

Speech by

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The International Monetary System

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Later today the G-7 finance ministers and central bank governors meet in London. Markets are speculating on what the communiqué will or will not say about exchange rates. On such matters a private exchange of views might serve us rather better than a public statement. What is a matter for public discussion, however, is the mix of exchange rate regimes we see in the world today, and the consequences for international monetary stability.

The current international monetary system comprises three large currency blocs: the dollar, the euro, and an Asian bloc of currencies that are to varying degrees fixed against the dollar. These blocs, of broadly comparable size, produce more than two-thirds of world output in total. Given their size, the choice of exchange rate regime of one bloc has a significant effect on the options available to the others.

Countries have always faced constraints in choosing their exchange rate regime. Any country can have only two out of the following three – an independent monetary policy, a fixed exchange rate and an open capital account. At various times countries have tried – and failed – to have all three. But in a world of large currency blocs decisions about exchange rate policies are interdependent. A monetary stimulus in the US will have a different effect on the euro area if, say, Asian countries have flexible exchange rates rather than fixed rates against the dollar. So the choice of exchange rate regime by any one bloc both depends on and affects the choices of the others.

How did we end up in this position? Under the gold standard of the late 19th and early 20th century, exchange rates were fixed and capital flowed freely internationally. Domestic monetary policy was subordinated to the demands of the gold standard, except in time of extreme crisis when the need for flexibility overcame the desire to adhere to the standard. From the end of the Second World War until 1971, the member countries of the Bretton Woods system had a formal commitment to fixed but adjustable exchange rates, and capital accounts were largely closed to give members the flexibility to operate independent monetary policies. Since the breakdown of the Bretton Woods arrangements, countries have been free to make quite different choices of exchange rate regime, and have not hesitated to do so. As international financial markets have developed, there has been a general movement to flexible exchange

rates supported by credible domestic monetary policies. That is a sensible use of the price mechanism to respond to complex and unpredictable shocks.

Two particularly important exceptions have been the gradual fixing of the exchange rates between members of the European Union, culminating in monetary union, and the more or less formal policies of the newly industrialised Asian countries and Japan to keep the value of their currencies stable against the dollar. Moreover, the Asian central banks have been accumulating large dollar reserves. For most of the post-war period, the quantity of central bank reserves held by Asian central banks was of the same order of magnitude as the reserves held by the G-7. Over the past 15 years, both Japan and non-Japan Asia have rapidly increased their reserves, which are now nearly ten times as large as the combined reserves of the rest of the G-7. Two thirds of these reserves are in dollars, a much larger proportion than the US share of world output.

The counterpart to the Asian bloc's current account surpluses and acquisition of dollar reserves has been large current account deficits in the US. There is nothing inherently wrong with such 'imbalances'. In principle, they reflect the use of financial markets to allocate savings from around the world to the most profitable investment opportunities. But there is likely to be a limit to the amount of debt that one country can issue as a result of *persistent* deficits before investors start to worry about its ability or willingness to repay. When the country in question is also the issuer of the reserve currency, the rapid build-up in the assets denominated in the reserve currency contributes to the potential instability of the international monetary system. That might result in nominal exchange rate movements that are far larger than those needed for an orderly rebalancing of asset positions.

It is easy to see how each bloc can view this possibility as the responsibility of the others.¹ But that misses the point: the current global imbalances are the natural result of policy decisions by all three blocs. They are, in the language of economists, a

¹ Over the past year, senior policymakers from within the G-7 are reported to have claimed that "It's awfully important that the euro zone adopt policies that will allow them to grow faster. Their slow growth is hurting our growth" (John Snow, AFX news 24/03/04), and that "Our American friends need to put in place a determined policy to control their deficits and so that their currency does not distort commercial trade" (Nicolas Sarkozy, AFX news 25/11/04), or indeed that China's exchange rate policy "has become a destabilizing force in the world economy, has led to major international exchange rate and trade imbalances throughout the world" (Open letter from US senators Schumer, Bunning, Durbin, Graham, Dodd and Bayh to Vice President Richard Cheney, 22/01/04).

general equilibrium outcome. It is therefore meaningless to try to identify the culprit, and blame any one bloc's woes on another.

So where does this analysis leave us? Let me identify three challenges for the future.

First, do we still need a reserve currency as a source of global liquidity? In a world of free capital movements, and developed financial markets, there is no obvious need for an official asset to provide international liquidity, as shown in the decline in the relevance of the SDR. But since the Asian financial crisis in the late 1990s, a number of central banks in that part of the world have increased their dollar reserves in order to protect themselves from possible future crises by creating what I have termed a "DIY lender of last resort" facility in dollars. Is the dominance of the dollar in world reserves a reflection of historical factors that are less and less relevant today? Or are there fundamental reasons for the world's central banks to continue using one main currency as a source of liquidity?

Second, given that each bloc's policy choices reflect domestic objectives, what could be achieved through international meetings? The starting point is the need to find a common analysis. Domestic policies should at least be based on mutually consistent assumptions. Only when there is agreement on the nature of the risks inherent in current international monetary arrangements will there be the possibility of a cooperative outcome that is an improvement for all, not just for some.

Third, how might we arrive at such a common analysis? The G-7 arose out of an earlier episode of concern about exchange rate movements in the 1980s. Most smaller countries can choose their exchange rate regime without worrying about its impact on the rest of the world. But the large countries – especially the three blocs I identified at the outset – cannot ignore their interdependency. That is why it is important to expand the group of countries that discuss these issues beyond the G-7 to include those, such as China and India, whose actions increasingly have global economic consequences.

My main conclusion is that the international monetary system should be seen not as a series of bilateral relationships, but as a multilateral arrangement, albeit one where a

small number of the key players can usefully communicate with each other. I believe that we need to rethink the role of the IMF in the international monetary system. I encourage the Fund to articulate a positive vision for the management of the international monetary system in its forthcoming strategic review. I am not convinced that the future of the Fund is primarily as an occasional international lender of last resort for middle-income countries suffering financial crises.

At this Conference the emphasis is naturally on ways to promote productivity and enterprise. Monetary stability at home is now widely recognised as a necessary condition for a successful economy. It provides, as I said at last year's conference, a springboard for enterprise. But international monetary stability is no less important if trade is to prosper. In *The Importance of Being Earnest*, Cecily is instructed by her tutor, Miss Prism, to read her political economy. But Miss Prism continued, "The chapter on the Fall of the Rupee you may omit. It is somewhat too sensational. Even these metallic problems have their melodramatic side." What would poor Cecily have made of the recent melodrama surrounding the values of the dollar, the euro and other paper currencies? It is clear that the aim of central banks to make monetary policy less exciting and more boring needs to be complemented by a collective effort to bring boredom to the international monetary stage.