INTRODUCTION

Money in the New Millennium: The Global Financial Architecture

James A. Dorn

> The key to avoiding [international currency] crises is not international gimmickry. Instead of fiddling with exchange-rate arrangements, policymakers should pay attention to the currencies themselves. So far, absurdly, these remain undefined in value; and their values depend precariously on the changeable policies of central banks, which are constantly badgered with short-run-oriented advice from home and abroad.
>
> —Leland B. Yeager (1998: 264)

Fundamental Monetary Reform

The Mexican currency crisis of 1994–95, and the ensuing crises in Asia, Russia, and most recently Brazil, have focused attention on the global financial architecture and provided an opportunity to think about fundamental monetary reform. Policymakers are beginning to acknowledge that the system of pegged exchange rates is not feasible in a world of mobile private capital, and that a clear choice must be made between rigidly fixed exchange rates and freely floating rates. But most policymakers continue to ignore the deeper issue of the inherent weakness of monetary regimes based on discretionary government fiat monies.

The basic issue is, Will governments leave markets alone and focus on establishing a legal framework for free trade, free capital flows, and sound money, or will they be led by the so-called best and brightest to create institutions that enhance the discretion and power of the state? The temptation is to think that we can improve upon the spontaneous or undesigned order of the free market by deliberately

Cato Journal, Vol. 18, No. 3 (Winter 1999). Copyright © Cato Institute. All rights reserved.

designing a new global financial architecture. The problem is that, when government planners and bureaucrats are doing the designing, the incentive is to have too much government discretion and too little market discipline.

Thus, the debate over a new global financial architecture is, at heart, a debate over the role of government in a free society. The overriding principle of freedom should not be compromised by limiting the choice of monetary institutions to a little more or a little less government discretion. Rather, the choice should be between government fiat money systems, on the one hand, and free-market monetary systems, on the other.

Much has been written about the International Monetary Fund bailouts and the problem of moral hazard, but one should not forget that the moral hazard problem is only one aspect of the difficulties facing the current international financial system. Pegged exchange rates and discretionary government fiat monies are the underlying sources of instability in the global monetary order. With either rigidly fixed or freely floating exchange rates and a rules-based monetary system, there would be no serious adjustment problem for the balance of payments and, hence, no major problems of liquidity or confidence. With a money of stable value and with prices set in the free market, adjustments would take place more smoothly—and errors would be corrected more quickly—than under the current hybrid system. In such a world, of course, there would be no role for the IMF.

The failure of central planning means that the relevant choice for the new millennium is between market liberalism—a system in which individual liberty predominates—and market socialism (the so-called mixed economy or Third Way), in which the state plans the market and compromises freedom and responsibility. The setbacks in those countries practicing ‘‘crony capitalism,’’ however, should make the consequences of the choice between true and false markets clear. It has not been an excess of capitalism and freedom that is at the heart of the global currency crises in developing nations but, rather, an excess of government and interventionism.

These broader philosophical issues should not be lost sight of in the debate over the specifics of a new global financial architecture.

The Global Financial Architecture

Most of the papers in this issue of the *Cato Journal* were first presented at the Cato Institute’s 16th Annual Monetary Conference, October 22, 1998, which was cosponsored with *The Economist*.[1] The papers have been revised and updated for publication.

That conference—"Money in the New Millennium: The Global Financial Architecture"—was a reaction to U.S. Treasury Secretary Robert Rubin's call for a new "global financial architecture" that is "as modern as the markets." His plan calls for increasing transparency and disclosure, strengthening the role of the IMF and other multinational financial institutions, making the private sector more accountable, and improving financial regulation in emerging market economies (Rubin 1998). The idea of the conference was to consider the institutional changes needed to make the global financial system less disturbance prone and, thus, to examine the role of market forces in shaping the new financial architecture versus the role of government.

If the fundamental solution to a country's inability to meet its obligations to foreign creditors is a workout negotiated by the debtors and creditors, why are disbursements from official sources needed? Has the IMF become "the Typhoid Mary of emerging markets, spreading recessions in country after country," as Jeffrey Sachs contends? The distinguished contributors to this volume address those questions and others relating to the shape of monetary institutions and the regulatory framework in the 21st century and beyond, including the implications of European monetary union for the global financial architecture, the role of dollarization, and the use of capital controls to stem hot money. In considering those and other topics, lessons are drawn from the Asian financial crisis and from other historical episodes of monetary instability.

An Overview

In his opening paper, *Lawrence H. Summers*, deputy secretary of the Treasury, considers one essential element of building a new global financial architecture—namely, how to ensure that capital flows efficiently from developed to developing countries. He wants "a safe and sustainable system" as opposed to the uncertain and volatile system of today. Three ideas stand out in his analysis:

- "Market discipline is the best means the world has found to ensure that capital is well used."

[1]The paper by Steve Hanke and Kurt Schuler was added after the conference, as was the paper by Juan Luis Moreno-Villalaz. Clive Crook, deputy editor of *The Economist*, contributed greatly to the success of the conference.

- "As capital market integration increases, countries will be forced increasingly to more pure floating or more purely fixed regimes."
- "The most important determinant of every country's fortunes is the policy choices of its people and its government."

Summers reminds us that we cannot have all good things; choices must be made—"The core proposition of monetary economics is a trilemma: that capital mobility, an independent monetary policy, and the maintenance of a fixed exchange-rate objective are mutually incompatible." That is why, if countries want to benefit from free international capital markets, they must choose either freely floating exchange rates or permanently fixed rates.[2]

In a world dominated by private capital flows, the days of pegged exchanges rates are numbered. Indeed, Treasury Secretary Rubin has recommended that emerging economies adopt credible institutions that either rigidly fix the exchange rate (e.g., by adopting a currency board) or let the exchange rate float. He now believes that intervening to defend unsustainable pegged rates is a mistake. According to Rubin (1999), the general rule should be: "The international community should not provide exceptional large scale official finance to countries intervening heavily to defend an exchange rate peg."

If that rule were followed rigidly, and pegged exchange rates lost their appeal, the IMF's role would be greatly reduced—and that is exactly what *William Niskanen*, Cato's chairman, thinks should happen. Rather than searching for new roles for the IMF, he would abolish it. In his paper, he argues that the global financial architecture in the 21st century would be more secure without an agency that, instead of producing healthy economies, has created "loan addicts."

Steve Hanke, professor of applied economics at the Johns Hopkins University, has long criticized pegged exchange rates as a pseudo system based on political compromise rather than free-market principles. For him, both freely floating rates and permanently fixed rates are consistent with market liberalism. The poor record of central banks in developing countries leads Hanke to argue for a currency board system as a credible way to bring about monetary stability in emerging economies. In his paper, he emphasizes the danger of exchange controls, which he sees as "nothing more than a ring fence within which governments can expropriate their subjects' property."

[2]This trilemma is well known in international monetary economics, but has often been lost sight of in practical policy proposals. The pegged exchange rate system is a prime example. For an insightful discussion of the so-called doctrine of alternative stability, see Yeager (1976: 651–54) and Friedman (1998).

Hot money and one-way option speculation are related to pegged exchange rates, argues Hanke. Imposing capital controls is not the answer to capital flight. They will only erode freedom and decrease wealth in those nations that limit convertibility and constrain capital flows. When people are free to move their capital to higher valued uses, governments must change their policies or suffer the consequences.

Dollarization is a tighter form of currency unification than a currency board, and can quickly give people in developing countries a secure medium of exchange. That is why, even without official dollarization, many people in emerging economies choose to hold U.S. dollars rather than an unstable home currency. Hanke recommends dollarization as a sound monetary institution for those countries that do not have the monetary and fiscal discipline needed to maintain the long-run value of their currencies.

Hanke and *Kurt Schuler*, an economist with the Joint Economic Committee, propose that Argentina move from a less than perfect currency board system to dollarization. They think that Argentina should do this unilaterally, so that it is not bound by an official treaty, and that people be given the choice of moving to another currency if the Federal Reserve changes the course of monetary policy. They argue that the transition to dollarization would be relatively easy and that Argentina's new monetary constitution would lead to lower interest rates and faster economic growth than under the existing currency board system. Argentina could certainly learn from Panama's experience with dollarization, which, as *Juan Luis Moreno-Villalaz* notes in his paper, has been positive.

Laurence H. Meyer, a member of the Board of Governors of the Federal Reserve System, discusses the roles of market discipline, regulation, and supervision in increasing global financial integrity. He makes a case for greater disclosure to improve market discipline and calls for reform of international capital standards and bank supervision. Reforms should take account of the dynamics of global capital markets and recognize different approaches to risk management. The Basle capital standards should reinforce market discipline, if global financial integrity is to be improved.

Randall Kroszner, an economist at the University of Chicago's Graduate School of Business, shows how private regulation has evolved to create stability in global financial markets. Participants in newly developing financial markets have an incentive to create institutions that benefit all traders by reducing risk and increasing stability. Clearinghouses, rating agencies, contractual innovations, organizational changes, and so on have all worked toward those ends. If continued progress is to be made in the search for global financial order, Kroszner advises that "public regulation should not be permitted to crowd out dynamic private regulation."

The bailouts of the 1990s differ substantially from earlier rescues. Under the Bretton Woods system, countries that faced temporary balance-of-payments problems could get official assistance to maintain a pegged exchange rate. Today, the assistance is of longer duration, much larger, and frequently aimed at countries that have already abandoned a pegged rate. Banks and investors who are bailed out are the primary beneficiaries. Moreover, those countries typically face insolvency rather than mere liquidity problems. *Michael D. Bordo*, an economic historian at Rutgers University, examines those differences and finds that the large bailouts of the 1990s, beginning with Mexico, have created a serious moral hazard problem. If lenders and borrowers expect to be bailed out, they will have an incentive to engage in more risky ventures and lend and borrow excessive amounts. He exposes the myth of pure contagion, and argues that history shows that those economies with sound policies are not much harmed by a currency crisis in an economy with unsound policies.[3] Yet, the threat of contagion has been used to justify the very bailouts that increase moral hazard and make future bailouts even likelier.

Bordo concludes that "a pervasive problem in the case of all crises was pegged exchange rates." Such rates create a false sense of confidence and encourage home-country banks to borrow short term, at low interest rates, in dollars, and to relend long term, at higher interest rates in the local currency—with the expectation that there will be no devaluation. However, once speculators recognize that the home currency is overvalued, they will drain foreign exchange reserves and the peg will collapse. The damaging effects of that compromised system could be avoided, says Bordo, by allowing exchange rates to float freely. The global financial architecture would also be improved, according to Bordo, by changing lending practices: "Today's monetary authorities, including the IMF, should follow Bagehot's principles: Lend short term at a penalty rate on good collateral that exceeds the value of the loan."

Harvard economist *Jeffrey Sachs*, another critic of pegged exchange rates and the IMF, contends: "It is not the devaluation but rather the *defense* of the exchange rate preceding the crisis that has often opened the door to financial panic." The devaluation merely signals the loss of foreign exchange reserves at the central bank. Foreign creditors panic because they know the bank cannot act as a lender

[3]For an excellent discussion of "the myth of contagion," see Anna J. Schwartz (1998: 252–54).

of last resort for dollar-denominated debts, so they attempt to take their capital out of the country as quickly as possible. In the process, the domestic economy shrinks. The normal sequence begins with net capital inflows to developing economies having pegged exchange rates, the exchange rate becomes overvalued, reserves are depleted, a devaluation occurs, and there is a net capital outflow. In Sachs's view, "IMF actions have probably contributed to the [creditor] panics."

Like Bordo, Sachs believes that it would be much better to let currencies float than to peg them at unrealistic rates.[4] There would then be no need to hold large foreign reserves with which to defend an overvalued currency. In addition, Sachs would limit short-term borrowing in emerging economies by the use of "prudential standards" (rather than capital controls), improve capital adequacy standards, and allow greater foreign competition and ownership in the financial sector. He also suggests that new mechanisms should be developed that allow creditors to respond to panics collectively, including "methods for creditor-debtor bargains for stretching out loans, converting debts to equity, and writing down claims, in the event that a panic is followed by a solvency crisis." Those reforms would reduce moral hazard by moving decisions to the market and private parties and away from governments, central banks, and international organizations.

Y. C. Richard Wong, executive director of the Hong Kong Centre for Economic Research, draws some important lessons from the Asian financial crisis. He attributes that crisis to multiple factors, including overconfidence in pegged exchange rates, excessive capital inflows (based, in part, on the expectation of a bailout as in the 1994–95 Mexican crisis), currency and maturity mismatches, poor risk assessment practices by bankers, and crony capitalism. The two most relevant lessons from the Asian crisis are that (1) pegged exchange rates are bound to fail in today's global economy and (2) such rates inevitably lead to a moral hazard problem, given the existence of the IMF.

If Asian central banks cannot be trusted (the Thai central bank deceived markets by overstating foreign exchange reserves, which led to capital flight once the truth was known), then a currency board system is an attractive alternative. Hong Kong's board helped maintain credibility for the Hong Kong dollar during the Asian crisis, but

[4]Unlike Thailand and South Korea, which pegged their currencies to the U.S. dollar, Australia let its currency float. Consequently, the central bank did not have to have as its main priority the defense of the Australian dollar. Instead, the bank eased and Australia weathered the Asian currency crisis—GDP grew by 3.6 percent in 1997 and 5.1 percent in 1998 (Witcher and Wessel 1999: A1).

Hong Kong did not escape that crisis entirely. To stem capital flight, emerging economies in Asia, and elsewhere, must resolve to establish sound currencies and restructure their financial systems to eliminate moral hazard and crony capitalism. Market alternatives to bank financing should be allowed to develop, argues Wong.

Jose Pinera, president of the International Center for Pension Reform in Chile and a distinguished senior fellow at the Cato Institute, sees in the Asian financial crisis a unique opportunity for increasing free markets and reducing the scope of government. For him, the main lesson from the crisis is that the "Third Way"—under which free-market principles and the rule of law are compromised by government intervention—is the wrong way toward freedom and prosperity. The failure of government intervention in capital markets and foreign exchange markets—and the failure of industrial policy—indicate that the problem in Asia is not too much capitalism but too much interventionism. The only real choice, therefore, is to move further toward the market. As Pinera writes, "The way out of the Asian crisis is to abandon the Third Way—in both its economic and political dimensions—and introduce more free markets, more civil liberties, and more democratic accountability. Introducing capital controls is not the answer." From his view, "The Asian crisis may turn out to be the fall of a second Berlin Wall, that of a supposedly Third Way to development and freedom."

One important change in the global financial architecture that has already taken place is the creation of the European Monetary Union. *Robert Mundell* and *Charles Calomiris,* both economists at Columbia University, offer insights into the future of the euro as an important international currency. Mundell, an early proponent of the euro, is optimistic that "the dollar-euro exchange rate is going to become the most important price in the world." He believes there will be a strong incentive "to stabilize and reduce fluctuations" in that price and that Japan will want to keep its currency in line with the euro-dollar rate. Thus, he predicts "that by 2010 we will be back to a world where we get more fixed exchange rates, and the International Monetary Fund will be dragged back to its original function." Calomiris, on the other hand, predicts that political factors will play havoc with the euro, as "soft-currency" countries threaten to exit the union unless the European Central Bank agrees to accommodate their excessive government spending by monetizing their fiscal deficits. He believes that the clash between hard- and soft-currency countries will cause increasing tension within the European Monetary Union and lead to its eventual collapse.

William Poole, president of the Federal Reserve Bank of St. Louis, concludes the volume by making the case for zero inflation. He thinks that "zero is a very nice number" and that the arguments for moderate inflation are misleading and incorrect. Experience has taught that economic growth depends on real, not monetary, forces, and that even mild inflation can distort investment decisions and misallocate resources. For those and other reasons, Poole argues that "zero inflation should be the paramount objective of monetary policy."

Monetary Institutions and Incentives

The currency crises of the 1990s have all dealt with discretionary government fiat monies. Establishing a currency board system or moving to freely floating exchange rates will help in specific cases, but the underlying problem of a unit of undefined value still haunts the global monetary order. That is why Poole's focus on a rules-based monetary regime is important. Attention needs to be directed toward fundamental monetary institutions and how alternative monetary regimes affect incentives and behavior. And that is why Leland Yeager's opening quote is so appropriate: "The key to avoiding crises is not international gimmickry. Instead of fiddling with exchange-rate arrangements, policymakers should pay attention to the currencies themselves."

Real reform of the global financial architecture would mean a much smaller role for what Yeager (1998: 262) calls the "big players" (governments, central banks, and international organizations that try to design the global financial architecture) and a much larger role for private traders and the spontaneous market order. In his view,

> Fundamental reform . . . would avoid sudden unpredictable changes in policy regimes and in official transactions; it would hold down the scope of large centralized decisions, whose effects are harder to cope with than the gradually occurring cumulative effects of innumerable decentralized private decisions; it would reduce the role of official big players on whose dominant decisions the changeable expectations of the public focus. It would provide money of stable or at least of predictable purchasing power [Yeager 1998: 265].

The way to do that is to introduce more freedom and more competition into the money-supply process and let people choose the best currencies. That is an idea F. A. Hayek and others have advocated, but that all governments oppose (see Hayek 1976, 1978; Yeager 1997). With innovations in information technology and with financial deregulation, however, the money of the 21st century may well be private currencies of defined values rather than uncertain government fiat monies (see Dorn 1997).

For the present, "international gimmickry" continues, with the most recent example being the IMF's new "Contingent Credit Line," designed to assist sound developing economies *before* they run into trouble. But preapproving a country for billions of dollars in credit for use during a possible crisis, provided that country meets certain standards, is a recipe for increased moral hazard. The new facility is based on the myth of contagion and, like the current facilities, will likely lead to more, not fewer, crises—as long as pegged exchange rates, the IMF, and discretionary central banks prevail.

Such gimmickry should not be allowed to crowd out a discussion of real reform. The papers in this volume remind us that getting institutions and prices right is essential for economic development. Private property, limited government, and sound money matter greatly for freedom and prosperity. All systems are imperfect, so there will always be tradeoffs in the choice of monetary and exchange-rate regimes. The central issue is whether market-led development or state-led development will prevail—there is no viable Third Way.

References

Dorn, J.A. (ed.) (1997) *The Future of Money in the Information Age*. Washington, D.C.: Cato Institute.

Friedman, M. (1998) "Markets to the Rescue." *Wall Street Journal*, 13 October: A22.

Hayek, F.A. (1976) *Choice in Currency: A Way to Stop Inflation*. London: Institute of Economic Affairs.

Hayek, F.A. (1978) *Denationalisation of Money: The Argument Refined*. 2nd ed. London: Institute of Economic Affairs.

Rubin, R.E. (1998) "Address on the Asian Financial Situation to Georgetown University." U.S. Treasury News, 21 January.

Rubin, R.E. (1999) "Remarks on Reform of the International Financial Architecture to the School of Advanced International Studies." U.S. Treasury News, 21 April.

Schwartz, A.J. (1998) "International Financial Crises: Myths and Realities." *Cato Journal* 17(3): 251–56.

Yeager, L.B. (1976) *International Monetary Relations: Theory, History, and Policy*. 2nd ed. New York: Harper and Row.

Yeager, L.B. (1997) *The Fluttering Veil: Essays on Monetary Disequilibrium*. Edited by G. Selgin. Indianapolis, Ind.: Liberty Fund.

Yeager, L.B. (1998) "How to Avoid International Financial Crises." *Cato Journal* 17(3): 257–65.

Witcher, K.S., and Wessel, D. (1999) "Strong Banking System Helps Australia Prosper as Neighbors Struggle." *Wall Street Journal*, 28 April: A1.