

2. ROBERT MUNDELL:

The more I listen to discussions of currencies and new patterns of international relations, the more I am impressed by the many-sided aspects of these issues. I mean this as a truism since we can look upon the world monetary system as a set of institutions that have particular functions, we can look upon the systems that grew up inside that world as mechanisms for facilitating economic arrangements, we can see institutions and mechanisms as historical outcomes of an evolutionary process of the world economy. We can also view them as political institutions that are adjusting to changing political circumstances in the world. Jacques Polak, with his remarkable erudition and perceptiveness, has focused attention on the institutional aspects of the problem, but, of course, all other issues emerge or are latent in the background.

In meetings between academics and officials, such as this one, the function of the academic is not to imitate the official but to create his own role, which is to ask questions as they appear within the confines of his own knowledge, playing the role of a wild card in the deck, if only because the international issues that come up are very draconian in the effects they are likely to have on the international monetary system.

First of all, we are dealing with institutions that create money, and the purpose of creating money is to create inflation. The consequence of

you do not know the effects of these measures and you probably cannot know them because there is no world experience that allows one to predict their role. You can of course adopt a rule and say, "Well, if we create 10 billion dollars' worth of SDRs, it is not going to amount to much". But you do not know the effects on the behaviour — psychologically or otherwise — of the different nations that make up the system, and that in fact is an important issue with respect to both SDR and the EMF. The same is true, of course, of the substitution account.

As Jacques Polak mentions, many people thought that a great feather in the cap of the SDR was that it did not have any assets backing it. Fritz Machlup, in his book, endorsed this feature of the SDR enthusiastically. But the other side of the coin is that nobody wanted to create many of those SDRs with no assets backing them. And the SDR, in the first round, turned out to be a failure. It is a failure from the standpoint of the way in which the monetary system has evolved. It did not create new stability in the system. We have had an outbreak of world inflation since we added this type of asset to it. Now, the fact that it did not have a backing to it should not be an example for the EMS. Maybe it should be the alternative to it. You can look upon the substitution account as a way of doing away with that inefficiency, because it works as if the substitution account is going to create a backed SDR. As a result, there will be an unbacked SDR (which is the allocation type of asset) and a backed SDR which emerges out of the substitution account. Of course, if reserves are put into a substitution account, that cancels one form of reserves and replaces them with SDRs, hence the name of substitution account. (Incidentally, I would rather not call it that, even though substitution is one of its functions). But will it have a liquidity effect? The answer hinges on how it affects U.S. monetary policy. If, as a result of its creation, the US follows a vastly more expansionary policy than before, then it will have a strong expansionary liquidity effect. That is, whenever somebody takes dollars out of the system, puts them into the account, gets SDRs, and the IMF stores the dollars, the US may go and refill the basket again. For the same reason, the package to support the dollar adopted in November 1978 was a flop, because though the U.S. said they were going to defend the dollar, they eventually just poured the money back into the market. They defended the dollar in the short run, but they expanded the money supply until last summer. The point is simply that the effects on monetary policies of the creation of new reserve assets are very unpredictable.

Jacques Polak has touched, with his usual wisdom, on several very important issues but the basic question is, "Is there a need for the ECU?". To me, whether the ECU is necessary or not depends on whether you want a political union within Europe or whether you do not.

This is a political question about the creation of an exclusive political entity or group. The EEC is not quite an economic group in a sense; if it were, Switzerland would normally be part of it and the BIS would be a more natural monetary institution for economic Europe. Neither does one suggest that NATO make its own currency; instead, the intention is definitely to create an institution of the Economic Community.

Whatever the motivation, the creation of currencies of this kind always involves the capturing of externalities. Any new institution that is created is an attempt to internalize what used to be an externality in the system. The externality may be the filling of a gap that reflects a power vacuum or that reflects a monetary advantage. In the case of the ECU, there are two gaps. One is an economic gap and the other a political one. The political gap provides the cement with which the nine countries of the Community can get together and create a new institution, a European Central Bank, which would be a basic institution for a Western European State. If that state goes ahead it will be a tremendously important institution. If it does not go ahead but collapses, if the political impetus that is nascent behind it all collapses, then the European Fund will collapse or its nature be changed beyond recognition.

Big institutional changes of the EMF type are predicated on the changes of movement towards political harmony of such diverse entities as the European countries. There is a basic need for such a movement: — in fact, that need has existed since the fifties — a need for protection against invasion by Russia or the Soviet Union, and for emulation of the United States. That is the political root of the movement towards the EMF. The economic root is the attempt to capture seigniorage.

The US has been capturing all the seigniorage in the world monetary system with the spreading of the US monetary system around the world, a form of unlicensed, uncontrolled, branch banking all around the world, something that is forbidden in the United States, even in the State of New York. (You cannot branch bank anywhere in the United States, except in California. That is why, by a silly accident, the biggest bank in the world is a Californian one, because California allows branch banking.)

No single European country can match the power or importance of the dollar. They can of course have a very effective currency, such as the Swiss franc. But, as Mr. Languetin aptly pointed out, the real asset in the system is the dollar. The dollar is the real asset in the system because it has one property that no other currency has: it is the biggest asset in the system and has the property of marketability. This is a reflection of the law of diminishing marginal utility. If you write the demand curve for all the currencies in the world, the dollar has the technical property of having the lowest slope of the demand curve. The demand curve is flattest. When you increase the quantity of dollars as compared

to that of another currency, its marginal utility declines the least. This means that you can always market a billion dollars anywhere at any time, but you cannot do that with any smaller currency for fear of breaking the market.

What we have today is a collection of choices among different assets. We have the SDR as a kind of constitutional asset and vehicle currency of the system. Gold is a separate real asset that is undervalued and cannot be used or circulated because it is undervalued. And the ECU is a political asset so far, but could emerge as something else. The DM is a rival asset and the second most important living currency in the system, as I think Emminger always calls it; it is a rather important asset for the market. The Swiss franc is a treasure like gold because Switzerland has a high gold reserve, and they undervalue gold about tenfold. Somehow, rightly or wrongly, the market seems to think that whenever the price of gold goes up, Switzerland gets richer.

This brings us to an interesting question that Jacques Polak raised: who should hold which asset? Should the Europeans hold the new SDR, i.e. the backed SDR through the substitution account, or should the substitution account hold ECUs? Which should hold which? I think the important issue here is that of a junior asset versus a senior one. We should always think of the SDR in the constitutional framework of the world system as the senior asset of the world economy; in other words, the constitutional asset. When the ECU gets going and gets used, then there should certainly be a parity, so that the substitution account in which the SDR replaces the dollar also holds ECUs. Two of its assets could be Europe's ECU and America's dollar. The account should also hold a host of other currencies. This would constitute the embryo of a World Bank. It should be made quite clear that the superior or senior asset in the system is the world asset just as the senior government in the system is the world government and not a national government.

The tone of Dr. Polak's paper reflects a certain defensiveness or worry about the ECU. In a sense, it is as if he was looking over his shoulder at the competition, as if the ECU was a new thing which may take away from the creation of the substitution account. I think, however, it would be fair to say that we would not have had the movement towards the substitution account without the European Fund. The United States may not have moved in this direction; it might not have accepted the idea of an account without the Europeans. There will be competition between the creation of these two institutions and it will be very important who gets there first, because if the ECU goes ahead very rapidly, then people will lose interest in the substitution account or drag their feet in moving in that direction. On the other hand, there is a threat to the

common political purpose of the Community if the SDR gets really strong and successful and if all the defects of the SDR mentioned by Jack Polak are corrected.

(The absurd 16-currency SDR basket could be reduced to a 2- or 3-currency one. You only need one dollar plus one mark to form a basket. As I suggested two years ago, that is enough to make a good world currency. Even from the standpoint of the unit of account, it would make things very easy, because you just need to know one exchange rate. A new, more interesting name should be invented for it: Mondor, Unor, Intor, or any name that has a measure of appeal for the public. The Fund could also market their gold in a new form by selling a gold SDR. After all, the SDR was originally expected to be a gold unit and had a gold weight guarantee, as Pierre-Paul Schweitzer insisted upon in the late sixties, and this may be important in the process of selling them.)

The reality, however, that we have to guard against, is that inside this room and inside these institutions we get involved in technicalities while Rome is burning. We are likely to be in the midst of big exchange market developments, even this year, and we are threatened in the near future with an outbreak of world inflation that could be horrendous if nothing is done to stop the growth of world liquidity. I see nothing that will come out of these institutions in this context. These institutions will create liquidity. The fund has never contributed to adjustment; it creates the opposite of adjustment, it delays adjustment. If we give countries credit, they do not improve their current account by the amount of credit they are given. If we do not give them credit, they have to adjust, there is no alternative to adjustment. What the Fund does is to create a more efficient form of adjustment and it does create a safety net, or cushion for financial institutions.