

MILTON FRIEDMAN AND THE EURO

Antonio Martino

Milton Friedman did not like the euro. In early 1999 I wrote to him mentioning my daughter Erika's thesis and, in a letter dated March 12, 1999, he wrote back:

Erika's thesis on "The Euro and the Dollar" is one of the subjects I have been maintaining a real interest in. As you know, I am very negative about the euro and I am very doubtful about how it will work out. However, I am less pessimistic about it now than I was earlier simply because I never expected that the various countries would display the kind of discipline that was required in order to qualify for the euro. The convergence in inflation rates, interest rates, and so on was greater and more rapid than I would have expected.

I believe that the monetary-fiscal constitution adopted with the introduction of the European single currency is consistent with Friedman's intellectual legacy. Let me explain.

The ideas of Milton Friedman on money have been so largely spread and absorbed that it may appear trite to repeat them once again. But, since there still is a lot of misunderstanding on the issue, I may be forgiven for giving a summarized version of them.

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Discretion versus Rules

In the field of money and public budgets, the market-liberal view, which stresses the need for impartial rules and constraints on the discretionary powers of government, has been contrasted with the Keynesian one, which viewed money and the public budget as instruments of short-run discretionary policy.¹

For the better part of the last 50 years, the Keynesian view has been prevalent: only the accurate manipulations of monetary aggregates and especially of the public budget by the authorities in charge of economic policy could prevent the instability, the cyclical fluctuations, and the crises that were typical of a capitalist system. It was up to economic policy—the enlightened action of government officials—to remedy the deficiencies of a market economy, and prevent stagnation, recession, and mass unemployment.

Today, the traditional liberal wisdom is vindicated: a growing number of economists support the need to take monetary policy decisions away from the discretion of monetary authorities, and entrust money to a monetary constitution, a set of impartial rules, aimed at providing that framework of stability without which markets cannot efficiently operate. Similar considerations apply to fiscal policy: a decreasing number of economists today believe that full employment, price stability, and economic growth can be achieved by the expert manipulation of budget deficits, while more and more economists of all persuasions have finally come to accept the need for a fiscal constitution—a set of rules making it impossible for governments to borrow their countries into bankruptcy.

The Keynesian ideas that inflation was the unavoidable price of economic growth, that there was a stable tradeoff between inflation and unemployment, that it was possible to reduce interest rates through monetary expansion, and that the time horizon for monetary policy decisions had to be dictated by the needs of short-term stabilization policies have all succumbed to the empirical evidence and the theoretical analyses of the last 30 years.

There is no evidence that economic growth inevitably involves price inflation. On the contrary, there are good reasons to believe that monetary instability hinders long-term projects and makes

¹What follows draws on Martino (1997).

economic growth more difficult, as evidenced by the experience of a number of Latin American countries.

The idea of a stable tradeoff between inflation and unemployment is thoroughly discredited: an unexpected acceleration of inflation may temporarily reduce unemployment below its “natural rate,” but this effect is short-lived. Only an accelerating inflation could keep unemployment below its “natural rate,” but even that unappetizing possibility is dubious.²

Manipulation of monetary aggregates can influence interest rates only temporarily: as soon as inflationary expectations catch up with reality, the Keynesian “liquidity effect” is replaced by the “Fisher effect,” which will more than offset the initial impact of the unexpected change in monetary policy (Thornton 1988). Nominal interest rates tend to be higher, not lower, when monetary policy is loose.

As for stabilization policies, it is now largely (though certainly not unanimously) agreed that our insufficient knowledge, unreliable short-run macroeconomic forecasts, and variable time lags in the impact of monetary policy decisions, make it likely that policies aimed at stabilizing the economy in the short run may end up being pro-cyclical rather than anti-cyclical. Attempts at “fine-tuning” the economy often result in additional, avoidable instability. Consequently, “Monetarists . . . favor stable policy rules that reduce variability and uncertainty for private decisionmakers. They argue that government serves the economy best by enhancing stability and acting predictably, not by trying to engineer carefully timed changes in policy actions which are frequently destabilizing” (Meltzer 1991: 31).³ In a sense, the monetary-fiscal constitution embedded in the euro reflects the change in the thinking on these matters brought about by Milton Friedman’s “counter-revolution in monetary theory” (Friedman 1970).

This being said, it is surprising that some liberals question not the workability of the constraints implanted in the euro system, but the desirability of its goals—as if restraining arbitrary government in the fields of money and public budgets was incompatible with their ideals. Criticism of the European monetary framework, not by die-hard Keynesians but by well-known advocates of a liberal order, has

²See Friedman (1968, 1975, 1977); Tullock (1972, 1973); Bordo and Schwartz (1983).

³See Friedman (1953: 117–32, 204–50; 1962: chap. 3; 1969); Haberler (1974); Romer (1986).

stressed that constraints on the size of the budget deficit would deprive European countries of much needed automatic fiscal stabilizers. Still others have mourned the end of national stabilization policies, which would condemn our countries to otherwise avoidable instability. American economists have used the same arguments, which is surprising. None of them, as far as I know, has ever advocated that each state in the United States should have its own currency, be free to run large budget deficits, be allowed to monetize its debt, and manipulate the exchange rate in its dealings with the other states.

It could be argued that it is not acceptable to compare the United States, a politically united and economically homogeneous country, with the European Union, a collection of different and heterogeneous sovereign countries. A one-size-fits-all monetary policy is undoubtedly less appropriate for a group of heterogeneous nation states than it is for a relatively homogeneous market economy like the United States. In other words, it can be argued that the United States has almost reached the position of being an optimum currency area whereas for the European Union that result is many years away. However, if the discretionary manipulation of money and public budgets is considered harmful, even sovereign and independent countries could only benefit from the adoption of fiscal and monetary rules that put an end to the follies of the past.

The euro construction deserves criticism, but it seems to me ironic that we should criticize it because it puts an end to the political manipulation of money, deficits, and exchange rates. It may be argued, however, that the Maastricht constraints are too much of a good thing, that countries with very different economic circumstances need diverse monetary policies. Which brings to mind one of the innumerable *Titanic* stories: “Leaning against a bar on the *Titanic* after disaster had struck, John Jacob Astor is supposed to have said: ‘I asked for ice, but this is ridiculous.’”

The fiscal constraints introduced with the new currency must be criticized not because they are undesirable—in my view they are a necessary component of a liberal order—but because they are ineffective. This is amply evidenced by the “creative accounting” gimmickry used by many countries to achieve the required deficit to GDP ratio of 3 percent, and by the immediate abandonment of fiscal prudence by some countries as soon as they were included in the euro club. Also, the Stability Pact has been watered down at the request of Germany and France.

I am convinced that the euro can be viewed as recognition of the liberal position in favor of monetary and fiscal rules: discretionary monetary policy has been replaced by a firm commitment to price stability on the part of an independent European Central Bank. Debt monetization, by far the single most important cause of price inflation in this and previous centuries, will become impossible. The Maastricht Treaty explicitly forbids the ECB to come to a defaulter's rescue—that is, to monetize any country's borrowing.

Not only are member countries unable to finance government spending through inflation, they are bound by the Stability Pact to keep their deficit at less than 3 percent of GDP. Except under unusual recessionary circumstances, violators would face automatic or semi-automatic and massive fines (*The Economist* 1996). As long as these rules are respected, discretionary fiscal policy on the part of national governments will disappear. Finally, the adoption of a single European currency would mean the end of arbitrary manipulations of the exchange rate—"exchange rate policy," as it was called, would vanish. In its intentions at least, the Maastricht world is one of strict and impartial rules, a living monument to the market-liberal wisdom.

It is true, however, that the accountability of the ECB is not adequately assured. The admirable intentions may end up being negated should the ECB decide to pursue the wrong type of monetary policy, which would be disastrous. Inflation and deflation are bad enough at the national level; they would be devastating at the European level.

Introduction of the Euro

I now come to what I consider the most serious drawback of this new currency: the way it was introduced. At the time of deciding the exchange rate between the euro and the national currencies, the people in charge were clearly convinced that it was merely a technical problem—to find the most appropriate rate at which to convert national currencies into the euro. The idea was to avoid fixing it too high or too low in order not to give excessive commercial advantage/disadvantage to any one country. That approach, however, reflects a complete misunderstanding of the nature of the problem.

The notion that a group of experts could determine the purchasing power of this new fiduciary currency reminds us of the superstition denounced by F. A. Hayek (1976b: 23):

During the Middle Ages. . . the superstition arose that it was the act of government that conferred the value upon the money. Although experience always proved otherwise, this doctrine of the *valor impositus* was largely taken over by legal doctrine and served to some extent as justification of the constant vain attempt of the prince to impose the same value on coins containing a smaller amount of the precious metal.

As we know, the euro was introduced coercively, its purchasing power supposedly determined by a group of experts. The idea that one euro should purchase exactly as much as 1,936.27 lire at its introduction and forever is the most bizarre in the whole construct. If it were possible to take a piece of paper that had never been used as money before and determine its exact purchasing power at the moment of its introduction and for the rest of eternity, poverty would disappear right away. Printing a banknote does not cost much: it would be possible, by printing unlimited quantities of paper money, to create enormous wealth and wipe out poverty once and for all.

As any student of money knows, things do not work in this manner. The purchasing power of money is determined by a gradual process of discovery; it results unintentionally from the millions of decisions of buyers and sellers through time. Even assuming for a second that at the moment of its creation one could guess its value to be in the neighborhood of 2,000 lire, there was no reason whatsoever to expect that it would maintain that purchasing power forever.

What happened is that those who were asked to use the newly created fiat currency treated it like a foreign currency. Indeed, when we travel to a country using a currency other than our own, we have a hard time figuring out the meaning of money prices and we regularly translate them into our own money. In general, we end up treating the foreign currency as if it was worth less than what the official exchange rate suggests, and we end up spending more than otherwise, paying higher prices for whatever we buy than if we were using our own currency. That is why stores catering to tourists are generally more expensive than those serving local customers.

This is what happened to the euro in Italy and I suspect in all other countries as well: prices went up, and its purchasing power was substantially reduced, because consumers were not exactly aware of its “real” value. Most people conjecture that today the euro has a pur-

chasing power of roughly 1,000 lire. This means that the real value of all nominal assets was cut in half. No wonder that the first five years after the introduction of the euro were years of relative stagnation for euroland. Countries of the European Union that had not adopted the new currency in general had higher growth rates and lower unemployment than those using the euro.

Things were made worse by the fact that at the beginning the euro was rejected by international markets. On January 4, 1999, the euro was quoted at \$1.18; then its value gradually declined: on June 7, 2001, one euro was worth \$0.85. Afterward, its gradual acceptance as a reserve currency strengthened it versus the U.S. dollar: on September 20, 2007, the euro went above the \$1.40 level for the first time, reaching \$1.4023. The initial depreciation of the European single currency made European products more competitive in the American market, but this did not completely offset the negative impact of the reduction in the internal purchasing power of the new currency. When the domestic adjustment process was completed, the increase in the international value of the euro made European products less competitive and this prolonged the stagnation.

All of these problems could have been avoided had the new currency been introduced in a noncoercive way, using it *for a predetermined period of three to five years* in parallel to existing national currencies with freely floating exchange rates—similar to Britain’s proposal for the “hard ecu.” Gradually, as the acceptance of the euro increased and people adjusted to the new currency, its purchasing power would have been established by the market—that is, by the many million decisions made through time by those who were using it. I am convinced that this is the solution Hayek would have advocated (see Issing 2000).

At first the new currency may have found a market among high-level transactors: financial institutions, people accustomed to deal in more than one currency. Then, gradually other agents would have adopted it, and only at the end of the acceptance process it would have become the currency of shopkeepers and consumers. The gradualism of the process would have ensured the discovery of its market-determined purchasing power, and the countries of euroland would have been spared five years of high unemployment and stagnation.

Currency Competition

The competition between the euro and the national currencies would have been extremely beneficial in many other ways, as money issuers would have had an incentive to make their currency attractive to consumers. The mechanism would have worked along the lines described by Hayek in his work on competing currencies:

The purpose of this scheme is to impose upon existing monetary and financial agencies a very much needed discipline by making it impossible for any of them, or for any length of time, to issue a kind of money substantially less reliable and useful than the money of any other. As soon as the public became familiar with the new possibilities, any deviation from the straight path of providing an honest money would at once lead to rapid displacement of the offending currency by others. And the individual countries, being deprived of the various dodges by which they are now able temporarily to conceal the effects of their actions by “protecting” their currency, would be constrained to keep the value of their currencies tolerably stable [Hayek 1976a: 125].

Let me stress at this point that, while I believe that the introduction of the euro should have been based on competition between the new currency and existing national moneys for a predetermined transition period, I do not believe that competition in currencies is the appropriate solution for the long run.⁴ As Gottfried Haberler (1983: 90) wisely remarked:

If the moneys issued by different banks competed freely in the market, the result would be either the emergence of a private monopoly or oligopoly of money creation, or the circulation, side by side, of several kinds of money with fluctuating exchange rates between them. Either one of these outcomes would be intolerable. The immediate result would be to bring the government back into the business of money creation.

Milton Friedman would have agreed, and he would have recommended completing the construction with a more robust monetary

⁴What follows draws on Martino (1993).

constitution based perhaps on his favorite rule of a fixed rate of growth of the money supply. I doubt, however, that he would have been optimistic about the future of this currency. Monetary unification without political unity has seldom existed before.⁵

In a letter dated April 27, 1999, he expressed his concerns very clearly:

Your views and mine are currently very much the same on the euro. . . . What most troubles me as it does you is that members of the euro have thrown away the key. Once the euro physically replaces the separate currencies, how in the world do you get out? It's a major crisis. As a result, I would strongly agree with your view that the euro should be abandoned before January 1, 2002.

At the same time, the odds are very great that it will not be abandoned. The defects of the euro will take some time to show up; nothing happens very rapidly in this area. There are fewer than three years to go. Even if difficulties deriving from the euro occur in those three years, the political system is unlikely to react quickly enough to end the euro. As a result, I think it would be very desirable for some systematic thought to be given to devising some way to get out of the straitjacket of the euro after 2002. The least Italy should do is to keep intact the plates which are used to produce lira.

Your piece is very persuasive but I am afraid it will not persuade.⁶

Conclusion

Can the euro be considered an application of the lessons we have learned from Milton Friedman? In a sense yes, in a sense no, and in yet another maybe. Yes, the monetary constitution embedded in the euro construction is Friedmanian in that it aims at price stability,

⁵Belgium and Luxemburg had monetary unification without political unity for many years before the introduction of the euro. Also, they followed very disparate fiscal policies: Luxemburg had the lowest public debt to GDP ratio in Europe, Belgium the highest. Yet, despite the high degree of homogeneity between the two countries, monetary unification was not immune from problems.

⁶Milton Friedman is referring to a paper I had written for an American weekly, which was never published, in which I argued that the introduction of the euro should be either postponed or made noncoercive by letting the new currency circulate alongside existing monies.

rules out debt monetization, and helps prevent exchange rate manipulation. No, because the European Central Bank's accountability is very weak and because the monetary rule is not made explicit. Nothing is said about how price stability will be achieved. Maybe, because the monetary authorities could pursue a stable course, avoiding both stagnation and inflation (yes, in this case), but they also have the power to destabilize the entire European economy (obviously no, if this happens).

Also, the construct is still based on the rule of man rather than the rule of law: if things go wrong, there is no provision for remedying the situation. Milton would not have approved this particular facet. He was well aware that the unrestrained power to do good is also the unchecked possibility to do harm. The liberal wisdom, at least since David Hume, has always assumed that, since it is possible that knaves could end up ruling, we should draw constitutions on that assumption. Not because that scenario is inevitable but because it is possible.

So far the ECB has behaved acceptably and it has succeeded in resisting pressures from national governments, but we have no guarantee that this is going to be the rule in the future. As Milton often said: "Money is too important to be entrusted to central bankers." He may prove to be right once more.

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