INTRODUCTION

The Search for Global Monetary Order *James A. Dorn*

Approaches to international monetary relations that foster competition among alternative currency units are more likely to enhance world welfare than systems like Bretton Woods that mandate change directed by supranational governmental bodies, which tend to ossify over time.

—Jerry L. Jordan

Globalization, Capital Markets, and Monetary Choice

Global trade liberalization, financial innovation, and information technology have created a new global economy in which private capital flows are dominant and governmental policy mistakes are quickly and severely penalized. The days when a group of central bankers and multilateral lending officers could dictate policy are over. If private investors disagree with official pronouncements, capital will flee to safe havens before the morning newspaper appears at the doorstep.

The lessons the Mexican and Asian currency crises should have taught us once and for all are that (1) a system of pegged but adjustable exchange rates is not a viable option in a world of mobile capital; (2) a clear choice must be made between fixed and floating exchange rates; (3) if monetary policy is not credible, the banking system is weak, and private property rights are not enforced, speculators will attack a currency with vengeance; and (4) the International Monetary Fund cannot prevent currency crises if the under-

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lying policies are wrong and may worsen them by increasing moral hazard.¹

The search for global monetary order is a search for monetary stability in an uncertain world. Perhaps the best we can do is to adopt rules that minimize harm, since no system is perfect. Those rules must be discovered; they are not known in advance by any single mind or any group of experts. That is why it is best to understand "search" in an evolutionary sense rather than to think it is possible for government planners to design a world monetary order. As Jerry L. Jordan, president of the Federal Reserve Bank of Cleveland, points out in his paper, "From a Hayekian perspective, it would be a 'fatal conceit' to think that a group of economic architects could dream up a monetary structure to house the global financial system for the new millennium." For that reason, he favors monetary competition over a new Bretton Woods system.

The fact that economists have imperfect information, however, does not mean they should not consider alternative monetary institutions from a theoretical perspective, or even compare existing institutions to some ideal, to try to discover better alternatives. But in doing so, economists must recognize the limitations of their vision and allow market forces to shape monetary institutions. People should be free to choose the currencies they wish to hold and the monetary arrangements they expect will best safeguard their property rights in money—that is, provide money of stable value.

A number of key issues arise in discussing the search for global monetary order. Four of those issues were the subject of panel discussions at the Cato Institute's 17th Annual Monetary Conference, October 21, 1999, which was cosponsored by *The Economist*. They are the following:

- Do we need a new Bretton Woods System?
- Is dollarization beneficial for Latin American countries?
- Has the new global economy changed the effectiveness of monetary policy?
- What are the relative merits of fixed versus floating exchange rates?

¹If investors in Thailand, for example, expect a pegged exchange rate to prevail (as they did prior to the Asian currency crisis in 1997–98) and think that the IMF will arrange a bailout if trouble arises (as happened in Mexico in 1994–95), they will have an incentive to borrow in dollars for the short term, convert into baht at the pegged exchange rate, and lend long term at higher interest rates. Banks and other investors will also take more risky investments. When the baht was devalued in July 1997, the real burden of the dollar-denominated loans skyrocketed.

In addressing those questions, the contributors to this volume seek to deepen our understanding of alternative monetary regimes and improve policy choices.

A New Bretton Woods?

The currency crises of the 1990s have led to a call for a new global financial architecture, which some economists interpret as the need to return to a Bretton Woods–type system or even a world central bank and a common currency. Such systems would be the antithesis of a global monetary regime based on the principle of spontaneous order and, thus, on monetary competition.

In answering the question of whether we need a new Bretton Woods, *Anna J. Schwartz*, a research associate at the National Bureau of Economic Research, argues that, if the object of reform is to manage exchange rates, "this vision of reform is not possible. Central banks and finance ministers are not endowed with the wisdom to know what are the correct values of bilateral foreign exchanges." She also contends that a return to the gold standard is not feasible today because governments would not tie themselves to rigid rules that would impose large costs on the private sector. The covertibility principle would be compromised beyond recognition. Most countries prefer to retain their monetary sovereignty and not tie the destiny of their domestic economies to the balance of payments by adopting fixed exchange rates. In Schwartz's view, "a new Bretton Woods system is not needed so long as independent central banks worldwide set as their primary goal an inflation-free economy."

Moreover, since today's private "capital markets can serve both public and private borrowers . . . on a commercial basis," Schwartz sees little justification for IMF financing of countries experiencing balance of payments problems or financial crises.

Pedro Schwartz, president of IDELCO in Madrid, is skeptical that even the best central bankers can match the outcome of a competitive market process in establishing sound money. He favors competition among national currencies over "a single world currency managed by a group of central bankers." Under a system of competing national currencies, floating exchange rates, and free capital markets—good money will drive bad money out. According to Schwartz, the accomplishments of the Bretton Woods system have been oversold: "Bretton Woods ushered in an era of world prosperity because it was the unwitting midwife of a return to a free economy."

Should Latin American Countries Dollarize?

The history of central banking in Latin America has largely been one of continuous currency debasement with brief periods of stability. To counter that history, Latin American countries must be willing to consider fundamental monetary reform. Dollarization is one sure way to limit the discretion of central banks and may be the wave of the future in Latin America. Indeed, Ecuador has already begun to dollarize, and Argentina has only a short step from its currency board regime to dollarization. Mexico, too, may decide to dollarize as it becomes more fully integrated with the U.S. economy.

Official dollarization would mean the legal recognition of the U.S. dollar as the home currency for all transactions. Such a move would make the Federal Reserve the central banker for those Latin American countries that chose to substitute the U.S. dollar for their own currency. The profit from supplying base money (seignorage) would go to the Fed (although it could be shared), but the Fed would not act as lender of last resort. Thus, countries that dollarize would lose the power to employ monetary policy to guide the domestic economy, but they would gain monetary stability, provided the anchor country (the United States) did not inflate.

Chilean economist *Juan Andrés Fontaine* opposes official dollarization, whereby governments impose the U.S. dollar on their people, but not "spontaneous dollarization," whereby people are free to choose the currency or currencies they prefer. He favors monetary competition, a regime of floating exchange rates, and independent central banks committed to price stability. In his view, "Currency competition is a natural extension of individual liberty and a practical way to protect Latin American economies from their central banks' monetary follies." Moreover, he sees "spontaneous dollarization" as "a positive step toward a Hayekian system of competitive private monies."

William A. Niskanen, chairman of the Cato Institute, argues that "the U.S. government should not promote a general dollarization of Latin America." However, if any Latin American country wants to dollarize, the U.S. government "should accommodate" that request. He suggests that, to offset the loss of seignorage to the foreign central bank that would occur as a result of dollarization, the United States should supply dollars to the foreign country at cost.

Dollarization, as a fixed exchange rate regime, is a step beyond a currency board system (CBS), because the reserve currency is fully substituted for the home currency. Thus, if Argentina, which now has a CBS, were to dollarize, its currency would cease to circulate and the

U.S. dollar would become the official currency. Interest rates would come even closer to U.S. levels, and there would be no risk of devaluation. (However, the dollar could still change its value relative to other foreign currencies, and an expansionary U.S. monetary policy could erode the future purchasing power of the dollar.)

Steve H. Hanke, professor of applied economics at the Johns Hopkins University, presents an abundance of data to show that the currency boards established in Argentina, Estonia, Lithuania, Bulgaria, and Bosnia-Herzegovina during the 1990s have worked well to create stable money and move those countries toward a free-market system. Accordingly, he writes, "It is time for economists to stop worrying about whether Currency Board Systems can work in theory and to start accepting and grappling with reality."

Mexico has long suffered from erratic monetary policy and devaluations. But there is little political sentiment for official dollarization. That is why *Roberto Salinas-León*, director of policy analysis for TV Azteca, favors "spontaneous, or de facto, dollarization." He thinks that, if Mexico allows "monetary choice," by eliminating "the legal tender monopoly of the peso," people will hold whatever currency best maintains its value. In this way, the U.S. dollar may naturally drive out the peso. But if the dollar were to lose its value, Mexicans would be free to switch to a better currency. Currency competition, in effect, would put pressure on the Mexican central bank to maintain the value of the peso or go out of business.

Monetary Policy in the New Global Economy

Has globalization weakened the impact of monetary policy on nominal income and prices? Not as long as there is a demand for base money, argues *Allan H. Meltzer*, a professor of economics at Carnegie Mellon University. Only a central bank can create high-powered, or base, money, which consists of currency held by the public and bank reserves. Monetary policy must ultimately work through changes in the monetary base. Since the new economy has not changed that fact, one cannot argue that globalization has made monetary policy ineffective, according to Meltzer. He does agree, however, that this conclusion is stronger for large economies than for "small, open economies with free capital movements."

What globalization has done is to force countries to choose between a floating rate system and a fixed exchange rate. With the former, a strong central bank committed to price stability is essential. If that condition cannot be met, then a CBS is one way to eliminate the monetary authority's discretion. The central bank would still issue base money, but the supply of base money would depend on the balance of payments, not on the discretion of central bankers. Of course, the central bank could be replaced entirely by the currency board, which would then issue home currency backed fully by the anchor currency. Dollarization, on the other hand, would mean that base money would be provided by an outside central bank, so the domestic central bank could be eliminated.

Meltzer believes that monetary policy is still effective and could be used to help Japan out of its long slump. What Japan needs to do, in his opinion, is to temporarily increase the rate of money growth until the current excess demand for money becomes an excess supply. People will then increase their spending, and deflationary forces will dissipate. In the process, the yen appreciation will reverse itself, and, as the real exchange rate is depreciated by more rapid money growth, Japan's competitiveness will return. A robust Japanese economy will benefit other Asian economies.

The low nominal interest rates in Japan should not deceive the Bank of Japan, argues Meltzer. Those low rates do not imply monetary ease or a "liquidity trap." Rather, the deflation that has plagued Japan reflects tight, not loose, monetary policy, which must be reversed to return Japan to "noninflationary economic growth." Monetary expansion, argues Meltzer, is a sensible alternative to deflation as a way to adjust the real exchange rate.

Stanford University economist *Ronald I. McKinnon* sees the Japanese situation in a different light. He thinks that Japan is in a liquidity trap, thus, monetary policy alone cannot be effective. What must be done, in his view, is to change expectations about the future foreign exchange value of the yen—the notion of an ever-appreciating yen (in terms of dollars) must be reversed. To do so, he recommends a joint effort by the United States and Japan to anchor the future value of the yen by exchange market intervention *and* appropriate monetary policy. Once people believe that the yen/dollar exchange rate will stabilize, they will resume a more normal rate of spending and banks could resume lending.

Exchange rate intervention, however, begs the question of how policymakers can know the equilibrium real exchange rate. There is also the problem that it is impossible to fix the nominal exchange rate, conduct an independent monetary policy, and have free capital movements. Finally, if there is no liquidity trap, but rather an excess demand for money, Meltzer's proposal appears more suitable. Yet, even in that case, Japan would still have to restructure its corporate sector and recapitalize or shut down insolvent banks.

Charles W. Calomiris, a professor of finance and economics at

Columbia University and a member of the International Financial Institution Advisory Commission, reviews the proposals for reforming the global financial architecture contained in the IFIAC report in light of criticisms raised by the Treasury and other critics. The IFIAC report, known as the "Meltzer Commission Report" (Allan H. Meltzer chaired the commission), was released in March and makes specific recommendations for revamping the IMF, the World Bank, and other multilateral development banks. Much of the criticism, argues Calomiris, is based not on "economic logic" but on "the political economy of foreign policy." He defends the economic reasoning on which the report is based and the underlying principles, especially "the premise that the World Bank and the IMF should not and cannot continue to serve the ad hoc political purposes of broad foreign policy."

The commission unanimously agreed that the IMF should not engage in long-term lending, and a strong majority (8 of 11 members) recommended that the IMF limit itself primarily to providing liquidity for emerging market economies. As Calomiris notes, "By providing lines of credit to countries that meet minimal pre-established standards, and lending to them as a senior creditor at a penalty rate, the IMF could prevent avoidable liquidity crises without sponsoring counterproductive bailouts of banks at taxpayers' expense." This reform would be a major change in the way the IMF conducts business. The only remaining question is whether the IMF is even necessary in a world where private capital markets are more than sufficient to provide liquidity to worthy borrowers on the terms suggested in the report.

George Selgin, an economist at the University of Georgia, asks how the advent of the euro may affect global monetary policy. His conclusion is that, if the euro becomes a strong currency in which people have confidence, then it can compete with the U.S. dollar and act as a brake on Federal Reserve policy. U.S. inflation would lead holders of dollars to shift to euros. Monetary competition will help ensure that the dollar remains strong. However, if the euro fails, then both European and U.S. inflation are likely to increase in the future, contends Selgin.

Fixed versus Floating Exchange Rates

There has been much written about the relative merits of fixed versus floating exchange rates. In his paper, *Peter B. Kenen*, a professor of economics and international finance at Princeton University, reviews some of the arguments for and against fixed rates. He agrees that pegged but adjustable exchange rates are not feasible and that the real choice must be between flexible rates and firmly fixed ex-

change rates. However, he thinks that, "for all but the smallest countries, which are economic appendages of larger countries and might as well adopt those large countries' currencies, flexible rates are more appropriate." Inflation-rate targeting, aimed at price stability, could then be used "to confer credibility on monetary policy."

Alan C. Stockman, a professor of economics at the University of Rochester, contends that "the choice of an exchange rate regime has been oversold." First, that choice "is merely a subissue in the broader question of overall monetary policy," whose "role can be easily overstated" (see Friedman 1968). Second, "that choice pales in comparison with establishing a legal system that carefully defines property rights and creates an institutional framework in which people can freely utilize and trade their resources." In other words, limited government, freedom of contract, and secure property rights should remain at the forefront when considering why some countries are rich and others poor. And, when deciding on an exchange rate regime, about the best one can do, says Stockman, "is to take a broad perspective on how to do the least harm." With that approach in mind, he concludes "that floating exchange rates have a strong advantage over fixed exchange rates, at least in the absence of common currencies."

In the final paper, *Leland B. Yeager*, an emeritus professor of economics at Auburn University, reminds us that it makes little sense to talk about fixed exchange rates in a world of discretionary government fiat monies. He takes us back to the need for fundamental monetary reform aimed at creating money of stable value. Until the question "What sorts of currencies?" is answered, currencies will remain adrift without any real anchor.

Monetary reform must begin, says Yeager, by having "the largest countries or monetary areas establish institutions assuring domestically stable units of account, perhaps even by getting governments out of the business of issuing money" (see Yeager 1997: 337–425). Once that primary task is accomplished, those countries "can safely let exchange rates and balances of payments take care of themselves." For Yeager, "it is diversionary to talk of reform of exchange rate systems without attention to domestic monetary systems themselves." That is a point worth remembering in the search for global monetary order.

References

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