

*The Quaid-i-Azam Memorial Lecture*

## **Debt, Growth, and Poverty in the International Monetary System**

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This paper explores the relationship between debt, growth, and poverty and the international monetary system. With a well-functioning international monetary system, economic policy works well, instruments are assigned to targets appropriately, and discipline is maintained. The fixed exchange rate is contrasted with alternative monetary rules. The monetary rule is the weakest system; monetary targeting has failed in every country in which it has been tried. An advantage of the fixed exchange rate is the clue it provides to the price level, interest rate, and future monetary policy. Other things being equal, the use of a currencies basket is inferior to a single currency peg, while a freely floating exchange rate system puts itself at the mercy of speculators.

The paper points out the conditions for a successful currency area as a consensus on a common inflation rate; a common basket of goods with which to measure inflation; exchange rate that must be locked; member countries must adopt a common monetary policy; and a formula must be devised for distributing and using the seigniorage profits from monetary expansion. There is a need to study the possibility of an Asian currency area and the links between the APEC and the SAARC. Regular and mutual surveillance on monetary, fiscal, and exchange rate convergence, and policies that minimise exchange rate uncertainty and work towards a currency club area based on a common anchor—initially the dollar—are needed. Setting up of an Asian Monetary Fund is also suggested, one that is closely modelled on the original IMF articles of agreement and will provide an anchored fixed exchange rate system.

### **1. INTRODUCTION**

It is a great pleasure for me to address this PSDE conference on “Debt, Growth, and Poverty”. The subject addresses problems at the cutting edge of world economic policy. Poverty needs growth; growth needs new technology and foreign capital; and foreign borrowing increases indebtedness, which leads to the possibility of bankruptcy, collapse of growth, and an exacerbation of poverty. That it is a real threat is confirmed by the debt and financial crises of the 1980s and 1990s, which continue into the present time.

My own topic does not emphasise the interrelationship between debt, growth and poverty as much as the connection between all three and the international monetary system. They are not ordinarily linked together. Rather, they are treated as strange bedfellows! What economic journal links the two subjects? What institutions stress the connections? With few exceptions the literature on economics distances them as much as it does the dichotomy between real and monetary economics.

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This observation was brought home to me a year and a half ago when I took part in a conference in Paris sponsored by the World Bank with the grand title, “Development Thinking at the Millennium”.<sup>1</sup> In this three-day conference on the subject of fifty years of economic development, there was, apart from my presentation, no discussion at all of the relation between growth and macroeconomic policies. Never the twain shall meet!

This dichotomy shows up in our international institutions, in which the World Bank looks at “development” problems and the International Monetary Fund looks at “monetary” and “exchange rate” problems.<sup>2</sup> In the fixed exchange rate system that the Bretton Woods charter ratified, there was a clear-cut division of labour. The IMF was in charge of supervising and providing short-term balance-of-payments support to maintain the fixed exchange rate monetary system. The IBRD was in charge of providing long term loans to assist reconstruction and promote development.

This division of labour meant that the IMF focused on macroeconomics and the IBRD on development. The IMF provided “programme” lending in the context of the equilibrium of the economy as a whole, whereas the IBRD focused on individual investment “projects”.

When the international monetary system broke down in the early 1970s, however, that division of labour lost its meaning. The advent of flexible exchange rates blurred the distinction between programme and project lending. After 1973 the IMF and IBRD became the “public money” adjuncts of, respectively, the short- and long-term capital markets. Yet the focus of the IMF on monetary macroeconomics and the World Bank on real development persisted long after the distinction, from the standpoint of economic policy, had lost its significance.

Debt is the bridge between the short and long run. This truth came home in the debt crises of the 1980s and the 1990s.

How is growth and poverty related to the international monetary system? I think the answer is quite clear. When the international monetary system works well, economic policy falls into place, instruments are assigned to targets appropriately, and discipline is maintained. When it works badly, as during the Chaos of the 1930s and in the 1970s, policy becomes badly designed, lending dries up, growth falls and poverty increases.

## 2. KEY TRENDS IN THE WORLD ECONOMY

September 11, 2001, is a day that will live in infamous history. It has left an indelible mark on the United States and world expectations. I shall have more to say

<sup>1</sup>The Annual World Bank Conference on Development Economics—Europe: “Development Thinking at the Millennium”, June 26–28, 2000, Pierre Mendès France Conference Centre, 139 rue de Bercy, 75012, Paris.

<sup>2</sup>There has long been a problem of the division of labour between these institutions. At the Bretton Woods conference, Keynes, in his impish mood, asked: “Why do you Americans insist on calling the bank the “Fund” and the fund the “Bank”?”

about it later. But for the moment I want to emphasise that it should not be allowed to obscure ongoing trends in the world economy that are anything but irrelevant to the issues of debt, growth and poverty.

The first item on the list is “new economy”, the IT revolution that is raising productivity and lowering cost in every sector of life it touches: in firms, households, institutions and governments. The mere spread of existing technology would be enough to keep productivity rising for years to come. But in fact IT technology advances at breakneck speed, creating the opportunity for some countries to leapfrog ahead of former leaders. The revolution, which has overtones of the printing and electricity revolution combined, is potentially very equalising because it lowers the cost of acquiring knowledge and technology, one of the most critical and scarce factors of production in poor countries. Education is here a key factor because it increases the absorptive capacity and determines the pace at which the new technology can be utilised. An investment in internet connections and broadband networks can have a high payoff in the developing countries.

I want to make another point in this connection. At the present time the US is the technological leader in the IT industry, with Japan and Europe coming up. The dominant language of the internet is now English and this is likely to be the pattern for years to come. This confers a great advantage on the United States and other English-speaking countries. It also suggests that “catchup” will depend partly on training in the English language and that presents a suggestion for teaching English in school at an early age. Countries like India, Pakistan, Bangladesh, the Philippines, Hong Kong and Singapore are among those favoured in this respect and could generate important comparative advantages in the software industries.

A second factor is globalisation. In a world of peace, globalisation is the natural state of mankind, the ubiquitous attempt to exploit and reap the gains from international exchange. Earlier episodes of globalisation occurred in the 19th century, under the *pax Britannica*; The current globalisation era began with the end of the Cold War and the *pax Americana*. Globalisation implies integration at the world level. It is good from the standpoint of efficiency and uniformity. It might be bad from the standpoint of diversity and cultural differences. Every country has to meet the challenge of globalisation in its own individual way.

Having said that, however, it must be said that the countries that treat globalisation as an opportunity rather than a problem will benefit the most. Just contrast the export growth of China, the Asian “tigers” and now Mexico with that of many less open countries of South Asia over the last several years. The key link here is between globalisation and foreign investment. Opening up traditional economies to the rest of the world conveys some costs and the benefits, to a larger extent now than ever before, depend upon foreign direct investment, and its magic package of capital, technology and markets. Two fast-growing countries have been particularly successful in this regard: a big country, China, and a little country, Ireland.

The third factor concerns the US economy. It is currently in a slowdown, perhaps a genuine recession as it is defined conventionally. But it must be noted that it is a pause after a very remarkable period. Over the past two decades, the US economy has experienced very rapid growth, creating something like forty million jobs in two decades. The foundation for this growth was laid with the supply-side tax cuts of the 1980s, which lowered Federal income taxes in the highest bracket from 70 percent in 1980 to 28 percent in 1988. At the same time corporate taxes were lowered from 48 percent to 34 percent. This complete revamping of this tax structure of the US economy set the stage for a much more efficient private sector that had its pay off throughout the 1980s and 1990s and continues to this day. Except for a nine-month recession at the end of the 1980s, the twenty-year period has seen continuous expansion. Since the expansion was resumed in 1991, we have had a 10-year expansion, the longest in US history. Of the four great expansions of the 20th century—1938–45, 1963–70, 1982–90, and 1991–2001, the later is the longest in US history.

The significance of this expansion for the rest of the world should not be underestimated. From 1980 to 2000, US imports quintupled, from \$256.9 to \$1,257.6 billion, the most powerful engine of growth in the world economy. At the same time the US current account deficit, around \$400 billion or 4 percent of US GDP, contributed to export-led growth in the rest of the world and generated a steady and rapid increase in international liquidity. What will be the consequences for growth, debt and poverty if the US economy enters a period of stagnation or just slow growth?

If the engine has now sputtered, the US will be confronted with a problem of financing its huge current account deficit and the rest of the world will have to cope with the need to find a new “motor” for the world economy. The deficit/debt situation here is relevant. The U.S. had large deficits in the 1980s, but at a time when it was a creditor in the world economy. Now that the U.S. has become the world’s largest debtor, the financing problem takes on a different hue, and could lead to a serious depreciation of the US dollar.

The fourth factor relates to the advent of the euro and a rethinking of the organisation of currency areas. The highlight here is the euro. I like to think of the euro as one of the important monetary events of the 20th century. Unlike the breakdown of the anchored fixed exchange rate system in the early 1970s, the euro has a promise of changing the power configuration of the system, competing as an alternative to the dollar. In this respect, the advent of the euro is the most important event in the system since the dollar took over from the pound sterling as the most important currency in the world during World War I.

### **3. GROWTH AND THE EXCHANGE RATE SYSTEM**

For most of world history, the international monetary system has been characterised by fixed exchange rates anchored to one or both of the precious metals. The gold standard arose out of bimetallism in the 1870s, after silver had been

effectively demonetised in major countries and no country was willing or able to maintain the bimetallic ratio. If there was a focal point of the gold standard, it was London, the world's capital market, and sterling, the currency of the British Empire, was the most important currency. The gold standard was an effective international monetary system that presided over an era of rapid growth, price stability, high employment and balance of payments equilibrium.

Already before World War I, however, the handwriting was on the wall, dooming the gold standard as an automatic system. Already by the late 1800s, the United States had become the biggest economy in the world and at the opening of World War I it was bigger than the economies of Britain, Germany and France put together. What changed the post-war international monetary system was the creation in 1913 of the Federal Reserve System, a central bank for the economic superpower, that in effect sowed the seeds of its destruction.

As Keynes noted in his 1923 book, *A Tract on Monetary Reform*, the "gold standard was already a barbarous relic". He meant by this that it was dominated by the policy of a "few" central banks. He might as well have said the Federal Reserve System, which already had over half the world's monetary gold stock. When World War I broke out, the European countries went off gold and the latter was shipped to the United States, partly in payment for war *materiel*. The gold imports were, along the rules of the old gold standard, monetised and the US price level doubled. In the 1920-21 recession, prices fell by 30 percent and then stabilised. But prices were still 30 percent above pre-war levels. At this time the world was on what could be called an "anchored dollar standard", with most countries linking their currencies to the dollar or floating.

The European rivals, anxious to restore what they thought could be a new gold standard equilibrium, went back to gold: German, following the stabilisation of its hyperinflation, in 1924. Britain in 1925 and France in 1926, followed by most of Europe and the rest of the world. The world price level was still 30 percent higher than before the war and gold stocks were correspondingly undervalued and scarce. The scramble for gold meant deflationary monetary policies and the world price level, following the US stock market crash in 1929 and the Smoot-Hawley Tariff in 1930, plummeted. But 1933 the world price level was back at its pre-war equilibrium, but the great deflation had given way to the great depression.

Economists tended to blame the gold standard (rather than the bungling of it) for the deflation and depression. Britain went off gold in 1931 and the United States, in 1933. The United States then set a new official price of gold at \$35 an ounce in 1934. The dollar, no longer redeemable into gold for Americans and convertible only for foreign monetary authorities, became the unit of account of the international monetary system that was endorsed at Bretton Woods. The United States fixed the price of gold and the other major countries fixed the US dollar. But this system did not have a global adjustment mechanism. The United

States was no longer obeying the rules of the game, governing its monetary policy by gold flows. Instead it was aiming at “internal balance”, which meant at the time full or at least high employment, and price stability only as a secondary consideration. In practice the course of the price level was ever upward and eventually the gold price, set in 1934, became obsolete after secular inflation and additional inflation associated with three wars, i.e., World War II, the Korean War and the Viet-Nam War. US gold stocks plummeted from a high of 700 million ounces in 1948 to less than 300 million in 1971, most of which went to Europe. Faced with demands for more gold conversions in August 1971, President Richard M. Nixon took the dollar off gold and the other major countries took their currencies off the dollar, thus ending the Bretton Woods system of fixed exchange rates. Although an attempt was made to erect a dollar standard in December of the same year, it broke up as a result of a conflict between the policies of the United States and the rest of the world, giving rise to generalised flexible exchange rates that, in 1976, would be enshrined in the amended IMF Articles of Agreement.

The mechanisms at work in the post-war fixed exchange rate system are worth noting. US monetary policy set the pace for world monetary policy and the U.S. inflation rate became the floor inflation rate for the European countries that had moved to a surplus position. Europe wanted the United States to reduce its inflation rate and correct its balance of payments. The United States at first promised to try to correct its deficit but then, in the grip of the Viet-Nam War, tried to get the surplus countries to appreciate their currencies. The European counter to this argument was that the inflationary country should do the adjusting in the interests both of its own economy and the rest of the world. No currency area of fixed exchange rates can work if there is no agreement on the common inflation rate and the mechanism for controlling the money supply of the area as a whole.

Despite these defects, however, the performance of the international economy under the fixed rate system was much better than that after fixed rates had been abandoned. Countries adhering to the monetary standard experienced, on the average, inflation rates lower than 3 percent in the two decades between the end of the Korean War and the move to floating exchange rates in 1973. Although the dollar standard did not possess the same degree of inflation control as the gold standard, it was much better than the flexible-rate arrangements that followed it.

Table 1 demonstrates that, for the major countries, on grounds both of inflation and growth performance, the era of fixed exchange rates was superior to the period of floating. It is apparent that the rates of inflation are higher and the rates of growth lower *in every single case*. The experience of the G-7 countries—the

Table 1

*Inflation and Growth, Averages, 1963–72 and 1973–82*

Country	Inflation 1963–72	Inflation 1973–82	Growth 1963–72	Growth 1973–82
U.S.	3.5	9.0	3.8	1.6
Japan	5.4	8.3	9.7	3.5
Germany	3.1	5.2	3.6	1.9
France	4.4	11.4	5.3	2.5
United Kingdom	5.3	14.7	2.9	0.8
Italy	3.8	17.4	4.6	3.0
Canada	3.6	9.3	5.3	3.0

WEFA *Historical Statistics*, July 1993.

pacesetters for the world—reflected the consequences of the breakup of the international monetary system into a regime of flexible exchange rates.<sup>3</sup>

A flexible system of exchange rates was, of course, by no means a new phenomenon when it became generalised in 1973. In the past, however, flexible exchange rate had emerged, for the most part, out of the exigencies of war and revolution. There were some exceptions. One was the argument of Thomas Attwood, a member of the Birmingham school writing soon after the end of the Napoleonic wars. He argued for flexible rates as an alternative to Britain's deflationary return to the gold standard after the Napoleonic Wars. Irving Fisher in 1912 and Keynes in 1922 advocated a standard based on price stability as an alternative to the gold standard. Frank Graham had advocated flexible exchange rates in the 1940s as part of his scheme for a commodity reserve currency. Canada had adopted flexible exchange rates in violation of IMF rules in 1950 before returning to fixed rates in 1962.

It was, however, the influence of an unlikely pair of economists which did most to foist flexible exchange rates on the world in recent decades. They were James Meade, an English liberal socialist, and Milton Friedman, an American

<sup>3</sup>The inflation of the early 1970s is sometimes blamed on the Middle-East War in 1973 and the subsequent quadrupling of oil prices, just as the acceleration of the price level in the late 1970s is blamed on the doubling of oil prices. There is no doubt that the rise in oil prices played a role in the increase in inflation. It could not, however, have occurred without the increased elasticity of international money, manifested in the explosion of the Eurodollar market, arising from the movement to flexible exchange rates. From the end of 1972 to the end of 1974, the Eurodollar market increase by 79 percent, from \$284.7 billion to 509.5 (See IMF *International Financial Statistics Yearbook*, 1986, p. 68); after the second oil shock, in the year 1979, the Eurodollar market expanded by 30 percent, from \$1,537.5 billion to 1,856.7 billion. In both cases, the explosion of international money accommodated the oil price increases. In both cases also. In both cases also the dollar price of gold and foreign exchange reserves soared.

conservative libertarian. Meade saw flexible exchange rates as a way of allowing macroeconomic planning on a national scale while preserving, as he thought, the benefits of a market economy. Friedman saw them as a preferable alternative to the panoply of discriminatory trade and exchange controls that had sprouted up all over the world. That was back in 1950. It is interesting and very relevant that these two important economists were from the two countries that have been world leaders at the centre of the international monetary system over the past two centuries.

The early arguments made a “case for” flexible exchange rates. “Fixed prices” smacks of wartime controls. Initially, Friedman’s argument that flexible rates would replace controls postwar controls. In the Tinbergenian policy matrix, two extra degrees of freedom appear to be obtained, as the exchange rate is shifted from the target to the instrument category.

#### 4. ALTERNATIVE MONETARY RULES

But a choice between fixed and flexible exchange rates is an oxymoron. They are incomparable. A fixed rate is a monetary rule and gives the country the inflation rate of the area to which it is fixed. By contrast, a flexible rate is only the absence of that particular monetary rule and is consistent with hyperinflation! A fixed exchange rate therefore has to be contrasted with alternative monetary rules. Once this is seen, and we compare alternative routes to a given degree or definition of monetary stability, the extra degrees of freedom disappear. To be sure, the exchange rate is shifted from the target to the instrument camp, but at the same time, money or the price level is shifted from in the opposite direction, from the instrument to the target camp!

The three possibilities are noted in Table 2:

Table 2

<i>Alternative Fixed Points of Economic Policy</i>				
System	Fixed Point	Variable	Variable	Variable
A	Money Supply	Exchange Rate	Price Level	Gold Price
B	Exchange Rate	Price Level	Money Supply	Gold Price
C	Price Level	Money Supply	Exchange Rate	Gold Price
D	Gold Price	Money Supply	Exchange Rate	Price Level

In an abstract static general equilibrium model, these systems are formally equivalent. With four equations representing the excess demands for goods, money, foreign exchange and gold, and four variables—the money supply, the exchange rate, the price level and the gold price—and the assumption of homogeneity, there is one degree of freedom. The static equilibrium will be invariant with respect to the choice of numeraire.



I have put gold into the table for completeness—because of its historic importance and the possibility that it might be used again in our new century. But a discussion of gold at the present time would be a distraction from the main points I want to make and I will leave out of account in what follows the any discussion of gold.

In the real world there is a great deal of difference between these policy alternatives. Policy assignments in the real world are more complex. Policy management requires an assignment of instruments to targets that will optimise price level stability. Let me give you my views on the three assignments.

The monetary rule (or the money-base rule) is the weakest of the three systems. Under normal circumstances it is almost never optimal to fix the money supply or its rate of growth if the objective is to achieve price stability. There are two many different definitions of money; its measure is not easily obtainable on a day-to-day or even weekly basis; the demand for money is quasi-random in the short run, being influenced by exchange rate and interest rate expectations; the meaning of money is constantly changing with innovation and, even if a single definition of a monetary target could be agreed, it would be rendered obsolete by innovations; and so on. Monetary targeting has failed in every country in which it has been tried.

This is not to say—to repeat the obvious—that policy-makers should not carefully monitor the money supply; obviously all the variables in an economy have to be watched; policy-makers will always want to pay attention to the information implicit in the monetary aggregates. Especially in situations of high inflation, stability will not be achieved without control over the money supply. But the link between the money supply and the price level is too elastic to be suitable as a target.

Not so the exchange rate. The value of the exchange rate is well known on a daily and even hourly basis. It forms a suitable index on which to base expectations. A commitment to maintain a fixed exchange rate provides a guideline about future monetary policy. For small, open countries, the exchange rate is the most important price in the economy and the best indication of the value of money. When a small country fixes its currency to the currency of a larger partner, it will eventually get the inflation rate of its partner.

Obviously, the choice of a partner is important. The partner economy should be both large and stable. Size is important because, like a big oceangoing liner, it is immune to the tides of speculation. Stability is important; there is little advantage to fixing if the partner's inflation rate is higher than the inflation preferences of the fixing country. A fixed exchange rate also helps a country to gain access to the money and capital markets of its partner.

Fixing the exchange rate establishes monetary discipline; the balance of payments governs the change in reserves which, if not offset by changes in domestic assets of the central bank, will affect the money supply in such a way as to establish equilibrium. What is often not realised, however, is that a fixed exchange rate also

imposes fiscal discipline. A budget deficit would set in motion speculative forces that would undermine the fixed exchange rate. If fixed exchange rates have become rare it is because profligate governments have not come to grips with the problem of establishing fiscal balance.

Fixed exchange rates, however, is not an alternative for all countries. It would not work for countries that cannot achieve fiscal balance and do not have access to borrowing; inevitably, monetisation of the deficit would conflict with the monetary policy needed to maintain the exchange rate. Exchange rate adjustment is inevitable in countries that are inflating relative to their neighbours.

Nor would fixed exchange rates be an alternative for a country which, for economic or political reasons, cannot find an appropriate partner currency. The dollar is a high candidate as the anchor currency because it is at present the only global currency. Soon enough, the euro will become a global currency and compete with the dollar in that respect. Nevertheless political considerations might rule out a dollar fix in some countries. Such countries might choose to peg to a basket of currencies, such as the SDR or as basket of the dollar, euro and yen.

It should be realised, however, that, other things being equal, the use of a basket is inferior to a single-currency peg. One of the great advantages of a fixed exchange rate is the clue it provides to the price level, interest rates and future monetary policy. The more currencies in the basket, the more transparency and the unit-of-account advantage of fixed exchange rates is lost, and the more likely is the fix to be a soft rather than a hard fix as a results of surreptitious changes in the composition of the basket. The connection to capital markets is also less effective.

It goes without saying that a fixed exchange rate is not an option for the dollar. Mexico or Canada or Hong Kong can fix their currencies to the dollar, but the United States cannot fix the dollar to the peso or the Canadian or Hong Kong dollars. With the “n-th” currency with the largest transactions domain, the United States cannot expect to achieve stability by fixing its currency to a smaller currency area; it would only serve to dominate that country’s monetary policy. The United States therefore must have a mixed policy, paying attention to major factors like the US inflation rate, major exchange rates and the price of gold.

The most important ultimate policy target is the inflation rate. An inflation rate target between 1 percent and 2 percent would be appropriate, allowing for the acknowledged upward bias of the consumer price indexes due to undercounting of new products and innovations in the service industries. But ignoring the exchange rates and the price of gold would be a serious mistake. Inflationary impulses typically affect first the exchange rate and the price of gold before they have worked through to the price level. Inflation in the consumer price index typically has to wait for inflationary pressure to affect wage rates, which signals inflation only after the harm has been done.

In the special position of the United States, a movement upward of the price of major foreign currencies combined with an increase in the dollar price of gold is almost certainly an indication that monetary policy is too loose, whereas the opposite is a warning that monetary policy is too tight. Exchange rates and the gold price are leading indicators of changes in the inflation rate. This phenomenon is well illustrated by the mistakes made by the Federal Reserve between 1979 and 1981. In the years 1979 and 1980, the dollar was falling, the price of gold was soaring and the inflation rate had jumped, respectively, to three back-to-back years of two-digit inflation.

The Federal Reserve was guilty of the opposite mistake in 1981 and 1982. Money was tightened, the dollar soared on exchange markets and the inflation rate came down to 10.4 percent in 1981 and 6.2 percent in 1982. The brakes had been slammed on too heavily and unemployment soared to 11 percent. While the second mistake was more understandable than the first—the Volker Federal Reserve had to deal with inflationary expectations that had got out of hand—a slower disinflation would not have sacrificed so much output and employment.

I have discussed elsewhere (*Asian Wall Street Journal*, March 30th, 2000) my suggestions for a three-currency G-3 monetary union. It seems politically unrealistic today but the mechanics would not be difficult. It is outside the scope of my talk today to deal with this possibility now.<sup>4</sup> I want to now, instead, focus attention on Asian currency problems under the situation prevailing today.

Important exchange rate changes played a fundamental causal factor in the Asian Crisis. The appreciation of the dollar against the yen was an important cause of the so-called Asian Crisis. Recall that the dollar was 78 yen in April 1995 and then soared to 148 yen in June 1998. The depreciation of the yen/appreciation of the dollar had two effects on Asian economies: first because those countries that pegged their currencies to the dollar now suffered payments deficits and deflationary tendencies, and second, the depreciated yen cut off foreign investment from Japan. Foreign investment fluctuates with the yen-dollar rate: when the yen goes down, foreign investment from Japan drops off, cutting off that important source of growth. The devaluation of RMB also played a part. The RMB-dollar rate has become enormously important in Asia second only to the yen-dollar rate. At the beginning of that 1994 the dollar was raised from 5.5 to a de facto rate of 8.3 RMB, in conjunction with the elimination of some controls. This devaluation brought in its train an inflation spike of 24 percent in 1994, but inflation was quickly brought down in the

<sup>4</sup>A three-currency monetary union would involve bringing the three currency areas to the stage that the euro area has arrived at before completing the transition to the single currency, which is scheduled in Europe for the first half of 2002. Essentially, there are five steps: (1) choose a common inflation target; (2) devise a measure of the common price level (such as Eurostat's harmonised index of consumer prices (HICP)); (3) select a monetary leader (assumed here to be the Federal Reserve System) and a pivot currency (the dollar); (4) direct the Bank of Japan and the European Central Bank to lock their currencies to the dollar; (5) form a Monetary Policy (or "Open Market"). Committee from the boards of the three central banks meeting periodically to make decisions on monetary policy, expanding or contracting the joint assets of the combined banks; and (6) make provisions for the disposition of seigniorage.

next two years, and in fact became negative in two recent years, as the appreciating dollar brought on a mild deflation. These exchange rate changes were culpable in the crisis. Had there been a stable exchange rate system in place in Asia, Asia would not have had anything like the crisis that ensued.

### 5. INSTABILITY OF THE DOLLAR, EURO AND YEN EXCHANGE RATES

A major problem for Asia in the future is the volatility of the yen-dollar rate. If I were possible to look ahead to a stable dollar-yen rate, Asia would not have a basic problem with running its monetary policy. Or to put more exactly, any problem it had would be of its own doing. But when the two most important currency areas relevant to Asia each have price stability combined with huge exchange rate changes—these are *real* exchange rates changes—then this poses a major problem. It would be very much in the interest of Asia, and rest of the world, if the dollar-Yen rate could be fixed again, as it was between 1948 and the 1970s.

There are some who continue to say that you cannot fix the exchange rate now because capital movements have become too large and dominate exchange rates so that the central bank cannot fix the rate. The vast sums involved in cross-border transactions are all based on exchange rate uncertainty. Trillions of dollars are committed in hedge fund operations, swamping ordinary transactions. With transactions running over \$1.5 to 2 trillion dollar in daily turnover, what kind of central bank's intervention can compete? The lesson, so it is said, is that you cannot fix exchange rates now because they will be swamped by these huge derivative transactions, the hedge funds and waves of speculation.

I think this view is completely wrong. It makes capital movements the culprit. My view takes a leaf from Napoleon's comment to the effect that there are no bad soldiers, there are only bad officers. I believe there are no bad capital movements, only bad monetary and exchange rate systems. You do not see bad capital movements between New York and California or any other state within the United States because exchange rates are securely locked. There were bad capital movements in the euro area before the middle of 1998 because exchange rates were uncertain. But after the middle of 1998, even before the euro had been introduced, when bilateral exchange rates were securely locked, speculative capital movements against the lira, mark, franc and peseta and the other currencies of the euro area became a thing of the past.

There were some observers—even economists—who said before the middle of 1998 that fixing exchange rates would create such speculation of one currency against the other currency that it was going to a breakdown even before things get started. Yet none of it happened. The euro came into being with very little intervention because the locking of exchange rates was completely credible, and because the mechanism for adjusting the balance of payments was well understood. Everybody understood that the national central banks would now

follow a passive monetary policy appropriate for a fixed exchange rate system and that monetary aggregates would be under the control of a central authority, the European System of Central Banks and its executive arm, the European Central Bank.

Again, I must emphasise that I mean a truly fixed exchange rate not a pegged rate with an independent monetary policy. A pegged exchange rate will sooner or later come under attack from speculators who perceive that there is no adjustment mechanism for the balance of payments and no real commitment to defend the rate in the crisis. Once an attack starts, a one-way option builds up in which speculators have nothing to lose and everything to gain by betting against the currency.

A freely floating exchange rate system puts itself at the mercy of speculators, including the huge multinational corporations with liquid funds that in many cases vastly exceed the entire money supplies of some countries. A gyrating exchange rate tends to overshoot its equilibrium in both directions. It is almost never the right policy to leave an exchange rate up to the vicissitudes of speculation. Even very large currency areas, such as the dollar and euro areas, have from time to time found it desirable to prevent overshooting of the exchange rate by intervention in the foreign exchange market.

It goes without saying that all countries cannot initiate a policy of fixed exchange rates. The United States cannot fix its exchange rate to the Mexican peso or the Canadian dollar. It would not give the United States the stability by fixing the currency to a small country. The U. S. could, to be sure, fix to the Canadian dollar, but it would dominate Canadian monetary policy without giving any stability to the United States to rely on. A big country cannot fix to a little country. It has to be the other way round.

Some countries have found stability by inflation targeting with occasional intervention or management of the exchange rate a feasible system. The advantage of inflation targeting is that monetary policy can choose its own inflation rate, independent of policy in any other currency area. This is still the policy of choice for the dollar, euro and yen areas. But success depends on credibility of government policy, which depends on consistency and past history. A few areas that have succeeded in building up credibility have been Taiwan, Singapore and Chile.

The best system for a small country, however, may be a hard fixed exchange rate to a large and stable currency like the dollar or euro. It is easier for a small country to establish credibility with a transparent commitment to a hard fixed exchange rate than it is for a country build up confidence with inflation targeting, especially if it has a past history of inflation. Argentina, for example, after decades of monetary instability built a credible currency-board-like system and very quickly

achieved stability.<sup>5</sup> The same can be said for Hong Kong.<sup>6</sup> Stability in both cases has to be measured by the inflation rate of (in this case) the dollar area.<sup>7</sup>

A credible system of fixed exchange rates in East Asia—a currency area for East Asia—would be a step in the direction of better monetary arrangements. But a major barrier to that solution is the volatility of the yen-dollar rate. Hong Kong and China and Malaysia have fixed exchange rates with the dollar, but cannot have fixed exchange rates in general unless the dollar-yen rate were also fixed. If that rate were fixed, the advantages of fixed exchange rates based on the dollar would be unquestionable.

Given the reality of the current situation, including the prospect of volatility of the yen-dollar rate, the desirability of fixed exchange rates with the dollar depends on an assessment of what US monetary policy is likely to be in the future. In looking over the history of US monetary policy, it needs to be recognised that the Federal Reserve System was only created in 1912. It is really the youngest of the central banks in all big countries. That is why Keynes said in the 1920s that we (meaning Britain) could not rely upon fixing to the dollar because the Federal Reserve was too inexperienced, it would be pressured by special interests, and might not run a stable monetary policy. As it turned out, Keynes was right because at the worst possible moment, in the early 1930s, the Federal Reserve shifted course from inflation targeting to the gold standard, bringing on the destructive deflation of the 1930s that sowed the seeds of World War II.

<sup>5</sup>It should be noted that Argentina got into trouble with its currency board in the wake of the Mexican crisis in 1995, and the Brazilian devaluation of 1999, in both cases because of speculation that the currency board system would be changed or that the peso would be devalued. A consistent background factor was the apparent inability of Argentina to achieve fiscal solvency. Instead of cutting expenditures to levels of taxation they resorted to borrowing- and worse-borrowing in foreign currency, eventually building up such a mountain of debt—\$150 billion—that it credit came into question and interest rates on the debt soared, aggravating fiscal insolvency. Recently, late in 2001, the government resigned and was replaced with one president after another, with default on the debt considered now inevitable. Most recently, the latest Duhalde government in early 2002 announced a policy of devaluation and the abrogation of the convertibility law regime. No doubt future historians will make the mistake of blaming the currency board system for the crisis rather than the political ineptness or impasse that led to fiscal insolvency.

<sup>6</sup>Hong Kong's currency board also came under attack when commitment to the rate of HK\$ 7.8 by the Hong Kong Monetary Authority came into question during the Asian crisis. The inability to establish complete credibility of the exchange rate has invited discussion of the issue of dollarisation as an alternative to the currency board system.

<sup>7</sup>This is not to say that the national inflation rate in a country that is fixed to (say) the dollar will get exactly the same rate of inflation as the United States. For one thing, countries have different weights in their price indexes. For another, differential rates of productivity growth in the traded and non-traded goods industries can make real exchange rate changes necessary and that will show up in differential inflation rates. For example, Hong Kong's inflation rate was consistently higher than that of the United States after the currency board was established, partly because the entry rate undervalued Hong Kong's currency, but more importantly because Hong Kong's

US monetary policy has been unstable during the two world wars, the great depression of the 1930s and the great inflation of the 1970s. It is not a pretty record of stability! But in those periods most other countries were also unstable and in many cases much more unstable than the United States. The past experience has made current policy better. In the past two decades monetary officials have learned from their earlier mistakes. The United States has been lucky to have two back-to-back Federal Reserve Chairmen in Paul Volker and Alan Greenspan who have been outstanding. My guess is that now the United States have grown up to the task of having a stable monetary policy in the sense of keeping its inflation rate under control and preventing outright deflation.

It needs to be said, however, that even the best monetary policy adopted by the United States is not necessarily optimal for other countries that fix their currencies to the dollar. In the great wave of innovation associated with the new economy, growth in the United States has been exceptional and because this growth has occurred in the traded-goods industries, it has meant that the US real exchange rate has to appreciate against its partners. Under fixed exchange rates this means that the US inflation rate has to be higher than those of its partners in the same currency area. If the United States therefore targets an inflation rate close to zero, its partners would have deflation inflicted on them. It is relevant to ask whether the United States should take into account the interests of its partners in selecting its own inflation target or whether it should look at its own price level in isolation.

Has US monetary policy been too tight in recent years? A case can be made for this position. One indication is that the dollar price of gold—always a good indicator of inflationary or deflationary expectations—has fallen 30 percent since 1995. A second indication is that the dollar has appreciated sharply against major foreign currencies, particularly the euro. A third indication is that countries with currencies fixed to the dollar through the entire period—Panama, China, Hong Kong, Argentina are good examples—have all experienced outright deflation in recent years. A *prima facie* case can be made, therefore, that the US monetary policy has been too tight. It remains to be seen whether, as more countries enter the wider dollar area, the Federal Reserve Board will find it useful to adopt a wider currency-area view of inflation that takes into account the inflation rates of all the countries in the currency area.

The size of currency areas is very important. A large currency area has greater power to insulate itself from shocks than a small currency area, just as a large lake can absorb a meteor shock better than a small pond. That is why a big currency area has more “monetary power” than a small currency area. Other things being equal, a big country has a more stable currency and is much less subject to volatility than a small country. Even in comparing two countries—say Germany and the United States—each with an equal degree of monetary stability, the dollar is more stable

because it is much less subject to shocks than the German economy. The German economy was subject to the shock of the German re-unification and the new spending transfers of more than \$100 billion from West to East Germany. That fiscal shock upset the stability of the German economy, but the same shock would have had only about one third the effect on the US economy.

## 6. AN ASIAN OR APEC CURRENCY AREA?

What are the circumstances in East Asia? The first important observation is the power configuration: three potential superpowers—Japan, China and India. Of course these three powers have very different footings. Japan's economy is more than four times larger than China's and China's and India's populations are respectively ten and eight times larger than Japan's. The three economies taken together have a GDP not much smaller than that of the euro area.

The power configuration is relevant because it dictates the degree of hegemony. Leaving aside for the moment India, which has elected to distance itself from East Asian developments, it makes a fundamental difference whether Japan or China or both are included in the same monetary arrangement. In the same way a monetary arrangement in the Mercosur countries would have to consider the implications of domination by the Brazilian colossus, or a North American monetary union would have to consider the domination of the United States.

It is necessary to clarify at the outset that one must distinguish between a *common* currency and a *single* currency. A common currency might be possible in Asia, but a single currency is out of the question for the time being and in the foreseeable future. Here the European example is worth careful interpretation.

Europe took an incredibly big step when, in the Maastricht Treaty of 1991 (following the Delors report of 1989), it accepted a plan for a *single* currency in Europe. This involved the abolition of national currencies. The Delors Committee could have said instead that we are going to create a *parallel* currency and use it for international purposes, let the national currencies fall into disuse and, perhaps, quietly fade away. But it did not say that. It said: *replace*. This was a big gamble at the time, because it seemed to be far ahead of public opinion on the subject, or European willingness to cede to a supranational body that important element of national sovereignty. The gamble paid off, however, because of the sense of urgency for monetary union created by German unification and fear that a completely independent Germany would recover its age-old tendency to dominate Europe. Europe could only take that leap because of an urgent political need.

At the present time, there is no prospect at all for a *single* currency in Asia. Political integration has not proceeded—and may never proceed—far enough. An indispensable condition for a single currency is that it be a “security area”, i.e., a war-free zone of allies. Neither East Asia nor South Asia currently qualifies. Of



course it could be argued—and it is true—that a single currency would be a catalyst for peace because it enormously increases the cost of war. Even so a single currency would not be negotiable between enemies.

Having said that, it is nevertheless sometimes useful to conceive of a single currency as an intellectual experiment. It helps to fix ideas. Suppose it were possible politically to create a single Asian currency, would it be good for Asia? This is an important question because if a single Asian currency would not improve conditions in Asia, there would be no point moving in the direction of a weaker and less threatening monetary association. On the other hand, if it could be demonstrated that a single currency would help increase growth and reduce poverty, it would help to make the case for various steps in the direction of currency integration.

Remember the indispensable conditions for a successful currency area. First, there must be common agreement on the common inflation rate. (If this cannot be achieved, there is no point going further.) Let us suppose that all Asian countries—or those that would participate in a hypothetical single-currency union (if it were politically feasible)—agree on a common inflation rate of 2–4 percent.

Second, they must then devise a common basket of goods with which to measure inflation. Third, they must lock exchange rates. Fourth, they must adopt a common monetary policy, with a single monetary authority. Fifth, they must devise a formula for distributing or using the seigniorage profits from monetary expansion.

In other words, they follow the procedure followed by the euro area. It seems to me that such an arrangement could be highly desirable for many of the countries in Asia that were willing and able to increase trade with one another. Objections to it based on asymmetric shocks, immobility of labour, differential growth rates fall to the ground, not so much because they do not represent real threats but because exchange rates changes are almost never the best way of accommodating them.

But if the countries involved would reject a single currency on purely economic grounds there would be no good argument for proceeding with any other form of monetary integration. If, however, the single currency idea were thought to be a good one on purely economic grounds, but had to be rejected because of political considerations, there would be a case for proceeding to a looser less-committing form of monetary and exchange rate cooperation.

Let us consider a parallel currency, which involves less of a political commitment. The idea of a parallel currency is that it could be used by all or most of the Asian countries. Countries could retain their own currency but link it to the parallel currency, and the parallel currency could be the trading currency for the Asian countries, in much the same way as a common language permits communication between areas with different local languages.

However, the problem with the parallel currency is, first of all, it requires initiative and leadership. One conclusion from the history of monetary unions is that,

in the past, monetary unions have almost always been hegemonic. Germany, for example, was unified but under the authority of Prussia, Italy under the authority of Piedmont, etc. Typically, there is a dominant power that wants monetary union and supplies the leadership.

In Asia, of course, Japan is in the best financial position to provide leadership. The other big country in East Asia, China, does not yet have a convertible currency. But Japan has four problems. One is the perceived instability of its banking system. The second is a monetary policy that seems to focus on 0–2 percent deflation, rate of “inflation” that would be unacceptable to the rest of Asia. The third is a budgetary policy that has produced the biggest public debt in the world. The fourth is that Japan has allowed the yen-dollar rate to fluctuate excessively: the dollar was 250 yen in 1985, 78 yen in 1995, 148 yen in 1998, 105 yen in 1999 and 130 yen today! Unless Japan stabilised its currency to the dollar (like e.g., Hong Kong, China and Malaysia), the yen would be an unsuitable currency as the anchor for an Asian currency area.

In the absence of a qualified Asian currency as anchor, the alternatives are to use an outside currency or currency basket. A very attractive possibility is the dollar itself, which is already the anchor, as already noted, for a few Asian currencies including, importantly, China. Elsewhere<sup>8</sup> I have argued that the formation of an Asian currency would be greatly abetted if Hong Kong replaced its Hong Kong dollar with the US dollar, creating in Asia a rock-solid currency with New York interest rates and greatly reinforcing its current role as an international financial centre. This would, I argue, be in the interest of not just Hong Kong residents but China and the rest of Asia as well.

It might seem that the natural group to form an East Asian currency area would be the so-called APT group—ASEAN Plus Three, i.e., the ten ASEAN countries plus Japan, Korea and China. These countries are of course very different in their degrees of development, but intra-area trade and finance would be greatly helped by the formation of a common currency area. Some progress for cooperation in this direction has already been achieved. But how far it progresses would depend crucially on the relationship established between Japan and China.

At the APEC summit meeting in Shanghai in October 2001, I made the suggestion that APEC itself might—paradoxically it is a larger and even more diverse group than APT—be a better or at least easier framework in which build a parallel currency. APEC includes not just the ASEAN countries but China, Korea, Japan, Russia, Indonesia, Malaysia, Singapore, Thailand, Taiwan, Canada, Mexico, Australia, New Zealand, Chile, Peru and the United States. The combined GDP of the APEC countries is \$19 trillion, close to half world GDP.

With Japan, Russia, China and the United States in the same currency area, bilateral political difficulties between these countries might be greatly diluted.

<sup>8</sup>“Does Asia Need a Common Currency”, in *Hong Kong Economic Review*, 2002.

Such a currency area would work best if the United States adopted a passive attitude, neither advocating or discouraging it. The dollar would be the anchor and unit of account—at least provisionally—for the currency area. An APEC dollar anchored to the US dollar could be created and used as the reserve currency in the APEC area. A central monetary institution would have to be set up. But it is not appropriate now to go into the details of such an organisation. It is more important to see what interests this currency area would serve and its membership.

## **7. MONETARY COOPERATION IN SOUTH ASIA AND SAARC**

What about South Asia? By “South Asia” I shall concentrate on the countries forming the South Asian Association of Regional Cooperation, or SAARC. SAARC was established when its Charter was formally adopted on December 8, 1985 by the Heads of State or Government of Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. It provides a platform for the peoples of South Asia to work together in a spirit of friendship, trust and understanding. It aims to accelerate the process of economic and social development in Member States. Its original purposes were specified as follows:

- (a) to promote the welfare of the peoples of SOUTH ASIA and to improve their quality of life;
- (b) to accelerate economic growth, social progress and cultural development in the region and to provide all individuals the opportunity to live in dignity and to realise their full potentials;
- (c) to promote and strengthen collective self-reliance among the countries of South Asia;
- (d) to contribute to mutual trust, understanding and appreciation of one another's problems;
- (e) to promote active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields;
- (f) to strengthen cooperation with other developing countries;
- (g) to strengthen cooperation among themselves in international forums on matters of common interests; and
- (h) to cooperate with international and regional organisations with similar aims and purposes.

Whatever progress has been made in this group has been overshadowed by the difficulties in the conflict between Pakistan and India over Kashmir. At the most recent fourteenth summit of the seven countries in Kathmandu ended on January 6, 2002, on a tone of pessimism, disappointment and yes, resentment. While President Pervez Musharraf of Pakistan and Atal Behari Vajpayee shook hands, they were not able to hold bilateral talks on the most recent dispute and this led to the following

comments by the other heads of state, as reported by Edward Luce and Binod Bhattarai on January 6, 2002:

“Chandrika Kumaratunga, President of Sri Lanka, summarised the mood when she told her fellow leaders that SAARC had achieved very little of substance in its 16 years of existence.

SAARC was setup to promote the “spirit of regional co-operation” and to accelerate economic development in South Asia, which is home to more than half of the world’s absolute poor.

Ms Kumaratunga left little doubt as to what—and who—was to blame for SAARC’s lack of progress. The Kathmandu summit was the first to be held since 1998, the intervening two having been cancelled after disputes between India and Pakistan.

“Continuing tensions between members states and the lack of will among some members to participate even at the level of officials has hindered seriously our ability to implement the decisions [to promote development and trade]”, said Ms Kamaratunga.

Khaleida Begum Zia, prime minister of Bangladesh, which is home to 130m of the region’s population, put it even more starkly.

“We have not even made a dent in poverty alleviation”, said Ms Zia. “SAARC’s [1993] pledge to remove poverty by 2002 remains unlikely”, she added sardonically. Furthermore, the group had failed to follow up on its 1996 pledge to set up a South Asian development bank. “SAARC has yet to formulate, let alone implement, a single regional project”, said Ms Zia.

Even Majumoon Abdul Gayoom, President of the Maldives, and the only leader to have attended all 11 SAARC sumits, discarded his customary reserve.

“SAARC has stretched its credibility to the limits”, said Mr Gayoom. “It will take a Himalayan effort to restart what has unfortunately become a stalled process”.

In spite of its Himalayan backdrop, the Kathmandu summit produced little more than a couple of uncontroversial conventions on child welfare and tackling cross-border trafficking in women and children.

But accords on creating a South Asian free trade area (Safta) and on taking the region towards its goal of economic union were buried in diplomatic platitudes.

South Asian officials say that almost all the lack of progress can be blamed on India and Pakistan’s reluctance to lower trade and investment barriers to each other. As a result, intra-regional trade accounts for just 4 percent of South Asia’s overall trade, compared to 63 percent between members of the EU.

India's official trade with Pakistan was just over \$200m last year compared with more than \$1bn in informal trade via third countries. "India and Pakistan together make up more than 80 percent of the region's population", said one official in Kathmandu. "If they hate each other, what chance have the rest of us got of making meaningful progress"?

Defenders of SAARC point out that the association has made substantial progress in so-called "track II" area, which promotes "civil society" contracts in culture, academia, journalism and business.

"You should not under-estimate how much more informal contact there is between the people of South Asia, including Indians and Pakistanis, since SAARC was set up", said Sridhar Khatri, head of the Institute of Foreign Affairs in Nepal.

But even SAARC's one substantial agreement to date—the South Asia Preferential Trade Area—has become a mockery of its intended purpose, SAARC's defenders concede.

Of the more than 5,000 items on the list of goods that have preferential tariff rates in SAARC, only a fraction are traded goods.

Frequently traded items, such as agricultural commodities, textiles, and consumer goods, are excluded. Economists call this the "snowplough phenomenon"—in reference to the generous tariff concessions that the tropical nations of South-east Asia extended to each others' snowplough exports in the 1970s.

"After 16 years of SAARC you don't get a sense of concrete results", concedes Mr Khatri.

Is there any hope that SAARC could sharpen up its act? Only, officials say, once there is at least a semblance of normality between India and Pakistan—a prospect that now appears even more distant than before.

But at least this year's summit took place, they say.

It was left to Gen Musharraf to point out that attending summits was a bare minimum of SAARC existing at all.

"No country should hold SAARC to ransom", he said. His words presumably applied to both India and Pakistan".

If the goal of the SAARC is indeed economic union, would it not make sense to consider forming a currency area in the SAARC countries? If so, what would be its anchor? It seems to me that an outside anchor such as the dollar would be the best place to start. It might also be useful to consider closer cooperation with the APEC countries.

## **8. SOME RECOMMENDATIONS FOR ASIA**

Let me highlight some conclusions and make some additional observations regarding Asia.

**First**, does Asia Need a Common Currency? My answer was yes, but it cannot at present have a single currency.

**Second**, a parallel currency is possible but requires initiative and leadership.

**Third**—this is before we get into the common currency issue—Asia should set up a caucus of the Asian-IMF members to strengthen its role in the IMF and plan on nominating an Asian Managing Director at some point earlier in the future.

**Fourth**, use the caucus to support and initiate a far-reaching reform of the international monetary system that would contribute to Asia's agenda and add two things: an international currency and regionalisation of management.

**Fifth**, study the possibility of an Asian currency and links between APEC and SAARC.

**Sixth**, begin regular and mutual surveillance on monetary, fiscal and exchange rate convergence in these countries, a kind of informal Maastricht-like exercise.

**Seventh**, inaugurate policies that would minimise exchange rate uncertainty, the big enemy, the Mecca of speculation.

**Eighth**, work towards a currency area club or league based on a common anchor. Remember the experience of the Europeans. It would have been easy to create a fixed exchange rate system in Europe in 1970 because they already had one, more or less, based on the common anchor to the dollar. But it was very difficult after all the European currencies started to float and every country went on its own way, interest rates were all different. They all had different inflation rates after everything broke-up into the chaos of floating exchange rates. For Asia, at least initially, the anchor would have to be the dollar. There will be no alternative to that at the beginning.

**Ninth**, work towards an Asian "dollar" anchor based on the US dollar at the beginning, or the euro, or the Yen or gold or the dollar.

**Tenth**, and finally, set up an Asian Monetary Fund modelled on the original IMF Articles of Agreement providing for an anchored fixed exchange rate system, *mutatis mutandis*.

## 9. THE STATUS OF INTERNATIONAL MONETARY REFORM TODAY

An Asian currency area has to be thought of in the context of the international monetary arrangements, which need reform. I think the first step toward reform that is needed today is to improve the quality of the international exchange rate system. We have too many currency areas (zones of fixed exchange rates or monetary unions). The international monetary system would work better with fewer currency

areas and less fluctuation in the exchange rates among the dollar, euro and yen areas. These exchange rates are “public” rates because they alter importantly the levels of international indebtedness and therefore concern every country in the world. The dollar-euro and dollar-yen rates should be kept as stable as possible.

Second, there will be new currency areas and alliances. An alternative to joining one of the G-3 currency areas is to form regional groupings based on shared political and economic objectives. This is happening in Africa; in Latin America, there have been discussions of the possibility of creating a Mercosur currency, or even a Latin dollar. Similar discussions have been taking place in South Asia.

The third factor is reform, or should we say, restoration of an international monetary system. I certainly blame the disaster of the transition economies (because you can only talk about the 1990s as a decade of complete disaster for economies when only two or three of fifty of those economies have now the same GDP level as when the transition began) partly on the currency confusion those countries met when they became free. It is also due to the difficulties and inept advice they’ve been getting from the international institutions. Instead of being supportive of stabilisation policies based on hard fixed exchange rates, the institutions have promoted flexible exchange rates with no equivalent alternative monetary target. These countries should simply fix their currencies to another currency and use that as the anchor for their monetary stability. The creation of the euro zone should be a help in this direction. But with the euro fluctuating against the dollar, a euro-zone solution would be at best, second best.

And then finally, let’s consider the creation of a universal currency. Over most of recorded history the international monetary system has had the benefit of a universal currency based on gold, silver or both metals. More recently, back in the days of Bretton Woods, the British Plan (also called the Keynes Plan) envisaged a world currency, a universal currency called “bancor”, and the American plan (also called the White plan), envisaged a universal currency, called “unitas”. In other words, the original planning at Bretton Woods made provisions for a world currency. However, it fell afoul of American interests. There is a nice passage in the diaries of (Lord) Lionel Robbins about how delegates were talking about the potential new world currency and then suddenly the Americans stopped talking about it, because they had decided it was not in US interests. Gold or the dollar would suffice in the post-war world.

The need nevertheless persisted and persists to this day. An attempt to make up for the omission was made in the 1960s with the creation of the SDR, a gold-guaranteed reserve asset that would have economised on gold. But in the 1970s the gold guarantee was stripped away and it was transmogrified into a mere basket of sixteen, then five and now four currencies.

A country now has the option of fixing its currency to the dollar, euro or yen, or even going the full distance and dollarising (or “euroising” or “yenising”). It could also fix to a basket of these currencies or the SDR, which is a basket composed of 39 percent dollars, 32 percent euros, 18 percent yen, and 11 percent pounds sterling. The SDR is becoming a viable option as a unit of account for the world economy. The more countries adopted it as the anchor for their only currencies, the closer it would approximate a true international money, badly needed in the world economy. As Paul Volcker has put it, “a global economy needs a global currency”.



## Comments

### 1

I agree with Prof. Mundell that economic theory does suggest that the best monetary system would involve the use of a single currency. The idea of the existence of money is to facilitate exchange and thus a single unit of account and medium of exchange is preferable over several such units. A single currency also reduces the transaction costs, search costs, computational costs and thus enhances the efficiency of resource use. On this basis, it is safe to deduce that the justification for a system of national currencies freely convertible at fixed exchange rate is self-evident. Empirically, the European Union (EU) has successfully completed its long journey towards a single currency area. Unlike the United States where the political sovereignty by states is surrendered to a nation-state under an agreed constitutional and institutional arrangement, the case of EU is quite different. The nation-state members of EU have chosen to maintain their political sovereignty intact and only surrendered their monetary policy setting powers to a common entity. This journey towards the single currency has only been possible when certain pre-conditions defined precisely and quantitatively were fulfilled by each of the participating countries.

The convergence to a common set of economic indicators including fiscal deficit and the adherence to Growth and Stability Pact was the sine qua non for this transition to have been successfully completed. There are still unsettled questions in the minds of academics and impartial observers whether the political self interests of the various nation-states can always be reconciled and resolved with the collective economic interest of the EU. The economists do have a competitive model with a set of social safety nets in place which can convert the pursuit of individual self interest into the creation of some collective goods. But I am not aware that if there is an analogous model in politics which can mediate the conflicting interests of individual nation-states into arriving at an optimal or even second best solution that ensures collective best interests of the community as a whole. At the practical level, the existing institutional arrangements of the Council of Ministers and European Parliament are not strong enough to carry out this task. So it would be extremely interesting for other regions of the world as to how this unique experiment of the European Union actually works itself out in practice. The emergence of single currency areas elsewhere will thus very much depend upon the lessons learnt from this experiment.

But as Prof. Mundell himself specifies in his paper even the economic pre-conditions for single currency and fixed exchange regimes for emerging economics

are fairly stringent. He rightly argues that an indispensable condition for a single currency is that it be a security area—i.e. a War-free zone of allies. I doubt very much that South Asia, Middle East, East Asia, Sub-Saharan Africa or even Latin America can meet this condition. Second, a currency area of fixed exchange rates cannot work if there is no agreement on a common inflation rate and on the mechanism for controlling the money supply of the area as a whole. While inflation rates have come down in emerging markets in the recent years from the exceptionally high levels of 1980s the variance is still quite significant within the various regions. It is hard to conceive for Latin American countries to agree on a common inflation rate or for that matter for Indonesia or Singapore within the ASEAN regions. Third, fixed exchange rates would not work for countries that cannot achieve fiscal balance and do not have access to borrowing; inevitably, monetisation of the deficit would conflict with the monetary policy needed to maintain the exchange rate. Exchange rate adjustment thus becomes inevitable in countries that are inflating relative to their neighbours. A Budget deficit would set in motion speculative forces that would undermine the fixed exchange rate. If we analyse the causes of recent collapse of Peso-dollar fixed exchange rate regime in Argentina it becomes quite obvious that the inability of Argentina to catch up with Brazil when the latter allowed its currency to depreciate was a major trigger point. Fourth, there must be an agreement on the credibility of the partner country currency to whom the exchange rate will be linked. For example, if the US dollar is chosen as the anchor then it is the assessment of US monetary policy that will determine the choice. But the track record of US monetary policy has not been that impressive since the 1970s. For Asia, Yen could have been an alternative anchor. But the volatility of the Yen-dollar rate would then be transmitted to the Yen zone countries and the prospects of Japanese economy recovering out of its economic malaise soon do not appear very bright. Thus the choice of an appropriate anchor becomes highly problematic for the Asian Countries.

Fifth, the frequency with which national economies are subjected to unanticipated external shocks and ease with which equilibrium is disturbed placed an additional constraint on the policy-makers if the exchange rate is fixed. This will impair their capacity to respond and adapt to these shocks and thus is likely to take a greater toll on the welfare of the population. The weaker economies who choose to adopt a fixed exchange rate in order to establish credibility and derive long term benefits from this association are particularly going to be hit hard in the short term. The political fall out of such a shock and the policy-makers' inability to respond adequately and on time is likely to be quite severe and harsh.

If we examine only these five pre-conditions and mind it that these are only economic conditions and I haven't even alluded to political conditions I am not sure if there is any region among the emerging markets which can become a feasible candidate for single currency. The only examples of fixed exchange rate i.e. Hong

Kong, Argentina and Estonia are not very persuasive to change our minds. Argentina has paid a heavy price for its too long adherence to the fixed rate regime while Hong Kong and Estonia are very special cases, which cannot be generalised to a large segment of emerging economies.

The empirical case for a flexible exchange rate has been propounded by several studies carried out by the International Monetary Fund and among the academics by Calvo and Reinhert.

The theoretical case of floating exchange rate has in recent years been made by the new Monetary Economists. Neil Wallace attributes the existence of a distinct demand for money to the existence of legal restrictions imposed by each government on the voluntary market activity of individuals. Thus the demand for money function does not result from any fundamental economic process but because of intervention by governments in market activity. As government are at best national in scope, each country creates demand for money under its own specified set of regulations. If this argument is accepted, it would be difficult to determine an equilibrium exchange rate that clears the markets in all different countries under a single currency.

What I missed in this paper and what I was really looking forward was the views of Prof. Mundell on the inter relationship between debt, growth and poverty—a topic which is dear to the heart of policy-makers and practitioners such as myself. On the one hand there is a growing body of empirical literature which tends to suggest that developing countries participation in globalisation through international trade, capital flows and technology accelerates their economic growth rates and reduces incidence of poverty. Dollar and Kray have recently studied the experiences of a group of developing countries that have significantly opened up to international trade during the past two decades. They provide evidence that contrary to popular beliefs, increased trade has strongly encouraged growth and poverty reduction and has contributed to narrowing the gaps between rich and poor worldwide. On the other hand, there is a growing tendency among NGOs, Civil Society Organisations, some academics who strongly agree that globalisation is making the poor countries poorer and the rich countries richer and poverty has in fact gotten worse because of debt, growth and international trade. If Prof. Mundell had chosen to illuminate us with his Considered Views on this issue I am sure we would have become much wiser.

**Ishrat Husain**

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Mr Chairman, Professor Mundell, ladies and gentleman. It is a privilege to be asked to be a discussant on a paper by an eminent economist, a Nobel Laureate, whose works I have studied and admired since my university days. The paper under discussion today expresses nostalgia for the gold standard and advances one of Professor Mundell's well-known views about the international monetary system: that, as he once put it, "the optimum number of currencies for the world is like the optimum number of gods—an odd number less than three".<sup>1</sup> Since the gold standard cannot be revived, at least not as yet, Professor Mundell advises lesser countries either to adopt one of the holy trinity of currencies (dollar-euro-yen), or to peg their currency to one or more of them (as a basket). As the previous discussant has addressed the controversies surrounding the analytical aspects of these policy recommendations, I shall confine my remarks rather narrowly to the paper's appreciation of the present conjuncture in world economic history (Section 2), on which these policy proposals rest.

Professor Mundell notes four key trends in the world economy: (i) the spectacular rise of the "new economy", (ii) globalisation—in his words, "the natural state of mankind, the ubiquitous attempt to exploit and reap the gains from international exchange", (iii) the slowdown in the US economy, and (iv) the rise of the euro. In appraising these trends, he draws an insightful parallel between the emerging Pax Americana, as he puts it, and the earlier Pax Britannica (which unfolded over say 1840 and 1930).<sup>2</sup> Somewhat paradoxically, given the unhappy end of the earlier Pax Britannica, Professor Mundell seems to assume the inevitable triumph of the American venture (supported, in greater or lesser measure, according to their fortunes, by the other two members of the trinity—Europe and Japan). On this basis, his advice to Pakistan, other Asian countries, and all other mortals among nations, is to "embrace" these developments rather than "recoil" from them. Since the economics of his arguments rest heavily on his reading of the likelihood of global political outcomes, I would like in my comments to go over these arguments and suggest that quite the contrary conclusions, and consequently policy prescriptions, may be equally if not more plausible if global political prospects are evaluated differently.<sup>3</sup>

<sup>1</sup>Quoted in *IMF Survey*, Vol. 30, No. 13, dated 2nd July 2001 (p. 225).

<sup>2</sup>He has also mentioned early efforts in Holland to create a world market in the 18th century; and to that one could add similar efforts in Genoa in second half of the sixteenth century. So this would be the fourth time that the venture of globalisation is on the loose in the modern world.

<sup>3</sup>In making this case I rely heavily on Giovanni Arrighi, "The Global Market", *Journal of World Systems Research*, 5:2, (Spring), 1999, pp. 199–224, and Dani Rodrik, "Rethinking the World Economy", <http://ksghome.harvard.edu/~drodrik.academic.kxg/TNRpiece.html> (a slightly longer version of "The Global Fix", *The New Republic*, November 2, 1998.)

There are indeed great similarities between Britain's efforts to build a global market in the nineteenth and early twentieth century and American efforts to do so now. Any one who doubts this, anyone who is blinded by the novelty of the revolution in information technology should not forget that railroads, steamships, automobiles, telegraphs, radios, telephones were equally magical and miraculous to those who experienced them for the first time. Nor should we forget that the laying of submarine telegraph cables in the 1870s served to create a world market not very dissimilar from the satellite-linked markets of today. If we are taken in by the enormous expansion in trade and finance today, then we should not forget that between 1840 and 1870 the volume of seaborne trade between European countries increased by over four times. Over the same period the value of trade between Britain and the Ottoman Empire, Latin America, India and Australasia increased by almost six times. So I fully endorse the parallel that is hinted at in the paper before us: we have seen these developments before. The interesting question, however, is to what extent are there factors of similarity and to what extent are there factors of difference? And does the earlier experience provide a "lantern on the stern", Barbara Tuchman put it, through which we can glean the shape of the waves that lie ahead?<sup>4</sup>

Now it seems that a crucial difference between the earlier Pax Britannica and the present Pax Americana is that the attempt by Britain to build a world market was from the bottom up. It was based on Britain's mastery of the balance of power system that was established in Europe by the treaty of Westphalia in 1648, by the opportunities that arose after the end of the Napoleonic wars, which heralded the era of peace to which the paper refers. Such a balance of power system certainly does not exist today. Secondly, it was by exploiting this balance of power system and her de facto hegemony over Europe, that Britain was able, with the consent of other European countries, to liberalise trade all over the world—an effort that those elements in the world system that wield power today are attempting again. Thirdly, and this is an important difference, it arose from Britain's leadership in empire building in the non-western world.<sup>5</sup>

This system of Pax Britannica, without dwelling too much on detail, collapsed basically as industrialisation spread throughout Europe, not just the spread of industry but the industrialisation of the means of military production. This led to a breakdown of the global market because it eroded Britain's pre-eminent position and

<sup>4</sup>Barbara Tuchman, *The March of Folly: From Troy to Vietnam*, Ballantine Books, 1985.

<sup>5</sup>In this, India played a major role. India, which was a major competitor of European textiles, became a major producer of food and raw materials under Britain tutelage. At the same time India provided free military resources for Britain—in Lord Salisbury's unforgettable words, "India is English barrack in the oriental seas from which we may draw any number of troops without paying for them"—and this could be done because of the infamous home charges that were imposed upon India by Britain. As India had a very large surplus with most of the world but had a deficit with Britain for a long period of time, the British treasury's control over Indian's reserves allowed an enormous expansion in British financial power, by able to cash on Indian surpluses against her deficits through the imposition of home charges.

led to the rise in mercantilism, imperial competition, and other areas of challenge, under which the system collapsed finally when there was generalised war early in the century. During this period, as Eric Hobsbawm has said, “world capitalism retreated into the igloos of its nation-state economies and their associated empires”.<sup>6</sup> Now the question is: are there sufficient similarities between the earlier British experience and the present American efforts to build a global market for American goods and services, to suggest that this effort too will lead to a collapse? So far certainly, the lesson of history is that neither the Genoese in the 16th century, nor the Dutch in the 18th century, nor the British in the 19th century, were able to create a system which lasted. Because the system itself, whenever it succeeded, created an enormous surplus of capital which could not be invested within the normal areas of trade and production, leading to speculative investment in finance, that brought down the system.

Unlike Pax Britannica, Pax Americana is top down. It is a conscious effort at world government in which the integral instruments are: the creation of the United Nations, the Bretton-Woods institutions, and now the World Trade Organisation (WTO), under which sovereignty rights are being extended to non-western states, but without the protection or safeguards of the balance of power system. Concurrently, again unlike the British, there has been a centralisation of global military capabilities by the industrialisation of war. At the same time the United States, with its control over the financial surpluses in the world economy, has demonstrated that by embarking on research on new weapons, it can bring down major rivals in the global system. So whoever commands large financial resources in the world power arena, can embark on the creation on new weapons of terror, which can bring financial ruin upon its competitors. This much certainly argues for the durability of the American effort.

On the other hand, US control of global markets and finance is not at all like that of Great Britain before the war. As you have yourself said, the US has now become a major debtor nation and the surpluses in the world economy lie elsewhere—perhaps in the Euro zone, perhaps in Asia. I read therefore your assessment of the US economy and its prospects, quite differently. To begin with, I do not see the start of the US effort to build a global market, globalisation if you like, as having taken place with the supply side cuts of the 1980s. I do not see US President Reagan’s efforts as marking the start of America’s race for global dominance. I think that started much earlier. I don’t think we need go as far back as the American civil war late in the 19th century, which created a continental power that could aspire to global dominance, but we should go back at least to Roosevelt’s vision of globalising the successful New Deal to the world at large.

<sup>6</sup>E. J. Hobsbawm, *Nations and Nationalism Since 1780: Programme, Myth, Reality*, 2nd ed. Cambridge: Cambridge University Press, 1992.

Even though Truman reversed this, there were four elements that were common to both Roosevelt's and Truman's vision of American power in the world. First, American military power strategically placed around the world, initially as a strategy of containment of communism, today as the strategy of containment of "terrorism". Second, a new monetary system based on the dollar—and I need not add anything to Professor Mundell's account of how the gold-dollar based system collapsed and the pure dollar system emerged.<sup>7</sup> Third, economic assistance to military allies (in Europe and Japan) and client-states (in Asia, Africa, and Latin America). Fourth, political linkages (as an essential pre-requisite for military and economic assistance). There has been an essential continuity to these four aims in US conduct down to the present day.

Now, unlike the earlier British experience, the golden age of the quest for a US based Pax Americana during the 1950s and 1960s, was already at an end by the 1970s. By then the system had run into trouble. Capital had been accumulated, quite as it had been done at the turn of the last century in England, to a point where it had been diverted from production and trade to financial markets. By the mid-1970s the volume of purely monetary transactions in offshore markets had become a multiple of the value of world trade. To this was added \$80 billion of petrodollar surpluses, which truly created the rise of what might be called rogue capital, to borrow a phrase from Malaysian President Mahathir Mohammed. This capital became, and remains, a major source of instability for the world economy. Moreover, this capital is now poorly regulated. Whether Reagan intended it or not his attempt to shift the older vision placed the regulation of this rogue capital back into private hands. The big difference in the creation of UN Bretton-Woods institutions system was that unlike the nineteenth century, when capital had been regulated entirely privately, the UN system was a system based on public regulation of global capital. This was reversed with Reagan and that is where the problems began to arise.

In 1981, when Reagan came to the White House, the US federal deficit was of the order of \$75 billion. A decade later it was \$300 billion. Over the same period the US national debt rose from \$1,000 billion to over \$4,000 billion. That is what made the US the world's biggest debtor, very much as Britain became an indebted country after the end of the first war in 1914 by the time 1945 came around. Now in this situation, if 19th and early 20th century history is any guide, then the prospects for the US to maintain its hegemony of over the global financial system are limited, even though the prospects for its military hegemony remain more certain. This is also consistent with Professor Mundell's optimistic appraisal of the Euro's prospects. It is extremely likely then, if history is any guide, that either Europe or Asia—and in Asia the three countries that matter would be China, Japan and the Republic of Korea

<sup>7</sup>A peripheral note: after the initial severance of gold-dollar link by Richard Nixon, there was a period when the US was able to exploit what effectively became a strictly dollar system, to borrow and incur enormous debts, which led to the present consequence.

which hold, if I remember correctly, some 15 to 20 percent of global reserves—would be able to thwart the US bid for global hegemony. For these reasons I do believe that Professor Mundell's assessment of the prospects for US leadership of the world economy are somewhat more optimistic than is warranted by the historical analogies on which the paper's assessment rests.

This leads directly to the question: are the prospects for the Euro as bright area as Professor Mundell feels that they are? I think they can be, but the celebration of the significance of the issue of the Euro may be somewhat premature at this point. I am reminded of Chou En Lai's remark that it was too early to tell, when asked what he thought about the significance of the French revolution. I think that the launch of the Euro is really too recent at this point to judge whether it will be a significant event in history or not. Its significance will depend on who assumes the leadership of Europe. Let us not forget that England has chosen to distance itself somewhat from Europe. As a result, whether France or Germany emerge as the new leaders of the Europe will determine very greatly the extent to which the American aspiration towards global dominance will or will not be supported by Europe.

This leads finally to the question of the South Asian Association for Regional Co-operation (SAARC). I believe the recommendations on SAARC may be somewhat unrealistic, given again the enormous differences in initial conditions between Europe and the South Asian nations. Ishrat Husain has already commented on the technical aspects of the difficulties involved, but in drawing parallels with Europe let us not forget that Western Europe is really the secular name of Christendom. This is the source of its strength in that it is a homogeneous community of nations in which no fundamental disagreement on values exists. This realisation is embodied in the language of the Treaty of Rome, Which laid the foundation for economic integration in policy coordination, which now has culminated the launch of the Euro. These initial conditions, to put it mildly, do not exist in South Asia, but if one is to pursue this dream perhaps a regional bloc of West Asian countries—Pakistan, Iran, Turkey and countries to their North—may have a fighting chance at accomplishing the kind of the things that Professor Mundell hopes from SAARC.

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