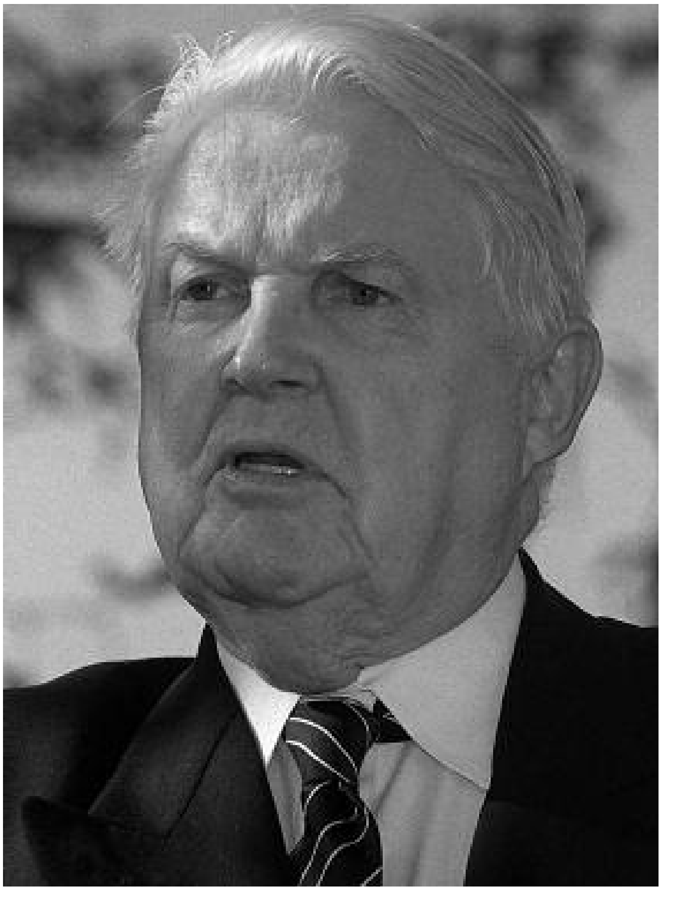
Fixed Against Flexible Exchange Rates

Interview with Robert Mundell

Robert Mundell is one of the most influential economists of the past half-century. He has taught at many universities around the world but since 1974 has been at Columbia University in New York. His work on how the extent of international capital mobility determines the effectiveness of monetary and fiscal policies has become the starting point for any undergraduate textbook in international economics. Based on Mundell's path-breaking research on optimal currency areas, many economists refer to him as the intellectual father of the euro. In 1999 he was awarded the Nobel Prize in Economics for his contributions to the discipline. Mundell was interviewed in Kingston, Ontario (his birthplace) by Christopher Ragan, Editor of World Economic Affairs.



The Need for New Financial Architecture

WEA: Following the Asian Crisis of 1997-98, in which the currencies of several Asian countries collapsed and the world was thought to be on the brink of recession, there were calls for reform of the world's "financial architecture". Such calls for reform seem to follow quickly on the heels of each financial crisis, but little seems to happen. What do you think is meant by the world's "financial architecture"?

Mundell: I think the financial architecture represents a system of convertibility between currencies and the way in which the world money supply is controlled. This was done many years ago through the gold mechanism.

WEA: What is the main concern about the financial system as it currently exists? Is it simply the large capital flows that we now observe?

Mundell: The major problem with the system right now is the high degree of volatility of exchange rates. You've got three large currency blocks in the world—the dollar area, the euro area and the yen area—but you have an extremely high degree of volatility of exchange rates between them, even though these areas are each and of themselves stable. This high degree of volatility is the biggest threat to the international monetary system. Part of the causes of that threat are speculative capital movements which exist solely because of uncertainty over exchange rates.

WEA: Some people argue that speculative capital flows are largely caused by bad policies within particular countries and that the main

problem is really those policies and not the financial system itself. What is your response?

Mundell: No, it is not true. Even though you've got good monetary policies within the dollar area—and also within Europe and Japan in terms of the target of price stability—you have a high degree of volatility of exchange rates. And bad capital movements are in response to that volatility. There is something inherently wrong with the international monetary system, as judged by the fact that you have instability and a high degree of volatility of exchange rates even when each of the areas in question has a high degree of stability. Of course in one sense, the root is bad policy. The three large currency areas have good monetary policies but bad exchange-rate policies.

WEA: Why is such exchange-rate volatility a problem?

Mundell: It is a problem because you get completely false pricing within the world economy. If we had an ideal system—a general equilibrium system with a single money—then you would have the law of one price working to a high degree throughout the world with transparent pricing and only minor changes in real exchange rates. But when you have big changes in the exchange rates between areas that have comparative price stability, and therefore big changes in real exchange rates, this creates economic distortions and a diminution in the gains from trade.

WEA: In terms of reform for the international monetary system, would you suggest not just a move to fewer currencies but actually a move to a single currency?

There is something inherently wrong with the international monetary system.

Mundell: Well, I don't think we can move toward a single world currency at the moment because we don't have any institution that could control that currency, such as a world central bank. But I think it would be possible to move toward a three-currency monetary union among the G-3 countries, just as eleven European countries moved toward locked exchange rates and a monetary union in the run-up to the euro. I could imagine a process by which two of the three currency areas locked exchange rates and co-operated on joint monetary policy, and then the third area would not want to be left out. As far as a single world currency is concerned, however, you would need a world government. If the world were ruled by one empire, you would have a world currency.

WEA: Part of the debate following the Asian Crisis involved the role and behaviour of the IMF. Some argue that the IMF imposed inappropriate conditions for its lending that worsened the economic situations in the borrowing countries. They argue that the IMF needs to change its practices. Has the role of the IMF changed significantly since its birth at Bretton Woods?

Mundell: Yes, the IMF was created to operate the system of fixed exchange rates and that was its main function. Once we moved toward floating exchange rates it lost that function. It tried to salvage a role for itself through the debt crisis of the 1980s, but it is no longer at the centre of nor is the "guardian" of the system. Its policies were harmful to many of the countries involved in the Asian crisis because they insisted that countries let their exchange rates float, which is an absurd policy for a small open economy.

WEA: What is the appropriate responsibility for the IMF today?

Mundell: The world gets the IMF it wants. There is no real leadership in the IMF. It is run and controlled by the countries that own it, and it is up to them to initiate changes they think are necessary. The IMF's policies reflect what the major powers—mainly the G-3 countries—give it. At the present time we don't have an international monetary system and we won't have one as long as the United States and Europe reject the idea. In the meantime, the smaller countries will have to protect themselves against a bad system by forming their own currency areas or attaching themselves to one of the floating G-3 countries. I do think the IMF could play a more serious role in discussions of reform of the system.

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WEA: Is the IMF currently interested in this kind of thing?

Mundell: The IMF doesn't think—it is an institution. There are probably individuals in the IMF that are interested in restoring an international monetary system. As an institution, the IMF lost its sense of direction after floating began in the early 1970s. The floating experiment has by and large been a failure.

The Latin American Move Toward Dollarisation

WEA: Several countries in Latin America are considering either formally adopting the US dollar or establishing currency boards that would fix the value of their currencies to the US dollar. What would be the main advantage to these countries from adopting such policies?

Mundell: The current interest in dollarisation or euroisation arises from the very poor international monetary system we have today. By dollarising, a country would be able to get the advantages of using a stable world currency like the dollar and the inflation rate of the United States. It would at the same time force discipline in fiscal policy because the central banks could no longer bail out countries that run budget deficits.

WEA: And what would be the main cost?

Mundell: The costs would be forgone seigniorage revenue, the psychological cost of scrapping the heritage of the national currency, and the loss of sovereignty to the issuer of the dollars. Personally, I think that enough of the benefits of dollarisation can be achieved without going to the full extent of scrapping the national currency. One possible solution is the currency board.

WEA: If they established a currency board, would they still earn the seigniorage revenue?

Mundell: They would get some seigniorage because part of the dollar (or euro) assets backing the national currency could be invested in treasury bills. A currency board or an alternative fixed exchange-rate system are ways in which a country could retain its legal monetary sovereignty as well as a substantial amount of seigniorage revenue. The problem with currency boards is that they require leadership at home, especially in view of the negative environment created by the IMF with respect to them.

WEA: Argentina has a currency board and is now apparently thinking about dollarising. What is your view of this idea?

Mundell: The dollarisation proposal in Argentina was brought up in recognition of the costs of the two large shocks that hit Argentina—one during the Mexican "tequila crisis" and the second with the Brazilian devaluation. These crises caused uncertainty about Argentina's commitment to continue with its currency board without changing the exchange rate. This uncertainty over the exchange rate meant that interest rates soared to offset the speculative pressures. Dollarisation was President Menem's proposal for dealing with it. It was partly a pre-election strategy. There was a serious discussion about it among some of his advisors, and also a proposal for a treaty with the United States to recover seigniorage. But I think it is an extreme measure that is not necessary in Argentina. It would involve a sacrifice of Argentinian sovereignty that would not in the long run be acceptable to the people.

Dollarisation is a desperation measure arising from the fact that the central bank has lost credibility.

WEA: Do you think Argentina has been well served by its currency board?

Mundell: I think Argentina for the first time in decades has got monetary stability. They have suddenly become a country—one of the very few countries in Latin America—that has monetary stability. It has been an exceptional success. At the same time it has forced Argentina to focus on some of its other problems, like its failure to implement supply-side reforms that are impeding employment and growth.

WEA: Are these policies—dollarisation or a currency board—ones that could be realistically reversed twenty years down the road when a country may have established the necessary credibility for having its own central bank?

Mundell: Dollarisation does not give a country credibility. It is a desperation measure arising from the fact that the central bank has lost credibility. If a country dollarises, it won't establish any credibility except in the sense that it now has the same monetary stability as the United States. But it wouldn't have established any credibility of its *own* monetary policy. Panama has been dollarised since 1903 and has had the same degree of monetary stability as the United States, but if it now created its own paper currency and central bank with discretionary powers, you could be sure that interest rates would soar and speculation against the currency would reappear.

WEA: Couldn't a country establish credibility on its spending or tax side that may give it some credibility in the future when it might like to introduce a domestic currency?

Mundell: No, I don't think dollarisation does anything at all, except give the country the monetary policy of the United States. I think people would attribute any stability to the use of the US dollar. But dollarisation does not establish credibility—it simply removes a source of instability. If the source of instability is brought back, the same problems will recur. I'm sure that some countries that dollarised would, at some point down the road, want to reverse that dollarisation and use the central bank again as a fiscal resource.

WEA: Which would be the main argument for not reversing it?

Mundell: Yes. Back in the 1920s, there was a movement to establish central banks in Latin America, largely under the recommendation of an eminent Princeton University professor, Edwin Kemmerer. That movement had its origin in World War I, when the dollar itself and gold became unstable. The international monetary system had broken down and rather than fix to an unstable system, it seemed to make sense to let each country solve its problems on its own. As it turned out, however, these central banks were the source of a great deal of instability even when the international monetary system had been restored, as it had been in the Bretton Woods era.

WEA: Would it be preferable for countries in Latin America to join a common currency bloc, separate from the United States?

Mundell: I think progress along these lines is possible. The biggest problem is to find a formula that would ensure that the new currency is stable. I do believe that the best way to build a new currency area is to start it as an offshoot of the dollar or, when the transition period is over, the euro. In the meantime, I think it is a good idea for countries to get together with their neighbours and exchange information about monetary and fiscal and exchange-rate policies, as the countries of Mercosur (Brazil, Argentina, Paraguay, and Uruguay), and associated countries (like Chile and Bolivia) are doing. This would be good for them in general.

WEA: Do you think Latin America would be a better currency bloc than Latin America plus the United States?

Mundell: I think that the route to a Latin American currency bloc would be best achieved through links with the dollar area first. Then, as I suggested to the countries in Mercosur, the best way for achieving convergence of the four countries in Mercosur would be by doing what Argentina did and fix their currencies to the US dollar. That would give them convergence. After that they can talk about creating a Mercosur currency that might be free of the dollar at some future date—or it might attach itself to the euro as an alternative possibility.

WEA: Is there much political opposition within Latin America to a single currency?

Mundell: Brazil is the biggest power in Latin America and Brazil speaks Portuguese, whereas the other countries, by and large, speak Spanish. There is a not inconsequential difference between the two even though they are both Latin languages. This makes integration more difficult, and it is at least a small barrier to the kind of political integration that would be needed to establish a common currency.

The more important issue is size. Who dominates? There are three big powers in Latin America—Brazil, Mexico and Argentina—but they are very different from each other. Brazil would not want to enter any arrangement in which it didn't at least have a veto. There are lots of political difficulties within Latin America between the various countries and there are also political difficulties within the individual countries—tensions between left and right, between fixed and floating exchange rates, and so on. But you could argue that those differences are not nearly as great even as they are between the countries that form the euro zone. At the present time, there is a difference between the approaches to stabilisation within the Mercosur countries. Argentina has had its convertibility law since 1991, giving it stabilisation through fixed exchange rates with the dollar. By contrast, Brazil has very recently achieved a high degree of stabilisation through inflation targeting. They will have to see which approach will suit Mercosur monetary integration in the long run.

The Case for North American Currency Union

WEA: Some economists have argued that North America stands to benefit from currency integration. These arguments have resurfaced recently in Canada, especially after the Asian Crisis and the depreciation of the Canadian dollar by about 10%. Assuming that you agree that the Bank of Canada has established its anti-inflation credentials over the past few years, what would be the main benefit to Canada of sharing a currency with the United States?

Mundell: The main benefit is that Canadians would get a world-class currency instead of a national currency that has no international cachet. Over the 1990s, Canada has been successful at achieving its low-inflation targets. But it was achieved at a very high cost in terms of unemployment in the 1980s. This was because Canadian monetary policy was very bad in the late 1970s and early 1980s and a high price had to be paid to get inflation back down toward the US level.

Dollarisation does not establish credibility—it simply removes a source of instability.

I don't think that Canada's policy systems have established credibility. I don't mean by that that people believe the Bank of Canada is going to do anything wildly inflationary. But you have to recognise that what Canada has been coasting on in the 1990s has been a period of outstanding economic growth in the United States. And in that period, the Canadian economy has been expanding too, but it hasn't participated in the spectacular success of the US economy with its 4% unemployment rate and soaring economy.

Historically, Canadian monetary policy has been subject to fits and starts. Canada devalued by mistake in 1949 and moved to floating in 1950 rather than correcting its mistake. By the late 1950s, Canadians became very unhappy with the stagnation that Canadian monetary policy and flexible exchange rates had brought, and, after a crisis in 1962, reverted to fixed exchange rates in the 1960s. During this decade Canada had about the same inflation rate as the United States. But in 1970 Canada went back onto flexible rates and at one point the Canadian dollar was as high as US$1.07.

Since that time, the Canadian dollar has been allowed to fall as low as US$0.62 and now the US dollar is worth 50% more than the Canadian dollar. It is true that in the 1990s Canada has got inflation under control, but it is not true that the Canadian dollar has earned the same credibility as the US dollar. I believe that in a decade or so the Canadian dollar will be down to US$0.50.

The route to a Latin American currency bloc would be best achieved through links with the dollar area.

The real gain that Canada would get from monetary integration is a vast increase in trade with the United States that would put Canada, with its huge natural resources and highly capable population, at the same standard of living as the Americans.

WEA: Canada's inflation-control targets have now been in place for 9 years, and the Bank of Canada has been successful in keeping inflation within the target bands in the face of both the Tequila Crisis and the Asian Crisis. Is there any reason to think that Canada will choose to depart from those targets when the next recession hits?

Mundell: Canada will do what it has always done in the past. When Canada gets into a recession, the Bank of Canada will have to react and let interest rates fall. And in the process the Canadian dollar will fall below its previous lows. And that's why I think the trend will be secularly down for the Canadian dollar. I don't think it's going to be suddenly down. Some people think it's going to go down to US$0.60, some people think it's going to go up to US$0.75. It's entirely possible that both these predictions could be right at separate points because there is a high degree of volatility.

The real test for the Bank of Canada is for the economy to go through a full business cycle and then end up with a higher or not lower Canadian dollar than it was before. And I think the likelihood of them doing this is very remote, given the past history of the Bank of Canada, the structure of Canada's multi-regional economy and the flexible exchange-rate policy of the Canadian government. Of course, it is not just the Bank of Canada here because there is also the other lever of policy. Canada has not learned to do what the Americans were able to do in the early 1980s—that is, how to slow down inflation at the same time that the economy is expanding. The mere fact of size of currency area puts Canada in a weaker position than the United States.

WEA: Do you think the US Federal Reserve is less likely than the Bank of Canada to expand their way out of their next recession?

Mundell: Countries smaller than the United States have always had a much more difficult time. The United States is like a big ocean liner —it doesn't matter about the waves going up and down. Canada is like a tugboat, going up and down over the crest of each wave. The small size just makes the dynamics of the policy problem more difficult.

I think the trend will be secularly down for the Canadian dollar.

Canada may keep its inflation targets. If Monetarists were in control of Canada and they gave complete priority to inflation and zero priority to anything else in Canada—as during the zero-inflation movement in the 1980s—there is no doubt that they could make the Canadian dollar do what they want. They could even make it appreciate but only at a tremendous cost to the economy.

WEA: The usual argument about the macroeconomic benefits of flexible exchange rates is that the exchange rate can adjust to external shocks and, in so doing, dampen the fluctuations in domestic output and employment. Could you comment on these benefits?

Mundell: I don't think there are any benefits in the long run. When Canada had a flexible exchange rate in the 1950s, it experienced exactly the same business cycles as the United States. Why didn't the flexible exchange rate insulate Canada from US recessions?

When the oil shocks hit the Canadian economy in the 1970s, Canada and the United States both let their currencies fall but Canada's inflation was more extreme even than the US inflation. The flexible exchange rate, far from insulating the Canadian economy from the oil shocks, aggravated the increase in prices in terms of Canadian dollars. In the middle of the 1980s, the Canadian dollar was about US$0.73 and the appreciation to over US$0.91 by the end of the 1980s served to aggravate the two-digit unemployment rates that Canadian monetary and fiscal policies had inflicted on Canada.

WEA: What about the argument that Canada and the United States should have flexible exchange rates because the two economies are typically subject to different shocks?

Mundell: Every place in the world is unique! A city has different shocks than its neigbouring countryside. Is that an argument for cities to have separate currencies from their rural hinterlands? British Columbia has different shocks than Nova Scotia. Should they therefore have different currencies? By this argument you would have millions of currencies around the world, which would be tantamount to destroying their functions as money!

WEA: What is the US interest in the issue of North American currency integration? Should the United States care one way or the other whether Canada adopts the US dollar or fixes its exchange rate?

Mundell: The United States has an interest in the Canada/US exchange rate, though it is only one-tenth as important to the United States as it is to Canada. The United States would gain by monetary integration with Canada as long as it didn't have to give up the US dollar. The combined area would be stronger and better and you would have a real free-trade area. It is important to realise the asymmetry that results from the different sizes. The bulk of the gains from integration go to the small country.

You can't have a real free-trade area with flexible exchange rates. It's absurd to think that lowering tariffs by 10% is going to make any difference when there can be big movements in the exchange rate that can wipe out profits. In a common currency area traders can accept small profit margins across the borders. But with volatile exchange rates small profit margins can be wiped out overnight. So traders have strong preferences for the domestic market. They can't afford to get involved in trade. Exchange rate volatility is like a huge mountain in between two trading countries.

WEA: What are the key political obstacles that need to be overcome in order to get a single North American currency, and do you think they are surmountable?

Mundell: Well, I don't think they are surmountable in the short run. The recent Canadian proposals for a new common North Amercian currency—Herbert Grubel's "amero"—would have the United States scrapping the most important currency of the last and this century, and the United States is not going to do that. In fact, I don't think this would be good for Canada or Mexico. Why would Canada and Mexico want to do something that could only weaken the US dollar? I would never advise the United States to scrap the dollar, at great cost to the rest of the world, just to help Canada and Mexico. Let me say, however, that I'd be more sympathetic to the proposal if it were spread over the entire world economy. That would be much more interesting and exciting. But scrapping the US dollar for the sake of a North American monetary union is a non-starter.

The best one could achieve would be to create a parallel currency that could be used side by side with the US dollar. For example, it would be possible to create an international dollar that would be readily convertible into the US dollar, and then use that international dollar as the basis for a western hemisphere currency, without ruling out its use also in Asia.

WEA: So you don't recommend that Canada adopt the US dollar?

Mundell: No. I don't recommend that and I do not believe it is necessary. I think the Bank of Canada and the Ministry of Finance could take a leaf from Argentina's experience and learn how to run a serious fixed exchange-rate system that would give them most of the benefits of the US currency without the sacrifice of the Canadian dollar.

WEA: Is this probable in your lifetime?

Mundell: I would say it is possible, but more probable in your lifetime. Over most of Canadian history we have had a fixed exchange-rate system and I think it is quite possible and even probable that we will go back to it again.

WEA: Thank you for spending time with me today. ◆