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‘Contestable Key Currencies System (CKCS): A Regime Transformation Is Needed for Global Monetary System’

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1. Malfunctioning of Floating Exchange Rates (FER)

FER and Inflation

-Widened inflation differentials among countries under FER

-Increased rate of world inflation by Laffer-Mundell Ratchet Hypothesis under FER. In fact, world rate of inflation was considerably increased under the current FER than that in the Bretton Woods (BW) system. Moreover, root cause behind the two oil price hikes in 1970s is FER, although some people think FER could well accommodated the two oil price hikes.

FER and Balance of Payments (BOP) Adjustment

-Profoundly widened current account surpluses and deficits under the current FER than those in the BW System

-No major effects on current account adjustment despite large swings in exchange rates among the major currencies, the dollar, the DM and the yen

-Almost 40 years experience of the current FER clearly shows that elasticity pessimism with regard to the Marshall-Lerner-Robinson Condition (the MLR Condition) was correct.

-In other words, income elasticity for imports is much larger than price elasticity for imports. Consequently, deflationary policies are right solutions to deficit countries under any exchange rate regime. Said differently, recovering I-S balance is the key to the solution for any deficit country, including the US.

-I have been arguing FER has no major effects on BOP (current account) since 1977 when I came to that conclusion by empirical study using my own Japan's BOP econometric model. Now I am much more convinced that conclusion was correct.

-If FER does not have sufficient effects on BOP adjustment, we have to revert to a very fundamental question why we should make exchange rates change moment by moment every day.

FER and Influences on Domestic Economies

-Very large harmful effects of large swings in exchange rates on the domestic economies, because exchange rate changes have large effects in real term through substantial changes in real trade balance expressed as export quantum index divided by import quantum index, unlike BOP which is purely a concept of nominal term.

-Substantial effects on employment in the both countries through large impact on real trade balance

FER and Influences on Private Firms' Profit-Loss Situation

-very big adverse effects on firms' business forecast by changing break-even points easily caused by large exchange rate changes. Firms' very painful cost reduction efforts for years would be nullified in an instance by substantial exchange rate changes on the border. It would be unfair in light of the principle of free market economy.

Frequent Over-shootings of the exchange rates

-Sometimes appreciation/depreciation occurred in succession in one direction by “talking intervention” and/or extrapolative expectations in the market in the current FER.

Undisciplined US economic policies under FER

-No BOP discipline could be imposed on the US at all under the current FER.

-Exports of undisciplined policies from deficit countries (US) to surplus counties would occur under FER. It is extremely detrimental to the efficiency of the world economy as a whole.

2. Very High Frequency of Crisis Occurrence under FER

According to Carmen Reinhart & Kenneth Rogoff’s book, *This Time Is Different* (2009), frequency of crisis occurrence (external debt crisis + banking crisis) in the current FER is almost equivalent to that in the notorious period of Inter War, and incomparably higher than those in the BW system or in the Gold Standard System (GSS). Obviously we live in a world with a very high possibility of crisis occurrence. In fact, we have experienced too many crises in the current FER, such as;

-the first oil price hike in Oct. 1973

-the second oil price hike 1979-1980

-Latin American debt problem since Aug.1982

-the Plaza Accord in Sep. 1985, and exorbitantly sharp appreciation of the yen and the DM

-Black Monday in Oct. 1987

-EMS crises 1992-1993

-Mexican peso crisis since Dec. 1994

-Asian currency crisis since July 1997

-Global emerging market economies’ crises in Russia, Brazil, Argentina and Turkey, etc. 1998-2001

-US sub-prime housing loan crisis in July 2007, and global financial and economic crisis since Sep. 2008

3. High Risk of US Policy Failures

(1) US BOP deficits have been always the largest problem for the world economy for the recent half century, because they have been inviting the dollar crises repeatedly. But, the US has been almost completely neglecting their BOP deficits, and has been always aiming at high economic growth selfishly and voraciously. The US has never addressed its BOP problem correctly for a half century.

- The first dollar crisis erupted in Oct. 1960 under the Eisenhower administration, because of chronic US deficits in basic balance since the end of 1950s.
- US deficits in trade balance since 1971
- US deficits in current account since 1977
- The US has been the world largest net external debtor since 1986.

(2)The two huge policy mistakes in the US for 30 years

- Unusual policy mix with fiscal laxity and extremely restrictive monetary policy in the first half of 1980s
- Continuation of too much accommodating monetary policy for a very long time since mid-1990s

4. Strikingly High Frequency of Crisis Occurrence in the US and UK in the History

The number of banking crises 1800-2008 source: Reinhart & Rogoff (2009)

- US; 15 times
- UK; 13 times
- Japan; 7 times
- Germany; 4 times
- Switzerland; 4 times
- China; 7 times

5. Overall Assessment of FER

- FER is “incompetent” in terms of no major effects on BOP adjustment, “harmful” in terms of substantial adverse effects on domestic economy, and even “unfair” contrary to the principle of free economic world.
- The characteristics of FER are disorder, lack of discipline and malfunctioning of adjustment mechanism.
- The only one benefit of FER is very compatible with democratic polity, because no one is needed to take responsibility for exchange rate changes even if a very large swing of the exchange rate happens in a very short period. Politicians could always say it was decided

in the market.

-Freemarketeers think the exchange rate is one prices, like an apple or a potato. However, the currency has the three fundamental functions, store of value, medium of exchange, and standard of value (unit of account, or numeraire). Currency and the exchange rates between the two currencies should be recognised as the yardstick for standard of value, not just a price. FER is an unwise system which makes its yardstick flexible. Inherently the yardstick must be fixed. Otherwise currency is not able to function as standard of value. In fact we are living in a world without any international standard of value.

-In conclusion, FER has fatal flaws.

6. Assessment of the Current FER in the History of 300 Years with the 6 Periods

(1) Silver Standard System (SSS), the end of 17th century - the end of 18th century,
de facto FER

(2) 3 Currency Blocs Based on Gold-Silver Bimetallic Standard (BSS), 1800-1867,
Fixed Exchange Rate Regime with GSS, SSS and BSS (central country = France)
A very stable system with rapid world trade expansion

(3) Gold Standard System (GSS), 1880-1914
Fixed Exchange Rate Regime with the central country of Britain
A very stable system with very high international mobility of capital

(4) Inter-war Period System, 1914-1945
The most unstable period with various monetary systems co-existed, but largely FER

(5) The Bretton Woods System, 1945-1971, Fixed Exchange Rate Regime,
the golden age of capitalism with the highest economic growth rate among the 6 periods and low rate of inflation

(6) The Current FER, 1945-, full-blown FER for the major currencies
World DGP growth rate is about 2 thirds of the BW system, but it is higher than GSS or BSS. The rate of inflation is much higher than the other periods.
The frequency of crisis occurrence is almost equivalent to the notorious Inter-war period.

-Although the current FER is much better than the system in the Inter-war period, the current FER is inferior to the Bimetallism (2), the GSS (3) and the BW system (5). The current FER is the second worst among the recent 5 periods, because it is extremely unstable.

-Under the BW system, the world economy recorded the best performance in recent 300 years.

-The BW system was not destined to collapse. The reason why the BW system collapsed was that the US did not carry out the role as the central country of the system.

-Under the current FER, the US is not fulfilling the role of the central country which is considered to avoid world inflation and any severe international crisis. I even doubt that the US does not recognise its role as the central country of the system at all. The US has huge vested interests in the current FER, but they do not recognize any obligation in exchange.

-Gold price has been exorbitantly high particularly after Lehman Brothers Shock. I think it reflects not only people's non-confidence in the dollar but also dissatisfaction and deep concern with the current international monetary system itself.

6. My Proposal of the Contestable Key Currencies System (CKCS) : A Regime Transformation

-The system aiming at "competitive equilibrium" is needed by establishing the 3 key currencies system with the dollar, the euro and the Asian currency.

-The key exchange rates among the 3 currencies should be fixed with a narrow fluctuation margin, so that BOP discipline could be imposed on each key currency.

-Each 3 key currency should have its own gold parity. Possession and trading of monetary gold by the private sector should be prohibited, because this is a kind of the Gold Exchange Standard System (GESS), like BW system.

-When countries accustom themselves to fixed currency relationships, wages, prices, and interest rates tend to harmonise across borders.

8. My Proposal for Immediate Solution

The Creditors' 5 Initiative (the C5 Initiative)

-International financial and monetary system must be re-established by creditor's logic, not by debtor's logic. In any country, domestic financial and monetary system must be designed and established by creditor's logic, unlike the current global system. In fact, however, the current global system has been managed by the largest debtor, the US. This is almost absolute contradiction in the world economy. That is why we are facing very high risk of crisis occurrence, because of debtor's lack of moral. The group of the 5 largest creditors, Japan, China, Germany, Switzerland and France should be established, and should propose the needed reform for the global economic management.

-C5 should request the US to issue "the Obama bonds" which are Treasury Notes denominated in creditors' currencies, not the US dollar.

-The US opposes any meaningful reform of international monetary system, as the central of the system country had always been doing in the history. We should not give up reform because of US opposition. We have to overcome it, otherwise any meaningful reform could not be achieved in the field of international monetary system.

The Germano-Japanese Model of economic management should be respected.

-Japan was an honour student keeping the rules of the game under BW system. The rules of the game under BW system were that BOP deficit countries should take the necessary deflationary policies in an attempt to improve their BOP position. This is the core principle of policy discipline for member countries under BW system or any other fixed exchange rate regime.

-Germany showed a model of stability-oriented policy for the member of the EMS. For example, France changed its basic policy in March 1983, following the German model. Since then the EMS had been working very smoothly.

-The world economy should be managed by the Germano-Japanese model of stability-oriented policy rather than boom-and-bust type of the Anglo-Saxon model.

Reform of IMF governance

-The core issue is to alter the Qualified Majority Voting (QMV) in the IMF Executive Board Meetings. Currently, 85% is required to decide important matters in the IMF, while the US has its voting power of 16.83%. Consequently, only the US virtually has a sole veto. The IMF is much worse than UN Security Council. It is extremely anachronistic for an international institution in the 21st century. The US is acting as if it were a feudalistic lord in the IMF. The IMF members other than the US should unanimously demand to change the QMV to two thirds or 70%. Any country/ area should not be allowed to have a sole veto in the IMF. The collective representation of the European Union in the IMF should be allowed only after the revision of the QMV. I could not believe any meaningful reform in the IMF until the revision of QMV will be realised.

Policy recommendations for China

-China is not needed to adopt FER, although the US has been requesting it. China changed its exchange rate regime in July 2005, saying it will take managed float. But, in fact China's exchange rate regime should be described as ultra-short stroke crawling peg by revaluing the RMB very gradually on a daily basis, and fixed to the dollar again since September 2008. I think crawling peg would not be bad for China currently.

-The RMB is virtually fixed to the dollar at the moment. But, it means the RMB is freely floating against the yen and the euro. It should be described as "One –third Fixed and Two-thirds Floating Exchange Rate Regime", not a really fixed exchange rate regime. This peculiar exchange rate regime is very unstable, because there is a substantial mismatch between China's international economic relationships and a way of currency pegging. It is much better for China to adopt the Triple-currency Basket Based Fixed Exchange Rate Regime which is the first stage of my proposal for "the Asian EMU" as mentioned later.

-But, China should revalue the RMB exchange rate soon, because China's current account surpluses as a percentage of GDP in recent years have been running around 10% which is just outrageously high. Keeping huge current account surpluses with no appreciation of the RMB means exports of unemployment to the rest of the world. BOP adjustment should not be made by exchange rate changes, because of no substantial effects on BOP. But, China should respond to criticism for exports of unemployment.

9. My Proposal for Asian Monetary System

The three stages for the Asian EMU (Economic and Monetary Union)

(1) -Triple-Currency ($,euro and yen) Basket Based Fixed Exchange Rate for every East Asian county other than Japan

-Establishing the Asian Currency Unit (ACU), and to be used for monitoring exchange rates of the countries within the region

(2) The Asian EMS of fixed exchange rate regime

-Start with 6 currencies of the Japanese yen, the HK $, the Singaporean $, the Korean won, the Taiwan $ and the Malaysian ringgit, first.

-And then, the RMB and the Thai baht could join the club later. It is going to be 8 currencies.

(3) The Asian EMU (a unified currency)