"The Evolution of the International Financial System"

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My remarks are organized in two parts. First, I offer some general comments on several aspects of currency arrangements. I follow with some observations on three features of the international financial system in the 21st century: the currency system, capital flows, and responsibilities of authorities in the major economies.

Currency Arrangements

A. A Common Global Currency?

Many believe that a common global currency is the most attractive monetary arrangement from a global perspective; some wistfully identify such a regime with the 19th century gold standard. Under such a regime, foreign-currency transaction costs would be eliminated, foreign exchange crises would be a thing of the past, and a single money and capital market would allocate efficiently a global pool of savings to achieve maximum expected returns. To obtain the full promised potential from such a regime, wages and prices would have to be flexible, labor and capital would have to be mobile, and the scope for governmental intervention in the economy would have to be extensively circumscribed so that automatic mechanisms could be unleashed to adjust to changes in national economic and financial circumstances; for example,

wages and prices (and, thus, real wages and relative prices) potentially would need to be free to decline and rise.

In the absence of those conditions, changes in global economic and financial circumstances - in particular, shocks with differential impacts on national economies - would be likely to lead to governmental intervention, at a minimum, to short-circuit the global system's automatic-adjustment mechanisms. For example, governments would be tempted either to cushion the downward adjustment of wages and prices or to cushion the impact on employment and output of insufficient flexibility in wages and prices. Moreover, if the common currency were to be issued by a global monetary authority, it would be necessary to reach agreement on the objectives and political accountability of that authority. Finally, unless the monetary regime were accompanied by an approach to the global financial system with no public safety net, multi-national agreement would also be required on the supervision and regulation of that system. At the national level, the scope to provide lender-of-last-resort support to the financial sector would be very limited.

Although I can imagine convergence toward such a monetary regime at some point in the 21st century, I doubt it is a realistic possibility in the next few decades.

B. International Currencies?

For most of the 20th century, at least one national currency has played a role in the international financial system as a major international currency, first sterling and more recently the dollar. I define an "international currency" as one that serves as an international unit of account, means of payment, and store of value for both the private and the public sectors. Moreover, a national currency that is used in international transactions or investment activities involving economic agents in two countries and the currency involved is issued by one of the

countries has a very different role compared with a national currency that is used in international transactions and investment activities among agents in two countries and the currency involved is issued by neither of the countries. By the first test, there are many international currencies today, particularly in the financial area where non-residents borrow in and, to an even greater extent, invest in assets denominated in local currencies. By the second test, there is only a handful of international currencies, actual and potential. In today's world, the choice of an international currency in the broadest sense is one made by the market and not via some governmental edict, and an international currency's role as a store of value for the public sectors (its reserve role) is of limited importance.[1]

The benefits to today's global financial system of the availability of an international currency are similar to those associated with a regime with a single global currency; they derive from reduced costs, increased efficiency, and enhanced liquidity in international transactions.[2] These benefits accrue primarily to the system as a whole as long as economic agents are free to use, or not to use, the international currency in their transactions. The costs to the system are minimal because national monetary authorities are not constrained by the monetary policy decisions of the country issuing the currency, are free to use their own policies to adjust to changing economic and financial circumstances, and are not required to hold their foreign

[1] For example, today less than 20 percent of foreign portfolio claims on the United States take the form of claims by official institutions.

[2] The distinction between a regime with common global currency and a regime with single international currency is analogous to the distinction between a world with a common language used by everyone in all communications and a world with many languages but only one language that is used in all "international" communications. In the absence of an "international" language, communication suffers because one or both parties would have to learn multiple foreign languages in order to communicate, and accurate communication suffers as a result. Multilingual communication, involving more than two languages, is even more handicapped.

exchange reserves in any one international currency. Financial institutions chartered in the country issuing the international currency may over time derive some benefit from their access to a lender of last resort that is perceived to have the ability to influence the creation of international credit, but this is hardly a benefit that can be recorded in a country's national income and product accounts. At the same time, the national monetary authorities in the issuing country may feel constrained in their decisions because of their reduced capacity to monitor and control the growth of credit denominated in their currency.[3]

It is fashionable to observe that the international financial system is headed toward a tri-poler world with three international currencies playing roughly equal roles. This may well be the case, but I would argue that there is no added efficiency for the system as a whole from multiple international currencies. Moreover, although some argue that more than one major international currency would provide a healthy element of competition, others argue that potential volatility would increase.

C. The Future of National Currencies?

For a country whose currency is not an international currency, the question is whether there is a net benefit to its independent status. The potential benefit derives from two features of the regime: the use of exchange rate adjustments to alter relative prices, and the scope for independent macroeconomic policy - primarily, but not exclusively, monetary policy. A country may choose to preserve its policy options by adopting a regime with some form of adjustable peg,

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[3] I do not include seigniorage on the use of paper currency as a benefit deriving from a currency's international role because in today's world, and as a rather recent development, such international seigniorage primarily derives not from the use of another country's currency in international (transnational) transactions but principally from its use in its domestic (internal) transactions.

but it cannot expect on a continuing basis to be able to exercise much independence in its monetary policy. If a country is to exercise significant independence in monetary or other macroeconomic policies on a continuing basis, it must have a substantial degree of exchange rate flexibility. However, even under floating exchange rates, the exercise of that independence is constrained by global economic and financial conditions, as the authorities of a number of major countries learned during the 1970s.

A relevant question is whether during the 25 years of floating exchange rates among the major currencies, and the growing integration of international money and capital markets over the period, the scope to exercise independent monetary policies has declined. Abstracting from changes in domestic and international economic and financial environment, i.e., from business cycles and the volatility of inflation, differentials among short-term real interest rates are a crude proxy for the de facto scope for independent monetary policies. This thought led me to look at some evidence.[4] What I found was that under fixed exchange rates in the 1960s, differentials in real short-term interest rates between Germany and the United Kingdom and the United States were 100-200 basis points.[5] In the 1970s, differentials (including for Japan) often exceeded 300 basis points and, and at times exceeded 450 basis points. In the 1980s, observed differentials declined somewhat, but they increased again in the 1990s, at times exceeding 300 basis points. The evidence from these crude proxies suggests that, with floating exchange rates, the scope to

[4] Proxies were constructed using nominal short-term (generally three-month) interest rates for Japan, Germany, the United Kingdom, and the United States deflated by the 12-month lagging CPI inflation rate. The absolute values of differentials with the U.S. short-term real interest rate were smoothed over rolling five-year periods. My former colleagues in the Division of International Finance at the Board of Governors of the Federal Reserve System generously constructed the proxies.

[5] Comparable interest-rate data were not readily available for Japan during this period.

exercise an independent monetary policy is larger than under fixed rates and remains substantial, at least for countries whose macroeconomic policies are fundamentally credible, including not only the G3 economies - Japan, Euroland, and the United States - but also, based on the U.K. evidence that was assembled, for countries such as Canada and Switzerland.

What about other countries and their currencies? We appear to be witnessing a trend away from the "middle ground" of pegged exchange rate regimes combined with discretionary monetary policies.[6] This is an appropriate and pragmatic trend, and the international financial community, in our view, should be reluctant to provide extraordinary financing to support middle-ground regimes when they are not supported by strong institutional arrangements and are potentially vulnerable. At the same time, adoption of a floating exchange rate regime does not automatically bestow on a country meaningful policy independence; that requires the establishment of a sustained record of policy and performance.

At the other extreme, a country may abandon its currency and adopt another country's currency as its own, for example, via dollarization. A country may choose to take such a step, having rejected the middle ground of an exchange rate peg, because its macroeconomic policies are insufficiently credible to take advantage of the scope for discretionary policy offered by floating. However, unlike the choice of monetary union which involves sovereign decisions by all the parties, the choice of dollarization, or the equivalent adoption of another country's currency, fundamentally should be for the authorities of the dollarizing country to make because the decision has large potential economic, financial and political consequences.

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[6] We have seen a trend toward floating exchange rate regimes, first in Asia in 1997 and this year in Latin America where four countries have followed Mexico's 1995 example and abandoned regimes involving various types of exchange rate pegs - Brazil, Chile, Colombia and Ecuador. Malaysia is a counter example, having adopted a peg in September 1998.

The United States, in principle, is open to a choice by another country to dollarize. However, we have said that it would be inappropriate to adjust the procedures and orientation of U.S. monetary policy in light of a country's choice to adopt the dollar, to increase the responsibilities of our bank supervisors to cover institutions in that country, or to provide expanded access to the Federal Reserve's discount window to its financial institutions. We have also indicated our interest in discussing such a choice with the authorities because, depending on the economic size of the country, its decision and the quality of its advance preparations potentially could impact adversely the United States as well as the global financial system.

Three Observations about the International Financial System in the 21st Century

I conclude with some observations on three features of the international financial system in the 21st century: the currency system, capital flows, and the responsibilities of authorities in the major economies.

A. The Currency System

Given the diverse development of exchange rate regimes over the past thirty years, I am reluctant to forecast the shape of the global currency system five, ten, twenty or fifty years from now. The safest judgment is that the currency system will continue to evolve along with the evolution of the international financial system. It is no accident, and in my view remains wise, that Article IV of the IMF Articles of Agreement calls upon "members to assure orderly exchange rate arrangements and to promote a stable system of exchange rates" not a stable exchange rate system. In a rapidly changing international financial system, the search for comprehensive approaches to global exchange rate systems is likely to be unrewarding.

When it comes to exchange rate regimes, there are no panaceas. It is easy to demonstrate that there is no single regime that is best for any national economy under all economic and

financial circumstances; the disturbances with which regimes must cope change over time. National authorities have to make choices about which regime on balance will best serve their economies; because changes in regimes are not costless, eclecticism also is not a realistic option. Similarly no global currency system promises to serve best the interests of the global financial system under all conditions. Hence, the ongoing debate about currency regimes.

In my view, it would be undesirable if the global financial system were to evolve in the direction of large currency blocs. In the jargon of the economists, there are today few natural optimal currency areas aside from cases where there economic integration is an overarching objective, such as Euroland. Viable currency blocs are likely to leave out a large number of economies participating in the global economy. Moreover, the analogy to trade blocs is weak. The economic case for a trade bloc rests on the observation that ex ante trade barriers are high; the establishment of the trade bloc serves on balance to reduce trade distortions, creating more trade than is diverted. Currency blocs, on the other hand, run the risk of increasing distortions through the erection of barriers to the free flows of finance where few exist today, at least among the major currencies and financial markets.

B. Capital Flows

When it comes to global capital flows, I do not believe that the global currency system is the major source of potential crises. Consider a regime with a common global currency. Under such a regime, as with national monetary systems, capital flows would not be immune from irrational exuberance or despondence, and crises would continue to be possible.

Whatever one's philosophy, at a pragmatic level, responding to potential problems associated with international capital flows by the imposition of controls on those flows is likely over time to prove to be inefficient (and, therefore, costly), ineffective, or both, unless the

national financial market itself is tightly controlled or highly underdeveloped. Moreover, experience has shown that as countries develop and grow, controls are relaxed and financial systems are opened up. Thus, a better response to the potential problems associated with international capital flows lies in the promotion of sound macroeconomic policies, flexible markets, robust financial systems supported by appropriate regulations and supervision, transparency about regimes and institutions, and adherence to agreed global standards.

C. Responsibilities of Authorities in the Major Economies

In order to provide support for the appropriate evolution of the international financial system in the 21st century, the authorities in the major economies should implement sound macroeconomic and structural policies, demonstrate their respect for market forces, and endeavor to follow a policy of inclusion when it comes to establishing the rules and principles that will guide and govern the financial system. All this may sound like very little, but it is remarkable how taxing it is to accomplish these tasks effectively and successfully.