

A Presentation by Nobel Laureate Robert Mundell

Professor of Economics, Columbia University

It is a great pleasure for me to address this conference on the subject of growth, poverty and the international monetary system. The subject might at first seem to bring together some strange bedfellows. After all, what literature in the learned journals of economics relates growth and the international monetary system or poverty and the international monetary system? I can illustrate that divide from a conference I attended in Paris last June sponsored by the World Bank, in which there was virtually no discussion, apart from my presentation, of the relation between growth and macroeconomic policies. What accounts for this divide? I cannot go into it deeply now, but let it suffice to say that the reasons lie partly in the dichotomy between real and monetary theory, and partly in the breakdown of the international monetary system.

How are 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 during the 1970s, policy becomes badly designed, growth falls, and poverty increases.

For this reason, I shall devote most of my lecture to a discussion of good and bad policies with respect to the international exchange rate system, consider the prospects and potential for an Asian currency area, and conclude with some steps on needed reform of the international monetary system. First, however, I want to plunge into my subject by commenting on some key trends in the world economy that are likely to affect the issues of poverty and growth with which this conference is concerned.

1. Key Trends Affecting Poverty and Growth

The first item on the list is the “new economy,” the information technology revolution, that has the hope of democratizing information in a remarkable way, of affecting productivity and cost in every aspect of economic life: in firms, households, institutions, and governments. Even if there were no new innovations, just the spread of existing technology would be enough to keep productivity rising for several years to come. In fact, information technology continues to move at breakneck speed, creating the possibility for some countries of leaping ahead of others that formerly were leaders. The events of the new

economy are potentially very equalizing, because they lower the cost of two very expensive factors of production, knowledge and technology, both of which are scarce in poor countries. An investment in Internet connections and broadband networks could have a high payoff for the developing countries.

I want to make another point in this connection. At the present time, the United States (US) is the technological leader in the information technology industry, with Japan and Europe coming up. The dominant language of the Internet is English and this gives a great advantage to the US and the other English-speaking countries. It also suggests that “catch-up” 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; the Philippines; Hong Kong, China; and Singapore are especially favored in this respect and should be able to develop important comparative advantages in the software industries.

A second factor is globalization, which you’ve all heard about, the good and bad aspects of it. It is not the first time we’ve had globalization trends. Globalization occurred at the beginning of the century under the first few years of the gold standard, with low tariffs, large capital movements, and a stable monetary system. It has been accentuated today by the information technology revolution and the big changes in communications. Globalization is neither good nor bad in itself: it is just that in the long run it is a step toward efficiency, but in the short run it involves all kinds of painful adjustments. And every country has to meet the challenge of globalization in its own individual way. The countries that treat globalization as an opportunity rather than a problem will benefit the most. Just contrast the export growth of the People’s Republic of China (PRC) with that of India! Notice the key link here between globalization and foreign investment. Opening up traditional economies to the rest of the world means that a lot of costs and benefits now depend, to a larger extent than ever before, upon foreign direct investment and its magic package of capital, technology, and markets. Two fast-growing countries have pointed the way here: a big country, the PRC, and a little country, Ireland.

The third factor is the US economic “miracle.” In the past 18 years, the US economy has been characterized by very rapid growth, creating something like 40 million jobs in the US economy, punctuated by the tax or supply-side revolution in the 1980s. Marginal income

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tax rates were lowered at the federal level from 70 percent in 1980 to 28 percent in 1988, and corporate taxes were lowered from 48 percent to 34 percent: a remarkable and complete revamping of the tax structure of the US economy

that set the stage for a much more efficient private sector and that had its payoff in the 1990s. That period of 18 years has been one of continuous expansion, except for a nine month recession at the end of the 1980s. The expansion resumed in the spring of 1991 and up until recently, we have been in the longest boom in US history. Of the four great expansions of the 20th century, this most recent expansion has been the longest. If it is now over, as early figures suggest, the US will be confronted with a problem of financing its

huge current account deficit of \$450 billion, 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 US has a current account deficit of over 4 percent of GDP, at \$450 billion a colossal annual flow. As this deficit encounters financing problems, and the dollar goes down, the US deficit, a great advantage thus far for the world economy as a source of both markets and foreign exchange reserves, will shrink, with vast implications for adjustment in the rest of the world.

The fourth factor is the continuation of the “Milken revolution” of the 1980s involving corporate restructuring. Companies are now bought and sold in the marketplace almost like ordinary commodities, and banks are being restructured. The optimum size of the firm has grown, and the optimum size of banks has grown. What becomes relevant is not the size of a firm in relation to the national market, but its size in relation to the world market. An open economy is the best way of ensuring that domestic monopolies are kept in check. Countries now need to look at company size in relation to the global economy.

The fifth factor relates to the advent of the euro and the reorganization of currency areas. The highlight here is the advent of the euro. It has been compared in importance to the breakdown of the international monetary system in the early 1970s. However, it is really quite different from that, because the euro has a promise of changing the power configuration of the international monetary economy, whereas the breakdown of the international monetary system (the movement from a fixed exchange rate system to flexible exchange rates) did not change that power configuration. Before and after 1971 or 1973, the dollar was the dominant currency in the world, as it has been throughout most of the 20th century. So I like to think of the advent of the euro as the most important event of the 20th century, at least since the dollar took over from the pound sterling as the most important currency in the world around 1915.

2. Growth and the Exchange Rate System

For most of world history, the international monetary system has been characterized by fixed exchange rates anchored to gold or silver, or both precious metals. That system was destroyed in the aftermath of World War I, when the gold standard broke down, was faultily restored, and broke down again. After 1934, when the US devalued the dollar and put the price of gold at \$35 an ounce, the dollar anchored to gold became the center of the international monetary system that was endorsed in the 1944 Bretton Woods arrangements that set up the International Monetary Fund (IMF) and World Bank. However, after the inflation fallout from World War II, the Korean War, and the Viet Nam War, the \$35 price of gold was no longer sustainable, and in August 1971, the US took the dollar off gold, and the other countries took their currencies off the dollar, giving rise to flexible exchange rates. Although an attempt was made to erect a dollar standard in December 1971, it broke up as a result of a conflict between US policies and those of the rest of the world. Generalized flexible exchange rates ensued that, in 1976, would be enshrined in the amended IMF Articles of Agreement.

a. United States monetary policy sets the pace

The mechanisms at work in the postwar fixed exchange rate system are worth noting. US monetary policy set the pace for world monetary policy and the US inflation rate became the floor inflation rate for the European countries that had moved to a surplus position. Europe wanted the US to reduce its inflation rate and correct its balance of payments. The US 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 those of the rest of the world. Fixed exchange rate zones do not work unless there is 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 system that followed it.

Table 1.1 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 pacesetter for the world—reflected the consequences of the breakup of the international monetary system into a regime of flexible exchange rates.¹

Table 1.1. 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

Source: WEFA *Historical Statistics*, July 1993

¹ 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 have occurred, however, without the increased elasticity of international money, manifested in the explosion of the Eurodollar market that arose from the movement to flexible exchange rates. From the end of 1972 to the end of 1974, this market increased by 79 percent, from \$284.7

A flexible system of exchange rates was, of course, by no means a new phenomenon in 1973. In the past, however, flexible exchange rates 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 1815. Irving Fisher in 1912 and John Maynard Keynes in 1922 advocated a standard based on price stability as an alternative to the gold standard. Frank Graham advocated flexible exchange rates in the 1940s as part of his scheme for a commodity reserve currency. In 1950, Canada adopted flexible exchange rates in violation of IMF rules, before returning to fixed rates in 1962.

b. The push to flexible exchange rates

It was, however, the influence of an unlikely pair of economists that 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 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 at the center of the international monetary system over the past two centuries.

The early arguments made a case for flexible exchange rates. "Fixed prices" smacked of wartime controls. Initially, Friedman's argument was that flexible rates would replace post-war 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.

3. Alternative Monetary Rules

But a choice between fixed and flexible exchange rates is an oxymoron. They are not comparable. 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 alternative routes to a given degree or definition of monetary stability are compared, 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 in the opposite direction, from the instrument to the target camp.

billion to \$509.5 (IMF *International Financial Statistics Yearbook*, 1986, p. 68); after the second oil shock in 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. Also in both cases, the dollar price of gold and foreign exchange reserves soared.

The three possibilities are noted in Table 1.2:

Table 1.2. Alternative Fixed Points of Economic Policy

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 any discussion of it out of what follows.

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.

a. The monetary rule

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 too 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 on, it would be rendered obsolete by innovations; and so on. Monetary targeting has failed in every country in which it has been tried.

“Fixed exchange rates, however, are not an alternative for all countries.”

This is not to say—to repeat the obvious—that policymakers should not carefully monitor the money supply; obviously all the variables in an economy have to be watched. Policymakers 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.

b. Setting exchange rates

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 a country's exchange rate 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 that, 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, are 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 that, for economic or political reasons, cannot find an appropriate partner currency. The dollar is a top 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; some countries might choose to peg to a basket of currencies, such as the special drawing rights (SDR) or a 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 and the unit-of-account advantage of fixed exchange rates is lost, and the more likely the fix is to be a soft rather than a hard fix, as a result 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; Canada; or Hong Kong, China can fix their currencies to the dollar, but the US cannot fix the dollar to the peso or the Canadian or Hong Kong dollar. As the possessor of the “nth” currency with the largest transactions domain, the US 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 US therefore must have a mixed policy, paying attention to major factors like the domestic inflation rate, major exchange rates, and the price of gold.

c. The inflation rate

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 the exchange rate and the price of gold first, 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 US, an upward movement 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; 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 US 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. In 1981 and 1982, the Federal Reserve was guilty of the opposite mistake: 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 Volcker Federal Reserve had to deal with inflationary expectations that had gotten out of hand—a slower disinflation would not have sacrificed so much output and employment.

I have discussed elsewhere (*Asian Wall Street Journal*, 30 March 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.² I want to focus attention instead on Asian currency problems under the situation prevailing today.

² A three-currency monetary union would involve bringing the three currency areas to the stage that the euro area had 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; (3) select a monetary leader (assumed here to be the Federal Reserve System) and a pivot currency (the

Important exchange rate changes have been a fundamental causal factor in the Asian financial crisis. The appreciation of the dollar against the yen was an important cause. 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, 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 by Japan. Foreign investment fluctuates with the yen-dollar rate: when the yen goes down, foreign investment by Japan drops off, cutting off that important source of growth. The

“A freely floating exchange rate system puts itself at the mercy of speculators.”

devaluation of the PRC renminbi (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 percent in 1994, but inflation was quickly brought 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.

4. Variations in the Dollar, Yen, and Euro

A major problem for Asia in the future is the volatility of the dollar-yen 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 it more exactly, any problem it had would be of its own making. 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 rate changes—then this poses a major problem. It would be very much in the interest of Asia, and the rest of the world, if the dollar/yen rate could be fixed again, as it was between 1948 and the 1970s.

a. Exchange rates *can* be fixed

There are some who continue to say that you cannot fix exchange rates now, because capital movements have become too large and dominate exchange rates, so that the central banks cannot fix the rates. 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 dollars in daily turnover, what kind of central bank interventions 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.

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, to meet periodically to make decisions on monetary policy and expanding or contracting the joint assets of the combined banks; and (6) make provisions for the disposition of seigniorage.

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 US 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, peseta, and 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 another that it would go 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 a 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 many of whose liquid funds 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 US stability by fixing the currency to that of a small country. The US could, to be sure, fix to the Canadian dollar, but such a move would dominate Canadian monetary policy without giving any stability to the US. A big country cannot fix to a little country. It has to be the other way round.

b. Fixed versus pegged exchange rates—which is best for Asia?

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 Taipei, China; 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, China.³ Stability in both cases has to be measured by the inflation rate of (in this case) the dollar area.⁴

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 dollar-yen rate. Hong Kong, China; the PRC; and Malaysia have fixed exchange rates with the dollar, but could not 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 dollar/yen 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

³ 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, China'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 dollarization as an alternative to the currency board system.

⁴ This is not to say that a nation's inflation rate that is fixed to (say) the dollar will get exactly the same rate of inflation as the US. For one thing, countries have different weights in their price indexes. For another, differential rates of productivity growth in the traded and nontraded goods industries can make real exchange rate changes necessary, and these will show up in differential inflation rates. For example, Hong Kong, China's inflation rate was consistently higher than that of the US after the currency board was established, partly because the entry rate undervalued Hong Kong, China's currency, but more importantly because Hong Kong, China's productivity growth rate in the internationally traded goods industries exceeded that in domestic industries, relative to the US, requiring an appreciation of real exchange rates. In the late 1990s, however, the situation was reversed and Hong Kong, China's inflation rate became less than the US inflation rate, even causing deflation in Hong Kong, China. The explanation for that shift was the information technology revolution in the US, coupled with the integration of Hong Kong, China with the PRC.

monetary policy, it needs to be recognized 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 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.

US monetary policy was 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 US. Past experience

has made current policy better. In the past two decades, monetary officials have learned from their earlier mistakes. The US has been lucky to have two outstanding

“At the present time, there does not seem much prospect for a single currency in Asia.”

back-to-back Federal Reserve chairmen in Paul Volcker and Alan Greenspan. My guess is that now the US has grown up to the task of maintaining a stable monetary policy: 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 US 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 real US exchange rate has to appreciate against those of its partners. Under fixed exchange rates, this would mean that the US inflation rate has to be higher than those of its partners in the same currency area. If the US therefore targets an inflation rate close to zero, its partners would have deflation inflicted on them. It is relevant to ask whether the US should not take into account the interests of its partners in selecting its inflation target, rather than looking at its own price level in isolation.

c. A currency-area view

Has US monetary policy been too tight in recent years? A case can be made that it has. 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; the PRC; Hong Kong, China; and Argentina are good examples—have all experienced outright deflation in recent years. A prima facie case can be made, therefore, that 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 impact better than a small pond. That is why a big currency area has more “monetary power” than a small one. 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 US, with an equal degree of monetary stability, the dollar is more stable, because the US economy is much less subject to shocks than the German economy. The German economy was subject to the shock of the German reunification 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.

5. 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, the PRC, and India. Of course, if we consider the South East Asian area, India is not well into it, and India has up until recently stayed aloof from South Asian entanglements. But in the new century, India will become 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. Whether or not Japan or the PRC (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, and a North American monetary union would have to consider the domination of the United States.

a. A common currency? Not likely

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 Asian 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, and 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 reunified and 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 useful to conceive 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 in moving in that direction by more politically feasible half-way measures.

Remember the indispensable conditions for a successful currency area. There must be 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 2–4 percent. They formulate a monetary policy along the lines 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, or differential growth rates fall to the ground, not so much because they do not create some problems, but because exchange rate 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.

b. A parallel currency

Let us consider the idea of 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 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, the PRC, does not yet have a convertible currency. But Japan has three 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, a 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. Of course these problems of Japan’s are correctable, and it would be in Japan’s own interest to reverse its policy mix and stabilize the yen.

c. Some directions for Asia

Let me make some conclusions regarding Asia. First, does Asia need a common currency? My answer is 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 for an Asian managing director at some point earlier in the future. Fourth, it should use the caucus to initiate and support a far-reaching reform of the international monetary system that would contribute to Asia's agenda and add two things: an international currency and regionalization of management. Fifth, it should set up a committee of the South East Asian Central Bank countries to study the possibility of an Asian parallel currency. Sixth, it should begin regular and mutual surveillance on convergence in these countries, a kind of informal Maastricht-like exercise. Seventh, it should inaugurate policies that would minimize exchange rate uncertainty, the big enemy, the Mecca of speculation. Eighth, it should work toward 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 its own way, with different interest rates. 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, it should work toward 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, it should set up an Asian Monetary Fund modeled on the original IMF Articles of Agreement providing for an anchored fixed exchange rate system, with the necessary differences having been taken into account.

7. 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 the 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 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 about 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. For the disaster of the transition economies (because you cannot talk about the 1990s as a decade of anything less than complete disaster for economies, when only two or three of 50 economies have the same GDP level now as when the transition began), I place the blame partly on the currency confusion those countries met when they became free. It is also due to the difficulties and inept advice they have been getting 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 us 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 postwar world.

The need nevertheless persisted, and persists to this day. An attempt to make up for the omission occurred 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 16, then five, and now four currencies: 39 percent dollars, 32 percent euros, 18 percent yen, and 11 percent pounds sterling.

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 to the SDR. The SDR is becoming a viable option as a unit of account for the world economy. The more countries adopt it as the anchor for their own 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.”