Increasing International Financial Stability

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Central banks have two major monetary responsibilities, domestic and international. Most central banks can achieve domestic price stability acting alone, and many choose to do so. Having made that choice, international stability—enhanced stability of exchange rates and capital movements—requires collective agreement.

I have long advocated a program that both achieves domestic price stability and increases exchange rate stability. My proposal does not require international conferences, foreign intervention in domestic policy, or enforcement by international supervisors. It is entirely voluntary and is enforced by markets, much as the international gold standard was enforced by markets.

(1) The United States, The European Central Bank, the Bank of Japan, and if China ends its exchange controls, the Bank of China agree to maintain domestic inflation between 0 and 2 percent a year.

(2) Any other country that chooses to import low inflation and maintain a fixed exchange rate can peg to one or a basket of the major currencies. They gain a benefit – price and exchange rate stability—that no country can achieve acting alone. The country that chooses this policy is responsible for maintaining its exchange rate.

(3) The major countries benefit by gaining exchange rate stability with all countries that peg to one or more of their currencies. The major currencies float to permit changes in productivity and possibly tastes.

(4) No country is required to join the system. It remains voluntary. The public good that the system provides gives an incentive to join.

(5) The system would introduce discipline that has been lacking since the breakdown of the Bretton Woods System. Like the old international gold standard, markets would do the enforcement. If a country ran large budget deficits, markets would devalue the currency and increase expected inflation.

(6) Countries could suspend operation of the system, as they did under the gold standard. Not permitting temporary suspension is a flaw in the European monetary arrangement that prolongs crises.

I do not claim this proposal would achieve ideal results. I do not believe that is possible for modern democratic governments. It offers the improvement of increased stability.

An ideal like zero stability is not achievable in an uncertain world. If adopted, the proposal would limit the damage that governments do, particularly the United States. A current example is the excessive expansion of bank reserves that spill over to other countries. Some, like Japan, respond by depreciating their currency. Others experience an unwanted inflation. Still others, Turkey for example, have difficulty adjusting.

Governments do not limit the damage or prevent it.

Two additional proposals. I would close the World Bank. There is little reason for it in a world of enormous capital flows. And I would put prudential restrictions on International Monetary Fund lending.