

**THE WORLD DOLLAR STANDARD AND  
ITS CRISIS-PRONE PERIPHERY:  
NEW RULES FOR THE GAME**



**Ronald I. McKinnon**  
Stanford University

January 08, 2003



**Indian Council for Research on  
International Economic Relations**

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## **Foreword**

Concern has been raised that while the dollar remains the single strongest money at the centre of the global financial system, dollar encroachment on domestic monetary domains can lead to instability in the fragile financial systems on the dollar's periphery, as for instance in some countries of Latin America. In a lecture on 'The World Dollar Standard and Its Crisis-prone Periphery: New Rules for the Game', Dr Ronald I. McKinnon, William D. Eberle Professor of International Economics at Stanford University and Senior Fellow at the Center for Research on Economic Development and Policy Reform at the Stanford Institute for Economic Policy Research (SIEPR), addressed this concern and dealt with monetary issues associated with the hegemony of the US dollar in international finance. Pointing out the need to have new rules for the dollar-standard game, he presented a set of rules to restructure and modify the present international monetary system.

The lecture was delivered at ICRIER on January 8, 2003, and is reproduced here for wider dissemination. I have no doubt that the insights and recommendations provided by Prof. McKinnon can help improve the working of the international monetary system.

**Arvind Virmani**  
Director & Chief Executive  
ICRIER

Let me say how delighted I am to be at ICRIER. I just returned from an all-day conference in Chandigarh yesterday and I am going on to Mumbai to the Reserve Bank of India at the end of the week. So this is a very nice opportunity actually to talk to people like you.

The topic is the World Dollar Standard. Everybody uses the word 'globalisation'. There are many books written on this subject, and everybody talks about it, but people are very uneasy about globalisation in most countries outside of the United States. People say, well, globalisation is just American imperial power in another guise. Part of the unease of course is military—the US is a superpower. But then other people get upset at the commercial influence of America's Starbucks coffee houses everywhere. French farmers try to burn down McDonald's hamburger stands because they don't like this intrusion. You also have people concerned with American pop culture, which can be very poor. However, I am not going to talk about any of these things.

What I want to talk about are monetary issues associated with the hegemony of the US dollar in international finance. The way the world money machine works is that there is a single strong money in the centre and it is used as a transaction currency in international exchange, spot and forward, as a reserve currency, as an intervention currency by governments, and as an invoice currency by importers and exporters. The dollar is considered the definitive money in the system. Then, on the periphery of the dollar standard, in Asia, in Latin America, and Africa, everybody has what I would call provisional money—their national monies.

Why provisional? If there is any disturbance—political or economic—say, in a Latin American country—everyone

flies out of the provisional domestic money, pesos, into the strong central money, i.e. dollars. So we essentially have a strong financial system in the middle—the US—and then fragile financial systems on the dollar's periphery. Because of this incredible imbalance or asymmetry in the world economy, the countries on the periphery are always vulnerable to attack. Unless the economy is shielded by capital controls, this ever-present possibility of a crisis and devaluation keeps finance on the periphery very short term. The shorter the term structure of finance, the more fragile is finance in the peripheral countries.

The US, the central country providing definitive money for the world economy, is almost like a world central bank. It has an unlimited line of credit with the rest of the world, denominated in its own currency, whereas debtor countries on the periphery have to worry because their debts are denominated in foreign exchange—usually dollars. They could be attacked, with their currencies crashing and their credit lines cut off. But the US, the biggest debtor of all, seems to have an indefinite credit line with the rest of the world.

Because of financial crises in different parts of the world, there is dispute in the US and elsewhere on how much the IMF or the US Treasury should step in and bail out countries like Argentina or Brazil that get into difficulty, or the East Asian countries in 1997–8, or India in 1991. There is a lot of debate. The hardliners, people like Allan Meltzer of Carnegie-Mellon University, will speak of the moral hazard from these bailouts. If countries get into trouble on the periphery, then the IMF and or the US Treasury come in and provide dollars. This, the hardliners allege, makes it more likely that peripheral countries will

get into trouble because they will become more cavalier in the way they treat their financial systems.

On the other hand, people like Ricardo Hausmann, of Harvard University, will say, well, because of the fragility on the periphery, sometimes in a crisis situation you should intervene very quickly to try and resolve it and not allow interest rates to rise to impossible levels. A characteristic of many of the fragile financial systems on the periphery is extremely high interest rates, as in Brazil at the present time. Everybody knows that Brazilian interest rates are not sustainable, but is there any way to bring these down to sustainable levels, or will Brazil go the way of Argentina?

The problem is that American hard-liners of this ‘no bailout’ schools don’t understand the reasons for the basic currency asymmetry in the world economy. They think that the central position of the US dollar just reflects the virtues of American capitalism. Because Americans have cooked up a superior kind of market economy, everyone is dying to buy dollar assets. Thus can Americans attract enormous amounts of capital from the rest of the world without difficulty. But other countries are less capable of managing their financial affairs satisfactorily.

This is a misunderstanding. The central position of the US in the world economy is an accident of history—pure serendipity. If it were not the United States, then it would have been some other country. It is not because the American financial system is inherently so much better or safer than that of other countries; it is because of the natural asymmetry in the world system.

Now let me try and explain what I mean. Suppose the world economy has ‘N’ national currencies, something like 150 at the present time. To finance the flow of goods and capital across borders, you cannot have bilateral trading in

each pair of currencies because it is too expensive. There is a terrific economy in picking just one currency as central money, as the vehicle currency in international exchange, and then you run all transactions through that single money. The number of foreign exchange markets you would need to have in the absence of a central money would be  ${}^N C_2$ . If  $N = 150$  countries, the combination of 150 markets taken 2 at a time gives 11,175 bilateral foreign exchange markets! But suppose everyone decides to use the dollar as the intermediary currency. Instead of having trade between the Swedish krona and Japanese yen if someone in Japan wants to buy a Volvo through a Japanese bank, the bank first uses yen to buy dollars and then dollars to buy krona. If everyone uses the dollar as the intermediary currency this way, the number of foreign exchange markets reduces to  $N - 1$ , i.e. 149. That is a huge economy of markets.

This economy is even more marked in forward

#### **Box 1: Economising on Foreign Exchange Trading**

Start with  $N$  currencies. How many active foreign exchange (FX) markets are there?

- The number of currency pairs is  ${}^N C_2 = N(N-1)/2$ . This is the number of foreign exchange (FX) markets if there is no central money.
- Now suppose one currency, the  $N^{\text{th}}$ , is chosen as international money. The number of active FX markets is reduced to just  $N-1$ .

*Example:* suppose the world has 150 different national monies. Then, it would have

- 11,175 FX markets in the absence of international money.
- 149 FX markets with international money, i.e. with a central vehicle currency.

exchange markets—30, 90, or 120 days in the future—because these markets are naturally much thinner than spot transacting. If everyone tried to trade bilaterally, matching buy and sell orders forward would be next to impossible; whereas running everything through the central money—the dollar—gives highly liquid and robust forward markets. Whence the natural asymmetry between the central clearing currency, the  $N^{\text{th}}$ , and the other  $N - 1$  national monies.

In the world economy, if the dollar had not somehow got started as the central money, the foreign exchange markets would essentially pick some other country's currency. The British pound sterling played this central clearing role in the nineteenth century. But it was not quite as strong as the dollar is now because there was a further, more fundamental, asset in the system—gold. Sterling was subject to runs into gold. Walter Bagehot wrote his famous book *Lombard Street*, describing how the Bank of England was supposed to behave in the face of a gold drain. Although sterling was the centre of the world capital market, the Bank of England did not have free rein to determine British monetary policy independently, as the US Federal Reserve Bank now does.

In the year 2003 in the world economy we have the dollar as the central money, but with no more fundamental asset. In this sense, the dollar standard is stronger than the sterling standard was. For this single facilitating world money, let us describe its monetary functions in textbook terms in the following table.

Once private foreign exchange markets become well developed in terms of this single vehicle currency—the dollar—then when governments intervene to stabilise exchange rates, they use the dollar as the intervention currency because it is more convenient to do so. Thus



governments hold exchange reserves mainly in dollars. India, now in mid 2003, has about US\$ 80 billion in official reserves. Of course, it makes it much easier for the US Treasury that you are holding this huge pile of US Treasury bonds! Korea is holding \$100 or \$125 billion or so, China \$300 billion, Japan \$500 billion, and so on.

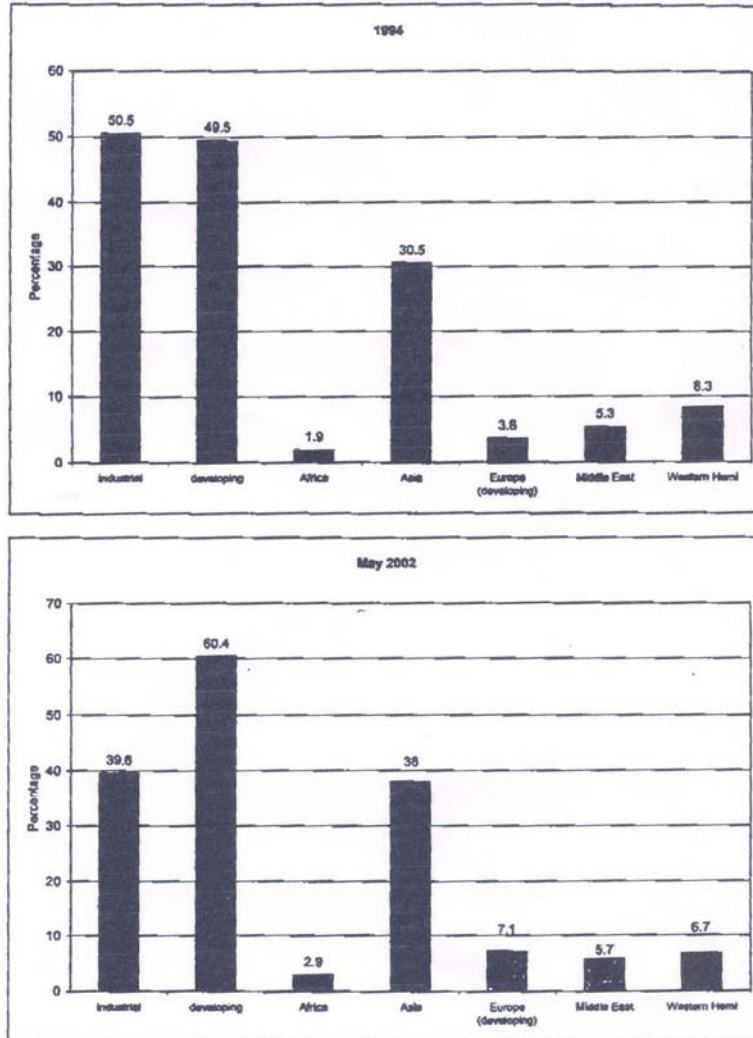
**Table 1: The US Dollar's Facilitating Role as International Money (1945 to 2003)**

	Private	Official
Medium of exchange	Vehicle	Intervention
Store of value	Banking	Reserves
Unit of account	Invoice	Peg
Standard of deferred payment	Private bonds	Sovereign bonds

If you think of a unit of account in international exchange, then the dollar is also the currency of invoice for exports and imports among countries outside of Europe.

As a standard of deferred payment, international capital markets are largely organised in terms of dollars. So when countries on the periphery go into debt internationally, they go into debt in somebody else's currency—dollars. This sets up the possibility of a currency attack. In contrast, the US—the biggest debtor among them all by a big margin with bigger external net debts as a proportion of its GNP than Brazil's—borrows in its own currency. Foreign central banks willingly build up their stocks of US Treasury bonds, and private foreigners want dollar claims on international banks and on the American economy! American banks

**Figure 1: Share of World Reserve Minus Gold**



don't see currency risk because this inflow of capital from the rest of the world is in the form of dollar bank deposits, and American banks make dollar loans without currency risk. So American households get a huge line of credit from the rest of the world—consumer credit really being financed by foreign capital inflows.

When we talk about the dollar as a vehicle currency in inter-bank transacting, we see that the US dollar is on 90 per cent or so of foreign exchange transactions—as shown in Table 2. In almost all transactions, the dollar is on one side or the other. Other currencies in the international system are more or less important, but much less so than the dollar.

**Table 2: Currencies Involved in Foreign Exchange Trading (per cent of global trading with each trade counting twice)**

<b>Currency</b>	<b>1998</b>	<b>2001</b>
Dollar	87.3	90.4
EMS currencies and Euro*	52.5	37.6
Yen	20.2	22.7
Pound	11.0	13.2
Swiss franc	7.1	6.1
Canadian and Australian dollar	6.7	8.7
All other currencies	15.2	21.3
<b>Memorandum:</b>		
<b>Total turnover in \$ billion</b>	<b>1430</b>	<b>1173</b>

Source: Bank for International Settlements, *Central Bank Survey of Foreign Exchange and Derivative Market Activity in April 2001: Preliminary Global Data* (9 October 2001). As each trade involves two currencies, each trade is counted twice, so percentages should add up to 200, but detail may not sum to total due to rounding.

\*EMS currencies include the ECU and Danish Krone.

**Table 3: Geographic Distribution of Foreign Exchange Trading (per cent of global trading)**

Country	1998	2001
United Kingdom	32.5	31.1
United States	17.9	15.7
Euro-zone countries	17.4	14.7
Germany	4.8	5.4
France	3.7	3.0
All other*	8.9	6.3
Japan	6.9	9.1
Singapore	7.1	6.2
Switzerland	4.2	4.4
Hong Kong	4.0	4.1
All other reporting countries	10.0	14.7

Source: Bank for International Settlements, *Central Bank Survey of Foreign Exchange and Derivative Market Activity in April 2001: Preliminary Global Data* (9 October 2001). Detail may not sum to total due to rounding.

\* Every country in this group experienced a fall in its share of global trading.

Perhaps counter-intuitively, Table 3 show that the dollar standard is not centred geographically on the US. Although the dollar is the predominant money in foreign currency trading, London has the biggest foreign exchange markets using the dollar as the clearing currency. The UK actually has the bigger proportion of foreign exchange trading. And then you have the offshore markets in Singapore and Hong Kong.

**Table 4: Net International Issues of Debt Instruments (per cent of global total)**

Currency or Nationality	1998	1999	2000	1 H 2001
By Currency of Issue				
Dollar	60.3	44.4	50.1	48.0
Euro-zone currencies and Euro*	33.0	47.7	37.8	45.7
Pound	8.4	7.1	8.4	5.8
All other currencies	-1.8	0.8	3.7	0.5
By Nationality of Issuer:				
United States	41.1	39.2	37.7	47.4
Euro-zone countries	31.4	41.3	45.0	40.8
United Kingdom	7.7	9.4	9.7	5.0
Other industrial countries	4.0	3.9	0.9	1.1
Developing countries and offshore centres	7.6	4.2	4.9	5.1
International Institutions	8.2	2.2	108	0.6
<b>Memorandum:</b>				
<b>Net issues in \$ billion</b>	<b>681</b>	<b>1230</b>	<b>1234</b>	<b>565</b>

*Source:* Bank for International Settlements, *International Banking and Financial Market Developments* (November 2000) and *BIS Quarterly Review* (September 2001). Detail may not sum to total because of rounding

\* Euro-zone currencies include ECU.

**Table 5: Cross-border Liabilities of Banks (per cent of global total identifiable by currency)**

Currency	1998	2000
Dollar	47.6	51.7
Euro-zone currencies and Euro	26.3	25.6
Yen	8.4	7.4
Pound	6.5	6.6
Swiss franc	3.2	2.7
Other	8.1	6.0
Memorandum:		
Total liabilities in \$ billion	8399	9307

*Source:* Bank for International Settlements, *BIS Quarterly Review* (March and September 2001). Detail may not sum to total because of rounding.

Table 6 gives the worldwide distribution of official exchange reserves. Before the advent of the Euro, in 1999, many economists were speculating that, well, the dollar has now got a rival and foreign central banks are going to start diversifying their portfolios into euros. Thus the dollar standard won't be as strong. In fact, there is no statistical evidence that this is true at all. There is a natural monopoly: in a given monetary domain, it is inefficient to use more than one money.

In the developing countries, Table 6 shows that about 70 per cent of their exchange reserves are in dollars. What you have to do is to take the unspecified reserves, reallocate the unspecified to the specified currencies, and find that about 70 per cent of the holdings of the developing countries are in US dollars. It used to be that the developing countries held some deutsche marks, a few francs, and pounds sterling. So the Euro is more or less held in the same balance as the old European national currencies were, but it is not really encroaching on the dollar-based system. This could change, but the dollar still predominates.

To show this dollar dominance in invoicing foreign trade, we pick Korea, just to give you an example. The Bank of Korea, on its website, has very valuable information on the invoicing of Korean imports and exports. Generally speaking, these data are very hard to come by. About 85 per cent of Korean exports are invoiced in dollars, even though quite a few go to Japan, so the yen is not all that important. Then if you look at the import side, 80 per cent are invoiced in dollars. Now the yen is a bit more important because there is a tendency for industrial countries to invoice some of their exports in their own currencies. Therefore, so many imports from Japan

are invoiced in yen. Nevertheless, it is overwhelmingly a dollar system.

Even if you look at Japan itself, which is the largest industrial country in the Asian region, it turns out that 52 per cent of Japanese exports to the world are dollar invoiced, with only 36 per cent invoiced in yen. The story is qualitatively the same for Asia—50 per cent of Japan's exports to Asia are in dollars, 48 per cent are in yen. But then if you look at Japanese imports from Asia, 74 per cent are in dollars and 25 per cent in yen. The only place the yen is used in Asia is in trade with Japan and then not very much.

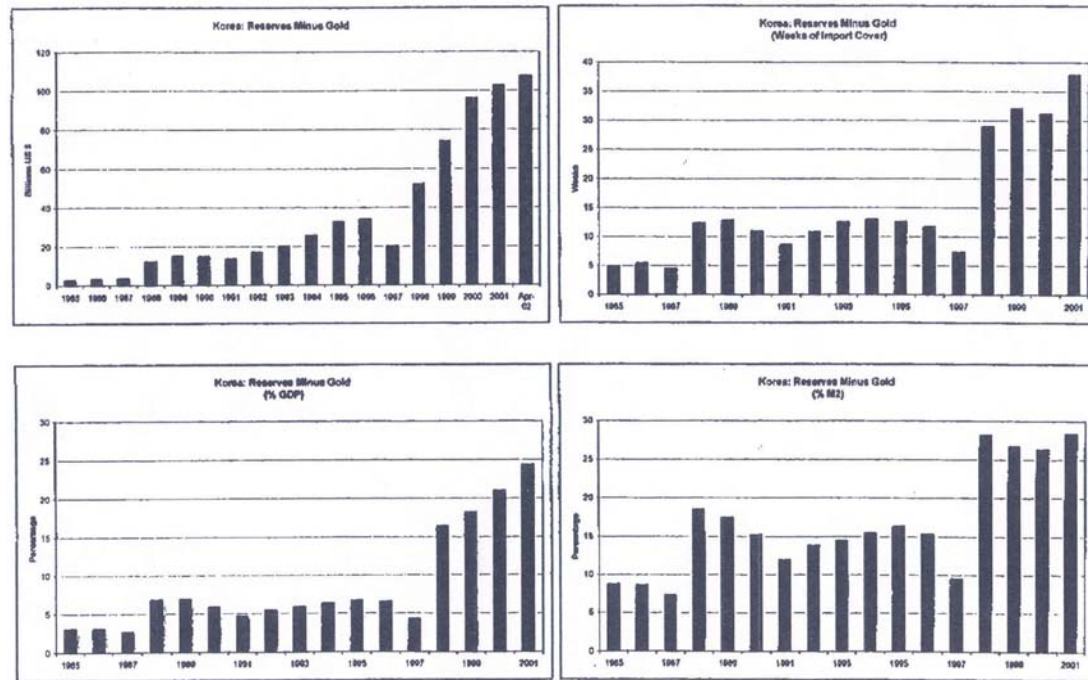
**Table 6: Currency Composition of Official Foreign-Exchange Reserves (per cent of global total)**

Country Group and Currency	1998	2000
Industrial Countries:		
Dollar	66.7	73.3
Euro-zone currencies and Euro*	16.8	10.2
Yen	6.6	6.5
Pound	2.2	2.0
Other and unspecified	7.6	7.8
Developing Countries:		
Dollar	65.3	64.3
Euro-zone currencies and Euro*	13.3	14.6
Yen	4.5	4.4
Pound	5.2	5.2
Other and unspecified	11.8	11.5

Source: International Monetary Fund, *Annual Report 2001*. Detail may not sum to total because of rounding.

\* Euro-zone currencies include the Deutschmark, French Franc, and Dutch Guilder, as well as ECU held by industrial countries.

Figure 2: Korea's Reserve Holdings





But, if you take any other pair of Asian countries, say India trading with Korea, virtually all trade is invoiced in dollars. So we have this very strong pattern in which private firms, of their own volition, use the dollar as the currency of choice in invoicing International trade.

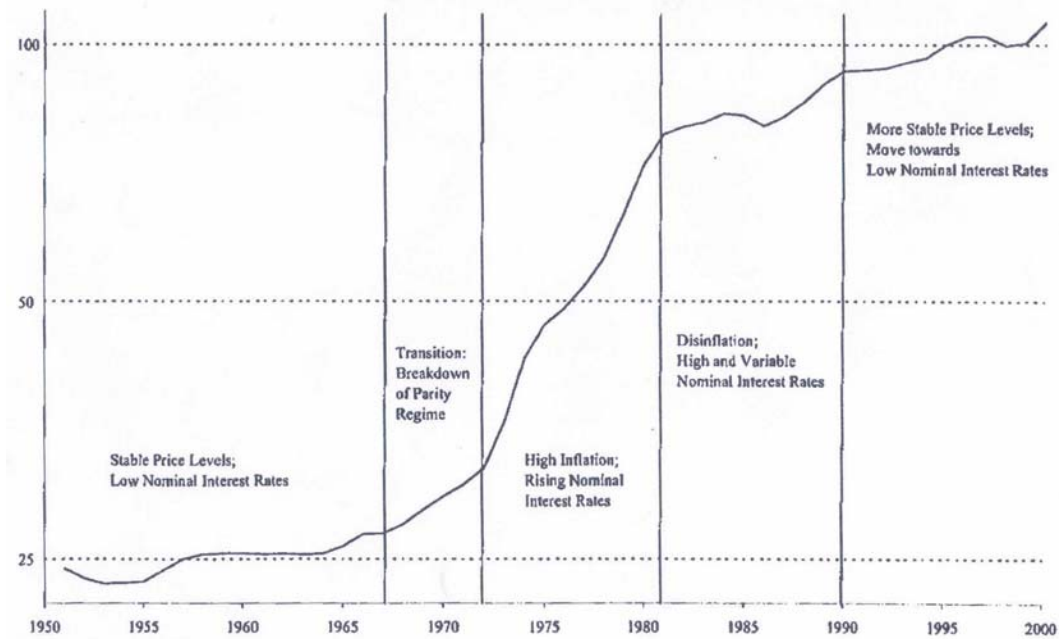
We have been concerned with the efficiencies of international exchange where only one money is used as the facilitating currency. But there is a second role, which is more of a macro role. Countries often peg to the dollar to anchor their own price levels. So we have my favourite diagram in Fig. 3.

Historically after World War II, when the dollar standard got started, the US was the only country with open capital markets. That is why the dollar became the official reserve currency. In this initial period, we have the dollar's value being quite stable, so in the old Bretton Woods parity system, a country fixed to the dollar can also stabilise its own price level quite successfully.

Then we go into the 1970s. There is a loss of control over the American price level, forced devaluation of the dollar by Nixon in 1971, and even by Jimmy Carter, I would say, in 1978. Anyway, this was a high-inflation period. This is an era that I would call the weak dollar standard, in the sense that other countries were not anxious to keep their exchange rates stable against the dollar. Other major industrial countries and many developing countries allowed their currencies to appreciate against the dollar; they did not see it as a good anchor for their own currencies. But the dollar remained the vehicle currency in transacting, though it was no longer the anchor for domestic price levels.

By the 1990s, however, the dollar had become very strong again. Over the last decade, the American price level

**Figure 3: The World's Nominal Anchor: US Wholesale Price (1951–2000)**



Source: IMF, *International Financial Statistics* (August 2001).

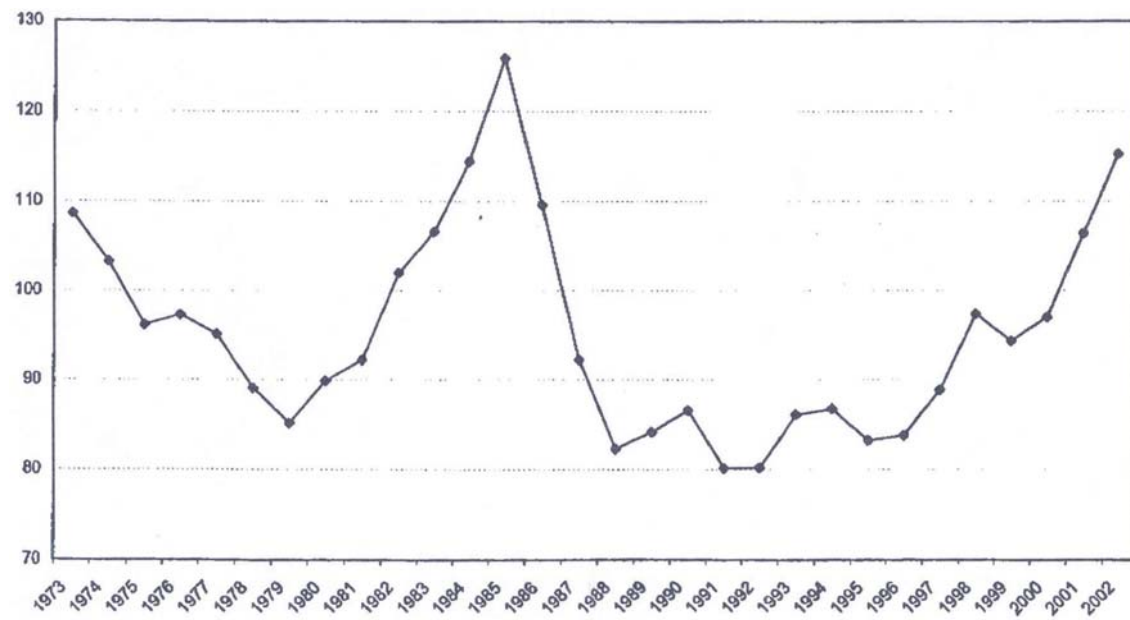
has become quite stable. Thus the anchoring role and the vehicle currency role come together. So we are in an era of a very strong dollar standard.

In East Asia before the crash, all the countries except Japan informally pegged to the dollar. Up to 1997, Singapore had a slowly appreciating currency, and Indonesia a smoothly depreciating currency. Nevertheless, on a day-to-day or week-to-week basis, these countries were stabilising their exchange rates. Then these currencies were attacked in 1997–8, resulting in deep devaluations, domestic bankruptcies, and an economic downturn.

People said, never again will we have a dollar standard like the one that existed before the crash, and that it was a big mistake to peg to the dollar. With a co-author, Gunther Schnabl, I have written a paper—which I am not going to bore you with—showing that the East Asian dollar standard is coming back together and looks more or less as it did before the crash. This is particularly true on a high-frequency basis. If you think of daily or weekly observations on the exchange rate, East Asian exchange rates are once again quite stable against the dollar. True, some drift on a monthly or quarterly basis more than they did before the crash. But with China fixed to the dollar at 8.3 yuan, Hong Kong at HK\$ 7.8, and Malaysia at 3.8 ringgits, the dollar standard is coming back.

At a conference at the Federal Reserve Bank in San Francisco in October, two good economists from the IMF, Nancy Marion and Joshua Eisenman, wrote a paper on the demand for foreign exchange reserves by Asian and other

**Figure 4: Inflation-adjusted Index of the Value of US Dollar against a Basket of Other Major Currencies**



Source: Federal Reserve

countries. They were trying to model how governments decide what their optimum reserve level is. They looked at the foreign rate of interest vs. the domestic rate of interest, the growth of the economy, and the degree of openness; then they fitted this model. The East Asian countries seemed to be outliers, but they are now huge outliers. You cannot make sense of this reserve holding in terms of an optimising model or when you just ask the question, What is the optimum inventory of reserves that I should be holding? These numbers are far above anything like that. Instead, countries have exchange rate objectives in terms of dollars, and the exchange reserve position is just residual.

So far I have talked fairly positively about the dollar standard, the great economy of markets in having a single international medium of exchange. If the American price level is stable, this is a very good nominal anchor for developing countries that peg to the dollar. The East Asians call, this 'soft' dollar pegging, because virtually no country, except Hong Kong, admits that it was or is pegged to the dollar.

To many countries, the negative side of the dollar standard is when the dollar begins to encroach on domestic monetary domains—beyond being just a facilitator of international exchange. In Latin America, you can get a big parallel circulation of dollars along with pesos, reals, and so on. Fortunately, in Asian countries this has not been the case—and Asian central banks should go out of their way to keep it from happening.

In Latin America, much of the initial impetus to have this parallel circulation of dollars comes from the fact that there are a lot of foreign workers in the US and elsewhere. Governments want them to send their money back to the domestic economy but the workers won't remit their money

**Box 2: Dollar Encroachment on National Monies in  
Domestic Uses: Emerging Markets on the Dollar  
Standard's Periphery**

- *Medium of Exchange:* Dollar banknotes or deposits circulate in parallel with domestic money in many Latin American, African, and FSU (former Soviet Union), countries but not generally in Asia.
- *Safe Haven (Store of Value):* In almost all emerging markets in normal times, domestic currency assets are held only at higher real interest rates than those on similar-term dollar assets: the existence of positive country—or currency-risk premia against the dollar.
- *Unit of Account:* Money wage and other short-term domestic contracts are directly or indirectly linked to the dollar exchange rate. Most common in emerging markets with a history of financial volatility—or ones in the throes of an attempted stabilisation programme. Uncommon in Asia.
- *Standard of Deferred Payment:* Foreign indebtedness, both short-term inter-bank borrowing and longer-term sovereign bond issues, is usually dollar denominated. But the currencies of other industrial economies can be used on occasion. Purely domestic-currency finance is generally short-term with no substantial longer-term market in private bonds—except for occasional dollar-linked issues.
- *Nominal Anchor for Domestic Price Level:* Outside of Europe, the national central bank informally gears domestic monetary policy towards stabilising its dollar exchange rate in some way or other. Purely domestic inflation targeting that ignores fluctuations in the country's dollar exchange rate is not feasible.

into a peso account. So the national government says it will allow you to open a dollar account in a domestic bank. That is the beginning of a slippery slope where dollar

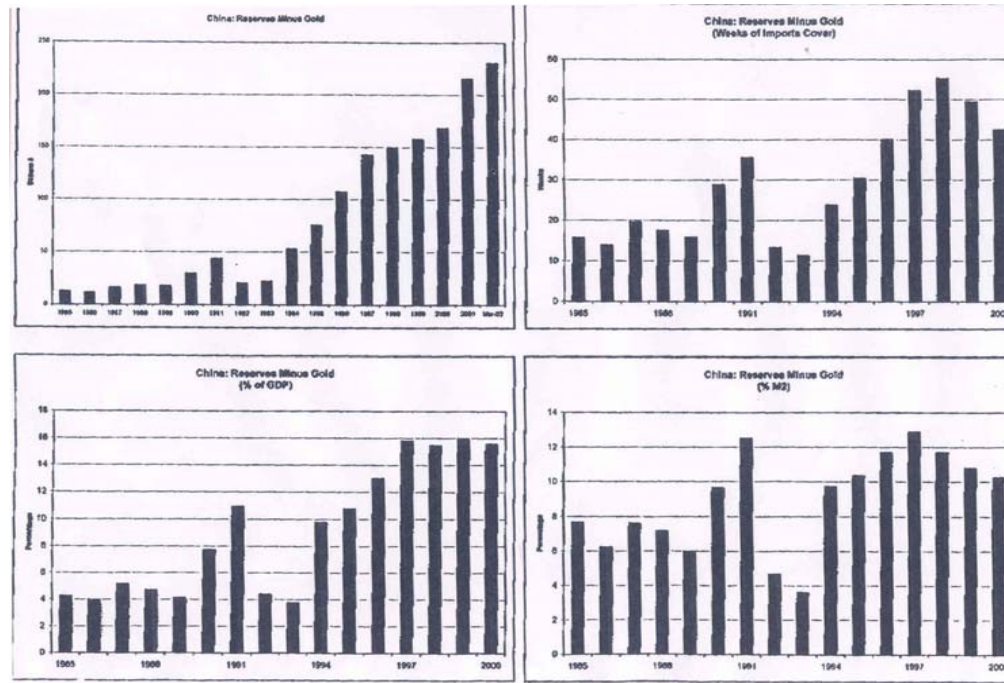
encroachment on the domestic economy eventually gets out of hand.

Latin America is extremely unstable financially, in part because countries have this parallel circulation and no possibility of capital controls. If there is any disturbance in the domestic economy, people just move into the parallel monies. Thus the demand for the monetary base of the domestic money is very unstable, besides becoming very small, resulting in high domestic interest rates.

India has been very successful in bringing interest rates down in the last year or two. But the usual character of the dollar standard is that countries on the periphery, who may be debtors, operate with a higher interest rate structure than at the centre. Then this is the risk premium that they have to pay, because of the potential for their currencies to come under attack. Thus, even if you are successful in keeping dollar bank notes out of your economy, you may still pay a penalty in the interest rate structure. The penalty that the Brazilians are paying at the moment is beyond belief; the rates vary but have been 20 per cent or above, purely unsustainable.

So we need new rules for the dollar-standard game. Let me first consider the position of the US itself in this system. The US has had a large current account deficit since the early 1980s. So America's net asset position, in the world economy has deteriorated: the US has a huge net debt of \$3 trillion or about 25 per cent of American GDP. For the

**Figure 6: China's Reserve Holdings**





last 20 years, learned commentators have been saying ‘This cannot last!’ In the 1980s, when President Reagan embarked on a big defence build-up without raising tax revenue, America developed a big trade deficit. At that time, the US was a net creditor in the world economy. But people looked at the huge American trade deficits in the mid-1980s and said, ‘This cannot go on. Something is going to happen to force it to end.’ Here we are, 20 years later, with the trade deficit even bigger and the net debt position gargantuan, and the learned statements about ‘This cannot go on’ continue. I just read it in the *Financial Times*, and I am going to read it to you. ‘Your country just cannot go indefinitely into debt. They have to repay their international borrowings.’ The *Financial Times* talks about the euro being an alternative, but I have shown you that the euro is really not encroaching on the dollar as the international reserve money. Although there is a serious problem with the current system, the *Financial Times* editorial should not cause you to lose any sleep over it. This could have been written in 1984 or 1985!

So this is the characteristic of the dollar standard—the centre country has a huge line of credit with the rest of the world, like any central bank issuing base money in its domestic economy would.

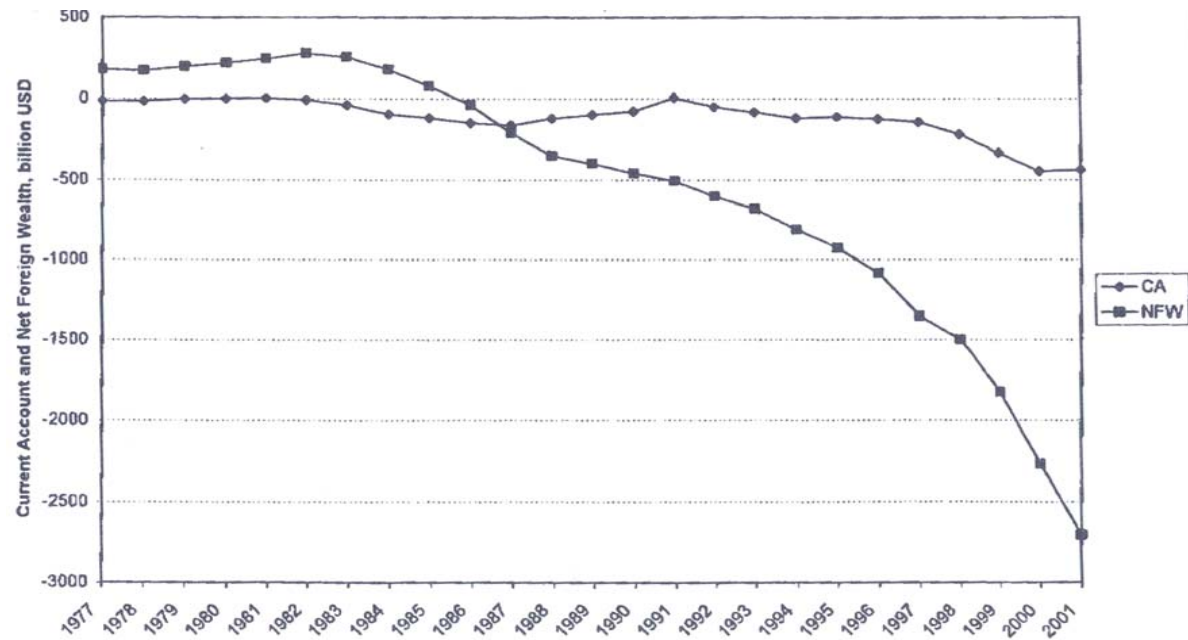
But there are alternative ways the US can satisfy the demand for liquidity by the rest of the world. One way is through the huge trade deficit, which is socially irresponsible because the US is taking out two-thirds of the available financial capital in international markets when developing countries have a much better use for it. These financial resources are all being sucked up by America because it is exploiting its central monetary position, which enables it to borrow without restraint.

However, you can have the dollar playing the central role, providing liquid assets to other countries, without the US running a trade deficit. The trade deficit is only one way of doing it.

In the 1950s and 1960s, under Bretton Woods, we had a strong form of the dollar standard with officially fixed dollar exchange rates. In the post-war period, industrial countries other than the United States had a huge pent-up demand for international liquidity, mainly in the form of US Treasury bonds and bank accounts. But the US at that time had a big current account surplus. You might ask how foreigners got their hands on these ever-increasing dollar reserves if there was no US current account deficit. The way the system worked then was through huge long-term capital outflows from the US—foreign direct investment, purchasing foreign bonds, Marshall Plan aid, and so on—that exceeded the current account surplus. This generated countervailing short-term capital inflows into the US that took the form of foreigners' building up their holdings of liquid dollar assets, which they wanted and needed.

In this post-war period, all industrial countries wanted to build up their liquid dollar assets except one—France! General De Gaulle thought that this central position of the dollar in the world system was 'an exorbitant privilege'. Any time France incidentally built up reserves of dollar assets, De Gaulle immediately went to the US Treasury and demanded gold in exchange, even though gold bore no interest. But all the others were quite happy to hold liquid dollar assets, with the US being a net lender to the rest of the world.

**Figure 7: The US Current Account and Net Foreign Wealth Position, 1997–2001**



Source: US Department of Commerce, *Survey of Current Business*.

To consider how our present international monetary system should be restructured or modified, I have a set of rules in Box 3—one set of rules for the developing countries on the periphery and another for the central country, the United States. These eight rules are hardly all encompassing. Yet they go some distance to resolve the philosophical impasse over the dangers of moral hazard in international rescue operations versus the need to take collective action to prevent a financial breakdown in one country from spreading to neighbouring ones.

I will review the rules proposed in Box 3 for the developing countries first. Currency asymmetry means that the kind of financial regulations that you need on the periphery may be much more stringent than what you need for banks in the US, or even in other industrialised countries. In 1989, the first Basel Accord tried to get all countries collectively to raise their capital requirements on banks. An 8 per cent risk-adjusted capital requirement was negotiated, but the only risk considered was default risk. Of course, the big risk that developing countries face is foreign exchange risk, currency risk. That is not in the Basel Accord in any substantial way, in part because it is negotiated with the centre countries. Thus Rule 1 suggests more stringent regulations governing foreign exchange exposure by banks in developing countries.

The Basel Accord also fails to account for maturity mismatches—where banks lend long and borrow short. There is no real sanction against that in the Basel Accord. Rule 1 recognises that the whole structure of bank regulation on the periphery may have to be more stringent and can go well beyond anything that you are going to get out of these international agreements.

### **Box 3: New Rules for the Dollar Standard Game**

#### *Developing Countries*

- Rule 1.** Recognise that the greater fragility of financial systems on the periphery requires prudential financial regulations more stringent than those appropriate within the industrial economies. To supplement domestic regulatory restraints on foreign exchange exposure by banks, capital controls may be needed.
- Rule 2.** Recognise that ‘soft’ pegging to the dollar helps reduce risk in peripheral countries whose domestic financial markets are incomplete—and becomes absolutely necessary in the presence of capital controls or severe limits on net foreign exchange exposure by banks. Desist from advising them to float their exchange rates against the world’s dominant money, and against their neighbours.
- Rule 3.** Aim for mutual exchange rate stability within natural economic regions such as South America or East Asia. Lend collectively through regional stabilisation funds as well as to individual distressed economies. Using the dollar as the anchor currency, set long-term exchange-rate objectives for the group to limit contagion from beggar-thy-neighbour devaluations.
- Rule 4.** Restrict short-term private borrowing by countries under IMF or World Bank programmes. Private and sovereign debt contracts must provide for the deferral of repayment should that country be declared in crisis.

#### *United States*

- Rule 5.** Conduct an independent monetary policy to limit inflation and stabilise the purchasing power of the dollar. Provide a stable nominal anchor for the price levels of developing countries.
- Rule 6.** Supplement the resources of the IMF in major crises and, if necessary, act as lender of last resort—subject to the conditionality laid out in Rules 1–4.
- Rule 7.** In non-crisis periods, remain passive in the foreign exchanges without exchange rate targets. Allow foreigners to transact freely in dollars. No capital controls for the centre country.
- Rule 8.** Do not force developing countries to open their financial markets—and cease pushing the entry of American banks and other financial institutions into their domestic economies.

Now consider Rule 2. Because we have one central currency, it is in the interest of any peripheral country to try to keep its exchange rate fairly stable against the dollar. (The exception is the small countries of Eastern Europe, which naturally key on the euro.) One reason for this is that you have incomplete financial markets in the peripheral countries. Often there is no long-term bond market—India is actually better than most others are—but they also lack well-developed forward markets in foreign exchange. Forward markets are hard to develop, particularly for net dollar debtors. Most governments recognise this and try to keep their dollar exchange rates fairly stable to provide an informal forward hedge. Because of the huge flow of short-term dollar payments coming due, it is too risky to let the exchange rate move randomly.

Also on the periphery, if you have banks with bad loan positions and weak balance sheets, then capital controls in some form may prevent banks from gambling by overborrowing internationally. Capital controls can be a form of prudential bank regulation for containing moral hazard on the periphery, although they are unacceptable at the centre. But once you impose capital controls, financial agents such as banks in your country are not able to take open positions in foreign exchange. If you restrain banks from taking open positions in foreign exchange—and there may be very good reasons why you want to restrain them—then the natural corollary is that the government must step in and make the foreign exchange market. It must also take responsibility for keeping the exchange rate steady.

When the IMF was formed in 1944–5, it was largely in response to a series of destabilising devaluations of the major currencies in the 1930s, what we call ‘beggar thy

neighbour' devaluations. After Britain went back on the gold standard in 1925 at its traditional mint parity, the next year there was a devaluation of the French franc. The undervalued franc then drained gold from Britain, which held its exchange rate on as long as it could—but under deflationary pressure. Britain was depressed throughout the 1920s. When Britain was forced off the gold standard in 1931, it devalued sharply. But this undervaluation of sterling made the position of the US extremely difficult: the US was losing gold in the early 1930s and was raising interest rates to stop the gold drain. In 1933, the US devalued quite sharply which then worsened the position of Germany and other Continental economies. Finally, by 1936, France, which had started the 'beggar thy neighbour' devaluations, found its exchange rate overvalued and had to devalue again—but not before deflationary cuts in domestic expenditures.

Nowhere in international affairs do you have bigger spillover effects from one country to another than when neighbours have big exchange rate changes. The initial impetus to form the IMF in 1945 was to prevent 'beggar thy neighbour' devaluations from happening again. And initially in the 1950s and 1960s, the IMF's parity regime was quite successful.

By 1971, however, the system of mutually agreed-on exchange rate parities was abandoned. Now, the IMF advises countries to float their exchange rates. But Rule 3 in Box 3 suggests that countries closely connected in trade—as in East Asia—should collectively agree on mutual exchange stabilisation to prevent contagion as in the 1997–8 crisis.

Latin America is almost beyond redemption. But it has the same sort of problems. No one country can stabilise

anything because neighbours suddenly devalue. Argentina looked as if it was OK in the early 1990s with its currency board. But then came major depreciations by Brazil and Uruguay—and Australia too because it has a somewhat similar economy to Argentina's. Chile is the unsung villain in Latin America—the peso gradually depreciated from 500 to the dollar in mid-1999 to 700 in mid-2001. Then Argentina crashed at the end of 2001. So 'beggar thy neighbour' devaluations are still with us.

I agree with my IMF colleagues that there should be some sort of an automatic mechanism for suspending debts repayments in a major crisis. These provisions in debt contracts are sometimes called 'collective action clauses', as per Rule 4 in Box 3. Then when a country is declared in crisis, you simply lengthen the term structure of their debt. I would include collective action clauses in sovereign borrowing as well as in private borrowing. This then makes it less likely for hot money—private money—to flow into that country to begin with.

So far I have looked only at rules for the developing countries, and now let me consider rules for the US. What should be the behaviour of the central country? Well, since it is the anchor for many of the other monetary policies, it is quite fine for the US to establish an independent monetary policy, as per Rule 5. So just aiming to stabilise the domestic purchasing power of the dollar is appropriate. The US Federal Reserve Bank should not worry about crises in other parts of the world, but be the independent anchor to which other countries adjust. In the 1950s and 1960s, that was pretty much the way the Federal Reserve Bank behaved. It had the only independent monetary policy in the system, and the others all just pegged to this



central money and adjusted their national monetary policies accordingly.

Now in the 1990s and into the new millennium, the situation is similar in many respects but without official exchange parities. The US sets its own monetary policy, and everyone else adjusts to it, which I don't object to. I would say it simply reflects the inherent asymmetry where one currency is the natural anchor for the others.

Once you accept this asymmetry argument, this means that de facto the US is the natural lender of last resort in major crises, as per Rule 6. It can create the definitive money in the world system. The IMF is the lender of first resort, but it has a limited amount of national currencies to lend out in crises. But the US is pretty unlimited as a lender of last resort. In the Mexican crisis of 1994–5, the US Treasury came through with a huge amount to bail the Mexicans out. I think that was correct and that was a quite successful bailout.

If you are from a different planet and people tell you that you have got these international organisations like the World Bank, which lends for development, and the IMF, which is the crisis manager, this seems very rational. But then if you look at what happens in major crises such as in East Asia, when an IMF mission goes out to Indonesia, there will be someone from the US Treasury on the same aircraft also going to Indonesia—or to Turkey or Brazil. My colleague John Taylor, who is now Deputy Assistant Secretary for International Affairs in the US Treasury, flies to trouble spots all over the world, and that is just part and parcel of the dollar's central role.

In non-crisis times, the US should remain pretty passive, as per Rule 7. Let foreigners hold dollar assets and do not try and freeze their accounts. In the Cold War, the

US was always trying to freeze foreign dollar accounts—Iranian, Cuban, Soviet—but that tends to undermine the system. The US should let foreigners decide what exchange rate they want against the dollar, and then remain passive and not try to set an exchange rate for the dollar. This is what I mean by passivity under Rule 7. Let foreigners impose capital controls if they are on the periphery, like India or China. This does not harm the system.

In contrast, if the central country in the world system, the US, imposes capital controls to inhibit transacting, the whole system collapses because everything is based on the dollar. Capital controls are a big no–no for the central country and maybe even for the other industrial countries. But on the periphery, capital controls are fine and may in some circumstances be a good idea for making the system work more smoothly.

One unfortunate aspect of American international policy has been to allow Wall Street to dominate the US Treasury. So investment banks always try to get the US government to force open the financial markets of other countries. This has led to a premature elimination of capital controls and more fragility in the peripheral countries. The most definite demonstration of this pressure from Wall Street would be China's application to the WTO. China was admitted to the WTO more than two years ago, but before the Americans would agree for China to join the WTO, the Chinese had to agree to a big opening of its financial markets to allow foreign banks to come in and accept RMB deposits and make RMB loans together with having freedom of action in the foreign exchanges. This would undermine China's capital controls.

Moreover, Chinese domestic banks have very big problems: they are very much encumbered with bad loan positions. Thus, allowing unencumbered foreign and new domestic banks to come into existence and compete horizontally with Chinese banks would be disastrous. Rule 8 is designed to prevent the American government from abusing its central position in being an agent of Wall Street and trying to get these countries to open their domestic financial systems prematurely.

If I had a Rule 9 (not presently in Box 3), what would it be? We need a restraint on the US current account deficit, which is harming the world economy by soaking up so much capital that would otherwise go to poorer countries. India is now in the strange position of actually running a current account surplus and thus lending net to the rest of the world—mainly to the United States through its accumulation of exchange reserves in the form of US Treasury bonds. Clearly, in a better ordered international financial system, India, with its low per capita income, should be a net absorber of foreign capital.

But it is very difficult to get the US to take action to reduce or eliminate its current account deficit. It could run with a fiscal surplus rather than fiscal deficit. Another way would be to give much bigger incentives to American households to try to build up private savings in the US. With an increase in America's net national saving, the consequent reduction in the US current account deficit would, in the long run, make the world economy much healthier.

Unfortunately, because of the international monetary asymmetry, there is no incentive beyond moral suasion for the American government to raise its national saving rate and behave more responsibly. Market constraints on

America borrowing from the rest of the world are just too soft—almost non-existent. Because of its long line of credit from the rest of the world, the US is free to fight wars, fund its domestic social programmes, and cut taxes virtually without restraint.

## About the Author

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