

The Role of the International Monetary System in Financialization

Jane D'Arista

Financial Markets Center

Paper prepared for the Political Economy Research Institute (PERI) conference on Financialization of the Global Economy, University of Massachusetts, Amherst, December 7-8, 2001

Introduction

Recent discussions of global architecture have focused on a wide range of financial issues without touching on the most basic element of the global system: the choice of the means of payment in cross-border transactions. The monetary aspect of problems within the existing international system continues to be relegated to the familiar ground of earlier debates over fixed versus floating exchange rates. Advocates of currency boards, the adoption of one nation's currency by another ("dollarization") and the formation of currency blocs see these monetary arrangements primarily as a means to achieve effective fixed exchange rate regimes. Those who favor floating exchange rates advocate closer coordination of the monetary and fiscal policies of the major industrial countries as a means for preventing overshooting and persistent over- and under-valuation. Other key aspects of the international monetary system are assumed to be responsibilities or functions of national monetary authorities or private financial institutions and are largely ignored when global architecture is discussed.

This paper focuses on the current international monetary system and on various proposals that would change or alter the current system. It attempts to evaluate these monetary arrangements in terms of how they affect growth and credit allocation in the global economy and whether they enhance or impede financial and economic stability. It concludes with a discussion of alternative proposals for reforming the monetary architecture by changing the means of payment in the global economy.

The current system: dollar hegemony

The usual reference to the dollar's dominance is in terms of its role as the primary reserve and transaction currency in the international financial system. But the consequences of that status for the dollar over the last three decades can now be measured not only in terms of the share of dollar assets in international reserve holdings, but also in terms of the high level of dollar-denominated debt owed both to foreign and

domestic creditors by borrowers in countries other than the United States¹, the amount of U.S. currency held and exchanged outside the United States by residents of other countries,² and the impact of changes in U.S. interest rates and the value of the dollar on developments in the global economy. These and other evidences of dollar dominance have led some to view the current monetary system as a primary bulwark for U.S. hegemony (Vernengo and Rochon 2001).

Although the dollar was the centerpiece of the dollar/gold exchange standard in place under the post-World War II Bretton Woods agreement, the requirement that member countries exchange their currencies for gold to settle balance of payments deficits gradually undermined its dominance. As other industrial countries recovered from the war's devastation and their economies resumed growth, U.S. balance of payments surpluses shrank, U.S. gold reserves dwindled and the dollar/gold exchange standard effectively collapsed with the closing of the U.S. gold window in August 1971.

A new, privatized international monetary system emerged in the aftermath of the collapse of the Bretton Woods system. Central banks no longer engaged in transfers of gold to settle balance of payments surpluses and deficits. While central banks in other industrial countries continued to exchange foreign for domestic currencies, the U.S. central bank relinquished its role in international payments to the larger, multinational private banks. U.S. actions reflected the influence of advocates for the belief that markets, not governments, should determine both the vehicle for and value of the international means of payment.

¹ At year-end 2000, 42 percent of total cross-border loans of BIS reporting banks were denominated in dollars. About 90 percent of cross-border lending was within the developed country bloc: only 8.1 percent of outstanding loans were to emerging market and developing countries. Similarly, the great majority of outstanding international debt securities are issues of entities in developed countries (84 percent; 24 percent by U.S. issuers) and only 8 percent by issuers in emerging market and developing countries. About 46 percent of outstanding international debt securities are denominated in dollars (BIS 2001). But the dollar-denominated debt of developing countries tends to be higher. Dollar denominated issues accounted for 71 percent of net new issuance of international debt securities by emerging market countries in the second quarter of 2000, down from a peak level of 83 percent in the fourth quarter of 1998 (IMF 2001). It should be noted, however, that an important aspect of the broader definition of dollarization includes the frequency with which domestic debt in emerging market countries is linked to the dollar. For example, 25 percent of Brazil's domestic debt is linked to the dollar and it is expected that, as a result of currency depreciation, the ratio of domestic debt to GDP will rise from 48 to 56 percent over the year 2001 (*Financial Times* 2001).

² Popular estimates put the share of outstanding currency held abroad at 50 to 70 percent. A Federal Reserve Board staff discussion paper estimates that it is much lower – about 30 percent in 1996, compared with 69 percent for the Deutsche mark and 77 percent for the Swiss franc – but has apparently continued to grow throughout the remainder of the 1990s (Doyle 2000).

That view broke with previous precedent. The U.S. Constitution gave Congress the privilege and responsibility for determining the value of the national means of payment. When it revalued gold in 1933, Congress prohibited the exchange of Federal Reserve notes for gold, authorized the Federal Reserve System – an agency of Congress – to act as the Treasury’s agent in holding gold reserves, and provided that gold be paid out only to foreign governments to settle international payments deficits. Neither the government nor the press took notice of the possibility that relieving the Fed of its role in international payments might undermine Congressional responsibility for maintaining the value of the dollar in the absence of a link to gold. Since gold payments could not be maintained, it seemed expedient to shift authority to settle payments in dollars from a public agency to private banks and to remove existing U.S. capital controls to facilitate and affirm that shift.

The post-Bretton Woods regime also entailed the introduction of a fiat monetary standard in both the U.S. domestic and the international payments system.³ International reserves remained a mixture of gold – a non-credit creating asset – and foreign exchange reserves. Foreign exchange reserves were held as investments in deposits or securities – that is, interest-bearing national credit instruments – in the reserve currency countries that issued them or in the external (so-called “Euro”) markets. The U.S. Treasury asked countries that chose to hold dollar reserves in the United States to hold them as investments in U.S. government securities. The effect was to transfer liability for reserve holdings from the Federal Reserve System to the Treasury.⁴

As the new system evolved, it began to extract an immense and expanding amount of wealth from emerging market and developing countries – and even from developed countries that chose to hold high levels of reserves to protect the value of their currencies. Because the fastest growing component of international reserves was foreign

³ The last link between gold and the dollar was cut in 1973 when Congress abolished the requirement that the dollar be backed by gold reserves equal to 40 percent of outstanding currency (von Furstenburg 2000).

⁴ Had dollar reserves been held as deposits in either the Fed or commercial banks, they would have skewed the narrow monetary aggregates and required frequent sterilizing responses by the Fed. Foreign official investments in Treasuries allowed the expansive effect of these inflows to be ignored. Even as foreign official holdings rose relative to Federal Reserve holdings, no offsetting sales by the Fed were undertaken. The fact that these investments were the equivalent to open market operations conducted by foreign central banks in the U.S. market was ignored even as credit expanded at rates greater than growth in GDP in many years from the mid-1970s through the 1990s.

exchange holdings invested in credit instruments, international reserves became hoards of dollar and other strong-currency denominated assets whose financial function was to expand credit in the markets of the major industrial countries, not in the countries that held them. Dollar reserves - \$1,450.5 billion or 76 percent of total international reserves at year-end 2000 (BIS, 2001) - are a channel through which other governments make direct loans to the U.S. government, government sponsored enterprises and private banks. Dollar reserves held in the United States (\$922.4 billion) constituted a stock of loans equal to 9.3 percent of U.S. GDP at year-end 2000 (U.S. Department of Commerce, 2001).

The product of little thought or planning, the current international monetary system has had important consequences for the global economy. It has been the driving force behind the export-led growth paradigm that has elevated trade surpluses to priority status as an objective of economic policy in all countries but one. Since the majority of private international financial transactions are conducted in dollars, countries that engage in international trade and investment must go outside their own economies to acquire a means of payment they cannot themselves issue. And that can only be done if a country sells more goods for dollars than it buys or if it borrows dollars. But if a country borrows, it will need to increase the volume of net exports to service the debt.

The current international monetary system has also been a critical element in promoting the financialization of the global economy. The credit-generating character of international reserves has contributed to a rate of increase in credit growth that has outstripped growth in GDP and trade in the majority of industrial and emerging market countries. And, as the June 2001 *Annual Report* of the Bank for International Settlements (BIS) observed, the “expansion of credit is an essential ingredient in the build-up of imbalances in the financial system and in any concomitant excessive accumulation or misallocation of real capital”(p.139).

Such a system appears to confer certain significant advantages on countries that issue currencies used in international transactions. Increases in international reserves result in capital inflows for investment in credit instruments issued in their markets. Because they augment domestic savings, foreign inflows increase the availability of credit and allow residents of the reserve currency country to save less. Moreover, by

increasing the number of investors and lowering the return on domestic credit instruments, the inflow of foreign savings releases funds for investment abroad.

As noted, that spillover effect creates a dynamic that helps perpetuate the cycle. Central banks in countries that receive excess liquidity from investors in reserve currency countries are encouraged to hedge the inflow by holding more reserves. Table 1 illustrates the outcome in terms of the amount and composition of reserve growth in the 1990s. Total foreign exchange reserves grew by 141.6 percent; dollar reserves by 235.8 percent. Most of the growth was in holdings of developing countries (up by 267.8 percent). By the end of 2000, the share of foreign exchange reserves held by developing countries had risen to almost 60 percent of the total, up from 39 percent at the beginning of the decade.

Meanwhile, the steady stream of capital inflows into the country that issues the premier international money can only continue if that country remains willing to buy the goods that other countries must sell to earn its currency. As U.S. trade deficits grew ever larger in the 1990s and its net international liabilities mounted to 22 percent of GDP by year-end 2000, questions similar to those raised by Robert Triffin (1968; 1992) about the sustainability of the global system became more insistent (Blecker 1999; Godley 2000; Godley and Izurieta 2001; D'Arista 2001). But the tectonic shift that the collapse of the current system will precipitate is yet to come. It is the peripheral faults in the privatized payments system that have produced the visible tremors to date: highly mobile capital, overlending, asset price inflation and the speculative attacks that raise interest rates and cause recessions (Berg and Borensztein 2000; LeBaron and McCulloch 2000).

Few would disagree with the view that “[t]he world financial system has become treacherous in recent years” (Sachs and Larrain 1999, p. 90). But few have looked at the monetary system itself as the source of the problem. Among those who do, either implicitly or explicitly, are proponents of dollarization. For example, one advocate of dollarization notes: “As long as the national currency, whether fixed or floating, is one that cannot be used for foreign or long-term borrowing, financial stability will remain elusive” (Hausmann 1999, p. 68).

Dollarization: reinventing colonialism for the sake of currency stability

Currency boards and unilateral dollarization are seen as ways to make a currency “uninteresting to speculators in search of targets for attack” (LeBaron and McCulloch 2000, p.32). While the recent experiences of Hong Kong and Argentina suggest that currency boards may not always offer that assurance, it is assumed that dollarization will – unless, of course, the currency of the issuing country itself is attacked. Like many defensive maneuvers, however, this is one that is addressed to the last war and may not provide a good defense for the next. Currently, Panama and Ecuador are the only countries that have adopted the dollar as their national currency. And even Panama, with its unique historical relationship to the United States, is not seen as free from the risk of external crises (Berg and Borensztein 2000).

The primary institutional realignment involved when a country adopts another’s currency is that its central bank loses its ability to conduct monetary policy and to act as a lender of last resort for the financial system. Such a country is not a member of a currency bloc with privileges of participation in policy decisions. All decisions affecting interest rates, exchange rates and the rate of expansion of money and credit are made by the central bank in the issuing country.

It is argued that this will be no great loss in countries that abuse the privilege of monetary issuance. Moreover, as some point out, capital account liberalization has already eroded the ability of “small” currency countries to set interest and exchange rates (Bogetic 2000). Add to that the premiums paid for currency and country risk, frequent shocks, the jolts of devaluation and the absence of long-term financing for the economy – what’s left to lose?

What might be left to lose is the capacity to grow. The real test of dollarization is whether or not it contributes to what must be the ultimate objective of any policy option: growth and prosperity. Speaking in favor of dollarization for his country at a conference at the Federal Reserve Bank of Boston, the president of the central bank of Argentina observed that this is not a solution applicable to all countries. In his view, the prerequisite for a dollarized country is being able to maintain productivity growth at a rate similar to that of the United States (Pou 1999).

But a country that cannot issue its own currency cannot ensure that there will be steady, adequate increases in the amount of money and credit needed for an expanding economy. Increasingly, monetary expansion will depend on being able to sell goods in exchange for the adopted currency or attracting investment denominated in that currency. But there is no certainty that it will be able to do either of these things in sufficient volume to ensure that prospects for productive growth are as good or better than they were before dollarization.

It is true that, even now, the growth of “small” currency countries largely depends on their ability to sell goods to “hard” currency countries and attract “hard” currency financial investment. But if “small” currency countries dollarize, their central banks will no longer hold international reserves and thus will not be able to acquire reserves denominated in other major currencies. As a result, it will be necessary for larger domestic and foreign-owned exporters to hold balances offshore for use in dealing with non-dollarized trading partners. Meanwhile, smaller domestic companies will find it difficult to expand and diversify markets for their exports without a central bank to supply foreign exchange. Moreover, the inability to supply non-dollar reserves when the dollar is overvalued relative to other currencies will intensify the dollarized countries’ dependence on the issuing country for sales of exports.

But that dependence will tend to increase in any event. Trade within the dollar bloc will more readily facilitate monetary expansion and growth for the unilaterally dollarized country. Such a country will become a “client” state of the country whose currency it has adopted. If it produces goods that country does not need or want, opportunities to export – and grow – may be constrained. The “client” country may have to restructure its economy to align it more closely with that of the larger economy if it chooses this form of monetary integration.

It is possible that this problem could be overcome if a larger share of the productive facilities of the “client” economy were in the form of direct investments from the larger economy - assuming that degree of economic integration were politically acceptable in both countries. If not, other problems may arise. For example, if a substantial share of productive facilities located in the “client” country were owned by its residents, growth would be hobbled by the absence of a central bank that can provide

liquidity to the domestic economy using open market purchases and discounts of domestic financial assets.

Moreover, as some proponents of dollarization concede, changes in liquidity will be tied to cyclical developments in the country that issues the currency (Bogetic 2000). Even if there are large gains for the “client” country in terms of controlling inflation and increasing the availability of long-term credit, inappropriate responses to its business cycle may increase, rather than reduce, financial instability. More important, the one-way nature of the linkage between the two countries will subject the “client” country to jolts that undermine economic stability and growth.

Another threat to growth is the effect this policy choice will have on the financial systems of dollarized countries. Arguments in favor of dollarization include the observation that floating exchange rate regimes shrink the financial systems in “small” currency countries as residents move savings into other countries (Hausmann 1999). It is assumed that dollarization will stop this movement and revive domestic financial activity. But the probability that foreign banks will come to dominate the financial sectors of “client” countries - especially banks from the country whose currency is adopted – may cloud this rosy scenario.

Leaving aside existing evidence of the domination of foreign banks in Panama and Argentina, it is obvious that institutions that have access to dollar funds at cheaper rates will have a substantial competitive advantage in a dollarized economy. Moreover, unlike domestic banks, foreign banks would have access to lenders of last resort and, as past episodes of “tiering” suggest, this also influences the cost of funds.⁵

Barry Eichengreen believes that the banking system in a dollarized economy “must be internationalized to compensate for the absence of a lender of last resort” (1999, p.220). Some see this as a positive development; a dominant role for large foreign banks presumably will result in fewer banking crises (Berg and Borensztein 2000). Moreover, retaining a predominantly domestic system would be costly since, without a national

⁵ “Tiering” means that banks from a given country are charged a higher rate for deposits or loans from other banks than their peers. After the Herstatt and Franklin National Bank failures in the mid-1970s, German banks operating in the Euromarkets were charged higher rates for interbank deposits than U.S. banks because the German central bank had allowed Herstatt to be closed without intervening or warning while the Fed had acted a lender of last resort until Franklin was sold and even took over the failing bank’s foreign exchange book to stabilize the currency markets.

lender of last resort, the dollarized country would need to establish credit lines and acquire collateral to deal with banking problems that might spill over into systemic crises.

But since the fortunes of foreign banks are not tied to the “client” economy, how will that affect the allocation of credit in a dollarized country? U.S. (or yen or euro-based) banks would certainly find additional sources of dollar deposits attractive. But how interested would they be in lending to small businesses, less-affluent consumers and homebuyers, farmers, regional governments, municipalities and other borrowers who make up the majority of a “client” country’s citizens? Absent a central bank that has both monetary authority and regulatory power over the majority of banks in the national market, who can or will take actions to ensure that there is an adequate and balanced flow of credit across the domestic economy? Would it be necessary to extend a version of the U.S. Community Reinvestment Act to the “client” economy to make certain that a reasonable share of funds deposited there are plowed back into local loans?

Credit allocation is also likely to be distorted by the fact that export sectors will necessarily be the favored recipients of credit, whatever its source. It is doubtful that enough credit will be left over to fund demand-led growth, and the low wages required to keep export prices competitive will also suppress demand. Thus the amount of income available to spend on goods produced for domestic consumption may be inadequate to enable the small business, housing and services sectors to expand and help create new jobs. If these downward pressures on demand cannot be offset by monetary and fiscal policies, income disparities will widen and poverty will increase.

In summary, the inexorable outcome of unilateral dollarization is dependence. A major tool of national policy is relinquished in the process of dollarization and is subsequently exercised by others without opportunities for input or representation. Indeed, there have been explicit assurances that the needs of a dollarized country will not be taken into account in formulating U.S. monetary policy; that only the interest of the United States will be considered (Greenspan 1999; Mack 2000). And these assurances were given with full awareness that the needs of a country that adopts the currency of another as its national currency are unlikely to be congruent with those of the economy of the issuing country – especially, as some have noted, if the “client” country is a commodity exporter (Sachs and Larrain 1999).

The threat to growth that this and other aspects of dollarization poses will erode the beneficial effects that have been advanced in its favor. And the threat to growth – much more than the loss of seignorage – is the heavy price countries will have to pay “for something they could have, by prudent policy and international cooperation, for free” (von Furstenberg 2000, p. 111).

The costs of unilateral dollarization for the U.S.

The February 1999 *Economic Report of the President* stated that the adoption of the dollar as the national currency of other countries would add to U.S. “power and prestige” by boosting the dollar’s role as an international currency; that it would also increase business for U.S. banks and financial institutions and lower transactions costs for U.S. trade and finance. In his 1999 testimony before the U.S. Congress, then Deputy Secretary of the Treasury Lawrence Summers said that dollarization would help the U.S. “consolidate or expand” its role in Latin American markets. Others list similar benefits and dismiss concerns that the dollarized countries may try to influence U.S. policy or that their financial problems could drain U.S. resources. Even if the Federal Reserve were to act as lender of last resort to “client” country banks, it is argued, the impact on the U.S. economy would be negligible given their small size.

In general, proponents see little downside for the U.S. in promoting this new role for the dollar. Nevertheless, both proponents and opponents of unilateral dollarization do see the potential for grievances originating in the “client” country. For example, “client” countries in recession might claim that the U.S. is exporting the negative effects of its policies to others (Bogetic 2000). Some countries might resent the terms of seignorage (von Furstenberg 2000). Moreover, political conflicts might arise that, as in Panama in 1988, could result in the imposition of economic sanctions by the U.S. (LeBaron and McCulloch 2000). Freezing dollar accounts and refusing to replace worn paper currency are actions that could have greater adverse effects on the “client” country than trade sanctions alone.

But there is also the potential for grievances to develop at home. Unilateral dollarization will inevitably spark debate about its impact on U.S. jobs and wages – and

with good reason. By reducing currency risk, it will increase incentives for U.S. corporations to relocate in “client” countries. The threat of capital controls will disappear. Linkages between the U.S. financial sector and those in dollarized economies will facilitate intercorporate transfers and lower transactions costs. Thus, a continued “restructuring” of the U.S. economy around the availability of lower wage costs in emerging or developing economies can be expected. And with it, a rising tide of dissatisfaction in the U.S. that will expand on the complaints voiced in Seattle and Genoa.

Another, equally troubling concern about the restructuring of the U.S. economy relates to the way in which unilateral dollarization will reinforce export-led growth in “client” economies and widen the U.S. trade deficit. In part, that will result from the fact that it will be easier and even more profitable for U.S. corporations to relocate in dollarized countries and export goods back to the U.S. market. And, as discussed in the previous section, monetary expansion in dollarized countries will depend on earning dollars through exports and attracting external loans and investment. If dollarized countries grow, it will be because their competitiveness – *i.e.*, low wages – promotes ongoing trade surpluses with the U.S. But if growth falters, there will be no benefits for the U.S. in the form of narrowing trade deficits since sales of American goods to these “client” states will also decline.

Perpetuating the export-led growth model through unilateral dollarization is also likely to have profound social and political consequences for both the U.S. and “client” countries. In the latter, the need for low wages in export industries and the absence of demand-led support for the production of domestic goods and services will focus social and political grievances on the “client” status of the dollarized economy. As U.S. businesses and financial institutions become the inevitable targets of those grievances, their risks will be compounded and concerns about country risk will reemerge with unintended wrinkles. Dollarization may then be seen as a source for substantial erosion of U.S. power and prestige.

Meanwhile, arguments that minimize the ways in which financial or political crises in dollarized countries will affect the U.S. overlook the implications of events around the 1994-1995 Mexican peso crisis. The fact that U.S. investors made substantial

purchases of Mexican securities in the period 1990-1994 suggested to many that the role of the U.S. Treasury in orchestrating the bailout was prompted more by the desire to minimize the losses of U.S. investors and financial institutions than their counterparts in Mexico or the Mexican economy. And since it was Mexicans – not foreign investors – that had to pay back the funds loaned, many argue that the bailout benefited Americans at the expense of Mexican taxpayers.

Given the stated terms for unilateral dollarization in proposals to date, protecting U.S. interests would certainly be the motivation for future assistance to “client” economies. But the size of the Mexican bailout and the number of official sources that contributed to the pool should serve as a warning about the potential costs of financial crises in countries with close links to the U.S. monetary and financial system. Absent capital controls to curb excessive inflows and moderate their short-term nature - as well as explicit regulatory constraints on overlending by both foreign and domestic institutions - the assumption that such crises will not occur in dollarized countries is unwarranted. Moreover, the potential for highly mobile capital flows to spawn future financial crises suggests that another of the underlying assumptions of unilateral dollarization – that it will make the world safe for (or from) universal adoption of open capital accounts - is also unwarranted.

Replacing the international monetary system with currency blocs

The creation of currency blocs is another in a series of responses to financial and economic instability that began in the 1970s. Each response has been heralded as the means to cure the particular form of instability dominant at the time. The initial decision – to replace the post-World War II regime with a privatized international monetary and payments system – was the U.S. response to its inability to continue to shoulder the unique burden required of a single national government under the Bretton Woods Agreement. While retaining the open international trading system that had been a central objective of the Agreement, the new system also allowed each country to choose the exchange rate regime – fixed or floating – that best suited its needs.

Industrial countries with large ratios of exports and imports to GDP chose to fix or peg their exchange rates to provide stability for the dominant sectors of their economy. While the Bretton Woods Agreement had assumed that controls on capital flows would be needed and used, the rapid growth of the private international financial sector after its collapse made controlling the flow of capital – and the exchange rate – more difficult.

In contrast, U.S. exports and imports accounted for a relatively small share of its GDP in the 1970s and even now are smaller than shares of other industrial countries. The U.S. was itself an optimal currency area, fully open to trade and labor mobility within its borders, generally subject to symmetrical shocks and with a highly developed system of compensatory fiscal transfers. Moreover, its primary international policy objectives involved the promotion of financial investment as well as trade. Thus, a floating exchange rate regime and the free flow of capital appeared best suited to U.S. needs and, over time, were consistently promoted as ideal standards for the global economy as a whole.

Critics of capital account liberalization might well argue that it is unfortunate for others that the global regime that suited U.S. interest in the 1960s and 1970s became enshrined as dogma. But it is no less unfortunate for the United States itself. As noted, the U.S. international investment position has deteriorated markedly. Throughout the 1980s and 1990s, other countries contributed disproportionately to the stream of financial investment on which U.S. growth depended. Managing its net liabilities to the rest of the world without a major jolt to its economy requires that the United States be able to continue to service debt in its own currency. Thus it appears to be in the interest of the U.S. government to maintain a central role for the dollar in the international monetary architecture. But that requires an ongoing accumulation of external debt that ultimately will prove unsustainable.

Given the U.S. dilemma, the advent of the euro seemed a potential threat to U.S. power and prestige. After three decades of instability that culminated in major speculative attacks on individual European currencies in the early 1990s, the European Union opted for a bloc solution to end monetary turmoil and mitigate the effects of dollar dominance. It was thought that adopting a single currency would allow capital to flow freely among the member states and between the bloc of member countries and the rest of

the world because the strength of the single currency would offer protection from speculative attacks. It was also assumed that, free from that threat, the European Central Bank could maintain a reasonably stable exchange rate while allowing its currency to float. Thus the euro seemed poised to challenge the dollar as both a transaction and reserve currency.

But the euro's potential role was undermined in the late 1990s by new speculative strategies that profit from differences in interest rates rather than bets on changes in exchange rates. While this so-called "carry trade" strategy involves the financial assets of many countries, the primary focus of these strategies has been on assets denominated in the three major currencies – the dollar, euro and yen. Multinational financial institutions borrow in a currency with low interest rates and invest in assets denominated in a currency with higher interest rates. It is highly profitable to do so as long as interest rate differentials do not move too far too fast (as they did in the fall of 1998). But it involves an exchange of currencies that depresses the exchange rate in the country or bloc of countries where funds are borrowed, and raises the rate in the country where funds are invested.

Interest rate differentials and investment flows were a major influence on changes in exchange rates among the major currencies in the years 1998-2000. Table 2 shows the sizable imbalances in payments among the three major economic areas in this period. An unusually large volume of acquisitions of U.S. companies by European firms contributed to dollar appreciation. But interest rate differentials that favored investment in liquid U.S. financial assets provided the spark that ignited a huge expansion of credit and a spectacular surge in U.S. growth (U.S. Department of Commerce 2000, 2001; Federal Reserve System 2000, 2001). Meanwhile, capital outflows from the euro area caused an unexpectedly large and ongoing fall in the euro's value and, more important, exerted downward pressure on domestic investment and growth. As for Japan, the failure to finance its huge current account surpluses undermined the effectiveness of its low interest rate policy in lowering the yen's value. Since so large a share of Japan's trade is invoiced in dollars, converting dollar-denominated export earnings into yen for investment in domestic financial assets fueled upward pressure on the Japanese currency.

The euro's ongoing depreciation may have dampened enthusiasm for dollarization as a means to improve the dollar's competitive position. But one of its critics is not convinced it has been laid to rest. He sees little chance to defend against "natural currency oligopolies on the make" and would prefer to see a union of peers – one or more unions of "small" currency countries based on the European model (von Furstenberg 2000, p. 113). Others, too, have argued that a monetary union is preferable to dollarization for Mercosur countries (Eichengreen 1999). Some favor dollarization because they think it could be a step toward achieving such unions (LeBaron and McCulloch 2000).

Among the benefits of monetary unions for "small" currency countries is their potential for expanding trade within the union itself. Many countries cannot afford to trade with one another now because of their need to earn dollars and other hard currencies. That and other advantages of a peer-determined system might also increase the ability of "small" currency countries to shift to policies that promote demand-led growth and focus on alleviating poverty and improving income distribution.

But what role will the powerful multinational corporations and financial institutions play in a global system of currency blocs? Would potential blocs of emerging market and developing countries do better than they have as individual nations in attracting private foreign investment? Absent controls in the source countries, could blocs of "small" currency countries use capital controls more effectively to prevent the destabilizing effects of short-term investment and over-lending? Or would they, like the major currency areas now, become subject to the arbitrage games that subordinate trade to a minor position in the huge volume of international financial transactions?

In the past, blocs have tended to enhance the potential for trade wars using the traditional weapon of currency devaluation. But with finance in the ascendancy, attracting foreign investment may appear more important and may require positive interest rate differentials and currency appreciation. The record of recent financial crises in emerging market countries provides evidence of the difficulty in finding exchange rate levels that will meet the need to sustain both trade and investment flows. And constructing currency blocs of either peer groups or "client" states will not solve that problem. Nor will such blocs achieve the particular goal for which they are being

proposed. They are likely to increase, rather than reduce, the negative effects of speculative capital flows.

Creating a multilateral international payments system

Reforms that fundamentally change the way systems operate usually require long gestation periods. The reform proposals themselves evolve with various adaptations in tandem with a growing awareness of the anachronisms in the current system and the range and depth of the problems for which those anachronisms are responsible. In the case of the Bretton Woods Agreement, it could be argued that its design was appropriate in the context of the hegemonic role the U.S. had to play in the aftermath of World War II and that the dollar's central role undoubtedly contributed to the success of the Marshall Plan. But the rapid recovery of Europe and Japan and the reemergence of a multipolar world increasingly undermined the ability of the U.S. to accept the role of hegemon and to adopt policies necessary for the good of all participants in the Bretton Woods Agreement.

In the 1960s, Robert Triffin led the way in calling attention to the need for a post-Bretton Woods system. His proposals were an integral part of the discussions that led to the Rio Agreement in 1967 that authorized the International Monetary Fund (IMF) to create and issue special drawing rights (SDRs). Although he was highly critical of the Rio Agreement, Triffin believed that its central achievement – the creation of new reserve assets to strengthen the balance of payments adjustment mechanism – was a first step in the right direction. Nevertheless, he warned that it would not constitute a viable reform effort if it failed to take a more comprehensive approach in assigning roles to all three components of reserves – gold, foreign exchange and collectively created assets – especially since gold would certainly be demonetized internationally as it had been nationally since the 1930s.

Triffin thought the central flaw in the Bretton Woods Agreement was the conversion problem. As the U.S. accumulated IOUs, the conversion of these obligations into gold posed a growing threat to the system. But avoiding conversion (as some academics and U.S. officials favored) threatened to force the rest of the world into the

dollar area. In Triffin's view, "...the alternative to the gold standard is not a dollar standard unilaterally run and managed by the United States alone, but a true international standard, calling for concerted decisions and management by all participating countries" (1968, p. 187).

Triffin's "created reserve assets" were similar to the reserve asset that Keynes called "bancor" in the proposals he had offered at the Bretton Woods conference. The institutional structure in Keynes' original proposal was a clearinghouse and the emphasis in its rules was on shifting the burden of balance of payments financing from deficit to surplus countries. Triffin's institutional structure incorporated an existing Bretton Woods institution – the IMF – to distribute created reserves and emphasized the link between reserve creation and development finance. He argued that the automatic allocation of SDRs in proportion to IMF quotas was "as indefensible economically as it [was] morally" – especially since two of the richest countries in the world were assigned about one third of the total (*ibid.* p. 194).

Several arguments and proposals for new issues of SDRs have been offered in the aftermath of the failure of the 1967 Rio Agreement to effectively alter the reserve asset structure of the international monetary system (IMF 1987; Lipton 1999; D'Arista 1999). And Keynes' proposal to create an international clearinghouse that would issue a new reserve asset has been revived by Paul Davidson (1991; 1996). The strength of all these proposals is that their objective is to create an international standard under multilateral governance. Equally important, they would remove the credit-generating attribute of foreign exchange reserves. Moreover, unlike Richard Cooper's proposal for a single world currency (1984; 1999), they implicitly assume that national central banks will continue to issue national currencies; that reform can be accomplished without the loss of national sovereignty.

But proposals that favor a dominant role for created reserve assets also have a central weakness: they fail to clarify issues relating to the management of the international payments system. Introducing a system of created reserves requires mechanisms to provide for their use in financing balance of payments deficits. Keynes' system was clear: created reserves were to be transferred among central banks much as gold had been. Private financial institutions would exchange foreign currency payments

for domestic currency with their national central banks rather than in private transactions. The limited role for private financial institutions in international payments would reduce the potential for speculative flows and exchange rate volatility. Moreover, capital controls would prevent leakages that could exacerbate payments imbalances.

Created reserve assets require such a framework for success. As noted, central banks in industrial countries now have little or no role in settling payments surpluses and deficits. In this context, new issues of SDRs would be meaningful only if linked to development. But even there, issues to emerging market and developing countries would have limited use. They could be used directly to settle debts to other governments and international financial institutions but would have to be exchanged for dollars to settle debts to private creditors.

But the U.S., too, would have limited use for the SDRs received in these exchanges. U.S. external obligations are denominated in dollars and most are owed by the private sector to foreign private creditors. The Federal Reserve would have to pay out dollars in exchange for reserve assets that cannot be used to service the private sector's debts. It would only be able to use them to settle the Treasury's obligations to foreign central banks. While some U.S. financial institutions would benefit from debt repayments from countries that received distributions of SDRs, U.S. households and nonfinancial businesses – burdened with the majority of the debt that net capital inflows have created – would not.

In any event, new allocations of SDRs are unlikely to lead to real monetary reform if the major national central banks remain sidelined in the game of international payments. When Triffin introduced his proposals in the 1960s, private financial institutions were already heavily engaged in international payments and foreign exchange transactions. They had already created external (“Euro”) markets in which financial transactions – depositing, lending, bond issuance, etc. – could be denominated in currencies other than the currency of the location in which the transaction takes place. The failure to subject these offshore transactions in a given currency to the same monetary and regulatory requirements that apply in the national market for that currency facilitated the private sector's ongoing usurpation of functions previously assigned to central banks and the IMF in the international payments system.

Now, with private sector dominance so pervasive, any attempt to replace foreign exchange with created reserve assets is sure to fail. And, given its dominance, the focus on reforming the regulation and governance of the private international financial system is not misplaced. But it is not sufficient. Proposals to reform both the international financial and monetary systems are needed and should be designed in tandem. And as decades of turbulence and crises have made clear, public institutions must reclaim their role in managing the international payments system.

“...a vision for a decade or two into the twenty-first century”⁶

What objectives and institutional structures would best meet the needs of the global economy in the twenty-first century? Assuming an open international trading system would remain a priority objective, how might such a system be made more egalitarian so that it would meet the needs of countries with large populations relative to the size of their economies as well as those with the reverse ratio? And which currency regime would be consistent with keeping international trade and investment open to all nations on equal terms? A single global currency? Currency blocs? Or, as in the past, a system in which almost all countries – certainly all large countries in terms of either population or output – have their own currencies?

Those who favor egalitarian as opposed to hierarchical systems of political economy believe that the best monetary regime is one in which each country is able to use the full range of policy tools to promote growth, stability and the welfare of a majority of its citizens. This means each country must have a central bank able to effectively manage national interest and exchange rates; one that will have adequate tools to influence liquidity and a balanced flow of credit; that can act as a lender of last resort for its financial system, and can conduct countercyclical operations to moderate booms and recessions. And that means, in turn, that if national policy is to be implemented effectively within a national market, each country must issue its own currency.

⁶ Richard N. Cooper (1999, p. 117), commenting on his proposal for a single currency. He noted that it “is not politically realistic today” but that the EMU was “a major step in the direction indicated”.

Over the last quarter century or more, most national currencies have earned second or third class status for their countries in the interdependent global system because they cannot be used in trade or for foreign borrowing. Thus, the possibility that all currencies, regardless of the size of the economy of the individual issuing country, could be used in external as well as domestic transactions is an objective worth exploring in designing proposals for reform.

Once again, Keynes' Bretton Woods proposal suggests an institutional framework for a new agreement that would achieve that objective. Like *bancor*, Keynes' clearinghouse was designed to accommodate a multilateral currency system. But the design of any new system must recognize the enormous changes in the political economy within and among nations that have taken place over the past half century. Those changes must be accommodated by giving equal weight to both population and economic output in the governing structure of any new international institutions. Moreover, the created reserve asset itself must respond to the need for inclusiveness: its value must be based on a trade-weighted basket of currencies of all member countries.

Some of the technical aspects of the design for a new international clearing agency are discussed elsewhere (D'Arista 1999). That proposal includes a requirement that all international reserves be held as liabilities of the clearing agency, backed by assets of equal value that would consist of the government obligations of its member countries. While foreign currency payments would be made through private banks in national markets, banks receiving foreign payments would be required to exchange them for domestic currency deposits with their national central banks. The national central banks would, in turn, be required to present them to the international agency for clearance. Since net payments through the international clearing agency would be debited or credited against a member country's reserve account, exchange rate changes would be determined by changes in reserves at bi-weekly or monthly intervals.

Both international trade and investment would be facilitated by this more stable exchange rate regime. Most countries would be able to promote internal and external stability without using capital controls. Should destabilizing capital flows occur, a country could moderate their effects either by shifting the mix of domestic assets and international reserves on the asset side of its central bank's balance sheet, by imposing

capital controls, or by requesting assistance through open market operations conducted by the international clearing agency. And if a supermajority of its members agreed, the agency could use its ability to conduct open market operations in any member country's national market to act as an international lender of last resort.

The above is only a brief sketch of one proposal that attempts to address the flaws in the current international monetary and financial system. No doubt other, better systems could and will be designed. But they must incorporate the still-valid objectives of the Bretton Woods Agreement for an open international trading system in an institutional framework that promotes more egalitarian participation by all countries in the global economy. Dollarization – however broadly or narrowly defined – is not a system that incorporates these objectives.

References

- Bank for International Settlements. 2000;2001. *Annual Report: BIS*.
.....2001. *BIS Quarterly Review*. Basle: BIS, March and June.
- Berg, Andrew and Eduardo Borensztein. 2000. "The Dollarization Debate". *Finance and Development*. Washington, DC: The International Monetary Fund. March.
- Blecker, Robert A. 1999. *Taming Global Finance: A Better Architecture for Growth and Equity*. Washington, DC: Economic Policy Institute.
.....1999. *The Ticking Time Bomb: Why the U.S. International Financial Position is Not Sustainable*. Briefing Paper. Washington, DC: Economic Policy Institute.
- Bogetic, Zeljko. 2000. "Full Dollarization: Fad or Future?" *Challenge* (March-April).
- Cooper, Richard N. 1984. "Is There a Need for Reform?" Federal Reserve Bank of Boston, Conference Series No. 28, *The International Monetary System: Forty Years After Bretton Woods*. Reprinted in *Essays in World Economics: The International Monetary System*. Cambridge, MA: The MIT Press, 1987.
.....1999. "Exchange Rate Choices". Federal Reserve Bank of Boston, Conference Series No. 43, *Rethinking the International Monetary System*.
- D'Arista, Jane. 1999. *Reforming the Privatized International Monetary and Financial Architecture*. Philomont, VA: Financial Markets Center. Reprinted in *Challenge* (May-June, 2000).
.....2000. "International Foreign Exchange Reserves: an Update". *Capital Flows Monitor*. Philomont, VA: Financial Markets Center (June).
.....2000. "Recent Developments in International Credit Markets". *Capital Flows Monitor*. Philomont, VA: Financial Markets Center (March).
.....2001. "A Time for Questions and Answers". *Capital Flows Monitor*. Philomont, VA: Financial Markets Center (August).
.....2001. "The U.S. International Investment Position at Year-end 2000". *Capital Flows Monitor*. Philomont, VA: Financial Markets Center (September).
- Davidson, Paul. 1991. "What International Payments Scheme Would Keynes have suggested for the Twenty-First Century?" In Paul Davidson and J.A. Kregel, eds., *Economic Problems of the 1990s: Europe, the Developing Countries, and the United States*. Aldershot, U.K.: Edward Elgar.

.....1996. "Reforming the International Payments System". In Robert A. Blecker, ed., *U.S. Trade Policy and Global Growth*. Economic Policy Institute Series. Armonk, NY: M.E. Sharpe.

Doyle, Brian M. 2000. " 'Here, Dollars, Dollars...' - Estimating Currency Demand and Worldwide Currency Substitution". International Finance Discussion Papers, No. 657. Washington, DC: Board of Governors of the Federal Reserve System.

Eichengreen, Barry. 1999. *Toward a New International Financial Architecture: A Practical Post-Asia Agenda*. Washington, DC: Institute for International Economics.

Godley, Wynne. 2000. *Interim Report: Notes on the U.S. Trade and Balance of Payments Deficits*. Strategic Analysis Series. Annandale-on-Hudson: The Levy Economics Institute.

.....and Alex Izurieta. 2001. *As the Implosion Begins...? Prospects and Policies for the U.S. Economy: A Strategic View*. Strategic Analysis Series. Annandale-on-Hudson: The Levy Economics Institute.

Greenspan, Alan. 1999. Testimony before the Subcommittee on Economic Policy and the Subcommittee on International Trade and Finance, U.S. Senate Committee on Banking, Housing and Urban Affairs, *Hearing on Official Dollarization in Emerging Market Countries* (April). Washington, DC: U.S. Government Printing Office.

Hausmann, Ricardo. "Should There Be Five Currencies or One Hundred and Five?" *Foreign Policy* (Fall).

International Monetary Fund. 1987. *The Role of the SDR in the International Monetary System*. Staff Study. Washinton, DC: IMF.

.....2001. *Emerging Market Financing: Quarterly Report on Developments and Prospects*. Washington, DC: IMF (August).

LeBaron, Blake and Rachel McCulloch. 2000. "Floating, Fixed, or Super-Fixed? Dollarization Joins the Menu of Exchange-Rate Options". In *Restructuring the International Financial System: AEA Papers and Proceedings*, Vol. 90 No.2 (May).

Lipton, David. 1999. Discussion. Washington, DC: Carnegie Endowment for International Peace.

Mack, Senator Connie. 2000. *Dollarization an Opportunity for U.S. to Export Principles as Well as Products*. Press Release. Washington, DC: U.S. Joint Economic Committee (July).

Pou, Pedro. 1999. "Is Globalization Really to Blame?" Federal Reserve Bank of Boston, Conference Series No. 43, *Rethinking the International Monetary System*.

Sachs, Jeffrey and Felipe Larrain. 1999. "Why Dollarization is More Straitjacket Than Salvation." *Foreign Policy* (Fall).

Summers, Lawrence H. 1999. Testimony before the Subcommittee on Economic Policy and the Subcommittee on International Trade and Finance, U.S. Senate Committee on Banking, Housing and Urban Affairs, *Hearing on Official Dollarization in Emerging Market Countries* (April). Washington, DC: U.S. Government Printing Office.

Triffin, Robert. 1968. *Our International Monetary System: Yesterday, Today, and Tomorrow*. New York: Random House.

..... 1992. *IMS – International Monetary System – or Scandal?* Working Paper. Florence, Italy: European University Institute.

U.S. Board of Governors of the Federal Reserve System. 2000; 2001. *Flow of Funds Accounts of the United States*. Washington, DC: FRS (various issues).

U.S. Department of Commerce, Bureau of Economic Analysis. 2001. *Survey of Current Business*, Vol.81, No.7. Washington, D.C.: Bureau of Economic Analysis.

Vernengo, Matias and Louis-Philippe Rochon. 2001. *From Capital Controls to Dollarization: American Hegemony and the U.S. Dollar*. Unpublished paper, Center for Macroeconomic and Development Policy, Kalamazoo College.

Von Furstenberg, George. 2000. "A Case Against U.S. Dollarization". *Challenge* (July-August).

Table 1: Outstanding Official Foreign Exchange Reserves
(in U.S. dollar billions)

	1990		2000		Change: 1990-2000	
	Amount	Percent	Amount	Percent	Amount	Percent
Total reserves	790	100.0	1,908.7	100.0	1,118.7	141.6
Industrial countries	481.7	61.0	774.8	40.6	293.1	60.8
Developing countries	308.3	39.0	1,133.9	59.4	825.6	267.8
Dollar reserves	432.0	54.7	1,450.5	76.0	1,018.5	235.8
Non-dollar reserves	357.0	45.3	458.2	24.0	101.2	28.3

SOURCE: Bank for International Settlements, *Annual Report*, 1991 and 2001.

Table 2: Balance of Payments in the Three Major Economic Areas
(U.S. dollar billions)

	Current Account			Net FDI & Portfolio Flows			Overall Balance ¹		
	1998	1999	2000	1998	1999	2000	1998	1999	2000
United States	-217	-331	-435	174	338	487	-43	7	52
Euro area	35	-7	-32	-218	-166	-144	-183	-173	-176
Japan	120	109	118	-63	-36	-60	57	73	58

SOURCE: Bank for International Settlements, *Annual Report*, June 2001.

¹ Calculated as the sum of the first two sets of columns.