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The Future of the Dollar as an International Currency

Remarks by

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## The Future of the Dollar as an International Currency

It is a pleasure to be here today at Cato's conference on Monetary Arrangements in the Americas after NAFTA. There are few more appropriate venues than Mexico to talk about the future of the world economy in general and our hemisphere in particular. Mexico is among the leaders in showing the people of the world that it can have a bright future through a continuing commitment to free markets, open international trade and investment policies, and sound macroeconomic management. The lesson from Mexico's experience, and indeed from other countries which have adopted similar policies around the world, is that promoting these policies is not easy, but it is clearly worthwhile.

While the precise mix of successful policies does vary slightly from country to country, the world has learned some key lessons. Widespread prosperity cannot be engineered from the central planner's rulebook. Higher real incomes do not flow from the ink of the currency printing press. Restricting the free flow of goods and investment may protect the few, but at enormous cost to the many. These rules are not new; they would not have surprised Smith or Ricardo. Indeed, as Margaret Thatcher used to remind Britain and the world so many times, "There Is No Alternative".

Indeed, it is important to remember the context of Margaret Thatcher's words. The fundamental soundness of these policies is not unique to developing nations, but to all economies. It is true that highly developed economies have a large stock of wealth

which temporarily may be consumed to avoid the stark consequences of pursuing unsound policies. Politicians may therefore buy time when they pursue wrong-headed notions before reality comes home to roost. For less developed nations, by contrast, time is of the essence and the consequences of not getting it right are more dire. But rich or poor, in the final analysis economic policies are unforgiving in their consequences.

Today my assignment is to discuss one aspect of sound economic policy: the positive role a currency can play in the international arena. In particular, I have been asked to consider the future of the dollar as an international currency. As my introduction implies, I must preface my conclusions by saying that the future of the dollar depends on which policies are pursued over the long term by the United States government and central bank. For in a very real sense, the international position of a currency is one of the most sensitive indicators of the efficacy of the policies being pursued.

The reason for this is that international currency markets are among the most competitive in the world. International contracts of all kinds can easily be written in any currency. The attractiveness of a currency for this purpose depends crucially on whether or not it is attractive as a medium of exchange. Open borders, liquid markets, and the absence of restrictions on capital movements are all essential to this attractiveness. The currency must also hold its purchasing power over the periods for which contracting parties may be concerned.

In the end, the value of a nation's currency depends on confidence in the decision making institutions of the issuing country. Today, as the world approaches the celebration of a half century without a global conflagration, a number of countries have had the opportunity to develop sufficient international confidence in the stability of their institutions to have their currencies play an international role. We in the United States cannot, therefore, assume that the international role of the dollar is unassailable. Unlike during the years immediately following the second world war, our institutions do not have a near-monopoly on global confidence. The position of the dollar in the world must no longer be taken for granted. It must be earned, it is not automatic.

As a result of the wide variety of choice in currencies, other nations have less to fear from potential abuse by those issuing the currencies. I know that there is some particular concern throughout the Western Hemisphere of potential risks from a growing hemispheric role for the dollar. I believe such fears are misplaced. In a sense, we are now in a "buyers' market" for international currencies. "Sellers", that is the issuers of currencies, must offer a quality product in order to attract users and maintain market share.

Ultimately, an indigenous competitor to the U.S. dollar may emerge from within the hemisphere. In that regard, it is almost certainly true that it is in the interests of such nations to pursue policies which increase both domestic and international

confidence in their economic institutions. But in the interim, the widespread use of an international currency in the hemisphere, be it the dollar, the mark, the yen, or some other currency holds substantial potential benefits and few risks to the countries of the region. As I already noted, the issuing countries must earn their customers' loyalty.

Earning a position for a nation's currency in the international arena naturally imposes certain constraints on policy makers. They must act in a manner which is consistent with preserving, and if possible enhancing, faith in the institutions of which they temporarily are in charge. I will turn to some specifics shortly. But first, let me say that although policy makers may feel temporarily constrained by the pursuit of virtuous policies, their countries, and ultimately their own freedom of policy making is enhanced. In short, it may be hard work, but it is worth it.

I believe that the benefits to the United States of having a leading international role for the dollar are enormous, and go well beyond those that are readily quantifiable. One cannot imagine, for example, New York retaining its role as the world financial capital if the dollar did not retain its leading role as a world reserve currency. New York's role in the U.S. economy should not be underestimated. It is a prime example of why the quantifiable benefits of the dollar's role are but a fraction of the total benefits.

But quantifiable benefits are illustrative. Let us begin by

considering the most basic value of a currency to its issuer: seignorage. The capacity of a country to issue currency means that, in effect, a portion of government spending can be financed by a permanent interest free loan. Holders of currency exchanged real goods and services in return for what is, to all appearances, little more than a piece of paper. In reality, the value of the currency flows from the services which that piece of paper can provide as a medium of exchange and a store of value. At first blush, the exchange of real goods and services for paper would appear to be as close to the proverbial "free lunch" as an economist could imagine. In practice, as my initial comments indicated, the price of the supposedly free lunch is real constraints on policy to convince holders that the currency has value.

An illustration of the amount of benefit which seignorage can provide comes from the experience of the U.S. dollar during the 1980s. By 1981, after two bouts of inflation in less than 10 years and serious concerns about the future of the U.S. role in the world, the ratio of dollars in circulation to U.S. GDP had fallen to just a bit over 4 cents of currency per dollar of GDP. Twelve years later, after a painful disinflation and sustained efforts by the central bank and successive Administrations at rebuilding the United State's international economic credibility, there were slightly more than 5 cents of currency for every dollar of GDP.

The extra penny per dollar of GDP amounted to \$64 billion in

extra seignorage resulting from an increased willingness to hold dollars. Total currency in circulation had risen by nearly \$200 billion over this period. Most of this increase was used to provide a medium of exchange for a higher level of nominal GDP. The extra \$64 billion, roughly the equivalent of half a year of corporation income tax collections, was and continues to be largely held by foreigners outside the U.S. economy.

These extra resources understate the real financial benefits. Most use of the dollar as a store of value is represented by interest-bearing holdings of government paper. While the government and taxpayer does not get the "free lunch" from these instruments that currency provides, the liquidity and convertibility of these instruments which stems from the role of the dollar as a reserve currency certainly carries some value. As a result, the yield of these instruments is lower than what they otherwise would be if the dollar did not have its current role. How much is involved is uncertain. But each basis point -- one hundredth of a percentage point -- off the yield on government paper is worth \$350 million annually to the American taxpayer.

Thus, the benefits to the United States of having a major international role for the dollar are quite significant. But, again, there is no free lunch. What, then, are the costs?

First, the United States government and central bank must run a credible long term anti-inflation policy. An international currency must be credible as a store of value as well as a medium

of exchange. Some might argue that an anti-inflation program, far from being costly, is actually beneficial to a nation's economy. I would not disagree. But it should surprise no one familiar with the United States if I reported that the political consensus against inflation is far weaker in my country than in, say, Germany.

Indeed, while international opinion on the recent tightening actions by the Federal Reserve seems divided between those who feel it was appropriate and those who feel it was not enough, some leading members of Congress have denounced the recent tightening as unjustified and excessive. Thus, while we might argue about the benefits to the economy of an anti-inflationary policy, it is clear that some policy makers do find it constraining.

A second constraint on policymakers seeking an international role for their currency is an obligation to keep their capital markets open and their currency readily convertible. I believe that a good portion of the decline in the international role of the British pound was the result of a series of experiments with exchange controls during the 1960s and 1970s. Convertibility is the sine qua non of internationalization of a currency.

There are two very straightforward reasons for this. The first is the conventional notion of liquidity. Exchange controls and other regulatory limits on capital flows limit the usefulness of a currency as a medium of exchange. The second is that exchange controls signal the likelihood of other policy changes



which are likely to attack the currency as a store of value. After all, why else would a government restrict its own citizens from taking money abroad or from holding other mediums of exchange, but to make their capital captive to national policies? Nor would it make any sense to impose controls if those likely policies were actually going to enhance the value of either the capital or the currency. Thus, capital controls and exchange controls are generally viewed as a strong signal of a currency to avoid.

A third constraint on policy makers in countries with an international currency is the need to promote a generally free trade policy. While less obvious a threat to a currency's value than exchange or capital controls, an interventionist trade policy limits the domestic convertibility of a currency into goods and services. At the very least it creates artificial price differentials between the domestic and overseas use of the currency. It also signals a willingness, if not a preference, by decision makers to bend economic policies to political ends. A skeptical foreign currency holder is likely to find such a willingness a risk factor in determining which assets to hold.

This final point has wider ramifications. Any government with a widely used international currency has a stake in promoting the expansion of world trade and a generally open world economic order. A vibrant world economy becomes, in an economic phrase, a valuable public good. The more vibrant the international economic order, the more demand for the country's

currency, and the more benefits which flow to the issuer. The self interest of a country such as the United States, with the widespread use of the dollar, is well served by a world which is generally free of international political conflict, and one in which political disagreements are not allowed to interfere with the free flow of goods and services. This may mean that policy makers must, from time to time, pursue international policies designed to promote this liberal world order which may be unpopular with key constituencies at home.

In sum, the costs of being the country of issuance of an international currency are low inflation, open capital and exchange markets, a relatively liberal trade policy, and the support of a world order in which trade is unimpeded by political differences. Some might say that these alleged costs aren't costs at all. The price of maintaining an international currency is the pursuit of sound policies -- ones which should be pursued in any event. But the individual policy maker, faced perhaps with a looming election or the need to appease key constituencies, may not always view things so cleanly. Perceived limitations on policy makers are real to those who must make the decision to promote an international currency, even if such limitations may be in their own country's long term best interests.

If being the issuer of an internationally used currency is clearly good -- what of being the user of such a currency? More to the concerns of this conference, even if the increased

dollarization of Latin American economies is good for the United States, is it good for Latin America? Is what is good for the United States necessarily bad for the rest of the hemisphere? There is a simple test that can determine the answer.

The key is whether the dollarization of the hemisphere's economy is being done voluntarily or through coercion. For example, if an occupying army imposed its currency upon the nation it occupied, that would quite clearly be abusive. But that is not the case here. Latin Americans have held United States dollars as a store of wealth, a protection against domestic monetary policies which eroded the value of their currencies. More generally, dollars are not the only alternative currency. Individuals and businesses may, and sometimes do, hold marks or yen. It is thus hard to maintain that dollarization is anything other than a voluntary process.

As a policy matter, therefore, dollarization is placing the same type of constraints on the governments and central bankers of the host countries as maintaining the dollar's attractiveness places on U.S. decision makers. As local currencies are forced to compete with the dollar, domestic economic policies must become less inflationary, more pro-market, and more internationally open. In some sense, therefore, dollarization is a transfer of power from political decision makers to the individual citizens and market participants of the hemisphere's countries. My personal view, which many here today share, is that such a transfer is not a zero-sum game, but is of net

benefit to the countries involved. As long as dollarization is voluntary, I believe that it is clear that it is a net benefit to the economies involved.

There is also a public goods aspect to increased dollarization which deserves mention. Much, if not most, of the international trade among Latin American nations has never been conducted in the currencies involved, but among third country currencies such as the dollar. Increased dollarization in Latin America therefore increases the possibilities for market development throughout the region.

Dollarization does hold risks. Not least among them is that the economic fate of the countries using the dollar becomes somewhat tied to a currency controlled by policy makers abroad. Mismanagement of the dollar will therefore not only affect the United States, but other countries as well. There is no obvious way to hedge such a risk. But, there are two mitigating realities which should be borne in mind. First, there are, and will continue to be for the foreseeable future, international alternatives to the dollar. As long as such alternatives exist, the widespread use of foreign currency within an economy is of lesser concern because the particular currency used can be fairly readily changed. Second, increased dollarization of the hemisphere's economy places reciprocal obligations and constraints on United States decision makers. A larger international role for the dollar means that the consequences of pursuing unsound policies viewed internationally as unsound are

potentially larger, and the rewards for pursuing internationally sound policies are similarly enhanced.

Like the traditional economic theories of exchange -- that both buyer and seller are beneficiaries, dollarization may well prove to be beneficial for all economies concerned. The only lost alternatives are inflationary, interventionist, or protectionist policies. Speaking frankly though, that kind of loss can only be viewed as a social gain.