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The Euro's Problems Are Fundamental

Theories abound about why the Eurozone's currency is flawed. But most diagnoses ignore the simple source of the euro's problems: It's fiat money.

by Lawrence White, PhD, Visiting Research Fellow

Nearly all commentators, apart from officials of the European Central Bank, agree that the euro is flawed in some way. There is much less agreement about *how* the euro is flawed and what a more ideal currency system would look like.

When the currency speculator George Soros says that "the euro is a flawed construct," as he did in a widely reported speech in Berlin last year, he means that the euro needs a stronger political union behind it. In his view, a single pan-European-Union welfare state would allow for the creation of one fiscal policy (one set of taxing and spending decisions), along with one monetary policy, for all of Europe.

The ECB's head, Jean-Claude Trichet, has similarly begun to complain in recent weeks about the inconvenient lack of a Eurozone finance ministry to centralize member countries' fiscal policies.

Soros hopes that with one pan-European government, financially conservative Germany would no longer rule the roost. The ECB could then pursue looser monetary policy, which he supposes would cure the ills of countries with weak economies and mounting public sector debts. This view is widely shared.

By contrast, when retired Dutch central banker André Szász says that the euro was flawed from the start, as he did earlier this year, he means that it is a mistake to have "a monetary policy of one-size-fits-all." Such a monetary policy will be too loose for some countries and too tight for others, or, as he puts it, interest rates will be "too low" for some countries and "too high" for others.

The wishful thinking is that an artfully timed monetary policy will improve an economy's real performance.

Paul Krugman has registered the same complaint, as has Marine Le Pen of France's National Front. This criticism is linked to the so-called optimum currency area analysis, which holds that to share a single currency, two or more economies should have harmonized business cycles so that a single monetary policy (interest rate) fits them all. Absent harmonized cycles, devaluation or exchange rate depreciation is supposed to help an economy in recession reduce its unemployment rate by lowering real wages or by stimulating real output through greater real exports.

Both of these diagnoses arise from false premises. They both rest on the wishful thinking of Keynesian economics, in particular, that an artfully timed discretionary monetary policy will improve or stabilize an economy's real performance by improving or stabilizing real variables. That is to say, these arguments take for granted an ability to exploit the Phillips Curve (to lower unemployment by cheapening the monetary unit), alternatively known as exploiting the "money illusion" of the workforce.

In fact, the real illusion here is our supposed ability to exploit the money illusion. A policy regime of printing more money and devaluing does not improve real economic performance or dampen business cycles. It does just the opposite. The historical evidence on that question is clear.

A better start to understanding the fundamental shortcoming of

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the euro is to begin with the simple fact that the euro is a fiat currency, a paper money standard. The investor Jim Rogers—a former business partner of George Soros, but of very different political persuasion—is right when he notes that "generally … paper money is flawed."

The Time-Inconsistency Problem. Economists have a technical term for the fundamental flaw in fiat money. They call it "the time-inconsistency problem" or "the credible commitment problem."

The classical allegory for the time-inconsistency problem is the episode in the *Odyssey* in which Odysseus wants to hear the beautiful singing of the Sirens. But he knows that without some binding constraint to keep him away from the ship's tiller, he will give in to the temptation to steer the ship in the direction of the Sirens and end up smashed on the rocks. The solution? He has his shipmates tie him to the ship's mast and plug all of their own ears with wax.

By constraining himself against temptation, Odysseus achieves a better outcome than if he had left himself with moment-by-moment discretion. In light of recent news, it is ironic that the man who knew to bind himself against short-sighted behavior was Greek.

When central bankers who issue fiat money have the discretion to alter monetary policy from month to month, to do whatever seems desirable at the moment, they also have a time-inconsistency problem. Finn E. Kydland and Edward C. Prescott brought this problem to the economics profession's attention, and received a Nobel Prize largely for doing so.

Central bankers promise low inflation and then find themselves pressured to do something else, such as temporarily lower unemployment or finance for government borrowing, by monetary expansion too rapid to keep inflation low. They face no penalty for breaking their promises. As a result, the private citizens who use euros, for example, don't know what the euro will be worth five or 10 years out, *unless* there is some kind of binding commitment to a steady policy path. Without a binding commitment, inflation is unnecessarily high and variable.

The European Central Bank has a commitment *on paper*, of course, to keep inflation below 2 percent. But in the face of pressure to buy the bonds of heavily indebted governments, to delay the day of reckoning for the sovereign debt crises of Greece, Ireland, and Portugal, the ECB's commitment to low inflation may crumble.

Contrast this system with a free-market silver or gold standard. Under such a monetary standard, the private mining firms that dig up the precious metals, the mints that produce coins, and the banks that issue redeemable notes and transferable account balances are all constrained by contract and by competition. There is no time-inconsistency problem in monetary policy because there is no monetary policy. Nobody has discretion over the quantity of money.

The challenge for those who believe in the rule of law is to reintroduce such constraints on money creation: if not a gold standard, then

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a serious and enforceable limit on fiat money. You can't believe in the rule of law and also believe in discretionary rule by central bankers.

The time-inconsistency problem was known to the designers of the ECB constitution and to some of the bank's early officials, in particular the German economist and ECB board member Otmar Issing and the ECB's first president, the Dutchman Wim Duisenburg. To their credit, they tried to tie the ECB to the mast and give the euro a binding pre-commitment to a steady policy path.

The ECB constitution specified that the ECB is to be exclusively committed to price stability, and a board statute early on declared that price stability means inflation no higher than 2 percent. Today, the ECB website continues to declare: "The ECB aims to maintain annual inflation rates as measured by the HICP [Harmonized Index of Consumer Prices] below, but close to, 2 percent over the medium term."

In 2000, I participated in a published exchange with Professor Issing, then a member of the ECB board. In a lecture to the Institute of Economic Affairs (London), Issing applauded the ECB constitution for solving the time-inconsistency problem by tying the ECB irrevocably to the single goal of price stability.

In my commentary, I said that it was too soon to tell whether the constitution's commitment on paper would actually bind the ECB in practice when pressure arose to pursue some other goal. For a commitment to be binding, there must be some penalty for going astray. The ECB constitution unfortunately *does not specify any penalty* for ECB officials who deviate from an exclusive focus on price stability. They do not lose their jobs. This is a fundamental design flaw. What is now the result?

Today, the leadership of the ECB, under pressure from the EU and the national fiscal authorities, is violating its constitutional duty by filling the ECB portfolio with junk bonds from Greece, Ireland, and Portugal in order to keep prices on those bonds high and yields low. The ECB is trying to support government bond prices generally to make debt rollovers cheaper by holding interest rates at a record low level, one that is inconsistent with keeping inflation at or below 2 percent.

The result of the new monetary policy is increasingly evident. In 2011, the euro inflation rate has been persistently above the promised 2 percent ceiling. The HICP has risen from 110.6 in November 2010 to 113.1 in May 2011, six months of inflation at an annual rate of *4.5 percent*, more than double the constitutional rate. How much higher will the ECB let it go?

Central bankers promise low inflation and then find themselves pressured to do something else.

The Europeans who gain most from a strict pre-commitment to low inflation are citizens of the countries that had the worst track record, pre-euro, on inflation. Those countries include Greece, Ireland, Portugal, Spain, and Italy.

By the same token, if the euro becomes a more inflationary currency, the countries with the most to gain by exiting the euro and switching to a stronger currency are those with national central banks that can produce low inflation, as indicated by their pre-euro track records, particularly Germany and the Netherlands.

To put it another way: Germany does not need the ECB constitution to have a relatively credible commitment to low inflation. Greece, Ireland, Portugal, Spain, and Italy do. If the governments with the worst debt problems raise the price of ECB membership for the citizens of all other countries by successfully demanding the transfer of hundreds of billions of taxpayer euros in their favor, then it is not those countries, but Germany and the Netherlands, that will be the first to find it prudent and politically popular to exit the Eurozone.

Does the Euro Make Debt Worse?

Under the international gold standard, at least where the central bank was bound to "the rules of the game" or (better yet) no central bank existed, there was no national monetary policy. Budgetary policy was separate from the monetary system. Budgets had to be balanced, not in any one year but in a credible present-value sense over a foreseeable horizon, for a government to borrow.

Under fiat money, by contrast, it is impossible to completely separate fiscal policy from monetary policy, given that the central bank can prop up government bond prices by monetizing debt. Or, to put it in more technical terms, the separation is breached because seigniorage from monetary creation appears in the government's budget constraint. The ECB constitution tried to build a wall against debt monetization, but that wall has now been breached.

Some, like Marian Tupy of the Legatum Institute in a recent op-ed, have argued that Greece's membership in the Eurozone allowed the Greek government to borrow at lower real interest rates, and thereby enabled its overspending. (In the language of addiction recovery programs, "enabling" an addict is a bad thing, not a good thing. It means untying Ulysses from the mast.)

If true, this implies that buyers of Greek bonds must have taken Eurozone membership as a signal of an *implicit guarantee* that they would be repaid because the ECB could be successfully pressured not to let Greece default. Bond buyers ap-

pear to have figured that the ECB's exclusive commitment to price stability was not durable, but would be sacrificed if necessary to bail out Greece. If that's what they figured, unfortunately it seems that they may have been right.

Given the ECB's problem in keeping its own hands tied, the fiscal entry rules of the Stability and Growth Pact, aka the Maastricht criteria—that no country is allowed into the ECB with a deficit of more than 3 percent or a debt more than 60 percent of GDP—seem like thoughtful precautions in retrospect. Thoughtful, but tragically ineffective. They attempted to reduce temptation by allowing into the ECB only countries that would have little debt to inflation away. But they have failed.

The rules haven't been enforced for violations *after* entry, or in the case of Greece for falsifying the data on the admission application (with the help of Goldman Sachs). The ECB has no political will, no precedent, and no guidelines to kick out a country in violation of the rules. (By the way, *most* ECB members are now running budget deficits over 3 percent.)

To preserve the credibility of the euro, the ECB must make a commitment not to monetize national debts.

To preserve the credibility of the euro, the ECB must make *a clear and credible commitment not to monetize national debts*. Otherwise, the euro is endangered by the time-inconsistency problem.

A no-bailout rule means that the ECB is barred from intervening in any nation's fiscal affairs. No special loans, no purchases of low-rated bonds, no acceptance of low-rated bonds as collateral. It means that the Greek government's excessive borrowing is the problem of the Greek government and its bondholders. Likewise for the Irish government, the Portugese government, and so on.

If the Greek government defaults, it defaults. And its bondholders have to accept a debt restructuring as the price they pay for the high yields they have been getting (which reflect of course the high risk of default). Will this undo the euro? No. *A default by the Greek government does not imply a crisis for the euro*, any more than default by the state of California's default implies a crisis for the U.S. dollar. Or any more than the actual 2008 default of the government of Ecuador, a country that uses the U.S. dollar as its official currency, created a crisis for the U.S. dollar. (The event was hardly noticed in the U.S. press.) On the other hand, printing euros to absorb or inflate away Greece's debt or forcing other Eurozone taxpayers to bear the debt *does* mean a crisis for the euro.

The flaw in the euro is not that the Eurozone is too large to be what economists call an "optimal currency area." If we judge optimality from the bottom-up perspective of the ordinary citizens, who want trustworthiness and low transactions costs (rather than from the top-down social-planner perspective of Keynesian macroeconomists who think that devaluation is sometimes a useful tool), *the optimal currency area is the entire world*—provided that the world currency has a stable purchasing power.

For the citizens of an open economy who want to enjoy cross-border trade and investment, and want to have a trustworthy currency, the option of their central bank to devalue carries a near-zero or even negative value, while the benefits of membership in a common currency area are important and positive.

What's the Alternative? I should acknowledge that the euro is better than some other fiat monies. It has so far held its value better than the drachma or the lira or the peseta used to. The Eurozone continues to grow because voters and politicians in central European countries, on the outside looking in, view the euro as more credible than the currencies they can produce by themselves.

On the other hand, the countries that chose not to join the Eurozone in 2000—Great Britain, Sweden, Denmark—have not changed their minds. Given that the fiscal burdens of Greece, Ireland, and Portugal will fall harder on Eurozone countries than other EU members, they can be glad they stayed out.

The best way to ensure that we have high-quality currency is to take the same approach we take to ensuring quality automobiles: free-market competition under a system of private property rights protected by the rule of law.

Is an apolitical, trustworthy, global currency really possible? Yes. We once had it. We call it the classical gold standard.

The only historical examples we have of market-regulated monetary standards are commodity standards, most importantly silver and gold standards. These are also the only historical examples of successful *global* monetary standards.

Gold and silver have the virtue of being no sovereign issuer's liability, and therefore of being independent of any sovereign issuer's insolvency, time-inconsistency, or vulnerability to capture by a political rent-seeking coalition.

Fundamental Reform. To achieve an international monetary system consistent with the classical liberal ideals of the free world, we need to move beyond tinkering at the margins of the monetary *status quo* and instead begin considering fundamental institutional reforms in money and finance.

In particular, we need to reopen the questions of whether we would not be better off without

reserve requirements and other legal restrictions on banks, deposit guarantees and other subsidies to bank risk-taking, the institution of central banking, and the reign of fiat money.

Here is my own "wish list" of ideal monetary and banking reforms.

Eliminate government guarantees on bank deposits and other liabilities.

Having done that, eliminate mandatory capital ratios, the main rationale of which is to protect deposit guarantee funds. The failed Basel agreements imposing uniform bank capital requirements wrongly seek to limit banking competition across countries.

Eliminate government reserve requirements on bank deposits.

Privatize the useful roles of central banks. Return the role of issuing currency to a system of competing commercial banks ("free banking").

Private clearinghouse associations can assume the role of central banks as clearinghouses and bankers' banks for settlement. The associations can also formulate and enforce solvency and liquidity rules for commercial banks. In addition, they can take the necessary steps to assure to their member banks that no other members will default at the next clearing and settlement session. In addition, clearinghouse associations can promulgate and enforce using any other standards (e.g. for disclosure of loan and deposit interest rates) favored both by bankers and their customers.

Private clearinghouse associations can also serve as a "lender of last resort," in the classic Walter Bagehot sense, to solvent but illiquid banks. Because of their expanded roles, the associations would have the up-to-date information necessary to identify solvent banks worth rescuing and an incentive to provide co-insurance to their members.

While the useful roles of central banks should be privatized, the harmful ones should be eliminated. Return the regulation of the quantity of money to the market via the commodity standard to eliminate arbitrary manipulation by national authorities. And get rid of restrictions not favored by banks or their customers.

The final item on my list is to replace national fiat money units of account with an international market-based commodity standard. The leading candidate commodity is gold, given its historical track record and the fact that central banks still own large (currently idle) stocks of it. But silver—equally tested historically—might also serve well.

An International Gold Standard. Under a gold-based international free banking system, currency and deposits would likely continue to be the commonly used payment media. But both would return to being commercial bank liabilities redeemable for gold.

We need to move beyond tinkering at the margins of the monetary status quo and consider institutional reforms.

Because of the issuers' contractual obligations to redeem in gold and corresponding prudential need to hold gold reserves, the dollar volume of paper currency and deposits in such a system—the stock of money—is geared to the volume of gold.

The volume of monetary gold is a slowly accumulating stock, its growth path ultimately determined by impersonal supply and demand forces in the gold-mining market. Growth in the stock of money is thus governed by market forces rather than by government fiat.

A gold standard does not guarantee *perfect* steadiness in the growth of the money supply, or perfect steadiness in the purchasing power of money. But historical comparison shows that in practice, gold has provided more moderate and steadier money growth and more stable purchasing power than the present-day alternative of relying on a central banking committee to determine growth in the stock of fiat money.

From the perspective of limiting money growth appropriately and avoiding price inflation, a gold standard without a central bank consistently works well, no matter who comes into political power.

Historical problems of instability associated with international gold flows during the classical gold standard period turn out on closer inspection to have been rooted in the national limitation of banking systems and the concentration of gold reserves in central banks. Problems of financial panics, including those of the greatest series of U.S. banking panics, those of 1929–33, were because of banking regulations that weakened banks. Gold standard countries such as Canada that avoided central banking and the sort of restrictions that weakened banks also avoided panics.

A gold standard does entail the resource costs of mining. But every known fiat standard has imposed the deadweight costs of inflation and the financial shallowing effects of variable inflation.

The deadweight costs of inflation are the higher transaction costs incurred by people going out of their way to avoid the tax that ongoing loss of purchasing power levies on currency notes and on deposits that pay less than a compensating interest rate.

The financial shallowing effects of inflation are lost gains from trade associated with the disappearance of markets in long-term nominal debt instruments, such as 30-year bonds and 30-year mortgages, because of the added risk to saver and borrower from reduced predictability of the purchasing power of money units to be repaid in the future.

These effects are seen throughout Latin America where the dollar has not been adopted.

Ironically, the resource costs of gold mining have actually been *higher* since Richard Nixon completed the demonetization of gold in 1971. High and variable inflation has led the public to accumulate gold as an inflation hedge, making the current real price of gold (currently around $1700 an ounce) higher than the real price at the end of the gold's monetary era (then nominally $35 an ounce). This in turn stimulates more gold mining.

Under free banking, without an artificially imposed high gold reserve ratio, a gold standard requires less gold than is currently stockpiled. (My article "Will the Gold in Fort Knox Be Enough?", written for the 2004 *Prospects for a Resumption of the Gold Standard* conference at AIER, further discusses how competitive market institutions can help address the resource costs of a gold standard.)

The resource costs of a gold standard are reasonably small, smaller than estimates of the deadweight costs of average fiat-money rates of inflation.

Properties of Free Banking. Free banking leaves the provision of everyday media of exchange, currency notes, and transferable account balances to freely competitive commercial banks. (Coins can be left to competing mints and token issuers, but I skip discussion of that possibility here.)

Under a gold standard, bank-issued monies are redeemable debt claims payable in gold. Banks are responsible for holding gold reserves adequate to meet the redemption demands they face. Balancing the benefits and costs of holding reserves requires banks to make some practical calculations about the public's payment practices. But bankers are good at precisely that sort of thing.

Claims on competing private money issuers are more trustworthy than claims on sovereign issuers because only the former claims are enforceable at law (no sovereign immunity) and because—absent government guarantees to tranquilize depositors and other bank creditors—a bank must be careful to maintain its reputation. Maintaining a reputation means meeting all redemption demands promptly and managing the bank's asset and liability portfolios such that its ability to meet all demands promptly is not doubted.

Without government deposit guarantees and without a government central bank to act as an official lender of last resort, should we expect more frequent banking crises? No.

Banks behave more prudently in the absence of institutions such as these that foster moral hazards. Banks maintain higher capital ratios and hold safer asset portfolios. Assets are better diversified and more liquid. Banks shy away from default risk, exchange-rate risk, and interest-rate risk (duration mismatching) in order to assure potential depositors of the bank's low insolvency risk. If necessary, clearinghouse associations can provide credible third-party certification of bank solvency and liquidity.

History shows us many competitive and stable banking systems without deposit guarantees or central bank lending.

Consider the offshore dollar banking market of the last 50 years. Did offshore banks invest heavily in subprime mortgages or subprime-mortgage-backed securities? No. Without guarantees, they can't attract deposits if they take such portfolio risks. Are the offshore banks currently in crisis? No. As a rule, failures, contagion effects, and crises have been *less* frequent in historical systems closer to laissez-faire. To avoid a weak banking system, governments should not undermine banks' efforts to maintain soundness and should not block market mechanisms that deter and punish unsound banking.

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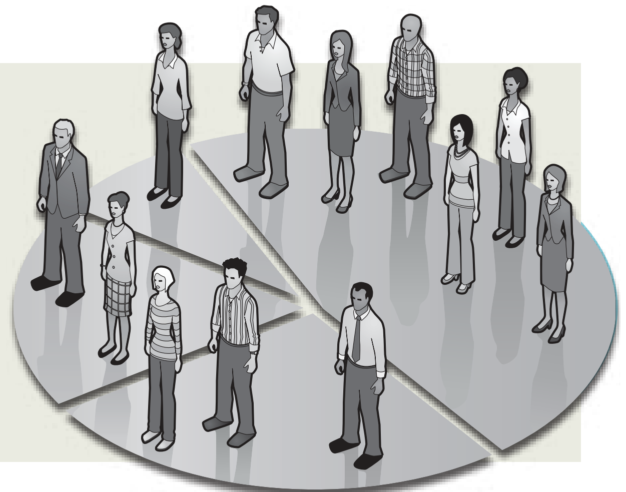

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