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Ronald I. McKinnon

# AN INTERNATIONAL STANDARD FOR MONETARY STABILIZATION

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## Preface

Over the past dozen years, the world economy has been wracked by rampant inflation, deep recession, recurrent exchange rate misalignment among major currencies, and increasing trade restrictions. In this study, Ronald I. McKinnon suggests a common cause for many of these ills: the narrowly *national* orientation of monetary policies in a world where markets for goods and capital have become increasingly *international*. The consequence is endemic financial imbalance in the world economy.

In particular, McKinnon argues that the asymmetrical position of the dollar in world finance and the absence of monetary policy coordination among the major countries resulted in the two great inflations of the 1970s and the sharp recession of the early 1980s. However, he believes there is a way out of this instability and makes a set of innovative proposals for doing so.

In each industrial country, McKinnon argues that the central bank should deemphasize purely national monetary indicators, such as interest rates or growth in domestic money, and increase the weight assigned to stabilizing the exchange rate against a hard currency trading partner. Such an outward-looking monetary policy need not conflict with domestic macroeconomic goals: he argues that the exchange rate is a robust leading indicator of changes needed in the nation's money supply to prevent unexpected inflation or deflation.

To stabilize the world economy, however, more is required of the major monetary authorities—in particular, the US Federal Reserve System and the central banks of Germany and Japan. In addition to smoothing fluctuations in the yen/dollar and mark/dollar exchange rates, they also need to cooperate to stabilize the absolute purchasing power of their currencies. Proper joint control over their *aggregate* money stock would then dampen (and even avoid) worldwide economic cycles of boom and bust.

As background for these proposals, the introduction to the study describes the evolution of the international monetary system from the late 1940s to the 1980s and argues that monetary control was lost in the early 1970s with the

shift from fixed to floating exchange rates. Impatient readers can skip to chapter 5 for the details of how a new international monetary standard could be constructed—with explicit coordination among the Federal Reserve System, the Bundesbank, and the Bank of Japan. Because of changed circumstances, this new system would be quite different from the regime created at Bretton Woods in 1944.

The intervening chapters are important for understanding McKinnon's case for a new international monetary standard. Chapter 2 suggests that previously persuasive arguments in favor of floating exchange rates are either incorrect or have become obsolete. Chapter 3 argues that any country, acting in its own best interests, should gear domestic monetary policy toward stabilizing its nominal exchange rate with some major hard currency trading partner(s).

Most importantly, chapter 4 provides empirical evidence that the United States—the center country—can no longer successfully conduct an autonomous monetary policy. The Federal Reserve, McKinnon argues, cannot afford to ignore the impact of international capital movements on the American monetary system and, through the exchange rate, on the American economy. Money growth in other hard currency countries affects the American economy now much more than it did in the 1950s and 1960s.

Many observers of international economic affairs will be aware that McKinnon has presented some of these ideas in previous writings. This new study, however, is different in several respects. First, it pulls together all components of McKinnon's analysis into a single, concise treatise. Second, it responds to several criticisms of his earlier work (in particular, with regard to the concept of "indirect currency substitution" now presented in chapter 3). Third, it offers a substantial amount of new empirical support for McKinnon's thesis. Fourth, and perhaps most important, it suggests a much more evolutionary—and thus presumably more practical—set of proposals for putting in place the policy reforms that McKinnon believes would bring stability to the American and world economies.

This is the first time that the Institute for International Economics has published a study not by a member of its own staff—although much of the paper was prepared while Professor McKinnon was a Visiting Fellow at the Institute in the fall of 1983. We do so because we believe the ideas presented here are of considerable importance in both understanding the international economic events of the past decade or so and in charting a course toward greater stability in the future. We hope that this publication will increase the attention paid to McKinnon's innovative and provocative approach, particularly in official circles throughout the world.

The Institute for International Economics is a private nonprofit research institution for the study and discussion of international economic policy. Its purpose is to analyze important issues in that area, and to develop and communicate practical new approaches for dealing with them.

The Institute was created in November 1981 through a generous commitment of funds from the German Marshall Fund of the United States. Financial support has been received from other private foundations and corporations, including a grant from the United States–Japan Foundation for partial support of this study. The Institute is completely nonpartisan.

The Board of Directors bears overall responsibility for the Institute and gives general guidance and approval to its research program—including identification of topics that are likely to become important to international economic policymakers over the period of, generally, one to three years. The Director of the Institute, working closely with the staff and outside Advisory Committee, is responsible for the development of particular projects and makes the final decision to publish an individual study.

The Institute hopes that its studies and other activities will contribute to building a stronger foundation for international economic policy around the world. Comments as to how it can best do so are invited from readers of these publications.

C. FRED BERGSTEN  
Director

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# **1 Introduction: The Evolving World Dollar Standard**

Everybody understands that Western industrial economies have become more open to foreign trade in the last 35 years. International competition is increasingly pervasive—indeed sometimes overwhelming—in national markets for manufactured goods. Since 1948, the General Agreement on Tariffs and Trade (GATT) has, until recently, successfully lessened official interventions—tariffs, quotas, and subsidies—in foreign trade among industrial countries. To be sure, important exceptions abound, and the threat of backsliding on the GATT is all too real in today's unstable financial environment. Nevertheless, commercial rules governing international trade in minerals and most manufactures, and in some services, are substantially the same as those prevailing within individual industrial economies. (The GATT has been much less successful in promoting free trade in agricultural products, which were excluded from the agreement early on at the behest of the United States.)

In contrast to freer trade in goods, the freer flow of private portfolio capital has come about almost inadvertently. With memories of “hot” money flows from the 1920s and 1930s, the 1944 Bretton Woods Agreements envisioned tight exchange controls over private capital movements in the postwar economic order. Article VIII confined the obligation to achieve currency “convertibility” to current account transactions. Article VI specifically prohibited use of resources of the International Monetary Fund (IMF) to finance outflows of private capital. “While wartime planning for the postwar order envisaged an open multilateral trading system, there was no similar intention to restore an open international capital market” (Williamson 1983, p. 7).

Nevertheless, the unplanned evolution of the Eurocurrency market in the 1960s now enables both firms and governments to borrow (or lend) internationally, on a large scale, in a variety of national monies without regulatory restraint (Witteveen 1982). Except for the late 1960s and early 1970s, the New York capital market has been open to foreign borrowers and depositors.

By 1980, exchange controls and other restrictions on capital flows had also been virtually eliminated in the national capital markets of Germany, Britain, and Japan. Thus today's capital market integration parallels that prevailing in world trade in goods and services, whereas in the late 1940s national financial systems were segmented by exchange controls, and Eurocurrency transacting did not yet exist.

Throughout this great transformation, the US dollar has played a peculiarly important role—albeit a changing one. For interbank clearing of 90 percent to 99 percent of international payments, the dollar is the vehicle currency (Kenen 1983). If a Swedish bank wants to buy sterling with marks, it must first buy dollars with marks, and then sterling with dollars.

Aside from gold, which is not readily liquid, most working official reserves of foreign exchange are interest-bearing dollar assets. Since the Marshall Plan in the late 1940s allowed European countries to rebuild their depleted exchange reserves, governments in industrial countries hold mainly US Treasury bonds and bills—and continue to intervene, sometimes heavily, in the interbank market for their currency against dollars. Reflecting these continual interventions under fixed or floating exchange rates, table 1.1 shows the substantial fluctuations in the dollar exchange reserves of the industrial countries over the past twenty years. The substantial exception to this convention is the tendency of some European countries to hold one another's currencies or European Currency Units in the context of a regional exchange rate agreement: the European Monetary System (Bergsten and Williamson 1982).

International trade in primary commodities—such as oil or wheat—is typically invoiced in dollars. On the other hand, each industrial country tends to use its own currency to invoice exports of manufactures and finance trade, although exports to the United States are mainly invoiced in dollars.

In this asymmetrical system, the currencies of less developed countries (LDCs) are not used at all to invoice their foreign trade or capital market transactions. Central banks or treasuries in LDCs hold more of their liquid exchange reserves in Eurodollar deposits than do industrial countries, and now diversify somewhat into other “reserve” currencies—such as deutsche marks and yen. However, LDC governments are big dollar debtors at longer term—especially if government guarantees of private foreign indebtedness are consolidated with official debt. When private Japanese banks lend to Mexico, the loans are typically (although no longer exclusively) denominated in dollars.

**TABLE 1.1 Direct dollar liabilities of the United States to foreign central banks and governments (billion dollars, year-end stocks)**

<i>Year</i>	<i>Canada<sup>a</sup></i>	<i>Japan<sup>b</sup></i>	<i>Western Europe<sup>c</sup></i>	<i>Total</i>	<i>Annual percentage change</i>
1963	1.79	1.59	8.51	11.89	
1964	1.81	1.50	9.32	12.63	+ 6.2
1965	1.70	1.57	8.83	12.10	- 4.4
1966	1.33	1.47	7.77	10.57	- 14.5
1967	1.31	1.45	10.32	13.08	+ 23.7
1968	1.87	2.26	8.06	12.19	- 7.3
1969	1.62	2.61	7.07	11.30	- 7.9
1970	2.95	3.19	13.61	19.75	+ 74.8
1971	3.98	13.78	30.13	47.89	+ 142.0
1972	4.25	16.48	34.20	54.93	+ 14.7
1973	3.85	10.20	45.76	59.81	+ 8.9
1974	3.66	11.35	44.33	59.34	- 0.8
1975	3.13	10.63	45.70	59.46	+ 0.2
1976	3.41	13.88	45.88	63.17	+ 6.2
1977	2.33	20.13	70.75	93.21	+ 47.6
1978	2.49	28.90	93.09	124.48	+ 33.5
1979	1.90	16.36	85.60	103.86	- 19.9
1980	1.56	21.56	81.59	104.71	+ 0.8
1981	2.40	24.72	65.22	92.34	- 11.8
1982	2.08	19.17	60.72	81.97	- 11.2
1983, Q3	2.76	20.45	63.25	86.46	+ 5.5

*Source:* IMF, *International Financial Statistics*, 1982 Yearbook and February 1983; US Department of Commerce, *Survey of Current Business*, December 1983.

a. Line 5 aad IFS (United States). Data for 1982 and through third quarter 1983 are derived from line 57, in "US International Transactions, by Area," *Survey of Current Business*.

b. Because direct US liabilities to the Japanese government were not available, the virtually identical series on total Japanese reserves in foreign currency was used—line ldd IFS (Japan).

c. Line 5 abd IFS (United States). Data for 1982 and through third quarter 1983 are derived from line 57, in "US International Transactions, by Area," *Survey of Current Business*.

In his 1983 empirical study, "The Role of the Dollar as an International Currency," Peter B. Kenen summarizes the situation:

There was some decline in the use of the dollar in international trade shortly after the shift to more flexible exchange rates a decade ago, and I ascribe the decline to that shift, not to the weakness of the dollar in the foreign-exchange markets. There has been some significant decline in the use of the dollar as a reserve asset and thus some movement toward a multiple reserve-currency system. But the dollar is still the dominant currency in the international finance system, even in the reserve system narrowly defined. Paraphrasing Mark Twain's remark on hearing that a newspaper had published his obituary, reports of the death of the dollar are greatly exaggerated. (Kenen 1983, p.3)

Finally, the financial position of the United States remains asymmetrical with respect to other countries. Throughout both fixed and floating exchange rates, interventions by the American government in the foreign exchange markets were comparatively infrequent; its reserves of foreign currencies were, and are, negligible. And there is a certain benign logic to a system whereby the center country does *not* have targets for relative currency values that could conflict with the desired dollar exchange rates of a multitude of other governments (Mundell 1969).

Consequently, for descriptive convenience, I shall refer to the postwar monetary system as a "world dollar standard"—with apologies to readers who, somewhat justifiably, do not like its imperial connotations. When the high degree of American autonomy under the present world dollar standard is contrasted with the more cooperative and symmetrical "international standard" proposed in chapter 5, perhaps both labels will seem more apt.

Since the industrial economies abandoned their fixed dollar parities in the early 1970s, the world dollar standard has become less stable. Exchange rates have shown great volatility day-to-day or week-to-week, and a tendency toward misalignment for months or even years (Williamson 1983b). The profitability of investment and production decisions across countries, and within any one country, is now more difficult to calculate. Steady gains in productivity in tradable goods—characteristic of the 1950s and 1960s—have eroded.

Monetary instability has diminished popular support for the ideal of free trade. In 1982–83, for example, the overvalued dollar markedly increased protectionist sentiment in the United States. In particular, quantitative

restrictions (more than tariffs) are seen as protective devices to insulate domestic industries from the effects of currency misalignments. Quotas limiting the importation of Japanese automobiles, or of European steel products, tend to make American (dollar) prices in these industries invariant to subsequent exchange rate movements.

Using an exchange rate index plotted quarterly and trade-weighted against 17 trading partners, figure 1.1 shows major fluctuations of the US dollar since 1970: large depreciations in 1971–73 and 1977–78, and the great appreciation of 1981–83. Figure 1.2 shows the sharp fluctuations since 1975 in the exchange rates of Germany, the Netherlands, Japan, and the United Kingdom. The dollar exchange rates of the three European countries fluctuate much more than their “effective” (trade-weighted) exchange rate, which is dominated by official intervention to limit intra-European fluctuations. Japan, not being part of a regional payments agreement, displays large fluctuations in *both* its dollar and effective exchange rates. Neither figure 1.1 nor 1.2 shows the great short-run volatility that accompanied these large quarterly and annual swings in the “floating” dollar.

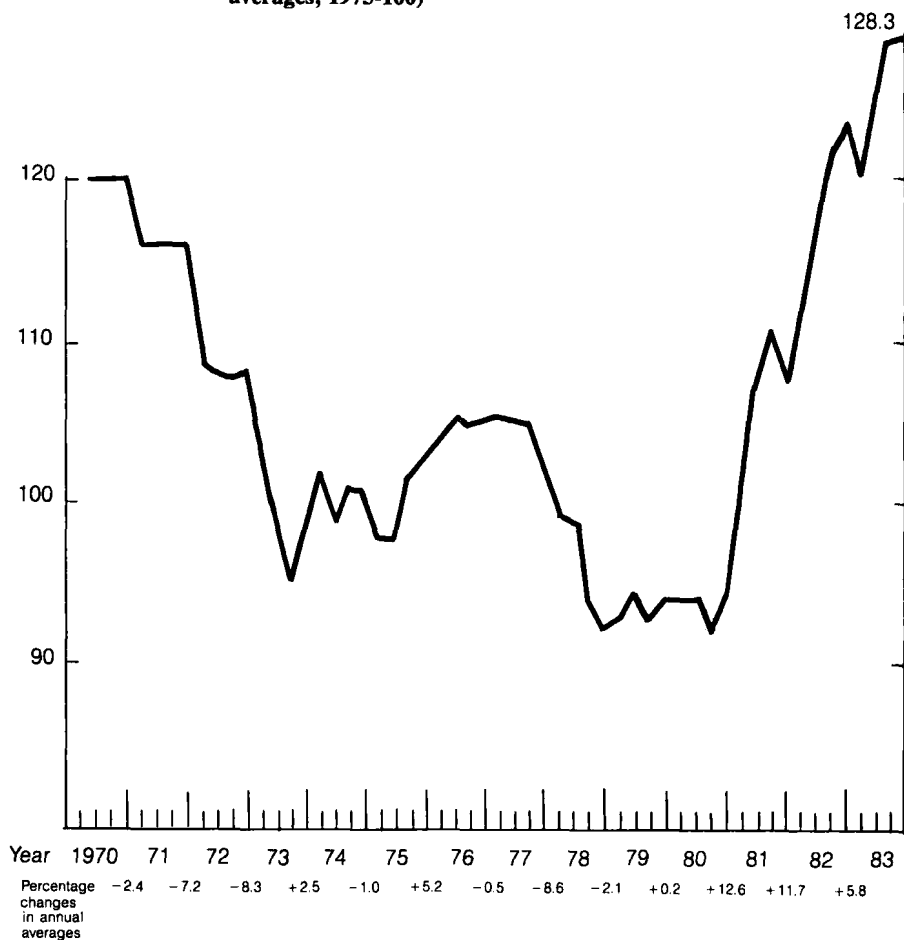
The world economy suffered major price inflations in 1973–74 and 1979–80, and a major deflation in 1982–83. Each of these episodes followed one of the sharp depreciations or appreciations of the US dollar shown in figure 1.1. That these fluctuations in the American and world price levels were mainly monetary in origin, and not primarily due to exogenous changes in the price of oil, is established empirically in chapter 4.

To understand better why monetary instability is inherent under floating exchange rates, consider first the nature of monetary coordination under the old regime.

## *The Fixed Rate Dollar Standard*

In the 1950s and 1960s, the American government maintained an official gold parity of \$35 per ounce through infrequent transactions with other central banks—mainly outside the open exchange market. However, the operational heart of the system of fixed exchange rates was the convention of having other central banks intervene in the open market for foreign exchange in order to keep their currencies within three-quarters of a percent of their dollar parities. To avoid intervention at cross purposes, the Federal Reserve System typically did not intervene in the foreign exchanges. Legal cover for this

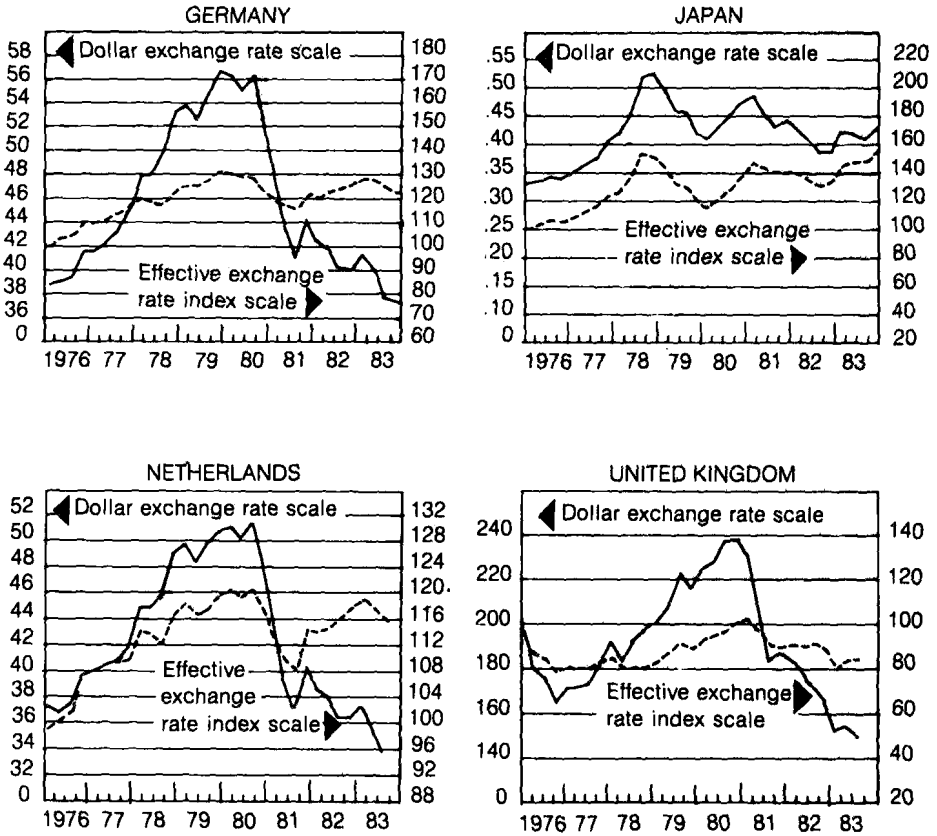
**FIGURE 1.1** Movements in the dollar exchange rate (plotted from quarterly averages, 1975-100)



Source: IMF, *International Financial Statistics*, various issues: line amx for the United States. Average trade-weighted value of the dollar measured against 17 currencies of the major industrial trading partners.

fixed rate dollar standard was provided by the Articles of Agreement of the International Monetary Fund.

Occasionally, the IMF sanctioned a discrete change in an official dollar

FIGURE 1.2 **Movements in exchange rates**

Source: Federal Reserve Bank of St. Louis, "International Economic Conditions," January 1984.

parity: for Britain in 1967, France in 1958 and 1959, and Germany in 1961. More often than not, however, industrial countries adjusted their internal financial policies to preserve the preexisting exchange rate. From 1950 to 1970, the Bank of Japan maintained its exchange rate at 360 yen to the dollar: monetary policy was eased when Japan's balance of payments tended toward surplus and tightened when deficits threatened.<sup>1</sup> Although the industrial

1. Countries that ran balance-of-payments surpluses vis-à-vis the United States were somewhat



countries were not then so highly integrated financially, monetary harmonization under the old fixed rate dollar standard was sufficient that:

- Changes in *real* (inflation adjusted) exchange rates were moderate: tradable goods prices—as measured by wholesale price indices—remained fairly well aligned across industrial countries.
- Major bouts of inflation or deflation on a worldwide scale were avoided: milder national business cycles were generally *not synchronized*.

An understanding of the restraints on American monetary policy during the 1950s and throughout most of the 1960s is, therefore, important. At first glance, the asymmetrical position of the United States gave it unique freedom of action: no obligation to enter the foreign exchange market directly to preserve some official parity, and the ability to finance American payments “deficits” by having foreign central banks acquire US Treasury bills or bonds. General de Gaulle called this America’s “exorbitant privilege.”

Was the gold convertibility by obligation a significant constraint on American monetary policy? Foreign governments’ infrequent conversions of Treasury securities into gold had no direct impact on the American money supply. Yet, visions of a continually dwindling American gold stock kept presidents Eisenhower, Kennedy, and even Johnson awake at night. This strengthened the conservative bias in American monetary policy toward stabilizing the domestic price level—and away from a more adventurous policy of targeting unemployment or real output in the mode of the then prevailing academic doctrine of macroeconomic management.

Whether or not the gold restraint was empirically important,<sup>2</sup> this more or less successful stabilization of the dollar prices of internationally tradable goods through the 1950s into the middle 1960s—see table 4.4 in chapter 4—

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less likely to adjust their internal monetary policies than those in deficit, (Michael 1971). The outstanding example was Germany, which allowed its dollar exchange reserves to accumulate continually in the 1950s and 1960s (at a fairly constant exchange rate) instead of increasing its domestic money supply in an offsetting fashion.

2. Because of the “Triffin Dilemma,” the dollar gold exchange standard cannot be reconstructed. Robert Triffin (1960) demonstrated that this system depended on having most of the world’s gold concentrated in one country, the United States after World War II. It also depended on having only modest outstanding dollar claims against the center country. As the world economy grew vis-à-vis the center country’s gold stock, Triffin showed that the dollar-gold convertibility commitment must break down sooner or later.