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Global monetary instability: The role of the IMF, the EU and NAFTA☆

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I dedicate this paper to my children, Maryanthe and Steven,
who will experience the evolution of our global monetary system

Abstract

This paper argues that the global monetary system has exhibited significant instability since the collapse of the Bretton Woods regime in 1971. The current challenge for economists and policy makers is the creation of a global monetary system that offers greater exchange rate stability without sacrificing international capital mobility. This paper proposes a solution that consists of three components. First, strengthening the international financial architecture to bring stability, primarily to emerging nations. Second, eventually creating a monetary union in NAFTA and extending it to other countries of the Western Hemisphere to bring stability to this region à la the European Monetary Union (EMU). Third, coordinating economic policies among the U.S., EU and Japan to stabilize these three key global currencies.

JEL classification: F3; E6

Keywords: Currency fluctuations; Global monetary instability; IFM; EU; NAFTA; Policy coordination

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1. Introduction

In his Nobel Lecture, Professor Robert Mundell (2000) argues that although the 20th century began with a highly stable global monetary system in the form of the gold standard, it ended with dysfunctional volatility of exchange rates that frequently caused global monetary crises. Mundell concludes that the global monetary system with which the 20th century closed was inferior to that with which it began. Thus, the challenge to economists and policy makers today is to design a system that offers greater exchange rate stability and experiences fewer financial crises.

In this paper, we first review the instabilities of the current global monetary system and, second, argue that the system's stability can be improved. Improvements include reform of the international financial architecture and the role of the International Monetary Fund (IMF), greater cooperation within regions and enhanced policy coordination among regions. In Section 2, we review the relevant features of the current global monetary system and define the meaning of instability. In Section 3, we examine the Asian financial crises as an illustration of the difficulties faced by the global monetary system.

The Asian crises have led academics and policy makers to call for a new architecture for the global monetary system. These ideas are discussed in Section 4. Then, in Section 5, we review the experiences of the European Monetary System (EMS) and European Monetary Union (EMU) with an eye to lessons for monetary cooperation in the Western Hemisphere.

These considerations suggest a three-part reform program anchored by a stronger, more resilient international financial architecture, designed to ensure greater monetary stability generally and among emerging nations in particular. The second component of our proposal seeks to improve regional stability among groups of trading partners. We examine the European experience and argue that it provides a viable model for the U.S. and its trading partners in the Western Hemisphere. The final component addresses the management of monetary and financial relations among the major regional blocs in Europe, the Western Hemisphere, and in Asia, clustered around Japan. These ideas are developed in Sections 6 and 7. Section 8 discusses two possible alternative scenarios focused on Tobin-type taxes or floating exchange rates. Section 9 concludes.

2. The current global monetary system

The current global monetary system was introduced abruptly on August 15, 1971, when the U.S. chose to discontinue the exchange of dollars for gold with foreign central banks. With the breakdown of the Bretton Woods system of fixed exchange rates, national monetary policies in the U.S. and elsewhere became more focused on domestic issues and exchange rates became flexible. The system has evolved to include a variety of exchange rate arrangements.[1] It includes three primary categories of exchange rate regimes.

The first covers hard pegs such as currency boards, dollarization and currency union. Second, come the soft pegs, such as the conventional fixed exchange rate peg, the crawling peg, the exchange rate band, and the crawling band. Third, comes the floating group, ranging from fully