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The New International Financial Architecture

By Ernest H. Preeg*

Exhaustive discussion over the past couple of years about a new international financial architecture has focused on better and possibly bigger International Monetary Fund (IMF) lending facilities for financially troubled emerging market economies such as Mexico, Thailand, Indonesia, South Korea, Russia, and Brazil. It will rise again to ministerial level at the World Bank/IMF meetings in Washington in September.

Unfortunately, this discussion is largely misdirected. A new financial architecture is emerging, but it principally involves a transition from the dollar-based system of the past half-century to a truly new framework of floating exchange rates and monetary unions, and in the process the IMF role should be reduced greatly. The most important policy challenge is to define currency relationships evolving among the dollar, the euro, and the yen, including how to deal with the unsustainably lopsided current account relationship of record U.S. deficits offset by large surpluses in the other two key currency areas.

The emerging new architecture is a result of rapid growth in international trade and investment since the mid-1980s and a parallel integration of world capital markets. As a consequence, government attempts to defend an exchange rate linked to the dollar have become very costly or unfeasible. Recent financial crises in Asia and elsewhere

have all been triggered by futile government attempts to maintain a dollar-linked exchange rate, and the result for all six countries listed in the first paragraph has been a shift to a floating exchange rate policy.

The new architecture, in fact, consists of two strong tendencies, either toward floating rates or monetary union, which can be called the “two corners architecture” to reflect this bipolarity. The monetary union option has been adopted in Europe through the formation of the European Monetary Union (EMU) and is being discussed within the Western hemisphere in terms of “dollarization”, whereby other countries simply adopt the dollar as a replacement for their national currencies.

The initial thrust of the new architecture, however, apart from the EMU, is almost entirely toward the floating rate corner, qualified as a managed floating rate policy, and much depends on how “managed” is defined. In particular, central bank intervention in currency markets, which can have significant impact on exchange rates, needs more clearly defined guidelines and disciplines. Such intervention, in recent years, has been used by some others as an instrument of trade policy, whereby the central bank buys large amounts of dollars to keep its exchange rate low and thus to stimulate a trade surplus. This mercantilist objective was especially strong during 1990-96 when foreign central banks increased dollar holdings by \$461 billion, equating to 90 percent of the U.S. current account deficit during those years. The result was a stronger U.S. dollar than would have occurred from market forces alone, and a possible doubling of the U.S. current account deficit by the end of the period. The financial crises of 1997-98 kept the

dollar very strong on its own, but as recovery begins in 1999 a renewed interest in central bank purchases of dollars is evident in some countries.

At this transition stage for the new architecture, the relationship among the dollar, the euro, and the yen is a managed float with very different definitions of “managed”.

The United States follows a basically free float with minimal currency market intervention by the Federal Reserve Board and the U.S. Treasury. The rare and highly publicized intervention to support the yen in June 1998 amounted to less than \$1 billion.

Japan, in contrast, has consistently used exchange market intervention as an instrument of trade policy. The Bank of Japan buys large amounts of dollars when the yen strengthens to the point of restraining Japanese exports. Official reserves have consequently increased from \$72 billion in 1992 to \$220 billion in 1998. When the yen rose to 110 in January 1999, the Bank of Japan immediately bought \$8 billion to push the rate back down.

The EMU doesn't yet have an exchange rate policy. As long as the euro is weak there is no interest in European Central Bank intervention, and the euro floats freely. But if the dollar rate should strengthen to 1.25 or more, while unemployment remains in double digits in key member states, pressures will quickly develop to buy dollars and avoid a decline in the European trade surplus.

Other major trading nations, including Canada, Mexico, Brazil, South Korea, Thailand and Indonesia, also have ill-defined floating rates. Interest rate policy is often used in conjunction with currency market intervention to influence the exchange rate. South Korea, now on the post-crisis recovery path, has been able to bring interest rates down below pre-crisis levels while the central bank buys large amounts of dollars to keep the won weak and the trade surplus intact.

A big question mark country for the new architecture is China, with the yuan pegged to the dollar, but on a nonconvertible basis. The result has been a consistent Chinese trade surplus and a huge build-up of official reserves by the central bank to \$149 billion, or more than 100 percent of annual imports. The implication is that the nonconvertible yen is undervalued, although China threatens to move in the other direction and devalue its currency further. At some point, the yuan needs to become convertible, and then the same “two corners” pressures will come into play. Hong Kong will also be affected because the Hong Kong dollar has been linked to both the U.S. dollar and the Chinese yuan, and if the latter were to become more flexible with convertibility, Hong Kong would have to choose whether to link to the U.S. dollar or the yuan.

In parallel with the broadening of the basic two-corner architecture, IMF loans would become less necessary or useful. Mexico, which floated its rate in 1995, then went on to float successfully through the financial crises of 1997-98 without recourse to the IMF or other large official borrowing. It is doubtful that other emerging market

economies now with floating rates will again need the kind of large financial packages put together over the past four years. A major benefit of a floating rate policy, in fact, is the discipline it imposes on governments not to let fiscal, banking, and other policies drift dangerously out of line.

In terms of geographic scope of the emerging new financial architecture, the industrialized countries, which account for 65 percent of world trade, are now all clearly in one or the other corner, with monetary union in much of Europe and managed floating rates elsewhere. One consequence is that none of these countries has taken out an IMF loan in more than 20 years. As emerging market economies follow this path toward the two-corner orientation, the “IMF graduates” share of world trade should rise to 80 percent or more.

There will still be an IMF role as the international forum for developing guidelines and disciplines for the new system, and for providing technical assistance for banking sector and other reforms in developing countries. But IMF lending programs, in addition to being much smaller, will focus more and more on the poorer, mostly smaller countries on the periphery of the international trade and investment system. Moreover, this geographic shift increases the overlap between IMF and multilateral development bank programs, and strengthens the case for merging IMF and World Bank lending programs.

From the U.S. perspective, the definitive shift from a dollar-linked to a floating rate financial architecture is equally stark. Canada and Mexico, the United States' two largest trading partners, accounting for one third of total U.S. exports, have close to a free float policy. Adding in Europe and Japan brings the share of U.S. exports up to 65 percent, and floating rate emerging market economies increase the share to at least 75 percent. China/Hong Kong and Argentina, in fact, are the only remaining major trading partners with an exchange rate clearly pegged to the dollar.

It is only in the context of this greatly changed set of financial relationships, and in particular the systemic shift to managed floating rates, that the record U.S. trade and more broadly based current account deficits can be addressed. In January 1999, Secretary of the Treasury Robert Rubin stated for the first time that the U.S. deficit is not sustainable, and the reasons are clear. The eighteen-year chronic current account deficit has transformed the United States from a net creditor nation of \$350 billion in 1980 to a net debtor of \$1.2 trillion in 1997, headed for \$2 trillion by 2000. This equates to about 20 percent of U.S. gross domestic product, projected to rise over 30 percent by 2005. With \$300 billion of additional debit accumulating abroad each year from the current account deficit, sooner or later there will be offsetting downward market pressures on the dollar to reduce the external imbalance. A slowdown in the U.S. economy and/or a pickup of growth in Asia and Europe could trigger such a shift. In the current state of highly integrated financial markets, moreover, the shift could be abrupt, with substantial adverse impact on U.S. economic growth and stock markets. This is the "hard landing"

scenario, and the policy question is what governments should or should not do within the new floating rate financial architecture to avoid a hard landing.

One thing the United States should not do is increase import protection to reduce the trade deficit because that would be self-defeating and lead to an even harder landing. The counterpart restraint in the financial field is for governments, and particularly the U.S., Japanese, and European governments, not to resist an early, orderly decline in the dollar as market forces dictate. As explained above, some other governments during the 1990s have used the exchange rate as an instrument of a mercantilist trade policy, and this should stop or be stringently constrained. More precisely, trading partners that have current account surpluses or only modest deficits – which at this point includes Japan, the European Union, China, and South Korea – should not be increasing foreign exchange reserves through central bank purchases of dollars. Indeed, under a floating rate financial architecture, a “prudent” level of foreign exchange reserves would be lower than before, and such countries with unusually high levels of reserves might, if anything, begin to reduce excessive reserve holdings.

These are the analytic and policy issues ministers should be addressing at the Bank/Fund meetings in September. A much smaller IMF lending program should be welcome, and the multilateral challenge of how to manage a soft landing for the dollar, including reasonable new disciplines on central bank intervention in currency markets, should be prominent on the agenda. Regrettably, however, such issues will likely be avoided, for two reasons.

First, purveyors of IMF loans would resist the notion of a greatly reduced financial program. A big architectural innovation of 1999 was creation of a new IMF contingent lending facility, which could result in more rather than less borrowing from the Fund by some countries. There is also a special problem with the Fund's largest borrower, Russia, currently in default to commercial lenders, and where the Fund has to offer additional loans in order for Russia to service existing IMF loans. Such linkage would render the Russian liabilities "non-performing assets" by commercial banking standards, but the IMF applies different standards.

And second and more important, there is widespread aversion to any discussion of whether the chronic U.S. current account deficit is sustainable and, if not, what to do about it. The U.S. deficit goes to the heart of the transition to a post-dollar, managed floating rate architecture, but any reduction in the deficit has to result in a reduction of surpluses elsewhere, which is politically unwelcome for most trading partners. Finance ministers continue to be more ostrich-like than forward thinking when it comes to the key components of the truly new financial architecture.

*Ernest H. Preeg is a senior fellow at the Hudson Institute in Washington, where he directs a project on the chronic U.S. current account deficit and a new economic architecture.