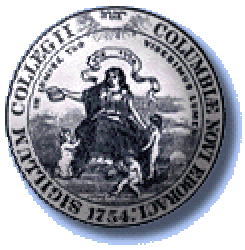

Columbia University

Department of Economics
Discussion Paper Series

The International Monetary System: Quo Vadis

Robert A. Mundell

Discussion Paper #:0102-34

Department of Economics
Columbia University
New York, NY 10027

March 2002

The International Monetary System: Quo Vadis

Robert Mundell

Columbia University

February 8, 2001

Manuel Guitian Memorial Lecture, International Monetary Fund, February 8, 2001

I. Manuel Guitian

Manuel Guitian was one of two brilliant students I met in 1965 at the Graduate Institute of International Studies in Geneva. Both went on to the University of Chicago for the Ph.D. program and to great distinction as economists. The other student was Rudiger Dornbusch.

My students at Geneva were required to write a research paper on international monetary economics. Manuel and I agreed that he should look into the Poincare-Rist stabilization of the franc in 1926. That got him interested in exchange rate theory and it was an interest that persisted throughout his life. The quality of his analysis of that important episode from the inter-war years convinced me that Manuel had a good future as an economist and I encouraged him to go to Chicago for his Ph.D.

University of Chicago Economics in the late 1960s was in one of its golden periods, maybe comparable to Vienna in the 1880s or Harvard, Chicago or Cambridge in the 1930s. There were Frank Knight (emeritus), Earl Hamilton (emeritus), Milton Friedman, Theodore Schultz, Harry Johnson, George Stigler, Hiro Uzawa, Arnold Harberger, Merton Miller, Bert Hoselitz, Robert Fogel, D. Gale Johnson, Gary Becker, Robert Aliber, Arthur Laffer, Stanley Fischer, Herbert Grubel, and myself.

This was the faculty milieu in which the "Spanish Mafia"--as we affectionately referred to Manuel Guitian, Alfonso Carbajo and Manola Gala–studied and worked and, yes, married.

Toward the end of his Chicago days Manuel asked me if I would be interested in organizing a conference in Madrid, in collaboration with his former professor there, Dr. Jose Naharro. Thus was born the "Conference on Optimum Currency Areas," held in Madrid in March 1970, the proceedings of which were published in a book edited by Harry Johnson and Alexander Swoboda in 1973, with the title, *The Economics of Common Currencies*. Manuel was a great help all through the organization of this meeting, which had a stellar cast that included Gottfried Haberler, Robert Triffin, William Fellner, Harry Johnson, Fritz Machlup, and Federic Boyer do la Giroday. It contained a number of interesting essays including my "A Plan for a European Currency."

I might mention one little-known incident in connection with this conference. I had invited General De Gaulle to give a dinner speech at the conference. He had stepped down as President of France and in my invitation letter I recalled to him the fact that at an earlier conference in Chicago in 1966, his former Minister of Finance, Valery Giscard d'Estaing, had given the keynote speech. Through his secretary he wrote back a nice letter, saying that he had promised his wife not to leave his home until he had finished his memoirs. But he ended the letter with an astonishing admission: "He regrets having to decline this invitation all the more *because he had never been to Spain!*" Imagine my surprise, then, to read that a few weeks after my conference in Spain, De Gaulle did visit Spain and was given an official welcome by Franco.

But now back to Manuel. Even before finishing his PhD dissertation, Manuel Guitian began his long career at the IMF. I kept urging him not to put off finishing it, and he finally delivered it. His career at the Fund took off and he was in a few years promoted to Division Chief. We kept in touch

whenever I was in Washington, and more frequently after I came to Columbia University. We also met frequently at conferences on the international monetary system.

Manuel and I had a chance to collaborate again on a conference in 1995. In the spring of that year I was a visiting professor at Renmin (People's) University and was organizing a conference for the People's Bank on "Inflation and Growth in China." It was through Manuel's intervention that the IMF became a major sponsor of it, along with contributions from Citibank and Deutsche Bank. It had a major pact on China's macroeconomic policy and the book on the conference, edited by Manuel and myself, was published by the IMF in 1996.

Over the years I was proud to watch Manuel's development as a mature economist, valued advisor and Department Director at the International Monetary Fund. Although a practitioner, his academic bent was always there. He was able to step back from day-to-day business and take a longer-run view of the Fund's objectives and accomplishments. At the IMF he became a kind of 'senior statesman,' writing thoughtful pieces on the direction the Fund and the international monetary system was taking. In some respects he took over the role that Marcus Fleming had in the 1960s and early 1970s. I know he played an important role in major IMF policy decisions.

I saw Manuel in the spring of 1999, on the occasion of some lectures to the Bank of Spain and learned then about his bout with cancer. Manuel had retired from the Fund and it was only there I learned about the transplant that seemed on its way to restoring his health; that was also an occasion for us to get together over dinner with Alfonso and Manola. The prospects for a virtually complete recovery for Manuel put us all in good spirits.

Alas, it was not to be. Manuel called to congratulate me on the Nobel Memorial Prize and to convey an invitation to speak at a conference organized by the Regional Government of Galicia in his home town, the great historic city of Santiago di Compostelo. This December 16 lecture was my first outside of Sweden since the prize was awarded. Manuel was there to introduce me as he had promised–with his family and his doctor. I had no idea however, how much his health had deteriorated. Yet he made a wonderful speech introducing me, and I will always remember his effort as a wonderful gesture to our long and deep friendship.

II. Quo Vadis?

The title of my lecture today comes from a passage in the Bible where the Apsotle Peter asked the risen Christ, "Domine, Quo Vadis"–Lord, where are you going? This passage became the title of a famous 9-reel motion picture made in Italy in 1912, a motion picture that was the first major feature film. A C. B. Demille remake of it in the 1950s brought the phrase into the common language. My subject is: "Where is the international monetary system going?

In the Biblical passage, Peter never got an answer. I have to try to provide one about the international monetary system. The answer to the question deals with the future. Can we know it? Can economists predict economic events in the future?

Actually, economists have a pretty poor reputation. During the 500th year anniversary of the

European discovery of what was thought to be Asia, it was said that Columbus must have been an economist. There were three proofs. First, when he started out, he didn't know where he was going. Second, at his destination, he didn't know where he had arrived. And third, the final proof, was that he did it all with public money!

Knowledge of the future derives from knowledge in the past. What is the relationship between knowledge of the future and knowledge of the past? In the 18th century, the great scientist Maupertuis came back from a trip to the north and astounded the world with his "theorem" asserting the symmetry of our knowledge of the future and the past. That earned him a vitriolic dispute with Voltaire, who thought the idea was absurd. Who was right? Here's my dog story.

If a dog was running away from me and turns a corner out of sight, I know his past but not his future. On the other hand, if he rounds a corner and runs toward me, I know nothing about his past and everything about his future! That sounds pretty symmetrical to me.

In both cases our knowledge about the future or the past comes from the common observation that all dogs understand Fermat's Theorem and the Calculus of Variations! The shortest distance between two points is a straight line. We can extrapolate with confidence because we have a theory we trust.

This is true in other areas too. We probably know just as much about the position of the earth in relation to the sun on that day in A.D. 33 when St Peter asked "Quo Vadis" –probably in Hebrew!-- as we do their relative positions in the year A.D. 3967. Again we have a good theory we have confidence in.

Our knowledge about the international monetary system in the future derives from our theories about how it works and how it evolves. These theories all depends on our experience and understanding of regularities in the past. If our theories are robust enough, we can make a roadmap of the future.

Good economists have often been able to make clever predictions about the international monetary system. As an illustration of that in my Nobel lecture, I gave the example of how three economists in the 1920s were able to predict the great depression long in advance. One economist came from Sweden, another from France, the third from Austria. I am speaking of course of Gustav Cassel, Charles Rist and Ludwig von Mises. They came from different schools of thought. But they were able to predict the great depression because they had in common the same correct theory of how the international monetary system works. They knew that restoring the gold standard at the inflated dollar price level in the 1920s would increase gold requirements, create a scramble for liquidity and bring on a monetary deflation. It did.

I will be discussing this issue in a generalized form in a lecture–the Thornton Lecture–I will be delivering at University College in London on March 14, 2001. The lecture is entitled "The Thornton Effect" because it was Henry Thornton who in 1802 revised Hume's and Smith's theory of the substitution of credit or paper money to take account of gold exports on the world price level. Hume and Smith had discovered that the introduction of credit (Hume) or paper money (Smith)

would displace specie of an equal value and because the money supply remained unchanged, so would the domestic price level. But Thornton criticized this conclusion on the grounds that it would only hold in (what we would call today) a small open economy. The effect on the world price level would be small or large depending on the proportion of specie displaced to the world supply of specie. I use this "Thornton Effect" to explain why shifts in the use of gold or silver as in the shift from bimetallism to the gold standard has important effects on the world price level.

The more theories of that type we have the more we can understand the evolution of the international monetary system and its future.

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 possibilities are noted in Table 28

Table 2. Alternative Fixed Points of Economic Policya

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 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 optimize 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 realized, 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, monetization 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 neighbors.

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 realized, however, that, other things 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 is lost, and the more likely is the fix to be a soft rather than a hard fix. 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% and 2% 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. 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% in 1981 and 6.2% in

1982. The brakes had been slammed on too heavily and unemployment soared to 11%. While the second mistake was more understandable than the first--the Volcker 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.[1] I want to now, instead, focus attention on 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 1994 the dollar was raised from 5.5 RMB 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 per cent in 1994, but inflation quickly came down in the 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.

Variations in the Dollar, Yen and Euro

A major problem for Asia in the future is the volatility of the yen-dollar rate. If it 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.

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 emphasize 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. I have already said that the United States cannot fix its exchange rate to the Mexican peso or the Canadian dollar. 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 to 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. The same can be said for Hong Kong.[2] Stability in both cases has to be measured by the inflation rate of (in this case) the dollar area.[3]

A credible system of fixed exchange rates in Asia—a currency area for 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 recognized that the Federal Reserve System was created only 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 Board 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.

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 a 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 Volcker and Alan Greenspan who have been outstanding. My guess is that now the United States has 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 per cent 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.

Prospects and Preconditions for a Single Asian Currency

What are the circumstances in Asia? The first important observation is the power configuration: three potential superpowers--Japan, China and India. Of course, if we think about this area – the South East Asian – India is not well into it and India has up until recently stayed aloof of South Asian entanglements. But in the new century India will overtake China as the most populous nation on earth and will have an important impact on the rest of Asia and the world economy. Having said that, however, I shall ignore for this discussion any consideration of a new role for India in Asia.

The power configuration is relevant because it determines whether a currency arrangement is likely to be hegemonic or not. Whether or not Japan or China (or India) is in a monetary arrangement makes all the difference in the world. 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.

Does Asia need a common currency? My answer is - Yes, it does need a common currency. But, it cannot have in the near future, if ever, a *single* currency. Here the European example is worth interpreting carefully.

Europe made an incredibly big step in the Delors report of 1989 when it made a plan for a *single*

currency in Europe. This involved the abolition of national currencies. The Delors Committee could have said, instead we are going to create a *parallel* currency and use it for international purposes, let the national currencies fall into disuse and fade quietly away. But, they did not say that. They said – replace. This was a big gamble at the time, because it seemed to be far ahead of European opinion on the subject or European willingness to give up that 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 does not seem much prospect for a single currency in Asia. Political integration has not proceeded far enough (and may never proceed that far). Nevertheless it is interesting to toy with the idea of an Asian currency as an intellectual experiment. Suppose it were politically possible 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 that direction by more politically-feasible half-way measures.

Remember the indispensable conditions for a successful currency area. There must be common agreement on the common inflation rate. Let us suppose that all Asian countries–or those that would participate in a single-currency union if it were politically feasible–agree on a common inflation rate of say 1-3 per cent. They formulate a monetary policy along the lines I have described earlier, on the pattern of the euro area. It seems to me that such an arrangement would be highly desirable for Asia. Objections to it based on asymmetric shocks, immobility of labor, differential growth rates fall to the ground, not so much because they are irrelevant but because exchange rates changes are almost never the best way of accommodating them.

But if the countries involved did not agree that a single currency would be desirable on purely economic grounds, there would be no good argument for proceeding to, say, a fixed exchange rate currency area.

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 in some fashion, 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 union is that, in the past, monetary unions have risen out of a hegemony. 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, 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 per cent 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 political and rises out of the differences in opinion about the blame for the Pacific War. Of course these problems are correctable, and may be healed with time.

Some Recommendations for Asia

Let me now make some conclusions regarding Asia. First, Asia needs a common currency, but it cannot 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 for an Asian Managing Director at some point earlier in the future. Fourth, the caucus should be used to promote a far-reaching reform of the international monetary system that would add two things to the Asia's Agenda: an international currency and regionalization of management. Fifth, set up a committee of the SEACEN or ASEAN-PLUS-THREE countries to study the possibility of an Asian currency. Sixth, begin regular and mutual surveillance on convergence in these countries, a kind of informal Maastricht-like exercise. Seventh, inaugurate policies that would minimize exchange rate uncertainty. 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. And then, 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 modeled on the original IMF Articles of Agreement providing for an anchored fixed exchange rate system, mutatis mutandis.

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 real taxation and 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, new currency areas and alliances will form. An alternative to joining one of the G-3 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 international currency confusion those countries met when they became free. It is also due to the difficulties and inept advice from the international institutions. Instead of being supportive of stabilization 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." The original planning at Bretton Woods thus made provisions for a world currency. However, it fell afoul of real politik. 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 and shifted the subject of discussion. The Americans had decided it was not in US interests and, perhaps, that Congress would not support it. Gold or the dollar would suffice in the post-war world. Like other superpowers before them, the United States rejected an international monetary reform that would include a world currency and perhaps compete with the dollar.

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 economized on gold. But in the 1970s the gold guarantee was stripped away and it was transmogrified into a mere basket of sixteen, and then five (an improvement), and now four currencies.

Are these grounds for optimism about the chances for a world currency? Would not the United States continue to reject the idea on grounds that it might take away the dominant role of the dollar? Perhaps not. The euro has gone some distance toward leveling the playing field, and the dollar itself will not retain the over-reaching role in the new century itself that it had in the past. The time may not be far off when the US itself will think that a world currency is in the US interests as well as the rest of the world.

A country now has the option of fixing its currency to the dollar, euro or yen, or even going the full distance and dollarizing (or "euroizing" or "yenizing"). It could also fix to a basket of these currencies or the SDR, which is now a basket composed of 45% dollars, 29% euros, 15% yen, and 11% 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 the American central banker Paul Volcker has aptly put it, “a global economy needs a global currency.”

1 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 harmonized 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. .

2 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. Similarly, Hong Kong’s currency board 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.

3 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.