

Euro Symposium

Reflections on Currency Reform and the Euro

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ABSTRACT

Lars Jonung and Eoin Drea (2010) conclude that the pessimistic stance taken by most American economists toward the euro in the 1989-2002 period “was probably fostered by the propensity of U.S. economists to view the euro as a political project driven by murky motivations and based on an insufficient institutional foundation.” If most American economists thought the euro was largely a political project, they were right on target. As one reads thorough accounts of the birth of the euro, it is clear that politics, not economics, ruled the roost (Brown 2004; Marsh 2009).

This realistic view—that “politics” dominates—does not suggest that one would take either a pessimistic or an optimistic stance toward the euro, however. In my experience as an adviser on currency reforms in Europe in the 1990s, I observed first-hand that politics, and on occasion personal pique, not the economics of optimum currency areas, dominated, and that this state of affairs could still produce good reforms.

In Estonia, which established an independent currency in 1992, the overriding national objective was to exit the ruble zone, and more broadly, Moscow’s sphere of influence. A currency board was the most effective way to rapidly accomplish the goal. The driving force behind Lithuania’s similar 1994 currency reform was Prime Minister Adolfas Slezevicius. A currency board

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appealed to him because it was a means to move the governor of the central bank to the sidelines and to impose fiscal discipline on his own Democratic Labor Party, which controlled parliament. A hyperinflation in Bulgaria in 1997 sparked a popular outcry for sound money and a currency board, an idea that had been circulating in professional circles since 1991. Indeed, a Bulgarian-language knockoff of an old monograph I had written in 1991 (Hanke and Schuler 1991) made the bestseller list in Sofia during the hyperinflation. Bosnia and Herzegovina also installed a currency board in 1997. It was mandated by the Dayton/Paris Peace Agreement of November 21, 1995—an international treaty. Montenegro, while still part of the Federal Republic of Yugoslavia along with Serbia, dumped the Yugoslav dinar and replaced it with the German mark in November 1999. This bold move by then-President Milo Djukanovic; was part of a political strategy to establish Montenegro's independence. Like the establishment of the euro, Montenegro's embrace of the German mark had politics, not economics, as its hallmark.

That there was a political rationale and popular support for the currency reforms that I was advocating made my day. That the finer economic points took a back seat failed to move me.² All of the above-mentioned countries continue today with the monetary policies they established in the 1990s. (Montenegro switched to the euro when euro notes and coins replaced the German mark.) The policies were adopted in large part for political reasons, but they have persisted because they have produced what was anticipated: strong economic results.

My views on exchange rates are based on the distinction between strictly fixed, strictly floating and pegged regimes. Fixed and floating rates are regimes in which the monetary authority is aiming for only one target at a time. Although floating and fixed rates appear dissimilar, they are members of the same free-market family. Both operate without exchange controls and are free-market mechanisms for balance-of-payments adjustments. With a floating rate, a central bank sets a monetary policy but the exchange rate is on autopilot. In consequence, the monetary base is determined domestically by a central bank. With a fixed rate, there are two possibilities: either a currency board sets the exchange rate, and the money supply is on autopilot, or a country is “dollarized” and uses the U.S. dollar or another foreign currency as its own, and the money supply is again on autopilot. From the perspective of an individual country, a monetary union such as the eurozone is similar to dollarization. In consequence, under a fixed-rate regime, a

2. The following publications contain the economic fine points and served as blueprints for currency reforms in the countries mentioned: Estonia (Hanke, Jonung and Schuler 1992), Lithuania (Hanke and Schuler 1994), Bulgaria (Hanke and Schuler 1991), Bosnia and Herzegovina (Hanke 1996/7) and Montenegro (Bogetic and Hanke 1999).

country's monetary base is determined by the balance of payments, moving in a one-to-one correspondence with changes in its foreign reserves. With either a floating or a fixed rate, there cannot be conflicts between monetary and exchange rate policies, and balance-of-payments crises cannot rear their ugly heads. Floating- and fixed-rate regimes are inherently equilibrium systems in which market forces act to automatically rebalance financial flows and avert balance-of-payments crises.

Most economists use "fixed" and "pegged" as interchangeable or nearly interchangeable terms for exchange rates. For me, they are very different exchange-rate arrangements. Pegged-rate systems are those where the monetary authority is aiming for more than one target at a time. They often employ exchange controls and are not free-market mechanisms for international balance-of-payments adjustments. Pegged exchange rates are inherently disequilibrium systems, lacking an automatic mechanism to produce balance-of-payments adjustments. Pegged rates require a central bank to manage both the exchange rate and monetary policy. With a pegged rate, the monetary base contains both domestic and foreign components.

Unlike floating and fixed rates, pegged rates invariably result in conflicts between monetary and exchange rate policies. For example, when capital inflows become "excessive" under a pegged system, a central bank often attempts to sterilize the ensuing increase in the foreign component of the monetary base by selling bonds, reducing the domestic component of the base. And when outflows become "excessive," a central bank often attempts to offset the decrease in the foreign component of the monetary base by buying bonds, increasing the domestic component of the monetary base. Balance-of-payments crises erupt as a central bank begins to offset more and more of the reduction in the foreign component of the monetary base with domestically created base money. When this occurs, it is only a matter of time before currency speculators spot the contradictions between exchange rate and monetary policies and force a devaluation, interest-rate increases, the imposition of exchange controls, or all three.

During the ramp-up to the launch of the euro, I served, among other things, as an officer of a hedge fund. Given my views on exchange-rate regimes, the period provided many profitable trading opportunities. After all, the Exchange Rate Mechanism (ERM) was a system of pegged exchange rates. When a pegged system experiences trouble, typically a country's interest rates rise, its currency slumps, or both. With this in mind, I was either selling deposits in a "weak" currency country or shorting other European currencies against the German mark. As an example of my thinking (and trading), in January 1992 I wrote:

Within the next month, the market will push sterling to its lowest point in the ERM band. Facing that eventuality, there are four possible British policy responses: 1) allow sterling to be devalued to about DM2.5 and eventually allow interest rates to come down a bit; 2) defend sterling and restore a central rate of DM2.95 by increasing interest rates a full percentage point to 11.5%; 3) negotiate a realignment of the ERM along the lines we suggest; or 4) bring back (God forbid) exchange controls.

Rational as options 1) and 3) might be, we believe that the Brits have invested so much political capital in the ERM and the ridiculous DM 2.95 that they will grudgingly choose option 2) and raise interest rates. Sell March three-month sterling deposits. Place stop at 90, good anytime. (Hanke 1992)

As it turned out, that was a profitable trade. But my judgment about what the United Kingdom would do with the pound caused me to miss the big trade on Black Wednesday, September 16, 1992, when the government floated the exchange rate, in effect devaluing, rather than raising interest rates further.

That said, there were paydays associated with bets against the ERM pegs. The most notable one occurred at the end of July 1993, when France's pegged rate, dubbed the *franc fort*, came a-cropper (Sulitzer 1993). In consequence, the ERM's narrow band was widened from 2.25% to 15% around the central rates.

I considered the euro sound from a technical perspective, because it requires a fixed exchange rate rather than pegged rates among member countries, but my policy views concerning the euro were generally skeptical during the euro's ramp-up phase. The basis for my skepticism was the idea that a strong euro would in the long run require a strong central state, as Robert Mundell (2000) has suggested. While I agree with Mundell's diagnosis, I did not, and do not, consider a strong central state desirable. For me, the European Union and the European Commission represent additional political and bureaucratic layers that will impede much-needed European economic liberalization.

While I was skeptical of a common currency for Europe, I favored European currency unification via currency boards (Hanke and Walters 1990). And I was not alone. During a May 1990 meeting in East Berlin with Karl Otto Pöhl, President of the Bundesbank, he confirmed that we shared the same vision (Marsh 2009, 131) and encouraged me to press ahead. Such a unified currency approach, with the German mark as the anchor, would have given Europe monetary stability, while at the same time it would have avoided the ratcheting up of the state and bureaucratic powers that have accompanied the euro.

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