The End of National Currency

Benn Steil

THE RISE OF MONETARY NATIONALISM

CAPITAL FLOWS have become globalization's Achilles' heel. Over the past 25 years, devastating currency crises have hit countries across Latin America and Asia, as well as countries just beyond the borders of western Europe—most notably Russia and Turkey. Even such an impeccably credentialed pro-globalization economist as U.S. Federal Reserve Governor Frederic Mishkin has acknowledged that "opening up the financial system to foreign capital flows has led to some disastrous financial crises causing great pain, suffering, and even violence."

The economics profession has failed to offer anything resembling a coherent and compelling response to currency crises. International Monetary Fund (IMF) analysts have, over the past two decades, endorsed a wide variety of national exchange-rate and monetary policy regimes that have subsequently collapsed in failure. They have fingered numerous culprits, from loose fiscal policy and poor bank regulation to bad industrial policy and official corruption. The financial-crisis literature has yielded policy recommendations so exquisitely hedged and widely contradicted as to be practically useless.

Antiglobalization economists have turned the problem on its head by absolving governments (except the one in Washington) and instead blaming crises on markets and their institutional supporters, such as the IMF—"dictatorships of international finance," in the words of the Nobel laureate Joseph Stiglitz. "Countries are effectively told that if

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they don't follow certain conditions, the capital markets or the IMF will refuse to lend them money," writes Stiglitz. "They are basically forced to give up part of their sovereignty."

Is this right? Are markets failing, and will restoring lost sovereignty to governments put an end to financial instability? This is a dangerous misdiagnosis. In fact, capital flows became destabilizing only after countries began asserting "sovereignty" over money—detaching it from gold or anything else considered real wealth. Moreover, even if the march of globalization is not inevitable, the world economy and the international financial system have evolved in such a way that there is no longer a viable model for economic development outside of them.

The right course is not to return to a mythical past of monetary sovereignty, with governments controlling local interest and exchange rates in blissful ignorance of the rest of the world. Governments must let go of the fatal notion that nationhood requires them to make and control the money used in their territory. National currencies and global markets simply do not mix; together they make a deadly brew of currency crises and geopolitical tension and create ready pretexts for damaging protectionism. In order to globalize safely, countries should abandon monetary nationalism and abolish unwanted currencies, the source of much of today's instability.

THE GOLDEN AGE

CAPITAL FLOWS were enormous, even by contemporary standards, during the last great period of "globalization," from the late nineteenth century to the outbreak of World War I. Currency crises occurred during this period, but they were generally shallow and short-lived. That is because money was then—as it has been throughout most of the world and most of human history—gold, or at least a credible claim on gold. Funds flowed quickly back to crisis countries because of confidence that the gold link would be restored. At the time, monetary nationalism was considered a sign of backwardness, adherence to a universally acknowledged standard of value a mark of civilization. Those nations that adhered most reliably (such as Australia, Canada, and the United States) were rewarded with the lowest international borrowing rates. Those that adhered the least (such as Argentina, Brazil, and Chile) were punished with the highest.

This bond was fatally severed during the period between World War I and World War II. Most economists in the 1930s and 1940s considered it obvious that capital flows would become destabilizing with the end of reliably fixed exchange rates. Friedrich Hayek noted in a 1937 lecture that under a credible gold-standard regime, "short-term capital movements will on the whole tend to relieve the strain set up by the original cause of a temporarily adverse balance of payments. If exchanges, however, are variable, the capital movements will tend to work in the same direction as the original cause and thereby to intensify it"—as they do today.

The belief that globalization required hard money, something foreigners would willingly hold, was widespread. The French economist Charles Rist observed that "while the theorizers are trying to persuade the public and the various governments that a minimum quantity of gold ... would suffice to maintain monetary confidence, and that anyhow paper currency, even fiat currency, would amply meet all needs, the public in all countries is busily hoarding all the national currencies which are supposed to be convertible into gold." This view was hardly limited to free marketeers. As notable a critic of the gold standard and global capitalism as Karl Polanyi took it as obvious that monetary nationalism was incompatible with globalization. Focusing on the United Kingdom's interest in growing world trade in the nineteenth century, he argued that "nothing else but commodity money could serve this end for the obvious reason that token money, whether bank or fiat, cannot circulate on foreign soil." Yet what Polanyi considered nonsensical—global trade in goods, services, and capital intermediated by intrinsically worthless national paper (or "fiat") monies—is exactly how globalization is advancing, ever so fitfully, today.

The political mythology associating the creation and control of money with national sovereignty finds its economic counterpart in the metamorphosis of the famous theory of "optimum currency areas" (OCA). Fathered in 1961 by Robert Mundell, a Nobel Prize–winning economist who has long been a prolific advocate of shrinking the number of national currencies, it became over the subsequent decades a quasi-scientific foundation for monetary nationalism.

Mundell, like most macroeconomists of the early 1960s, had a now largely discredited postwar Keynesian mindset that put great faith in the ability of policymakers to fine-tune national demand in the face of what economists call "shocks" to supply and demand. His seminal article, "A Theory of Optimum Currency Areas," asks the question, "What is the appropriate domain of the currency area?" "It might seem at first that the question is purely academic," he observes, "since it hardly appears within the realm of political feasibility that national currencies would ever be abandoned in favor of any other arrangement."

Mundell goes on to argue for flexible exchange rates between regions of the world, each with its own multinational currency, rather than between nations. The economics profession, however, latched on to Mundell's analysis of the merits of flexible exchange rates in dealing with economic shocks affecting different "regions or countries" differently; they saw it as a rationale for treating existing nations as natural currency areas. Monetary nationalism thereby acquired a rational scientific mooring. And from then on, much of the mainstream economics profession came to see deviations from "one nation, one currency" as misguided, at least in the absence of prior political integration.

Monetary nationalism in poor countries makes future financial instability likely.

The link between money and nationhood having been established by economists (much in the way that Aristotle and Jesus were reconciled by medieval scholastics), governments adopted OCA theory as the primary intellectual defense of monetary nationalism. Brazilian central bankers have even defended the country's monetary independence by publicly appealing to OCA theory—against Mundell himself, who spoke out on the economic damage that sky-high interest rates (the result of maintaining unstable national monies that no one wants to hold) impose on Latin American countries. Indeed, much of Latin America has already experienced "spontaneous dollarization": despite restrictions in many countries, U.S. dollars represent over 50 percent of bank deposits. (In Uruguay, the figure is 90 percent, reflecting the appeal of Uruguay's lack of currency restrictions and its famed bank secrecy.) This increasingly global phenomenon of people rejecting national monies as a store of wealth has no place in OCA theory.

NO TURNING BACK

JUST A FEW decades ago, vital foreign investment in developing countries was driven by two main motivations: to extract raw materials for export and to gain access to local markets heavily protected against competition from imports. Attracting the first kind of investment was simple for countries endowed with the right natural resources. (Companies readily went into war zones to extract oil, for example.) Governments pulled in the second kind of investment by erecting tariff and other barriers to competition so as to compensate foreigners for an otherwise unappealing business climate. Foreign investors brought money and know-how in return for monopolies in the domestic market.

This cozy scenario was undermined by the advent of globalization. Trade liberalization has opened up most developing countries to imports (in return for export access to developed countries), and huge declines in the costs of communication and transport have revolutionized the economics of global production and distribution. Accordingly, the reasons for foreign companies to invest in developing countries have changed. The desire to extract commodities remains, but companies generally no longer need to invest for the sake of gaining access to domestic markets. It is generally not necessary today to produce in a country in order to sell in it (except in large economies such as Brazil and China).

At the same time, globalization has produced a compelling new reason to invest in developing countries: to take advantage of lower production costs by integrating local facilities into global chains of production and distribution. Now that markets are global rather than local, countries compete with others for investment, and the factors defining an attractive investment climate have changed dramatically. Countries can no longer attract investors by protecting them against competition; now, since protection increases the prices of goods that foreign investors need as production inputs, it actually reduces global competitiveness.

In a globalizing economy, monetary stability and access to sophisticated financial services are essential components of an attractive local investment climate. And in this regard, developing countries are especially poorly positioned.

Traditionally, governments in the developing world exercised strict control over interest rates, loan maturities, and even the beneficiaries of credit—all of which required severing financial and monetary links with the rest of the world and tightly controlling international capital flows. As a result, such flows occurred mainly to settle trade imbalances or fund direct investments, and local financial systems remained weak and underdeveloped. But growth today depends more and more on investment decisions funded and funneled through the global financial system. (Borrowing in low-cost yen to finance investments in Europe while hedging against the yen's rise on a U.S. futures exchange is no longer exotic.) Thus, unrestricted and efficient access to this global system—rather than the ability of governments to manipulate parochial monetary policies—has become essential for future economic development.

But because foreigners are often unwilling to hold the currencies of developing countries, those countries' local financial systems end up being largely isolated from the global system. Their interest rates tend to be much higher than those in the international markets and their lending operations extremely short—not longer than a few months in most cases. As a result, many developing countries are dependent on U.S. dollars for long-term credit. This is what makes capital flows, however necessary, dangerous: in a developing country, both locals and foreigners will sell off the local currency en masse at the earliest whiff of devaluation, since devaluation makes it more difficult for the country to pay its foreign debts—hence the dangerous instability of today's international financial system.

Although OCA theory accounts for none of these problems, they are grave obstacles to development in the context of advancing globalization. Monetary nationalism in developing countries operates against the grain of the process—and thus makes future financial problems even more likely.

MONEY IN CRISIS

WHY HAS the problem of serial currency crises become so severe in recent decades? It is only since 1971, when President Richard Nixon formally untethered the dollar from gold, that monies flowing around the globe have ceased to be claims on anything real. All the world's currencies are now pure manifestations of sovereignty conjured by governments. And the vast majority of such monies are unwanted: people are unwilling to hold them as wealth, something that will buy in the future at least what it did in the past. Governments can force their citizens to hold national money by requiring its use in transactions with the state, but foreigners, who are not thus compelled, will choose not to do so. And in a world in which people will only willingly hold dollars (and a handful of other currencies) in lieu of gold money, the mythology tying money to sovereignty is a costly and sometimes dangerous one. Monetary nationalism is simply incompatible with globalization. It has always been, even if this has only become apparent since the 1970s, when all the world's governments rendered their currencies intrinsically worthless.

Yet, perversely as a matter of both monetary logic and history, the most notable economist critical of globalization, Stiglitz, has argued passionately for monetary nationalism as the remedy for the economic chaos caused by currency crises. When millions of people, locals and foreigners, are selling a national currency for fear of an impending default, the Stiglitz solution is for the issuing government to simply decouple from the world: drop interest rates, devalue, close off financial flows, and stiff the lenders. It is precisely this thinking, a throwback to the isolationism of the 1930s, that is at the root of the cycle of crisis that has infected modern globalization.

Argentina has become the poster child for monetary nationalists—those who believe that every country should have its own paper currency and not waste resources hoarding gold or hard-currency reserves. Monetary nationalists advocate capital controls to avoid entanglement with foreign creditors. But they cannot stop there. As Hayek emphasized in his 1937 lecture, "exchange control designed to prevent effectively the outflow of capital would really have to involve a complete control of foreign trade," since capital movements are triggered by changes in the terms of credit on exports and imports.

Indeed, this is precisely the path that Argentina has followed since 2002, when the government abandoned its currency board, which tried to fix the peso to the dollar without the dollars necessary to do so. Since writing off $80 billion worth of its debts (75 percent in nominal terms), the Argentine government has been resorting to ever more intrusive means in order to prevent its citizens from protecting what remains of their savings and buying from or selling to foreigners. The country has gone straight back to the statist model of economic control that has failed Latin America repeatedly over generations. The government has steadily piled on more and more onerous capital and domestic price controls, export taxes, export bans, and limits on citizens' access to foreign currency. Annual inflation has nevertheless risen to about 20 percent, prompting the government to make hamfisted efforts to manipulate the official price data. The economy has become ominously dependent on soybean production, which surged in the wake of price controls and export bans on cattle, taking the country back to the pre-globalization model of reliance on a single commodity export for hard-currency earnings. Despite many years of robust postcrisis economic recovery, GDP is still, in constant U.S. dollars, 26 percent below its peak in 1998, and the country's long-term economic future looks as fragile as ever.

When currency crises hit, countries need dollars to pay off creditors. That is when their governments turn to the IMF, the most demonized institutional face of globalization. The IMF has been attacked by Stiglitz and others for violating "sovereign rights" in imposing conditions in return for loans. Yet the sort of compromises on policy autonomy that sovereign borrowers strike today with the IMF were in the past struck directly with foreign governments. And in the nineteenth century, these compromises cut far more deeply into national autonomy.

Historically, throughout the Balkans and Latin America, sovereign borrowers subjected themselves to considerable foreign control, at times enduring what were considered to be egregious blows to independence. Following its recognition as a state in 1832, Greece spent the rest of the century under varying degrees of foreign creditor control; on the heels of a default on its 1832 obligations, the country had its entire finances placed under French administration. In order to return to the international markets after 1878, the country had to precommit specific revenues from customs and state monopolies to debt repayment. An 1887 loan gave its creditors the power to create a company that would supervise the revenues committed to repayment. After a disastrous war with Turkey over Crete in 1897, Greece was obliged to accept a control commission, comprised entirely of representatives of the major powers, that had absolute power over the sources of revenue necessary to fund its war debt. Greece's experience was mirrored in Bulgaria, Serbia, the Ottoman Empire, Egypt, and, of course, Argentina.

There is, in short, no age of monetary sovereignty to return to. Countries have always borrowed, and when offered the choice between paying high interest rates to compensate for default risk (which was typical during the Renaissance) and paying lower interest rates in return for sacrificing some autonomy over their ability to default (which was typical in the nineteenth century), they have commonly chosen the latter. As for the notion that the IMF today possesses some extraordinary power over the exchange-rate policies of borrowing countries, this, too, is historically inaccurate. Adherence to the nineteenth-century gold standard, with the Bank of England at the helm of the system, severely restricted national monetary autonomy, yet governments voluntarily subjected themselves to it precisely because it meant cheaper capital and greater trade opportunities.

THE MIGHTY DOLLAR?

FOR A LARGE, diversified economy like that of the United States, fluctuating exchange rates are the economic equivalent of a minor toothache. They require fillings from time to time—in the form of corporate financial hedging and active global supply management—but never any major surgery. There are two reasons for this. First, much of what Americans buy from abroad can, when import prices rise, quickly and cheaply be replaced by domestic production, and much of what they sell abroad can, when export prices fall, be diverted to the domestic market. Second, foreigners are happy to hold U.S. dollars as wealth.

This is not so for smaller and less advanced economies. They depend on imports for growth, and often for sheer survival, yet cannot pay for them without dollars. What can they do? Reclaim the sovereignty they have allegedly lost to the IMF and international markets by replacing the unwanted national currency with dollars (as Ecuador and El Salvador did half a decade ago) or euros (as Bosnia, Kosovo, and Montenegro did) and thereby end currency crises for good. Ecuador is the shining example of the benefits of dollarization: a country in constant political turmoil has been a bastion of economic stability, with steady, robust economic growth and the lowest inflation rate in Latin America. No wonder its new leftist president, Rafael Correa, was obliged to ditch his de-dollarization campaign in order to win over the electorate. Contrast Ecuador with the Dominican Republic, which suffered a devastating currency crisis in 2004—a needless crisis, as 85 percent of its trade is conducted with the United States (a figure comparable to the percentage of a typical U.S. state's trade with other U.S. states).

It is often argued that dollarization is only feasible for small countries. No doubt, smallness makes for a simpler transition. But even Brazil's economy is less than half the size of California's, and the U.S. Federal Reserve could accommodate the increased demand for dollars painlessly (and profitably) without in any way sacrificing its commitment to U.S. domestic price stability. An enlightened U.S. government would actually make it politically easier and less costly for more countries to adopt the dollar by rebating the seigniorage profits it earns when people hold more dollars. (To get dollars, dollarizing countries give the Federal Reserve interest-bearing assets, such as Treasury bonds, which the United States would otherwise have to pay interest on.) The International Monetary Stability Act of 2000 would have made such rebates official U.S. policy, but the legislation died in Congress, unsupported by a Clinton administration that feared it would look like a new foreign-aid program.

Polanyi was wrong when he claimed that because people would never accept foreign fiat money, fiat money could never support foreign trade. The dollar has emerged as just such a global money. This phenomenon was actually foreseen by the brilliant German philosopher and sociologist Georg Simmel in 1900. He surmised:

> Expanding economic relations eventually produce in the enlarged, and finally international, circle the same features that originally characterized only closed groups; economic and legal conditions overcome the spatial separation more and more, and they come to operate just as reliably, precisely and predictably over a great distance as they did previously in local communities. To the extent that this happens, the pledge, that is the intrinsic value of the money, can be reduced. ... Even though we are still far from having a close and reliable relationship within or between nations, the trend is undoubtedly in that direction.

But the dollar's privileged status as today's global money is not heaven-bestowed. The dollar is ultimately just another money supported only by faith that others will willingly accept it in the future in return for the same sort of valuable things it bought in the past. This puts a great burden on the institutions of the U.S. government to validate that faith. And those institutions, unfortunately, are failing to shoulder that burden. Reckless U.S. fiscal policy is undermining the dollar's position even as the currency's role as a global money is expanding.

Four decades ago, the renowned French economist Jacques Rueff, writing just a few years before the collapse of the Bretton Woods dollar-based gold-exchange standard, argued that the system "attains such a degree of absurdity that no human brain having the power to reason can defend it." The precariousness of the dollar's position today is similar. The United States can run a chronic balance-of-payments deficit and never feel the effects. Dollars sent abroad immediately come home in the form of loans, as dollars are of no use abroad. "If I had an agreement with my tailor that whatever money I pay him he returns to me the very same day as a loan," Rueff explained by way of analogy, "I would have no objection at all to ordering more suits from him."

The United States risks undermining the faith foreigners have put in its management of the dollar.

With the U.S. current account deficit running at an enormous 6.6 percent of GDP (about $2 billion a day must be imported to sustain it), the United States is in the fortunate position of the suit buyer with a Chinese tailor who instantaneously returns his payments in the form of loans—generally, in the U.S. case, as purchases of U.S. Treasury bonds. The current account deficit is partially fueled by the budget deficit (a dollar more of the latter yields about 20–50 cents more of the former), which will soar in the next decade in the absence of reforms to curtail federal "entitlement" spending on medical care and retirement benefits for a longer-living population. The United States—and, indeed, its Chinese tailor—must therefore be concerned with the sustainability of what Rueff called an "absurdity." In the absence of long-term fiscal prudence, the United States risks undermining the faith foreigners have placed in its management of the dollar—that is, their belief that the U.S. government can continue to sustain low inflation without having to resort to growth-crushing interest-rate hikes as a means of ensuring continued high capital inflows.

PRIVATIZING MONEY

IT IS WIDELY assumed that the natural alternative to the dollar as a global currency is the euro. Faith in the euro's endurance, however, is still fragile—undermined by the same fiscal concerns that afflict the dollar but with the added angst stemming from concerns about the temptations faced by Italy and others to return to monetary nationalism. But there is another alternative, the world's most enduring form of money: gold.

It must be stressed that a well-managed fiat money system has considerable advantages over a commodity-based one, not least of which that it does not waste valuable resources. There is little to commend in digging up gold in South Africa just to bury it again in Fort Knox. The question is how long such a well-managed fiat system can endure in the United States. The historical record of national monies, going back over 2,500 years, is by and large awful.

At the turn of the twentieth century—the height of the gold standard—Simmel commented, "Although money with no intrinsic value would be the best means of exchange in an ideal social order, until that point is reached the most satisfactory form of money may be that which is bound to a material substance." Today, with money no longer bound to any material substance, it is worth asking whether the world even approximates the "ideal social order" that could sustain a fiat dollar as the foundation of the global financial system. There is no way effectively to insure against the unwinding of global imbalances should China, with over a trillion dollars of reserves, and other countries with dollar-rich central banks come to fear the unbearable lightness of their holdings.

So what about gold? A revived gold standard is out of the question. In the nineteenth century, governments spent less than ten percent of national income in a given year. Today, they routinely spend half or more, and so they would never subordinate spending to the stringent requirements of sustaining a commodity-based monetary system. But private gold banks already exist, allowing account holders to make international payments in the form of shares in actual gold bars. Although clearly a niche business at present, gold banking has grown dramatically in recent years, in tandem with the dollar's decline. A new gold-based international monetary system surely sounds far-fetched. But so, in 1900, did a monetary system without gold. Modern technology makes a revival of gold money, through private gold banks, possible even without government support.

COMMON CURRENCIES

VIRTUALLY EVERY major argument recently leveled against globalization has been leveled against markets generally (and, in turn, debunked) for hundreds of years. But the argument against capital flows in a world with 150 fluctuating national fiat monies is fundamentally different. It is highly compelling—so much so that even globalization's staunchest supporters treat capital flows as an exception, a matter to be intellectually quarantined until effective crisis inoculations can be developed. But the notion that capital flows are inherently destabilizing is logically and historically false. The lessons of gold-based globalization in the nineteenth century simply must be relearned. Just as the prodigious daily capital flows between New York and California, two of the world's 12 largest economies, are so uneventful that no one even notices them, capital flows between countries sharing a single currency, such as the dollar or the euro, attract not the slightest attention from even the most passionate antiglobalization activists.

Countries whose currencies remain unwanted by foreigners will continue to experiment with crisis-prevention policies, imposing capital controls and building up war chests of dollar reserves. Few will repeat Argentina's misguided efforts to fix a dollar exchange rate without the dollars to do so. If these policies keep the IMF bored for a few more years, they will be for the good.

But the world can do better. Since economic development outside the process of globalization is no longer possible, countries should abandon monetary nationalism. Governments should replace national currencies with the dollar or the euro or, in the case of Asia, collaborate to produce a new multinational currency over a comparably large and economically diversified area.

Europeans used to say that being a country required having a national airline, a stock exchange, and a currency. Today, no European country is any worse off without them. Even grumpy Italy has benefited enormously from the lower interest rates and permanent end to lira speculation that accompanied its adoption of the euro. A future pan-Asian currency, managed according to the same principle of targeting low and stable inflation, would represent the most promising way for China to fully liberalize its financial and capital markets without fear of damaging renminbi speculation (the Chinese economy is only the size of California's and Florida's combined). Most of the world's smaller and poorer countries would clearly be best off unilaterally adopting the dollar or the euro, which would enable their safe and rapid integration into global financial markets. Latin American countries should dollarize; eastern European countries and Turkey, euroize. Broadly speaking, this prescription follows from relative trade flows, but there are exceptions; Argentina, for example, does more eurozone than U.S. trade, but Argentines think and save in dollars.

Of course, dollarizing countries must give up independent monetary policy as a tool of government macroeconomic management. But since the Holy Grail of monetary policy is to get interest rates down to the lowest level consistent with low and stable inflation, an argument against dollarization on this ground is, for most of the world, frivolous. How many Latin American countries can cut interest rates below those in the United States? The average inflation-adjusted lending rate in Latin America is about 20 percent. One must therefore ask what possible boon to the national economy developing-country central banks can hope to achieve from the ability to guide nominal local rates up and down on a discretionary basis. It is like choosing a Hyundai with manual transmission over a Lexus with automatic: the former gives the driver more control but at the cost of inferior performance under any condition.

As for the United States, it needs to perpetuate the sound money policies of former Federal Reserve Chairs Paul Volcker and Alan Greenspan and return to long-term fiscal discipline. This is the only sure way to keep the United States' foreign tailors, with their massive and growing holdings of dollar debt, feeling wealthy and secure. It is the market that made the dollar into global money—and what the market giveth, the market can taketh away. If the tailors balk and the dollar fails, the market may privatize money on its own.

This is our enemy Bankers, lawyers, judges, publishers, idiot preachers, teachers, etc.

What strange secrets are concealed in this curious logo?

From Latin to — UBIQUITOUS English