

The Evolving Global Monetary Order

Keynote Address by

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The title of my paper is different from the title given to this conference, reflecting a slight quibble about the dynamics of replacing an old order with something different. I prefer “evolving” rather than “search for” because I think the former suggests human action while the latter may suggest human design.¹ The danger of engaging in a search for a new global monetary order is that we may think that we have found it and stop the search. Certainly, it would be a “fatal conceit”² to think that a group of economic architects could dream up a monetary structure to house the global financial system for the new millennium. And, the idea of a new Bretton Woods suggests a “pretense of knowledge”³ that I do not share.

I hasten to add, though, that I will not be suggesting that “doing nothing” is the correct response to what seems to be emerging in monetary matters. Rather, we should be guided in our thinking about the framework in which things will evolve by the prescription of my former professor, Karl Brunner. Karl once said that the state should be “an umpire in a positive sum game, not the operator of a negative sum game.”⁴ I contend that the same should be true of any international organizations that are created by the various nation states.

Our study of the institutional arrangements and their consequences in the second half of this twentieth century has become an exercise in better informing us about what will not serve in the future, rather than what will best replace it. Starting probably with the great work of Lord Bauer,⁵ we have become informed about the unintended consequences of well-intended efforts by international organizations and various foreign aid programs. That is, we now know better what doesn’t work, or doesn’t work the way earlier architects had planned.

¹ Adam Ferguson, “History of Civil Society” (1767); “. . . nations stumble upon establishments which are indeed the result of human action but not the result of human design”. Also, *Human Action: A Treatise on Economics*, by Ludwig von Mises, Yale University Press, 1949.

² *The Fatal Conceit: The Errors of Socialism*, by Friedrich A. Hayek, in *The Collected Works of F.A. Hayek*, Vol. 1, edited by W.W. Bartley, III, Chicago: University of Chicago, 1989.

³ “The Pretence of Knowledge,” by Friedrich A. Hayek, *American Economic Review*, Vol. 79, Issue 6 (December 1989), pp. 3-7.

⁴ Karl Brunner, “The Poverty of Nations,” *Business Economics*, Vol. XX, No. 1, (January 1985), pp. 5-11.

⁵ For example, see “Aid Evaluation—Its Scope and Limits: Comment,” by Peter Bauer, in *North-South Cooperation in Retrospect and Prospect*, Catrinus J. Jepma, ed., New York and London: Routledge, 1988, pp. 182-186.

At the Cato Monetary Conference five years ago I talked about two ways we use the word *institutions*.⁶ First, there are organizations, such as ministries, bureaus, departments, agencies, and central banks—as well as international organizations, such as the IMF, the World Bank, and the Bank for International Settlements. Even the United Nations and NATO could be put into this type of grouping.

The second way we use the word institutions is to refer to rules—meaning contract enforcement, GAAP⁷, labor laws, laws of incorporation, the judicial system, and the enforcement of property rights. Rules also include various types of economic controls, such as wage, price, credit, interest rate, exchange, and capital controls, or even margin requirements. One would also include restrictions on financial industries such as loan-loss reserves, capital adequacy standards, debt limitations, credit allocations, leverage ratios, and so on.

Some of both of these types of institutions—the organizations that are created and the rules that are laid down—are intended to improve the workings of markets. However, some of both types of institutions—organizations and rules—are also intended to alter the working of markets because the benefits of intrusion are perceived to be greater than the costs. That is the case when political or social objectives seem to be more important than economic efficiency. Objectives such as income redistribution—a political decision to give priority to sharing wealth—rather than creating wealth—result in institutional arrangements that reduce the efficiency of markets.

Economic forces constitute an irresistible force, while some of the political institutions tend, over time, to become immovable objects. Even those political institutions that are intended to improve the workings of markets and are designed to have a great deal of inherent flexibility or adaptability tend to become immovable objects through institutional obsolescence.

The architects of new rules or organizations usually understand the need to create institutions that are “living organisms,” capable of adapting to changing conditions. This is true not only of constitutions for governing, but also of the various agencies of government with specific missions.

⁶ Jerry L. Jordan, “Money and Markets in the Americas: New Challenges for Hemispheric Integration,” edited by James A. Dorn and Roberto Salinas-León, The Fraser Institute, 1996, pp. 33-45.

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

The ultimate implication of a conflict between irresistible economic forces and immovable political institutions is that institutions must change, or they will fail. In other words, there must be an effective political and economic regeneration in which various institutional arrangements, especially organizations, take on the characteristics of living organisms—that is, they must be adaptable to a changing environment.

Joseph Schumpeter said, “the essential point to grasp is that in dealing with capitalism we are dealing with an evolutionary process....Capitalism, then, is by nature a form or method of economic change and not only never is, but never can be, stationary.”⁸

Schumpeter’s observation about capitalism applies equally well to all of the institutions that define the parameters of our global economy. Propelled by technological change and chance economic events, these institutions undergo a continual process of change. Those qualities that enhance economic well-being tend to survive, and those that do not eventually disappear. People adopt institutions—laws, rules, conventions, and customs—to define and enforce property rights and, more generally, to reduce the costs of economic exchange.

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

⁷ Generally Accepted Accounting Practices

⁸ *Capitalism, Socialism and Democracy*, by Joseph Alois Schumpeter, New York: Harper, 1950.

We are witnessing the difficulty of winning and maintaining the support of these two quite different groups of voters. Domestic ballot-box voters respond well to politicians who pander to their craving for wealth-*sharing* programs. Capital-market voters survey the world for those who pursue the best wealth-*creation* policies. Gaining the support of one is almost surely to diminish support from the other. The spread of democracy reduces the possibility of the even more perverse outcome in which governments redistribute wealth away from their own citizens toward foreigners, via various subsidies or guarantees.

The inherent tension of this dynamic has been playing out in many ways around the world. Sometimes it is manifested in what is characterized as a conflict between fiscal authorities and monetary authorities. Sometimes it is reflected in an inconsistency between the domestic purchasing power of a currency and its pegged international exchange value. Sometimes governments erect trade barriers to benefit import-competing firms, while also subsidizing consumers. Often politically connected lending by domestic banks violates international best practices of bank regulation.

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

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

International monetary developments in recent years can be explained in the context of powerful economic forces challenging ossified domestic institutions. Among the twentieth-century institutional arrangements that are coming under increasing scrutiny are central banks and national currencies. Certainly there are national vested interests in maintaining local governmental monopolies over the issuance of the national

media of exchange. Beyond that, the idea persists that a country has something called “monetary sovereignty” and can therefore pursue an “independent monetary policy.” History demonstrates, however, that national currencies inevitably compete in the international financial arena.

Sometimes the expression “independent monetary policy” seems to reflect an acceptance that national monetary policies are dominated by an undisciplined fiscal policy. However, the bad experiences with massive debt monetizations and consequent inflations has fostered efforts to find ways to insulate monetary authorities from the pressures arising from deficit financing and unfunded pension liabilities of governments. Judy Shelton⁹ cites a simple rule in the *Economist* ten years ago, “a government that insists on access to the printing press cannot be trusted with it.”

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

If monetary sovereignty or independence is not worth much in today’s global capital markets, and if seignorage is quite small in a noninflationary world, then the costs and risks associated with a national central bank and a national currency become harder to justify. Whatever the views of domestic politicians, the trend in the behavior of businesses and households around the world is unmistakable. Gresham’s law has been turned on its head. What we now see—where not prohibited by effective severe punishment—is the use of “high-confidence monies” driving out the everyday use of

⁹ *Money Meltdown: Restoring Order to the Global Economy*, by Judy Shelton, New York: Macmillan, Free Press; Toronto: Maxwell Macmillan Canada, 1994, p.260.

“low-confidence monies.”¹⁰ Just as the “brand name” of running shoes is more important to consumers than the location of the assembly plant, so too the “brand name” of currency used to denominate contracts and trade assets is more important than the “local content” or “national origin” of the standard of value.

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

Countries can take specific steps to allow and even encourage this competition. The first step is to remove any capital and exchange controls, including prohibitions on deposits denominated in foreign currencies. Argentina went a step further and clearly signaled its intention to maintain monetary stability by granting people the legal right to contract under any and all circumstances—including tax payments and other transactions with the government—in any currency they might choose. Legislation in Argentina requires courts to enforce contracts in the currency specified therein. This “specific performance” law¹¹ provides a level playing field for competition between the domestic and foreign currencies.

Sound Money

To prosper, every economy needs sound money. Changes in the money prices of goods and assets convey information. If an economy’s monetary unit is known to be a stable standard of value,¹² then changes in money prices will accurately reflect changes in the relative values of goods and assets. That is, price fluctuations signal changes in the

¹⁰ “The Competitive Supply of Money,” by Benjamin Klein, in *Free Banking. Vol. 3: Modern Theory and Policy*, Lawrence H. White, ed., Elgar Reference Collection. International Library of Macroeconomic and Financial History, No. 11, Aldershot, UK: Elgar, distributed in the U.S. by Ashgate, Brookfield, VT, 1993 (previously published 1974).

¹¹ Specific performance legislation is not a “legal tender law.” Legal tender laws require that residents of a country accept a certain currency in settlement of a financial obligation, *even if* they are owed a foreign currency, gold, or bales of hay. Specific performance legislation means the courts must require delivery of what was promised in the contract, even if that is the currency of another country, gold, or bales of hay.

¹² Monetary stability—a stable standard of value—is not the same thing as a stable “price level,” nor does it mean “zero inflation.” For a classic treatment of these terms, see *Human Action: A Treatise on Economics*, Ludwig von Mises, Yale University Press, 1949. For an excellent contemporary discussion, see George A. Selgin, *Less than Zero: The Case for a Falling Price Level in a Growing Economy*, Hobart Paper Vol. 132,

demand for, or supply of, goods or assets. Resource utilization then shifts toward more valued uses and away from those less valued.

However, if the information in changes in money prices is contaminated by inappropriate monetary policies, false signals are sent to businesses and households. Bad decisions are made, and resources are misallocated. Standards of living fail to rise at their potential rate. Nominal interest rates respond to shifting expectations about the future purchasing power of money. Changes in real interest rates are obscured. Again, resources are misallocated. Saving and investment decisions are affected, and growth is impaired.

It is now generally accepted that accelerations and decelerations of inflation do not enhance economic performance. Also, unanticipated inflations and deflations induce redistribution of wealth—especially between debtors and creditors—but they leave the average standard of living lower. The same is true of devaluations or revaluations of the external value of a currency. If a stable domestic standard of value is optimal, then as Mises said, “It is impossible to take seriously the arguments advanced in favor of devaluation.”¹³ A government’s decision to alter the exchange rate of a currency that had been fixed involves the breaking of promises. Losses are imposed on someone.

Even though the internal value of a currency must be stable to enjoy maximum prosperity, if that is not the case then the external value must ultimately reflect changes in the internal value. Clearly, if the domestic purchasing power of a currency falls, the external value must eventually fall relative to stable currencies. The notion that a country can maintain a permanently fixed exchange rate while tolerating domestic inflation has been proven to be false numerous times. That reality has led to increasing advocacy of floating external exchange rates, especially for developing countries that do not have the essential fiscal discipline to resist domestic inflation.

Alternatively, it is also argued that a way of imposing fiscal discipline is through an irrevocably fixed exchange rate—either a currency board or use of another country’s

London: Institute of Economic Affairs, 1997. An important conclusion is that the wealth gains emanating from a favorable productivity surprise should be reflected in rising purchasing power of money.

¹³ *Human Action: A Treatise on Economics*, Ludwig von Mises, Yale University Press, 1949, p. 790.

currency: dollarization. Even then, as Sebastian Edwards recently has documented¹⁴, a dollarized country such as Panama can avoid fiscal discipline so long as loans from taxpayers of industrial countries—channeled through an international agency—are available to cover the deficits. It is useful to contrast the case of Panama with state and local governments in the United States. State and local governments must match outlays with current or future tax receipts, unless the Federal government arranges transfers from taxpayers in other parts of the country.

Capital Flows and Exchange Rate Regimes

Questions of fiscal discipline bring to mind a broader point about credit in general. International capital flows have proven to be a mixed blessing to many economies in the post-WWII era. But investing the savings from foreign sources for economic development is not a new phenomenon. It would not be desirable to erect obstructions to the free flow of savings, even if that were possible. Instead, the challenge is to find ways to ensure that access to foreign capital does not so frequently appear to have been a curse, rather than a blessing. Capital mobility, per se, does not result in monetary or exchange-rate crises.

It is important to get the labels right. In economics, as in medicine, if the diagnosis is wrong, it is unlikely the prescription will cure the malady.

At its roots, Mexico in 1994–95 did not have a monetary crisis nor an exchange-rate crisis. Likewise, what ended up as an Asian monetary or foreign exchange crisis did not start out as such.

Common to all of these and other episodes were government guarantees or promises that ultimately were revealed to be unreliable. The prior presence of government guarantees (or, implicit promises) had induced behavior—relying on the guarantees or promises—that altered incentives to the point that risk/reward relationships had become distorted. Sometimes the guarantees were in the form of financial instruments—such as Tesabonos in Mexico—sometimes in exchange-rate pegs, sometimes in guaranteed loans to domestic banks, sometimes in government-agency or

¹⁴ Sebastian Edwards, “The IMF is Panama’s Lender of First Resort,” *The Wall Street Journal*, September, 24, 1999.

nationalized-industry borrowing. The failures of such arrangements in the crisis countries often *became* a monetary crisis or an exchange-rate crisis. Such market-corroding practices were already undermining sustainable prosperity even before access to foreign capital magnified the distortions.

Merely allowing the value of a currency to float does not eliminate the problems that are revealed in fixed-exchange-rate regimes confronted by financial crisis. Only a small number of currencies in the world enjoy a reputation that will permit either the issuing government or a private borrower the privilege of selling obligations to foreigners without incurring exchange-rate risk. And global capital markets may withdraw the privilege of borrowing in one's own currency. When a currency is not an external standard of value, both fixed- and floating-exchange-rate systems are vulnerable.¹⁵

A fixed-exchange-rate regime is one in which the government has promised to stand ready to supply foreign currency in exchange for the domestic currency. Obviously, the reliability of that promise is limited by the amount of such currency already held ("reserves") or which can be borrowed by the government.

Under a freely floating exchange-rate regime, the government makes no promise to provide the foreign currency necessary to cover a domestic borrower's short sales of foreign currency. That means capital inflows involve "uncovered short positions" of domestic borrowers of foreign savings. The risk of exchange-rate depreciation, as well as default, normally would mean the interest rate paid by the borrower will be higher than foreign market rates. As we have often seen, however, governments have sought to minimize the interest differential by providing guarantees of the obligations that domestic banks and other borrowers have incurred to foreign investors. This creates an unavoidable moral hazard because risk has been shifted to general taxpayers. Furthermore, because of the subsidy to borrowers involved in such guarantees, the demand for them will always exceed the amount the government can possibly honor. The nonprice rationing of the guarantees introduces political considerations into the allocation of capital flows. The inherent distortions to incentives undermine the discipline of market forces and all too frequently result in bad investment decisions.

Institutional investors in global capital markets conduct a continuous plebiscite on political and economic policies and developments in the numerous nation states of the world. Seemingly, no economy is immune from these pressures. Advances in communications and information technologies have been revolutionizing all the financial markets: equity, debt, credit, capital, and currency. Adverse judgments by participants in such markets can quickly and dramatically change the price and availability of funds to any borrower, large or small. In the United States in the late '80s and early '90s, one heard references to “bond market vigilantes.” I’m sure most countries of the world have in the past, and will in the future, feel they have come up against the capital and currency market vigilantes. It is becoming apparent that governmental promises—whether in the form of pegged exchange rates or in the form of deposit, loan, or investment guarantees—are on the endangered species list.

Brand Name Money

I want to return to the comment I made earlier that the “brand name” identification of goods—which has made the national origin of production irrelevant to consumers—is also becoming apparent in financial and monetary affairs. Lack of global specialization in goods was due to governmental and technological constraints. International brand identification evolved as these constraints diminished. As we are now seeing, brand identification of standards of value also becomes more pervasive as falling costs of information and communications technologies make it increasingly easy to compare the quality dimension of standards of value.

Under the true gold standard of an earlier era, most currencies were gold or silver certificates—warehouse receipts for the true standard of value. Then, in the Bretton Woods period, a dollar, firmly anchored to gold, served as a standard of value, and other currencies were defined in terms of the dollar. An obvious twentieth-century trend was the proliferation of national currencies, especially as new nation states emerged from the

¹⁵ This point is developed very well in a recent paper, “Exchange Rates and Financial Fragility,” by Barry Eichengreen and Ricardo Hausmann, Federal Reserve Bank of Kansas City Annual Jackson Hole Conference, 1999.

break up of the colonial empires and the Soviet Union. What is less apparent, though, is that while there are now a great many currencies, there are still very few standards of value. The birth of the euro and talk about “dollarization” reflect a growing acceptance that most national currencies will not become successful, independent standards of value.

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

Summary Remarks

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

Once it became clear to all that these countries were not employing “best practices” in their domestic financial markets, it also became clear that the content of previous “conditionality” had not fostered the development of the “Hayekian infrastructure” essential to a market economy. It is tempting to say that what is needed is an international organization responsible for working towards global adoption of sound banking and other financial market practices. However, the idea of empowering a “conditionality enforcer of first or only resort” is troublesome. Some combination of carrots and sticks will always be present. Whether carrots or sticks dominate will change over time, depending on personalities and political environment. I doubt anyone would defend a view that what is needed is a “global financial policeman/prosecutor/judge/jury and executioner” all rolled into one. To some people, the world’s capital markets may seem, at times, like the wild, wild west, but they would still stop short of a call for a financial “Judge Roy Bean.”

Instead, following Mises,¹⁶ we might think that a “financial night watchman” would better serve as the role model for the professional staff of any international organization that is empowered to work on behalf of creditor nation states. A common element of all financial crises of recent years was the existence of government guarantees—to pensioners, producers, intermediaries, and so on—that were revealed to be unsustainable. The sooner the revelation, the better countries were equipped to eliminate the distortions without a crisis, and to this end an international organization might truly add value.

There is little doubt that recent crises reflect the increased scrutiny of financial discipline imposed on a country’s policies and institutions by foreign investors and lenders. Global market participants have become a class of stateless voters, roaming around the world economies seeking the best wealth-creating institutions. They represent an irresistible force.

There is, however, a core tension between the interests of market participants and the incentives of local politicians to redistribute, rather than create, wealth. In the end, the forces of wealth creation will dominate those of wealth redistribution. The adjustment process has not been, and will not be, a smooth one.

Achieving discipline, though painful, will have a positive effect. As the president of Korea said earlier this year, there is a “silver lining” to the Asian currency crisis. The restructuring and reforming of the banking institutions now occurring in Asia will leave them better off. It would have taken much longer to bring about these much needed reforms without the “crisis atmosphere.”

This final decade of the millennium has seen considerable financial market turbulence. At the end, though, we have already evolved toward a more stable global monetary order.

¹⁶ “Liberty and Property,” by Ludwig von Mises; lecture delivered at Princeton University, October 1958, ninth meeting of the Mont Pelerin Society, reprinted by The Heritage Foundation, 1998.