The International Monetary System at the Beginning of the New Millennium

Robert A. Mundell

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Thank you very much for your introduction. It is a great pleasure for me to be at Hanyang University for the first time and to be speaking in Korea for the second time. I was here once before in November, 1992 for a conference on issues connected with what I am here for again, the APEC Forum, “Trade Liberalization, Capital Movement, and Monetary Stability.” My lecture today is on “The International Monetary System at the Beginning of the New Millennium.” I use in the title, “new millennium”, instead of “new year” or “new century” in order to emphasize the fact that the international monetary system has a long history, that it has taken centuries to evolve, and that it is still in the process of changing. When we look at economic events in the international monetary system in a historical context, we see some laws of its evolution that we can draw upon. This is what I hope to do today.

This lecture is not completely disconnected from the title and content of my Nobel Lecture delivered in Stockholm on December 8, 1999. That lecture was the last Nobel Lecture of the century and of the millennium, and I thought, therefore, that I could be a bit ambitious with the title. I was really in that unique position, with just a few days left in the 20th Century, where I could talk about the whole century. The title of my Nobel Lecture, therefore, was “Reconsideration of the 20th Century.” I did not say “Reconsideration of 20th Century Economics”; rather, I said “Reconsideration of the 20th Century.” How can we explain the meaning of the 20th century? The basic content of that lecture was to show that the international
monetary system itself had been a very important determinant of the events of the 20th century.
I want to begin now by outlining that sequence.

The 20th century started with a highly efficient international monetary system—the international gold standard. That gold standard gave the world a high degree of economic stability for much of the time it existed. It gave a high level of employment, low price levels, and low inflation rates. It was a world in which capital was highly mobile, moving from one country to another in an efficient fashion. The international gold standard could only be maintained with a few fixed points of policy. One was the requirement that fiscal stability be maintained. Countries had to have fiscal balance. Two others were: don’t tamper with gold and don’t tamper with exchange rates. They were parameters, not instruments of policy. Because they were fixed, expectations about them were fixed.

The gold standard, therefore, gave the international monetary system a high degree of stability. But it broke down in World War I. In the 1920s it was restored, but it broke down again in the 1930s. We then moved into a completely new framework for economic policy, a framework of macroeconomic management that relied on closed economy principles. The problem was that after World War II we went back to an international system!

In the post-war period countries were still following macroeconomic policies for a closed economy putting them on a collision course with the international monetary system. The system now began to break down because there was a conflict between the system and policies being followed. An international system can only survive if it is maintained by appropriate adjustment policies that take account of the need for equilibrium in the balance of payments. But, to use the two most famous examples, both the Americans and the British abandoned the automatic
adjustment policies necessary for equilibrium in the balance of payments. Their exchange
equalization accounts automatically canceled the monetary effects of gold or foreign exchange
losses by sterilization operations, thwarting the adjustment mechanism and imposing
disequilibrium on the rest of the world. The system eventually succumbed and broke down in
1971, when President Richard M. Nixon took the dollar off gold. In 1973, we moved to flexible
exchange rates. After taking gold away from the system and moving to flexible exchange rates,
the discipline of convertibility was ended, and countries embarked on inflationary expansionary
programs; these countries included the United States and almost all developing countries.

The United States had more inflation in the 1970s than it had ever had, even during times
of war. But in the 1980s, a reaction to inflation set in and the United States restored stability.
The monetary authorities tightened up its monetary policy after three years of back-to-back two-
digit inflation in 1979-81. With tax cuts and tight money it brought about monetary stability and
the supply side revolution in the 1980s. Gradually, under the influence of supply-side
economics, America restored its stability, and because countries like Germany and Japan had
also invested in stability, the last decade of the century became a period of comparative stability
in terms of price levels. This reversion to stability held for virtually all the major countries,
including the OECD countries.

The conclusion I made in my Nobel Lecture was that the 20th century ended with many
of the characteristics that were common to the first decade of the century---even though
everything in-between was completely different! In the 1990s we returned to price stability,
which was what we had in the first decade of the century under the gold standard. Meanwhile
Europe had been adding monetary integration to the pursuits of what became the European
Union. The Euro was created with eleven countries joining together to form a single currency and a monetary union. What the euro bloc had done, in effect, was to create a miniature gold standard system inside Europe. Today, therefore, there has been a partial return to old-fashioned principles, and we are embracing all the precepts people had about how to run the system in the first decade of the century (including balancing the budget, not allowing your public debt to get too high, and paying debt down so that high taxation will not be needed).

In an important dimension we have returned to exactly those principles that were scrapped in the decades between the first and last decades of the century. In this sense I have called the first and last decades the bookends of the century. But in two respects—the volatility of exchange rates and the lack of a universal unit of account, we are in deficit to the first decade of the century. Before I elaborate on that I want to mention another dominating force without which the century cannot be understood.

There was a little book written in 1906 that I call to your attention. It was based on a speech given by the American Ambassador to the United Kingdom, and the speech was delivered at Cambridge University, England. The title of the book was given to the American Ambassador, and he was asked to speak on a title, which he, indeed, did not choose himself. The title of the book was “The Greatest Fact in Modern History.” What subject do you think the author was referring to as being the “greatest fact in modern history?” It is not really so obvious, is it? Anyway, the subject he was given was “The Rise of the United States,” the subject matter of the book that had the title The Greatest Fact in Modern History.

It is important for us, as economists, to realize the truth of this. Back in 1789-92 the United States started with 4-5 million people. Suddenly, in just over a century, it becomes the
biggest economic power in the world. By the late 19th century, the United States was already the biggest economy in the world. But the preponderance kept increasing as the US economy further distanced itself from its rivals. By 1914, the United States economy was three times as large as the second biggest economy, the British economy, which was, in turn, closely followed by Britain’s rival, the German economy, which was nearly as large as the British economy.

At that time, 1906, the United States was unique among the great powers in not having a central bank. It had commercial banks, of course, and the U.S. dollar was completely tied to gold. Gold coins were circulated denominated in U.S. dollars. The coins included the Eagle and the Double Eagle, ten dollar and twenty dollar bills, (the price of gold was about 20 dollars an ounce). The Double Eagle, which weighed an ounce, was a twenty-dollar gold coin. The fact that there was no central bank in the greatest economy in the world meant that US monetary policy was automatic, it conformed passively to the its role as a participant in the gold standard, and the United States had no institution through which it could exert its monetary power. In short, it could be argued that the gold standard worked as well as it did before World War I because there was no Federal Reserve system to screw it up!

Even before World War I, and before the Federal Reserve began to exercise a decisive influence, there were hints that the gold standard was not going to work in the future in the same way it had in the past. As Keynes pointed out in his *Tract on Monetary Reform*, published in 1923, the gold standard came to depend upon the policy of just a few central banks. In 1913, when the US central bank, the Federal Reserve System, was finally created, the power of this youngest but instantly greatest of all central banks to dominate the system would only become obvious in its manipulation of the price level during and immediately after the war.
By the way, the oldest central bank is the Riksbank the Swedish central bank. In 1969, the Bank of Sweden celebrated its 300th anniversary by establishing the Nobel Memorial Prize in Economics. I suppose that had that not happened, I would not be standing here today!

But back to the Federal Reserve. In 1913, the new central bank had the power to make or break the gold standard. In 1914 World War I broke out, and Europe moved toward deficit financing and abandoned convertibility. Gold came to the United States to pay for war materials and raw materials. This was a situation that was quite typical before big wars, leading to the fall in the real value of gold and inflation in countries that stayed on gold. Not recognizing the significance of the new situation, the Federal Reserve monetized the gold inflows (the normal practice under the gold standard) and the US money supply began to increase rapidly. As a consequence the price level doubled in the United States from 1914 to 1920. It was only after the war that the Federal Reserve realized its error, and, in 1921, it started to tighten up, engineering a large deflation, bringing the price level came down from an index of 200 (1914=100) in 1920 to 140 in 1921.

In 1921 and 1922, John Maynard Keynes, the famous English economist, was in the process of writing the book, *A Tract on Monetary Reform*, that I referred to earlier. In this book he had noted the instability of the price level in the United States and therefore (because the dollar was fixed to gold) the instability of gold. He asked whether or not the Bank of England, which did not then have a coherent philosophy for its monetary policy, should concentrate on keeping the internal purchasing power of the pound stable, or instead should follow the old tradition of keeping its external value stable relative to gold. (The dollar and gold were fixed together because the United States, which did not enter the war until 1917, had managed to...
maintain the gold standard throughout.) What Keynes saw, however, was that neither the dollar nor gold were stable against commodities: the real value of the dollar and gold halved against commodities between 1914 and 1921, and, worse, appreciated against commodities during the deflation of 1921. If this was a foretaste of the future, a tie between the pound and gold (and the dollar) would condemn Britain to price instability. With the U.S. dollar going up and down considerably in real value, the British price level would have to fluctuate with the American price level if the Bank of England kept the pound stable against the dollar. The alternative for Britain would be to stabilize the price level in Britain, to follow a policy of, what we would today call inflation targeting. The stabilization of the internal value of the pound was what Keynes was recommending at that time, instead of targeting the exchange rate or the price of gold.

What Keynes said, in fact, was that you have a choice between internal and external stability. If the price level of commodities, expressed in terms of foreign currencies (like the dollar or gold), is fluctuating, fixed exchange rates would make the domestic price level also fluctuate. In that case, avoidance of instability of the price level would require the country to sacrifice fixed exchange rates (or a fixed price of gold). In general, unless the price level in the rest of the world is stable, the country has to choose between internal stability and external stability; it cannot have both. It can choose to stabilize the price level, which would require letting the exchange rate fluctuate, or it can stabilize the exchange rate by letting the price level fluctuate. Keynes argued that the primary goal of the monetary authorities should be to stabilize the price level, and that the goal of stabilizing the exchange rate, while important, was secondary. It is best to have both a stable price level and a stable exchange rate but if it is not
possible to have both—because the rest of the world is unstable—a country should give priority to internal stability.

Keynes was one of the first economists to realize that the Federal Reserve was now calling all the shots as far as the stability of the price level in terms of gold was concerned. For most of the 19th century, Britain had had the most important currency in the world. The pound, however, was no longer the equal of the dollar, and the US Federal Reserve System could dominate the Bank of England. Keynes thought that the management of the Federal Reserve might not be good enough, and this because it was inexperienced and too subject to pressures from private interests. The Federal Reserve, he thought will probably not take the lead in creating a policy of price stability. As it turned out, Keynes was wrong about the Federal Reserve in the 1920s but he was dead right about its policy at the end of the decade and into the 1930s!

In an op-ed article, just published this morning in *The Wall Street Journal*, entitled “Threat to that have Prosperity,” I addressed the question of the relative importance of external and internal stability. It is well known that Keynes gave primary consideration to internal stability, but it is not so well known that he argued that it was important to have external stability if it could be achieved without sacrificing internal stability. In my article, I argued that this issue is very relevant for us today, given the three large currency areas that have come to characterize the core of the world economy. But the same issues were relevant back then at the time Keynes was writing. If, for example, there were stability abroad—meaning that the dollar-gold price level was stable--Britain could have its cake and eat it too—both internal and external stability. As long as the dollar has a stable price level, then all Britain needs to do is to fix its currency to the
The pound, in turn, will then also have a stable price level. There is no conflict, and it is only when a foreign price level becomes unstable that there is a conflict. Keynes, therefore, made the very important point that countries should not let the exchange rate go if there is stability in the rest of the world. The primary consideration is internal balance, but the secondary consideration of external stability is also very important.

The advent of the Euro has brought up these issues afresh. As a result of its introduction, we have entered a new phase of the international monetary system. It is arguably the most important event in the international monetary system since the dollar replaced the pound as the major international currency in World War I. Unlike the breakdown of the fixed exchange system in the early 1970s, which left the dollar before and after the most important currency in the system, the euro creates the possibility of a change in the power configuration of the system. Upon its inception, it instantly became the second most important currency in the world. We now have three dominant monetary blocs, the dollar area, the euro area, and the yen area, which together comprise a transactions domain that represents well over half the world economy. It is not possible to talk about the architecture of the international monetary system outside the context of what happens to these three currency areas. These are the three key players at the present time in the international system.

Of course currency areas are not fixed in stone. They evolve with growth and political changes. You can imagine quite a way down the road that other currencies are going to become increasingly important. The Chinese renminbi or yuan could become a possible fourth currency if growth in China continues the renminbi becomes convertible. But at the present, we have to deal with the reality of these three important currency areas, and we also have to deal with the
reality that there is a high degree of volatility in the exchange rates between those currencies.

The volatility of exchange rates between the three currencies is in marked contrast to the internal stability each of the currency areas has achieved. The U.S. inflation rate has been consistently below 3 per cent over the past few years, as has the inflation rate in Japan. The euro is a recent creation but so far its track record, as the track record of the dominant currency in the area, the DM, has been exemplary. There seems little chance that any of the three large currency areas will lapse into monetary instability in the future, given the strong commitment to inflation targets between 0 and 2 per cent in each of the currency areas. But why should there be such volatility of exchange rates between currencies each of which have achieved price stability?

The volatility of exchange rates is harmful for those blocs because it aggravates instability of exchange rates, discourages trade, separates interest rates and reduces the gains from trade. But it is even worse for the other countries that have substantial trade with two or more of the three blocs. Look at the volatility of the dollar-yen rate over the past 15 years! In 1985, the dollar was around 250 yen. In April 1995, the dollar had fallen to 79 yen. Then, in only three years—from April 1995 to June 1998—the dollar soared to 148 yen. Recently the dollar has flopped down again to 105 yen. What is going on? Who gains from this volatility of the yen-dollar rate? Hedge fund operators may gain from the volatility but the people as a whole lose.

It is not any better when we look at the dollar-euro rate, even though we have had only a short time to look at it—not much more than a year. Since its inception the euro has depreciated by more than 20 percent—and this involves a real depreciation since price levels in the dollar and euro areas have been stable. The predecessor of the euro was the ECU (European Currency Unit) and the mainstay of the ECU was the Deutsche mark, over the past 25 years, it does not
look good. In 1975, the dollar was 3.5 marks. Five years later, it was held that at 1.7 marks.

Five years later, in 1985, the dollar soared to 3.4 marks. By 1992, at the time of the ERM crisis, the dollar flopped down below 1.4 marks, and now the dollar is up above 2 marks.

What is going on between zones that have stable prices? This is the major problem and defect of the international monetary system today. Do not think for a moment that the appreciation of the dollar over the period of 1995-1998 (combined, perhaps, with the devaluation of renminbi in 1994) did not play a key role in aggravating the so-called Asian IMF crisis. Volatility has become the enemy. That is the basic subject of my Wall Street Journal paper, “Threat to Prosperity,” which some of you have in front of you.

Is volatility inevitable? There is an old saw that intervention in the foreign exchange markets is useless because the daily turnover in the foreign exchange market is so high that it would dominate any intervention by the central banks. Well, that is just not true. How much intervention was needed when Europe, in the middle of 1998, decided to prepare for their monetary union by locking bi-lateral exchange rates? The franc, the lira, the peseta, the Deutsche mark, the guilder, the Belgian franc, the Austrian shilling, the Portuguese escudo—all the exchange rates were locked together. There was no speculation because the market knew that the central banks were serious about the rates and would back them up with unlimited intervention. As a consequence, no intervention was necessary!

It was also true that it was not just spot, but also future exchange rates were fixed. Interest rates converged throughout the area incredibly quickly. Is it not amazing that, for most of the 1990s up until 1997, the countries in the south of Europe, including Portugal, Spain, Italy, and Greece, had two digit interest rates, 10-13%, in many cases. When they decided to form a
monetary union, however, interest rates converged down to about 5%, an instant benefit for their economies and capital markets and especially for public finances of heavily-indebted countries. A fall in interest rates lowers the interest cost of servicing the debt, and reduces the budget deficit. A five percentage point reduction in interest rates brings more than a five percentage point improvement in the deficit/GDP percentage in a country where the Debt/GDP ratio exceeds unity and the maturity of the public debt averages one year or less.

Another point I want to emphasize--because it has been so badly treated in much of the literature--is that capital movements are nearly always beneficial between areas with truly fixed exchange rates. Capital movements are in the right direction as long as there is complete confidence in the exchange rate. You never get bad capital movements from New York to California, because the New York dollar is the same as the California dollar. Nor are there bad capital movements within the European Monetary Union. Capital movements go in the direction where they yield the highest rate of return, which is the direction of efficiency.

Problem arise with capital movements only when the exchange rate is uncertain. For example, consider all those countries that had fixed exchange rates in the post-war period. Japan had an absolutely fixed exchange rate of 360 Yen to the U.S. dollar from 1948 (the year of the 10-1 currency reform) until the 1970s. You never had problems of bad capital movements between Japan and the United States. Nor was there between the United States and Germany. Since 1948, when Germany had its 10-1 currency reform, here was a fixed exchange rate of 4.2 DM to the dollar. In 1961, for reasons that in retrospect seem suspect, Germany decided to appreciate its currency, lowering the value of the dollar from 4.2 DM to 4.0DM. That appreciation of the mark just whetted the appetite of speculators. They thought that, now that
Germany had started to change exchange rates, it might continue. The revalorization created a great wave of capital movements and some instability.

Examples could be multiplied indefinitely. You have the case in 1983 when, as you know, Hong Kong adopted a currency board. Exchange rates were set at 7.8 HK dollars to the US dollars. According to many criteria, that system worked beautifully. Until the crisis period of the late 1990s, the Hong Kong currency board was run by three commercial banks. Just before the British left, however, they created the Hong Kong Monetary Authority. Governments got into the picture and made a mess of it. The Hong Kong Monetary Authority started to talk about supporting the stock market in Hong Kong, instead of following the strict principles of a currency board. Hong Kong therefore had a little bit of a crisis due to the inevitable uncertainty over the exchange rate, but it recovered quickly and it did do much permanent damage. Confidence in the fixed rate was restored and, I hope, a lesson was learned.

People refer to the “Asian Crisis”. I mentioned, in fact, the culpability of the appreciation of the dollar against the yen as being a factor. I myself do not like the term, the “Asian Crisis”, because it was a crisis for just a few countries, and each crisis seemed to have different reasons. It was, of course, certainly a crisis for countries like Thailand, Malaysia, Indonesia, and South Korea, but it was not a crisis for Singapore, China, Hong Kong, Taiwan or Japan.

What did those five economies that did not have a crisis have in common? It was not fixed exchange rates. Singapore, Taiwan and Japan had inflation targets, China had a fixed exchange rate from 1994 to the present along currency board lines but, of course, with exchange controls or capital account. Hong Kong had a fixed exchange rate.
One thing these countries that escaped the crisis had in common was a precise and well-known target for their monetary policy. Everybody knew what the target of monetary policy was, and there was a track record showing that it would be consistently aimed at.

The other thing these countries all had in common was a very large foreign exchange reserve, so they did not have to draw on the IMF or accept outside advice. Those large foreign exchange reserves represent a kind of protection and a warning to speculators not to speculate against their currencies. To me, those two things are principles that should be written on stone. There should be very clear-cut, explicit and transparent targets for monetary policy. You must have ample foreign exchange reserves, especially relative to the debt situation of the country. Higher debt situations dictates the need for high foreign exchange reserves.

Policy choices can involve fixed or flexible exchange rates. But it is meaningless in the abstract to choose between fixed or flexible exchange rates. To me this is a poor way of putting the issue. A fixed exchange rate is a kind of monetary rule. If Hong Kong fixes the exchange rate to the U.S. dollar, that determines Hong Kong’s monetary policy. Argentina fixes its peso to the U.S. dollar and has done so since 1991; that has become Argentina’s monetary policy. A fixed exchange rate is monetary rule.

A flexible exchange rate is not a monetary rule. It is the absence of a specific monetary rule, that of fixing the exchange rate. A flexible exchange rate is consistent with price stability, but it is also consistent with hyperinflation. You have to compare a fixed exchange rate, which is a monetary rule, with other monetary rules.

There are only three monetary rules worthy of much discussion at the present time. One monetary rules if fixing the exchange rate. Another one is fixing the money supply. Milton
Friedman used to be an advocate of that, but I do not think anybody else is any more. The other is inflation targeting, or targeting a basket of commodities to stabilize.

Let me make a digression here. A few people might want to go back to the past and target the price of gold. This is an unusual view, and I don’t support it at the present time. But it has some basis. It could be argued that United States policy in the late 1990s was too tight and that it helped to create the Asian crisis. Because the price of gold was falling to twenty year lows ($250 an ounce after being around $350), they used it as an indication that American monetary policy was too tight and that America was deflating and imposing that commodity price deflation onto the Asian countries. My basic argument against a gold target is that gold has not been as stable against commodities as it used to be, partly of course, because of government policy. At the present time, for the United States, an inflation target is the preferable. So we are back to the three key choices for people are inflation targeting, monetary targeting, or exchange rate targeting.

Monetary targeting is a heavy-handed instrument, which does not work very well because the monetary supply is not very coherently defined and because its relation to the price level is not exact in the short run. As far as the definition is concerned, you have to decide whether or not you mean M₀, M₁, M₂, or M₃, or higher. There are all kinds of different definitions of money, and people who have espoused monetary targeting keep flipping from one to the other so you do not have a clear-cut, coherent position. The European central bank looks at but does not exactly target money supply. It does make projections of it, and they use the concept M₃, which is currency plus demand deposits plus time deposits plus Treasury bills and some certificates of deposit. My own view is that it is only useful to talk about targeting the
money supply in countries that have a lot of inflation. Countries in hyperinflation obviously have to, and they can only solve their problems if they can tone down the money supply. As we get down toward a 20% inflation rate for a year, it is much better for countries to think of targeting the price level or the inflation rate in order to get inflation rates gradually lower.

If you have a 15-20% inflation rate, it is idiotic to think of stabilizing the exchange rate against a stable currency. You can only start to think of stabilizing the exchange rate as your goal of monetary stability when the inflation rate has gone down to the inflation rate of the anchor that you are going to fix it to. It is only when inflation rate comes within that zone that it is feasible to start to think about fixing the exchange rate.

In the abstract nothing can be said about which of these targeting systems is better. It depends on the condition and position of the country. The United States cannot fix its exchange rate. What currency it would fix to? The Canadian dollar, a country one eleventh the size of the United States? the Mexican peso? No, big countries cannot fix to little countries, because they would simply impose their own inflation rate on the smaller countries. Smaller countries can peg to the big countries, not vice versa. So, the biggest country in the world cannot fix its exchange rate; it is not an option. The smaller countries can, however, and that is a new option that those small countries have. My own view is that small countries can typically gain by fixing their currencies to large and stable economic neighbors. I want to say something now about the volatility of the rates between the major blocs. What could be done about it? Let us imagine. Put politics aside, and just imagine you have a monetary union between Japan and the United States. That looks a little far-fetched right now, but everything I will say now could also be applied to a union between the United States and Europe. How would you go about this in these
two areas in which each has balance and stability? How would you go about making a monetary union? What would be involved in it, and how difficult would it be? Well, you could ask if it would be more difficult than getting eleven countries together in Europe and scrapping their national currencies in favor of a single currency.

I think that from the management standpoint, it would be much easier. There are two types. You could have a two-currency monetary union or one-currency monetary union. Let us suppose that they decided to replace their own monetary systems and have a one-currency monetary union. Let us look at the end game. If you had a single currency monetary union with Japan and the United States, how would it be managed? You would have to have a central bank that would have a policy committee in charge of open market operations. There would have to have a common index of prices for the Japanese and American economy, just as Europe has a harmonized index of consumer prices. There would have to be a common index of prices for the Japanese and American economy, just as Europe has a harmonized index of consumer prices. There would have to be a monetary target both countries agreed upon: a target of say, 2% inflation for that specified index. Naturally there would have to be periodical meetings of their policy committee to decide whether to expand or contract. And they would have to have another arrangement to divide up the seigniorage from monetary expansion. That is just what the Europeans did with eleven countries. If those conditions were met, there is no reason why monetary policy in the combined area would be worse than it is now. My belief is that it would be much better, and it would remove the contentious problem of the “correct” yen-dollar exchange rate.

What if the two countries wanted to keep their own currencies? The United States is not
going to give up the dollar, the most successful currency of the 20th century and the most
important currency in the world today. Japan might not want to give up its Yen. But you could
have a two-currency monetary union that would do exactly the same thing. There are a number
of ways of going about it, but I will choose the easiest. The U.S. is a bigger economy than
Japan. Use the dollar as the major operating vehicle and the Federal Reserve System as it is
suitably charged, as the operating central bank. They have the Bank of Japan fix the yen to the
dollar and do nothing else. Because it is convenient numerically, let us make 100 Yen equal 1
US dollar or 1 Yen equal 1 US cent. The Yen then becomes just another denomination of the
dollar. You are going to have to absolutely lock in the exchange rate. The Bank of Japan will
stand ready to buy and sell dollars at 100 Yen to the dollar. Interest rates in the two countries
would be the same.

All the forward rates would be fixed too. This is a “permanent” deal, and you will get all
the conditions of the single currency monetary union. Because of numerical coincidence, you
maintain the valuable element of transparency, the notational convenience, and all the things that
would be associated with it. You would then have the monetary officials from the Bank of Japan
and the United States that form the open market committee use the indispensable common index
of prices. The Fed would buy either U.S. or Japanese bonds to expand the money supply. The
policy committee would make policy according to their best judgment of how to hit their
inflation targets. You would make an arrangement to divide up the seigniorage---probably in
proportion to the GDP in the two different countries. You would then have a two-currency
monetary union with absolutely fixed exchange rates that would operate for all practical
purposes like a single currency monetary union.
Now, if you had such a system, do you not think that each country would have price stability with zero change in spot and forward exchange rates? Do you not think that a joint or interlocking currency would be the optimum for those two countries? I think the answer is absolutely yes. If that is the case, how can you justify a system that has such incredible volatility between the dollar and the yen? You cannot justify it, because we do not have in economics multiple solutions that are from a welfare standpoint, equivalent. There is usually only one optimum solution. There is no way in which you can show that fluctuations in these exchange rates are good. All they end up doing, quite apart from stuffing the socks of hedge fund operators, is destabilizing the financial market and the tax systems. Whenever you change the exchange rate a great deal, you change both the potential and the real burden of tax systems, the real value of bonds and the burden of indebtedness, and increase volatility in financial markets. This is not good for the world economy.

What we end up with at the end of the century, therefore, is a number of principles that we started the century with---but what we also end up with is a bad system between the major currency blocs. What Europe has done is lock the exchange rates of the eleven countries. That is having a demonstrative effect outside Europe. That is having a demonstrative effect in Latin America. Next month, I will be traveling around South America talking about a MERCOSUR currency. Many, many countries have seen that they would be better off in a larger currency area. They want to do what Europe has done. We do not know whether or not it will prove to be feasible.

What can be said about the “Asian” monetary system? What would it mean? What I will say is that in Latin America a number of things are possible which might be possible in Asia as
well. But politics overrides economics. You can get a monetary union working only between countries that have buried the hatchet, so to speak, on the international political scene. Currency areas, above all security areas, have to be a collaboration between countries which have decided against going to war with one another. A common currency, like the Euro, involves a sacrifice of monetary sovereignty and a sharing of monetary sovereignty, You give up compete sovereignty on monetary policy, but you get a sharing of much more important sovereignty throughout the whole area. You can only do that, however, if political relations make it feasible.

Currency areas work best among friends and allies.

I think it would be premature to start with any kind of plan for currency union or monetary union among the APEC countries. What I will be proposing tonight at the APEC forum is the development of an Asian Monetary Fund that would take us part of the way along the path towards monetary integration in Asia. It would be a big forward step and could become a catalyst for better political relations among different areas within Asia that could lead, at the end of the line, to an Asian monetary area. I will now conclude by thanking you all for coming.