"As Good as Gold"

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Discussions of international monetary reform have generally scanted the difference between two superficially similar but basically very different exchange-rate arrangements. One arrangement is a unified currency: the pound sterling in Scotland, England, and Wales, and, at an earlier date, in Ireland as well; the dollar in the fifty states of the United States and in Panama; since the currency reform of 1983, the Hong Kong dollar and the U.S. dollar; farther back in time, the pre-World War I gold standard, when pound, dollar, franc, and Mark were simply different names for specified fixed amounts of gold.

The key feature of a unified currency is that at most one central bank has the power to create money–"at most" because a pure commodity currency does not require a central bank. The U.S. Federal Reserve System has 12 regional banks, but only one central authority (the Open Market Investment Committee) can create money. Scotland and Wales do not have central banks. Hong Kong does not have a central bank.

The maintenance of fixed rates of exchange between different parts of a unified-currency area is strictly automatic. No monetary or other authority need intervene. One pound in Scotland is one pound in England, plus or minus perhaps the costs of shipping currency or arranging book transfers–just as under the pre-World War I gold standard the rate of exchange between the dollar and the pound varied from $4.8665 only by the costs of shipping gold (yielding the so-called "gold points"). Similarly, 7.8 Hong Kong dollars is essentially simply another name for one U.S. dollar, plus or minus a trivial amount for transaction costs. It requires no financial operations by the Hong Kong currency board to keep the exchange rate there other than to live up to its obligation to give 7.8 Hong Kong dollars for one U.S. dollar and conversely. And it can always do so because it holds a volume of U.S.-dollar assets equal to the dollar value of the Hong Kong currency outstanding.

An alternative arrangement is a system of national currencies linked to one another at pegged exchange rates. The central banks undertake to maintain exchange rates at the agreed values by altering ("coordinating" is the favorite term) domestic monetary policy appropriately. Examples of such an arrangement are the International Monetary Fund (IMF) before 1971; and, currently, the European Monetary System (EMS).

In my opinion, a system of pegged exchange rates among national currencies is worse than either extreme: a truly unified currency, or national currencies linked by freely floating exchange rates. The reason is that national central banks will not, under modern conditions, be permitted to shape their policies solely to keep exchange rates at the agreed level. Pressure to use monetary policy for domestic purposes will from time to time be irresistible. When that occurs, the exchange system becomes unstable. Pegged rates can be maintained for a time by governmentally arranged capital flows, by foreign-exchange controls, or by restrictions on international trade, but these are only temporary expedients and generally lead to the conversion of minor problems into major crises.

That was certainly the experience under Bretton Woods. Even in the heyday of the IMF pegged-rate system, exchange-rate changes were numerous and, when they came, often massive. The system lasted only so long as the U.S., first, followed a moderately non-inflationary policy and, second, was willing to be passive with respect to capital movements as well as exchange controls imposed by other countries.

The successive monetary arrangements in the Common Market–the European Payments Union, the snake, the current EMS–suffered the same fate. None of them has been able to avoid exchange-rate changes, and several have simply broken down. The current EMS has been working reasonably well because West Germany has been willing to play the role that the U.S. played under Bretton Woods: pursue a moderately non-inflationary policy, and tolerate capital movements and foreign-exchange controls imposed by other member countries.

Many observers give the EMS credit for enabling its members, notably France, to reduce inflation in recent years. However, the decline in inflation was a worldwide phenomenon, by no means limited to members of the EMS.

In my view, the worldwide inflation in the 1970s and disinflation in the 1980s are both linked to the end of the Bretton Woods pegged-exchange-rate system. Once the U.S. embarked on an inflationary monetary policy in the 1960s, the end of that system was inevitable, though the public execution was postponed until President Nixon closed the gold window on August 15, 1971. The world monetary system that has prevailed since has no historical precedent.

From time immemorial, money has existed, and, from time immemorial, it has been connected with a commodity, though the specific commodity has varied widely. From time to time, individual countries have cut the link and adopted fiat currencies, but almost always as a temporary response to a crisis, such as war, never as a permanent system. Of such episodes, Irving Fisher wrote in 1911, “irredeemable paper money has almost invariably proved a curse to the country employing it.”

Now, for the first time, no major currency is linked to a commodity, however loosely; every major currency is a pure fiat currency. Moreover, this system is regarded not as temporary but as the normal state of affairs. The remaining gold holdings of central banks are simply the residual grin on a vanishing gold standard.

Since 1971, the countries of the world have been sailing on uncharted seas. Not surprisingly, the end of any restraint, however weak, on the creation of money initially led to a sharp acceleration in monetary growth in the United States, which spread to other countries as they sought for a time to keep their currencies from appreciating vis-à-vis the dollar. The result was the worldwide inflation of the 1970s.

That outburst of inflation discredited the simpleminded idea of any long-term trade-off between inflation and unemployment, reduced the fiscal benefits from inflation, and increased the public’s aversion to inflation. It became politically profitable for countries to follow policies consistent with a sharp reduction in inflation. That occurred in the EMS, but it also occurred in Japan, in Britain, in the U.S., and in much of the rest of the world.

Two recent episodes illustrate by contrast the difficulty of relying on pegging one currency to another as a way to achieve disinflation. The first is Chile, which pegged her currency to the U.S. dollar in the late Seventies in order to promote the disinflation already in progress. Unfortunately for Chile, the U.S. dollar shortly embarked on a sharp appreciation against all other major currencies. The result was disaster: serious economic decline, indeed depression, the complete loss of credibility of government monetary policy, and the removal from office of those who had engineered the peg.

In 1985, Israel adopted the same policy for the same reason and pegged her currency to the U.S. dollar. The result was a great success because the dollar was poised for a sharp devaluation. The identical policy was utter disaster and shortsightedness in the one case; regarded as far-seeing wisdom in the other!

Recent British experience offers another cautionary tale. Former Chancellor of the Exchequer Nigel Lawson tried to peg the pound to the West German Mark at three Marks to the pound at a time when the pound was tending to appreciate relative to the Mark. The result was a sharp rise in monetary growth that brought the attempt to an untimely end and left a legacy of inflation and high interest rates that Britain is still struggling to overcome.

A truly unified currency–such as the dollar in the fifty states, Panama, and Hong Kong or the proposed single European currency–makes a great deal of sense. But to achieve it where it doesn’t exist–as in Europe today–requires eliminating all central banks, if the unified currency is a pure commodity currency, or all except one, if the unified currency is a fiat, or partly fiat, currency.

In Europe, the obvious choice for a single central bank would be the Bundesbank, which has been the dominant bank in the EMS. That would require eliminating the Bank of England, the Bank of France, the Bank of Italy, and so on, or converting them into administrative branches of the Bundesbank. A possible alternative is the Bank for International Settlements, which would require eliminating the Bundesbank as well. It is hard to regard either of these possibilities as a serious option.

The hope that a system of national central banks linked by pegged and managed exchange rates can prove a waystation to a truly unified currency seems to me an utter mirage. It will be no easier to abolish the central banks when such a system is in operation than before it starts. The prospect of a consortium of central banks operating as a unit, mimicking a single central bank, strikes me as equally farfetched.

Nearly four decades ago, I spent some months as a consultant to the U.S. Marshall Plan agency, analyzing the plan for the Schuman Coal and Steel Community, the precursor to the Common Market. I concluded then that true economic unification in Europe, defined as a single relatively free market, was possible only in conjunction with a system of freely floating exchange rates (I ruled out a unified currency on political grounds, if memory serves).

Experience since then has strengthened my confidence in that conclusion, though it has also made me far more skeptical that a system of freely floating exchange rates is politically feasible. Central banks will meddle, always of course with the best of intentions. Nonetheless, even dirty floating exchange rates seem to me preferable to pegged rates, though not necessarily to a unified currency.

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