"Remaking the International Exchange Rate System: The Optimum Currency Area Approach to a Global Currency"

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Thank you very much, it's a great pleasure to be here and to talk to you at, I think, this unique institution, The Chamber of Commerce University. This subject that I am talking on…well, I'm reading the newspaper and something about this headline reporting some of my remarks the other day, 'Fixed Currency System Outdated'. Now, if that were the case we'd have to throw out all of economics because if you didn't have any kind of fixed relationship between units of expenditure, money, you can never have the lock on price and you can never have a coherent market.

You have to go into that a little bit. I'll look at some of these issues. First: a rough history of the international monetary system. Through 3500 years of history, the international monetary system; there has been one, has been based on some kind of common currency or some kind of standard that can be used as a kind of universal currency. Back in the days when we think that maybe coinage was invented, and we have this one theory when we think it was invented about the 8th century B.C., when countries began to use coinage and coinage was overvalued and used by nation-states. And then in the great empires they all created a common currency because of the great economies that needed use of one currency or one unit.

Imagine a world of barter where there is no money and then you have ten different commodities or twenty different commodities or a hundred. Imagine how complicated it would be to think in terms of exchange relationships without a common means of account, and actually in the same way, how many monies should you have? How many monies would be good, for let's say, a country of 70 million people. Really, like the whole world, 3000 years ago. How many monies should a country with 65 million people, like Thailand, have? Would it be one money, or twenty, or one hundred…or a thousand or a million monies? One for each person, but how many currencies should Thailand have? If Thailand had many currencies you'd have to have many issues with currencies and many central banks in Thailand. Every province could have a different currency and then the question would be, if every province had a separate currency what would be the exchange rate between one currency and the other? Should they all be flexible? Would you want to have seventy currencies in Thailand all flexible with one another or would it be better to have the currencies all fixed so that there'd be a common unit?

That's really what the issue it. Another way of look at it is, think for a moment about the European Union. The EU has twenty-seven members now and it's got the European Monetary Union, which has thirteen members now, the most recent member added to it was Slovenia, a very tiny country. The thirteen members of the EMU include economies like Germany. Germany is the fourth largest economy in the world now. China took over Germany's place as number three in this. Germany, France, and Italy are all countries with GDP's over two trillion dollars, all using the same money. They gave up their currencies, first, they had fixed exchange rates and that presented inflexible rates between the EU countries. Then, they moved to the common currency. They gave up exchange rates. A common currency is the apotheosis of fixed exchange rates so we'd better be careful when we look at headlines like this.: 'Fixed Currency System Outdated', because if you do, you have to give up everything.

Imagine the world was all the people in this room and they had no money. They'd start off with ten products that could be traded. What would happen? People would go around and mingle. They'd make bargains with one another. It would be very complicated but eventually they'd settle on some kind of pricing but it would be a very inefficient way of establishing a price system. A price system starts usually because there's a market. A market develops when people look at the price ratios and then they always bid and they bid until get everything for the cheapest price and sell things for the highest price. Everyone wants to get the most and pay with the least and if there are price differences they can always trade back and forth and then those prices get eliminated. If you had one money in this room with ten commodities, ten prices of each of those commodities would eventually be established. That is not too bad; but suppose you had two currencies in the room, or three, or four, or five currencies in the room. You'd quickly get hundreds of prices in the room.

Today, there are about 185 members of the IMF, but some members don't have a currency. Sam Marino doesn't have a currency. San Marino is a little principality of 15,000 people in Italy. They don't have a currency. They use the Euro. There are a few countries like that; Andorra doesn't have a currency. Now, Germany doesn't have a currency of their own, they share that. In the IMF, there are 170 currencies even though there are 185 members. But, suppose there are 200 currencies. In a world of 200 currencies how many exchange rates are there? Well, there's a formula for it. It's 0.5 x N x N-1 where N is the number of currencies, which would be 19,900 exchange rates. You can look at the grids in the newspapers about exchange rates and if you have a grid of 200 currencies and you have a grid of 200 this way and 200 that way, you get 19,900 currencies, about 2000 currencies. Now supposing you had ten products to exchange, how many prices would there be? If you had one currency there would be ten products but if you had 200 currencies that would be 20,000 times ten products and that wouldn't be very efficient. Of course, you may want to have 200 currencies but if you have that then you could economize on the information that turns up by fixing the price of all currencies so they act like one currency.

That's what countries did historically back in Libya or before in India and China and before this. They started with a coinage and that coinage was based on a metal or a common product that was widely used and the common product turned to be the most efficient were the precious metals: gold, silver, and copper. They served different things: If you took the amount of gold it would take to buy a cup of coffee it would be so small you wouldn't be able to use it. You wouldn't be able to use it for small transactions, even silver wouldn't be very good for it. You'd need copper transactions. You'd need silver for middle-sized transactions. Gold was the most used by the richest countries and for long distance international trade because it's the cheapest to travel. Per unit of gold it's the most valuable and it was the cheapest to use for international trade. Of course, now, we don't have to worry about gold and silver because we don't use these now. But, for a long time we had a tri-metal system, where the price of gold, silver, and copper were fixed. In the 19th century until 1873 was the bi-metallic system. The price of gold and silver were fixed. One country fixed both gold and silver and it was a big country and a significant country. Then that would the fixed price, a price that would reign in the world economy starting in 1803. France was a big country then. Earlier, in 1792, Alexander Hamilton, the Secretary of the Treasury in the United States set the USA on the Bi-Metallic Standard. He fixed the price of gold and silver. Gold was fifteen times more valuable than silver; the ration was 15:1. Then, after the French Revolution, came a big inflation in paper that set the standard back to Bi-Metallic. Hamilton chose the same standard for gold and silver that King Louis the XVI had had. So you had 15:1 in France, which was the big country, big economy. The US was a little economy back then. The US got bigger and eventually became a bigger economy than the French economy and then bigger than any other economy.

The idea was that countries all over the world achieve a kind of unity. They had the common denominator of the fixed price of gold. We had fixed exchange rates all through the world in the 1870's. The Bi-Metallic Standard broke down in 1860 because of France and the USA, the two big countries. The USA was a big country by this time. One year later the Civil War broke out in the US and the US then didn't have any gold or silver. And then in 1870 there was a war between France and Germany and then France left the bi-metallic system. Gradually, Germany went on the Gold Standard and then Scandinavia and Italy went on the gold system and then the USA went back to Gold in 1879 and then all the world moved off the Silver Standard and moved toward the Gold Standard. Because the big countries went on the Gold Standard, the price of sliver went down and the price of gold went up because everyone was buying gold. And they had a bit of deflation because gold was becoming more valuable and there was a big difference between the gold and the silver countries. The gold countries had three decades of deflation from 1876 to 1896 but not the other countries on the Silver Standard, which included India and China. By 1914 all the major countries were on the Gold Standard.

There was a huge hunger, a huge need, a desirability of keeping fixed exchange rates between the gold and silver countries. John Stuart Mill, the great philosopher and economist, writing in 1848, said “so much barberry in the transactions of nations. Nations choose to serve their own individuality to their own inconvenience in the manner of their nations having a separate currency of their own.”

This is about the time of the breakup of the bi-metallic systems. How did I choose that 1873 date? I looked at the prices of gold in terms of silver in London and in all of the time from 1815 to 1873, the price of gold and silver didn’t move outside the range of 15:1. But then in 1873, a lot of things were happening. Many countries were dumping silver on the world market. How many of you have ever seen the movie ‘The Wizard of Oz’? That’s about the gold standard. The Oz is the ounce of gold and the wizard, at that time, was President Cleveland who had the great distinction in the 19th century in the USA to say the gold standard was hurting deflation. Prices were going down for three decades and the Americans didn’t like it. Americans were on the flexible exchange rate, the Greenback Standard, in the 1870’s. In 1896, it turned around because 1895 was the discovery of gold in South Africa when Russia and Austria-Hungary were going on to the Gold Standard, which created more demand for gold. The increase in supply was enough to overcome that and gradually move to an inflationary period. The discovery of gold in South Africa was able to dominate the system. Today, in the world as a whole, there’s about five billion ounces of gold above ground. One billion ounces of that is in the Central Bank. Central banks all over the world still have 900 million or 950 million ounces of gold and now the prices has just gone up over $800 an once. When countries were on the Gold Standard, currencies were named for different weights of gold. The British currency, the most important at the time, was called the Pound. The standard exchange rate between the Pound and the US Dollar was the Pound was 4.86 to the US Dollar because there was 4.86 times as much gold in the Pound as in the Dollar. It’s a good idea to keep an eye on these transitions; it gives you one way to look at history.

In 1914, WWI broke out. A more important monetary event occurred one year earlier. In 1913, the US created a central bank. It didn’t have one before. This was important because the US economy alone was bigger than the next three biggest countries: England, France, and Germany. We use the term ‘currency area’. A currency area is the zone of fixed exchange rates. A lot of countries fix their currencies to the US dollar. Panama has done that since 1904 and so they get more of an American monetary policy. It's a little different from a fixed exchange rate because they don't produce a paper currency. They have their own currency call the 'Balboa' but that's a coin. Most of the Gulf States keep their currency fixed to the US Dollar and China kept their currency fixed to the US dollar from 1994. So the Dollar Area is another currency area. And the European Area covers not just the thirteen countries in the EU but all the other countries that are fixed to the EU. Also, fourteen countries in Africa are tied to the Euro zone. The GDP of the US Area is 14 trillion dollars. The GDP of the Euro Area is 11 trillion dollars. The GDP of the Yen is 4.7 trillion dollars.

So, if all the European countries went back to their original currencies, all the countries that are tied to their currencies would have to split off and etc. etc. So be careful what you wish for. When we got rid of the Gold Standard we didn't replace it. All the central banks in the Euro zone, the most famous in the world, had no monetary policy, no independence. The only importance they have is the heads of those banks sit on the council of the central banks. If you have any fixed exchange rate it won't work unless you have a budget balance or proven fiscal policy, it doesn't mean you don't have a deficit but if you build up a lot of public debt, you have to pay it back afterwards.

Britain had seven wars in France in the 18th Century. Every time it ran big deficits to finance the war and then after the war they had to pay back the debt. So, you need prudent fiscal policy, low public debt, limited international borrowing, and low tax rates, and constraint on global expansion. But under the Gold Standard, it depends on the amount of gold and the expansion of the money supply. A world under the Gold Standard is limited by the discovery of gold. Well, as the world's population expands, the demand increases for more money but there's not an expansion of gold to keep up with population, so the price of gold gets more expensive, which means prices go down, deflation, so there's a restraint on gold. This is a kind of warning that there is a limit to growth. Only now are people beginning to think there are limits to growth. We are getting big potential catastrophes, Global Warming, endangered species, the destruction of rain forests. Population is now 6.5 billion people in the world. What would happen if that same rate of expansion continued to the year 3000? There would be trillions and trillions of people in the world. The population explosion will be curtailed, I think. People believe it will reach a limit of 9 billion people and stay stable. But nobody can really know.

So, after WWI, the Dollar replaced the Pound Sterling as the world's major currency. After 1944, the IMF and the World Bank were created. That didn't create any monetary system that just ratified the monetary system that had come into place in 1934. From 1934-1971, the international monetary system was based on the Dollar and gold. That system broke u p in 1971 when President Nixon took the Dollar off gold and the countries moved to flexible exchange rates. Nobody wanted that, so they wanted to go back to fixed exchange rates and there was a committee working day in and day out, trying to find a way to negotiate a return to a fixed exchange rated and it was difficult. They couldn't agree because the other countries wanted to treat the Dollar like any other currency and yet, you couldn't strap down the Dollar. We're facing that today. Some people say we need intervention to stop the falling Dollar. But how do you get that? It's like trying to stop a waterfall. You'd have to buy up excess Dollars in the world. The central banks can go in and buy and take these Dollars. Thailand can go buy up those Dollars but in the process it would create inflation.

The other thing to do is to let the currency depreciate. It's a mess. The system we have is not working. We have to recognize the mistake was not working hard enough to get back to the International Monetary System. People who are advocating flexible exchange rates were saying three things: One, countries don't need reserves. Back then, reserves were 50 billion Dollars. Today, they are 5 trillion Dollars. Two, you don't have exchange controls. Now people have exchange controls anyway. The third thing was that if you have flexible exchange rates you won't have any imbalances. But we have more imbalances than we eve had before. The USA has a 90 billion Dollar deficit, Japan has a 150 billion Dollar deficit, Germany has a 180 billion Dollar deficit, and Spain has a 90 billion Dollar deficit.

Charles Reese, a very smart economist said, "democracy goes the gold standard." He meant that the demand of the population on the government to do more things for them will have more of a deficit but it will be financed by the Central Bank and that will put countries off the Gold Standard just like war does.

Some people think that the Great Depression killed the Gold Standard but Europe went back to the gold standard around 1925, creating a tremendous increase in demand for gold that brought on a big deflation. My theory is the USA killed the gold standard but because the Dollar replaced gold. Gold was held in the Central Bank, 900 million ounces of it, but it was not being used. The IMF in 1944 was set up to manage the Dollar, the Gold Standard, and the exchange rate system, but it broke down. Now, for a while, the USA was pressuring countries to change exchange rates, such as China and Japan, but they didn't like the label of 'China bashing' or 'Japan bashing'. So, they gave that responsibility to the IMF. In 1997, the IMF would look at all the countries in the world and then give advice on exchange rates. Well, this didn't have much bite. So, they came up with new guidelines. A country with a big trade imbalance and large deficits would have a currency called 'misaligned' and because the IMF had been criticized for picking on only small countries, they picked on the US Dollar first. So, they said the Dollar is overvalued. The problem is the IMF had 'Article IV Consultation' and that's coming up in China.

Right now, Japan has a surplus of 150 billion Dollars. Was the exchange rate the remedy for Japan? Well, in 1985 the G-5 got together to pressure Japan to appreciate their currency. In the next ten years it tripled in value against the US Dollar, but the trade balance today in Japan is bigger than it was then. It created fifteen years of stagnation and deflation in Japan. Now I read for the first time since 1990, real estate prices have stopped falling. The Asian Crisis, no doubt about it, was caused by the instability of exchange rates. These are the years when the Yen plummeted and the dollar soared. This dried up all Japanese investment in Southeast Asia. The Japanese left Southeast Asia and moved to China. The Asian countries didn't have a very smooth way to get on their own valued currencies as they were fixed to the Dollar and the Dollar was fixed. This set China on the great and glorious path because they have kept that exchange rate through thick and thin.

How do you decide how many currencies there should be? Someone asked me that question. I said, "It should be like God, an odd number less than three."

From a transaction standpoint, it would be great if every country used the same currency or related their currency to a common currency. With one currency you have ten prices but with ten currencies you have a thousand prices. If everyone spoke one language we could communicate better. With different languages we need interpreters, specialists, and things of that nature. Languages are a medium of expression and currencies are a medium of exchange.

In the ancient world, the Talent was the medium of exchange. But what was the Talent? It was a weight, but also a value. It was the weight a man could carry. What was the Talent of money? It was the equivalent of a pound of weight. In the 19th Century, in Europe, there were advocates for a common coin for the world. The most popular idea was to take Francs or one Pound or five Dollars. Britain said no because the pound was the closest thing to a global money. Britain didn't want rivals for it.

In 1913, the USA GDP is bigger than the other countries but Britain is the standard of the monetary system. Then, the Gold Standard was reformed in 1928 and the USA became the center of that Gold Standard because it had stayed on gold all throughout the war period when other countries had gone off it. This is the rise of the US as a superpower.

You could talk about the possibility of an Asian currency, which could combine the major Asian countries. This is a possibility for the future. In Thailand, if people say, 'we want flexible exchange rates; we don't want to be part of a monetary system. We don't want reforms, we like these multi-lateral guidelines', they are not thinking independently about this. But, it would be a great benefit, in my opinion, for, not just the smaller countries who would gain, but all the three, four, or five countries in Asia. They would gain because they wouldn't have to cope with this monetary crisis that we're going through at the present time.

Now, what is the end result of this crisis? Here's what I would predict; since the Dollar became the global currency there's been a fixed Dollar Standard. What has happened is the Dollar has gone up and down. Every time there is a big change, the system transforms and there's a new form of the Dollar Standard but the end result is that there will still be a Dollar Standard. But it won't be effective because of the problems that countries, like Thailand, have. In the newspaper today, I saw Thailand, Columbia, and Korea have a problem with the Dollar and a whole batch of countries have this problem as this is not a good system in terms of performance. But, it is not something we have to wait a long time for, it is just a matter of will. Look at the problems we have in the world to get any country to agree on Global Warming, or the endangered species, or political problems.

Thank you.