to impose measures on member states. The ESRB, mainly entrusted to the ECB, can address warnings and recommendations. Moreover, the commission proposes to establish a European System of Financial Supervisors, consisting of a network of national financial supervisors working in tandem

with the reformed European supervisory committees. The two new authorities should cooperate closely to assure a smoother supervising interaction at macroprudential and microprudential levels (Commission of the European Communities, 2009).

Here, our task is not to discuss the details of the European and American reforms. Our aim is to highlight the connections among monetary, financial, and fiscal sovereignties. As far as monetary and financial sovereignties are concerned, economic theory clarifies the link very well. In the case of a financial crisis,

everyone will demand liquidity . . . and everyone in the system understands that the only liquidity that really exists is central bank money . . . So when there is financial instability, there is likely to be monetary instability. This establishes a link between the natural role of the central bank as a provider of payments finality and its role in financial stability. (Schinasi, 2003, p. 9)

Concerning the link with fiscal sovereignty, the European case is interesting because it clearly shows that without a European financial system, national governments strive to maintain the core of oversight powers in their hands, thus breeding uncertainty. The decision on the bailing out or failure of a bank involves a parallel decision on public finances. Therefore, because the EU has a tiny budget, not big enough for this kind of policy, the powers of last resort rest with the member states, not with the EU. But in such a case, a real European supervision is practically impossible; indeed, the ESRB can address only warnings and recommendations. If a financial crisis hits several European banks simultaneously, some national governments can decide not necessarily in agreement with other governments; for instance, one government is in favor of the bailout and another for the failure of a certain bank. For this reason, so far, a European resolution authority has not been seriously taken into consideration.

The European case is useful to understand the difficulties in creating an efficient financial supervisory board in the international framework. Even if the G20 has set up a Financial Stability Board, it is doubtful that a world resolution authority would be created. Without solving the parallel world financial problem, the global financial system is doomed to remain unstable for many years.

Fiscal Sovereignty

The original debate on the theory of the optimum currency areas has only incidentally considered the link with fiscal sovereignty (the exception is Kenen, 1969). The European experience, with the Maastricht treaty, did not help to enlighten the problem. Indeed, the EU budget was about 1% of the EU-GDP before Maastricht and is till today of the same amount, even though a debate on its reform is open. Therefore, we are obliged to refer to the theory of fiscal federalism to

discuss the fiscal problems of a supranational union of national peoples. The theory of fiscal federalism was shaped on the experience of the existing federations, mainly the United States (for a survey, Oates, 2008). The main limit of this approach is that fiscal federalism is considered a theory of fiscal decentralization. On the contrary, the main international problems are exactly the opposite: to fix the tasks and the fiscal powers of a supranational government. The central tasks and powers of the existing federations are not necessarily the same as those of a future supranational government.

This awkward problem was almost ignored in international political economy until recently because the perspective of a supranational government was considered unrealistic. But the recent and lively debate on global public goods raised the problem not only of their implementation but also of their financing. From the economic point of view, a public good is a good not produced by the market—because no firms can get a profit from its production—and it has the qualities of nonexcludability and nonrivalry. A global public good benefits all peoples and all national governments. Here, we profit from this new perspective, recalling that the main principle of fiscal federalism—sometimes also defined multi-level finance—is that every level of government should be independent but coordinate with other governments. The best way to coordinate different governments is to draw a constitution, but the EU grew on the basis of intergovernmental treaties. For a government, to be independent and coordinated means that its tasks and its financial means should be defined with the maximum accuracy to avoid overlapping with the tasks and powers of other governments. From that point of view, it is important to refer to the so-called subsidiarity principle: A certain task (policy) should be assigned to the lowest level of government if possible but to the higher level when the lower government is not able to provide a certain public good or can provide it only inefficiently (with higher costs).

From the broad debate on global public goods (International Task Force on Global Public Goods, 2006; Kaul, Grunberg, & Stern, 1999; Stiglitz, 2006), we pick out some uncontroversial issues: international security, economic stability, and sustainable development. Of course, international security falls outside the horizon of macroeconomic theory. We only recall that, according to us, an important and reasonable step forward is the reform, proposed in 1992 by the UN secretary general, Boutros Boutros-Ghali, to create a military peace-enforcement unit at the disposal of the UN Security Council. From a comprehensive point of view, international security is a precondition for international cooperation and a new economic order. As far as international economic stability is concerned, we have already tried to show that a world monetary union and a supranational authority for supervising the financial market should be considered the crucial institutions to provide this public good—but this is not enough. The world community must face other challenges, which can be epitomized in the general perspective of sustainable development.

With this general label, usually people talk about two different problems. The first is the impact of economic growth on natural resources. The spread of industrialization in all countries produces serious external effects: Life on the planet will be increasingly in danger if industrial growth does not become sustainable. The second problem is social sustainable development. The enormous gap between the standard of living of rich and poor people is considered not only a scandal but also the cause of many other problems, like emigration and terrorism. The UN is the main forum for the organization of aid to development, to fight poverty and protect health, to overcome discrimination against women, and to spread literacy. These two aspects of sustainable development were, in the past, faced with specific policies and agencies. But now, it is increasingly clear that they should be considered as different aspects of the same problem: a sustainable development plan to save the planet and to realize international justice (Stern, 2009). The difficult debate within the UN for an effective global policy against climate change shows that one of the hurdles to overcome is the unequal responsibility of the emerging economies for planet pollution compared with industrialized countries. Rich countries started to pollute the planet 250 years ago, at the beginning of the industrial era. Therefore, the total costs of the fight against climate change should be allocated not on a per capita formula but according to the pollution accumulated by all people. Rich and poor people are not at the same level in the playing field.

A UN budget, of the same relative size as the EU budget, financed mainly by ecotaxes and taxes on financial capitals, is a crucial means for global governance. It can be used to finance a world police force, as suggested by Boutros Boutros-Ghali, and to plan for sustainable development, including scientific research to face epidemic diseases and ecological threats. Moreover, a UN endowed with fiscal competences can help national governments to face the increasing power of private global finance, which overwhelms national powers and their capability to issue public debt. The two problems are connected because the real guarantee for buyers of public bonds is the capacity of the government to collect taxes. The development of a global financial market has greatly reduced tax revenues coming from capital and increased the pressure on unqualified labor and other immovable factors. In the global financial market, countries do not cooperate but compete to exploit the common tax base. For a single country, it becomes impossible to impose higher tax rates than other countries on financial capital and highly skilled labor. Because every country tries to exploit the same tax base, the strategy of exporting national fiscal pressure, attracting consumers and capitals from other countries with low tax rates, is becoming more and more popular (Tanzi, 2000, 2002). The way out from the increasing erosion of national fiscal sovereignty is the creation of a Supranational Fiscal Authority within the UN with the power to tax multinational firms and global financial capitals. A

share of the revenue collected by the authority can finance the UN budget.

A Macroeconomic Policy for a Supranational Government

The great depression of the 1930s was the main spur for Keynes's *General Theory*. Keynes conceived a macroeconomic theory to solve the problems of a closed economy. Today's international macroeconomic theory overcomes this original sin only marginally, because it studies the behavior of open national economies cooperating spontaneously without the need of supranational institutions. For instance, the international monetary problem is basically considered as the choice between fixed and flexible rates of exchange: The third way, a monetary union—a supranational public good—is not usually taken into consideration. After the global financial crisis, the time is ripe for a radical renewal of the macroeconomic theory. In this article, our aim was to show that some crucial economic problems could be better solved with the creation of supranational institutions, when international cooperation fails.

In a nation state, the central government holds the reins of monetary, financial, and fiscal policies. In the international market, the problem is to centralize some of these functions, when competition among national institutions can cause major market failures. Usually, in economic theory, this problem coincides with the detection of the free-ride behavior of a public goods consumer. In international economics, the ideological screen of national sovereignty prevents a clear understanding of the problem, which is faced firstly by means of intergovernmental cooperation and not by supranational institutions.

The reform of the international monetary system is a case in point. The governor of the Chinese Central Bank understood that the financial crisis was a by-product of the dollar standard, but his advice is shaped in the traditional intergovernmental framework. The dollar, the present international reserve currency, should be replaced by SDRs issued by the IMF. This proposal goes in the right direction, but it does not dispute the monetary sovereignty of nation states, which can continue to issue their currency according to the liquidity requirement of their national economy. The problem of managing global liquidity remains unresolved. Rightly, Richard Cooper observes that the SDRs can play only a “modest role” in solving international monetary problems. Of course, they can “reduce the pressure many countries evidently feel to earn additional reserves” and “this in turn would lead to some reduction in current account deficits around the world, notably in the United States” (Cooper, 2010, p. 11). But the dollar will remain the main reserve currency because governments will find it convenient to invest their reserves in the U.S. financial market.

If the proposal of a world monetary union is taken into consideration, the same practical step could be suggested and

realized in a short time. Of course, a world bank cannot be built in just a few years, but a world monetary policy can be simulated if the political will exists among the governments of the G20. Let us suppose that the G20 countries (or an important group of countries) agree to adopt a “global inflation target” (Taylor, 2009, p. 63) of 3%. This reform (as suggested in Mundell, 2005, and Fiorentini & Montani, 2010) does not require the immediate creation of a supranational institution; in practice, it is similar to the informal rules of the game followed by central banks during the gold standard. Neither does it require the substitution of national currencies, as happened in the EMU. But it represents a first step toward a world monetary union because it can allow the overcoming of the so-called inconsistent triad, limiting the powers of national central banks, especially if the agreement is sanctioned by an international treaty and a World Council of Central Banks is set up. Because every national bank is bound to maintain a common inflation rate, the interest rates will converge and the exchange rate should remain fairly stable. Of course, a serious financial crisis cannot be fully avoided, as in the case of excessive national public debts (like the Greek crisis). But the creation of an effective unified monetary market can greatly reduce the risk of international investments, mainly in emerging economies, and the need for international reserves.

Other parallel steps in the fields of finance and fiscal policies should follow the creation of a world monetary union, as said before. Here, we limit ourselves to stressing how the supranational perspective can also change the cultural framework on the debate concerning the relationships between market and state. In his survey on fiscal federalism, Oates observed,

The essence of such systems is a combination of fiscal and market institutions that provides a set of incentives to individual agents for efficient behaviour. A relatively decentralized public sector, characterized by competition among jurisdictions in a setting of a common market without barriers to trade, can provide a powerful inducement for public decision makers to behave in ways that promote the welfare of their constituencies and sustain the efficient performance of private markets. (Oates, 2008, p. 183)

In a centralized state, the market is usually conceived in opposition to state power. But the welfare of the citizens depends neither on the market alone nor on the public sector alone. For this reason, the theory of market fundamentalism is wrong, and so is the theory of state fundamentalism, as the Chinese have well understood. A global market can provide greater welfare to all citizens and peoples of the world only if it is conceived not as an end in itself but as a means to provide more international justice, more economic stability, and a clean environment. A new macroeconomic theory, if supported by efficient supranational institutions, can greatly contribute to providing these global public goods.

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