PRIORITIES IN REFORMING THE INTERNATIONAL MONETARY SYSTEM: A PANEL DISCUSSION

IS GLOBALIZATION REALLY TO BLAME?

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Implicit throughout this conference has been the assumption that something is wrong with the international monetary system, and that whatever that something is, it has been the primary cause of the financial crises that we have seen, starting in Thailand in July 1997 and spreading across other countries in Asia, to Russia, and then finally to Latin America via Brazil. Many people have suggested that increased capital flows, as well as globalization, are to blame for the recent crises. Our more interconnected world may have led to new rewards but certainly to new risks, and those new risks have not been well contained.

I think it is useful to gain some historical perspective on this issue, because it is not in fact very clear that we are now in a more "globalized" world than we were in previous periods—in particular, at the start of this century. A study published in the IMF *World Economic Outlook* of 1997 suggested the following:

(l) Capital mobility was higher in the period 1870 to 1914 (the period of the gold standard) than in the 1990s, as measured by the average of the absolute values of current account deficits of leading exporting and importing countries;

(2) Foreign financing was more important in total investment for a set of major capital importers at that time than for today's capital importers; and, perhaps even more surprisingly,

(3) Portfolio investment was more important in that period than today, as a percentage of total capital inflows.[1]

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[1] During the gold standard, capital flows were even greater than today and these flows helped countries like Canada, Australia, New Zealand, Sweden, and of course Argentina

On the other hand, as Ricardo Hausmann pointed out yesterday, the significant differences in the capital/labor ratios for emerging and industrial economies are so large that the flow of capital that we are seeing is small, compared to the level required to close that gap in some reasonable period of time. Therefore, we should not place the blame on the 1990s increase in capital flows; we should look for other differences in order to find out which factors might lie behind the current problems.

A Recent Invention: Fiat Money

One important difference is in currency arrangements. Until very recently the dominant monetary arrangement was one that relied either directly or indirectly on monies backed by gold. Recently there has been a significant increase in the number of pure fiat monies. Richard Cooper counted 101 in 1998, and this looks like too many to me.

Indeed, we have become so accustomed to the use of fiat money, and to its main property, namely an independent monetary policy, that we sometimes miss the point that *fiat money is a very recent innovation, one that is only 25 years old*. It was not really until the collapse of the Bretton Woods arrangement in 1973 that true fiat money appeared.

Money: Making or Buying It?

Let me ask a provocative question. We do not suggest that each country should produce every possible good. We are happy with the idea that we should import automobiles or TV sets from the more efficient producers; why should we not apply the same logic to money? Should a small emerging economy produce its own money, or should it buy it from a more efficient producer?

Of course, money is not any ordinary good; it is not even a good, but an institution, and history has made money play a significant part in "national sovereignty." So to discuss issues such as "Money: Making or Buying It?" may be too provocative for some.

The Demand for "Making" Money

What is so particular about money, that every country wants to have one of its own? It is true that history may be clouding the issue. The

and others to experience tremendous growth over the period. Indeed, the system of fixed exchange rates permitted countries like Canada and New Zealand to finance one-third of their domestic investment and financed one-quarter of the investment in Australia and Sweden. In contrast, during the 1990s, foreign investment financed about 10 percent of an average emerging country's capital imports.

production of fiat money started with private banks and went on to nation states—with the full backing of gold—and, in the end, countries developed full fiat monies. Probably it is this history that has led to the idea that this is the natural, and maybe the only, way of obtaining the benefits from the use of money.

But another reason may be more important. Since the Great Depression, every country wants to have its own fiat money because it wants to have an independent monetary policy. Without a fiat money, a country cannot have (aspire to) truly independent monetary policy, and since monetary policy is believed to be a very important countercyclical tool, most countries will want to be able to use that instrument.

Now I do not find that monetary policy is such a great instrument, in particular for small, open, emerging economies. These economies have a capital/labor ratio that is significantly smaller than in developed countries, and therefore they need to have an open capital account. *This is not a question of choice, except in the short run, or in a transition period.* But a small, open, emerging economy with an open capital account cannot have an independent monetary policy, with either fixed or flexible exchange rates, as Richard Cooper showed us yesterday.

So much for the demand side of having every country produce its own money. What about the supply side? In other words, are they able to do it?

The Supply Side of "Making" Money

For money to play its crucial role as a store of value and as a successful means of effecting transactions, its value must be readily identifiable and absolutely trustworthy over time. Therefore, for a country to be a successful producer of such a money, it requires a set of institutions to guarantee these characteristics. To have a currency, it is not sufficient to declare the "peso," let us say, to be legal tender and buy a printing machine. A far more complex process is involved, since we need to develop institutions aimed at guaranteeing the value of money. Only then can we have some chance of producing a currency.

On the other hand, a reduction in the number of monies presents significant advantages. Money is like a language. If we all agree to use the same language, we achieve tremendous gains in efficiency. If we all use the same money, then we do not have to spend time and resources investigating the current and potential future value of particular monies.

The fact that the production of money generates a potentially large benefit, and that this benefit can be appropriated by the state (through seigniorage), often leads to the temptation to misuse the power to print money. This in turn has led to a significant overuse of this invention, with the expected consequences affecting credibility.

So it is not clear at all that every country is capable of developing the necessary institutions to be able to produce a national fiat money. Many countries could benefit from buying the monetary institutions of some country that has been successful in developing them. However, most emerging economies have attempted to develop their own fiat money but have not succeeded. *I believe this fact lies at the core of the problems of the international financial architecture, at least with respect to emerging countries.*

Currency Risk or Liquidity Risk? The Devil's Choice

As I have already mentioned, emerging countries are capital-scarce, and this scarcity implies a strong need for capital inflows. The volume of capital inflows during the 1990s has been small (huge if we compare it with the 1980s, but small with respect to the flows at the beginning of this century, and with respect to the needs to balance capital/labor ratios globally). This small capital inflow is related to the fact that, almost by definition, emerging countries do not have internationally accepted currencies. *Indeed, most investors regard emerging countries' currencies with great suspicion.*

This distrust means that when international investors and emerging country borrowers make a contract, they face a choice. They may choose to contract in domestic currency, in which case contracts will be short-term. Or they may contract in a currency in which they have confidence (normally the U.S. dollar), at longer maturities. This choice gives rise then to the "twin mismatches." Capital flows create either high liquidity risks (stemming from short-term domestic currency contracts, which must be rolled over frequently) or currency risks, or most likely both, as even in dollars, financing will generally need to be rolled over to match the maturities of investment projects. We have seen the liquidity risk problem very clearly in the case of the Brazilian crisis, and we have seen both the currency and the liquidity risk problems in the case of Korea.

Now, during good times, such mismatches may matter very little. The emerging countries' borrowers and private investors see a rosy future and, hence, despite the liquidity and currency mismatches that are present, they are happy to finance longer-term projects, assuming that they and other investors will be happy to roll over loans when the time comes. This is the "good equilibrium."

Now suppose that things start to go badly. This could occur for any reason. It could be because of an exogenous shock to export prices, or it could be because of an internal/endogenous shock—perhaps a poorly run banking sector finally results in a serious financial sector problem, or perhaps a forthcoming election puts pressure on an incumbent government to spend too much, increasing the fiscal deficit.

In any event, investors, analysts, and rating agencies (maybe in that order) start to focus on mismatches. They say that country X has large outstanding liabilities in U.S. dollars and must roll over Y billion of domestic currency debt in the coming six months. And this looks almost impossible! As you can imagine, we are moving fast, very fast, toward a "bad equilibrium."

What do private investors do? Some demand higher risk spreads, some pull out. This means that whatever the cause of the original deterioration in the fundamentals, now things are worse. The reduced availability of external finance and the higher country risk spreads lead to slower economic growth and perhaps to recession, affecting the fundamentals. *Suddenly the fundamentals look unsustainable.*

I would not want you to interpret my remarks along the lines that fundamentals are not important. I would be the first to say that country fundamentals are of prime importance in crisis avoidance. But *in the volatile world of emerging markets,* fundamentals change for both endogenous and exogenous reasons and, when they do, *financial vulnerability in terms of maturity or currency mismatches can play a very significant role*.

Ways of Reducing Financial Vulnerability

What are the ways to reduce the financial vulnerability of emerging economies, given the fact that they lack a strong currency? The three alternatives are capital controls, the provision of international lender of last resort facilities, and exchange rate arrangements such as the adoption of a reserve currency, or dollarization, as it has become known in the present debate.

The Argentine Experience

Let me analyze the Argentine experience, so that I may put these three alternatives in perspective. Argentina has had a successful economic program during the past eight years. Its program has included substantial structural reforms like privatization, deregulation, a complete overhaul of the financial system, opening of the trade and capital accounts, reform of the pension system, and, last but not least, the implementation of a currency board committed to price stability. During that eight-year period, the pace of inflation has been lower than in the United States and productivity growth higher, and capital inflows—both portfolio and foreign direct investment—have been significant.

But if the changes were to be found only in these variables, we might be concerned about the maintenance of these achievements. Fortunately, significant institutional improvements have been achieved as well, among which I could mention a new fiscal culture at the government level, where the budget constraint is omnipresent, and a new productivity culture at the company level, where they understand that the price level is given, and the solution to any problems that may appear must lie in productivity gains.

But Why Change, Why Dollarization?

So, you may ask, why might your government want to change such a wonderful system? And the reason is that even after eight years of playing by all the rules, we have not been able to develop a true national money, a money that is a unit of account and a store of value in the long run. Therefore, we are subject to the two mismatches that I described above, and the twin crises (banking and currency crises) that they may bring in their wake. We have to bear high and very volatile country risk spreads, which reduce investment, productivity growth, employment, real wages, and so on.

One solution to these problems might be to close the capital account, but the following conditions must be recognized:

> First, Argentina needs foreign capital to complement domestic savings and to take advantage of good investment opportunities.
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> Second, as Sebastian Edwards has shown, even the paramount exchange controls—those of Chile—do not seem to have had a significant effect; and
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> Third and last, but not least, capital controls are easy to circumvent and can lead to corruption.

This does not mean that we should not worry about the maturity structure of our debt. That is one of the main concerns of the Central Bank and the Treasury of Argentina. But we look at this problem from the point of view of prudential regulation and liquidity policy, and not capital controls.

The other solution is the provision of an international lender of last resort. If there were such a lender, then we might have smaller and less volatile country risk, since the probability of contagion in Argentina from financial crises in other countries would be reduced significantly. This would allow us to have smaller capital and liquidity requirements in our domestic banking system and consequently a much deeper domestic financial system. (We now have twice the Basle-recommended capital ratio, and hold 20 percent of every short-term liability in U.S. Treasury securities.)

Even though some signs of progress toward an international lender of last resort are visible (such as the new Contingent Credit Line of the IMF), the general consensus, expressed in this conference and elsewhere, is that it is unlikely that we will see any significant improvement in the near future. So without the possibility of an international lender of last resort, and excluding altogether capital controls, what are the alternatives faced by Argentina?

Alternatives to the Currency Board

We may want to persist and maintain the present currency board scheme. Is this a sound decision? What are the costs and benefits? If the explanation for our high risk premium lies in Argentine history, as has been suggested at this conference, then as new history replaces old we may get lower and less volatile spreads. In that case, in say another 8 to 16 years, we may eliminate country risk.

But then, what are the benefits? At that time, we may be able to have a fiat money of our own and therefore a truly independent monetary policy! Great! The only problem is that we do not believe that a small emerging economy, with an open capital account, can benefit much from an independent monetary policy. Therefore, whatever the cost, the benefit may not be large enough to justify maintaining this policy.

That is the reason we started, in 1998, talking with the U.S. Treasury about the possibility of an agreement on dollarization. President Menem's announcement in January 1999 during the Brazilian devaluation was one way of signaling very strongly, to international and national investors alike, that Argentina would not consider the possibility of devaluation and, if anything, would dollarize.

What Is Dollarization?

Dollarization is a buzz word like globalization, one that means different things to different people. I want to be precise about what it is that we understand by dollarization. Let me start by saying what we are *not* requesting from the U.S. Treasury. We are not asking for a seat at the FOMC, nor to share in making U.S. monetary policy; we are asking neither for U.S. supervision of Argentine banks, nor for U.S. lender of last resort facilities for our financial system.

What we are asking for is basically very simple—a fiscally neutral agreement on seigniorage for both countries. This would mean that the United States would maintain the seigniorage it is already getting from the dollar bills the Argentinians have in their pockets, and the Argentine central bank would retain the flow of seigniorage on the 14 billion pesos that they also hold in their pockets, which are backed by $14 billion in U.S. Treasuries.

If we agree on this point, then that flow of seigniorage could be used as collateral for a contingent credit for, say, $14 billion, which represents 20 percent of the deposits in the Argentine financial system. This contingent line could be provided by the Treasury, the Fed, or the private banking community, since the collateral will be rated AAA. Such a line of credit would be very important, because it would provide the important additional lender of last resort capability for the Central Bank of Argentina, in addition to liquidity requirements and the contingent repo line.

What Do We Expect from Dollarization?

What are the benefits that we expect from dollarization? Dollarization, by definition, will eliminate exchange rate risk. This risk contributes to maturity as well as currency mismatches, and its elimination will significantly reduce country risk, permitting the development of a deeper domestic capital market. We may also expect a significant reduction in interest rates, which will have a positive impact on investment, growth, and real wages. We would also see a reduction in government expenditure on the order of 1 percent of GDP coming from the reduction in interest rates.

Let me make clear that I do not believe that dollarization, or any exchange rate regime, can substitute for good fundamentals. But I think that in the case of Argentina, dollarization could improve its economic performance significantly over the next 10 years.

Preconditions for a Country Considering Dollarization

Let me also make clear more generally that dollarization is not a substitute for good economic policy. Countries that are seriously considering the adoption of the U.S. dollar need to assess the following: first, whether they are in condition to keep inflation under control; second, whether they can maintain productivity growth at a rate similar to that of the United States; and third, whether they can ensure that fiscal and other liabilities can be kept under control. For these reasons, I would suggest that a country must meet at least the following preconditions for a successful dollarization:

1. Be already using the dollar as a store of value or as a unit of account or as a means of payment.
2. Have had a period of price and exchange rate stability, vis-à-vis the U.S. dollar, based on consistent macroeconomic policies.
3. Have strong fiscal institutions that assure that the consistency of macroeconomic policy will be maintained in the future.
4. Have an open, privatized, and deregulated economy, one that assures that productivity growth will be at least as great as in the United States.
5. Have a sound financial system that imposes no hidden monetary or quasi-fiscal liabilities on the central bank or other institution.
6. Promote price and wage flexibility so as to attain a significant degree of flexibility in the relative prices of nontraded goods.
7. Have as large a ratio of international reserves to currency in circulation as possible, so as to get as large a flow of seigniorage as possible, a flow that will allow its use as collateral for a liquidity facility. This liquidity facility will be the country's lender of last resort.