A COMPETITIVE BIPOLAR KEY CURRENCY SYSTEM

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I. *A New International Monetary System*

The ideal is that trade barriers should be confined to tariffs and that the adjustment of international balance of payments be left with overall adjustment measures. However, the reality is that overall adjustment measures *per se* do not work promptly and effectively with the result that some countries have an unfavourable trade balance while others have a favourable balance for prolonged periods. Hence the difficulties in removing non-tariff barriers and the fears that they might, instead, be increased. Thus, more than anything else, the streamlining of the international monetary system and foreign exchange rates so that overall adjustment measures can function promptly and effectively is necessary. Though it is not clear what sort of cooperative relation exists between the GATT and the IMF, it is difficult to see how trade liberalisation can be negotiated with GATT as its focus and how it can be prompted by means of tariff cuts or the reduction and removal of non-tariff barriers without regard to the international monetary situation. If the latter is in a state of confusion, liberalisation of trade can only regress.

The Tokyo GATT ministerial meeting declared, after a long discussion between the U.S.A. and France, that "The policy of liberalising world trade cannot be carried out successfully in the absence of parallel efforts to set up a monetary system which shields the world economy from the shocks and imbalances which have previously occurred. The ministers will not lose sight of the fact that the efforts which are to be made in the trade field imply continuing efforts to maintain orderly conditions and to establish a durable and equitable monetary system. The ministers recognise equally that the new phase in the liberalisation of trade which it is their intention to undertake should facilitate the orderly function of the monetary system."[1]

In the near future, it is almost certain that effective new rules and procedures to assure sufficiently prompt adjustment of payments imbalances by both surplus and deficit countries will be set up in the IMF. The new rules would be exchange parities subject to frequent and relatively small adjustment according to some objective indicators, with provision for wider margins and options for temporary floats under appropriate circumstances.

More fundamental reform in the international monetary system may not be easy and will take a longer time, for the United States supports the present floating exchange rate system as a means of continuing her "benign neglect" policy.

My view is that a bipolar key currency system between the dollar and the "Europa"

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[1] Declaration of Ministries, approved at Tokyo on September 14, 1973, Ministerial Meeting, GATT.

which will be established before long under the European currency integration scheme. A central cross rate can be set between the two currencies and they would be used as reserve assets, intervention currencies and vehicle currencies. The central exchange rate between the two key currencies would be adjustable according to new rules for exchange adjustment.

If the side in surplus wants to avoid revaluation or make a smaller revaluation, it would be required to lend to the IMF. International liquidity should not be increased either through the balance-of-payments deficit of a key-currency country, as it was under the dollar standard, nor through arbitrary control without any backing as it has been in the present SDRs. Rather international liquidity should be increased through investments by surplus countries.

If the side in deficit wants to avoid devaluation or make a smaller devaluation, it would be required to borrow the counterpart key currency through the IMF and to submit to international surveillance by the IMF.

Because of competition between the two key currencies, the result of which would be revealed in the cross-rate between them, the two sides would be forced to pursue monetary and balance of payments discipline. In addition, third countries would have freedom as to which key currency they choose as a peg, in what proportion they hold the two key currencies and even to switch the key currency to which they peg. Thus, the behaviour of these third countries enforces further discipline upon the key currency countries.

This is a brief outline of my proposal of a competitive bipolar key currency system as a new international monetary system. In what follows I, first, examine the reasons for putting forward this proposal for reform of the international monetary system (Section II). Secondly, the working of the proposed system is analysed in more detail (Section III). Finally, the feasibility of the bipolar key currency system between the U.S. dollar and the European common currency are briefly assessed (Section IV).

II. *Dilemma of a Single Key Currency System*

It is obvious that the present "floating" exchange rates of almost all major currencies throughout the world is not a sound and durable solution but a necessary evil flowing from the turmoil in the international monetary system. The IMF will set up new rules for exchange rate adjustment within wider bands so that exchange rates are adjusted both in deficit and surplus countries equitably, more often, and promptly according to movements in objective indicators such as foreign reserve position.[2] Then, there will be little difference between the present managed floating rate and the IMF's adjustable peg except for revised rules for exchange rate adjustment. The floating rate effectively equilibrates the balance-of-payments and prevents speculative movements of short term capital. But the floating rate neglects the other important role of the exhcange rate, namely, to facilitate steady growth of trade and foreign investment and to maintain a desirable composition in the balance-of-payments (i.e., without maintaining balance through large short-term borrowing). Therefore, the adjustable peg, though it should be more flexible than heretofore, may be re-instituted as soon as possible when the present confusion due to the oil crisis calms down.

[2] See, for example, Robert Triffin's "fork plan" in his "International Monetary Collapse and Reconstruction in April 1972," *Journal of International Economics*, September 1972.

Consideration of more basic reform of the international monetary system, requires examination of the characteristics of an international key currency. The proper functioning of a genuinely international reserve currency requires the development of both a currency that is privately useful and used, and one which must be able to serve as an "intervention asset" in exchange markets. As a corollary securities denominated in that currency must be available for private transactions of a higher-yielding form of wealth convertible on predictable terms into other currencies.[3] Only a national currency like the U.S. dollar meets these conditions. That country is the largest and most economically diversified trading and financial centre in the world, and its national currency is widely used and accepted as vehicle and intervention currency throughout the world. Every other nation has confidence in the value of the key currency which is backed by huge productivity, assets and resources of the key currency country. In other words, the backing of key currency which should be a national currency, is not gold or other international money like the SDR but huge national economic power. Besides these, the centre country has to have a stable price level, keeping stability in purchasing power over goods and services.[4]

There is a view, however, that "the use of *national* currencies as *international* reserves constitutes indeed a built-in de-stabilizer in the world monetary system,"[5] and, therefore, that the internationalisation of the foreign exchange component of monetary reserves is necessary. Triffin's World Central Bank, Bernstein's composite reserve unit and other plans were proposed in order to create an "international money" besides gold under internationally managed currency system along this line. The Special Drawing Right (SDR) of the IMF is one form of the international money, which created about $9.3 billion international liquidity in 1970–72.

The SDR is useful as a numeraire along with gold and may increase somewhat international liquidity in so far as it is acceptable among monetary authorities. But the SDR does not work as a key currency for it cannot be used as a vehicle and intervention currency. Moreover, the value of the SDR may be doubted and confidence in it be lost f the volume of SDRs is increased cumulatively, for it lacks any solid backing[6] except the iIMF's prestige or the name "international monetary co-operation."

Thus, a reformed international monetary system on IMF-S.D.R. lines may not be a preferable solution. Instead of that, I prefer the reconstruction of the exchange standard with two key competitive currencies. The gold exchange standard in the IMF was not itself unsound, but it became unhealthy and precarious because it relied on a single key currency, the dollar, and worked as a *de facto* dollar standard, although before World War II the pound was used together with the dollar.

The soundness of a competitive key currency system compared with a single key currency system may be analysed from the viewpoint of the dilemma between liquidity, confidence and adjustment, the three main issues in the international monetary system.

[3] Harry G. Johnson, "Issues in International Monetary Reform," *Portfolio, International Economic Perspectives*, Vol. 2 No. 3, pp. 6–7.

[4] Cf. Harry G. Johnson, "Political Economy Aspects of International Monetary System," *Journal of International Economics*, September 1972, p. 419.

[5] Robert Triffin, *Gold and the Dollar Crisis*, Yale University Press, 1960, p. 87.

[6] The issuance of a national currency is a creation of credit backed by national products, while that of an international money in addition to national currencies results in double creation of credit without any backing.

The single key currency system falls in the three dilemmas while the competitive key currency system is free from all of them.

First, there is the dilemma between increases in international liquidity and loss of confidence in the key currency. Sufficient growth in international liquidity is required to sustain an optimum growth of world trade and investment. It is obvious that supply of new gold which increases at 1–1.5 per cent annually (in addition, demand for non-monetary use has been increasing rapidly) is far from sufficient. The monetary system has in a long history improved in the direction of "gold saving" and evolved into the gold exchange standard. The IMF has contributed to some extent to increase international liquidity through increased total fund quotas, relaxed conditions for general drawings, etc., but the contribution has been limited for the IMF has been based upon a fund principle which does not allow any creation of international money—the S.D.R. representing a significant deviation from this principle. Therefore, a national currency, the dollar, filled the gap in fulfilling a rapidly increasing need for international liquidity and a *de facto* dollar standard prevailed during the post World War II era up to August 1971.

But as the dollar was spread too much throughout the world and the dollar holdings in foreign countries exceeded American gold reserves, confidence in the dollar was to weaken. International liquidity, the dollar, was supplied only through continued deficits in the American balance of payments, a further source of loss of confidence in it. While the U.S.A. keeps her balance of payments in balance or surplus, international liquidity will not increase at all or rather decrease, although confidence in the dollar strengthens. This is the so-called "liquidity dilemma," which appeared since late 1950's and became gradually more serious, resulting in uncertainty in the international monetary system.

Since 1968, the U.S.A. proceed inflationary policies to mitigate the unemployment problem and a policy of benign neglect externally, spreading the dollar glut throughout the world. This was possible for the dollar was a sole key currency which enjoyed the privilege of "seigniorage." In the end, the redemption of dollars in gold was stopped *de facto* in 1968 and *de jure* in 1971. No international measures are able to restrain American inflation and balance-of-payments deterioration. The U.S.A. forced surplus countries to revalue exchange rates instead of devaluing the dollar. A compromise was engineered through the Smithonian negotiations in December 1971, the agreements from which did not last long. The result was the general float in exchange after February–March 1972.

Now, imagine there is a competitive two key currencies, and that the dollar and the Europa (a common currency in the European Community) are used in the framework of IMF system. The dollar is not able to continue to avoid balance-of-payments discipline, for, if so, the hegemony in the international monetary system will be taken over by the Europa through competitive market mechanism as will be explained in the following section. The two key currencies will restrain each other so as to maintain a stable international monetary system.

How to increase international liquidity in the new system remains as a problem. A spillover from the fact that the national economic activities (domestic production and foreign trade and investment) in the two key currency countries grow steadily, will be increased use between the two centres and among third countries of the two key currencies as international liquidity.[7] The IMF must enhance its genuine function of balance-of-payments financing through an increased fund quotas and further softening conditions of drawing. The side in balance-of-payments surplus, sometime the Europa and at other times the dollar, may invest or lend its surplus to the IMF which, in turn, finances deficit of other countries under its surveillance. This is similar in concept to the oil facility which the IMF inaugurated in 1974.

Secondly, there is the dilemma between increased liquidity and delayed balance of payments adjustment. It is desirable to maintain stable exchange rates as long as possible and to limit adjustment only to the case of fundamental disequilibrium in a country's balance of payments. This is the case of the adjustable peg system in the IMF. To maintain stable exchange rates in non-fundamental disequilibrium, each country needs international reserves and facilities to borrow which the IMF was intended to supplement. But as international liquidity which each country holds increased sufficiently, necessary adjustment in exchange rates and/or demand controls even in the fundamental disequilibrium are delayed or postponed, resulting in a large and disruptive attack of speculative capital movements. The USA, the reserve centre, overcome its fundamental disequilibrium by benign neglect policy up to December 1971 and even thenceforth, spreading inflation throughout the world. Generally floating rates were the only measure able to cope with speculative capital movements but this system damaged other important functions of stable exchange rates and did not reduce the necessary volume of international liquidity.

Under a system of two key currencies, neither of the two reserve centres would be able to continue balance of payments maladjustment and benign neglect policy for the cross exchange rate between the two key currencies would be continuously adjusted in the exchange market. If the surplus centre allowed its exchange rate to revalue less than the market forces demand, it would have to invest the surplus to the IMF, whereas if the deficit centre were to devalue its exchange rate less than it is appropriate, it would have to borrow the other key currency through the IMF. Such investment and borrowing should be within the range which would not jeopardise confidence in the two key currencies. International liquidity would be increased adequately through such a new facility in the IMF.

Thirdly, there is the dilemma between adjustment and confidence. The USA insisted for long time that devaluation of the dollar was neither possible for other countries might follow suit to the devaluation of the gold par value of the dollar, nor desirable for the devaluation of the dollar which was the sole international key currency working as reserve asset and intervention as well as vehicle currency, would impair seriously confidence on the international monetary system. Therefore, the USA sought revaluation of other strong currencies like the German mark and the Japanese yen.

The dollar standard is a system of *n* national currencies with one (the dollar) serving as the numeraire in which the position of the numeraire currency necessarily makes its position asymmetrical with those of the other currencies, because to fix the price of the other currencies in terms of the numeraire requires using the numeraire currency as an intervention currency, and also promotes its use as a medium of international exchange and a store of

[7] The total exports of the USA and the enlarged EC in 1973 amounted to $240 billion which accounted for 53 per cent of the world trade. Suppose a third of that amount or $80 billion is used as international liquidity. This may be sufficient for international liquidity but not too large portion in total national money circulation of the two centres. According as the steady increases in their trade, international liquidity increases too.

international value.[8] It is impossible to keep for a very long period the value of a key currency intact in terms of gold or an artificial international money like the SDR. Moreover, it is not necessary to do this but it is important to maintain the purchasing power over goods and services of the key currency as stable as possible.

In the two key currency system, the devaluation of the dollar is the revaluation of the Europa and *vice versa*, and the value of the two key currencies taken together may be kept stable if the competition between them acts as a restraint and discipline. This is somewhat similar to the value of present SDR which is the weighted sum of standard package of major currencies. But in the new system, neither gold nor artificial international money like the SDR is needed as a numeraire. Since there is only one cross rate between the two currencies, one key currency is used as a numeraire for the other key currency and third countries are indifferent in their use of either the dollar or the Europa as numeraire. Gold is not a numeraire but may be used for settlement of payment between the two reserve centres at market price as a highly liquid asset.

III. *Working Mechanism of a Bipolar Key Currency System*

The working of the proposed two key currency system may be explained more systematically as follows:

(1) A cross rate is established between the two key currencies, say the dollar and the Europa. The cross rate is preferably fixed (i.e., central cross rate) within wider bands but adjustable in the case of fundamental disequilibrium as the IMF envisages in its new rules for adjusting exchange rates. But the cross rate may, if necessary, be managed floating rate as at present.

(2) Devaluation of one key currency in the central cross rate is synonymous with revaluation of the other one. Thus, the value as a numeraire of the two key currencies taken together is maintained unchanged. It is of no significance which side, either the deficit or surplus centre, takes the initiative in changing the central cross rate.

(3) In order to stabilise the cross rate within the wider band, the reserve centres may ntervene in exchange market by using the counterpart key currency and may, if necessary, pay and receive gold which is not numeraire but a highly liquid asset at market prices.

(4) If the side in surplus wants to avoid revaluation of the central cross rate or make revaluation smaller, it has to invest through a special facility (similar to the oil facility) in the IMF. International liquidity would be increased through such investments by the surplus country, instead of through the balance-of-payments deficits of a key currency country, as it was under the dollar standard, or through the increased issue of the SDRs which lack any real backing.

(5) If the side in deficit wants to avoid devaluation of the central cross rate or make devaluation smaller, it has to borrow the counterpart key currency through the IMF special facility and to submit to international surveillance by the IMF.

(6) Because of the competition between the two key currencies, the result of which is revealed in the cross rate, the two sides are forced to follow monetary and balance of pay-

[8] See, Harry G. Johnson, "Political Economy Aspects of International Monetary Reform," *Journal of International Economics*, September 1972, p. 417.

ments discipline. If one of the key currencies failed to measure up over a sufficiently long period, it would lose its hegemony in the international monetary system and be taken over by a third currency which may eventually emerge to be alternative key currency.

(7) Insofar as the key currency economy grows steadily and the value of the key currency is not subject to speculation, the rest of the world, including the counterpart key currency country, will want to accumulate the key currency as foreign exchange reserves in the range that each country thinks it is safe and optimal. Within that range, the key currency country is able to maintain a balcne-of-payments deficit which is actually its short term foreign investment, bringing about increases in international liquidity.

(8) Third countries have freedom as to which key currency they choose as a peg, in what proportion they hold the two key currencies and even to switch the key currency to which they peg. Since they take these choices according to the cross rate between the two key currencies, the behaviour of these third countries enforces further discipline of the key currency countries.

(9) Third countries may choose one key currency as a peg originally because of trade and investment interdependence with that key currency country and neighbouring third countries. Third countries have to adjust exchange rates according to the new IMF rules when they fall into payments disequilibrium in relation to the pegged currency. They can obtain financing from the IMF through its general drawing right as well as the special facility proposed. However, if third countries switch their pegged currency frequently and exercise other freedoms excessively, this may disturb the smooth working of the two key currency system. This danger may be prevented if two optimum currency areas are established: one is the European currency area as already presumed in our argument and the other the dollar (or Pacific) currency area.[9] Then, third countries in a currency area may be able to overcome with more ease their balance of pyaments difficulties by the support of the key currency. Moreover, because each optimum currency area covers a wide and diversified market area, fluctuations in areal balance of payments vis-à-vis the counterpart currency area will be smaller and the cross rate more stable. This may be properly called a bipolar key currency system.

IV. *Prospects for the Bipolar Key Currency System*

The bipolar key currency system proposed in this chapter is not only soundly based theoretically but it is also a feasible prospect.

First, its feasibility depends upon the progress in European Monetary Union. Already European Monetary Cooperation Fund and common currency unit called Eurco have been established. The common float of European Community countries in March 1973 was seen as an important step towards the bipolar key currency system. While France's withdrawal from the EC common float in January 1974 cast doubt on the solidarity of European currency integration, she returned to it in July 1975, showing her enthusiasm for the completion of integration by 1980. In the light of the past experience in the EC, the realisation could be earlier than that.

[9] See, Kiyoshi Kojima, "A Pacific Currency Area: A New Approach to International Monetary Reform," in his *Japan and A Pacific Free Trade Area,* Macmillan, London, 1971.

Secondly, the argument for setting up two optimum currency areas using flexible exchange rates between them has a long history[10] and advocates urge that the time has now come to put the idea into practice.

Thirdly, it has been recently suggested that a new world economic order should involve tripolar coordination, between North America, Western Europe and Japan, the three major powers in the western capitalist world.[11] The international monetary system could be stabilised and standard package of SDR's be worked well through closer cooperation in exchange-rate management between the dollar, the mark and the yen.[12] My proposal is on the same line in principle but I prefer the two key currency system for in the case of three or sixteen currencies an international money like the SDR is necessarily required as a numeraire. Some advocate that Japan should establish a yen currency area.[13] I think this is quite premature for the Tokyo exchange and financial market is not only too narrow but also still subject to stringent exchange control with which the government is unwilling to dispense. Japan might do far better to remain under the umbrella of the dollar.

Fourthly, the reform of the international monetary system depends most upon the U.S.'s attitude. She prefers the continuation of the *de facto* dollar standard using the dollar as intervention and vehicle currency and reserve assets. But the European Community might inaugurate the gold exchange standard with its common currency, the Europa, redeemable in gold. Then, the U.S.A. would have to resume competitively the gold exchange standard for otherwise the Europa is thought to be superior key currency and the hegemony of the USA in international monetary system may be taken over. This might be realised fairly soon, as one variant of the bipolar key currency system and might be far better than the present uncertain international monetary situation although our proposal is preferable. In that case trouble in setting the appropriate price of gold could become one of sources of worldwide inflation.

[10] More of important are: *The United States Balance of Payments in 1968*, The Brookings Institution, 1963, p. 259. R.I. McKinnon, "Optimum World Monetary Arrangements and the Dual Currency System," *Banca Nazional del Lavoro Quarterly Review*, Vol. 16, 1963, pp. 379-85. Robert A. Mundell, *The International Monetary System: Conflict and Reform*, The Private Planning Association of Canada, July 1965, pp. 47–8. Richard N. Cooper, *Sterling, European Monetary Unification, and the International Monetary System*, British-North American Committee, 1972. Richard I. McKinnon, "The Dual Currency System Revisited," H.G. Johnson and A.K. Swoboda, ed., *The Economics of Common Currencies*, George Allen & Unwin, London, 1973. Robert A. Mundell, "A Plan for a European Currency," *The Economics of Common Currencies, ibid.* Harry G. Johnson, "SDR's: The Link that Chains," *Foreign Policy*, No. 8, Fall 1972.

[11] Cf. Earnest H. Preeg, *Economic Blocs and U.S. Foreign Policy*, National Planning Association, Washington D.C., 1974.

[12] See, Ronald I. McKinnon, "A New Tripartite Monetary Agreement or a Limping Dollar Standard," Princeton University, *Essays in International Finance*, No. 106, October 1974.

[13] See, for example, Nihon Keizai Chosa Kyogikai, *A New International Monetary System and the Yen* (in Japanese), Tokyo, July 1973. Hiroshi Shibata, "Japan and Yen Currency Area," unpublished paper read at the 30th general meeting of the Japanese Society of International Economics held at Nagasaki, November 3, 1971. Sachio Kohjima, "Moves Towards Internationalisation of the Japanese Yen and Japan-Australia Currency Relations," Kiyoshi Kojima, ed., *Harmonisation of Japanese and Australian Economic Policies*, Japan Economic Research Center, June 1975.