Federal Reserve Bank of Cleveland

The Challenge of Stability: Mexico's Pursuit of Sound Money

by Jerry L. Jordan

Mexico needs a stable standard of value. Indeed, no economy can achieve its potential without a stable standard of value.

Mexico needs to experience another extended period of sustained prosperity, as it did in the 1960s. A necessary condition for prosperity is sound money. So long as fears of exchange rate or banking crises persist, no country can sustain a period of rising standards of living.

There is no mystery about what conditions will foster sustainable growth. The experiences of the transition economies of the former Soviet Union and Eastern Europe have provided us with many valuable lessons. One of those lessons is that a market economy requires a Hayekian infrastructure. That is, there must first be a foundation of enforceable property rights, generally accepted accounting principles, stable currency, and sound financial intermediaries.

If public contracts are not honored and private contracts are not enforced, markets are impaired. If title to property is not certain, normal banking is not possible. If financial statements are not reliable, investment opportunities are obscured.

Sound Money

Changes in the money prices of goods and assets convey information. If an economy's monetary unit is known to be a stable standard of value, then changes in money prices will accurately reflect changes in the relative values of goods and assets. That is, price fluctuations signal changes in the demand for, or supply of, goods or assets. Resource utilization then shifts toward more valued uses and away from those less valued.

However, if changes in money prices are contaminated by the changing purchasing power of money, false signals are sent to businesses and households. Bad decisions are made, and resources are misallocated. Standards of living fail to rise at their potential rate. Nominal interest rates respond to shifting expectations about the future purchasing power of money. Changes in real interest rates are obscured. Again, resources are misallocated. Saving and investment decisions are affected, and growth is impaired.

Neither inflation nor deflation enhances economic performance. Unanticipated inflations and deflations induce redistribution of wealth—especially between debtors and creditors—but they leave the average standard of living lower.

How can Mexico best achieve a stable standard of value and, hence, sound money? Jerry L. Jordan, President and Chief Executive Officer of the Federal Reserve Bank of Cleveland, explored this question in his address to the DUXX Graduate School of Business Leadership at its Forum on Public Policy in Monterrey, Mexico. This *Economic Commentary* is adapted from his remarks.

A former Federal Reserve governor used to say, "a place that tolerates inflation is a place where no one tells the truth." He meant, of course, that true changes in the relative values of things cannot be observed when the purchasing power of money is not stable.

The standard of value is stable—money is sound—when people make decisions in the expectation that all observed changes in money prices are changes in relative prices, and all observed changes in interest rates are changes in real rates.

The Challenge

There is no single best way to achieve and maintain a stable standard of value. Even the commodity-backed currencies of the eighteenth and nineteenth centuries were subject to periodic inflations or deflations—as when new gold or silver mines were discovered, or mines were depleted.

The choice of monetary regime has implications for fiscal policies; and that, in turn, means political choices must be made.

Under a true gold standard, a country's internally and externally held debt both represent claims to its gold reserves. This effectively limits the government's ability to engage in deficit spending. The size of government is restrained by the ability to raise taxes.

Under the gold exchange standard of the Bretton Woods System,[1] a country's externally held debt still represents a claim on its gold holdings. The government's ability to engage in deficit spending is constrained primarily by the willingness of its residents to add to their holdings of government bonds.

Under a pure fiat money system,[2] such as we have experienced since 1973, the universal challenge has been to find effective constraints on the growth of government spending financed by the issuance of new debt. In this fiscal environment, achieving and sustaining stable currencies has been a worldwide challenge for central banks.

This pursuit of sound money has followed several paths. The gold exchange standard, for example—with pegged exchange rates in the post–World War II period—helped war-torn countries establish the credibility of their new currencies and central banks.

After the demise of the Bretton Woods System, a few countries—such as Austria and Holland—were successful in providing relatively stable domestic currencies by adopting a credible hard peg to a stable foreign standard of value, such as the deutsche mark. A few countries—Switzerland, and later Canada and New Zealand—were relatively successful with floating exchange rates despite their small, open economies.

At times in history, currency boards also have been successful means of importing stable standards of value. For countries with historically undisciplined fiscal policies, currency boards have proven an effective means of achieving a fiscal regime that enables a more disciplined monetary environment.

The recent creation of a new currency—the euro—to replace the national currencies of 11 European nations is yet another method of insulating monetary authorities from fiscal authorities. A successful, stable euro will require fiscal reforms that might not have been possible in the political environments of the individual member nations.

And recently, "dollarization" has emerged as still another approach to importing a stable standard of value. But, like all approaches, there are pros and cons that must be carefully weighed before a choice is made between alternative monetary regimes.

In principle, Mexico could acquire a stable standard of value in several different ways. Some of the necessary conditions for success are common to all approaches. However, the political difficulty of achieving and maintaining these essential conditions depends on historical, social, and political developments that vary greatly from country to country.

The ability to achieve and maintain fiscal discipline is a key condition for success. Even communist governments eventually learned the lesson that what can be distributed and consumed is limited, ultimately, by what can actually be produced. But as we know, governments of all types have had a tendency to promise more than is likely to be produced.

Two crucial developments that led to monetary instability earlier in the twentieth century were capital markets that permitted greatly increased debt-financed spending by governments and the spread of fiat currencies issued by central banks. Successful fiscal discipline has been threatened, most recently, by the growth in unfunded pension liabilities of governments with adverse demographic trends.

In the early 1980s, this linkage between the fiscal regime and the implications for the monetary environments was labeled the "dismal arithmetic of monetarism." This premise held that any country that found it politically difficult to achieve and maintain a disciplined fiscal policy would ultimately resort to the unlegislated tax of debasing the currency. In such circumstances, what we call monetary policy becomes a fiscal instrument—a method of funding government.

This "fiscal dominance" hypothesis of the early 1980s—in an environment of large national debts and annual deficits all over the world—led to forecasts of high and rising inflation in both industrialized and developing countries.

Instead, determined pursuit of disciplined monetary policy in many countries imposed constraints on fiscal authorities. In the case of the euro, political decisions were agreed to in international treaties to achieve and maintain the balanced fiscal policies necessary for a successful monetary regime.

The experience with currency boards has been similar. Once a decision is made to give monetary stability the highest priority, constraints on spending and taxing authorities are inevitable. Residual uncertainties about the durability of currency board arrangements stem from uncertainties about the domestic political will to maintain the fiscal discipline crucial to continued success of the currency board.

Dollarization

In January 1999, following the devaluation of the Brazilian *real,* Argentine President Carlos Menem suggested dollarization as a possible means of solidifying his country's commitment to sound money. Since 1991, Argentina has operated a currency board,[3] pegging the peso one-for-one to the U.S. dollar and backing its monetary base with dollars. Under this arrangement, Argentina's central bank has been remarkably successful at fostering price stability in that country, thereby satisfying a necessary condition for sustained, long-term economic growth consistent with Argentina's potential. Nevertheless, foreign developments—such as the crises in Mexico, Asia, and Brazil—have raised questions about Argentina's political resolve to maintain a U.S. dollar standard of value.

President Menem's words have been echoed throughout Latin America, where dollars already circulate widely, but the cry is loudest in Mexico. Supporters see dollarization as a way to permanently protect Mexico's growth and prosperity from devastating, periodic bouts of inflation and peso depreciation.

Like all monetary arrangements, dollarization would impose certain constraints on political authorities. Public trust ultimately depends on reputations. Constraints on policy discretion are valuable, because they buy time in which to build these reputations. These constraints involve both costs and benefits that countries must consider on a case-by-case basis. I do not give policy advice on the issue of dollarization, because not everyone gains, or gains equally, from the choice of one monetary regime versus another.

Why Sound Money Matters

Money serves to lower the real economic costs of engaging in economic exchange, but its effectiveness in doing so hinges on the stability of its purchasing power. If people suspect that a monetary asset will lose its purchasing power, they will reduce their holdings of it, look for substitute monetary assets (dollarize), and devise alternative—and less efficient—methods of exchange. When this happens, the costs of undertaking daily transactions rise as the public diverts real economic resources away from alternative and more productive uses. Resources are wasted. By conserving these economic resources, stable monetary institutions promote allocative efficiency and economic growth.

Although governments generally understand the benefits of stable money, they also have strong incentives to generate unanticipated inflation. This is especially true of politically weak governments, who attach a low probability to a long tenure and, therefore, heavily discount the more distant gains of economic growth. Through expansions of the money supply, governments can gain seigniorage and levy an inflation tax—without the consent of the public as expressed through a legislative process. In addition, through unanticipated inflations, governments are sometimes tempted to try to exploit a short-term trade-off between employment and inflation.

Once caught off guard, however, the public will become more wary in the future. For their own protection, they will reduce their holdings of domestic money. The spontaneous dollarizations in Argentina and Mexico in the early to mid-1980s exemplify this response. Some Latin American governments initially resisted these unofficial dollarizations, but their responses to currency substitutions (such as capital controls) tended to compound the inefficiencies associated with monetary instability.

Faced with the public's clear preference for a stable currency, governments may adopt institutional constraints on their ability to inflate—like independent central banks, exchange-rate pegs, or currency boards. All have been tried, some have been successful, but most have been abandoned when political circumstances changed. The small, but persistent, spread between interest rates on Argentine peso-denominated debt and interest rates on dollar-denominated debt reflects the slight probability that Argentina might break its dollar peg, or alter the rules under which its currency board operates.

Institutional constraints on monetary policy—by themselves—do not directly address the fiscal-policy and banking-structure problems that often give rise to monetary instability in emerging-market countries. Moreover, they do not erase the need to re-think the political and societal infrastructure that restricts a nation's ability to develop and grow.

Ultimately, the only way governments can attain the optimal outcome to the fiat money problem is by developing a reputation for behaving in a responsible manner. Switzerland, a small, open economy, has achieved sustained economic growth with reasonable price stability without the aid of a currency board, the European Monetary Union, or pegging to another currency.

Although the integrity of a stable purchasing power ultimately depends on reputation, constraints on monetary policy discretion can enhance a government's standing—though they do so only as a signal of intentions with regard to other institutional reforms. Argentina's currency board has successfully eliminated inflation while that country adopted more general, market-based economic reforms. Argentina's intention to develop the economic infrastructure of a normal market economy has been made clear. Monetary constraints alone, however, would stand little chance in countries like Russia that have made little progress in establishing the Hayekian infrastructure essential for markets and a liberal democratic order.

Economic Adjustments Under a Common Currency

Regions, sectors, and industries do not always prosper equally, even in a common currency area. Regional booms and busts still occur. Some sectors or industries expand while others contract. This kind of disparate economic performance may have its origins in the domestic economy or in developments in another currency zone.

For the past couple of years, the U.S. dollar has been relatively strong—especially compared to currencies in Asia and some in Latin America—and overall, the U.S. economy is performing very well. Nevertheless, this prosperity is not universal. Steel companies are losing money, declaring bankruptcy, laying off workers, and shutting down plants. I am certain that steel company executives would like to see a weaker dollar, especially relative to the Japanese yen and other Asian currencies. The story in textiles is similar.

The U.S. oil sector is also depressed, so Alaska, Louisiana, and Texas are not doing so well. Likewise, the Midwest agricultural sector that depends heavily on exports, or has to compete with imports, is having a hard time. The economy of Hawaii has been depressed for several years as a result of the decade-long recession in Japan.

All of these adverse economic conditions create political pressures for government assistance. Sometimes the aid comes in the form of subsidies, sometimes tax relief, sometimes protection against competition from imports. Ultimately, though, both labor and other productive resources will leave these depressed sectors and regions and migrate to areas and industries where opportunities are more promising. The greater the flexibility and efficiency of labor and capital markets, the better the odds of resisting pressures for political relief that come from adverse developments.

The recent launch of the euro—a common currency to be shared by 11 European nations—provides an opportunity to learn more about political responses to the pressures arising from diverse economic conditions. Whether a single, uniform monetary policy can serve both the booming economy of Ireland and the stagnating economies of Germany and Italy remains to be seen.

In addition to labor and capital markets, the health of the banking industry influences a nation's ability to adjust to changing economic circumstances. Even within a common currency area, a lack of diversification of assets or funding sources can create problems for banks faced with regional or sectoral booms and busts. During the oil-price collapse of the 1980s, for instance, U.S. banks that were tied exclusively to oil-region economies failed or were acquired by healthy banks in other regions. More diversified Canadian banks all survived.

Nationwide branch banking in the U.S. is not yet two years old, but there is no question that greater diversification has contributed to the soundness of the larger regional and super-regional companies. The U.S. found that maintaining political boundaries to branch banking in the common currency area of the 50 states was destabilizing. Under the currency board arrangement of the past eight years, Argentina has seen the foreign ownership share of its banking sector grow to 50 percent. There is little question that the continued success of the currency board has been enhanced by the financial stability attained by the internationalization of banking.

For the banking system to remain healthy, additional liquidity must be readily available in times of heightened uncertainty. When truly systemic events occur—the public desires to hold more currency because of century date change uncertainties, or banks attempt to hold more reserves against their deposits during political crises—the only source of additional currency or reserves is the issuing central bank. This classic "lender of last resort" function[4] can be fulfilled only by the central bank empowered to expand or contract its balance sheet without limit. In a world of fractional reserve requirements imposed on deposit liabilities, an elastic source of central bank money is essential. However, that function need not be provided domestically.

In the modern world, this so-called lending function is typically performed through open-market operations, without any need for direct central bank lending to local institutions. All that is necessary is that the supply of central bank money in the market expands as demand increases. Moreover, subsidiaries or branches of foreign banks effectively diversify a country's banking system, making it less vulnerable to economic disturbances. Because of their close ties to the parent banks and access to global financial markets, they may be more able and willing than local banks to maintain lending when faced with deposit outflows.

Market Choice and Change

Permitted the choice, people prefer to hold money that will offer the most stable purchasing power over time. When countries impose capital restraints or establish legal tender rules, they limit their citizens' ability to protect their income and wealth from inflation. Argentina clearly signaled its intention to maintain monetary stability by granting people the legal right to contract under any and all circumstances—including tax payments and other transactions with the government—in any currency they might choose. Legislation in Argentina requires courts to enforce contracts in the currency specified therein. This "specific performance" law[5] provides greater assurance that the effective dollarization will not be reversed.

A dollarization process is already under way—without official sanction—in many Latin American countries. Permitting parallel currencies would have some of the benefits of officially sanctioned dollarization, but would maintain greater flexibility during the transition process. In fiat money regimes, Gresham's law becomes inverted—high-confidence monies drive out low-confidence monies. The resulting discipline from competing standards of value strengthens the political resolve to achieve the fiscal balance necessary for monetary stability.

A fundamental principle of a market economy is consumer sovereignty. People will act in a manner that enhances their own well-being. In the process—as if guided by an invisible hand (to quote a wise man)—they generally will promote the best interests of society at large. The spontaneous, informal dollarizations in many countries over recent decades demonstrate that people know that sound money serves their personal interests. National interests also are served by providing a stable standard of value.

Footnotes

1. Under the Bretton Woods System, the dollar was pegged in value to 1/35 of an ounce in gold, and the currencies of the various Allied nations (Great Britain, France, and their allies) were pegged to the dollar.

2. Money with little or no value in use relative to value in exchange. Modern paper currency, coins, and checkable deposits are examples of fiat money; their value comes from people's willingness to accept them in trade of goods.

3. Argentina does not have an orthodox currency board; rather, it established a currency board-type arrangement, with related economic reforms, in 1991 under the "convertability" plan. Unlike traditional currency boards, Argentina's system has a central bank and allows for some discretionary monetary policy. See Steve H. Hanks and Kurt Schuler, "A Dollarization Blueprint for Argentina," Cato Institute, Foreign Policy Briefing, March 12, 1999 (available at http://www.cato.org/pubs/fpbriefs/foreignbriefs.html).

4. The expression "lender of last resort" emerged when the primary method by which central banks provided additional liquidity to the banking *system* during banking panics was by "rediscounting" commercial loans at the discount window. The objective was to reassure a nervous public that they could convert deposit balances to currency if they so desired. In recent decades, the discount window at the U.S. central bank has declined in importance as a source of central bank funds. Instead, open-market operations have become the primary method of satisfying increased public desires to add to their cash balances.

5. Specific performance legislation is not the same thing as legal tender laws. The latter require residents of a country to accept a certain currency in settlement of a financial obligation, *even if* they are owed a foreign currency, gold, or bales of hay. Specific performance legislation means the courts must require delivery of what was promised to the contract, even if that is the currency of another country, gold, or bales of hay.

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