Symposium on In Search of
a Stable Currency System in
the 21st Century
December 1999

Occasional Papers

No. 9

In Search of a Stable Currency System in the 21st Century

Published by
I I M A
Tokyo
2000

Contents

Opening Remarks

Toyoo Gyohten
President
Institute for International Monetary Affairs

The year 1999, the gateway to the millennium, brought about some significant developments in international financial markets.

The euro, the single European currency, was born after 50 years of unrelenting endeavors. This, I must say, is the greatest achievement of post war international financial history.

The American economy changed its nature dramatically in the wake of telecommunications evolution, and is enjoying the longest expansion of the post-war years. Despite the accumulating current account deficit, the de facto dollar standard outside Euroland is in effect expanding.

Japan is finally on its way to recovery after 8 years of economic stagnation. The Japanese government is using the recovery of Japanese markets and financial reform to intensify its serious attempt to expand international use of the yen.

The East Asian economy, which had been devastated by the financial crisis of the past two years, is recovering and enjoying a V shaped comeback. The economies of some countries in the region have recovered to where they were before the outbreak of the crisis. On the other hand, there is still a long road ahead to complete the restructuring of both domestic and international financial systems to avoid the recurrence of financial and monetary crises in the future.

Latin America has overcome a number of crises and is making various attempts at economic and political stabilization. Needless to say, the US is a crucial neighbor for Latin American countries but there are conflicting factors at work. On the one hand, there is a momentum for less dependence on the United States, but on the other there is no denying the increasing influence of the dollar in the region.

The vicissitudes that swept through the international financial markets last fall started an international effort to restructure the international financial architecture. The areas to be considered were agreed at the Cologne summit this year, but there are still challenging issues ahead : how to develop an enforceable international understanding and the important issue of how to promote burden sharing in the private sector.

How will the international monetary and financial architecture develop in the 21st century? Will dollarization spread globally and reinforce the dollar's domination? Does the United States want such a situation?

When will the euro become the other key currency along with the dollar? What kind of relations between the euro and the dollar do the authorities of Euroland envisage?

How will Japan try to establish the yen as the key currency of Asia, standing where it does in the gap between the dollar and the euro? What vision does Japan have of the monetary and financial system in Asia, and what about relations between the yen and reminbi?

Latin American countries tend to exercise independence in their economic policies. With such a tendency, how do they intend to enhance cooperation within the region? What policies do they intend to pursue regarding the role of the dollar?

In Asia, taking into account the invaluable experience of the recent crisis, what perspectives and expectations do Asian countries have as regards financial cooperation and the ideal foreign exchange rate system in the region as well as the role of Japan, China, the United States and Europe in the region?

All these questions are pressing and significant for us all. They closely relate to each other, making the questions more complicated and making it impossible to answer them easily. We are acutely aware of these difficulties and limitations. However, we are holding this symposium today to hear the expert opinions of the leading policy makers of their regions, which I hope will be as unconstrained as can be.

Their opinions may not fall smoothly into place. But I am certain that their thoughtful comments will greatly benefit us and that there will be much for us to learn.

The New International Monetary and Financial Architecture

Jean-Claude Trichet
Governor,
Banque de France

It is a great pleasure to be here in Tokyo and I am greatly honoured to have been invited to the 8th Symposium of the Institute for International Monetary Affairs. I would like to thank you for giving me the opportunity to express my views on the International Financial Architecture.

Rather than trying to predict the international currency system that will prevail in 2020 I would like to focus more cautiously but more realistically on the work under way to adapt the International Monetary and Financial System to the globalisation economy. I will consider especially three important topics which are at the core of the current reflection on the reform of the international financial system :

－the need for reducing volatility of capital flows
－the choice of exchange rate regime
－the governance of the international monetary and financial system

I will add to this review some thoughts on the conditions of the success of the euro which are also conditions for the euro to contribute to a more balanced international monetary system.

1. Reducing volatility in capital flows

Contributing to more stable capital inflows to emerging markets is the objective of a number of recent proposals put forward by the international financial community. Let me just comment on current proposals which I consider as particularly important.

The bulk of these proposals aims at :

－Reducing or eliminating distortions that bias capital flows toward shorter maturities and preventing over-indebtedness
－Promoting more effective risk assessment and pricing by creditors/investors and as a result contributing to a more effective functioning of international capital markets
－Containing moral hazard.

The recent financial crises have brought to the fore the importance of sound debt and liquidity management in helping countries withstand external shocks. These issues have been or are being discussed in a number of fora, especially in the Financial Stability Forum group on capital flows. One proposal in this area is the so called “Guidotti rule”, namely that countries should manage their external assets and liabilities in such a way that they are always able to live without new foreign borrowing for up to one year. Beyond this simple balance-sheet rule, a “liquidity-at-risk” approach has been suggested by A. Greenspan, involving the calculation of a country's liquidity position under a range of possible outcomes for relevant financial variables (commodity prices, credit spreads...). The IMF contribution to this effort will be to supply the Guidelines for Good Practices on Transparency in Debt Management Policies. The IMF is also reflecting on debt and reserve related indicators of external financial vulnerability. The World Bank is designing a manual of “best practices in the area of sovereign debt and risk management”.

More generally, policies designed to discourage excessive short-term foreign borrowing and based on market mechanisms should be supported. For instance, unremunerated reserve requirements on short-term foreign liabilities should not be discarded; domestic savings should be more systematically mobilised through the development of domestic financial markets. To this regard, the World Bank has begun to produce a manual that will provide practitioners in the government and the private sectors with guidance on the development of domestic debt markets. The BIS based Committee on the Global Financial System has recently produced a useful document identifying general principles and more specific policy recommendations relevant to the promotion of liquid government securities markets.

The design of Deposit Insurance Schemes is another important measure contributing to reducing or eliminating implicit government guarantees limiting moral hazard on the lenders as well as on the borrowers side. A study group has been created under the umbrella of the Financial Stability Forum. It will assess the feasibility of setting out international guidance on deposit insurance.

As to the promotion of a more efficient functioning of global markets, I would like to emphasise two points :

- Firstly, one of the most effective recipes for countering herd behaviour that has been observed in the recent financial turmoil, is full transparency of each particular entity, of each particular country, of each particular borrower, of each particular signature. Full and reliable transparency is needed to allow a proper judgement of the merits of each case. More transparency is necessary for proper risk manager and risk pricing. Improvements in the SDDS, notably the adoption of a detailed template for foreign exchange reserves disclosure, more transparency regarding Article IV reports and compliance to internationally agreed standards and codes, as well as transparency of private sector financial institutions, will certainly improve risk assessments.
- Secondly, the decision to introduce a new capital adequacy framework to

replace the 1988 Accord is an important step towards a more comprehensive approach to addressing risks. The new framework should significantly improve the way regulatory capital requirements reflect underlying risks.

Reducing moral hazard is a crucial condition for lenders and borrowers to be more prudent. Recent crises have emphasised the need to improve the approach of the international community to financial crisis prevention and resolution. In particular, there is a need to provide the private sector with a clear framework indicating that it will bear the consequences of its risk taking decisions.

The Cologne G-7 framework is a good basis for an effective involvement of the private sector. It is an acceptable compromise between a case-by-case approach and a rules-based one. I think it necessary, in particular, to build a consensus around the following three points :

– first, the principle of equality of treatment should prevail : no one category of private creditors should be regarded as privileged relative to others
– second, there is a need to support the introduction of collective action clauses in emerging market sovereign bonds. Argentine issued both American and European-style bonds. The Argentine experience shows that the market does not penalise emerging market issuers on their European-style bonds. In other words, this provides support to the notion that collective action clauses represent a rather marginal innovation in terms of cost which is worth implementing
– third, it should be made clear that very large packages should no longer be expected from the official sector

Let me now turn to another very important matter highlighted by the Asian financial crisis : the choice of exchange rate regime.

2. The choice of exchange rate regime

As a first reaction to the financial crises in Asia, Russia and Brazil, many observers took the view that exchange rate pegs are inherently unstable and that either firm fixing or free floating are preferable to any intermediate regime. Against this background I believe there is a need for a more balanced view.

There is no ideal exchange rate regime that can meet the needs for countries that widely differ in terms of economic and financial conditions. Thus, an exchange rate regime should be assessed on the basis of its ability to contribute, in the specific circumstances of a given country, to a stable macro-economic environment by supporting an exchange rate level consistent with underlying fundamentals and expectations.

For developing and emerging countries a wide variety of exchange rate regimes prevail. Corner solutions (free floating or currency boards) are not necessarily the most appropriate choice. Although floating rates may appear suitable for coping with volatile capital flows and asymmetric shocks, they might prove disruptive for the real sector of small open economies, which often lack the size for developing the necessary market infrastructure to cope with exchange rate volatility.

The recent financial crises have highlighted that macroeconomic discipline alone does not suffice to sustain pegs and thus must be accompanied by sound financial systems, good corporate governance, effective regulation and supervision, as well as greater transparency in monetary and financial policies.

Although requirements for sustaining pegs have become very demanding intermediate solutions might still remain a relevant option for a number of countries, notably small open economies with a dominant trading partner that maintains price stability, I have especially in mind the EU accession countries, and less developed economies experiencing high inflation. In such cases, anchoring the currency contributes to monetary and financial stability.

While the choice of exchange rate regime remains the responsibility of national authorities, the IMF has a clear role in advising its members to pursue appropriate exchange rate policies, in view of the systemic implications of such decisions. In this context, the IMF should adopt a cautious attitude in providing its resources in the context of Fund-supported programs, should there be any doubts about the consistency between macroeconomic policies and the exchange rate regime.

3. Role of the international institutions

In promoting more efficient international financial institutions and arrangements, the G-7 has reaffirmed the central role of the IMF and the World bank in the international economic and financial system and created the Financial Stability Forum to enhance international co-operation and co-ordination in the area of financial market supervision and surveillance. More recently the G-7 has set up the G-20 to foster the dialogue between industrialised and emerging market economies.

The IMF has a central role to play in macroeconomic surveillance which is its main purpose. The conditionality associated with its financial support is essential to give economic agents a clear assessment of the efforts made by Members committed to implement adjustment programmes.

Furthermore, the IMF has a crucial role to play as regards prevention and assessment of compliance to international codes and standards. I have already mentioned actions taken by the IMF in improving Data Dissemination and publication of Article IV reports. The IMF has launched a series of experimental Reports on Observance of Standards and Codes which summarise the extent to which countries observe certain internationally recognised standards, focusing primarily on the areas of direct operational concern to the IMF.

Together with the World Bank the Fund has recently set up a Financial Sector Assessment Programme. As a by-product of this programme, the Financial Stability Assessment Reports should identify the main vulnerabilities affecting financial systems and make recommendations to mitigate these vulnerabilities. This is an important enhancement to the surveillance activity.

The new mechanism for informal dialogue in the framework of the Bretton Woods institutional system, the so-called G-20, aims at building consensus between industrialised countries and emerging market economies on the main issues related to the reform of the global financial architecture, thus facilitating the implementation process.

Given the large number of institutions and fora involved in the efforts aiming at a better global financial architecture, the creation of the Financial Stability Forum reflects an important effort to co-ordinate work in progress and identify issues not yet addressed. The Financial Stability Forum created three working groups dealing respectively with Highly Leveraged (FSF) Institutions, Capital Flows and Off-Shore Centres. We are looking for the conclusions and recommendations of these groups in March 2000. The FSF established recently a task force on implementation which should explore crucial issues related to promoting the implementation of international standards relevant to strengthening financial systems.

4. The conditions for a complete success of the euro

The successful introduction of the euro is, in itself, a major reform. For that reform to be a full and complete success a number of conditions have to be met.

I see four main conditions :

The first condition is the credibility of monetary policy guaranteed by the independence of the European Central Bank, which is enshrined in the Maastricht Treaty and rooted in the independence of each national central bank. If the euro is to be consolidate its statute of highly credible currency, it must keep the confidence of the 290 million Europeans in the euro area and also the confidence of non-Europeans with whom we do business. This is, in particular, ensured by resisting any kind of pressure on how the new currency is managed.

The necessary dialogue between monetary policy officials and economic policy officials is fully taking the independence of the ESCB into account and also the objective of price stability which, according to the Treaty, must guide the monetary policy of the euro area. The respect for the independence of the monetary policy is a condition for the success of the euro, in particular in the framework of the "Cologne process"— macroeconomic dialogue for the implementation of the employment Pact-adopted at the last European Council.

Satisfying this first condition related to the credibility and the independence of the monetary policy, will be facilitated by the harmonious functioning of the European monetary team, which is composed of twelve players, the ECB and the national central banks from the eleven founding countries. This is this full, twelve-member monetary team which is playing on the field, with a single team spirit; and this team spirit is one of the priceless assets of Europe.

The second condition is compliance with the provisions of the Treaty and the guidelines laid down in the Stability and Growth Pact with regard to fiscal policy. Close co-ordination of fiscal policies and vigilant peer surveillance within the informal council of the eleven participating member states — the "Euro Eleven Club" — and by the ministers of finance of the 15 Member States convened in the Ecofin Council is essential to ensure a balanced policy mix throughout the eurozone. The medium-term objective of achieving "public finances that are close to balance or in surplus"— means nobody gets to run a selfish budget deficit. To comply with this objective is indispensable for the union as a whole to weather periods of economic difficulty and for individual countries to withstand possible economic downturns which affect only their own economy.

We have to understand that monetary policy alone cannot ensure price stability without the appropriate fiscal discipline at the overall level of the Economic and Monetary Union.

For my part, I would give three economic justifications for the Treaty provisions that gave rise to the Stability and Growth Pact.

- First, by co-ordinating the fiscal policies of the Member States of Monetary Union, the pact ensures a good policy mix within the euro area. This is essential for monetary policy.

- Then, the pact helps prevent well-run economies from having to bear unjustified risk premia by setting up a system of penalties for excessive deficits.

- Finally, the stability pact allows us to disprove the assertion that the euro area has no automatic stabilisers in the event of asymmetric shocks to a member economy. Indeed, by urging governments to aim for a fiscal position of close to balance or in surplus in the medium term, the pact enables them to let fiscal deficits increase during recessions without exceeding the 3%reference value. In short, it allows them to create a fiscal buffer during normal economic periods that can be drawn on, if an asymmetric shock occurs.

The third condition is that all European countries must resolutely undertake structural reforms. Continental Europe is experiencing too high levels of unemployment, despite the fact that the jobless rate has been declining in most of its economies. According to the IMF and the OECD, around 80% of this unemployment is structural, that is, generated by our own burdensome rules and regulations.

The fourth condition is that all economic leaders in Europe must be clear-sighted with regard to the crucial question of competitiveness. Pre-euro economic policy meant monitoring trade balances, the balance of payments and the foreign exchange and interest-rate markets. Authorities thus received constant feedback on key indicators affecting national economic performance and could react accordingly. These indicators were sensible, multiple and very reactive.

Most of these indicators have disappeared at the national level or have seen their significance weakened, with the advent of the euro. But, of course, they remain on the euro-wide level. This is why the co-ordination of fiscal and economic policy provided for by the Treaty is so important.

Nevertheless, the rules of a market economy, especially competition, continue to apply to each economy. Jobs are created by consumers when they choose the goods and services they feel are the best value for money. Businessmen allocate these jobs to various possible locations in various countries according to the relative competitiveness of these locations. It is therefore necessary to monitor competitiveness even more closely than before through indicators such as unit production costs, and the tax and regulatory framework.

Contrary to the pre-euro period, loss of competitiveness will not show up so quickly on radar screens like exchange markets, interest rates markets or external accounts, so economic managers must be even more vigilant in watching pertinent competitiveness indicators. The sanctions for economic policy errors might come more slowly and insidiously via rising unemployment and weak growth.

In conclusion, let me stress three points :

Firstly, the global economy is doing much better than a year ago, which is perhaps the best proof of an appropriate handling of the difficult situation in which we were in 1998. World output growing at a pace of 3% in 1999 and 3.5% in 2000 is pretty encouraging. Particularly encouraging for me, being in Asia, is the fact that the newly industrialised Asian economies are likely to grow at a pace of a little more than 5%, both in 1999 and in 2000.

This calls for two "coup de chapeau": one to the Asian economies themselves which have demonstrated a remarkable capacity to adjust in a very short span of time. The second to the international community and the IFIs, in particular the IMF and the World Bank, which have demonstrated in the most difficult circumstances of the last 24 months lucidity, determination and courage. I know that saying that is not necessarily fashionable. But it is precisely because it might not be fashionable that it is worth saying it.

Secondly, this is not the time for complacency. The global economy is in much better shape but remains fragile, taking into account the risks and the challenges that exist, facing the international community. It is very important to take advantage of the present good state of the global economy and global finance to proceed in the direction of reforms. Being complacent in relatively quiet times would be a big mistake. Let us actively set up and generalise the good practice principles and the codes of good conduct for the public as well as the private sectors. Let us actively reinforce cooperation amongst all parties concerned including within the framework of the Financial Stability Forum and the G-20 which will meet in Berlin very soon.

Let me also say that I regret the lack of consensus that has been observed in Seattle on trade issues. Global trade is a win-win game and it is a pity that it is so often presented as a zero sum game, which is not the case. A good agreement in the trade area is in the interest of all — developing countries, emerging economies, countries in transition, industrial countries — and above all, in the interest of global prosperity and economic and financial stability.

And thirdly, I would like to stress the tripolar nature of the present international monetary system. The three major economies and the three major currencies have to contribute to the stability and prosperity of the industrialised world. Being an European in Japan let me point out three points that are of importance in my eyes :

— First, I entirely subscribe to the G-7 communiqué published in September, in Washington as regards the yen in its relation vis-à-vis the other major currencies, namely the dollar and the euro. I add that the three currencies are shaping up a global triangle and that it is important to consider the dollar and the euro on the same footing as regards their relationship with the yen.

— Second, as Wim Duisenberg has said in the name of the Board of Governors, we are, in the Eurosystem, pursuing a policy of solid, strong, credible Euro and the Euro has an important potential for appreciation.

— and Third, here in Tokyo, I will say — as the US put it over the last seven years, namely "a strong dollar is in the interest of the US" — that I strongly believe that "a strong Euro is in the interest of Europe".

The Evolution of the International Financial System

Edwin M. Truman
Assistant Secretary for International Affairs, U.S. Department of Treasury

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 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

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.

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 tripoler 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, 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

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.

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, 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 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.

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.

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.

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

[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.

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.

Lessons from the History and Future Monetary System

Haruhiko Kuroda
Vice Minister of Finance for International Affairs, Ministry of Finance, Japan

Please allow me to make my presentation in Japanese.

The theme of today's symposium is “In Search of A Stable Currency System in the 21st Century”. In order to discuss the international monetary architecture of the 21st century, we must first reflect on the long history of the international monetary system, and second, on the experiences of the past several years. I believe that it is critical to study those two areas before we go on to the future.

First, let me ask you to look back on the history of the international monetary system since the beginning of the gold standard in the 19th century. The gold standard worked extremely well from around 1870 to right before the beginning of the First World War. This, as you are all aware, was a complete fixed exchange rate system based on the price of gold. At the same time, the flow of funds was remarkably free.

Then, between the two world wars, we had what is generally called the gold exchange standard. This was a time of confusion, exchange rates fluctuated and the international flow of funds was very much limited. I believe this was an extremely bad, failed system.

After the Second World War, the Bretton Woods system was established. Under this so called gold-dollar standard, a fixed exchange rate system using an adjustable peg was applied worldwide. The international flow of funds was relatively restricted.

This system continued until the beginning of the 70s, and the global economic situation was very good during that time.

Problems arose with the introduction of what is called the "general float" system which continued from the beginning of the 70s to the present day. This system can be seen as having a dollar standard, where the major currencies are all floating. As for the international flow of funds, we are now experiencing a massive increase in quantity.

Although the performance of the global economy under this system has not been as bad as during the years between the two world wars, nevertheless it has been much worse than during the 25 years of the Bretton Woods system.

It is very difficult to know what we should learn from this history. But I agree with Dr. Truman that the international flow of funds has become so wide and deep, and furthermore, is likely to expand even more, that it has become extremely difficult to simply move into another fixed exchange rate system. I do not think it appropriate to make a choice that would reverse the current trend of the flow of funds or reverse the tide of change.

Here I would like to touch on two recent experiences. One is the Asian monetary crisis and the other is, as Dr. Trichet emphasized, the birth of the euro.

I think the Asian monetary crisis has taught us three things. First, is the danger of pegging to the dollar. Needless to say, all Asian countries have extensive trading relations with the United States. However, the relationship with the United States is not the dominant relationship. Rather, trade or investment within the East Asian region is the most significant relationship. These Asian countries also have extensive trade and investment relationship with Euroland. The crisis showed the great danger of pegging to the dollar either formally or virtually despite these relationships.

The second risk was the risk associated with the flow of capital. We learned what dangers there were, especially in short-term foreign currency borrowing. Of course, Thailand, Indonesia and South Korea had different problems each. In Thailand, the huge external debt in the non-banking sector created a serious problem. In Indonesia, it was the massive short-term foreign currency borrowing in the corporate sector. On the other hand, in South Korea, it was the commercial banking sector with mammoth short-term foreign currency borrowing that triggered the crisis. The international flow of capital has brought about a positive mid to long-term effect in these countries, but we paid dearly to learn the huge risks involved in acquiring short-term capital.

The third lesson is that even if the macro economic situation is good, that does not make the economy immune from various risks or allow it to survive the risks related to a monetary crisis. The vulnerability of financial institutions is an especially significant issue. We learned that this is true not only of the weak financial institutions in the developing markets, like many Asian countries, but that it is true also of financial institutions of developed countries like Japan, the United States or Europe. The conclusion we drew from this experience is that there should be a much stricter supervision of financial institutions. There needs to be a system where it is possible to take strong measures when necessary.

Let me move on to the second recent experience, the birth of the euro. Dr. Trichet has already given us an eloquent explanation of the developments and I do not see much that I can add. But let me emphasize that behind the successful birth of the euro, there were more than 30 years of incessant endeavors towards the integration of trade and investment as well as various regulations within the region. Integration was also pushed in macro economic policies, such as can be seen in the so called convergence criteria. We must realize that the success of the euro was only possible with developments on both these fronts.

The role of the euro will possibly extend beyond Europe in the future. I believe the euro will begin to be used as an international currency in various forms around the world. In 10 to 20 years, we will see a situation where the dollar will not be the only dominating currency but where the euro will be used like the dollar as an international currency.

Having reflected on the history of the international monetary system since the 19th century and discussed the recent Asian monetary crisis and the successful birth of the euro, I must move on to the monetary system in the 21st century. My conclusion is likely to be very much like that of Dr. Truman.

I, too, believe that for the time being, the exchange rates of the yen, the dollar and the euro will fluctuate. I do not see it as realistic to fix the exchange rates among these currencies nor to squeeze the fluctuation to a very narrow band. However, I would like to add that it is worth taking measures to limit the fluctuation among these currencies to a reasonable degree and to reduce volatility as much as possible. This will benefit not only the three regions but the whole world. Of course this is not an easy task. With the increasing use of the internet in various commercial transactions, the speed with which the capital flows will accelerate rapidly and the amount of funds will expand and penetrate into every corner of the world. There is no way to stop this trend, and it is crucial to maintain completely free flow of capital among the three regions. Under these circumstances, it is very difficult, at the least, to limit foreign exchange fluctuations. But such an attempt is worth making, and I believe, should be tried even more seriously.

What are the situations outside of the regions of the three currencies?

In Europe, there are already many countries surrounding the 11 countries of Euroland that have pegged their currencies to the euro. Many countries in Northern, East, Central, and Southern Europe, have virtually pegged their currencies to the euro, and there is a possibility that Euroland itself will expand in the future.

The situation in Latin America and Asia are somewhat different from Europe. As Dr. Truman mentioned, dollarization is spreading on the one hand, but on the other, there are countries which still have a strong preference for a flexible exchange rate system. Also, dollarization is likely to progress haltingly, affected by various considerations and uncertainties. But the dominating share of the American economy in the Western hemisphere seems to indicate that an international system or rather a regional system using the dollar will develop in Latin America.

The situation is a bit more complicated in Asia. As Mr. Gyohten posed the question in his remarks, what will be the role of the yen? I believe the role of the reminbi will increase in the future and it does not seem to me that there will be much possibility of Asia becoming a "yen zone". However, I do see the more expensive use of the yen and even the reminbi and thus the development of such regional monetary system based on them in Asia. In that system, measures will inevitably be taken to shrink the exchange rate fluctuation of the yen and other currencies. I think the realistic development in Asia would be to use a basket of the three currencies, the yen, the dollar and the euro, as a reference, or aim to decrease exchange rate fluctuations against this basket. Such developments are quite probable and worth serious consideration.

The regional developments that I have been talking about will, I believe, occur in the first half of the 21st century. As Dr. Truman mentioned, by mid century there will be efforts to search for a global currency, a global common currency. But that would be so many years ahead and it is still too early to consider taking concrete measures to prepare for such a development. I think new efforts will be made after regional developments, that I mentioned previously, take effect, which will be well into the 21st century.

I have talked quite extensively on the outlook for the 21st century. I have deliberately talked about long term perspectives, because I believe that even when we are having daily discussions on the yen-dollar rate or the euor-dollar rate we should discuss with a longer perspective in mind.

Thank you.

The Quality of Money

Domingo F. Cavallo
Former Minister of Economy,
The Argentine Republic

The future of the International Monetary System

The preceding discussion suggests that in the future, the transformation of the International Monetary System will be driven by the different countries' search for quality currencies.

If the International Monetary System's future structure develops in this way, it will not be a complete novelty in history. In a recent book, the transformation of the bimetallic system in the gold standard regime between 1880 and 1914 is explained in the following way :

> "The greater number and size of domestic and international transactions which resulted from economies undergoing an industrial revolution gave an advantage to gold over silver. Since the value per bulk of gold was roughly fifteen times greater than that of silver, gold would naturally become more important as a medium of exchange in environments where the size and frequency of transactions and incomes were growing. The greater internationalization of economies in Europe and the US made the standard which was practiced by Britain all the more compelling, since the international capital market and more specifically the international market for commercial debt (i.e. bills) were dominated by sterling. Finally, the spectrum of domestic politics changed significantly in the developed world in the XIX th century. The rise of political liberalism was a manifestation of the political rise of an urban-industrial class and a challenge to the traditional dominance of an agricultural class. With the shift in the political bal-

ance of power came a concomitant shift in monetary preferences from a standard oriented around a bulky and inflationary metal (i.e.silver) to one oriented around a light and non-inflationary metal (i.e.gold)."

If the reasoning that I have presented throughout this conference is correct, we can foresee that nations, in their search for a higher quality currency, will decide to set aside independent monetary policies and this decision will eventually reduce the number of currencies in the global economy.

As long as the formation process of large monetary areas lasts, the IMF should be the institution in charge of determining when a country is capable of transforming its Currency Board into a Central Bank. This means that in practice, the IMF would judge the quality of currencies. Access to a window of last resort loans while their currencies have not passed the quality test, should be the incentive to stop countries from conducting independent monetary policies prematurely. In sum, the IMF would have a very similar role to the one it was created for at the start of the Bretton Woods System.

(The fact cannot be discarded that, even with a reduced number of better quality currencies and with the respective central banks' perseverance in the implementation of monetary policies aimed towards price stability in each monetary area there will be a lack of stability of each currency vis a vis the others. If this were to happen, it is likely that the same forces that today provoke the increase in the size of the monetary areas, will trigger the creation of a single world currency in the future. At that time, the central banks of the large monetary areas and the IMF should be replaced by a World Central Bank. In any case, at the current pace of events, this is merely a conjecture.)

Finally, I would like to propose the following synthesis to this conference : "Money matters" but "What really matters is the quality of money."

Currency as an institution

Currency is a very important economic institution, both for the market economy and for public finances. Prices of goods and services are valued in money. Public budgets are approved and controlled in monetary terms. Most of the property rights enjoyed by people are defined and put into effect in money values.

When a currency loses value, that is, when the level of prices increases, the functioning of the market economy worsens because those who buy and sell goods and services cannot easily distinguish between changes in relative prices and changes in absolute prices. In other words, a currency that lacks a constant value decreases the informative quality of the economy's price system. The formulation and control of public budgets, and particularly of tax collection, become increasingly uncertain and complex in inflation-ridden economies. When currency changes value in an erratic way, there is an arbitrary alteration in monetary-defined property rights.

In synthesis, a currency that is unable to maintain a constant value worsens the functioning of the fundamental mechanisms of economic coordination in modern economies: the market and the budget, and it makes property rights more unsure.

A currency's quality resides in its ability to safeguard price stability in the long term and in the degree of acceptability which the currency generates among the relevant economic agents in order to achieve its commercial and financial transactions.

The best indicator of a currency's quality is the interest rate established in contracts for long-term loans. The closer the interest rate is to the economy's growth rate, the greater the currency's quality. This is so for a simple reason: the disappearance of inflationary or deflationary expectations is reflected in interest rates that ensure the economy's long-term equilibrium with a stable general price level. Another indicator of the currency's quality is the intensity with which it is used in transactions beyond those of its own national economy.

The quality of a currency deteriorates when the government misuses it to finance the fiscal deficit or to increase the economy's external competitiveness. If instead of standing by a quantitative rule, such as the one proposed by monetarists, and allowing the interest rate and the exchange rate to be freely determined by the market, the government decides to use monetary policy to repeatedly influence the interest rates or the economy's external competitiveness, economic agents will begin to expect higher rates of inflation.

They will notice that the government will only be able to produce real transfers towards debtors and tradable goods' producers if it succeeds in collecting the inflationary tax. Paradoxically, the long-term interest rate will end up rising as a consequence of the growing uncertainty on the property rights that are monetarily defined. In the medium and long-term, the relative position of debtors and tradable goods' producers, at least those who make intensive use of capital, will worsen in a permanent way.

When a certain degree of discretion is used in the management of a national economy's monetary policy triggering divergent movements between short-term and long term results on interest rates and external competitiveness, it must be concluded that such an economy no longer has a high quality currency. When that conclusion is reached, the fundamental concern becomes how to recover credibility in the currency.

Monetarists insist: it' s a matter of abandoning discretionary measures and permanently adopting a quantitative rule. My analysis and experience lead me to a different conclusion: the existence of other high quality currencies must be taken advantage of in order to recover trust in one's own currency. As a matter of fact, both points of view are alternative only during the period of time when the local currency has ceased to be reliable and until the credibility in the currency is recovered.

Once the currency succeeds in recovering its quality, the monetarists' prescriptions will become relevant again and the economy will have regained the possibility of implementing an independent monetary policy. In the meantime, in order to recover the quality of its currency, the government must refrain from implementing monetary policies and live with whatever measures are taken by the patron currency's country.

Currency Boards and Central Banks

A Currency Board is an institution whose aim is to ensure a currency's convertibility in terms of another, considered the patron currency or supporting currency. It cannot implement an independent monetary policy. A Central Bank is an institution that creates and manages a fiduciary currency and has the capacity to implement an independent monetary policy.

The normal institutional sequence in the monetary organization of an open economy is a successful Currency Board that ends up becoming a Central Bank. This happens when the convertible currency appreciates vis a vis the supporting currency. If this appreciation originates in a deterioration in the quality of the supporting currency, the Currency Board is usually kept and the patron currency changed. But, if the appreciation is the result of increased productivity levels in the economy that prove consistently greater to those of the patron currency's economy, the national currency will most likely be allowed to float freely and the Currency Board will be transformed into a Central Bank in order to conduct an independent monetary policy.

The sterling pound and the US dollar were convertible currencies into gold since 1821 and 1879 respectively. The Bank of England functioned in practice as a Currency Board until the pound became inconvertible in 1913. The dollar's fixed parity convertibility regime with gold was kept during the First World War and only dropped in 1933, during the Great Depression. In the periods when the sterling pound was used as the basis of an active monetary policy, there were frequent and severe monetary crises, and it was this aspect that led to the end of the role it played as the reserve currency. It was precisely the accumulation of gold by the Federal Reserve's Bank that led the dollar to become the anchor of the monetary system created at Bretton Woods at the end of the Second World War. Consequently, both the sterling pound and the dollar went through two stages, Currency Board and Central Bank. In the second stage, the dollar was less affected than the pound by monetary crises and hence it gained an increasingly important role as a reserve currency.

The history of the yen and the German mark since the end of the Second World War can also be seen in terms of this typical institutional sequence. Under the Bretton Woods Agreement, all national currencies, including naturally the yen and the German mark, had a value determined in dollar terms, but they could be adjusted in the case of a “fundamental unbalance” in their balance of payments. The Germans and the Japanese never devalued their currencies and advanced towards the convertibility of their current accounts, so that towards the end of the Bretton Woods System their currencies were practically convertible into dollars in a fixed parity and their respective monetary authorities were virtual Currency Boards.

For over twenty years both economies witnessed higher productivity gains than these of the US economy, and thanks to that, when the dollar, weakened by expansive policies of the 60's, abandoned its anchor role in the Bretton Woods System, the yen and the German mark started floating freely, with a clear tendency towards appreciation. Thereon the Bank of Japan and the Bundesbank began to operate as Central Banks responsible for their respective independent monetary policies.

The clearest examples of the institutional sequence from Currency Board to Central Bank are seen in the Singaporean and Malaysian economies. The Malaysian Confederation's Currency Board ceased to exist in June 1967, following the rupture between Singapore and Malaysia. Singapore established its own Currency Board using the pound sterling as its reserve currency. In Malaysia, the Malaysian Negara Bank played the same role. Both countries' currencies were freely interchangeable during this period. In 1972, after the pound was freely floated, Malaysia and Singapore fixed their currencies to the dollar. In this way, they tried to maintain gold parity and avoid their currencies' depreciation vis a vis the sterling pound. In 1973, the dollar began to devalue. The ringgit and the Singaporean dollar followed suit, speeding up the process known as “imported inflation”. The Singaporean and Malaysian governments allowed their currencies to float freely and a quick appreciation ensued. Appreciation expectations and the solid position of both economies allowed for a successful exit out of the system instead of a traumatic one.

Fixed Exchange Rate and Currency Board

Emerging economies have frequently chosen to fix the value of their currencies to a patron currency, even without full convertibility. Fixing the value of the currency is a less perfect institutional arrangement than the Currency Board, because it doesn't grant those who will use the local currency absolute safety that, under any circumstances, they will be able to purchase the patron currency at the fixed price. Restrictions to convertibility and to capital flows usually lead to the emergence of a parallel market where currencies are traded informally at a different value than the fixed parity one.

The Central Bank often believes it has a certain leeway to carry out an independent monetary policy, and as a matter of fact, capital flow restrictions allow for a considerable difference between interest rates on domestic currency transactions and external ones. Consequently, in the short term, variations in the internal credit growth rates allow for changes in the domestic interest rate, even when the exchange rate is fixed.

When restrictions on capital markets and on the currency's convertibility begin to relax, either because economic agents find more efficient ways of evading rules or because authorities decide to remove restrictions, if the Central Bank attempts to ensure a fixed parity through a sufficiently restrictive monetary policy, internal interest rates increase significantly, reflecting inflationary and high devaluation expectations. This means that by simply fixing a non-convertible currency's exchange rate, this will not contribute towards improving the currency's quality.

The same effect does not occur when the exchange rate is fixed and is accompanied by a Currency Board and, at a practical level, the economy functions with two currencies: the local one and the patron currency. Under this institutional arrangement, the interest rate differential in the two currencies tends to disappear, since the possibility of conducting an independent monetary policy is eliminated and hence, economic agents cease to expect a different inflation rate to that of the patron currency.

In synthesis, it is not the exchange rate but the convertibility of the local currency and the economy's bimonetary character which allow for a recovery of the local currency's quality. The ultimate success of a Currency Board regime rests precisely on the fact that the exchange value can cease to be fixed, but without a monetary crisis, that is, through appreciation when it begins to freely float.

In contrast to bimonetary Currency Boards, the simple fixing of the exchange rate, with the Central Bank's ability to conduct an independent monetary policy, almost always ends in a monetary crisis.

The Lender of Last Resort

The main reason why countries prefer to omit the Currency Board stage and go directly to the Central Bank one, even when they wish to maintain a fixed exchange rate, is because they believe it is crucial to have a lender of last resort that can act during financial crises.

Yet if the currency is of low quality, when a banking crisis breaks out, the currency that people demand is not the local one, but rather gold or a foreign currency that offers them security. In that case, the Central Bank cannot act as lender of last resort in an effective way because it can only issue the domestic currency. By issuing more local currency notes there will be a monetary crisis that instead of reversing the banking crisis, it will exacerbate capital flight to foreign countries.

The study of this phenomenon allows us to broaden the traditional interpretation of the 1930's crises as a result of the Federal Reserve Bank's mistake in allowing dollar supply contraction in the USA. Following the experience of the 1913-1926 period with inconvertible floating currencies, the only currency that had succeeded in keeping high gold reserve levels was the dollar.

With the arrival of the 1929 crisis, countries like Argentina, Australia, Brazil, Canada, Austria, Hungary, Germany and even Great Britain tried to get their central banks to help out commercial banks. Yet since people wanted gold or currencies that were strongly backed by that metal, governments had to apply strict exchange controls or allow their currencies to devalue heavily. These two consequences destroyed the international trading system of the time.

History would have been different if liquidity had come early from the Federal Reserve Bank, the only Central Bank capable of issuing currency without the risk of losing all its gold reserves. Unfortunately, the Federal Reserve Bank started injecting liquidity only in 1933, when the crises were very deep and the world had entered into depression.

A loss of liquidity can only be neutralized by issuing high quality currency. The attempt to do so from central banks that control currencies with low credibility ratings can only worsens the crisis.

Brazil and Latin America

The creation of a common currency following a period of relatively fixed parities among the different currencies was Europe's strategy to achieve a high quality currency. Let me just say in a few words how we see the process in my region in South America, and more broadly in Latin America.

Our currencies, our local currencies, are low quality currencies because of our long history of inflation. Whenever we fix the exchange rate in an artificial way to the dollar or we let our currency float and try to conduct independent monetary policy, the outcome is generally bad. We generate inflation or we create a lot of uncertainties that get reflected in very high interest rates.

That is why some countries have decided to dollarize, like Panama, or to adopt the currency board using the dollar as a patron like Argentina. The only two countries that have finally eliminated inflation in Latin America are precisely Panama and Argentina. All other countries still have inflation above 3% per annum, because they still operate with low quality currency.

Now why has Argentina decided to adopt currency board using the dollar as a reserve currency rather going directly to full dollarization? The reason is that we still believe that in South America we may have our own currency and conduct our own monetary policy. But that will be in the future after we recreate confidence in our currency. To recreate confidence in our currency and prevent our currency to continuously devalue vis-à-vis the dollar or other high quality currencies, we have to use currency board system.

Brazil tried to fix the real to the dollar without currency board system and it could not maintain the policy. It collapsed in January this year. After the collapse of the real, they have tried to let the real to float freely and to conduct an independent monetary policy. But that has somehow reinitiated inflation in Brazil. We start to think that Brazil will have to adopt a sort of currency board system to recreate confidence in the real. The Brazilians, like Argentina, have trilateral trade system, that has one third with the United States, one third with Europe and one third with Asia. If they adopt a currency board system like Argentina's one, they'll not use the dollar as the patron, but the basket of three currencies, the dollar, the euro and probably the yen. In case the Brazilians adopt such a currency board with a mix of three main currencies, as the tutors for the local currency, of course Argentina will introduce the same change in its monetary regime. That will facilitate the creation of common currency for Mercosur, eventually for South America.

Now what will be the final outcome? Probably a currency that floats in a loss of implementation of independent monetary policy for South America, or before that it may happen that we finally adopt the dollar as our own currency, but that will happen only when there is a decision by the US to transfer the dollar into a currency for the Americas rather than the currency only for the US.

So we want to keep two alternatives open: To use the dollar and eventually other high quality currencies as the tutors for increasing the confidence in our currencies, and eventually adopting the dollar if the US decides transferring the dollar into currency for the Western Hemisphere. I think that Mexico, the Caribbean and the Central American countries will simply use the dollar as the tutor or patron currency because they have most of their trades with the United States.

So in that sense we cannot take Latin America as a unity. Is different the case of Mexico and Central America from that of South America, or these Southern part of South America, Brazil, Argentina and Chile. In the last case we have much more diversified trade and that is why we will consider in future adopting a three currency basket as the tutor for our regional currency. This is what I think will happen in my region.

In Search of a Stable Currency System in the 21st Century

Yoon-Dae Euh
President,
The Korea Center for International Finance

The switch from a fixed exchange rate system to a floating system after the collapse of the Bretton Woods System has presented new problems. Some of these problems include the rapidly growing size of international capital flow relative to that of international trade, and the instability of the foreign exchange markets as the speed of international capital flow increases. So, it is essential to find a new framework to stabilize the international currency system.

In this respect, it is necessary to consider alternatives for the present international monetary system. In particular, along with ongoing discussions over the currency board system, dollarization and regional unit currency, there is a growing sense that a target zone system has to be introduced.

Take a glimpse at what the international currency system will look like in two decades. The dollar will surely remain a vehicle currency, but the Euro will be palling with the dollar as European countries rush headlong to EMU. Hence, the existing dollar-based monetary system will be transformed into a bipolar currency system. At the same time, most Latin American countries will likely peg their currencies to the dollar through dollarization or a currency board system. Meanwhile, there is also considerations to create a yen block or Asian Currency Unit in the Asian region. If such a block appears, the international monetary system will be ruled by a triumvirate : the dollar, the Euro and the yen.

There's still long way ahead to setting up a regional currency system in Asia. The obstacles result from a relative lack of political and economic homogeneity in that region (as compared to say, Europe) and the lack of common interests. However, the need for a stable regional currency has become a priority in connection with the region's economic development. Therefore, Asian countries are expected to cooperate to map out some measures to keep currencies stable. Under the Japanese leadership, China might play a bigger role in the region's currency system, based on its political power. We can also assume that the Japanese yen, Chinese yuan and Korean won will fall under a currency stabilization system similar to ERM(exchange rate mechanism).

Currency System in Asia

Let's look more closely at the currency system in Asia. Before the currency crisis of 1997, most Asian countries had pegged their currencies to the dollar. This system had helped their economies grow, but led to their collapse when the headlong depreciation of Japanese yen dealt a massive blow to their trade balances.

In the wake of the crisis, a considerable number of Asian countries adopted the floating foreign exchange rate system. However, the countries suffered from poor liquidity in foreign exchange markets, and lacked risk hedge tools. Under the floating foreign exchange rate system, the foreign exchange rate fluctuated violently in accordance with supply and demand in the market. This destabilized the overall economy. Some Asian countries, which adopted the floating exchange rate system, are now seeking ways to protect their markets from the effects of the liberalization of capital flow.

The alternative to the fixed exchange rate system and the floating exchange rate system is a currency basket system, which is a mid-point between the two.

This system allows each country to link its currency to the currency basket, based on its trade weighting and economic situation. By doing this, countries have been able to maintain a more proper value for their currency than the dollar peg system. What's more, by allowing their currencies to move within a certain range (e.g. 10% up and down) from the base rate, the country can keep its monetary policy stable, and secure flexibility against outside shocks such as capital flight. To make the currency basket system a success requires a powerful international organization to govern the stability of the foreign exchange.

Foreign Exchange System in Korea

Until the 1970's, Korea's foreign exchange rate was substantially pegged to the dollar, even though the nation adopted a unitary floating exchange rate system. In February 1982, the nation introduced the currency basket system under which the won's value was linked to the currencies of major trading partners such as the US and Japan. Under the currency basket system, the governor of the central bank was expected to determine an optimal daily base rate by considering the international balance and interest differentials between home and abroad. But, at the time the Korean government was accused of manipulating the market to improve its trade balance.

In March 1990, Korea introduced the market average foreign exchange rate system under which supply and demand decided the foreign exchange rate. But, many suspected that the government manipulated the market again through “dirty floating.”

In November 1997, during the foreign exchange crisis, Korea's foreign exchange market was penalized, and the government was forced to abolish all caps on the range of its floating exchange. When the free-floating foreign exchange rate system was implemented, the won/dollar rate immediately suffered from massive fluctuations. However, the market stabilized as it recovered its pricing function backed by the support of international financial institutions and Korea's commitment to economic restructuring.

Korea's foreign exchange market still has less market players and lower liquidity than that of its well-developed stock market. Therefore, the currency market is very sensitive to outside shocks, evidenced by the fact that the foreign exchange rate vacillates with minute changes in real demand.

To address the problems, the Korean government is building the infrastructure of a foreign exchange market designed to lift market liquidity and increase the number of players. In step with these plans, the government boosted liquidity by liberalizing its foreign currency transactions in April 1999. At the same time, it introduced a foreign currency broker system and opened its futures exchange to develop a variety of financial derivatives such as currency futures.

Asian Currency Union

The Asian region must begin to scrutinize the introduction of a regional currency system, in line with the emergence of new currency units in Europe and dollarization in Latin America. With the use of regional currencies, local currency barriers will disappear. The move might also spur new growth, as the currency system will help stabilize the regional currency and activate regional trade.

However, the emergence of a regional currency is still far from reality in that common historical, social and cultural traits each country shares give a wider room for a regional currency to be created. The economic structures of present Asian countries are still very different, and are reluctant to cooperate. Trust among them falls short, to boot.

Fortunately, a consensus exists that Asian countries have to pay more attention to the Japanese yen along with the dollar in operating their currency policies. Most Asian countries believe the creation of a yen block is for their national interests. But others, including the US and the International Monetary Fund are against the creation of such a block. Some point out that the yen is still no globalized in the transaction of goods, exchange of foreign currencies, issuance of bonds and in operation of foreign reserves. Instead of yen block, they propose a regional currency union based on a new type of Asian Unit Currency; the idea looks untimely as there is still no leading player or unity among the countries.

Yen's Globalization

Asia can reckons the yen's globalization to be more realistic and helpful. The yen's globalization should be dealt with in view of the stabilization of the global economy. Trade within the region accounted for 35% of total trade in Southeast Asia in 1996, up from a meager 25% 1986. At this point, enhancing the yen's role in trade and finance will contribute to stabilizing the Asian economy.

Of course, it will be in the interests of Japan to increase the frequency of yen use in Asia. Around 40% of its exports are destined to the Asian region. Hence, the stabilization of the yen and other Asian currencies assure the Japanese of solid exports, and the yen's globalization clears the way for Tokyo to become the hub of international financial markets.

Japan's efforts at making an efficient financial infrastructure to lift the yen's status to a vehicle currency are also crucial. To do so, it must reform its government bond market and short-term money market, and enhance its settlement and credit rating system. To boost the yen's liquidity in the Asian region, Japan has to open up its trade markets and import more from its Asian neighbors.

Co-implementation of Economic Policy in Asia

Along with the yen's globalization, the need for co-implementation of currency policy among the Asian countries surfaces. It is critical that Asian countries cooperate with each other in foreign exchange and currency policies to prevent another crisis from recurring and to help the development of the regional economy. As evidenced in 1997, a currency crisis in one Asian country spreads easily to neighboring countries. And economic cooperation is needed to address the problems of excessive competition in exports and the glut of facilities.

The other reason is a matter of survival. Every time one country in the region devalues its currency to spur domestic economic recovery and export competitiveness, the possibility of trade war increases. Most of all, Asia must cope with a global trend of building economic blocks for common interests

Asian Monetary Fund

Asian countries have started to heed the need for a currency union for continued economic development and currency stabilization. The operation of a regional currency union provides a systemic tool for a country to protect its currency from international speculators although it has a handful of foreign reserves.

Required to launch AMF is to win sympathy and cooperation both in the region and from the global society. With situation unripe, the creation of regional currency union is sure to fall abortive even though there is a desperate need for the creation of AMF. Hence, the Asian countries need to reinforce relationship on all fronts. That will be the first step to create a currency union in the region. To this end, most important is Japan's role. Japan has to encourage troubled Asian countries to claw back to growth.

Conclusion: To Prevent Crisis in Asia

The most serious dilemma the Asian countries hunkered down in 1997 is largely of their own making: it originated from bubble-bust resulting from economic recession, a series of corporate bankruptcies, mounting bad loans in financial institutions, blundering economic policies, over-capacities, cronyism and many more besides. There were also outside factors. As most Asian countries adopted the dollar-linked foreign exchange rate system, the weakness of the Japanese yen since 1995 can be said to have triggered the Asian crisis by debasing the price competitiveness of Asian export products.

As the century comes to a close, it is time to reflect on idea that have shaped it, and the lessons it leaves behind. To prevent the recurrence of currency crisis in Asia, Asian countries have to not only continue pedaling economic restructuring but prepare a system to ease the fluctuation of foreign exchange rate and fend off speculative capital flow. In particular, Asian countries must be dedicated to create a currency stabilization system in the region, then co-implement economic policies and seek common benefits in the region. As witnessed in the 1997 crisis, currency crisis a country suffered will not be a “fire across the river.”

Panel Discussion

Gyohten : We have heard, just as we had expected, very informative and thoughtful comments from our five speakers. They all strongly agree on the necessity to have an international monetary system that provides both medium- and long-term stability. However, again as we expected, the procedures or processes and the necessary policies to meet that goal were quite diverse from one speaker to another.

Mr. Trichet projected a very confident outlook on the future of the euro. If the euro develops to be a stable and strong currency, that will lead to the establishment of a new international monetary system with at least two major currencies, the dollar and the euro.

I believe Mr. Truman was indicating that as long as the dollar remains the most efficient currency in the world, as well as the most accepted, it is inevitable that it should perform the role of the key currency. He suggested that from that point of view a system of multiple national currencies is not efficient, nor a positive development.

Mr. Kuroda pointed out that it is extremely difficult for the yen to become an international currency along with the dollar and the euro. But he was suggesting that it is quite natural for Asia to have its own regional currency in reflection of the mutually dependent economies of the region and the recent experience of financial crisis.

Dr. Cavallo described the difficult situation in Latin America and I think he was suggesting that it is the most realistic situation for the Latin American countries to follow the most reliable currency.

Dr. Euh emphasized that, although the situation in Asia is diversified, the region needs to devise its own currency system, whether it is a single currency, a basket or merely policy coordination.

I believe what these comments are suggesting is that although we are not sure of what will happen in 50 years time, we will continue to have a multiple currency system, as we have now, for the first decade or two of the 21st century. Needless to say, efforts will be made to improve the functioning of this multiple currency system.

The understanding reached at the Cologne summit evolved out of the recognition of current deficiencies. On the issue of capital transfer which has been a major problem in recent years, I think it is now widely accepted that it is necessary to have some kind of discipline, or a way to deal with excessive movements internationally, instead of merely allowing capital to flow freely because it is the golden rule and nothing can nor should be done.

Needless to say, the problems related to capital flow and the foreign exchange rate of currencies are closely related. For example, the exchange rates among the dollar, euro and yen are showing very interesting and unprecedented patterns. The euro is weak against the dollar. But the dollar is weak against the yen. This reflects that fact that the exchange rates among these currencies are closely related to the capital flows denominated in these three currencies.

Now I would like to direct my question to our speakers. It seems that the most realistic scenario for the foreseeable future is that we will continue to have multiple currencies used around the world. Standing on this premise, do you think the current conditions of capital flow and foreign exchange rates should be left as they are? Or do you think we should take up them as internationally shared problems and devise some measures to cope with them? If you think it necessary to take some measures, please make your suggestions based on where you stand as a country or as a region. But at the same time I would like to ask you to comment not only on your respective country and region but also your expectations for other countries which I am sure you have.

I have been criticized for not being generous with time. But since I would like to accept questions from our audience as well, I would appreciate it if you will limit your answers to 5 minutes each. Following our previous order, may I ask Mr. Trichet of Banque de France to start this second round?

Trichet : Thank you very much. You indicated that we had only 20 minutes. Some of us were mostly observant, but others were a little bit bolder. Now I know that I have 5 minutes but it will suffice, no doubt.

First of all, it seems to me that we had a good deal of common understanding as far as I am aware of. It seems to me that pragmatism appeared in all expositions as being some principle, which was very important and I totally agree with that. It seems to me that none of us said it's very easy, you just do this and that and you will solve the problem. It seems to me that we are much more realistic and pragmatic. I would agree both with Ted and with Domingo and Mr. Kuroda and Euh, a friend from Korea when they say we have to work hard but there is no immediate solution.

What is very important in my opinions is whatever system we got for the exchange rate for emerging countries, for countries in transition or for developing countries in general, whatever system we'll embark on, sound fundamentals are absolutely the key and we are sure that the absence of sound fundamentals is a recipe for disaster whatever system we are in. And I would particularly stress the fact that sound macro policies, fiscal and monetary policies, are absolutely the key, and we also know that, through a lot of experiences, sound banking sector, sound financial sector and appropriate handling of those principles of good conduct and good appropriate behavior are indispensable.

Being a central banker, I cannot help mentioning the 25 core principles for prudential supervision in the banking sector that are extremely important. I have to say that it is really one of the main features of the new world in which we are that the Basle committee working under the chairmanship of Bill McDonough is now entirely devoted to embark on global prudential supervision, not prudential supervision only for a handful of industrialized countries, not prudential supervision for industrialized countries as a whole, but prudential supervision for all developing countries and emerging countries and countries in transition——, which changes profoundly the nature of the exercise and particularly when a global consultation is being worked out.

I have also a remark on the presentation which I don't like too much in some of the flavor or connotation or whatever, that there would be some kind of opposition between the euro and the dollar. I don't feel at all things like that. We need a solid dollar, we need a solid management of the US economy. We need of course a good monetary policy and good fiscal policy and the like. And the dollar needs, of course the euro, to be managed properly in the best fashion possible. We have a mutual interest in behaving as properly as possible and that was the case before. There is no dramatic change. I mean we have embarked into G-7 meditation a long time ago and it seems to me that the understanding of all partners was that it was a win- win game and we were not fighting for one to gain over the others or the reverse. The idea is that it's a win - win game and through appropriate cooperation each particular country and the global economy and finance and the monetary system as a whole is better off.

So, I feel really that with the euro, we have not necessarily dramatically changed. Before we had de-facto Europe which was not yet merged as far as the currencies were concerned, but very closely linked, and now we have a single currency in the euro area. But again it seems to me that it's the interest of the entire world that this is a reliable, credible, solid currency as well as we need also a solid and credible US dollar. And again I definitely know that I don't see myself an opposition or quarreling or any kind of that sort. I'm a little bit uneasy when it is presented in that fashion because it doesn't seem to me to capture the reality.

What is absolutely true is that we need appropriate cooperation because de-facto those three economies we are mentioning, are playing a very important role. And it is absolutely clear that the US economy is playing a very important role, so we have all an enormous stake in the US economy itself. We know that the European economy has enormous responsibilities, too, and we know that for the global system to work correctly we need the participation, and I would say active implementation of sound policies in all respect. I hope that I was not too long.

Gyohten : Thank you very much, Jean-Claude. You were well in time. Ted, may I ask you to respond?

Truman : I'm tempted to say that I agree with everything that Jean-Claude said and to yield my time to Kuroda-san. However, that probably is dangerous for both of us, as they would be now thinking about some euro - dollar block that we are establishing and I'm sure I will disappoint Toyoo if I weren't to say something.

It does seem to me interesting that, picking up Jean-Claude's point about pragmatism, some of us were careful to say that we might well have a global currency in the second half of the 21st century but I think it's almost guaranteed that no one at least sitting up here will be alive. Maybe there are some younger people in the audience. That I think does display a certain degree of pragmatism.

Second, I think it is important in thinking about these issues to look at recent experience — I'm particularly referring to Asia. Has the problem been one of the dollar or the peg, the dollar- peg system? There was a suggestion in some of Kuroda-san's comments that the issue was the dollar, and therefore that the answer would be an appropriate basket.

I'm not sure this is the case, actually. First of all, I would point out as a matter of historical record that Thailand actually had a basket — it may not have been the "right basket,"—but it seems that the problem there was the peg. So if we had a country that was pegged to a basket combined with the euro, the dollar and the yen, on some appropriately trade weighted basis, the issue would be if it was the pegging itself that led to excessive external borrowing as part of the system.

To come to the third point, the issue was capital flows that overwhelmed pegs. Capital flows were forcefully reassured by the presence of pegs that would be able to flow in and flow out. Trying to be minimally provocative, I would say that the jury is still out on whether it is the peg or the nature of the peg or the flows or institutional arrangements that gave rise to the flows.

I would point out again, as I said in my other remarks, that it seems to me in the case of flows that we have capital flows within national systems and we don't worry about them. Domestically, we may worry about excessive exuberance in the stock market or something, but we don't worry about capital flows. So it is, I think, a little disingenuous to worry about capital flows in an international context when we don't worry about capital flows in a domestic context. One answer may be, in an international context, that you don't have a similar regime. The answer therefore would be not to operate on the flows but, as Jean-Claude suggested, to operate on the code of practices and so forth so that the capital can flow internationally based upon common rules of the game.

I do think the point that Jean-Claude made about the euro and the dollar is absolutely right. It's in some sense easier to think about zero sum games or win-win games, and I don't think that the issue of the world of international currencies--- and I was careful to define international currency not from the standpoint of the issuing country but rather from the standpoint of system as a whole,--- is a win-win or zero sum game. I do not think some sort of benefit has accrued to the United States in particular from the international role of the dollar over the last 50 years. And I do not think now the issue is whether this is going to be shared up with Japan or Europe or Argentina or something else (I am leaving aside the issue of seigniorage on cash currency issuance which is a minor matter.)

I think we do have a mutual interest in good policies, as Jean-Claude said, and that the issue is whether it is efficient to use some other currency to denominate prices. It seems to me that doesn't have any deep economic significance in the sense of what its implications are for the country that happens to be an issuer.

The last point I would make is a comment on Domingo's excellent and scholarly and provocative remarks. I think one point he made is very important. Dazzled with all complexity that these issues have when he was talking about whether the United States was going to make - was prepared to make --- the dollar into the currency for the Americas. That well may come, but I think the important point to understand, and it was very clear in his remarks, is that it is a political statement. There was an economic logic that would drive that political process much as it existed in Europe and that drove the integration over 40 plus years, now the creation of the euro. I think that it is a very complex political process and it is not something that one can lightly enter into with a stroke of a pen. It involves in particular the citizens of all the relevant countries who have to accept such a decision.

Kuroda : As chairman Gyohten said, we will have to continue to live in a multiple currency system for the foreseeable future in the 21st century. Under these circumstances, it is extremely difficult to fix the exchange rates among the dollar, yen and euro. This is not only because the macro economic situations of these areas will not easily coincide but more importantly because it is necessary to maintain a completely free international flow of capital among these regions. I believe that is crucial for the global economy. The question is what kind of foreign exchange regime and what amount of free transfer of capital we ensure for emerging markets, for countries in transition or for developing countries in general.

Our experience in Asia indicated that deregulation of capital accounts should be done in sequence taking into account the stage of economic development, the strength of financial institutions and how rigorously they are supervised.

I also believe that there is now an international consensus that capital inflow regulation, such as that applied by Chile, should sometimes be accepted. Furthermore, in a situation such as another currency crisis, it might become necessary to have private sector involvement, and as part of that, a "standstill", or foreign exchange control. To be realistic, I believe such remedies could be unavoidable in a crisis situation.

For the emerging economies a complete floating system is probably not possible due to the size of their economy and, as Dr. Cavallo mentioned, because of the credibility of their central banks. This means that there should be a mechanism to stabilize their exchange rates, and under these circumstances I think it is necessary to have some measures to control the balance of capital accounts.

Mr. Truman said that the problem was not the transfer of capital but the pegging of foreign exchange rates. In the United States, Europe and Japan there are no serious difficulties regarding foreign exchange, foreign lending or borrowing; but for emerging markets there could be serious problems in these areas, and I believe they will need prudent regulations and other relevant measures.

Cavallo : Just two comments on capital movements and the need for capital controls. What we have learned in Latin America is that if you have a peg like the Argentinean one that is with a discipline of keeping enough foreign reserves to back fully the local monetary base and you have full convertibility for your currency, then you do not need capital controls because at the same time you are not trying to use domestic monetary policy and you do not generate inflow and outflow originated in the wrong movements in the local monetary policy. Now if you adopt a currency system by which you limit currency convertibility and at the same time you allow for some flexibility in the exchange rate using a crawling peg or band system like in Chili, Brazil and Mexico, then it is very important that you have some control on capital movement like the Chileans did. In that way you can avoid a monetary crisis. What doesn't work is a system by which you try to manage the exchange rate somehow, you try to implement to some extent domestic monetary policy but you keep complete mobility for short- term and long-term foreign capital. It is this combination that generates the monetary crisis like it was seen in Mexico and in Brazil. That's the first comment.

The second one is that as in Latin America we need to use a high quality currency — either the dollar or the euro or the yen or a combination of the three of them or a combination of two of them as tutors for our currency — because of the history of inflation and low quality and lack of credibility in our domestic currencies. Our job of adopting an appropriate monetary system will be facilitated if the range of fluctuations among the three main currencies is not that large. The concern on moving from, let's say, simply a dollar patron like we have in Argentina to a basket of three currencies like the Brazilians are thinking on relates to the fluctuation between the euro, the dollar and the yen. So if, by improved structural policies or fiscal policies in the three main economies or some mechanism for monetary coordination, the fluctuations among the three main currencies were limited, then life would be much easier for emerging economies in terms of choosing a patron currency.

Euh : My comments will stick to Asia rather than to a global one. When Sakakibara-san mentioned about the danger of hedge funds in his memoir in Yomiuri-shimbun or other monthly magazines, he mentioned that in early 1997 he had a chance to meet George Solos and Solos mentioned that the next target would be Korea. So he mentioned it openly in the local newspaper.

But the problem occurring in Korea is that, actually the money not only from America and the European country were withdrawn, but all Japanese financial institutions withdraw the money before the Korean currency debacle. What does this mean? Actually, the leftover is European. The Japanese withdraw, and the American withdraw and the European remained. So what I'm trying to say here is that to become a leader you have to sacrifice something. If you are going to take advantage of all situations, then you cannot be a leader. Every Asian country, especially Korea wants Japanese to become a leading role in Asia. However I still don't know whether Japan has that kind of capacity. Thank you.

Question and Answer Session

Questioner : Thank you for all your interesting comments. I would like to ask Mr. Trichet a question. But before that I would like to point out that there is an interesting phenomenon for Mr. Trichet, Mr. Truman and Mr. Kuroda in the foreign exchange market. One euro is now about one dollar, and one dollar is about one hundred yen. There are discussions about revaluating the yen and if that should happen the ratio between the three currencies will be 1:1:1, which — this is just a light hearted remark — will be a good omen for the 21st century. My question to Mr. Trichet is this. Ever since the euro was introduced and was launched, there was a high expectation for a strong euro. It was very strong in January this year but the recent tendencies in the foreign exchange markets are not favorable. One of the reasons that is pointed out in the financial industry is that there are numerous obstacles to conquer on the road to Europe economic and currency integration. You mentioned four very important disciplines. But, in spite of them, aren't the policies directed inward toward Europe? Isn't it argued that they do not have global considerations, rather just regional? What does Mr. Trichet think of these arguments. I would appreciate your comments.

Trichet : I was given a paper which I think must be also given to each member in this assembly, and I allow your attention to page 1 where you can see the situation of various currencies over time starting from the 70's. It is certainly telling a little bit on the exchange system, the floating exchange system.

As regards the euro, I will only say that, first of all I disagree with the fact that there are any major difficulties in the integration of Europe. On the contrary, I consider that what we have been doing over last years, but it's a long period of time, and Ted was absolutely right in stating that the European unity is a long historical process. But what we've been doing including in the recent time is really very important, and I don't see any of the difficulties that could emerge in the integration today. On the contrary, it seems to me that it proceeds quite well and quite rapidly. As regards the reasons why such currencies go up and such currencies go down, you have the market literature and you can look at it very carefully. As a central banker, I will only tell you that we are pursuing a policy of a solid and strong euro, a euro which keeps its value. It's up to you to observe what we are doing, and draw the conclusion. The euro in my eyes has a strong potential for appreciation. I'm sure that it will be demonstrated in the market.

And third, if you need any terms of reference coming from me, I will pick up the terms of reference of the US over the last years where the dollar was up or down. The reference was “A strong dollar is in the interest of the US.” And I would tell you “A strong euro is in the interest of Europe. Full stop.”

Questioner : There is a debate raging in Japan around the monetary policy conducted by the Bank of Japan. And because it has global implication, I hope the panelists will not go the Asian way and refuse to comment on another country's domestic monetary policy. Briefly, politicians anxious for their reelection and ministerial financial official with short memories are asking the Bank of Japan to bail out public finance and to monetize the public debt. One implication would be to have a very weak yen. Now I wonder what Mr. Truman would have to say to an implication of monetary policy that would lead the dollar up to 160 or 150 yen. I'm also very interested to hear what that would do to the recovery in Asian economies and especially Korea. That's the first question. Countries that are supporting this move are oblivious of the implication for the forex market.

The second question is directed to Mr. Jean-Claude Trichet, because he went through more or less the same experience in the early 90's in Europe when the Frankfurt policy was made a scapegoat for high unemployment. People are forgetting that physically you don't solve a structural problem of the nature that Europe had, and that Japan has, with manipulating monetary policy, and manipulating the currency.

Truman : Well I think I'm going to disappoint you. We think that Japanese policy, monitoring other policies, ought to be directed at the Japanese economy, and strengthen the stability of the Japanese economy. No policy is exempt, if I may put it that way, but I'm not about to put in place prescriptions as to what any particular policy it should be.

Trichet : As regards the potential for central banks to be scapegoats, a number of us come from a central banking constituency, I think that all responsible entities, all responsible institutions have that potential whether they are a central bank. It appears from time to time, and I think that I'm sure he is absolutely right in mentioning that it happened in my own country. I will not comment on what's happening here in that respect. I will only say that it seems to me that the major questions that are posed here and are fortunately in a process to be solved are structural reforms, reshaping and restructuring of the productive sector. That is really the key to me, of course in the medium run. I mean these are the big investments that will produce yields in the time to come. And that is certainly again, if you have a medium and long term perspective, extremely important in comparison with the macro policies. Thank you.

Questioner : My question is addressed to Mr. Yoon-Dae Euh. Following the recent Asian financial crisis, the idea of the Asianization or the internationalization of the yen has begun to gain momentum. But we know that it is a distant conjecture. For example if the American dollar has come under intense pressure to depreciate, the measure will have a repercussion on the Japanese economy in terms of recovery, given the fact that Japan is one of the most important trading partner to United States. But if we assume that the idea of the Asianization or the internationalization of the yen has become a reality, in what way will that protect Japan from the repercussions of other major currencies in other regions such as the dollar. Thank you very much.

Euh : Can I answer the first question about the impact of depreciation of the yen if there is any? As you know at the third quarter of this year, the Korean GNP growth has become more than 12% per annum basis and with only 1% inflation, the best performance in Korean financial history. But we have hangering problems in the coming years because of potential inflation next year. If you look at the capital flow and current account surplus in this year, we are expecting that we'll have a current account surplus of $23 billion, and next year we are even expecting that at least we'll have a more than $10 billion current account surplus. By having this surplus, we could fortunately overcome the problem of financial debacle which we encountered in 1997. But if you look at the origin of growth of 12% in the third quarter, at the end of this year we'll have a 9% GNP growth. The two third of the growth has been resulted from exports sectors. As you mention, if Korean products lose its competitiveness against Japanese products, we'll have big trouble definitely.

So as one of cores of Korean macro economic policy, before we used to put on GNP growth and lower inflation. However, because of the experience of the financial debacle 2 years ago, we are trying to emphasize more on the balance of the trade account or the financial, or current account. So if we lose competitiveness so that we cannot continue to grow in the export market, then the Korean economy will definitely face big problem.

About the Asian currency unit, I think the situation of developing an Asian currency unit or an Asian monetary fund would be similar to the case of EU countries. If you look at the trade flow as I mentioned earlier, intra-region trade has increased remarkably more than double compared to two decades ago. If one country in Asia goes to other Asian countries more than 50%, definitely the currency of Japan should be the key currency for Asia. That's a trend.

I don't know whether we should create a euro-like Asian currency unit, or yen globalization, but we have to stick to a means for us to make our currency stable. And if we look at, as the Japanese government mentions, the flow of the capital going to European countries or especially to the United States, maybe around 40% of buyers in terms of amount of Treasury Bonds are Asian-oriented. The largest holder of Treasury Bonds are Japanese. Even Korea went seventh in the world, I mean in terms of getting Treasury Bonds, it is 14th in the world, but in terms of reserves it went 7th in the world. There are abundant of currency available in Asian countries. You should sound means to circumvent indirect route. That's efficient. So, we should study about those things. It's just the problem we have to solve, the task we have to solve. I don't know the answer for that one. Again, I'm asking that we need leadership in this region.

Kuroda : I do not think it appropriate to comment on the current movement of foreign exchange rates here, so I do not intend to do so. But, as Mr. Euh mentioned, intra-regional trade in Asia is increasing rapidly. When we look at trade between Japan and South Korea, it is not only trade between the two countries that is expanding but competition in trading goods in third countries is also increasing rapidly. Under these circumstances, it is desirable to have stable exchange rates for the stability of economies in these countries as well as for stable trading relationships. However, the relationships between the yen, dollar and euro are complex. I think the euro is too weak and that it will recover, but it is extremely difficult to limit the fluctuations among these three currencies within a small range. We have experienced in the past exchange rates moving unreasonably far from what the fundamentals suggest they should be. In those circumstances different aspects of policy were coordinated and such an unnatural situation lasted for only a short while. It was solved in the short term. I think we have to continue to take such measures.

Questioner : I would like to ask a little bit specific question to Mr. Bernard Jean-Claude Trichet. I'm just reading a book titled Lessons Pour Notre Temps by Jacques Rueff. In this book there is a chapter of comments made by Mr. Jean-Claude Trichet — marvelous comments. So, my question is whether Jacques Rueff has some validity when we consider the future course of international monetary system, or is he totally out of fashion. Thank you.

Trichet : Thank you very much for this question. By the way, I have to say hello to a number of friends that are in this audience, and in particular to the man who has the question. It was an illusion in fact that Jacques Rueff was very keen on having gold playing a very important role in an international monetary system, although he also has some echoes in the US and in part of the world. I will not embark into any long-term diagnosis on what's likely to happen. It seems to me that what we have to say is that gold remains an important asset in our world and you know that it is the position, to my knowledge, of the major gold holders — they have indicated their position in the recent public communiqué as regards part of them. But I hope I am not translating incorrectly the position of the major stock holders, namely the US or France or Germany or Italy, to say that it is not the intention of those who have those gold holdings to sell them. I have nothing else to say, so we will see exactly how the international system moves and I have myself no particular stake into these long- term vision which Ted has embarked. Within 50 years we will see what happens. Now we have to make the present world functioning as well as possible. If so there is already quite a heavy task now on our shoulders.

Questioner : To Dr. Cavallo, I fully recognize the role played by the convertibility Law that Argentina has adopted. But I would like to know your opinion how you are going to reconcile or solve the difficult dilemma between the fact that you keep pegging your currency to the dollar and your policy to lower the customs duties in MERCOSUR, where Brazilian real has been substantially devalued while Argentina keeping one to one relationship with the dollar.

Cavallo : That is a very relevant question. After the devaluation of the real, and the fact that now the Brazilian authorities say that they will manage the currency using a free floating but still the currency is non convertible, therefore there will be some room for maneuvering in terms of affecting the value of the currency by arbitrary decision. We do have a problem in MERCOSUR, but what is becoming very clear is that competitiveness in Brazil vis a vis competitiveness in Argentina does not only depend on the exchange rate. Actually the Brazilians have not gained in competitiveness as much as the change in their exchange rate would suggest.

As a consequence of the devaluation of their real in all their uncertainties that were introduced in the Brazilian economy, now the cost of capital is much higher in Brazil than in Argentina. They are paying much higher risk premiums when they borrow in dollars and even much higher risk premiums and the currency risk premiums when they borrow in reals. So the competitiveness that they have gained by reducing their wages in dollar terms after the devaluation, has been eroded somehow by the increased cost of crediting capital associated with uncertainties that they have introduced.

In addition, in order to balance the budget, the Brazilians have to introduce tax increases. Many of the taxes that they have introduced are very distortive, and they have been also affecting competitiveness in a negative way.

So the strategy that Argentina has decided is a completely different one from that of Brazil. It is to keep the currency system, to work in balancing the budget by reducing government expending rather than by increasing taxes, in trying to convince investors in Argentina. Both from Argentina and from abroad, that Argentina is a reliable country as to pay lower country risk premiums and also to have as low as possible devaluation in premiums and enjoy lower cost of credit, and in that way gaining competitiveness without having to reduce the wages in dollar terms to the extent that the Brazilians have reduced.

And the political consequences of the two approaches are very interesting. The president of Brazil has been losing popularity after the devaluation of the real and the new elected President for Argentina De la Rua won the election after reassuring the Argentineans that he would preserve the currency system and that he would stick to the very stable currency. That means that in Argentina keeping the currency and price stability is highly praised by the population, by the citizens.

That is why I think that in the future the political systems both in Brazil and in Argentina will work for greater currency and prices stability, and increasing competitiveness will be looked for through reducing cost of capital, reducing cost of credit, elimination of distortive taxes and increased productivity rather than in cutting the value of assets by devaluing the currency.

Questioner : My question is rather general in nature about the possibility of certain coordination between the three currencies. Most of the speakers, if not all, came to the conclusion that it is impossible to have a system of stable exchange rate between the three currencies for practical reasons — national interest reasons. But there are two points that I wish to ask.

First, Mr. Kuroda implied that creating the system to stabilize the yen euro dollar exchange rate would negatively affect the flow of capital among the three currency areas. What is the reason for this assertion? In the case of the European Union during the ERM, ESM phase, stabilizing exchange rates did not negatively affect the flow of capital.

And Mr. Trichet, — I wish to learn from him — how much does he see the process that took place in the European Union by which the monetary integration was a result of not only a vision, political vision, but as well as a necessity due to economic integration? To what extent this is a preview of what our world is watching by which the economic globalization and the increasing irrelevance of voters would force us into a global monetary system in a way or another?

Kuroda : I have repeatedly emphasized the importance of coordination among the three currencies. Needless to say, the most important thing is for the three regions to pursue effective macro economic policies that will enable them to have sustainable economic growth without inflation, and for the economies of the three regions not to diverge extremely, in other words for one region to have an inflationary tendency and for another to have a deflationary tendency. Based on this basic understanding, what we need to do is to try to avoid extreme fluctuations of exchange rates by coordinating our policies or intervening in markets in a coordinated way, depending on the circumstances that arise. We already have a degree of cooperation within the G-7 framework. We will continue this cooperation in the future and, when necessary, will strengthen our coordination.

Trichet : I would say the same on the first question. The sense of our expositions is certainly not to suggest that international cooperation is useless or that it doesn't work. It seems to me that it would be a contresens, if I may say. On the contrary, it seems to me that we have an accumulated in the last 12 years, or 15 years a large degree of cooperation between the major industrialized countries and it seems to me that this process is to be appropriately praised. It might be fashionable to say it doesn't exist or it's total failure but it's not true. And as regards the present situation, I myself fully subscribe, of course, to the last G-7 communiqué. And again we have a degree of cooperation which one should not underestimate.

As regards the experience of Europe, I would only remind all of us that the founding fathers of the European unity had in mind a common market, we call it “Common Market in '56.” At that time we were in the Bretton Woods System, so we were in the closed eye fixed exchange rate system in the world and of course in Europe as a part of the world.

The idea that to really run a fully operational single market, common market, you have to run also a single currency, is an idea which can be probably demonstrated and has been demonstrated by economists and experts.

And it seems to me that it is that combination of the will — the strategic will — to achieve the ambition of the single market, with also undoubtedly a political ambition for European unity which has triggered this extraordinary endeavor which is the single currency. That being said, of course I don't suggest that this experience can be expanded without looking very carefully at the conditions that exist in other parts of the world. We have to understand that this is really the case of Europe, something which was very special, and again which will be a great success in my eyes.

Gyohten : Thank you very much Jean-Claude. With your very confident assurance of the increasing global cooperation, I'm afraid I have to declare the conclusion of this symposium. Before doing that I certainly wish to repeat my thanks to all of you panelists and also to our audience both of which really actively participated in the discussion and I think made this symposium very great success. I'm sure all audience did enjoy listening to our panelists' presentation and their deep insight and also at the same time I hope this symposium has left with many food to digest and prepare the positive options on the countries concerned, particularly in this country Japan which is still struggling to make the final and assured rebouncing of the economy. So please join me in thanking our panelists for their excellent presentation.

Thank you very much.