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MONEY AND THE INTERNATIONAL MONETARY SYSTEM

By

H. Robert Heller

Member, Board of Governors of the Federal Reserve System

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I am very honored to have been invited to deliver the annual Homer Jones memorial lecture. In deference to his memory I believe it is appropriate that this lecture be concerned with some of the enduring themes that pervade thinking about money.

Many distinguished economists have pondered the role of money and prices and the question of whether it is better to organize our monetary affairs along national lines or whether an international monetary standard is more appropriate. In arriving at an answer, important aspects of freedom, liberty, and constitutional sovereignty have been addressed.

The complexity of the topic is attested to by the fact that the debate is still not settled definitively. As a matter of fact, the current debate about the desirability of a common European monetary standard and the formation of a European central bank have rejuvenated many of the old arguments.

My central theme today will be the role of money and monetary stability and the question of whether it is more appropriate to rely upon a national monetary standard or an international one.

There is also a personal reason why I have chosen this topic. It has troubled me for many years that some of my friends and colleagues view themselves as monetarists and analyze domestic policy from that perspective, while another group of my friends maintain that fixed exchange rates are the glue that holds the world economy together. From their perspective, the world would be a better place in which to live if we would only adopt a gold standard.

This reminds me of the time when I set out on my first trip to Latin America. As I was leaving, an expert on the region told me: "Young man, as you travel from country to country in Latin America, you cannot fail to notice that half of the central bankers you encounter will advocate fixed exchange rates, while the other half see flexible exchange rates as the only solution to their country's problems. Pretty soon you will also learn that virtually all of them attended the University of Chicago. As far as I can tell, the only reason for their different convictions is that the first group studied in Chicago in a year when Harry Johnson and Robert Mundell taught the Monetary Workshop, while the second group took the course in a year when Milton Friedman was teaching it."

Eventually, I learned that the views of both groups could be reconciled on the global level because the different conceptual and behavioral assumptions underlying the two approaches converge on the global level. If there were to be only one world economic and financial system, the debate about fixed versus flexible exchange rates would not have been enjoined in the first place. Unfortunately, that is not the world we live in.

But even for the world that we live in, there is a surprisingly close association between the global level of international reserves (or the global monetary base), the world money supply, and the world price level. But that finding does not answer the question of whether financial stability is better achieved by having individual nations manage their own monetary affairs in an independent, decentralized manner; whether a global monetary constraint should be relied upon bring about national monetary discipline; or whether there exists a workable compromise that we can all live with.

Clearly, I will not be able to do justice to all the complexities and nuances of the topic in such a limited span of time. Hopefully, brevity will allow me to crystallize some of the arguments and to bring some of the issues sharply into focus.

I will first consider the role of money in the economy and then discuss some of the problems of defining monetary stability. I will then turn to the role of freedom in determining the ideal monetary system and finally present what I would consider to be the rudiments of a workable compromise system in our imperfect world.

The Roles of Money

Money enhances economic freedom. In the absence of money, we would still be free to make choices, but these choices would be more costly, cumbersome, and constrained.

To see how money enhances economic freedom it is useful to remind ourselves that money fulfills several distinct roles: it serves as a unit of account, a medium of exchange, and a store of value.

As a unit of account, money enhances freedom of choice by permitting price comparisons to be carried out more readily. It lowers information costs and thereby improves the choices available.

As a medium of exchange, money lowers transaction costs and allows individuals to exercise their freedom to acquire goods and services through transactions. Without money, there would still be the possibility to engage in barter exchange, but this process would certainly be more cumbersome and costly.

As a store of value, money makes it possible to exercise intertemporal choices. By allowing people to accumulate funds and to spend them later, it enhances their freedom of choice over time.

One may even argue that money increases political freedom. Not only does money offer greater independence and freedom of decision making, but a generally acceptable means of payment and store of value enables the individual to turn his back upon one political system and to take one's life savings to live somewhere else under a different political regime.

Thus, it is not surprising that politically repressive regimes tend to provide their citizens only with a money that has little or no international acceptability. Furthermore, they tend to punish those who try to enhance their freedom of choice and scope for independence by accumulating foreign currencies. It is also not surprising that in times of extreme political suppression, gold has often become an increasingly important treasure.

Money and the Price Level

We have discussed the various roles of money. Money can fulfill these tasks in an optimal fashion only if it is a stable unit of account, a stable means of exchange, and a stable store of value. In other words: money should provide a consistent yardstick, and that is synonymous with a non-inflationary environment.

Unfortunately, the measurement of inflation itself poses not only certain philosophical, but also important practical problems. If money itself is the yardstick, how can its value be defined in terms of something else? If the monetary unit, say the dollar, were to be defined in terms of gold, isn't it then true that gold is the yardstick? In that case, gold will at least assume the unit of account function, while the dollar may serve as the means of exchange and the store of value.

The value of a national currency may also be defined or measured in terms of other national currencies. But obviously this cannot be true for all currencies as this would involve circularity of reasoning. There must be an ultimate yardstick. The Bretton Woods system solved this problem by defining the value of all currencies in terms of the dollar, while the dollar was defined in terms of gold.

In a national economy the measuring rod for the value of money is typically provided by the price level. However, the definition of the price level is not as unambiguous as it may seem at first sight.

Most customary measures of the price level rely upon weighted averages for transaction prices of current goods and services. These are the familiar indices of producer prices, consumer prices, and the GNP deflator. For instance, the GNP deflator measures the value of the stock of money, a concept which has meaning only at a given point in time, in terms of the prices of goods that are produced during a certain period of time, that is, a flow variable.

But how about the prices of assets, such as commodities and real estate? Aren't these prices relevant when it comes to judging whether we are in an inflationary or deflationary situation? One may well argue that it is more appropriate to measure the value of money in terms of other assets because money itself is an asset. While there are good arguments to be made for the consideration of tangible asset prices in assessing the value of money, matters become increasingly complex as we broaden the spectrum to financial assets as well. One may also argue that stock prices are a convenient proxy for real asset values. But other influences, such as a change in management, may also influence the value of a stock.

Matters become even more complicated in the case of bonds. While they are an asset on one individual's balance sheet, they are also a liability on someone else's balance sheet. Their value is also directly influenced by monetary policy, and it is easy to get into circular reasoning in that connection. While bond prices do give useful information, it is probably better to consider that information separately from information conveyed by changes in real asset prices.

I would conclude from this discussion that if we are interested in the stability of money as a unit of account, store of value, and means of transaction, the appropriate indices for determining changes in the value of money should incorporate prices which reflect these functions. That is, asset prices, commodity prices, intermediate as well as final goods prices might be given appropriate attention in defining and measuring price stability and the value of money.

Gold as a Monetary Standard

Given the complexities of measuring the price level itself and of defining the value of money, it is therefore not surprising that over the centuries people have sought refuge in simplicity and expediency and focused on gold as a universal constant that provided a practical unit of account, a medium of exchange, and a store of value.

More so than any other commodity, gold has combined the various monetary attributes and has done so over centuries of human history. Moreover, a large and distinguished number of economists has advocated a gold standard at some point in their professional lives. But many of them have subsequently abandoned their beliefs that gold can serve as a national, and indeed global, money and advocated alternative systems.

I argued earlier that money plays an important role in maintaining and enhancing economic and political freedom. In my mind, gold fails to meet this crucial test for a monetary standard. The two largest gold producing countries in the world are the Soviet Union and South Africa. Due to their position as key suppliers they wield considerable influence over the market price of gold. I view neither one of them as an economically or politically reliable and stable supplier. Thus, I would not entrust them with the degree of influence over our economic, financial, and, indeed, political affairs that a move to a gold standard would entail. I find this objection so fundamental that I see a further debate of the pros and cons of a gold standard as essentially unproductive and pointless. There is simply no reason why free and democratic nations should cede an important part of their sovereignty into uncertain hands.

Of course, everyone should be free to make his or her own choices whether they wish to hold gold, use it as a store of value, or as a medium of transaction among willing individuals. Government should neither fix the price of gold, nor impede its private use.

Freedom and the Monetary System

Choosing an international monetary system involves many profound constitutional questions that affect a nation's sovereignty.

The deep desire to protect and foster human freedom unites both the advocates of a national monetary rule and the proponents of an overarching international monetary standard. For simplicity's sake I will refer to them as the monetarists and the internationalists. The two groups also distinguish themselves by advocating an international monetary system that relies upon flexible and fixed exchange rates respectively.

Both the monetarists and the internationalists hold the view that government should serve the people and that the role of government should be strictly limited. In the economic realm, both groups believe in price stability as the key objective of monetary policy. They also want to limit the role of government, and therefore advocate the adoption of "monetary constitutions" or predetermined rules according to which policy is to be carried out.

In that they are united against the interventionist view, which holds that active governmental decision making is a positive force that is needed to bring about economic stability, efficiency, and welfare maximization.

But national and international monetarists adhere to different philosophical concepts and notions about which monetary arrangements best protect human freedom. Monetarists believe that human freedom is best protected if governmental authority is exercised at the most decentralized level of government; the internationalists believe that a global monetary rule would take monetary decision making powers out of the hands of national governments and thereby minimize the chance of inappropriate interference by national governments. Thus, monetarists and internationalists tend to differ in their prescriptions as to how best to organize the monetary system. In addition, there are certain empirical judgments about the way the world works that underlie the two approaches. Let me explore these differences in some detail.

Monetarists tend to argue that in order to preserve individual freedom, the power of the state should be limited. They claim that the only consistent way to accomplish this objective is to disperse governmental power through decentralization. Thus, governmental functions should be exercised on the most decentralized governmental level possible. The national government should exercise only those powers that cannot be delegated to regional or local governmental units.

While the power to create money and regulate the value thereof should be exercised at the national level, monetarists believe that the authorities should be constrained by a domestic rule as to monetary growth.

From this it also follows that the government should not be externally constrained. Preserving that international independence is therefore a key requirement of any international monetary system. Consequently, the international monetary system should be constructed in such a way that monetary decisions are taken at the most decentralized level possible: namely, the nation. Flexible exchange rates are therefore advocated by the monetarists as a means of preserving the political and economic independence of the country. Under such a system, international policy coordination is not only unnecessary, but even undesirable as it will inevitably infringe upon the freedom of the nation state. Instead, flexible exchange rates are advocated as an insulating buffer among countries.

In contrast, internationalists tend to argue that individual economic freedom can best be attained in a system where one common international currency is used in the entire world. In such a system, individuals are free from national economic and financial constraints and can maximize their welfare unfettered and unhampered by national boundaries and political intrusions. They are at liberty to engage in transactions with anybody else in the entire world. In the views of many internationalists, such a system is provided by an international gold standard, where gold serves as the actual medium of exchange. Under such a system, the uncertainty of exchange rate fluctuations is also eliminated and global welfare maximization therefore becomes a true possibility.

The true internationalist sees the nation state largely as a political construct that has only limited economic importance. A common global monetary standard will allow individuals to maximize their economic and also their political welfare.

Both sides are united in their view that the preservation and enhancement of individual freedom and liberty is the ultimate and overarching goal of any social order. That is the ideal. They both wish to attain that ideal by minimizing the political and economic power of the state. Furthermore, they assume that competitive forces will bring about economic adjustment in a speedy and efficient manner.

The question is whether this ideal view of the world is realistic, or whether the imperfections still existing in the world call for a compromise that may well fall short of the idealistic systems represented by pure monetarism or internationalism.

A Pragmatic Approach

I believe that the world is still an imperfect place. Economic conditions vary widely around the globe. Perhaps most important of all, the degree of economic integration also varies widely. Few truly global markets exist. Instead, we have a series of national and regional markets that are linked with varying degrees of perfection.

In other words, the economic and financial world is a patchwork quilt rather than a homogenous entity. Some would argue that this makes the world even more interesting or beautiful -- and in a world with positive information costs, it may be just as efficient.

The problem confronting us is therefore one of constrained optimization and the development of a set of rules that will permit the maximum degree of freedom in the economic and political realm while taking into account the need for collective decision making in certain areas.

Nowhere is that more apparent than in the monetary sphere. Just like a separate money issued by each individual person would lose its usefulness, so does a global monetary standard not necessarily serve everyone best. The debate about the advantages and disadvantages associated with a common monetary standard and a central bank for Europe shows the problems and the issues involved.

Let me set out what I consider to be some relevant considerations that should guide us in the decision as to what monetary system might serve us best.

First of all, the goal of monetary policy should be to provide a stable financial environment so that private decision makers can maximize their welfare. A stable monetary standard will help to minimize transaction costs and aid in rational economic decision making. Stability in this sense can be defined as the absence of any bias in decision making that would be induced by a tendency for the price level to vary in a systematic fashion. This state of affairs will be reached when the change in the general price level is close enough to zero so that it will be ignored by the economic agents in their decision making process.

Second, the value of money should not only be measured in terms of output prices of items sold, but also in terms of asset prices.

Third, price stability can be achieved only in an economically and financially integrated area. The world we live in does not yet represent such a fully integrated market area. National borders, artificial or informal barriers to economic and financial flows, information barriers, and the like, all contribute to a compartmentalization of the world economy.

Fourth, a common indicator, such as a global commodity basket, can provide a useful reference point for national and international policy makers. Such a reference point is not only helpful in the formulation of domestic policy that introduces sensitive asset prices into the decision making process, but it also gives important information about the development of global inflationary or deflationary pressures. Indeed, the use of such a commodity price indicator was agreed upon at the Toronto Summit meeting of the industrialized nations.

Fifth, more or less homogeneous economic and financial zones constitute the optimal domains for various monies or monetary standards. As economic and financial integration progresses and the barriers among different economic regions are being reduced, the natural monetary domain is also enlarged. At the present time, such progress is particularly pronounced in Europe, which is rapidly moving toward becoming an integrated economic and financial entity. As a consequence, the European discussion about monetary integration is nowadays more than theoretical speculation and may well move into the realm of reality in the not too distant future.

Sixth, it should be recognized that monetary integration has not only economic, but also political significance. While it is not necessary that each sovereign country has its own monetary unit, there must be a sufficient degree of political consensus to permit the use of a common monetary standard. This common monetary standard can be established through the formation of a joint political decision making body, the delegation of the monetary decisions to a common central bank, adoption of a commodity or gold standard, or the formal or informal acceptance of a standard represented by another monetary authority. In the latter case, the political underpinnings of that decision making body must be sufficiently similar to their own political beliefs and priorities to assure that no substantive conflicts arise.

As the global integration of economic and financial markets proceeds, and as political interdependence increases, it therefore stands to reason that monetary integration will increase as well.

In that connection it is important that progress in one area is accompanied by progress in the other areas. Just as it would be unrealistic to expect rapid political integration, it is also unrealistic to see monetary integration as getting out too far in front. Time for adjustment and consensus formation must be permitted.

But as confidence in ever increasing economic and financial integration increases and as political cooperation becomes an enduring reality, progress toward greater monetary integration will be made as well. That is, the monetary domains will tend to expand and over time we will move closer to a global monetary standard.

What does all that imply for the real world that we live in?

In that connection it is good not to forget important lessons of history. Soon after the establishment of a government for the United States, the First Bank of the United States was founded in 1789. Its charter was not renewed and it was succeeded by the Second Bank of the United States, which ceased to exist in 1836. Why? Simply because there was not yet enough of an economic and political consensus in the young nation to support a uniform monetary policy. The interests of the merchants and traders of the East could not yet be reconciled with the priorities of the farmers and settlers of the South and West. Thus, the United States had to do without a central bank until the formation of the Federal Reserve System only 75 years ago. And even then, the Federal Reserve System was designed to assure representation of the views of the various regions of the country, as well as a balanced representation of the banking, commercial, industrial, agricultural, and public interests.

Looking beyond our borders, we already see an ever increasing integration in the economic and financial affairs of the United States and Canada. The U.S. dollar is used widely in Canadian capital markets. It is also used as a medium of exchange and a store of value in much of Latin America. But clearly there is no political base for monetary integration among the various countries of the American continent.

Matters have proceeded further in Europe, where the economic integration movement has also been accompanied by the establishment of common administrative and political institutions. This sets the stage for the important debate about the desirability of establishing a central bank for Europe, which could issue a common currency and administer a common monetary policy.

It is instructive to trace the development of the European Community because it illustrates the interdependence between economic, monetary, and political integration. An economic beginning was made by the original six signatories to the Treaty of Rome that established the European Economic Community. Gradually other nations entered the economic union.

In the monetary sphere, Belgium and Luxembourg have long had a common currency. The common monetary arrangements of the European snake constituted essentially a period of experimentation and experience gathering, but taught important lessons that were then incorporated in the more formal European Monetary System. While the original members of the European Economic Community are now all participants in the European Monetary System, some of the countries that joined the Community later have not yet taken this step. Overall, progress has been gradual and not devoid of disappointments and setbacks.

All this has been accompanied by the establishment of common European political institutions and an administrative apparatus that has progressed from what amounted to coordinating functions to an important decision making role. Thus, an ever increasing economic and political consensus is formed that may in due course represent a sufficient foundation for the establishment of a common European currency and monetary policy.

I have previously advocated the establishment of unitary exchange rates as an intermediate step that might be taken by Europeans. Under such an arrangement, all currency exchange rates would be aligned such that one German mark would equal one French franc, one British pound, and so on. The institutional arrangements of the current EMS system would be maintained. Under such an arrangement, the various currencies would soon become accepted across the continent, and in effect a uniform means of exchange for the continent would be created. If successful, a full monetary union and European central bank might follow in due course.

The formation of such a European currency area would undoubtedly have implications that would transcend European borders. Already quite a few African countries peg their currencies to those of European countries, and it can be expected that these and possibly others would want to peg to a common European currency as well.

Conclusion

What may we conclude from this discussion?

One, the choice of a monetary standard and a monetary system involves important political choices and is rooted in basic notions about how best to protect and preserve human freedom.

Two, a certain congruence among economic, financial, political, and monetary arrangements is needed for their public acceptance and to assure their viability.

Three, as the world becomes more integrated, progress toward the establishment of ever larger monetary domains can also be made. But by necessity, that progress is slow and gradual.

I believe that we are privileged to live in a time where we are witness to considerable progress on all fronts and are able to participate in building a more integrated world, where economic and political decisions can be made with increasing freedom for all people.
