Chapter 3

Monetary Instability: Are National Currencies Becoming Obsolete?

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Nothing signifies the growth of instability in today's international political economy more than the disruptive financial crises that have swept the world in recent years – the speculative attacks on the pound sterling and other European currencies in 1992-93, which broke up the old European Monetary System; the fall of the Mexican peso in 1994, which sparked a worldwide contagion in financial markets that came to be known as the tequila effect; the East Asian crisis of 1997-98, which began with crash of Thailand's currency, the baht, and then spread outward in another contagion, which some this time labelled a case of "bahtulism": the Russian default of 1998; Brazil in 1999; and the continuing troubles of Argentina, Turkey, and others. In just one decade the world's monetary system has gone to the brink a half dozen times. No wonder there is so much talk – albeit, to date, rather little action – about reform of what we now call the international financial architecture.

Yet in a very real sense, all of these crises may be considered little more than the tip of the iceberg – the outward manifestations of a much more fundamental transformation of the global monetary environment. That transformation, which I wrote about in my recent book The Geography of Money (1998), is being driven by a rapid acceleration of cross-border competition among currencies – what in The Geography of Money I called the deterritorialization of money. Circulation of national currencies no longer coincides with the territorial frontiers of nation-states. A few popular monies, most notably the U.S. dollar and Europe's new euro (succeeding Germany's Deutschemark), have come to be widely used outside their country of origin, competing directly with local rivals for both transactions and investment purposes. Many weaker currencies, conversely, have been reduced to a minority share of the money supply in their own country of issue. All of the crises of the last decade can be understood as instances of national monies that, in this increasingly unstable environment, have lost their market appeal.
This instability, then, raises a truly fascinating question. In all markets, we know, the logic of competition suggests that, ultimately, many weaker rivals will be eliminated. And so, we might think, the same should be true in the market for monies. Does this mean that national currencies are becoming obsolete? Are many of the monies around the globe – the diverse kips (Laos), quetzals (Guatemala), pulas (Botswana), and levs (Bulgaria) – destined to go the way of the Dodo bird? The short answer, for many, is almost certainly Yes. Extinction could be the fate of the currencies of even some of the world’s richest economies, such as Canada’s beloved loonie.

In this paper, I will make three main points. I start with the transformation of today’s global monetary environment. The implications of deterritorialization for the survival of national currencies are only beginning to be understood. My first point is that currency competition compels governments to choose from among a limited number of strategies, only one of which involves preservation of traditional territorial money. Second, a good number of national monies will indeed disappear, leading to an increasing population of regional currencies of one kind or another – a distinctly new geography of money. But, third, there is no sure way to predict what that new geography of money will ultimately look like. We have a fairly good idea of the principal factors that are likely to influence state preferences, but many configurations are possible and even probable.

THE NEW GEOGRAPHY OF MONEY

That the global monetary environment has been greatly transformed in recent decades is undeniable. A half century ago, after the ravages of the Great Depression and World War II, national monetary systems – with the notable exception of the United States – were generally insular and strictly controlled. Starting in the 1950s, however, barriers separating local currencies began gradually to dissolve, first in the industrial world and then increasingly in many emerging-market economies as well. Partly this was the result of an increased volume of trade, which facilitated monetary flows between states. But even more it was the product of intense market competition that, in combination with technological and institutional innovation, offered an increasingly freer choice among currencies. Currency substitution widened access for a growing number of actors at all levels of society.

Most scholarly attention has been paid to the remarkable growth in recent decades of capital mobility, reflected in a scale of international financial flows unequalled since the glory days of the nineteenth-century gold standard. The high level of capital mobility today is commonly cited as one of the most visible artefacts of contemporary globalization. But these flows are just part of the story of money’s growing deterritorialization. A focus on capital mobility, emphasizing integration of financial markets, highlights only
one of the standard functions of money: its use as a store of value. In fact, the
interpenetration of monetary systems today has come to be far more
extensive, involving all the functions of currency—not just money’s role as a
private investment medium but also its use as a medium of exchange and unit
of account for transactions of every kind, domestic as well as international.
Cross-border currency competition means much more than capital mobility
alone.

Deterritorialization is by no means universal, of course—at least, not
yet. But it is remarkably widespread. Krueger and Ha (1996) estimate that
foreign currency notes in the mid-1990s accounted for twenty percent or more
of the local money stock in as many as three dozen nations inhabited by at
least one-third of the world’s population. In all, as much as one-quarter to
one-third of the world’s paper money supply is now located outside its
country of issue. Most currency substitution is concentrated in Latin
America, the Middle East, and republics of the former Soviet Union, where
the dollar is favoured; or in East-Central Europe and the Balkans, where the
DM traditionally predominated. By a different measure, focusing on foreign-
currency deposits rather than paper money, the International Monetary Fund
identifies some eighteen nations where by the mid-1990s another state’s
money accounted for at least thirty percent of broad money supply. The
most extreme cases, with ratios above fifty percent, included Azerbaijan, Bolivia,
Croatia, Nicaragua, Peru, and Uruguay. Another thirty-nine economies had
ratios approaching thirty percent, indicating “moderate” penetration.

What are the implications of this transformation for the survival of
national currencies? For specialists in open-economy macroeconomics, who
typically focus narrowly on capital mobility, the significance of recent
developments is restricted mainly to implications for the choice of exchange-
rate regime. Traditionally, the exchange-rate issue was cast in simple binary
terms: fixed versus flexible rates. A country could adopt some form of peg
for its currency or it could float. Pegs might be anchored on a single currency
or a basket of currencies; they might be formally irrevocable (as in a currency
board) or based on a more contingent rule; they might crawl or even take the
form of a target zone. Floating rates, conversely, might be managed or just
left to the interplay of market supply and demand. More recently, the issue
has been recast—from fixed versus flexible rates to a choice between, on the
one hand, contingent rules of any kind and, on the other, the so-called “corner
solutions” of either free floating or some form of monetary union. Today,
according to an increasingly fashionable argument known as the bipolar view
or two-corner solution, no intermediate regime can be regarded as tenable.
Owing to the development of huge masses of mobile wealth capable of
switching between currencies at a moment’s notice, governments can no
longer hope to defend policy rules designed to hit explicit exchange-rate
targets. The middle ground of contingent rules has in effect been “hollowed
out,” as Barry Eichengreen (1994) memorably put it.
But that too is just part of the story. In reality, much more is involved here than simply a choice of exchange-rate regime. At its most fundamental, what is involved is nothing less than a challenge to the long-standing convention of national monetary sovereignty. Governments have long claimed an absolute monopoly over the issue and circulation of money within their own territory. Currencies were to be territorial – exclusive legal tender within the nation’s frontiers – with strict lines separating one monetary domain from another. However, once we look beyond capital mobility alone to the broader phenomenon of currency competition, we see that in many areas of the world the traditional dividing lines between national monies are becoming less and less distinct. No longer are most economic actors restricted to a single currency – their own home money – as they go about their business. Cross-border circulation of currencies, which had long been common prior to the emergence of the modern state system, has dramatically re-emerged, resulting in a new configuration of currency spaces – a new geography of money. The functional domains of many monies no longer correspond precisely with the formal jurisdiction of their issuing authority.

Currency deterritorialization poses a critical challenge because governments have long relied upon the advantages derived from formal monetary monopoly to promote their conception of state interest. In fact, five main benefits are derived from a strictly territorial currency: first, a potential reduction of domestic transactions costs to promote economic growth; second, a powerful source of revenue (seigniorage) to underwrite public expenditures; third, a possible instrument to manage the macroeconomic performance of the economy; fourth, a potent political symbol to promote a sense of national identity; and finally, a practical means to insulate the nation from foreign influence or constraint. But all these gains are eroded or lost when a government is no longer able to exert the same degree of control over the use of its money, by either its own citizens or others. Instead, in a growing number of countries, policymakers are driven to compete, inside and across borders, for the allegiance of market agents – in effect, to sustain or cultivate market share for their own brand of currency. The monopoly of monetary sovereignty yields to something more like oligopoly, and monetary governance is reduced to little more than a choice among marketing strategies designed to shape and manage demand.

Broadly speaking, for affected states, four strategies are possible, depending on two key considerations – first, whether policy is defensive or aggressive, aiming either to preserve or promote market share; and second, whether policy is unilateral or collective. These four strategies are:

*Market leadership:* an aggressive unilateralist policy intended to maximize use of the national money, analogous to predatory price leadership in an oligopoly.

*Market preservation:* a status-quo policy intended to defend, rather than augment, a previously acquired market position for the home currency.
Market alliance: a collusive policy of sharing monetary sovereignty in a monetary union of some kind, analogous to a tacit or explicit cartel.

Market followership: an acquiescent policy of subordinating monetary sovereignty to a stronger foreign currency via a currency board or full dollarization, analogous to passive price followership in an oligopoly.

Of these four options, a strategy of market leadership is of course generally available only to governments with the most widely circulated currencies, such as the dollar and euro. For the vast majority of states with less competitive monies, decision making is limited to the remaining three—a tricky tripartite choice. For these states, the very survival of national money is at stake.

CURRENCY REGIONALIZATION

The basic question for such states is the familiar one of constrained choice. What limits on national policy are they willing to accept? Should governments seek to sustain their traditional monetary sovereignty (market preservation)? Or, alternatively, should they countenance delegating some or all of that authority upward, either to the joint institutions of a monetary union (market alliance) or to a dominant foreign powers (market followership)? Involved is what one source calls a “sovereignty bargain”—a voluntary agreement to accept certain limitations on national authority in exchange for anticipated benefits. Monetary sovereignty is either pooled in a partnership of some sort, shifting authority to a joint institution like the European Central Bank (ECB), or else surrendered wholly or in part to a dominant foreign power such as the United States. The former president of the Argentine central bank put the point bluntly: “Should a [country] produce its own money, or should it buy it from a more efficient producer?” Buying from a more efficient producer necessarily implies a degree of regionalization in currency relations.

Currency regionalization occurs when two or more states formally share a single money or equivalent. With a strategy of market alliance, governments agree to merge their separate currencies into a wholly new joint money, as members of Europe’s Economic and Monetary Union (EMU) have done with the euro. This is currency unification, what the economist George von Furstenberg (2000) calls a “multilateral sharing model of monetary union.” Examples already in existence around the world include, in addition to EMU, the CFA Franc Zone in Africa and the Eastern Caribbean Currency Union (ECCU). A looser version, called the Common Monetary Area (CMA), also exists in southern Africa, encompassing South Africa and three of its smaller neighbours, Lesotho, Namibia, and Swaziland.

Alternatively, with a strategy of market followership, any single government can unilaterally or by agreement replace its own currency with an
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