Commentary: Macroeconomic Policy Implications of Currency Zones

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It is a great pleasure to return, once again, to Jackson Lake Lodge where the visage of the craggy peaks of the Grand Tetons across the gleaming surface of Jackson Lake always seems to provide such appropriate inspiration for discussions of the international monetary and financial system. It is especially a pleasure to comment on the thoughtful and stimulating paper of Jacob Frenkel and Morris Goldstein.

Few here will be surprised—and perhaps some may even, be reassured—that I share most of the views that Jacob and Morris express in their fine paper. There is, after all, a certain element of incest associated with my commentary on their paper.

Before assuming his responsibilities as governor of the Bank of Israel and before his five-year tour of duty as economic counselor and director of research at the International Monetary Fund (IMF), Jacob was, for many years, my close colleague and frequent coauthor at the University of Chicago. I have also known Morris for many years. While we have not yet had the opportunity to work as colleagues and coauthors, who knows what the future may hold? (For the present, at least it may be said that I did not suggest that Moms draft the comments on his own paper.)

Rather than remark on the wide range of important issues discussed by Frenkel and Goldstein,'I should like to focus my brief comments

on three central issues: (1) the essential relationship between exchange rate policy and monetary policy, (2) the critical political element in the choice of exchange rate regime and (3) the nature and functioning of market mechanisms for enforcing fiscal discipline on national governments.

First, as Frenkel and Goldstein emphasize, especially in an environment of open trade and capital mobility, there is a tight relationship between the choice of national monetary policies and the choice of exchange rate regimes. Specifically, the decision to fix the nominal exchange rate between national currencies is necessarily and simultaneously the decision to limit very severely the range for independent national monetary policies—it is almost (if not quite) the decision to adopt a single, unified monetary policy. From this vitally important principle, there follow critical implications both for the circumstances under which a currency bloc will be appropriate and viable and for the operation of a currency bloc if one is established.

For the question of the appropriate size and makeup of currency blocs, the key issue is the willingness and desirability of subordinating national monetary policies to the constraints implied by fixed nominal exchange rates. Here, I would emphasize the basic conclusions of Frenkel and Goldstein. For a variety of reasons, on economic grounds, a stronger case can be made for greater exchange rate fixity ***within*** the European, American, and Asian blocs than ***between*** these major blocs. Also, I heartily endorse the following key point of Frenkel and Goldstein concerning the viability of arrangements to fixed exchange rates between these blocs.

> "So long as the anchor countries (of the blocs) do give the highest priority to price stability (as the objective of monetary policy), tight and ambitious exchange rate commitments will lack the credibility they need to be effective (since market participants will learn that when push comes to shove, interest rate adjustments necessary to defend exchange rate targets are not forthcoming."

Within a currency bloc, there are essentially two alternatives:

either there will be a leading national monetary authority that determines its own policy, with other countries adjusting to that policy; or there will need to be some more symmetric mechanism for determining the overall monetary policy of the bloc. To an important extent, this is the key issue to be resolved in discussions about a European central bank for the European Monetary System (EMS). It is generally agreed among members of the EMS that there should be a high degree of nominal exchange rate stability (perhaps evolving into a common currency). Up to this point, the Bundesbank, which has consistently pursued a low-inflation monetary policy, has provided the nominal anchor for the EMS. Rather, the key question concerning the establishment of a European central bank is whether to replace Bundesbank leadership with a more politically symmetric mechanism for determining monetary policy in the EMS.

This question leads naturally to my second main point—the general importance of political considerations in determining monetary and exchange rate arrangements. Nothing in the economic concept of an "optimal currency area" automatically implies that sovereign nations would naturally and inevitably constitute the geographic domains of monetary units. Nevertheless, at least in modern times, there are few examples of national governments that have not sought to enforce a single monetary standard within their domain of political authority. As a scientific matter, the hypothesis that political considerations dominate over economic factors in determining the domains of operation of different currencies is extremely powerfully supported by the empirical evidence. No other hypothesis can conceivably explain the close correlation between currency areas and domains of political authority both over time and across the surface of the globe.

Political considerations also importantly influence monetary and exchange rate arrangements among nations. As Frenkel and Goldstein conclude—and as I would agree-creation of a currency bloc and ultimately of a single currency in the European Community (EC) has both potentially important economic benefits and potentially important economic costs. Concerning the relative balance of benefits and costs, economic analysis indicates forcefully that "it all depends." Political considerations, however, suggest tighter exchange rate arrangements and closer monetary coordination among mem-

bers of the EC as an expression of increasing political solidarity. In the end, whether the EC creates a powerful European central bank (that effectively takes control of EC monetary policy) and ultimately moves to a single currency depends, in my judgment, more on the strength of European political identity than on narrow calculations of economic benefits and costs.

My third main point concerns mechanisms for imposing fiscal discipline on national governments. As Frenkel and Goldstein note, little has been settled at this stage concerning the implications of currency zones for the issue of fiscal discipline. I would add that inadequate fiscal discipline can be a problem regardless of a country's monetary and exchange rate arrangements, although the nature of those arrangements may affect manifestations and consequences of inadequate fiscal discipline.

Under a floating exchange rate regime or under an adjustable peg system, when a country gets into fiscal difficulties, the adjustment to deal with these difficulties often involves a change in the exchange rate. In contrast, under a single unified currency system, a national government or a sub-national governmental unit loses the capacity to alter the exchange rate as part of the mechanism for dealing with a fiscal crisis. After a detailed discussion of the pluses and minuses of the alternative exchange rate and monetary systems, Morris and Jacob conclude that fiscal discipline tends to be a little stronger under a fixed exchange rate or unified currency regime than under a floating exchange rate regime.

Perhaps recent experience in the United States provides further useful evidence on this point. We observe that many state governments have recently faced large fiscal deficits and have been taking dramatic, some might even say draconian, measures to correct their fiscal imbalances. In contrast, the federal government of the United States has cruised happily along for nearly a decade with a budget deficit of more than 3 percent of GNP, and is currently running a deficit of nearly double that size. Even though the federal government has not relied on money creation to finance its deficit, the fact that the U.S. government issues its own money appears somehow to provide greater fiscal flexibility than is typically enjoyed by state

governments that do not have separate monies.

The last issue that I want to discuss in the Frenkel/Goldstein paper is how fiscal discipline is imposed in a system with a single currency or with rigidly fixed exchange rates. The mechanism for imposing discipline is not only, and probably not primarily, the tendency for borrowing costs to rise as an individual debtor's activities appear to become less and less fiscally prudent. Instead, the most important mechanism for imposing discipline is what happens when the crunch comes—when actual and potential creditors come to believe that a borrower may be unable or unwilling to service his obligations. That is when fiscal discipline is most actively and effectively enforced.

It is important to understand that this critical part of the mechanism of fiscal discipline functions for private debtors as well as for governmental borrowers. For example, as a number of practitioners of leveraged buyouts have learned during the past two years, fiscal discipline is imposed when your creditors decide not to advance new loans or to roll over existing loans. Similarly, for virtually all businesses that get into financial difficulty, the sternest 'discipline is imposed when the crunch comes—when creditors come to doubt that they will be repaid.

This same mechanism operates for governmental borrowers. Fiscal discipline was finally imposed on New York City in the crisis of the mid-1970s when the city could no longer roll over its short-term debt. For national governments (borrowing in foreign currencies), the same point is illustrated by the recent debt crisis. As several developing countries discovered in the early 1980s, fiscal discipline is sometimes'imposed not by a gradual rise in their borrowing costs, but rather, by a sudden shutdown of credit availability. Thus the key issue for fiscal discipline is how the system functions in a crisis and what circumstances provoke a crisis.

On this point, it is important to re-emphasize something that Moms said in his presentation—for the system of fiscal discipline to work effectively, both debtors and creditors need to recognize that they will bear part of the costs of a financial crisis. Debtors must bear an important part of the costs so that they will have appropriate

incentives to avoid the indiscretions that generate fiscal crises. Thus, in the case of New York City, it was important that subway fares and bridge tolls needed to be increased and municipal payrolls needed to be reduced as conditions for financial assistance. Similarly, as Pedro Aspe emphasized yesterday, the Mexican government had to make tough decisions about massive cuts in its budget deficit as an essential condition for resolving its financial crisis.

Creditors also need to feel the pain of financial crises. After all, as a moral matter, excessive and imprudent borrowing is possible only if there is excessive and imprudent lending. Perhaps more important, as a practical matter, excessive and imprudent borrowing is effectively stopped when fiscal discipline is imposed by the termination of excessive and imprudent lending. The incentive to terminate such lending comes from the desire of creditors to avoid the pain of being caught in a financial crisis. The creditors who prudently withdraw before the crisis, get out whole; those who delay, take their lumps. If creditors know that they will suffer no losses, they have no incentive to pull the plug on excessive borrowing. This, of course, is an important part of the great savings and loan debacle. Insured depositors knew that they had nothing to lose by lending to institutions that offered particularly attractive interest rates, even if those institutions were deeply insolvent. For creditors to be provided with the essential incentive to impose effective discipline on borrowers, creditors must know that they are likely to suffer losses, along with borrowers, if lending is excessive and imprudent.

To conclude these remarks, I require an appropriate transition which I borrow shamelessly from Monty Python—"And now for something completely different."

Much of the discussion at this conference has focused on the growth of trade blocs and the demise of the General Agreement on Tariffs and Trade (GATT). Personally, I take a more optimistic view of the development of the world trading system. At the beginning of this century the world was divided into trading blocs, as it has been for much of history. Those trade' blocs were called "empires" and they were often exclusive, protectionist, and antagonistic. During

the period of the GATT—the period since World War 11—we have moved dramatically away from the old imperial systems and toward a much more open system of world trade. Recent developments in the European Community and in North America are not reversals of this broad trend of development of the world trading system.

Indeed, the most important developments of the past five years have clearly been in the direction of broadening the principles of open trade. One of the most important exceptions to the general rules of the GATT for most of the postwar era has been the special exemption granted to developing countries from abiding by the rules of open trade. Somehow, the combination of mercantilist illogic, nationalist bravado, and Marxist nonsense placed the knife of protectionism into the hands of developing countries and invited them to slit their own throats. During recent years, an ever growing group of developing countries have recognized the stupidity of inward looking economic policies and have moved unilaterally to remove their self-constructed barriers to participation in the world trading system. This is a very positive development, most especially for these countries, but also for the GATT system. In the Uruguay Round of trade negotiations, many developing countries are no longer protectionist pleaders for special privileges. Quite rightly, they demand that the industrial countries live up to their rhetoric, saying, in effect, "Look, you stinkers, why aren't you abiding by the rules of open trade?'

Another great exception to the general application of GATT principles has been the world's last great empire—the Soviet Union and its former satellites in Central Europe. The past two years have seen the demise of that empire, and many of the subject states of that empire are now banging at the door of GATT and of the European Community, demanding entry into the system of open world trade.

Thus, there is legitimate concern about the delay in concluding the Uruguay Round and the threat that it may ultimately fail. There is also reason to worry that regional trading arrangements may incorporate some protectionist elements. Nevertheless, the main trend of development is still toward a more open system of international trade. "The force is with us."