An Economist Looks at Europe | MAY 4, 2015

Sound Money through Monetary Competition

Pedro Schwartz*

- | An Economist Looks at Europe

Money is the wild card of the capitalist game. In the past century, financial and monetary upsets recurred, with the Great Depression as the nadir. In the present century, just when the End of History was around the corner and political and economic democracy seemed victorious over all other social systems, the Great Recession hit. We do not yet have a complete picture of why this happened, but there is little doubt that our monetary arrangements proved defective. This was especially so when central bankers went beyond their duty to supply sound money and tried to manipulate the real economy: some even thought they had the means to get rid of the business cycle once and for all. The enemies of the free economy now sing three mantras: climate change, growing inequality, and the malfunction of financial markets. The first two I will leave to the care of statisticians, who can better analyze the defective extrapolations of data on which they are based. Today I will concentrate on money, an institution that is of the essence of the market economy and that gainsayers proclaim can, under no circumstances, be left to the market.

My Peruvian proposal for Greece

My thesis is as follows: A sound currency is a necessary condition for people safely making the free choices that lead to sustained growth. Sadly, however, sound money seems to be beyond the ingenuity of most countries. In some instances, monetary competition results in sound money, especially in Latin America, where the outstanding case of parallel currencies is Peru. In contrast is the failure of the 'eurolization' of Greece (if I am allowed the neologism), by which an outside currency, the euro, is imposed on a country incapable of fulfilling the necessary conditions for is

success. My suggestion will be that Greece move to a scheme of parallel currencies of the kind I observed in Peru during my last visit there. With both the euro and a new drachma running in Greece, the country could stay in the Eurozone but do so under less offensive political restrictions and at a much lower social cost.

The case of Peru is not the same as that of the 'dollarized' economies of Panama, Ecuador, or Hong Kong (or those of the Eurozone). Peru is not dollarized but runs a system of parallel currencies. For a decade and a half Peruvians have been allowed to use and to hold two currencies in competition with each other: the Peruvian *sol* and the US dollar. Peruvians are free to buy and sell, to deposit and lend, to save and invest, at home and abroad, in either currency. The exchange rate between the two is in effect fully flexible. This means that if individuals and businesses in Peru were to lose confidence in the *sol* there could be a run on the national currency—a harsh discipline on the Central Reserve Bank of Peru which reinforces its resolve to keep prices in check. In my view, a crucial element of Peru's well managed monetary arrangements is that the national currency is in the last resort subject to the discipline of *monetary competition* through a *free and flexible exchange rate*. The result for Peru over the last ten years has been outstanding: the yearly rate of inflation in *sols* has averaged 2.5% and the real rate of growth 6.5%—despite the recent fall in the prices and production of the primary goods they export. Since for Greece eurolization has been a failure, should we not learn from the example of a two-currency economy such as that of Peru?

The aim of monetary arrangements

Sound money is one where changes in the general price level do not distort the relative price of goods, services and assets.[1] When the productivity of the economy rises, the general price level tends to fall, which is the same as saying that the value of money should go up. However, most central bankers continuously try to avoid any fall in the price level as 'dangerous deflation', unwilling to admit that there are 'good deflations' brought about by all round lower costs of production. This is what leads me to criticize the idea that a central bank must stabilize money by keeping the consumer price index (CPI) at a 2% increase per year, which the economics profession says is equivalent to zero if improvements in the quality of goods are taken into account. In an improving economy the general price level should *fall* with total factor productivity. What should be aimed at is not

price stability but sound money, whose effects on the real economy are 'neutral' because the price level is allowed to fall with increases in general productivity.

If stable money is the best central banks can offer us, we should be thankful for small mercies. By aiming to keep the value of their money stable, central banks will at least refrain from using their power to issue money to meddle in the national economy; they will also be strengthened in their resistance to improper government demands, and they will have more reasons to call for the lifting of all price and wage controls.

A central banker's lot is not a happy one, as Gilbert and Sullivan would have us sing. We should perhaps let the optimal quantity of money be determined bottom up by competition in the market, rather than top down by central bankers and governments. We shall see how a regime of parallel currencies approximates this ideal.

Monetary strategies

See the EconTalk podcast episode**Cowen on the European Crisis**for more on these topics. See also**European Union** by Marian L. Tupy in the *Concise Encyclopedia of Economics*, and **"Eurozone: It Seemed a Good Idea At the Time",** by Anthony de Jasay, Oct. 3, 2011, Library of Economics and Liberty. For more on Gresham's Law, applicable to a fixed exchange rate system, see ***The Natural Law of Money,*** by William Brough.

Four main kinds of monetary policies are being applied in the world today to supply neutral money (as far as is possible).These strategies are: (1) giving up the national currency altogether for one of the world currencies; (2) pegging the rate of exchange to the dollar, the euro, or to gold, via a currency board; (3) permitting the use of parallel currencies with fully flexible exchange rates, leading to the discipline of possible runs on the domestic currency if badly operated; and (4) trying to manage the national currency independently and responsibly by 'inflation targeting'.

1. 1. In Latin America stability is often approximated by 'dollarizing' the economy. A strong foreign convertible currency becomes the legal tender of the country. It is easier to do so in small countries because in any case they would not be able freely to manage their exchange rate. Populist policies will drain the liquidity of the country. Dollarization or 'eurolization' is what disciplines the profligate governments of Ecuador or Greece.

2. 2. A country with a currency board pegs its money to a convertible currency accepted worldwide. Such is the case of Hong Kong, whose rate of exchange has been kept in a narrow band centered on HK$7.75 per US dollar. If the budget did not show a small surplus and prices and wages were not fully flexible, the fixed exchange rate would lead people to hoard or export the good currency while reserves last and bad money would displace good: 'Gresham's Law' would lash in.[2]
3. 3. Under parallel currencies the central bank must treat a world currency as if it were legal tender side by side with the local one. Peru is the shining example. The domestic currency must not be over-issued for fear of seeing the 'Reverse Gresham's Law' operate. With a flexible exchange rate and free capital movements, people do not fear the Government will suddenly expropriate their holdings in good foreign money: so they tend to use only the foreign currency and treat the domestic currency as small change if too much is printed. To avoid the drift, budget surpluses; low foreign debt, both private and public; no bailing out of banks and businesses; and prices and wages flexible downwards are in order. The advantage of parallel currencies is that the ups and downs of the business cycle or sudden reverses of the terms of trade can be temporarily accommodated.
4. 4. Inflation targeting is more often employed by large countries that do not have the possibility or the will to hook onto sounder money. Their governments do not want to lose their sovereign right to lay an inflation tax on their currency—that is to say, to engross the benefits of inflation finance—or to give the economy stimulating pre-election shots in the arm. They promulgate self-denying monetary rules, such as making their central banks independent or promising to keep inflation within a band around a path of 2% yearly price rises. But inflation targeting is not enough unless the central bank is *really* independent. Hence, the commitment to low inflation is well complemented by the discipline of a parallel currency. As in Peru, belt *and* braces is best.

Parallel currencies in Peru

When I visited the two capable persons in charge of monetary policy at the Reserve Bank of Peru I was struck by two things: how very much on top of the management of the *sol* they were, and how they balked at the idea that the US dollar served as a kind of macroeconomic discipline. They were rightly proud of the Bank's record of low inflation and how this had contributed to Peru's continued growth but gave the impression that they would prefer to have the dollar play a much smaller role than it does.

There are good reasons for this downplaying of the dollar. Obviously Peruvians cannot control the monetary policy of the Fed, which is

exclusively centered on the United States. This exposes a small country partially tied to the dollar to large unexpected shocks. The recent announcement by Janet Yellen that the Federal Open Market Committee might consider raising the federal funds rate in June has sent shivers down the spine of many a central banker, in addition to shaking bond markets round the world. Imagine the effect of a return of the United States to positive real interest rates on dollar denominated mortgages! So it is understandable that the Peruvian Central Bank should be happy with a reduction of the dollar portion of the payments and assets of its residents.

The year 2014 was a relatively hard one for Peru, almost as bad as 2001. Oil and natural gas prices had been falling for some time. Other primary goods, such as gold, copper and zinc, were also in retreat, as were foodstuffs exported by the country. El Niño led to a necessary suspension of fish catches. This had repercussions on internal activity and demand. GDP grew by 'only' 2.4%.

The fact that Peru had two currencies allowed the government and the Reserve Bank to take some compensating measures. Public expenditure increased and monetary policy was eased, always with an eye to inflation and the rate of exchange. Now the country is back on its growth path.

The primary obligation of the Reserve Bank according to the Peruvian Constitution is to preserve monetary stability. This it does by using sophisticated instruments with which they have successfully adhered to a yearly inflation target of 2% (+/-1): a hardy model of the economy; a watchful eye on inflation expectations to see if they are 'anchored'; management of the interest rate and for assurance sake an 'old fashioned' instrument, to wit, required reserves.

The fact that Peru has two currencies complicates the Bank's management of the interest rate. It can only set the interest rate for the *sol*, since that for the dollar is determined by the Fed. For this reason, the Reserve Bank of Peru manages dollar denominated assets and loans with what I have called an unfashionable instrument: the required reserves of the commercial banks. Banks must deposit 50% of new dollar denominated deposits at the Reserve Bank but only 9% of those denominated in *sols*. Lenders who have not reduced consumption loans in dollars by a set amount by the end of the year will face an increase in their required reserves. The main effect of

these discriminatory measures is to reduce external financial risk while still allowing full convertibility and transferability of Peruvian funds.

The management of the exchange rate is of special interest in this analysis of a country with two currencies and free movement of capital. Since August of last year, the US dollar has been appreciating markedly. The Reserve Bank of Peru, instead of letting the *sol*depreciate further, which is what so many countries have been doing, especially in the developing world, has started buying local currency, while keeping a prudent reserve in foreign currency. Forex interventions to reduce volatility in the short term are transparent, since they appear on an electronic board visible to dealers; and long swings of the exchange rate are fully allowed to take place.[3]

It is understandable that the Reserve Bank should mainly focus on a successful domestic monetary policy rather than on the fact that Peruvians deal in two currencies. The Bank could in principle move to a well governed domestic *fiat* money, with foreign currencies playing no special monetary role. This could only be achieved on the basis of consistently well behaved and reliable governments. In the four large countries whose monies compose the Special Drawing Rights of the IMF (dollar, euro, pound, and yen) monetary competition is only effective in the long run. Peru however is a small country in Latin America, where not only governments but Constitutions are unstable, so that mistakes of monetary policy quickly show up on the exchanges.

Conventional wisdom has it that an orthodox monetary policy is incompatible with real growth. Peru is a counterexample. Ever since 1991 Peru has lived under the tight discipline of a system of parallel currencies with free prices and virtually no business subsidies. The average rate of growth over the last ten years has been 6.5%, despite the fall of primary good prices and the effect of "el Niño". The average rate of inflation over the same period has been 2.1%, generally seen as nearly zero.

All this does not mean that the Peruvian economy is free of problems. The need for better productivity is noted by the Reserve Bank itself, demanding a correction of institutional defects such as ill-defined property rights, confusing and incoherent taxation, the low efficiency of the goods markets, and an over-regulated labor market with as much as half the labor force

forced underground. An orthodox monetary policy, however, clearly contributes to the progress of the country.

Two currencies for Greece?

> "The crucial idea is that people should be able to choose in what currency, the euro or the drachma, they would denominate their future contracts: if in drachmas, they would be more competitive."

The monetary dispensation under which Greece is laboring is the first one of the four I listed above: 'eurolization'. For small countries dollarization or eurolization are similar to being on the gold standard. To stay on the dollar, the euro, or gold and avoid suffering unduly, a number of conditions must be respected: ready liquidity must be at hand to maintain the money supply, the budget should be in surplus year in year out, and prices and wages ought to be fully flexible. For a country like Greece that relies on runaway credit, groans under an overblown welfare state, is tied down by a surfeit of regulation and politically set prices, enforces rigid labor laws, keeps a large bureaucracy, and fosters labor unions, an outside monetary standard demands reforms that public opinion will not suffer.

It is clear that Greece will never be able to repay its debts: it owes the European Central Bank €104 billion ($112 billion) and that is only 30% of its total debt, when its GDP amounts only to some €224Bn. As Wolfgang SchĘuble, the Finance Minister of Germany said at the recent IMF Annual Meeting in Washington, "Our goal is not about the debt, it's about making Greece an effective, competitive economy, and for its people to prosper." The Greeks, because of the cost and for ideological reasons, seem to find it impossible to understand that if they want to stay in the euro they will have to carry out reforms demanded by its creditors. A referendum with the choice starkly put may break the deadlock. But is there not a danger that to ease the way for Greece and other euro-members in difficulty the very concept of the euro as a stable currency will be put in jeopardy?

It is now clear that the euro was an economic mistake. The single currency should be redrawn by letting Europeans *choose* it for their transactions, their savings and their investments. Currency choice could be instituted by the reissue of their original denominations with the permission for the euro to circulate alongside with it *at a fully flexible rate of exchange*. If the domestic central bank starts to over-issue, the reverse Gresham's Law would kick in. Then the domestic currency would tend to be used only as

small change and the state would be deprived of most of its 'seignorage'. The ECB could then manage the euro with the only aim of making it a really solid currency. Such a move would have to be carefully designed but is not unfeasible.

In the case of the Greek drachma, the new currency would be issued at a 1/1 rate with the euro. It would then float down to the level where the foreign balance would right itself. Pricing wages, taxes, social benefits and domestic assets in drachmas would help make the Greek economy competitive in foreign markets and attract outside capital.

The once-and-for-all cost could be hefty but the unceasing bleeding would stop. The ECB would have to proffer a guarantee that euro deposits in Greek banks would be safe and fully mobile. Foreign debts expressed in euros would be a burden which could be alleviated along the well tried lines of the *Club de Paris* for sovereign debt and the "London Club" for private. Mortgages denominated in euros would be a problem for local residents, just as they would if Greece crashed out of the euro. As regards new bank deposits in drachmas, they would again be fully mobile but at the current rate of exchange.

The crucial idea is that people should be able to choose in what currency, the euro or the drachma, they would denominate their future contracts: if in drachmas, they would be more competitive. The drachma need not disappear if the Greek Central Bank applies a conservative monetary policy—indeed the incentive to behave would be there if they wished to maintain their *seignorage* income. Thus, the optimal amount of local currency would be decided bottom-up by individuals and firms, depending on the rate of exchange.

The mismanagement of the Greek crisis could turn out to be a blessing. The original design of a single currency has turned out to be unfeasible. It implied transforming nominal convergence of deeply diverse economies into real convergence, which is proving socially and politically too costly for some members. The time has come to examine the possibility of turning the euro into a choice currency in competition with the national currencies. Making the euro a *common* rather than a*single* currency could have rescued Greece from its plight and can help other member countries in difficulties to heal their economies while not forsaking the European currency project.

Footnotes

1.

As Jerry Jordan writes: "A belief in sound money is not the same as a belief in 'price stability.' Sound money (like under the classical gold standard) is when people make decisions in the firm belief that all observed changes in prices—of assets as well as goods and services—are changes in *relative prices*, and that all observed changes in interest rates are changes in *real interest rates*. That does not, and cannot, happen when money is 'managed' in a fiat money world. Central bankers (and their political overseers) are so fearful of the dreaded 'deflation' that there is an institutional bias in favour of at least a mild positive rate of inflation."**http://soundmoneyproject.org/2015/03/managed-money-%E2%89%A0-sound-money/**, March 2015.

2.

Originally Sir Thomas Gresham (1519-1579) explained the disappearance of silver coins in England by pointing at the increase in the price of silver, which made shillings worth more than their face value. He should have added that within a shilling coin the rate of exchange between the face value of the coin and the silver content is fixed by law and cannot change to follow the movements in the price of the metal. When the market revalued the silver content of the shilling people could do one of two things: hoard and export the coin; or clip it and file it, which is a way of reducing the amount of silver per monetary unit.

3.

In January 2013 the price for dollars was as low as 2.55 per *sol*; in March 2015 it was 3.09.

*****Pedro Schwartz is "Rafael del Pino" Research Professor of at San Pablo University in Madrid where he directs the Center for Political Economy and Regulation. A member of the Royal Academy of Moral and Political Sciences in Madrid, he is a frequent contributor to the European media on the current financial and social scene. He currently serves as President of the Mont Pelerin Society.

For more articles by Pedro Schwartz, see the **Archive.**