

Federal Reserve Bank of Cleveland

The Evolving Global Monetary Order

by Jerry L. Jordan

This final decade of the millennium has seen considerable financial market turbulence. The old order is evolving. How should we respond to what seems to be emerging in monetary matters? Certainly, it would be a “fatal conceit”¹ to think that a group of economic architects could dream up a monetary structure to house the global financial system for the new millennium. I hasten to add that I do not suggest that we do nothing. Rather, I believe that we should be guided by Karl Brunner’s prescription: the state should be “an umpire in a positive sum game, not the operator of a negative sum game.”² I contend that the same should be true of any international organizations created by nation-states.

International monetary developments in recent years can be explained in the context of powerful economic forces challenging ossified domestic institutions. By “institutions” I mean both organizations and sets of rules (such as contract enforcement, labor laws, laws of incorporation, and the judicial system, or various types of economic controls, such as wage, interest-rate, exchange, and capital controls). Some institutions are intended to alter the working of markets because the benefits of intrusion are perceived to be greater than the costs. That is the case when political or social objectives seem to be more important than economic efficiency. Objectives such as income redistribution—a political decision to give priority to sharing wealth, rather than creating wealth—result in institutional arrangements that reduce the efficiency of markets.

The study of institutional arrangements and their consequences in the second half of the twentieth century has become a matter of learning what will not serve in the future, rather than what will best replace it. We have become informed about the unintended consequences of well-intended efforts by international organizations and various foreign-aid programs.

For example, the Bretton Woods System, established in the final days of World War II, had built into it rules for exchange-rate adjustment. Nevertheless, because of the asymmetry in the way the rules worked, there proved to be a rigidity that caused the system to break, rather than bend, in the face of specific economic forces—namely, the debasement of what was intended to be the anchor currency, the U.S. dollar.

The ultimate implication of a conflict between powerful economic forces and rigid political institutions is that institutions must change, or they will fail. There must be an effective political and economic regeneration in which various institutional arrangements, especially organizations, are adaptable to a changing environment.

■ The Evolving Nature of Institutions

Propelled by technological change and chance economic events, the institutions that define our global economy undergo a continual process of change. Qualities that enhance economic well-being tend to survive, and those that do not eventually disappear.

In a speech at the Cato Institute, Jerry L. Jordan, President and CEO of the Federal Reserve Bank of Cleveland, discussed the forces shaping the emerging global monetary order and offered guidelines for the design of any international organization promoting efficient international financial markets. This *Economic Commentary* is adapted from his remarks at the Institute’s Seventeenth Annual Monetary Conference on October 21, 1999.

The idea that tangible manufactured goods must compete not only in local shops but also increasingly in the global town square is obvious to everyone. Yet the thought that institutional arrangements are also tested against others in the international arena is not so well understood. Ideas must face competition no less than goods and services. Politicians have long known that they must compete, but their focus was on rivals in their own party or other political parties in their country. What has changed is the competition they face from policies and institutional arrangements in other countries. The voters are not only the citizens at the local ballot box, but also the financial-asset managers in global capital markets.

Domestic ballot-box voters respond well to politicians who satisfy their craving for wealth-sharing programs.

Capital-market voters survey the world for those who pursue the best wealth-creation policies. Gaining the support of one is almost sure to diminish support from the other.

Courts that will not enforce the contracts and protect the property of their own citizens will not be used by foreign trading partners. Banks that engage in unsound local lending practices cannot sustain the risk-adjusted rate of return sought by foreign investors—unless government guarantees transfer risk exposure from banks and investors to the general taxpayer. Governments with unsustainable fiscal policies, such as promising overly generous pensions to citizens, will find it increasingly difficult—or impossible—to raise sufficient taxes or issue new debt to meet their commitments.

In the end, just as trade barriers cannot permanently withstand the competition of better goods produced elsewhere, so too exchange and capital controls cannot serve as permanent obstacles to pressure from capital-market voters who constantly search for the best wealth-creating environment.

■ The Lessons of Financial Crises

There is little doubt that recent crises reflect financial discipline imposed on countries' policies and institutions by the increased scrutiny of foreign investors and lenders.

International capital flows have proven to be a mixed blessing for many economies in the post–World War II era. But erecting obstructions to the free flow of savings is not desirable, even if it were possible. Instead, the challenge is to ensure that access to foreign capital is more often a blessing than a curse.

Capital mobility does not in itself result in monetary or exchange-rate crises. At its roots, Mexico in 1994–95 did not have a monetary crisis or an exchange-rate crisis. Likewise, what ended up as an Asian monetary or foreign-exchange crisis did not start out as such.

Common to all of these and other episodes were government guarantees or promises that ultimately were revealed to be unreliable. The prior presence of government guarantees (or implicit promises) had induced behavior—relying on the guarantees or promises—that

altered incentives to the point where risk/reward relationships were distorted. Sometimes the guarantees took the form of financial instruments—such as Tesobonos in Mexico—exchange-rate pegs, guaranteed loans to domestic banks, or government-agency or nationalized-industry borrowing. The failures of such arrangements in the crisis countries often became a monetary crisis or an exchange-rate crisis. Such market-corroding practices were already undermining sustainable prosperity even before access to foreign capital magnified the distortions.

Merely allowing the value of a currency to float does not eliminate the problems revealed in fixed-exchange-rate regimes confronted by financial crisis. Only a few currencies in the world enjoy a reputation that permits either the issuing government or private borrowers the privilege of selling obligations to foreigners without incurring exchange-rate risk.

Under a fixed-exchange-rate regime, the government stands ready to supply foreign currency in exchange for the domestic currency. Under a freely floating exchange-rate regime, the government makes no such promise. The risk of exchange-rate depreciation from overly expansionary monetary policy means that interest rates paid by domestic borrowers will be higher than global market rates.

As we have often seen, however, governments have sought to minimize the interest differential by guaranteeing the obligations that domestic banks and other borrowers have incurred to foreign investors. This creates an unavoidable moral hazard. Furthermore, because such guarantees involve a subsidy to borrowers, the demand for them will always exceed the amount the government can possibly honor. The nonprice rationing of guarantees introduces political considerations into the allocation of capital flows, further undermining the discipline of market forces.

Institutional investors in global capital markets conduct a continuous plebiscite on the political and economic policies developing in the nation-states of the world. Seemingly, no economy is immune to these pressures. Advances in communications and information technologies have been revolutionizing all the financial markets. Adverse judg-

ments by participants in such markets can quickly and dramatically change the price and availability of funds to any borrower, large or small. It is becoming apparent that governmental promises—whether in the form of pegged exchange rates or deposit, loan, or investment guarantees—are on the endangered-species list.

■ Central Banks and National Currencies

Other twentieth-century institutional arrangements coming under increasing scrutiny are central banks and national currencies. Certainly there are national vested interests in maintaining local governmental monopolies over the issuance of national media of exchange. Beyond that, the idea persists that a country has something called “monetary sovereignty” and can therefore pursue an “independent monetary policy.” History demonstrates, however, that national currencies inevitably compete in the international financial arena.

In globally oriented discussions, “monetary independence” refers to the asserted benefit of having a central bank and a national currency that permit a country to choose independently “the appropriate rate of inflation.” It is increasingly difficult to understand what such a statement means. If it means the “politically acceptable” rate of inflation from the standpoint of domestic constituencies, then the inherent economic inefficiencies of policies that systematically debase the purchasing power of money mean less-than-potential wealth creation. There are unavoidable wealth redistributions and deadweight wealth losses that result from debasement of the currency, whether intended or not. Traditional rationalizations for deliberate inflation—such as claims of rigid wages or implications for real exchange rates—seem increasingly quaint.

To prosper, every economy needs sound money. Changes in the money prices of goods and assets convey information. If an economy's monetary unit is known to be a stable standard of value,³ then changes in money prices will accurately reflect changes in the relative values of goods and assets. That is, price fluctuations signal changes in the demand for, or supply of, goods or assets. Resource utilization then shifts toward more valued uses and away from those less valued.

However, if the information in changes in money prices is contaminated by inappropriate monetary policies, false signals are sent to businesses and households. Bad decisions are made, and resources are misallocated. Saving and investment decisions are affected, and standards of living fail to rise at their potential rate.

It is now generally accepted that accelerations and decelerations of inflation do not enhance economic performance. Unanticipated inflations and deflations also induce redistribution of wealth—especially between debtors and creditors—but they leave the average standard of living lower. The same is true of devaluations or revaluations of the external value of a currency. A government's decision to alter the exchange rate of a currency that had been fixed involves the breaking of promises. Losses are imposed on someone.

If the internal value of a currency is not stable, then the external value must ultimately reflect this. Clearly, if the domestic purchasing power of a currency falls, the external value must eventually fall relative to stable currencies. The notion that a country can maintain a permanently fixed exchange rate while tolerating domestic inflation has been proven to be false numerous times.

If monetary sovereignty or independence is not worth much in today's global capital markets, and if seigniorage is quite small in a noninflationary world, then the costs and risks associated with a national central bank and a national currency become harder to justify.

Whatever the views of domestic politicians, the trend in the behavior of businesses and households around the world is unmistakable. In the absence of fixed exchange rates, Gresham's Law no longer applies. What we now see—where not prohibited by effective severe punishment—is the use of “high-confidence monies” driving out the everyday use of “low-confidence monies.”⁴ Just as the brand name of running shoes is more important to consumers than the location of the assembly plant, so too the brand name of currency used to denominate contracts and trade assets is more important than the local content or national origin of the standard of value.

International brand identification of goods evolved as governmental and technological constraints diminished. As we are now seeing, brand identification of standards of value is also becoming more pervasive as the falling costs of information and communications technologies make it increasingly easy to compare the quality dimension of standards of value.

Under the true gold standard of an earlier era, most currencies were gold or silver certificates—warehouse receipts for the true standard of value. Then, in the Bretton Woods period, a dollar, firmly anchored to gold, served as a standard of value, and other currencies were defined in terms of the dollar. An obvious twentieth-century trend was the proliferation of national currencies, especially as new nation-states emerged from the breakup of the colonial empires and the Soviet Union. What is less apparent, though, is that while there are now a great many currencies, there are still very few standards of value.

In time, the emergence of national fiat monies during the twentieth century, together with securities markets that allowed the issuance of government debts payable in fiat monies, will be viewed as an experiment that made the costs of monetary mischief increasingly clear. Traditional justifications for monetary independence will sound hollow, and constraints on fiscal-policy actions will become more binding.

■ Guidelines for the New Millennium

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

Countries can take specific steps to allow and even encourage this competition. The first is to remove any capital and exchange controls, including prohibitions on deposits denominated in foreign currencies. Argentina went a step further and clearly signaled its intention to maintain monetary stability by granting people the legal right to contract under any and all circumstances—

including tax payments and other transactions with the government—in any currency they might choose. Argentine legislation requires courts to enforce contracts in the currency specified therein. This “specific performance” law⁵ provides a level playing field for competition between the domestic and foreign currencies.

During the Asian crises of 1997, broad macroeconomic policies—fiscal policies, monetary policies, and balance-of-payments accounts—did not raise any warning flags. Instead, the less obvious underlying flaws in the domestic financial markets (especially the banking companies) were revealed to be pervasive. Undercapitalization, connected lending, inadequate supervision, duration mismatches, uncovered exchange-rate exposure, and other flaws were revealed in the postmortem of the so-called currency crises.

It is tempting to say that what is needed is an international organization responsible for working toward global adoption of sound banking and other financial-market practices. However, the idea of empowering a “conditionality enforcer of first or only resort” is troublesome. Some combination of carrots and sticks will always be present.

Whether carrots or sticks dominate will change over time, depending on personalities and political environment. I doubt anyone would defend the view that what is needed is a global financial policeman/prosecutor/judge/jury/executioner all rolled into one. To some people, the world's capital markets may seem, at times, like the wild, wild west, but they would still stop short of a call for a financial Judge Roy Bean.

Instead, following Mises,⁶ we might think that a financial night watchman would better serve as the role model for the professional staff of any international organization that is empowered to work on behalf of creditor nation-states. A common element of all financial crises in recent years was the existence of government guarantees that were revealed to be unsustainable. The sooner the revelation, the better countries were equipped to eliminate the distortions without a crisis. To this end, an international organization might truly add value.

■ Footnotes

1. Friedrich A. Hayek, "The Fatal Conceit: The Errors of Socialism," in W.W. Bartley, III, ed., *The Collected Works of F.A. Hayek*, vol. 1, Chicago: University of Chicago Press, 1988.
2. Karl Brunner, "The Poverty of Nations," *Business Economics*, vol. 20, no. 1 (January 1985), pp. 5–11.
3. Monetary stability—a stable standard of value—is not the same thing as a stable "price level," nor does it mean "zero inflation." For a classic treatment of these terms, see Ludwig von Mises, *Human Action: A Treatise on Economics*. New Haven: Yale University Press, 1949. For an excellent contemporary discussion, see George A. Selgin, "Less than Zero: The Case for a Falling Price Level in a Growing Economy," *Hobart Papers*: vol. 132, London: Institute of Economic Affairs, 1997. An important conclusion is that the wealth gains emanating from a favorable productivity surprise should be reflected in the rising purchasing power of money.

4. Benjamin Klein, "The Competitive Supply of Money," in Lawrence H. White, ed., *Free Banking: Modern Theory and Policy*, vol. 3. Elgar Reference Collection. International Library of Macroeconomic and Financial History, No. 11, Aldershot, UK: Elgar, 1993 (previously published 1974).

5. Specific performance legislation is not a "legal-tender law." Legal-tender laws require that residents of a country accept a certain currency in settlement of a financial obligation, even if they are owed a foreign currency, gold, or bales of hay. Specific performance legislation means the courts must require delivery of what was promised in the contract, even if that is the currency of another country, gold, or bales of hay.

6. Ludwig von Mises, "Liberty and Property," a lecture delivered at Princeton University, October 1958, at the Ninth Meeting of the Mont Pelerin Society, reprinted by The Heritage Foundation, 1998.

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