Crisis in the Eurozone and its implications for the evolution of the International Monetary System

By Domingo Cavallo, for the "Astana Economic Forum 2012", May23-24, 2012

The reconstruction of Europe after World War II, following the monetary conference in Bretton Woods, took place with a system of national currencies fixed to the US Dollar. This currency system created the conditions for price stability and the Marshall Plan provided the needed external financing.

After the dismantling of the Bretton Woods System, Europe, that in the inter war period had experienced the dramatic instability associated with beggar thy neighbor exchange rate policies and a variety of inflationary and deflationary episodes across countries, decided to organize a coordinated monetary system of national currencies (the "Snake in the Tunnel") that evolved into the European Monetary System. The Eurozone was the most advanced stage in this process of monetary coordination that has to be interpreted as the result of a long and complex historical process of economic and political integration rather than the outcome of some technocratic "social engineering" experiment.

Crisis in the Eurozone: proposed solutions

Since 2009 onwards, many countries in the Eurozone have gone into recession, high unemployment, financial instability and debt crisis that in the opinion of many leading macroeconomists will only be solved after the nations in crisis abandon the Eurozone and reintroduce national currencies. This operation is commonly denominated "recovery of national monetary sovereignty".

In the opinion of those economists, the devaluation of the new currency of each country in crisis would allow a fast recovery of competitiveness and a significant debt reduction. This would eventually entail the reintroduction of almost all the national currencies that existed before the creation of the Euro.

Why successive exits from the Euro of the weak economies is a bad idea.

Proposals to cope with the crisis in the Eurozone by going back to a system of uncoordinated national currencies, which is what would emerge as a result of successive exits of the weaker economies from the Eurozone, will bring Europe back to where it was in the 70's, after the dismantling of the Bretton Woods System or, even worse, to where it was in the interwar period of beggar thy neighbor exchange rate policies and widespread episodes of monetary disorder.

My prediction is based on two facts that can be illustrated with Argentine experience: the new national currencies will not provide an effective monetary anchor for the respective national economies and the governments will eventually abandon efforts towards fiscal consolidation to appeal to the politically much simpler solution of printing money to finance fiscal deficits. For many years governments will maintain the illusion that currency devaluation keeps the economy competitive without making efforts to implement productivity enhancing structural reforms.

Let's explain the first fact. The demand for the compulsorily reintroduced national currencies in a world of ample capital mobility and extreme currency substitution will be very low. Citizens of those countries that exit the Eurozone will prefer to convert the holdings of the newly created national currency into Euros or other stronger currencies and the initial devaluation will be very large. Inflation will be drastically reintroduced into those economies and the subsequent use of monetary printing to finance fiscal deficits will transform the initial inflationary impact into a persistent phenomenon, making impossible for the national central bank to provide a nominal anchor for the national economy.

Argentina since 2002 is the clearest recent historical example of this succession of events. In Argentina "de-dollarization" and the recreation of the non-convertible Peso did not bring about growth but persistent inflation and complete loss of credit. Since 2003 GDP growth came from the combination of the capitalization and modernization of the economy during the 90's and historically record high foreign terms of trade after 2002.

The second fact is even more self-evident: the arguments that the proposers of "recovery of monetary sovereignty" for the countries in crisis are twofold: it will not be necessary to reduce government expenditures because there will be monetary financing for the fiscal deficits and currency devaluation will allow to recover competitiveness without engaging in politically painful structural reforms. It is evident that in such a situation it is infinitely less likely that governments will introduce any significant reforms in the rules of the game of the economy.

The experience of Argentina since 2002 is also a clear example of the way government behaves after the reintroduction of "monetary sovereignty": the pro market and pro-growth reforms of the 90's have been reversed and Argentina has recreated all the structural problems that hyperinflation had unraveled in the late 80's.

The exchange rate mechanism that helps to minimize domestic recessionary costs in the process of adjusting external imbalances works the way conventional open economy macroeconomics predicts when the national economy has a national currency and most of its financial contracts are written in that currency. But it does not work the same way in an economy that has all its domestic contracts written in the external currency.

In the latter case, the new domestic currency is introduced by a forced re-writing of all the outstanding contracts and the devaluation is not a movement towards equilibrium in the foreign exchange market but the outcome of the rejection by the public of the newly created national currency. As a consequence, the exchange rate overshooting is many times larger than what would occur when a country that has a local currency pegged to a foreign currency runs out of reserves and abandons the peg.

In the conventional case, after the devaluation of an existing domestic currency the Central Bank will still be able to use the currency as a nominal anchor for the economy. But in the case of a very large initial devaluation of a newly created national currency that starts with the re-writing off all exiting financial contracts, the Central Bank will not be able to target inflation through monetary policy. Low demand for that currency and big deficits to be financed by monetary creation will make it impossible to bring down long term inflationary expectations by setting very high nominal interest rates.

In those countries that in the past moved to a currency system that would deliver greater price and currency stability are precisely those in which their citizens know that the politicians faced with the alternative of undertaking difficult fiscal and structural reforms to restore equilibrium or printing money to finance them will very likely opt for the second alternative. Thus to expect that the “recovery of monetary sovereignty” will create favorable conditions for the implementation of structural pro-growth reforms is wishful thinking.

Solving the Crisis preserving the Eurozone

If the idea of monetary disintegration is rejected up-front as my analysis suggests, the solution of the Crisis in the Eurozone requires:

1) Gradual fiscal consolidation in the countries with very large and persistent fiscal deficits;

2) Structural reforms to introduce greater wage and price flexibility in all the markets of the economy and to open up profitable opportunities for efficient investment and productivity increase.

3) Tax reform to reduce the gap between labor costs and disposable income of workers in the formal economy. Replacement of Taxes on nominal wages by increased effective VAT rate.

4) Orderly debts restructurings (“bail ins”) and European financial support to smooth over time fiscal consolidation and the structural reforms as to transform them into a pro-growth strategy rather than measures that transform recessions into depressions (“bail outs” by the ECB, the EFSF and the IMF).

5) To avoid future crises European Nations will need: a) to coordinate national fiscal policies and, in the case of the nations that did not demonstrate fiscal discipline and have completely lost credit, b) to resign fiscal sovereignty. To pretend resignation of fiscal sovereignty by fiscally disciplined nations is anti-historical.

6) Europe should introduce Eurobonds with enough earmarked tax revenues to secure their normal servicing as a mechanism to allow: a) the orderly debt restructurings of the countries that the markets have identified as non-solvent and, b) to finance future fiscal deficits of countries that are reforming their economies but have no access to capital markets at normal interest rates.

7) The European Central Bank will have to provide enough liquidity to reassure financial stability and also to facilitate recovery in the countries in recession the same way as the FED provided liquidity and the necessary monetary stimulus to the recovery of the US economy.

If Germany and other countries that are not in crisis are not willing to support such a solution because they are afraid of its inflationary consequences, then they should consider the alternative of reintroducing their own national currencies and having a more restrictive monetary policy. This is the only orderly way the Eurozone could be partially disintegrated without facing the risk of an aggravation of the crisis in the weaker European economies.

The alternative of reintroducing the Deutsche Mark as the national currency of Germany

Even though the exit from the euro of countries in crisis would only aggravate the crisis and reduce the chances of recovering sound economic growth and stability, an exit from the Euro of Germany would not produce those perverse effects. The Euro without Germany would weaken probably to parity with the Dollar because the markets will predict that the ECB without Germany would do what the FED has been doing in the US. That depreciation would not produce the inflationary impact of the large depreciation that would have suffered instead the newly introduced national currencies in the countries in crisis and would certainly facilitate the external adjustment with less recession and more employment in the crisis economies.

On the other hand, the reintroduced Deutsche Mark would not be rejected but very likely welcome by the German People and many other wealth holders in the world. This means that the demand for the Deutsche Mark would probably increase and its market value would rise vis-à-vis other currencies, and particularly vis-à-vis the Euro. The Deutsche Bundeskank would again recover its monetary sovereignty to implement a monetary policy strictly committed to price stability without endangering the recovery of the rest of the European countries in crisis.

In spite of these advantages, it is not very likely that Germany would adopt this decision because the appreciation of the Deutsche Mark would immediately reduce the competitiveness of German exports, particularly in relation to its important European markets. In practice Germany would face the same problems that the extreme appreciation of the Swiss Franc posed on the Swiss Economy in 2011.

My guess is that if the Germans seriously study the potential economic consequences of reintroducing the Deutsche Mark they would realize that it would be better for them to admit a more expansionary monetary policy by the ECB that would at the same time preserve the Euro in its current format.

Implication for the evolution of the International Monetary System

The progress towards the organization of an International Monetary System functional to a stable and expansionary global economy will require the creation of large monetary areas with convertible currencies and Central Banks that will be able to target inflation in the respective areas. At the same time, the system would contribute through monetary policy coordination to preserve price, monetary and financial stability in the global economy.

The immediate consequence of the crisis in the Eurozone is to delay this process of global monetary coordination; but once the Eurozone shows that the Euro survives the current crisis and the European nations find a way to improve their monetary and fiscal institutions as to reduce the risk of future crises, the experience accumulated by the Eurozone Nations will help to guide the process of monetary integration for the Global Economy on sounder grounds.

Hopefully, the current crises, which originated not only in excessive leverage of government, banks, firms and household in several countries of the Eurozone, but also in excessive leverage in the UK and the US, will help to find better monetary and financial regimes for the global economy. These regimes will for sure incorporate greater efforts of monetary and fiscal policy coordination and a more integrated financial regulatory framework.