Comments by Governor State Bank of Pakistan on the paper Debt, Growth, Poverty in International Monetary System by Nobel Laureate Prof. Robert A. Mundell at the Annual Conference of Pakistan Society for Development Economists at Islamabad on January 14, 2002.

I agree with Prof. Mundell that economic theory does suggest that the best monetary system would involve the use of a single currency. The idea of the existence of money is to facilitate exchange and thus a single unit of account and medium of exchange is preferable over several such units. A single currency also reduces the transaction costs, search costs, computational costs and thus enhances the efficiency of resource use. On this basis, it is safe to deduce that the justification for a system of national currencies freely convertible at fixed exchange rate is self-evident. Empirically, the European Union (EU) has successfully completed its long journey towards a single currency area. Unlike the United States where the political sovereignty by states is surrendered to a nation-state under an agreed constitutional and institutional arrangement, the case of EU is quite different. The nation-state members of EU have chosen to maintain their political sovereignty intact and only surrendered their monetary policy setting powers to a common entity. This journey towards the single currency has only been possible when certain pre-conditions defined precisely and quantitatively were fulfilled by each of the participating countries.

The convergence to a common set of economic indicators including fiscal deficit and the adherence to Growth and Stability Pact was the sine qua non for this transition to have been successfully completed. There are still unsettled questions in the minds of academics and impartial observers whether the political self interests of the various nation-states can always be reconciled and resolved with the collective economic interest of the EU. The economists do have a competitive model with a set of social safety nets in place which can convert the pursuit of individual self interest into the creation of some collective goods. But I am not aware that if there is an analogous model in politics which can mediate the conflicting interests of individual nation-states into arriving at an optimal or even second best solution that ensures collective best interests of the community as a whole. At the practical level, the existing institutional arrangements of the Council of Ministers and European Parliament are not strong enough to carry out this task. So it would be extremely interesting for other regions of the world as to how this unique experiment of the European Union actually works itself out in practice. The emergence of single currency areas elsewhere will thus very much depend upon the lessons learnt from this experiment.

But as Prof. Mundell himself specifies in his paper even the economic pre-conditions for single currency and fixed exchange regimes for emerging economics are fairly stringent. He rightly argues that an indispensable condition for a single currency is that it be a security area ---- i.e. a War-free zone of allies. I doubt very much that South Asia, Middle East, East Asia, Sub-Saharan Africa or even Latin America can meet this condition. Second, a currency area of fixed exchange rates cannot work if there is no agreement on a common inflation rate and on the mechanism for controlling the money supply of the area as a whole. While inflation rates have come down in emerging markets in the recent years from the exceptionally high levels of 1980s the variance is still quite significant within the various regions. It is hard to conceive for Latin American countries to agree on a common inflation rate or for that matter for Indonesia or Singapore within the ASEAN regions. Third, fixed exchange rates would not work for countries that cannot achieve fiscal balance and do not have access to borrowing; inevitably, monetization of the deficit would conflict with the monetary policy needed to maintain the exchange rate. Exchange rate adjustment thus becomes inevitable in countries that are inflating relative to their neighbors. A Budget deficit would set in motion speculative forces that would undermine the fixed exchange rate. If we analyze the causes of recent collapse of Peso-dollar fixed exchange rate regime in Argentina it becomes quite obvious that the inability of Argentina to catch up with Brazil when the latter allowed its currency to depreciate was a major trigger point. Fourth, there must be an agreement on the credibility of the partner country currency to whom the exchange rate will be linked. For example, if the US dollar is chosen as the anchor then it is the assessment of US monetary policy that will determine the choice. But the track record of US monetary policy has not been that impressive since the 1970s. For Asia, Yen could have been an alternative anchor. But the volatility of the Yen-dollar rate would then be transmitted to the Yen zone countries and the prospects of Japanese economy recovering out of its economic malaise soon do not appear very bright. Thus the choice of an appropriate anchor becomes highly problematic for the Asian Countries.

Fifth, the frequency with which national economies are subjected to unanticipated external shocks and ease with which equilibrium is disturbed placed an additional constraint on the policy makers if the exchange rate is fixed. This will impair their capacity to respond and adapt to these shocks and thus is likely to take a greater toll on the welfare of the population. The weaker economies who choose to adopt a fixed exchange rate in order to establish credibility and derive long term benefits from this association are particularly going to be hit hard in the short term. The political fall out of such a shock and the policy makers' inability to respond adequately and on time is likely to be quite severe and harsh.

If we examine only these five pre-conditions and mind it that these are only economic conditions and I haven't even alluded to political conditions I am not sure if there is any region among the emerging markets which can become a feasible candidate for single currency. The only examples of fixed exchange rate i.e. Hong Kong, Argentina and Estonia are not very persuasive to change our minds. Argentina has paid a heavy price for its too long adherence to the fixed rate regime while Hong Kong and Estonia are very special cases, which cannot be generalized to a large segment of emerging economies.

The empirical case for a flexible exchange rate has been propounded by several studies carried out by the International Monetary Fund and among the academics by Calvo and Reinhert.

The theoretical case of floating exchange rate has in recent years been made by the New Monetary Economists. Neil Wallace attributes the existence of a distinct demand for money to the existence of legal restrictions imposed by each government on the voluntary market activity of individuals. Thus the demand for money function does not result from any fundamental economic process but because of intervention by governments in market activity. As government are at best national in scope, each country creates demand for money under its own specified set of regulations. If this argument is accepted, it would be difficult to determine an equilibrium exchange rate that clears the markets in all different countries under a single currency.

What I missed in this paper and what I was really looking forward was the views of Prof. Mundell on the inter relationship between debt, growth and poverty – a topic which is dear to the heart of policy makers and practitioners such as myself. On the one hand there is a growing body of empirical literature which tends to suggest that developing countries participation in globalization through international trade, capital flows and technology accelerates their economic growth rates and reduces incidence of poverty. Dollar and Kray have recently studied the experiences of a group of developing countries that have significantly opened up to international trade during the past two decades. They provide evidence that contrary to popular beliefs, increased trade has strongly encouraged growth and poverty reduction and has contributed to narrowing the gaps between rich and poor worldwide. On the other hand, there is a growing tendency among NGOs, Civil Society Organizations, some academics who strongly agree that globalization is making the poor countries poorer and the rich countries richer and poverty has in fact gotten worse because of debt, growth and international trade. If Prof. Mundell had chosen to illuminate us with his Considered Views on this issue I am sure we would have become much wiser.