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The Folly of Currency Pegs

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The current flap over the sustainability of Greece's membership in the European Economic and Monetary Union (EMU) is reminiscent, in many ways, of the events leading up to the collapse of the Bretton Woods system—another ultimately untenable currency regime—which was put into place after World War II and terminated by the break of the dollar's link to gold after August 1971. The period of increased exchange-rate flexibility that followed the demise of the Bretton Woods system turned out to be beneficial. The same possibility exists with respect to the aftermath of the current currency crisis in Europe. However, for now, European governments and the International Monetary Fund (IMF) have pledged €45 billion for Greece, to shore up Europe's nonoptimal currency area, which includes (along with Greece) Spain, Portugal, and Ireland in a nominal currency union with Germany. That system will also break down, and Europe will be better off for it, notwithstanding widespread warnings from European politicians of what an "unthinkable" disaster a breakup of the EMU would be.

A Trail of Broken Currency Pegs

In the nearly forty years since the Bretton Woods system of fixed exchange rates broke down, governments and central banks have repeatedly imposed severe burdens—to no avail—in attempts to maintain unsustainable exchange-rate pegs. In 1971, governments remained in denial about the viability of floating exchange rates for some time. Indeed, the attempt to return quickly to fixed exchange rates in December 1971, dubbed at the time by President Richard Nixon as "the most significant monetary agreement in the history of the world,"[1] was fruitless. By February 1973, all currency pegs were abandoned because few countries, if any, were willing or able to follow policies consistent with fixed exchange rates. Nor should they have been. The abandonment of fixed exchange rates—although it was not realized at the time—was fortunate. The oil-price shocks of 1973–74 would have blown apart any system of fixed exchange rates in the midst of a highly disruptive crisis environment that required substantial exchange-rate adjustments. Today, substantial exchange-rate adjustments are required in the EMU in the aftermath of the 2008 financial and economic turbulence caused by the bursting of the housing bubble.

Since the 1970s, among the most ill-founded currency pegs are those involving Argentina, Greece, and China. Argentina's peg to the U.S. dollar lasted from 1991 through 2001 and ended with a debt default by Argentina and, of course, a break in the exchange-rate peg of the Argentine peso to the dollar. Heedless of the costs and distortions associated with unsustainable currency pegs, the EMU has made the euro the currency of a widely diverse set of European countries, a number of which should not be in what amounts to a hard-currency bloc centered on Germany. Pretending that the Argentine peso is a U.S. dollar or that Greece and Germany can operate with a common currency does not make it reality, unless Argentina adopts the monetary policies of the U.S. Federal

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Reserve or Greece adopts the monetary policies of the European Central Bank (ECB), a proxy for the hard-currency Bundesbank.

Basic Principles

The efforts to link currencies together should be guided by basic principles of economics. The Theory of Optimum Currency Areas was articulated long ago by Nobel laureate Robert A. Mundell, a Canadian economist who thought deeply about the desirability of a currency peg between Canada and the United States.[2] More will be said about this in the context of a more detailed discussion of why Argentina's currency peg had to break and why the EMU should not include several European countries—Greece among them.

Also relevant to the analysis of the sustainability of the EMU is Robert Triffin's pathbreaking analysis of why the Bretton Woods system of fixed exchange rates, including a peg of the dollar to the price of gold, had to break down. As Triffin explains in his book *Gold and the Dollar Crisis*, the provision whereby the United States was obliged under the terms of the Bretton Woods agreement to guarantee the $35-per-ounce price of gold and to supply gold to foreign central banks at that rate, on demand, could not be sustained.[3] The higher prices rose during the late 1960s, the fewer goods—other than gold—$35 would buy. So, as Gresham's Law predicts, the U.S. supply of gold dried up while cheap money (dollars) drove out the dear (gold). The Bretton Woods system and the dollar peg to gold at its heart put the United States in the position of serving as a residual supplier of gold to those who saw erosion in the purchasing power of the dollar as U.S. inflation rose. After it became clear that the United States would be unable to supply the rising demand for gold, the country abandoned the dollar peg to gold at $35 per ounce in August 1971.

The parallels between the potential breakdown of the EMU and the breakdown of the Bretton Woods system will emerge as the discussion proceeds. It is ironic that the instability of pegged-currency systems—usually established in the name of fostering more stability—results from a basic fact. Countries that peg their currencies lose control over monetary policy. If Greece uses the same currency as Germany, it must adopt ECB monetary policy. If the United States pegs its currency to gold, it must adopt monetary policies that imply a fixed dollar price of gold by keeping prices stable. That might or might not be desirable, but simply saying that "the dollar is as good as gold" or that Greece has a hard-euro currency does not make it so.

When policies diverge, pressure increases for currency pegs to break. A crisis ensues—like the current Greek crisis—and calls are issued to effect a quick reduction of spending in countries where evidence of excess spending has emerged. If the excess spending has gone on too long and debt accumulation is on an unstable, unsustainable path, the currency peg breaks. With substantial hard-currency debts having been accumulated (as they were in the case of Argentina and have been in the case of Greece), a default accompanies the collapse of the currency peg. The United States did not officially need to default at the end of the Bretton Woods system because it simply devalued the dollar against gold and other currencies—in effect, lowering the real value of its external debts in terms of hard currencies and gold.

The eagerness of governments to enjoy the overrated benefits of fixed exchange rates without paying the price of such arrangements leads to financial exchange-rate crises. Beyond the cases of Greece in the EMU and the United States under the Bretton Woods system is a long list of disruptive "crises" tied to stubborn and, ultimately, unsuccessful efforts to maintain nonviable currency pegs.

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The governments that cause such crises and economists who in the midst of crises bemoan "the failure of economics" do not seem to recognize a fundamental fact based soundly in economic theory: a country or region can peg the price of its money against other monies—the exchange rate—or the quantity of its money, but not both.[4] Members of an optimum currency area, the theory of which, as previously noted, Mundell articulated fifty years ago, must allow mobility of labor, capital, or both or otherwise permit large resource transfers among themselves to enjoy the benefits of a single currency.

For example, Greece should not share a currency with Germany (or have a currency pegged to Germany's) as it has done by joining the EMU, unless it is willing to adopt what are essentially German monetary policies as expressed by the ECB. The only way to avoid this and

maintain a shared currency would be for Greek labor to move freely to Germany as pressure for currency depreciation rises, just as California labor can move to Colorado or any other U.S. state under the same circumstances. Full labor mobility—that is, Greek labor moving rapidly to Germany when the overvalued currency creates an excess supply of labor in Greece and excess demand for labor in Germany—would negate the need for currency adjustment. As it is, large increases in the productivity of German labor relative to Greek labor and an ECB monetary policy aimed at price stability in northern Europe imply that the euro is overvalued in Greece.

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The ECB's Destabilizing Role in the EMU

Greece—and, for that matter, Spain, Portugal, and Ireland—was, for a time, sustained as a member of the EMU by virtue of substantial financial transfers from other European countries, especially Germany, and by European banks. The ECB itself has been the primary enabler of such transfers. When Greece, among other Mediterranean economies, needs to borrow heavily to finance excess spending (relative to that consistent with monetary union), yields on Greek bonds rise relative to yields on German bonds. European banks buy the Greek bonds to get the higher yield. The banks can then finance their purchases by "swapping" Greek bonds with the ECB at full face value, effectively enabling the banks to borrow at a 1 percent interest rate from the ECB while earning the 6 percent—or higher yield—rate on Greek bonds. This mechanism provides the same enabling arbitrage in an unstable currency system that was provided by the U.S. dollar peg to gold. That peg enabled foreign central banks to swap dollar holdings for gold while gold was appreciating in terms of goods as U.S. inflation rose steadily after 1967.

The lending subsidy from the ECB has meant that Greece can easily finance rising fiscal and external deficits by borrowing, effectively against the ECB pledge that Greek-issued, euro-denominated debts are as good as German-issued, euro-denominated debts. As that notion became increasingly strained by virtue of the rapid increase in Greek-debt issuance to finance excess spending, more lending to Greece became even more profitable given that the ECB facilitated the swap mechanism. The process continued until, in November 2009, it was suddenly "discovered" that Greek borrowing had risen so rapidly that the Greek government was running a deficit equal to nearly 13 percent of gross domestic product.

Such a deficit has been termed "unsustainable," and European finance ministers have declared that it must be sharply reduced. They have demanded that the Greek government cut spending and raise taxes dramatically, which would exacerbate the powerfully contractionary burden on Greece of an overvalued currency. Meanwhile, the ECB continues to allow accommodative swapping of Greek debt. European banks—stuffed with a large part of the $400 billion of Greek debt as a result of the ECB's heretofore generous swap facilities—have called their finance ministers and demanded measures to support Greece in order to avoid a devaluation of Greek debt or a Greek default, as either would cost them dearly.

Lessons from Argentina and America

Notwithstanding the highly touted Greek rescue package of €45 billion unveiled on April 12 by European governments in conjunction with the IMF, Greece will probably default on its debt sometime within the next year, just as Argentina defaulted on its debt in December 2001 after a decade-long peg to the dollar that suffered from the same flaw as Greek membership in the EMU. The United States and Argentina were not part of an optimal currency area for much of the same reason that Greece and Germany are not. Argentina overspent and overborrowed on the notion that its U.S. dollar–denominated debt would maintain value as well as U.S. dollar debt issued by the United States. Overborrowing was followed by default when Argentina could not repay the debt without a politically catastrophic reduction in spending or tax increases—the same situation Greece faces today. It bears repeating that there is nothing new going on here. The U.S. dollar peg to gold—the heart of the postwar Bretton Woods system—produced the same result: U.S. overspending. President Lyndon B. Johnson's

post-1967 "guns and butter" policies were followed by a devaluation of the dollar against gold and against the hard currencies of Germany, Switzerland, and Japan.

In the case of the EMU and Greece—with Spain, Portugal, and others likely to follow—the most surprising aspect is the failure of European and ECB leadership to recognize the clear signs of incipient breakdown of a fixed exchange-rate regime. Nonviable currency pegs are, as we have seen, very familiar events, the identification of which is guided by ample precedent and theory. The early stages may work well and enable plenty of additional borrowing, but, ultimately, unless conditions like a high degree of labor mobility or stable monetary policy are met, the currency peg creates an unstable train of events. The surge in borrowing that a currency peg to a strong entity initially enables boosts spending financed by debt; when this occurs, either the exchange rate has to adjust or a default on the additional debt will result.

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Compounding the Greek Currency Crisis

The roles of the IMF and ECB in the Greek currency crisis are especially troublesome in view of the clear lessons about nonviable currency pegs that have emerged from numerous previous crises. In 2004, after heavy IMF involvement in attempting to sustain Argentina's unsustainable peg to the U.S. dollar, the IMF's independent evaluation office issued an evaluation report, *The IMF and Argentina, 1991–2001*. The report was pointedly critical of the IMF's role in prolonging Argentina's currency peg for far too long by offering ill-judged loans. The termination of that currency peg in December 2001 resulted in a disruptive default on the country's debt.

Simon Johnson, a former chief economist at the IMF, provided a pointed reminder on his website, on which he wrote about the Greek crisis and its parallels with Argentina's ill-fated currency peg. Johnson cited the stern warnings in the IMF's evaluation report on the Argentine crisis: "The IMF should refrain from entering or maintaining a program relationship with a member country when there is no immediate balance of payments need and there are serious political obstacles to needed policy adjustment or structural reform."[5]

That warning against continued financing for a country with excessive debt that either needs to devalue or default is being ignored in the case of Greece. Just a few days after Johnson published his warning, the IMF agreed to provide up to €15 billion in the €45 billion package for Greece aimed at avoiding devaluation or default. Ironically, the increase in the IMF quota that permitted such a large IMF grant to Greece—far in excess of the amount normally provided based on Greece's IMF quota—was partially funded by an increased contribution from Greece to the IMF. No one at the IMF seems to have noticed the absurdity of this circular funding path or to have absorbed the lessons so recently learned in Argentina.

The continuation over the last year of the ECB's swap facility—whereby it effectively lends subsidized funds to European banks to buy Greek debt, thereby enabling more overspending by Greece—also seems incomprehensible in the context of rising implicit overvaluation of the underlying Greek currency. While publicly pontificating about the need for fiscal discipline to avoid inflation pressures in Europe, the ECB has knowingly served as enabler for the Greek fiscal profligacy that it now decries. Little wonder that the Greeks are put off by the heavy dose of euro hypocrisy regarding the current crisis.

The obvious fact is that the eurozone, with its single central bank and sixteen separate national treasuries, will not survive the aftermath of the 2008 bursting of the financial bubble. The corollary to this is that, given the persistent recurrence of such bubbles, currency pegs are inadvisable ex ante and even more damaging ex post while governments are wasting resources and delaying necessary adjustments by lending to accommodate fixed exchange-rate regimes that will ultimately break down.

Life after Currency Adjustment

The Bretton Woods system, a global arrangement of fixed exchange rates, did not survive the surge in American spending tied to the simultaneous pursuit of President Johnson's "Great Society" surge of social spending and the costly Vietnam War. The system ended, exchange rates fluctuated, and the world economy continued to function more smoothly than it had before when ill-fated attempts

to shore up fixed exchange rates created myriad costly market distortions. Let us hope that the Europeans see the light before even heavier costs and distortions are visited on Europe to support the fantasy that it constitutes an optimum currency area. As Greece, Ireland, Spain, and Portugal are discovering the hard way, it does not.

And I have not even discussed China's strained currency peg to the dollar.

Notes

1. *The Economist*, December 25, 1971, 10.

2. Robert A. Mundell, "A Theory of Optimum Currency Areas," *American Economic Review* 51 (1961): 657–65. Another prominent Canadian economist, Ronald McKinnon, also wrote extensively about optimum currency areas. A reading of the literature on optimum currency areas leaves the clear conclusion that the EMU presents a—temporary—triumph of political expediency over economic reality.

3. Robert Triffin, *Gold and the Dollar Crisis* (New Haven: Yale University Press, 1960).

4. For a recent example illustrating this point, see John Kay, "Economics May Be Dismal, but It Is Not a Science," *Financial Times*, April 14, 2010.

5. Simon Johnson was quoting one of the core recommendations in International Monetary Fund, Independent Evaluation Office, *Evaluation Report: The IMF and Argentina, 1991–2001* (Washington, DC: International Monetary Fund, 2004), 7, available at www.ieo-imf.org/eval/complete/pdf/07292004/report.pdf (accessed April 27, 2010).