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Globalization, Euro and the World Monetary System

Can a Globalized Economy Function in the Long Run Without a Global Currency?

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Table of contents

Summary and recommendations p. 5

The illusion of stability p. 10

The Louvre accord: a one-shot success p. 10
The shortcomings of current cooperation p. 11

The euro enigma p. 13

The euro: an achievement and a challenge p. 13
Will the euro be a strong or a weak currency? p. 15
The virtues of an attractive euro p. 17
Asian uncertainties p. 18

The need for order p. 20

Apparent divergences of interests p. 20
A necessary complement to globalization p. 21
A risk of increasingly costly exchange-rate crises p. 23
The misleading facility of the status quo p. 26

Dreams and realities p. 28

A strengthening of multilateral macroeconomic surveillance p. 29
A controlled liberalization of capital movements p. 30
A greater involvement of the private sector p. 32
The case for a “target zone” agreement p. 35
A long-term goal: a world currency p. 39

An historic responsibility of the G7 p. 41

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Summary and Recommendations

Currency fluctuations, whether good or bad, are a fact of life that cannot be eliminated. Even in the days of the gold standard, currencies could be devalued and were subject to swings determined by their relative quality. The existence of fluctuations should not, in itself, be the subject of concern; rather, it is a matter of fact that (1) these movements are disorderly, (2) all too often–as with the yen and dollar in 1995-96–they are justified neither by the quality of the currencies, nor by business-cycle timing differences, nor by credible prospects of divergence in economic, fiscal or monetary policies, and (3) they are liable to induce persistent misalignments in the currency markets.

It is vitally necessary, therefore, to set up a framework for currency fluctuations, so that currencies will no longer exert a disruptive effect on trade and growth. The measures needed to improve the organization of the international monetary system can be summed up in the following five proposals:

• *The G7 should reform its own operating procedures* in order to achieve greater efficiency in the type of actions required. It must no longer be paralyzed by conflicts of interest in the short run, notably between its governments and central banks. It must recapture the initiative and assume its full responsibilities in guiding the international monetary and financial system and in crisis management. The G7 should also force itself to define a more coherent doctrine for the use of the IMF.

• *The IMF should become the guarantor of the quality of its members' currencies*. To do so, it must incite its members more forcefully than in the past to abide by strict prudential rules and to submit to multilateral macroeconomic supervision exercises. When concrete risks of a national or international liquidity crisis develop, the Fund should also make sure that (1) the role of lender of last resort is effectively per-

formed at the global level and (2) private creditors are involved in crisis management at the earliest possible stage.

• *The creation of target zones would certainly be the best way to ensure orderly currency fluctuations*. Despite the lack of unanimous support for the idea, there hardly exists a credible long-term alternative. In the short run, however, an arrangement involving mandatory concerted-action mechanisms–triggered by the crossing of preset limits–would have the practical advantage of being rapidly negotiable among the G7. Initially flexible and relatively non-binding, this monetary cooperation should become more ambitious as economic policies converge and mutual confidence deepens–the ultimate aim being to arrive at a target-zone system.

• *The European Central Bank and the European governments must commit themselves to a solid–that is, stable–euro*, because the euro must at all costs be attractive in order to win acceptance as an international reserve currency. This is the prerequisite for its success in Europe; it is also the only way to set in motion, from the outset, a virtuous circle that will lead the United States to prefer–out of necessity if not conviction–a long-term cooperation strategy. For this purpose, the euro needs to rely on a balanced macroeconomic policy and on the implementation of the structural reforms required to achieve robust, long-term, job-creating growth in Europe.

• *The prospect of a "global currency"* is, in the longer run, the logical outcome of this new international monetary and financial architecture, whose main concern will be to ensure that globalization benefits all. Initially the global currency could take the form of a currency basket based on more objective data than the present Special Drawing Rights. Like the single European currency in its day, the global currency requires a strong political commitment.

Globalization, Euro and the World Monetary System

Ever since the collapse of the Bretton Woods architecture, the world monetary system has been torn between two conflicting forces. The more powerful of the two is the concept of flexible exchange rates, which derives its legitimacy from the ideological climate of economic liberalism. The other, somewhat weaker, force originates in the belief that total exchange-rate flexibility is harmful to economic growth and free trade. It has prompted the many empirical attempts to stabilize the system and–most importantly–it has led to the establishment of a regional single currency for Europe: the euro. The yet unsettled debate between these rival concepts has acquired a new intensity. The quickening pace of globalization gives even greater urgency to our initial question: can a globalized economy function in the long run without a global currency? Implicit in this query is a crucial choice between two alternatives: will the dynamics of globalization lead to the establishment of a world monetary system, or will monetary fragmentation and the resulting financial instability eventually trigger a reversal of globalization? This debate seems academic during quiet spells–but flares up at the slightest tremor. The truth is that monetary calm is an illusion: there is always, somewhere, an imbalance that needs clearing, with, in the background, the risk of destabilization of the entire global financial system. The crisis in the emerging economies and transition economies–with its contagion effects–provides a sobering reminder.

The world economy has undergone radical change with the abandonment of the dollar's convertibility to gold in 1971, the adoption of floating exchange rates in 1973 (ratified in 1976 by the Jamaica Agreement), and the progressive liberalization of capital movements. The result has been a greater volatility of exchange rates in general–especially for the U.S. dollar–as well as of long-term interest rates. Monetary authorities and governments failed to avoid a rise in world inflation in the 1970s following the first oil shock. Central banks and

governments have sought to restrain currency fluctuations through direct market intervention or by attempts to coordinate macroeconomic policies.

The London summit of 1977 and the Bonn summit of 1978 were the most ambitious attempts at international economic-policy coordination. But these efforts failed because of the second oil shock and the political changes in the United States and Europe. The Plaza Accords of 1985 and the Louvre accord of 1987 marked a second attempt to coordinate monetary policies. They were unquestionably successful in reducing the dollar's exchange rate to a more balanced level and in curbing its subsequent fluctuations. But the agreements failed to find the institutional embodiment that some of their architects had envisaged. The accords eventually succumbed to the economic shocks of the late 1980s and early 1990s, as well as to the divergence of interests that emerged on these occasions within the Group of Seven (G7). In the end, the most far-reaching attempts to coordinate monetary policies and to institute "managed" currency floats occurred at the regional level in Europe. The momentum for these efforts came from the extreme openness of the European economies.

A quarter-century after the collapse of the Bretton Woods system and the creation of the European currency "snake", the success of Europe's regional monetary cooperation, in the context of the European Monetary System (EMS) introduced in 1979, has triggered a new, radical change in the international monetary system: the advent of European monetary union as of January 1st, 1999. But the adoption of the euro poses a new question: will the new currency be a factor of monetary stability or instability? The world exchange-rate system will henceforth revolve around two benchmark currencies: the dollar and the euro, to which one may add the yen. Will this simpler playing-field automatically bring rationalization? There is an even more basic underlying choice:

- either the euro is perceived as an artificial, fragile political construct–in which case it is not a first step toward the creation of a "global currency" in the very distant future;

• or the euro is seen as the result–hastened by Europe's political resolve–of the creation of the single market; in this case, it signals a very gradual process that could be reproduced, with suitable modifications, in a globalized economy.

International monetary cooperation issues have become increasingly crucial with the deepening of economic globalization. Globalization has made considerable progress, going beyond the level achieved on the eve of World War I, before the wave of nationalism and protectionism that ensued. Trade has been liberalized through multilateral agreements such as GATT and, more recently, the Marrakesh accords, as well as regional pacts such as the single European market and NAFTA. This process has made international trade a powerful economic force over the past two decades, stimulating economies big and small. Economic agents too have become more global, to the point that some conduct most of their business outside their home countries. This is especially true of many multinationals headquartered in Europe, the U.S., or Japan. But the most spectacular advance of globalization has occurred in the financial sphere, through the information-technology revolution and the liberalization of capital flows.

Despite economic and financial globalization, the world is still split into a number of currency zones, each of them tied–to varying degrees–to reference currencies such as the U.S. dollar, the Deutsche mark, and even the Japanese yen. Economists have traditionally held the view that the multiplicity of currencies is not an obstacle to globalization. Quite to the contrary, they regard exchange rates as the most natural adjustment mechanism possible. But monetary disorders have driven governments to an empirical search for other solutions to the problems raised by the global economy's monetary segmentation.

The prime forums for this global effort at international monetary cooperation have been the International Monetary Fund (IMF) and, even more so, the Group of Seven (G7). The effort, however, has been largely sporadic, with no noteworthy successes to its credit since the Plaza Accords of 1985 and the Louvre accord of 1987. Two factors have led governments and central banks to neglect international cooperation: (1) the priority assigned to short-term goals, often domestic;

(2) economic conflicts of interest between countries. Do these factors explain the severe monetary and financial disorders of the 1990s? Currency crises, concomitant financial crises, and long-term exchange-rate misalignments have burdened the world with economic, political, and social adjustment costs that have undermined growth and employment[1].

This paper argues in the first section that current international monetary cooperation only delivers an illusion of stability. The second section discusses the implications of the euro for the international monetary system and assesses the uncertainties that remain. The third section explains why a globalized economy needs a minimum level of monetary and financial stability. The fourth section discusses the conditions for such minimum stability. The concluding section sets out the responsibilities of major industrial countries and of the G7.

■ The illusion of stability

It is highly regrettable that the 1987 Louvre accord, despite its indisputable success, did not lead to the kind of institutional build-up that its promoters had in mind. Instead, its demise gave rise to strictly informal cooperation, clearly insufficient to prevent a deepening of monetary and financial disequilibria in the world.

The Louvre accord: a one-shot success

The late 1970s and the 1980s saw a revival of interest in international monetary and financial cooperation. The latter culminated in the Louvre accord, which provided a framework for controlling and smoothing the movements of the dollar and the other leading international currencies until the late 1980s. The agreement kept the global economy on

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1. In its annual *RAMSES* report (Ifri (1999), *RAMSES 2000. L'entrée dans le 21e siècle*, Paris, Dunod), the French Institute of International Relations addresses the challenges of globalization and emphasizes the merits and stakes of international economic and financial cooperation. See notably the chapter by Pierre Jacquet, "Gouverner l'économie mondiale".

a more orderly course. The successes of international cooperation in this period include notably the following:

• the joint interventions in the currency markets in 1987 in response to the excessive slides of the dollar;

• the joint easing of interest rates throughout the world after the 1987 stock-market crisis;

• the IMF interventions in the developing-country debt crisis of the 1980s, followed by the 1989 Brady plan.

While the 1980s were marked by institutional international cooperation, the 1990s witnessed a gradual convergence of economic policies–and fundamentals–across the world. The central banks of the main OECD countries have achieved independence from their governments and have adopted convergent inflation targets of 2% or less. The U.S., Europe, and Japan have progressively implemented programs to contain fiscal spending and deficits: in the medium term, this effort should restore some leeway for cyclical fine-tuning by governments. Microeconomic policies have usually moved toward deregulation and greater freedom for market forces. This economic-policy convergence has been driven by the recognition that accommodative monetary and fiscal policies bring relatively little improvement in growth and jobs over the long run. As regards specifically fiscal policy, the convergence is also due to real interest-rate levels: in structural terms, these have exceeded economic growth since the early 1980s, creating the risk of explosive debt spirals in countries that have been unable to curb their public spending.

The shortcomings of current cooperation

One hard fact stands out: since the early 1990s, the bilateral exchange-rate fluctuations of most currencies have remained very wide. They even substantially increased after the EMS 1993 crisis. And it is not because these larger bilateral swings have sometimes canceled one another out for certain currencies such as the U.S. dollar or Deutsche mark that we should minimize their negative economic consequences, particularly for the emerging countries. In fact, they have entailed heavy adjustment costs for all the economies in their efforts to reshape

their industrial bases and redirect their trade flows. The heightened instability of exchange rates cannot, of course, be blamed solely on poor exchange-rate management. It is also due to the persistence of unbalanced macroeconomic policies in some countries and the resulting instability of expectations in the financial markets.

More basically, the informal monetary cooperation now prevailing has not averted the major accidents we have seen since the early 1990s. The truth is that coordinated international actions have barely addressed the current-account imbalances (notably of Japan and the U.S.), competitive devaluations, and the inappropriate macroeconomic policies implemented by some countries. By contrast, the progress attributable to trade globalization–in particular within the framework of the Marrakesh agreements–is under constant threat from the proliferation of non-tariff trade barriers and the resurgence of trade disputes. Moreover, international financial cooperation has always occurred at a very late stage, after the crises have erupted. This was the case for developing-country debt in the 1980s, the dollar's fall in 1994-95, the Mexican peso crisis of 1995, and the Asian currency crisis of 1997.

In this respect, the Asian currency crisis provides a good example of the shortcomings of international monetary cooperation. Indeed, all of its causes had been clearly identified for some time: obsolete specialization, loss of competitiveness, a surge in private debt in foreign currencies, a poorly regulated financial system, major distortions introduced by the authorities, excessive current-account deficits, speculative bubbles, and rigid management of exchange rates. The G7 and the IMF did not take early action to urge these countries to modify their monetary policy, regulate their financial systems, and enact the structural reforms that all observers agreed were necessary. Instead, the two organizations not only waited until the outbreak of the crisis (Thailand, July 1997); most important, they also let the crisis spread to all of emerging Asia and swell to global "systemic" proportions before deciding on concrete action. The Asian countries obviously bear a prime responsibility for the situation. But it can hardly be denied that international private investors, particularly the commercial banks, are significantly to blame for the scale of the Asian crisis. And it is also clear that international cooperation was slow to materialize.

The inadequacy of international cooperation is attributable to several factors. The growing independence of the central banks–each with its different culture–has hampered teamwork. The belief in the absolute power of the markets has led economic and financial decision-makers to doubt the efficiency of currency-market interventions. The lack of an accepted monetary standard, the IMF's weakness, and inadequate international financial supervision have made it more difficult for the leading countries to reconcile their divergent interests. The feeble legitimacy of the G7 in the eyes of its partners has complicated and–more crucially–delayed the treatment of the financial problems of developing countries. Lastly, the lack of room for maneuver in public finances in the U.S. until 1993, in Europe since 1992, and in Japan since 1994 has led monetary authorities the world over to concentrate on purely domestic priorities at the expense of international coordination.

■ The euro enigma

The euro extends and crowns the regional monetary cooperation first initiated by the European snake and then strenghtened by the creation of the EMS. The euro also completes the establishment of the single market. Whether the euro will emerge as a strong or weak currency depends not only on external factors, but also on factors that are endogenous to the euroland. Nonetheless, there is no doubt that the euro will be an attractive currency both for Europeans and for Europe's world partners. The behavior of Asian countries is likely to play a crucial role in the development of the euro on the international monetary scene.

The euro: an achievement and a challenge

The European Monetary System (EMS), which has long offered the fullest example of regional monetary cooperation, went hand in hand with the creation of the single European market. For Europe, the crowning act of regional cooperation is monetary union, a move that will have deep repercussions well beyond the continent itself. Will the

euro's advent have an automatically positive impact or, on the contrary, will it make the system more unstable? The launch of the euro has altered the framework of international cooperation. The two leading currencies–the euro and the dollar– serve as benchmarks for the vast majority of the world's economies. They provide the building-blocks needed to construct a true world monetary system, commensurate with the globalization of economic and financial relations. What role will the yen play in this new configuration? It is doubtful that the Japanese unit will be able to act as a reference currency like the euro and the dollar, at least in the short term.

The euro inherits a situation in which the European currencies already occupy an important position in the global economy. The European Union (EU) accounts for 31% of world output and 20% of international trade. Thirty-three percent of international securities transactions, 32% of international private-sector securities, 25% of international loans and international bond issues (in the first half of 1999, this ratio rose to 45%, at par with the U.S. dollar share), and 10% of official reserves are denominated in European currencies. Before the euro, thirty-five percent of currency transactions concerned EMS units[2].

How will the euro fit into this picture? Despite the need for portfolio diversification resulting from monetary unification itself, the size of the European market will stimulate not only a higher demand for euros by comparison with the existing national currencies, but also a larger supply of euros, as demonstrated by the success of euro-denominated international issues since January 1st, 1999. This is due to the empirical link between a currency's international status and its market size. Beyond this correlation, the euro's position should be assessed on the basis of the uses to which the new currency will be put:

• As a *store of value*, the euro will gain acceptance proportionally to the depth, liquidity, breadth and openness of the European financial

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2. *Sources:* Bank for International Settlements; *The Economist;* A. Prate and G.J. Schinasi (1997), "EMU and International Capital Markets", in P. Masson et alii (eds), *EMU and the International Monetary System*; R.N. McCauley (1997), "The Euro and the Dollar", *Working Paper*, Basle: Bank for International Settlements.

market. Acceptance will probably be achieved for government securities after these have been switched over to euros; in the other market segments, major progress is still needed. Demand for the euro will also be all the stronger if it does not expose investors to a negative exchange-rate risk–i.e., if it is a solid currency.

• As a *unit of account*, the euro will be all the more widely used as it will replace the dollar as the currency in which Europe invoices its international trade. This substitution will probably take time because of the dollar's established position, particularly in commodities, aeronautics and other sectors.

• As a *means of payment*, the use of the euro in currency transactions will be all the more widespread if it establishes itself as a peg or reserve currency for the central banks. The diversification of foreign-exchange reserves should begin as soon as Europe's growth outlook brightens. The prospect of EU enlargement to the countries of central/eastern Europe should also incite many applicants to peg their currencies to the euro. Conversely, the commodity-exporting countries will find it harder to diversify their reserves as long as commodities are priced in dollars.

Will the euro be a strong or a weak currency?

Whether the euro will turn out to be a strong or a weak currency depends on several factors, the foremost of which is the monetary policy of the European Central Bank. Under its charter, the ECB's mission is to guarantee internal monetary stability. At the outset, to establish its credibility, the bank will presumably opt for prudence, as its initial decisions indicate. Moreover, in its early years, the ECB will probably be more preoccupied with internal-equilibrium rather than external-equilibrium concerns, notably owing to the problems it will face in controlling "domestic" monetary movements. In the post-transition phase, however, the bank is likely to pay closer attention to the euro's external value, given its impact on Eurozone prices. Upward exchange-rate fluctuations induce downward import-price variations, and vice versa. These swings affect all domestic prices in proportion to the share of imports in the economy and depending on the prevalence of index-linkage mechanisms. However, the Eurozone is less open

than the national economies that compose it. The respective averages are 11% versus 20%. The gap is due to the differences in the recording of intra-EU trade, which is treated as domestic trade for the Eurozone and as external trade for the national economies. Exchange-rate movements will have a weaker inflationary impact than they did prior to monetary union, unless the euro's introduction increases exchange-rate volatility. The issue, therefore, is not so much the euro's strength or weakness as its "right" value, robustness, and stability.

In this respect, one should not underestimate the effects of cultural differences between central banks. Broadly speaking, the power of the central banks has grown in recent years. However, the Federal Reserve and the European central banks have pursued different priorities: the U.S. central bank is committed to preserving economic growth and price stability, while the Europeans concur with the Bundesbank in giving precedence to price stability. These divergences have played a role in the difficulties encountered in international monetary cooperation. They have caused disagreements over the determinants of international current-account imbalances, and have fostered the development of a regional approach to monetary crises where strong regional institutions exist, as in Europe. Trans-Atlantic cultural differences should not, however, be exaggerated. Beyond differences in philosophy and communication, it is fair to say that the Federal Reserve and the Bundesbank have pursued broadly similar goals in the past. For example, the Bundesbank–just like the Fed–has not hesitated to overshoot its money-supply target and adopt a forward-looking attitude when required by the circumstances, especially the shifts in the velocity of monetary circulation.

But the euro's value also has an institutional aspect. It is easier to establish the independence of the central bank from governments than in the eyes of public opinion. For the public, the credibility of a central bank rests on its ability to explain its policy and convince citizens that it is on the right path. By this yardstick, the Bundesbank and Federal Reserve have enjoyed a strong social consensus within the framework of their historically well-organized exchanges with civil society and political leaders (consider, for example, the Fed's relationship with Congressional committees). This is not yet the case with the ECB. The

lack of formalized public relations is very likely to be a source of psychological instability for the bank. There is every reason to fear that the ECB may be worried by social expectations of what it can achieve, especially if the issues at stake have a strong national resonance. Until the Eurozone governments develop a consistent language in their dealings with the ECB, the bank will respond with extreme caution and reserve in its dialogue with these governments and with European citizens. Yet the manner in which this dialogue is established will probably affect the euro's value.

Lastly, the value of the euro will depend on Europe's macroeconomic situation and its efficiency in controlling its public finances. If the weakness of European fundamentals were to persist–in particular, if Europe were unable to return to a robust growth path capable of significantly reducing unemployment–investors would leave the European market and the euro would remain weak against the dollar. Conversely, the euro would probably become a strong currency if Europe saw its economy improve at the same time as it implemented structural reforms–notably in the areas of public and social finances, taxation and the labor market. Whatever the outcome, there is one factor that will unquestionably promote the euro's long-term strength: the European economies' current-account surplus with the rest of the world.

The virtues of an attractive euro

In itself, the euro's launch does not necessarily reduce international monetary instability. Beyond the short-term uncertainties regarding the credibility of the ECB, two factors may actually increase the euro's volatility:

• *Greater capital mobility* between Europe and the rest of the world, stimulated by the elimination of the financial risks linked to European monetary fragmentation.

• *"Benign neglect" by the ECB* toward exchange rates. That could be incitated not only from the Eurozone's limited trade openness with the rest of the world, but also from the fact that the elimination of intra-European exchange rates will remove a major cause of instability in Europe itself. With the single currency, Europeans have taken a deci-

sive step toward monetary stability and therefore have less to gain from further progress at the international level.

The euro's place in the international monetary system will depend not only on Europe but also on the United States. The U.S. has strong economic and strategic reasons to maintain the dollar's pre-eminence as an invoicing currency, in particular for commodities. It is also in the U.S. interest to maintain the dollar's dominance as a reserve currency for the central banks, because this provides a stable resource for financing the U.S. deficit. Since the correction that followed the collapse of the Bretton Woods system, the dollar's share of foreign-exchange reserves has remained fairly stable at slightly over 60%.

The stakes are high, because the emergence of a firm euro capable of rivaling the dollar should exert a pressure on the quality of U.S. fundamentals. In particular, it should spur the U.S. to cut its external deficit and to implement a macroeconomic policy more compatible with global economic interests. Indeed, if the U.S. did not perform this adjustment, the dollar would weaken against the euro, making it harder to finance the U.S. external deficit. The U.S. would probably have to pay higher interest rates when the Eurozone could enjoy lower ones. If, instead, the U.S. decided to trim its current-account deficit, a major source of international monetary instability would disappear, since the exchange rate needed to ensure the sustainability of the U.S. current-account balance would converge toward the dollar's purchasing power parity (PPP).

A firm euro will offer a powerful incentive for transatlantic cooperation as it will facilitate the convergence of interests between the two continents. Europe stands to gain from this cooperation, in view of the risks of international monetary destabilization implied by potential difficulties in refinancing the U.S. external debt.

Asian uncertainties

Relationships between the euro and the dollar may be upset by Asia: the economies of its three regional powers–Japan, China, and India–are still relatively closed to the outside world but will eventually

open up. India, at present the most closed of the three, is likely to open its doors to global trade in due course. China is expected to liberalize its capital movements and join the World Trade Organization (WTO). Japan will probably grant foreign competitors easier access to its domestic market. This greater openness to the rest of the world will shift the center of gravity of globalization even further toward Asia. The change will inevitably entail a redistribution of comparative advantages across the world and within Asia, heightening the risk of rivalry among the three regional powers. But Asia is not only a region of change. It is also a region in crisis. In Japan and South-East Asia, the crisis is an open one. In China and India, the crisis is latent: both countries have yet to enact the bulk of their structural reforms, even as entire industries, particularly in the public sector, are effectively bankrupt. Acute monetary tensions are therefore likely to persist in Asia.

Asian uncertainties are aggravated by the lack of a regional benchmark currency–in contrast to the situation in Europe and the Americas. The dollar can no longer perform that function, because Asian trade and finance have diversified: Europe and, even more so, Japan now play an important role. The yuan is not suitable, since China has not liberalized its capital movements and has not yet reached a sufficient level of economic development. The yen is handicapped by the size of Japan's current-account surplus, which prevents the currency from guaranteeing sufficient liquidity in the zone. Admittedly, the lack of a reference currency is offset by Asia's substantial foreign-exchange reserves. However, these may not necessarily ensure adequate regional monetary stability, as the recent crisis has shown. There is another, separate issue. Until now, the reserves have been invested in U.S. Treasury paper. With the elimination of the dollar peg for the South-East Asian currencies, a larger portion of reserves may be shifted into euros. China and Japan are favorable to the idea.

Lacking a common benchmark currency, Asia may find itself relegated to the sidelines of international monetary cooperation. True, Japan's current-account surplus may cause the United States to focus on bilateral monetary cooperation with Japan at the expense of multilateral cooperation with the G7 or trans-Atlantic cooperation with

Europe. This scenario, while conveniently simple for Japan and the U.S., would exacerbate global monetary tensions without solving the problems entailed by the lack of an Asian currency peg. In sum, Asia may well hamper international monetary cooperation for many years ahead, whereas it would have everything to gain from such teamwork.

■ The need for order

In the short term, the world's economic players do not equally view the gains to be derived from a minimum of monetary order. But taking a longer term perspective, it is quite obvious that the globalization of trade and production processes requires a common monetary reference. The scale of potential future exchange rate crises should at least lead major industrial countries to care about providing a minimum level of monetary stability. Despite its apparent facility, the current situation of very little cooperation is not an acceptable scenario.

Apparent divergences of interests

Businesses that have globalized their operations are typically in favor of greater international monetary stability. This is especially true of small and medium-sized firms. Stable currencies reduce economic uncertainties and minimize the costs of hedging against exchange-rate risk. Despite these benefits, not all shareholders may be interested in greater currency stability. Some may invest in companies to acquire a portfolio of stocks whose exchange-rate risks are negatively correlated with a risk exposure elsewhere: for example, an investor might want to buy into a company because of its dollar risk, which offsets a Deutsche-mark risk exposure in other industries. Thus, even in the business world, the convergence of interests cannot be taken for granted.

Financial institutions offering instruments designed to cover exchange-rate risks–particularly in the short term–stand to gain from a moderate degree of exchange-rate volatility. Since the collapse of Bretton Woods, financial institutions have generated substantial earn-

ings from this type of activity. Between 1996 and 1997, the main U.S. banks doubled their earnings on currency transactions thanks to the rise in volatility. Other players in the financial industry, however, may have a different attitude. Pension funds, especially those offering defined-benefit plans, are relatively averse to this type of risk.

A necessary complement to globalization

It is often argued that flexible exchange rates create the right currency environment for trade globalization, as they facilitate price adjustments in the event of asymmetrical shocks or microeconomic imbalances. In particular, flexibility dampens the negative consequences of nominal rigidities and makes it possible to anticipate the expected effects of structural policies designed to reduce these imbalances.

Flexible exchange rates also allow a smoothing of economic activity across business cycles when these are not synchronized at the world economic level. Market expectations about future monetary policies cause exchange rates to fluctuate by about 10-15% around their equilibrium values: these movements are helpful in redistributing economic activity between countries in a cyclical upswing and those in a cyclical downswing. On this point, it should be noted that a closer synchronization of cycles at the world level is probably undesirable, as it carries the threat of massive recessionary movements that would be hard to control. The role of exchange rate movements in smoothing cyclical fluctuations, however, must be qualified. In fact, economic fundamentals and differences in cyclical timing explain less than 30% of the fluctuations in dollar, yen and mark nominal exchange rates: the proportion for real exchange rates is even lower[3]. For example, the dollar weakened against the yen and mark in 1994-95 despite the fact that the United States was ahead of Japan and continental Europe in the cyclical upswing.

In addition, empirical studies have shown that the potential negative effects of exchange-rate volatility on international trade, investment

3. These estimates are drawn from equilibrium exchange rates series calculated in 1997 by the research department of the French finance ministry.

and growth were, as a rule, insignificant–and that they have tended to decline in recent years[4]. Indeed, only the developing countries seem sensitive to exchange-rate volatility. There are three main explanations for this apparent paradox:

• The increasing use of financial instruments to hedge exchange-rate risks. However, the efficiency of the market pricing of exchange-rate risks is open to question: the statistical series show that actual exchange rates do not tend to move in the direction indicated by forward rates.

• The growth of within-firm trade in multinational corporations: intra-company trade currently accounts for 20-25% of total international trade and 40-50% of international trade by multinationals alone.

• Imperfect competition in the international markets, due to their fixed entrance costs and the unpredictability of exchange-rate fluctuations. Businesses respond in two ways to this imperfect competition: (1) they refrain from systematically passing on the fluctuations to their prices, and (2) they adjust their margins in order to minimize price variations in local currency. These behaviors, referred to as "pricing to market," entail geographic differences in export prices.

In fact, as empirical research confirms, international trade and national economic performance are less affected by the short-term volatility of real exchange rates than by the scale and duration of exchange-rate imbalances[5]. A country's choice of exchange-rate regime plays an important role here, as the EMS experience shows. Intra-EMS trade was far less sensitive to exchange-rate variations than trade with countries outside the EMS. Judging from the imbalances witnessed in recent years, the current flexible exchange-rate system is unsatisfactory. On the one hand, exchange-rate disequilibria have tended to persist over time, as exchange rates spontaneously return to their equilib-

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4. A survey of empirical studies is provided in M. Goldstein (1995), "The Exchange Rate System and the IMF: a Modest Agenda", Washington D.C.: Institute for International Economics.
5. See M. Goldstein, *op. cit*. [4], and O. Razin and S.M. Collins (1997), "Real Exchange Rate and Growth", Working Paper Series, n° 6174, Cambridge, MA: National Bureau of Economic Research.

rium value only very slowly[6]. On the other hand, most interventions of the international community took place too late, and participants have accepted excessively long periods of misalignment for non-EMS currencies such as the dollar and yen–not to mention the financial crises that could have been avoided. Inertia in international monetary cooperation has triggered the resurgence of protectionist temptations, especially in countries whose currencies have appreciated too quickly: these countries have seen themselves the targets of their partners' competitive devaluations. This is evidenced by the proliferation of trade disputes involving appeals to the WTO, anti-dumping suits, agreements on export self-restraint or on carving up domestic markets, and so on. There is now a clear threat of a reversal in the trade-liberalization process, which could lead to the formation of trade blocs.

A risk of increasingly costly exchange-rate crises

All the accidents that have occurred to date–including the Asian crisis–were eventually contained. Their magnitude, however, has steadily increased along with their social and economic costs and the international transmission of their effects.

• The turbulence consecutive to the collapse of the Bretton Woods system was brought under control by letting the dollar float, a move that did not entail excessive costs for the industrialized economies.

• Despite the Plaza Accords and the subsequent Louvre accord, the dollar's overvaluation and later devaluation in the 1980s exacted a far higher price from the world economy in terms of macroeconomic imbalances than the monetary turmoil of the 1970s.

• The developing-country debt crisis was solved only at the last minute through IMF intervention, supplemented by the Brady Plan. The price paid by the countries involved was a halt in their economic catch-up: GDP per capita in Latin America did not increase in the 1980s.

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6. According to K. Rogoff, an average of five years is necessary to resorb 50% of an exchange rate misalignment: K. Rogoff (1996), "The Purchasing Parity Power Puzzle", *Journal of Economic Literature* (June).

• The peso crisis cut Mexico's output by 6% despite USD38 million in financial support from the international community. The shock wave spread to most Latin American economies. Together with the U.S.–Japan trade dispute, it contributed to the depreciation of the dollar in 1995. The dollar's slide is, in turn, partly responsible for the downswing in the EMS core economies and for the steep aggravation of the Japanese crisis in 1995-96.

• The collapse of the Thai baht in July 1997 triggered a crisis that gradually spread to the emerging economies of East Asia in the fall of 1997, then to Russia over the summer of 1998 and Brazil in early 1999. The crisis has only just begun to ease, at the cost of financial support from the international community (a total USD120 billion) equivalent, in relative terms, to the support granted to Mexico in 1995. The crisis has exacted a high price from the global economy. The total loss in world output over 1998 and 1999 can be estimated at 2.5 percent of world GDP[7]. Worse still, a crisis that would have engulfed the entire global financial system was only barely avoided in the fall of 1998. Even today, Japan's financial system remains a threat to the global economy.

As past experience shows, such crises can be controlled at an acceptable cost to the international community as long as equities and real estate are spared. But when the value of these assets is affected, public opinion begins to worry. This reaction is not surprising as regards real estate, since more than half of all households in most developed countries are owner-occupiers. It is more surprising in respect of equities, as share ownership is still relatively limited in most countries except the U.S. Presumably, households perceive the fall in stock prices as a sign that the economy's real value is collapsing. Moreover, for households that do own shares, falling prices impact both on their income level and on the value of their holdings–whereas a decline in bond prices has no effect either on interest or on the value of the principal at maturity. Whatever the motives of households, their reaction is not illogical in economic terms, since a plunge in equity and property prices weakens

7. In a year, Indonesia's GDP has fallen by 17%, Thailand's by 12%, Malaysia's by 10%, Korea's by 7% and Japan's by 3,5%.

the value of loan guarantees in real terms and undermines confidence. The economy can no longer be financed efficiently, jeopardizing the solvency of economic agents and the growth capacity of the economies involved. The experience of recent years shows that this risk threshold is being crossed more often than it used to be.

The increasing size of monetary and financial accidents is largely due to the liberalization of capital movements, advances in information technology and financial intermediation. True, the decentralization and diversification of global finance have spread the risks of losses, thereby lessening the systemic-crisis risk in lender countries. At the same time, these phenomena make it more difficult and expensive to manage the crises that do erupt. Also, private capital movements–when unregulated–amplify the existing macroeconomic imbalances. The sequence of events is familiar. Initially, capital inflows cause economic overheating, speculative bubbles and an exchange-rate appreciation. As long as the signals sent by exchange rates are ignored, the imbalances continue to widen. The current inertia of international cooperation leaves little hope of a preventive action from the international community. In the end, the economy's greater vulnerability triggers capital flow reversals, sparking a currency crisis and an economic downturn made worse by the build-up of imbalances. It is only once the crisis has started that international intervention becomes conceivable. The cost of the necessary adjustment becomes the focus of disputes, resulting in long, difficult *ad hoc* negotiations over the terms of international cooperation. This is achieved too late to avoid heavy collective costs.

All the recent crises–Mexico, Japan, Asia–have been aggravated, and in some cases actually triggered, by the fragility of local financial institutions. These failed to observe basic prudential rules, either because no such rules were imposed at all or because, when such rules did exist, they were too weakly enforced. The Asian crisis offers an unfortunately perfect example of the risks incurred–and the threat posed to the global economy–by countries that liberalize capital movements without simultaneously adopting adequate financial-sector regulations. Capital flows into these countries stimulate excessive money creation, which, even when it does not drive up product prices,

"inflates" asset prices (equities, real estate and exchange rates)–hence fueling speculative bubbles. When these bubbles burst, the economy's access to financing will be rapidly constrained by rising interest rates and the greater moral hazard inherent in credit transactions. Banks will respond by rationing the credit supply in order to minimize their risk exposure. As a rule, these bubbles extend into the international financial system, contributing to a global misallocation of resources. The credit crunch is therefore liable to spread from the country involved to entire sectors of the world economy.

The misleading facility of the status quo

Despite these risks, the status quo has a number of advocates. They generally consider that the current system of flexible exchange rates provides an "economical" response to shocks. To simplify the argument somewhat, exchange-rate flexibility may be regarded as a means of confining the necessary adjustments to a single price. Recent experiences have also convinced many observers that monetary authorities can no longer successfully oppose international capital movements. This belief rests on three main arguments:

• The commitment to defend an exchange rate is not credible in countries suffering from economic and financial weaknesses, for it demands interest-rate rises that carry a prohibitive domestic cost and are hence unsustainable in the long run. Recent history has shown that markets will not attack a currency unless it exhibits a manifest fragility due to a potential contradiction between the country's external commitments and domestic interests.

• Failure in defending an exchange rate against the markets exposes the country involved to financial costs that are increasingly prohibitive when measured against the international financial support available in such cases: it is not uncommon for a country to lose the equivalent of 100% of its IMF quota in one month of currency-market interventions.

• Flexibility also entails a high credibility cost for the monetary authorities. Their sensitivity to the cost is all the greater as they have limited resources at their disposal by comparison with the volume of capital involved in a speculative movement. The authorities' power is, above all, symbolic as it largely rests on their credibility.

Exchange rates also serve as effective and useful indicators of economic imbalances–when they are left to play the role of market prices, i.e., when they are allowed to match a currency's supply and demand. Indeed, before defending arbitrary exchange rates, countries would do well to seek to implement sounder macroeconomic policies, reduce structural rigidities in the labor and goods markets and ensure closer convergence of their economic policies. Some draw the over-simple conclusion that nations have only two alternatives to guarantee currency stability in the long term under a floating-rate system: macroeconomic-policy convergence or monetary union (bearing in mind that monetary union, to be sustainable, requires a minimum of fiscal-policy convergence as well).

As we have just seen, the arguments of the defenders of flexible exchange rates are not irrelevant and it would be especially dangerous, in our fast-moving world, to defend fixed nominal exchange rates outside of a monetary union. But it would be just as dangerous to rely entirely on market forces and allow currencies to float freely, even assuming a reasonable convergence of macroeconomic policies. In particular, there is little justification in rejecting out of hand all the potential benefits of more ambitious monetary cooperation. There are three main reasons why this is so:

• Fully floating exchange rates are not a realistic option. In practice, central banks are forced to intervene regularly to stabilize participants' expectations and promote a more orderly market behavior when the markets are unable to reach equilibrium on their own. Even when sterilized, these interventions can be efficient–less through the portfolio allocations they generate than through the signals they send to the markets. The signals may indicate future economic-policy changes or the path that would bring the markets closer to a better equilibrium[8]. To be truly effective, however, interventions must be concerted. This implies a prior agreement on a monetary reference capable of securing a sufficient consensus

8. The effectiveness of exchange rate interventions is empirically demonstrated in K.M. Dominguez and J.A. Frankel (1993), "Does Foreign Exchange Intervention Work?", Washington D.C.: Institute for International Economics.

despite divergent national interests. Also, interventions will be all the more effective if they take place early, before the imbalances become too severe and before the authorities lose credibility.

• As the experience of recent years has shown, the convergence of economic policies and performances does not in itself guarantee exchange-rate stability. To begin with, it is not a wholly credible goal: past, present, and expected cyclical differences–and, above all, structural differences–call for a variety of national policies. This diversity, in itself, can induce significant exchange-rate fluctuations. Moreover, as we have seen, exchange-rate swings are very largely due to the intrinsic instability of exchange rates, which economic-policy convergence cannot deal with.

• More basically, international cooperation is always useful in a climate of uncertainty about the workings of the global economy–and in particular about international shock-transmission mechanisms. It helps to dampen the impact of that uncertainty and to improve the macroeconomic efficiency of structural-reform policies, sometimes even in the short run. Cooperative strategies achieve consistently better results than non-cooperative ones, provided that the authorities are capable of learning from their past successes and failures.

■ Dreams and realities

In order to allow for a better functioning of the world economy and for a consolidation of the benefits from globalization, it is therefore crucial to deepen international monetary and financial cooperation. More specifically, five goals should be pursued: first, a strengthening of multilateral surveillance, notably in emerging markets; second, stricter financial discipline in the banking sector as a necessary complement to a pursuit of liberalization of international capital flows; third, a greater involvement of the private sector in the management of financial crises; fourth, the emergence of an exchange-rate agreement based on some form of "target zones," even if, in the short term, more flexible forms of cooperation are likely to be more realistic; finally, in a long

term perspective, the creation of a world currency should become a focal point of international cooperation.

A strengthening of multilateral macroeconomic surveillance

The first step toward more active international cooperation consists in improving our knowledge of the situation of national economies. For this purpose, we must begin by enforcing compliance with strict accounting standards–preferably international–by the public sector and the private sector alike. The quality of the statistics published by the countries themselves must also be improved. This applies to the input-output tables for goods and services as well as monetary and financial statistics, particularly on reserves, debt levels and maturities and the health of the financial sector. A major factor in statistical quality is timely publication, for example, twice a year. Like companies, the governments and central bankers of emerging countries should also commit themselves to providing investors and international financial institutions with straightforward explanations at regular intervals, for example, when publishing the national statistics: these commentaries should cover the authorities' analysis of their country's economic situation, the problems they are facing, the measures they are considering to deal with them, and the economic policy they would like to implement in the longer run. Mexico has done this rather successfully since the 1994-95 crisis. An attempt at dialogue with the financial institutions would help diminish the likelihood of abrupt reversals in their investment positions–particularly in the emerging countries–and promote a more orderly functioning of the markets. All the players would acquire greater visibility, which would encourage monetary and financial stability.

Meanwhile, multilateral supervision exercises should be strengthened and made more transparent. The G7, which is the natural framework for managing strategic monetary responsibilities in the world, is already conducting similar exercises on the basis of an IMF technical report. But the exercises remain confidential and, as a rule, perfunctory. It would be desirable to make the exercise more public and to inform the markets of the opinion of IMF experts on

the global macroeconomic situation, as well as on global economic and financial imbalances. It would also be desirable to publicize in a more systematic manner the IMF's assessments of the economic policies being implemented around the world, notably as regards the control of public finances and the enforcement of monetary stability, which are the preconditions for a more orderly pattern of exchange-rate movements. In the light of recent crises, the analysis of macroeconomic imbalances could be usefully supplemented by a critical analysis of the position of financial institutions–given the fact that the latter are a source of systemic risk for the world economy. This publication would serve two purposes: (1) it would ensure that IMF analyses can be debated in the public arena, bearing in mind that economic and financial calculations are not an exact science[9]; (2) it would create a moral obligation for G7 to take a stance on the issues addressed by the IMF. The G7 would not be tied by the IMF findings, but it would nevertheless presumably be incited to react and publish its own opinion on the situation. To preserve the climate of confidence needed to conduct effective consultations under the IMF's article IV, the publication of IMF analyses would have to respect the confidentiality of information transmitted to the Fund by national governments.

A controlled liberalization of capital movements

Earlier financial crises were due to problems in current-account balances; recent crises have been triggered mainly by problems in capital-account balances. The global economy is at risk from inadequate regulation of financial institutions in countries that have opened up to international capital movements. These risks suggest that, independently of the exchange-rate regime, international monetary cooperation must focus on the conditions in which not only "central-bank money" but also bank credit are created around the world. To ensure credit-market efficiency, it is urgent to agree on stricter prudential rules than those applied today. The consensus among experts on this need is strong enough to allow effective measures to be taken promptly

9. Particularly when it comes to current-account balances and equilibrium exchange rates.

within the framework of the Financial Stability Forum[10]. The IMF and the World Bank should be specifically mandated to supervise the implementation of these arrangements and should be given the resources to incite countries to abide by them.

The basic prudential rules should cover such areas as the transparency of bank and corporate accounting, provisions against non-performing loans and the capital-adequacy requirements for different categories of debt. On the last of these points, one should reconsider whether it is sound to maintain the waiver of even token capital-adequacy ratios to cover sovereign or State-guaranteed debt of OECD countries–including South Korea and Mexico. In practice, these securities admittedly involve little risk exposure for lenders, especially if one considers the support from the international community available to governments. But this overlooks the fact that sovereign-debt reimbursement problems have very often generated severe monetary crises in the past, and that it is unsound to grant such favorable treatment to a type of loan carrying major risks of negative externalities. In any event, the introduction of a restructuring clause in all bond contracts–suggested below–would presumably lead to the imposition of stricter prudential rules for sovereign bonds, besides allowing a more equitable distribution of risk across different categories of claims.

The Asian crisis also offers a good reason to consider the possible advantages of restricting short-term capital movements. True, these flows do not only feed and drive speculation. They are also a normal means of financing economic activity, as a complement to long-term capital. However, they tend to powerfully aggravate currency crises, especially in countries with fragile, under-regulated financial institutions. Such countries should clearly avoid liberalizing their capital accounts until they have cleaned up their financial sectors and clarified the relationships between the latter and the authorities. On the other hand, the *ad hoc* introduction of controls on capital outflows in a financial crisis is not a good idea, as it is a unilateral blind reaction. As the

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10. The actual scope of this consensus was specified in a document of the Committee on banking supervision of the BIS (1997), “Core Principles for Effective Banking Supervision”, Basle: Bank for International Settlements.

Latin American countries experienced in the 1980s, it risks depriving the country of access to the international capital market for many years.

The suggestion for a small, worldwide tax on all international capital movements–put forward by the economist James Tobin–is not objectionable in principle. It does, however, raise two problems. First, its low rate would presumably make it ineffective in dealing with speculative movements above a certain size threshold. Second, it is hard to see why countries in good financial health would want to discourage short-term capital inflows in the same manner as vulnerable emerging countries. The Chilean solution of "taxing" capital inflows does not pose the same problems. The IMF should study in greater detail the arrangements that would meet the efficacy goal, which consists in discouraging short-term capital flows into the vulnerable economies without stopping those flows from helping to finance the healthy economies.

A greater involvement of the private sector

The involvement of private international investors in the earliest stages of crisis management is justified by (1) the substantial moral-hazard risks associated with financial interventions by the international community and (2) the negative externalities created by financial panics:

• It is legitimate to ask whether the growing scale of financial interventions by the international community has not aggravated crisis risks. True, private international investors have suffered sizable gross losses in recent crises (about USD350 billion since 1997). But we cannot rule out the possibility that the IMF's financial aid to beleaguered countries–which serves chiefly to repay private creditors–has encouraged the latter to take excessive risks in the emerging countries. From this standpoint, the prospect of being more routinely involved and "bailed in" in the management of future crises would certainly make them more cautious and selective in their investment choices.

• More basically, experience shows us that losses of confidence by private international investors can quickly turn into financial panics that harm the countries involved as well as the private lenders them-

selves. Indeed, even if an individual investor's medium-term confidence in a crisis-hit economy is not affected, that investor may find it advisable to pull out because of the risks of short-term losses due to the withdrawal of other investors. The only effective response to such negative externalities is cooperation between all the players involved.

Private international investors should therefore be involved in crisis management more routinely and at an earlier stage, via suitable mechanisms. Some players would like this to be done on a voluntary and case-by-case basis–as in Mexico in 1982 and South Korea and Brazil more recently–in order to reassure investors and avoid a general increase in risk premiums (spreads) for the emerging countries. Others argue that the multiplicity and increasing dispersion of private creditors involved in emerging countries makes it increasingly difficult to establish strictly voluntary coordination. These observers conclude that multilateral financial authorities should be empowered to impose restructuring in the interests of the crisis-hit countries and their creditors alike. To avoid legal action by unhappy investors, however, they suggest that all countries–including G7 members–should include in their debt-security contracts a clause allowing their debt to be restructured under international supervision in the event of a serious crisis.

Clearly, the normal enforcement of contracts must remain the rule. It is the best way not to discourage private international investment in emerging countries. In the event of a crisis in an emerging economy, the first reaction should therefore be to organize voluntary debt restructuring[11]. The presence of multiple creditors is not an obstacle to this "bail-in" approach: in the recent crisis in the emerging countries, the commercial banks, rather than the numerous bond investors, were primarily responsible for capital outflows.[12] As an inducement, credi-

11. This view is also supported by the former managing director of the IMF, J. de Larosière (1999), "Le système monétaire international à la lumière des crises", *Commentaire*, Fall.

12. During the recent crisis of emerging markets, bank-credit amortization accounted for 80% of capital outflows, while bond-debt amortization represented only 20%. See Institute of International Finance (1999), *Capital Flows to Emerging Economies* (April).

tors who agree to join in a restructuring program could be offered more attractive guarantees. Depending on the type of restructuring, the guarantee could involve a minimal exchange rate less depreciated than the current rate, or any other suitable arrangement. However, the action of the international financial community–when circumstances require it–should not be hampered by private creditors' strategies.

Thus, in the event of an unusually severe crisis requiring international assistance, it should be possible to impose a restructuring of all debt categories (excluding debt owed to international institutions) in a manner consistent with the specific situation of the country concerned. The restructuring would, of course, be conducted under the aegis of the IMF and the Paris Club: there would be no question of allowing the debtor governments to decide whether or not to enforce the constraint. One should also examine the possibility of allowing the IMF to continue lending even if unpaid arrears remained. More generally, the introduction of a restructuring clause in bond contracts would make crises far easier to manage by automatically involving private creditors. It would also incite investors to assess their risk exposure more accurately. This ought to be reflected in the ranking of bond prices. Lastly, the emerging-country governments should make sure to introduce an effective bankruptcy law and a deposit insurance system. This legislation is essential for orderly crisis management since it would allow one to limit the impact of cronyism and make the debt easier to restructure. It would also facilitate private-sector involvement and would help foster a climate of confidence.

The moral hazard implicit in the international community's financial-support mechanisms also exists among governments and local debtors. However, as with private international investors, we should not exaggerate the hazard, insofar as recent crises have shown that governments and local debtors can be severely sanctioned the day the crisis erupts. Yet in a longer-term perspective it is important for the international community to be protected from the risk. For this purpose, it is desirable to treat countries as differently as possible according to whether or not they have followed international recommendations in their economic and financial policies. "Virtuous" countries should be eligible for international help on substantially more favorable eco-

nomic, financial, and political terms than the other countries. The recent decision to open a credit line for "virtuous" countries hit by a contagion effect is a first step in this direction. The political dimension of the issue would, of course, require the active involvement of the G7 in defining the incentives and their linkage to macroeconomic and financial country monitoring.

The case for a "target zone" agreement

The relationship between the U.S. dollar (USD) and the Deutsche mark (DEM) and the French franc (FRF) has been fairly stable for the past ten years or so: the maximum swings have been 10-15% on either side of an average value, in USD/FRF terms, ranging from FRF5 to FRF6.50 per USD. Given this pattern, we might be tempted to recommend the preservation of current practices and let the floating exchange-rate system continue as it is, without major reform. But this only concerns the relationship between the euro and the dollar, or rather between the FRF–DEM pair and the dollar; the issue of the relationship between these two dominant currencies and the yen on the one hand, and various currencies around the world on the other, would remain unresolved. Hence our recommendation of a reform aimed at ensuring greater stability–without, however, introducing a rigidity (in the form of fixed rates) that could harm the growth of economic regions whose cycles are not synchronized. There are several possible approaches. All hinge on the notion of concerted action by U.S. and European authorities. The purpose of the cooperation should be to address the following question: what is the desirable fluctuation band for the dollar against the euro, in view of the goals stated earlier? If this question is not tackled, as is the case today, then there is a strong risk that the system will continue to drift–sparking financial crises such as those we have witnessed in recent years. There are several possible degrees of coercion that such cooperation could involve.

Hard target zones

The most ambitious form would be to adopt "*target zones*," as proposed by the economist C. Fred Bergsten and by the Bretton Woods

Commission[13], which, however, recommended postponing implementation until a greater convergence is attained in economic policies around the world. The agreement would concern fluctuation bands around central rates for the euro, dollar and yen, which would be periodically adjusted to reflect inflation differentials and economic fundamentals. The central rates would be set at levels that ensured the internal and external equilibrium for the world's economies and avoided the competitiveness losses that undercut the credibility of governments' exchange-rate commitments. The band should be large enough to accommodate the exchange-rate swings–sometimes as wide as ±10-15%–caused by economic fluctuations. The band would be made public: this would create a "honeymoon effect" on the markets and establish the credibility of the exchange rates; it would also confine central-bank interventions to situations of severe imbalance where that credibility would have been lost in the markets despite its having won a consensus among monetary authorities. The central banks would have the obligation to intervene "at the margins." The prime responsibility for managing the system would be vested in the G7, supported by the IMF. In this framework, the G7 would agree on target-zone levels, while governments would perform the public-finance adjustments and central banks would carry out the interventions.

More flexible, secret target zones

A less ambitious variant of target zones would be to maintain the principle of compulsory action when the exchange rates approach the fluctuation limits, but to keep the central rates and fluctuation bands secret. This is the solution that most closely resembles the Louvre accord of 1987, notably in the vision then defended by France. In practice, it is more flexible than the first option, as it leaves the monetary authorities some leeway for deciding when and how to act, while keeping their credibility intact since they would be making no public commitments. At the technical level, there has been a lively debate over whether or

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13. See C.F. Bergsten and R. Henning (1996), *Global Economic Leadership and the Group of Seven*, Washington D.C.: Institute for International Economics (chapter 7), and Bretton Woods Commission (1994), *Bretton Woods: Looking for the Future*.

not to disclose the target zones. Those who support disclosure say it would make the bands "self-stabilizing" at their outer margins–the so-called honeymoon effect. Others argue that the zones should be kept secret, so as to preserve maximum uncertainty over central-bank interventions and thereby heighten the risks incurred by speculators. The experience of recent years, however, actually supports neither side: the 1992 EMS crisis demonstrated the limits of the self-stabilizing behavior of published fluctuation bands; on the other hand, the markets have showed they can discover the confidential target zones fairly quickly by testing the central banks.

Target zones are probably the only credible framework for organizing currency fluctuations. The problem with target zones, however, is that they have not won any consensus in the G7 or among experts. One objection to them runs as follows. Introducing fluctuation bands would admittedly reduce the volatility of forward exchange rates relative to spot rates. But the bands' credibility would be heavily eroded by the inability of the central banks to commit themselves to unlimited intervention at the margins. A second counter-argument is that target zones could foster "self-fulfilling" speculative attacks because the defense of the bands creates a conflict between the monetary authorities' domestic goal and external goal, undermining the credibility of the second. Since the domestic goal of price stability would take precedence for the central banks–especially the independent ones–it is clear that monetary policy cannot be applied to an exchange-rate target except in very special circumstances. In truth, it is mainly the lack of consensus between the major monetary powers that limits the credibility of target zones.

An institutionalization of monetary consultation around reference parities

In the short run, however, if an agreement on target zones seemed too difficult to reach, the minimum requirement would be to agree on automatic but relatively non-binding consultation procedures to decide on joint action. This would consist in defining confidential "reference exchange rates" for the dollar, euro and yen: any overstepping of these boundaries would oblige governments and central banks to immedi-

ately consult without awaiting the next official G7 or IMF meeting. The reference exchange rates would not be made public, and they would be regularly adjusted to reflect changes in economic and financial fundamentals. The central banks and governments would reserve the right to act in unison, based on the divergence of actual rates from the reference values–the likelihood of action being proportional to the size of the divergence (the effectiveness of such a "flexible response" to exchange-rate fluctuations was illustrated by the success of the wide band EMS that was put in place in mid-1993 at France's suggestion). This would be a significant step forward from the present arrangement, which requires no consultation. It would provide a remedy for the excessive delays that often characterize international monetary cooperation and it would thus oblige the monetary authorities and governments to face up to their duties.

Thus, even if no consensus emerges on target zones, there are ways in which international monetary cooperation can be strengthened even today. Steps can be taken in a flexible manner, progressively leading to more ambitious solutions–such as target zones–as mutual confidence develops between G7 governments and central banks. But it needs emphasizing that, whatever the strategy adopted, its "sustainability" will always depend on its credibility. This, in turn, rests primarily on the compatibility between the selected reference exchange rates and the economic fundamentals–which need to be assessed in a short- and medium-term perspective. The assumption here is that the rates will not be fixed but can be adjusted gradually (i.e., if possible, without jumps) in response to changes in economic performance and shifts in short-term and structural economic policies–whether these are actually being implemented or seem sufficiently likely to be applied in the future[14].

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14. The working of a reference parity system was analyzed by J. Williamson (1999), "Crawling Bands or Monitoring Bands: How to Manage Exchange Rates in a World of Capital Mobility", *International Economic Policy Brief,* 99-3, Washington D.C.: Institute for International Economics. For a detailed discussion of the benefits from a reference parity system, see also C.F. Bergsten, O. Davanne and P. Jacquet (1999), "The Case for Joint Management of Exchange Rate Flexibility", Working Paper 99-9 (July), Washington D.C.: Institute for International Economics.

It should go without saying that the quality of international cooperation inevitably depends on the quality of the currencies themselves, i.e., for the most part, on their stability. Indeed, how else can one define the quality of a currency? Unfortunately, studies on the monetary policy of governments and central banks seldom address this quality issue. The monetarist arguments for regulation through quantitative management of the money supply have exerted such intellectual dominance that the quality of the currency is almost never discussed any more. Yet the concept was a central one for the influential French economist Jacques Rueff, and in the past it was effectively demonstrated by the functioning of the gold standard (of which Rueff was a staunch advocate). The issue may seem less urgent in the leading industrialized nations–the quality of whose currencies rests on the independence and credibility of the central banks–but the same is not true of the emerging economies. There, the concern over currency quality has led to the adoption of currency boards and even to extreme proposals for dollarizing some of the Latin American economies. Currency boards in various forms are presently functioning around the world, notably in Hong Kong and Argentina. In both these countries, the quality of the currency–officially pegged to the U.S. dollar–and the central bank's strong resolve have likely helped avoid the serious monetary crises that have hit other countries. Should currency boards be extended to other emerging or transition economies? The solution should be examined with care, especially in countries whose central banks have problems establishing their credibility.

A long-term goal: a world currency

The crises of the 1990s have witnessed the emergence of the IMF's role as lender of last resort[15]. The Fund increasingly applies to nations the same principle that central banks apply to financial institutions in the event of a systemic risk, namely: "too big to fail." The IMF has access to resources that it can lend to member countries faced with a

15. For a very subtle analysis of this dimension of the IMF role, see S. Fisher (1999), "On the Need for an International Lender of Last Resort", speech before the American Economic Association, January.

liquidity or solvency crisis. It also plays a leading role in negotiations between crisis-struck debtor countries and their creditors. Today, there are proposals to give the IMF a central responsibility in defining and implementing a minimum regulatory framework for financial institutions in countries potentially eligible for the Fund's financial support. As a result of its mission to coordinate–indeed unify–its members' initiatives, the IMF has taken on these duties, which go far beyond the scenarios envisaged in the Bretton Woods agreements. The new architecture of the international monetary system will probably strengthen the IMF's role as lender of last resort. At that point, the IMF would only need the authority to issue money for its role as lender of last resort to become equivalent to that of a central bank. Admittedly, it can allocate Special Drawing Rights to its members by an 85% majority vote, but the allocation must be distributed proportionally to its members' quotas. SDRs are therefore manifestly unsuitable for the treatment of crises affecting a specific group of countries. One may legitimately ask, therefore, if the IMF should not eventually be given broader money-creation powers.

The project of a global currency acting as a world standard of value, a peg for local currencies and a reserve instrument for central banks is certainly no more unrealistic than the project of a single European currency looked twenty-five years ago[16]. Like the euro, it would be the concrete expression of political authority in the monetary sphere. This manifestation of political power would surely be more appropriate than those we are witnessing today in the manipulation of interest rates and exchange rates by governments. Like the ecu, the global currency could take the form of a basket of international currencies. It would act as a reference currency, offering a better gauge of macroeconomic imbalances in the world–particularly in terms of cyclical timing differ-

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16. The first economists to suggest that the international monetary system should evolve toward a single world currency were R. Mundell (1983), "The Case for a Managed International Gold Standard", in M. Connolly (ed.), *The International Monetary System: Choices for the Future*, New York: Praeger; and R.N. Cooper (1984), "A Monetary System for the Future", *Foreign Affairs*, 63:1. I have also advocated the same line in "Rebuilding an International Monetary System", *The Wall Street Journal*, 24 February 1988.

ences between countries as well as their structural strengths and weaknesses. Unlike SDRs, however, the weightings in this currency basket would have to be based on objective data and would need to adjust to shifts in the global economy, in keeping with transparent rules. There should also be a provision enabling the rules of allocation among members to be modified from one transaction to the next.

Why have banks not already taken the initiative to offer their customers a basket of international currencies? Why has the SDR market–unlike the ecu market–failed to flourish? The difference is due to the fact that SDRs were implicitly covered by the dollar, the only global currency until now. This situation is likely to change with the emergence of the euro as the competing international currency. Another explanation is that some European countries, such as France, have agreed to borrow in ecus. This suggests that nations would have a key role to play in the development of a global currency. While this prospect is not unrealistic in the long term, it makes less sense in the short run–at least in Europe–since the main priority of European countries in the years ahead will be to make sure the euro market is running smoothly and to switch their public debt into the single currency.

■ An historic responsibility of the G7

Since the late 1980s and the obsolescence of the Louvre accord, the G7 has lost its ability to define coordinated responses to the challenges facing the global economy[17]. It has failed to establish its legitimacy and credibility in the eyes of the emerging countries. It has been incapable of promoting initiatives to deal with the rise of unemployment in the European economies, the deepening recession in Japan, the explosions of current-account imbalances between the leading currency zones (Japan, United States and Europe), and the crises in the emerging regions. Instead of urging the international financial organizations to set up “early warning” and “rapid reaction” systems, the G7 has

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17. The decline of the G7 has been very lucidly analyzed by C.F. Bergsten and R. Henning, *op. cit.* [13].

basically contented itself with managing a sort of "mutual non-aggression pact" between the main industrial powers. It did little to curb the instability of currencies in flexible exchange-rate systems or to counteract the consistent overvaluation of currencies in fixed exchange-rate systems. As a result, all the G7 countries–and not only the emerging countries–experienced at least one major currency crisis in the 1990s, among them the EMS crisis of 1992-93 and the yen surge and dollar slide of 1995.

Today, everyone criticizes the IMF and blames it, if not for the crises themselves, at least for the scale of the recent episodes. This was not the case before the Asian crisis. It should be remembered, however, that the IMF's actions in Asia, Russia and Brazil were carried out with the full backing of its board of directors–that is, of its member States, notably the G7. It is all the more inappropriate for G7 countries to attack the Fund as they were ultimately responsible for the international monetary and financial order; they failed to perform that duty owing to the vain disputes among their governments and between their governments and central banks. As a result, the G7 has not sufficiently adapted to the new global economic environment, in particular the explosion of international capital flows and the rise of the emerging economies. The G7 thus bears a special responsibility in the playing field without rules, constraints, or sanctions born of the collapse of the Bretton Woods system.

The G7 must now change this situation and contribute promptly and decisively to the edification of a full-fledged international monetary and financial order. First, the G7 must define a new doctrine for IMF intervention and give the IMF the means to act by granting it greater latitude in its negotiations with countries seeking its help and by increasing its financial resources. After the quota increases now under discussion, IMF resources measured against international trade volume will stand at only 11% of their level in 1945: this does not make sense. Second, the G7 must reform itself in order to (1) take better account of the interests of the new, emerging economies and (2) achieve the flexibility needed to adapt to global economic and financial change without being paralyzed by short-term conflicts of interest. In particular, the G7 structure should be adjusted to separate

the initiatives concerning the relations between the three main currencies (euro, dollar and yen) from broader initiatives that call for an adequate representation of small countries and emerging countries. These are the necessary foundations of a new international monetary and financial architecture. Their establishment requires close cooperation between the main industrialized countries, at government and central-bank level. Indeed, their governments and central banks must be fully aware that their international responsibilities, in an open economy, are simply an extension of their domestic obligations.

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