

Challenges to Central Banking From Globalized Financial Systems

Conference at the IMF in Washington D.C., 16-17 September, 2002

Discussant Paper on Regional Monetary Arrangements

How can Monetary Policy be Conducted in the Union?

by

K. Dwight Venner, Governor, Eastern Caribbean Central Bank

The international financial system is going through a critical transition period as is evidenced by the many proposals to create a new or refurbish the existing international financial architecture.

This is in response to the many crises which have been constantly occurring over the last two decades throughout the international system.

Three major factors have had some bearing on the profound changes in the international financial system and consequently on the increased volatility of the system, namely, the demise of the Bretton Woods system of fixed exchange rates, the technological revolution in computers and telecommunications, and the deregulation of financial markets in most countries.

While this has had many positive effects it has introduced a new element of instability leading to many banking and currency crises starting with the Mexican debt crisis of 1982, the ERM crisis of 1992, the Mexican tequila crisis in 1994, the Asian crisis of 1997, the Russian crisis of 1998 and the Brazilian crisis of 1999. In recent times Turkey, Argentina and Brazil are again experiencing crisis conditions.

The globalization of financial systems and the possibility of international contagion pose significant challenges for all central banks as they learn to cope with the consequences of such events and the widespread implications for their domestic economies.

In the current environment of regular crises financial stability in and of itself has become an international public good. In responding to the challenges posed by a globalised financial system, countries and their central banks have to operate on two fronts. On one front they have to contribute in whatever way they can to ensuring the stability of the international system. On the other they have to derive means of mitigating the impact of external shocks on their domestic financial systems.

The case for monetary unions as one way of addressing these issues is presented in an excellent paper by Gert Jan Hogeweg.

On the subject of the European Monetary Union – this example is somewhat unique given Europe's prominent role in the world. However, it addresses both issues of international stability

Discussion Paper on Regional Monetary Arrangements

- by *K Dwight Venner*

and a considered response to external shocks. There are consequently important lessons and implications for other groups of countries and regions that have already established or have intentions to establish monetary unions.

The paper will proceed by reviewing the European experience as set out in Jan Hogeweg's paper and then highlighting the experience of the Eastern Caribbean Currency Union in contrast.

The European Union is important, as stated above for its critical importance in the international financial system. With the effective establishment of the European Central Bank and the successful launching of the Euro there is now a triad of international currencies which supercede all others namely, the dollar, the yen, and the euro. In the quest for stability in the international system this can be regarded simplistically as reducing the number of individual currencies and thus making the system less complicated (numerically as least) and by extension less prone to volatility. This process would be in line with the thinking of the proponents of dollarisation who would argue that most of the currencies now in existence are insignificant and the acceptance and use of any of the major three currencies would provide these countries with an effective medium of exchange both domestically and in the country whose currency they are using as well as being a credible unit of account.

Another argument would suggest that the introduction of the euro gives these countries greater choices in the management of their foreign exchange reserves and allows other agents to increase the diversification of their external portfolios. This follows from the popular theme in many academic conferences provocatively entitled "The dollar versus the Euro" which is a nuanced sub title for the larger subject, "Europe versus America".

This sentiment is directly related to the actual and potential role of the euro in the international financial system.

The accepted view is that the role of international currencies is predicated on four criteria (Hartman and Issing).

1. The breadth, liquidity and openness of domestic financial markets.
2. The stability of the currency and confidence in its future stability.
3. The size, strength and international linkages of the domestic real economy.
4. The previous use of the currency.

On items 1 and 3 the euro area is not only significant but has tremendous potential. With respect to 2 and 4 the euro would have to draw on the experience of the legacy currencies, particularly the D-mark and the institutional arrangements into which the new currency has been inserted. This brings us then to the issue of optimum currency areas which allows us, based on the literature, to identify the United States as such an entity and comparing the euro area as well as other monetary unions with it.

George Tavlas has identified nine (9) criteria as appropriate for choosing participants in an optimum currency area. These are similarity of inflation rates, degree of factor mobility; openness and size of the economy; degree of commodity diversification; price and wage

Discussion Paper on Regional Monetary Arrangements
- by *K Dwight Venner*

flexibility; degree of goods market integration; fiscal integration; the need for real exchange rate variability; and political factors.

The issue is whether all of these have to be satisfied *ex ante* before the process can proceed or whether there is an internal dynamic provided by the political factors mainly in which these are met *ex post*.

The United States historically and politically inhabits an integrated economic and financial space. Europe since the end of the Second World War has been in the process of creating an economic and geographic space of some equivalence.

The twelve existing members have a larger population than the United States as well as a larger participation in international trade. The United States however has a higher level of output. With the accession of new members from Eastern and Central Europe the euro area would be an even bigger force in international economic and financial affairs.

The road to monetary union in Europe has been influenced in a very significant way by history and politics. The progress in European integration has been inspired by the need to create political stability in Europe after two devastating world wars. However, one could surmise that one thing feeds on another and argue that if the progress on the economic front did not deliver major benefits the process could have been aborted.

It is interesting to take note of the current situation where economic integration has been virtually completed, a monetary union has been successfully completed despite serious misgivings in some quarters, but the political process is incomplete and is unlikely to make much progress in the near future.

This is an intriguing result as the prevailing wisdom was that monetary union was difficult, if not impossible to achieve if not preceded by some form of political integration. This was inferred from the fact that countries would have to give up sovereignty over monetary policy which would be a major political act and decision. It is interesting to note that some, if not all European countries have held referenda on this matter. Denmark has held two which resulted in negative votes and the United Kingdom, a major player, is having some difficulty in coming to a decision on joining the Euro area.

The major policy issues which surround successful monetary union as clearly pointed out in the paper are the independence of the Central Bank and fiscal discipline. The acceptance of these two conditions are of the highest order in political decision making. They signify the willingness of politicians to give up power over monetary policy and to accept being bound by fiscal rules.

Countries will have to weigh the costs and benefits of such decisions bearing in mind the objective conditions which now characterize the international financial system. There has been a shift in power from the traditional sources of power and influence namely central banks and commercial banks to markets dominated by mutual funds, pension funds, bond holders and rating agencies. On the assumption that monetary authorities have lesser degrees of freedom and the use of the exchange rate is not as potent as an active policy tool, the arguments in favour of

Discussion Paper on Regional Monetary Arrangements
- by *K Dwight Venner*

securing some level of stability through monetary union arrangements may be compelling for a number of countries.

The credibility of the new arrangements will not be easily accepted if the central bank does not have the freedom to maintain low sustainable levels of inflation. Also, since fiscal policy is decentralized there must be some binding agreement on fiscal convergence as in the Maastricht Treaty.

The application of a single monetary policy to countries with different economic circumstances can also be a difficult prospect if there are no compensating arrangements or an acceptance of the trade-offs and their benefits which should be clear and apparent to the domestic polity. The Europeans treated with this issue by having a three stage process which established criteria for eventual membership.

The question which must be asked is not only what can be learned from the European experience but also what can the European situation contribute to increased international financial stability.

A fixed rate across such a large number of important countries does introduce an element of stability. An important issue however would be the further integration of European financial markets to allow for a more competitive and efficient allocation of financial resources on a global basis.

There are serious governance issues for the international financial community which the experience of Europe clearly illustrates. This is related to the process which has highlighted the potential and the limits to political and policy coordination between sovereign states and the path to be followed in the accession of new states.

Hypothetically and conceptually the most efficient and least volatile of the arrangements for the international financial system would be a single currency and a world government. That would be one corner solution so to speak. A hegemonic arrangement with a dominant international currency and fixed exchange rates characterized the Bretton Woods system, which is now history. The actuality is far removed from these two options and tends towards the other extreme of crisis management of an inherently unstable system.

Monetary unions, again hypothetically, could be viewed conceptually as intermediate solutions which may not as the case of the European, and other unions seem to suggest, require a full political arrangement in the sense of an umbrella government. Another way of putting this is that groups of countries may not have to meet all the criteria of an optimum currency area, *ex ante*, if they can identify certain benefits which they find desirable and have the political will to follow through on such arrangements. Of course, they would also have to commit to some Maastricht like criteria, implying a further diminution of national sovereignty in order to ensure the credibility of the new arrangements.

One can then envisage as a response to the challenge of a globalised financial system with its incipient volatility an upsurge of monetary union arrangements on a regional basis, as is

Discussion Paper on Regional Monetary Arrangements
- by *K Dwight Venner*

beginning to occur in Western, Southern and Central Africa, as well being discussed in Asia and Latin America.

The objectives of these arrangements would be credible monetary systems and low inflation. The question then would be, would international markets put a premium on the establishment of such arrangements? There is some slender evidence that they might. However, the reduction of the actual number of currencies still leaves the problem of the misalignment of the three major currencies.

The new monetary unions will have to pick the appropriate relationship to the three major currencies. Put another way, they will become a part of a wider currency area which can be defined as the optimum currency area or sphere of monetary influence.

This is the situation with the two largest currency unions in existence prior to the Euro Area, the CFA Franc Zone and the Eastern Caribbean Currency Union. The Eastern Caribbean Currency Union (ECCU) is an arrangement among eight small island economies which has been in existence since October 1983. Like the Euro area there is an economic and functional cooperation integration arrangement in place which preceded the establishment of the Eastern Caribbean Central Bank. This was the Treaty of Basseterre (1981) in which Article 3(2) of the Treaty requires the member states to “coordinate, harmonise and pursue joint policies in a number of fields (17) prominent among which is currency and central banking.

Currency arrangements on a regional basis however predated the ECCB as a currency board had been in operation since 1950 involving three larger regional states, Trinidad and Tobago, Guyana and Barbados.

The major argument in favour of a monetary union was not that it necessarily satisfied the criteria for an optimum currency area but that central banking services could be more effectively and creditably provided through a regional as opposed to a national arrangement. One suspects that the same arguments would be made for the CFA franc zone as a common colonial history, geographic proximity and economies of scales of administration could be cited as critical arguments in favour of a monetary union. There is another critical factor and that is the role of the former colonial power within whose currency arrangements, the so-called Metropolitan Exchange Standard, the countries resided. The French Treasury, for example, provided an explicit guarantee to the CFA franc zone for its reserves. The British Treasury gave a guarantee to the sterling area countries on their sterling reserves after the 1967 devaluation of the pound. The ECCB has no such guarantee from either the British or latterly the American government since the switch to the dollar peg and has had to establish its credibility by its policies and the performance of the economies of its constituent members.

The arrangement has certainly brought stability to the currency and banking systems. In the case of the former the peg to the US dollar of EC\$2.70 to the US dollar has been maintained since July 1976 with the cross over from sterling. There have also been no banking crises of note in the ECCU.

Discussion Paper on Regional Monetary Arrangements
- by *K Dwight Venner*

There are two major differences between the ECCU and the Euro arrangements. Firstly, ECCU countries inherited a regional arrangement while Euro land moved deliberately to that status. Secondly while the countries of Euro land had developed financial markets and substantial intra regional trade flows the ECCU represents the polar opposite.

The second difference implies that the ECCU does not comply with two of the fundamental criteria for an optimum currency union and yet the arrangement has functioned smoothly and brought clear benefits to its members.

The answer seems to be in the observation made earlier and can be put this way. Following the European Union, or in this with the European Union following the ECCU, the independence or autonomy of the central bank and acceptance of fiscal discipline can be cited as two very necessary conditions for successful monetary unions.

The Articles of Agreement of the ECCB have inserted in it certain fundamental clauses relating to its governance, the exchange rate, the backing of the currency and fiscal accommodation of governments. These can be referred to as the entrenched clauses of the agreement which require unanimous approval to be changed.

A critical element however has been the performance of the governing bodies, that is the Monetary Council, comprised of Ministers of Finance, and the Board of Directors, public and private sector appointees of individual governments. Peer pressure and review as well as a desire to achieve the overall objective of financial and economic development have been critical factors in the success of the union over the last nineteen years.

The Council has set fiscal and debt corridors for member countries and has also established a mutual assistance fund out of distributed profits to assist countries in difficulty. Access to this fund is by application to the Council which sets the conditionalities for draw down.

The ECCU is a good case study of the potential that monetary union holds out for small open economies which agree to share monetary sovereignty and are prepared to accept monetary and fiscal rules which give credibility to the arrangement. The ECCU can also be said to be a part of the optimum currency area of the United States. It has therefore accepted the inflation policies of the United States and in a sense leverages this to create a macro economic environment conducive to growth and development.

In conclusion it is reasonable to assert that in a patently imperfect world experiencing significant financial volatility and with multiple sovereignties, monetary unions provide the possibility for shared sovereignty and monetary and fiscal discipline which may have some impact on the overall stability of the international financial system. The influence of the Euro area at one level and the success of smaller monetary unions could be of great significance in establishing such a trend as this model is emulated in other regions of the international community. The demonstration effect like the theory of optimum currency areas is alive and well.