

The Euro from Afar

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Thank you. Thank you very much for inviting me to this prestigious congress and to give me a great opportunity to bring my experience on monetary reform from Argentina and to relate it to the introduction of the Euro in your continent.

Let me start with my conclusion: the introduction of the Euro will be very good for Europe and for the world. Now, why I am so optimistic? The main reason is that I think there are too many money systems and many national monetary policies in the world, and that is neither good for the working of the world economy nor for the working of national economies. I have learned this both from monetary theory and from my own experience as a policy maker in Argentina.

By reading economic theory I was convinced by those who argue that the only target of monetary policy should be price stability and that monetary policy is completely ineffective in getting real results for the economy. Therefore, monetary policy should not be used to dampen the business cycle or try to affect the real interest rates, unemployment or competitiveness. The instruments and the policies to be used to induce real effects into the economy should be others, not monetary tools. Bob Lucas is the academician that expressed this view in the clearest way and that is why he was given the Nobel Prize.

In Latin America, and particularly in Argentina, we have learned this from practice. Because monetary policy was used and abused in order to promote growth, to reduce unemployment or to increase competitiveness. At the time politicians nationalized companies and increased government intervention into the economy, raised import tariffs and generated big fiscal deficits, they believed that investment and growth could be facilitated by creating credit through the central bank. And also it was believed that currency devaluation could help increasing competitiveness in a sustainable way. And that was completely wrong. The only outcome of the attempt to use monetary policy to speed up growth, to reduce unemployment and to increase competitiveness was persistent inflation and eventually hyperinflation as we suffered in Argentina.

At the same time that policy makers were making all these mistakes our people learned that our national currency was not a good one. And even though there were restrictions on them to use foreign currencies, in practice they started to use the dollar as an alternative currency. In a country like Argentina, for example, by the late 1980s, the dollars that were in circulation in the economy and that were used in everyday transactions largely exceeded the local currency units. People in our country learned that having freedom to choose the currency was a way to preserve their economic and political freedom. And they behaved that way. Having learned from our own experience on the complete ineffectiveness of monetary policies to speed up growth, to reduce unemployment, to increase competitiveness, we decided to prevent the use of these policy tools in relation to these economic objectives and to concentrate in stabilizing our economy. For that purpose we decided to create a monetary system that would reassure the removal of inflation from our country. And this is why we decided first of all to give people freedom to choose the currency. They have been choosing

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the dollar as their currency even though it was obligatory to use the austral, the old Argentinian currency.

If we had done only that we would have today a completely dollarized economy. The dollar would be used in everyday transactions, deposits would be in dollars; loans and financial intermediation would be in dollars.

But actually in Argentina if you look at the financial system as a whole, deposits are fifty percent in pesos and fifty percent in dollars, exactly the same as in Hong Kong. Now, what did we do to have at least fifty percent of our assets in the local currency? We tried to create a currency that was at least as good as the dollar. And, of course, to convince Argentinians that a new currency was at least as good as the dollar was not very easy. The way we found to assure that every peso that circulates is backed by one dollar. So we created the currency board as a machine to produce the pesos that are put into circulation, and that currency board reassures that every peso that circulates is backed by one dollar.

What did we gain from this exercise? Why not just let the Argentinians use the dollar and become, as somebody told me, the fifty first state of the United States? You know there are at least two reasons. One is national pride, because if we said "look, now the dollar is our currency," probably people would have voted against us in the elections. But there is also an economic reason. We have now 20 billion dollars backing our monetary base, and those twenty billions dollars generate 3% or 4% interest, so we get 60 to 80 billion of income, which otherwise would be collected by the United States. But in all our respects the dollar is also our currency and because now Argentinians are convinced that the peso is almost as good as the dollar, they are still using it, half and half.

Now, why do I tell you this story? Because through this story we gain a lot in Argentina. First of all we have now less than one percent annual inflation. Secondly we are growing fast. During the last seven years the economy grew almost seven percent per annum. And in 1995 at the time of the Mexican crisis we did suffer a recession, but we did not re-introduce inflation into our economy, and without devaluing our currency the recovery was stronger than in Mexico.

Now, how is all this related to the Euro and to the future of Europe? As a consequence of creating this monetary system in Argentina we have no monetary policy any more. So the central bank has been transformed into a monetary authority like that of Hong Kong's. The scope of the central bank to create domestic credit to provide lending of last resort to the banks or to provide financing to the government is very, very limited. It can use excess reserves but not the reserves that are backing the monetary base. Now, what happened as a consequence of that limitation? It happened that no politician in Argentina looked at monetary policy and more as a way to increase competitiveness or to affect the real interest rates and the credit conditions. And, therefore, all the political attention and the attention of the businessmen and of the lobbyists, of everybody, was directed towards the two determinants of credit condition. So we started to speak in Argentina of eliminating distorted taxes, of removing regulations that prevented increased productivity, of increasing domestic saving, of reforming our social security system, and our insurance regulation and so on. For the same reason we are now reforming labor legislation to introduce greater flexibility, because everybody understands that there can be no artificial lowering of interest rates to increase employment. Therefore the only way to tackle unemployment, which is very high in Argentina, is to introduce flexibility in labor markets. So by setting aside the possibility of using monetary policies to other economic objectives rather than a price stability, we gained in the quality of our political discussion and political decision-making process in relation to the real problems of our economy.

And I think that that will happen here in Europe with the introduction of the Euro. To the extent that each individual country continues having monetary policy as an available tool, there would be episodes of currency crisis because some governments will feel free to use a competitive devaluation to try to increase competitiveness or to create domestic credit in order to promote growth. But once that tool is not available for the individual governments the politicians in each particular country will engage in relevant discussions on what has to be done to increase competitiveness and to improve credit conditions on a sustainable basis. So I am very optimistic in this respect and I think it will really improve the functioning of the European economy and also of the political system in each one of the individual countries.

Why will the Euro be good for the world? Because if Europe expands due to the increased productivity, more competition and more investments opportunities the world as a whole will get more rapid growth. Some people argue that as Europe will have the build up of its strong currency reputation, it will be forced to start with very high interest rates. I don't think that the strength of the currency depends mainly on decisions on the level of short-term nominal interest rates set by the central bank. The strength of the currency depends mainly in the strength of the economy and of course on how clear is the rule, the monetary rule, that the new monetary authority will adopt as a way to reassure price stability. So I think that, of course, there will be changes in the exchange rate between the dollar and the Euro, but I think that the competition between the dollar and the Euro reserve currencies will somehow obligate the two monetary authorities to be very prudent and to behave very well in terms of reassuring price stability in both the dollar and the Euro areas. I think that in a few years the Japanese will be promoting in Asia the use of the Japanese yen or an Asian currency to prevent the kind of currency crisis that are now creating so many problems.

Countries that get rid of national monetary policy and stick to the commitment of a common currency or peg their own to a foreign currency through a currency board will force their politicians and their citizens to focus on the real problem of the particular economy, and that will prevent the mistakes that eventually provoke currency and financial crisis. So for this reason I am optimistic about the future of the Euro. To those nations like the Czech Republic that are not members yet of the European Union, I would advise them to give their citizens freedom to choose the local currency or the Euro, with the local currency pegged to the Euro by a currency board.

I predict the Euro will be a good anchor to improve stability in Europe and will help European politicians to improve the economic institutions of their nations with significant gains in terms of economic growth and prosperity.