

# Contestable Key Currencies System Based on GESS

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at ADBI-DG Ecfm-EIAS Conference

in Brussels, Feb. 4, 2010

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# Introduction

A Regime transformation, not just a reform, is needed for international monetary system.

As for immediate solution, we should not give up because of US opposition. The US opposes any meaningful reform, because it has huge vested interests in the current international monetary system.

- We in the international community have to overcome it with enhanced international cooperation.
- How to discipline the US is the key to success of the new international monetary system.

# Malfunctioning of Floating Exchange Rates (FER)

## 1. FER and Inflation

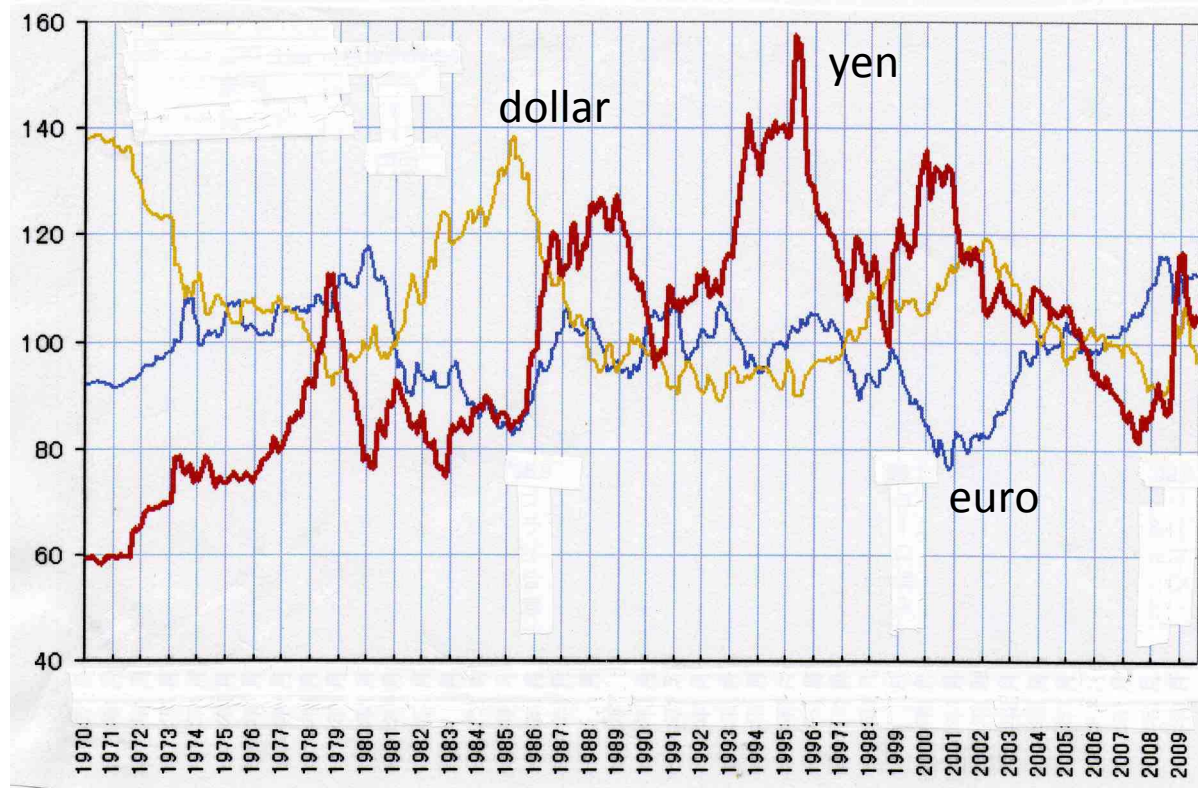
- Widened inflation differentials among countries through depreciation-inflation-spiral in high inflation countries.
- Increased rate of world inflation by ratchet effect
- FER is root cause behind the two oil price hikes in 1970s. In fact, inflation rates in the current FER are much higher than those under the BW.
- FER has nothing superior to the fixed exchange rate as for inflation.

# Malfunctioning of FER(2)

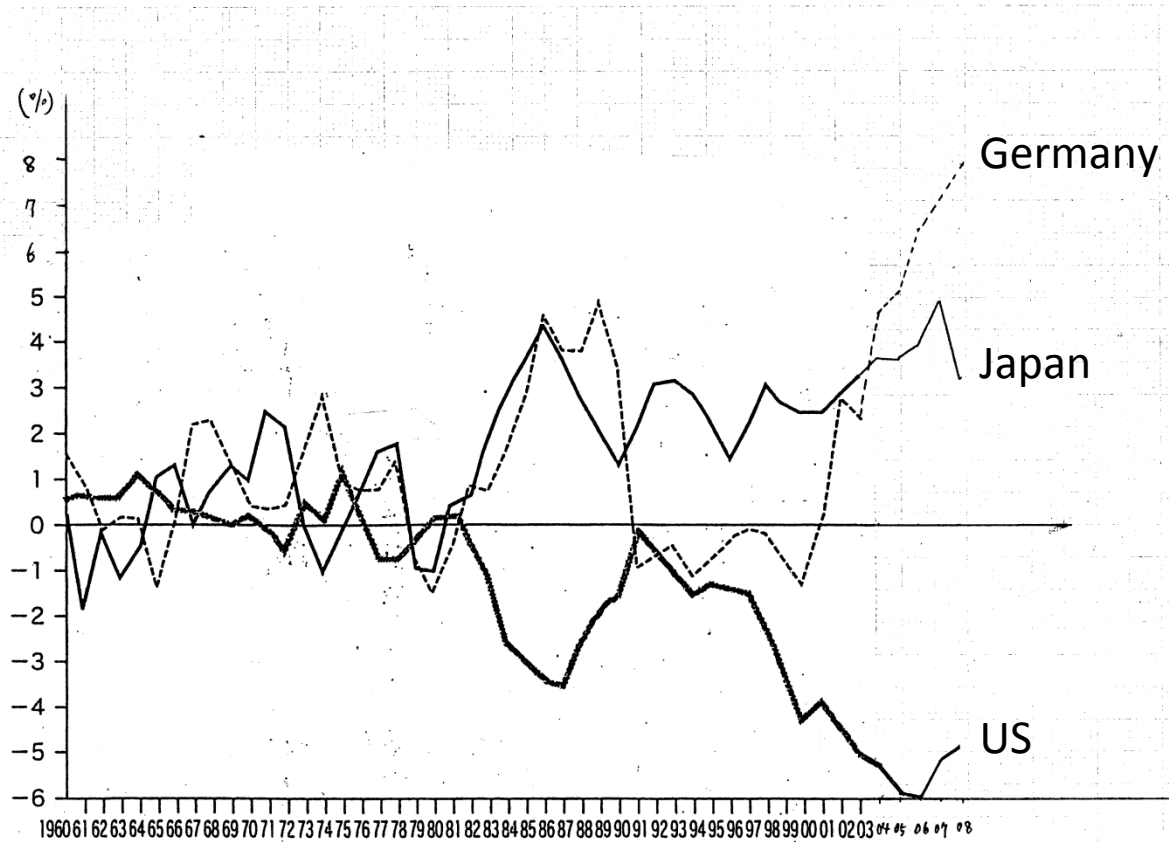
## 2. FER and Balance of Payments (BOP) (1)

- Profoundly widened current account gaps under the current FER
- No major effects on current account adjustments despite large swings in REER among the major currencies
- 40 years experience clearly shows elasticity pessimism on the MLR Conditions is 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.

# Real Effective Exchange Rate (REER)



# Current Account as a Percentage of GDP (1960-2008)



OECD, "Economic Outlook—Historical Issue"

# Malfunctioning of FER (3)

## 2. FER and BOP (2)

- In other words, income elasticity for imports is much larger than price elasticity for imports.
- Consequently, deflationary policies are needed for deficit countries to make BOP adjustment effectively.
- Said differently, recovering I-S balance is the key to the solution for any deficit country including the US.
- I have been arguing malfunctioning of FER since 1977 from an empirical study by using my own Japan's econometric BOP model.

# Malfunctioning of FER (4)

## 3. FER and Influences on Domestic Economies

- Very large harmful effects of large swings of exchange rates on domestic economies through a substantial change in real trade balance, unlike BOP which is a concept of nominal term.
- Substantial effects on employment in the both countries through large impact on real trade balance.

# Malfunctioning of FER (5)

## 4. FER and Firms' Profit-loss Situation

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

# Malfunctioning of FER (6)

## 5. Frequent Overshooting

- Sometimes appreciation/depreciation occurred in succession in one direction by “talking intervention” and/or extrapolative expectations under the current FER.
- In fact, humps of the Yen’s steep appreciation were created by “talking interventions”, several times including “James Baker’s Hump” 1986-1987.

# Malfunctioning of FER (7)

## 6. Undisciplined US Economic Policies under FER

- No BOP discipline could not be imposed on the US at all under the current FER.
- Exports of undisciplined policies from the US to surplus countries would occur. It is extremely detrimental to the efficiency of the entire world economy.

## Very High Frequency of Crisis Occurrence under FER

- Frequency of crisis occurrence under the current FER is almost equivalent to that in the notorious period of the Inter-war. See the next slide.
- Incomparably higher than those in the BW or 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; -----

# Frequency of Crises Occurrence (1900-2008)



Source: Carmen Reinhart & Kenneth Rogoff,  
This Time Is Different: Eight Centuries of Financial Folly,  
Princeton University Press, 2009

# High Risk of US Policy Failures (1)

## 1. Lack of US BOP Discipline (1)

- US BOP deficits have been always the largest problem for the world economy for a half century, because they have been inviting the dollar crises repeatedly.
- But, the US has been almost completely neglecting their BOP deficits, and has always been aiming at high economic growth selfishly and voraciously.

# High Risk of US Policy Failures (2)

## 1. Lack of US BOP Discipline (2)

- 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
- US has been the world largest net debtor since 1986.

# High Risk of US Policy Failures (3)

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

-Unusual policy mix with fiscal laxity and extremely restrictive monetary targeting policy by FRB under the leadership of Paul Volcker in the first half of 1980s

-Continuation of too much accommodating monetary policy by FRB under the leadership of Alan Greenspan for a very long time since mid-1990s

# Strikingly High Frequency of Crisis Occurrence in the US and UK in the Long History

The number of banking crises 1800-2008

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

source: C. Reinhart & K. Rogoff (2009)

# Overall Assessment of FER (1)

- FER is “incompetent” in terms of no major effect on BOP adjustment, “harmful” in terms of substantial adverse effects on domestic economy, and even “unfair” contrary to the principle of free market economy.
- The characteristics of FER are disorder, lack of discipline, and malfunctioning of adjustment mechanism.
- Only one benefit of FER is very compatible with democratic polity, because no one is needed to take responsibility for exchange rate changes.

# Overall Assessment of FER (2)

- Freemarketeers think the exchange rate is one of prices, like an apple or a potato. But, this is gravely wrong.
- Inherently, currency has the 3 fundamental functions, store of value, medium of exchange, and standard of value (unit of account, or numeraire).
- Currency and exchange rate between the 2 currencies should be recognised as the yardstick for standard of value, not just a price.
- FER is a very unwise system which makes its yardstick flexible.

# Overall Assessment of FER (3)

- Inherently, yardstick must be fixed, otherwise currency is not able to function as standard of value.
- In fact, we are living in a world of without any international standard of value. The steep rise in gold price is considered to be its reflection.
- Most of financial derivatives and mark-to-market accounting standard may not be needed under the fixed exchange rates. It seems to me FER is the root of all evils.
- In conclusion, FER has fatal flaws.

# Periodization of International Monetary History of 300 Years into 6 Periods (1)

- ① Silver Standard System (SSS), end of 17<sup>th</sup> C.-end of 18<sup>th</sup> C., de facto floating
- ② 3 Currency Blocs Based on Gold-Silver Bimetallic Standard System (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 Rates, central country = UK, a very stable system with very high international mobility of capital

# Periodization of International Monetary History of 300 Years into 6 Periods (2)

- ④ Inter-war Period System, 1918-45  
The most unstable period with various monetary systems existed, but largely FER
- ⑤ The Bretton Woods System, 1945-1971, Fixed Rates, the golden age of capitalism with highest economic growth rate among the 6 periods and low inflation
- ⑥ The current FER, 1945-, full-blown FER for the major currencies, the level of world GDP growth rate is about 2 thirds of the BW, but it is higher than GSS (③) or BSS (②). Inflation rates are much higher than other periods. Frequency of crisis is equivalent to ④.

# Assessment of the Current FER among 5 Periods International Monetary System in more than 200 Years (1)

- Although the current FER is much better than ④, it is inferior to the ② , ③ and ⑤.
- The current FER is the second worst among the 5 periods, because it is extremely unstable.
- Under the BW, the world economy recorded the best performance in recent 300 years.
- The BW system was not destined to collapse. The BW collapsed, because the central country of the system did not carry out its role properly.

# Assessment of the Current FER among 5 Periods International Monetary System in more than 200 Years (2)

- 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 recognise any obligation in exchange.

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

# My Proposal for Immediate Solution (1)

1. The Creditors' 5 Initiative (the C5 Initiative)
  - International financial and monetary System must be re-established by creditors' logic, not by debtors' logic.
  - In any country, domestic financial and monetary system must be designed and established by creditors' logic, unlike the current global system.
  - However, the current global system has been managed by the largest debtor, the US. This is almost absolute contradiction in the world economy.
  - This is why we are facing very high risk of crisis occurrence because of debtor's lack of moral.

# My Proposal for Immediate Solution (2)

## 1. The C5 Initiative (2)

- 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.
- The C5 should request the US to issue "the Obama bonds" which are Treasury Notes denominated in creditors' currencies, not the dollar.
- The US opposes any meaningful reform of international monetary system, as the central country had always been doing in the history. We should not give up reform because of US opposition, otherwise any meaningful reform could not be achieved.

## My Proposal for Immediate Solution (3)

2. The Germano-Japanese Model of economic policy
  - Japan was an honour student keeping the rules of the game under the BW. The most important rule under the BW was that BOP deficit countries should take the necessary deflationary policies.
  - This is the core principle for member countries under the BW or any other fixed rate regime.
  - Germany showed a model of stability-oriented policy for EMS members.
  - The world economy should be managed by Germano=Japanese model of stability-oriented policy ,not by boom-and-bust Anglo-Saxon model.

# My Proposal for Immediate Solution (4)

## 3. Reform of the IMF governance (1)

- The core issue is to alter the Qualified Majority Voting (QMV) in the IMF. Currently, 85% is required to decide important matters, while the US has its voting power of 16.83%. Consequently, only the US virtually has a sole veto. IMF is much worse than UNSC.
- It is extremely anachronistic for an international institution in the 21<sup>st</sup> century. The US is acting as if it were a feudalistic lord in the IMF.
- The IMF members other than US should unanimously demand to change the QMV to two thirds or 70%.

# My Proposal for Immediate Solution (5)

## 3. Reform of the IMF governance (2)

- Any country/region should not be allowed to have a sole veto in any international institution.
- The collective representation of the EU 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.

# My Proposal for Immediate Solution (6)

## 4. Policy recommendations for China (1)

- China is not needed to adopt FER, although the US has been requesting it.
- China's exchange rate regime since July 2005 should be recognised 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 styled gradual revaluation is not so bad for China.
- The RMB is virtually fixed to dollar at the moment. But, it means that the RMB is freely floating against the yen and the euro.

# My Proposal for Immediate Solution (7)

## 4. Policy recommendations for China (2)

- 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.

# My Proposal for Immediate Solution (8)

## 4. Policy recommendations for China (3)

- 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.

# My Proposal for Asian Monetary System (1)

## The 3 stages for the Asian EMU

- ① Triple-currency Basket Based Fixed Exchange Rate Regime for every East Asian countries 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 \$, Singaporean \$, the Korean won, Taiwanese \$ and Malaysian ringgit, first.

# My Proposal for Asian Monetary System (2)

## The 3 stages for the Asian EMU

- ② The Asian EMS (continued from the previous slide)
  - And, then the RMB and Thai baht could join the club later. It is going to be 8 currencies in total.
  
- ③ The Asian EMU (Economic and Monetary Union)
  - A unified Asian currency