*George Macesich**

AGE OF FIAT MONEY: DOLLAR AND EURO

Fiat Money

There is a profound change in the world's monetary regime. Since August 1971, when United States President Richard Nixon closed the gold window and thus removed the dollar from any link with gold, the United States and much of the world embarked on a fiat monetary regime. One consequence is that there is no anchor to the world's long-term general level of prices. This paper discusses these changes for the dollar and the euro, the world's two major currencies.

Before 1971, a watered down version of the traditional gold standard served as the world's monetary regime. Under such a regime only the U.S. dollar was backed by gold. In the post-World War II period, such an arrangement made sense since the United States held more than three-quarters of the world gold supply. In the 1960s and 1970s, government expenditures in the country increased significantly owing to various domestic and foreign programs. Ultimately these expenditures, for the most part, deficit financed by increases in the supply of dollars, led to inflation and forced the United States and the rest of the world off the gold standard in 1971 and on to the fiat standard.[1]

It is called the "fiat standard" owing to the fact that it is money created by government fiat and backed only by the promises of respective countries' monetary authorities to protect the value of their currencies. It is precisely the value of those promises and their ability to provide an anchor to the long-term price level that casts in doubt the fiat monetary regime. Past attempts to operate such a regime have not been successful.

* G. Macesich, Ph.D., Professor Emeritus of Economics, The Florida State University, Tallahassee, Florida. Paper recieved in January 2008.

Skeptics point to the staggering amount of debt that the United States, European countries, Japan, and other industrial countries have been running up. Indeed, Laurence Kotlikoff, an American economist, estimates the present value of the United States government's future obligations, including pensions and health care benefits, to be $45 trillion. European governments are not much better in managing their obligations. And Japan, for instance in 2005, registered a gross national debt of more than 160 percent of its Gross Domestic Product.

Thus far the respective monetary authorities and central banks have managed a satisfactory operation of the fiat monetary regime, thanks in good part to the independence granted them by their politicians and governments. If and when some or all governments find themselves crushed by debt so-called "independence" of their central banks and monetary authorities can be easily removed. What then is the worth of their fiat money based as it is on a political promise to pay? Understandably the skeptics may turn out to be correct when they cast doubt on a fiat monetary regime.

A New World Money?

There is now general agreement that the euro is a major world currency next to the dollar and yen. To be sure the dollar's dominant position in international trade and finance has given the United States a number of benefits including seigniorage from dollars held abroad, liquidity discount on government debt, and the ability to finance America's current account deficits in dollars.

The attractiveness of such benefits for Europe underscores the importance of the euro. There are however problems in attaining these benefits. Robert Mundell, for instance, draws on the theory of optimal currency areas to emphasize a number of problems, some of which Europe has solved and others, which continue to be a challenge.[2]

In effect, the optimal area for a common currency to be used depends on the degree to which real resources can be transferred within it in response to shocks. According to Mundell, the issue depends on the mobility of capital and labor. If these factors can move easily from a depressed area within the common currency zone to a more prosperous one, the zone should continue to use a common currency. If not, the depressed area should be allowed to depreciate its local currency relative to the rest of the zone. This would stimulate local demand for its idle capital and labor and thus make its products cheaper relative to the rest of the zone. At the same time imports from the rest of the zone would be more expensive thereby decreasing local demand for output from the rest of the zone. The net effect would be to help spread the effects of the shock to the local area's trading partners.

Another variation to the theme of optimal currency areas is provided by Ronald McKinnon who argues that if the local area is already open to trade with the rest of the currency zone, then local capital and labor would realize that devaluation had reduced their real returns and wages. They would raise their nominal rates of return and wages enough to cancel out the effects of devaluation. Accordingly, the size of the optimum currency area depends on the intensity of trade within it.

Of course a third way to soften shocks on the local area is by fiscal transfers within the common currency zone. This is done, for instance, in the United States and in most industrial countries. The EU does appear to have the desire to do the same though it remains to be seen whether there is the political will to go along with the significant fiscal transfers required in many areas of EU and potential member countries.

Many observers agree that while the EU has made progress both in terms of mobility of labor and capital and in terms of fiscal transfers, much remains to be done. The European labor markets are more rigid than those in the United States. Shocks caused by the currency union will very likely last a long time owing to the fact that wages are slow to adjust. All of this is further confirmed by the high rates of unemployment in Europe. The conclusion is that only in terms of openness and intensity of trade relations do EU countries qualify as comprising an optimum currency area. It is likely that smaller countries within the EU will benefit by a common currency with their trading partners, and small countries outside the EU that find their trade carried out predominantly with one or more large countries within the EU would do well to join in the common currency.

For all its attractiveness to many people, the euro is still the only international currency in history that does not have a strong central state or a metallic backing. The experiment flies in the face of historical experience that political union precedes economic union and a single currency. The EU apparently hopes to be the exception. At the center of this experiment is the European Central Bank (ECB) modeled after the German central bank and charged with maintaining a non-inflationary monetary policy. The ECB is analogous to the Federal Reserve Board of Governors, while Europe's national central banks became counterparts to the regional banks in the United States.

To judge from the evidence, the Europeans great wish that a strong euro will rival the dollar as an international reserve currency, has been realized in good measure. The EU is now one of the world's largest trading regions and its currency is one of the world's most important.

The European visionaries great desire was that a strong EU-wide currency will rival the dollar as an international reserve currency helping to make Europe an economic giant in the global economy. This, in turn, they envision will lead to the formulation of a political and security union in Europe. One can only wish them well and success.

For a heavily taxed and regulated EU with social welfare problems, Europe has its challenges that a single currency may not be able to address effectively. Countries still in control of most economic and social policies will continue to grow at different rates. If they are unable to alter exchange rates, unemployment and eventually declining wage rates will become the necessary adjustment means. It should come as no surprise that political reaction will likely occur as a result. As a result progress toward political union will not be easy.

The international implication for a euro-dollar has been understood by various observers. If confidence in the ECB is established there may well be significant diversification from the dollar to the euro. Some countries may well opt to keep more of their reserves in euros. If the European venture is successful it may provoke the formation of an Asian monetary union pushed by Japan, China, and other Asian countries. The world will have alternative assets to the dollar and euro to use in international reserves as a by-product. In itself, this is an attractive option to other countries if any one of the three leading currencies lean toward instability.

The European Central Bank (ECB) plays a singularly critical role in the EU. Although designed to be independent from political pressure, the ECB is having a tough time guarding its status from European politicians pushing their own views of interest rates and related issues. It is thus not surprising that not everyone agrees that central bank independence is a good thing. Doubters suggest that the supposed correlation between central bank independence and low inflation is suspect. Even if correct, the “credibility” issue that goes with the argument for independence may not hold. It is difficult, so the argument goes, to objectively define “independence.” Sometimes one or another definition is used. Other studies do find such a correlation.

The received central bank argument that independence increases credibility and credibility of getting inflation down may not be correct. Evidence suggests that central bank independence fails to reduce the cost of disinflation and may actually increase it. Indeed, in countries with relatively independent central banks, the record suggests that this in fact is the case. Again, the problem may be in the proper definition of “independence.” Of course other possibilities including independence and low inflation are jointly the result of some third factor such as society’s willingness to tolerate high inflation. Also, it may well be that central bankers are less sensitive to unemployment than politicians. In any event, the ECB is designed to be the most “independent” in the world and in time the EU and the rest of the world can judge the results.

Some members of the EU expect great things from a single currency. Others are not sure what the future may bring. Germany hopes a single currency will reduce European tensions. Spain looks toward a reduction in regional economic disparity. France hopes that the euro will become an important counterweight to the dollar. Britain tends to look at the euro as a threat to its own exceptionalism. Italy apparently sees the euro as a means for bringing about order in its own monetary and financial affairs.

A single currency does have an important benefit particularly in improving the transparency and efficiency of a single European market. On this score, individuals are better able to judge the value of investments. It is not clear that a single European currency and monetary union before a true political union will do much for real or imagined problems and insecurities that many Europeans have.

It also may well be that in the final analysis the European monetary union is political. One senses that many European leaders view monetary union as desirable because it will contribute to a European political union. If the European monetary union and the euro fail, European political unions may indeed be set back with little future prospects.

If Europe and its euro are to achieve the many goals set, it is essential to open up trade and capital markets to non-Europeans as well as non-members. Until such an opening is fully, or in good measure, achieved, the role of the euro as an international reserve currency—and of the European Union as an economic power will be limited. In fact, it may be tempting for the Europeans to mimic the "benign neglect" they have often accused Americans of following for the dollar. Some observers hold that with the euro and dollar concentrating exclusively on domestic concerns, world instability might increase. This is a lesson that should have been learned from the 1930s when the dollar and pound were two semi-dominant currencies.

A Return to Gold?

Skeptics of both the dollar and euro call for monetary reform. The usual call is for a monetary regime anchored by a dollar convertible into gold. These calls repeatedly stress the dissatisfaction with the existing fiat monetary regime.

Critics of the fiat monetary regime note in particular that this regime fails to deal properly with the problem of defining a monetary standard of measurement. There is the question of the global unit of account for signaling value across borders. Capital flows are in jeopardy thanks in good measure to the absence of a sound monetary regime. It is little wonder that some emerging countries, in the view of critics, are opting to withdraw from the global economy and abandon the free market rather than be victimized by monetary chaos. The crisis in the closing years of the twentieth and into the twenty-first centuries is largely the result of a fiat monetary regime that has broken down.

The way to put matters right, in the view of these critics, is to adopt a global gold standard. Unlike the failed Bretton Woods regime, which was a gold exchange standard whereby only the United States was required to convert the dollar into gold at a fixed rate and only foreign central banks were allowed the privilege of redemption, their proposal is for a return to the classic international gold standard. In effect, countries would once again be required to maintain convertibility into gold of their currencies and permit every individual the right to redeem their cash balances into gold.

These proposals are straightforward. Under the gold standard (or specie standard) a country is committed to keeping the price of gold fixed and is willing to convert its money into gold at a fixed price. In such a regime, the country's monetary authorities must maintain gold reserves sufficient for the volume of sales that may be necessary from time to time to peg the price of gold successfully. Such authorities would be required to sell gold whenever the price of gold tended to rise. If the monetary authorities were to pursue a discretionary policy that resulted in inflation, the prices of all goods and services, including gold, would rise. In such an event, the rise in the price of gold would necessitate gold sales by the monetary authorities which would eventually deplete the country's gold reserve. As a result, the monetary authorities of a country on a gold standard cannot carry out a serious discretionary monetary policy.

The advantage of a gold standard is its tendency toward a predictable long-run value of a gold standard country's money. In effect, the country's monetary authorities assure that its money and gold are perfect substitutes. The aggregate price level in such a country is thus inversely related to the value of gold relative to other goods and services. If gold falls in value because the price level has risen, there is a disincentive to mine more of it.

If there are exogenous shocks, such as discoveries of new gold, unpredictable swings in the value of money can occur. A number of examples are readily available from monetary history, e.g., California and Alaska gold discoveries in the nineteenth century.

A study by Anna J. Schwartz compares the economy under the historical gold standard with the experience of the United States and United Kingdom following World War II.[3] The study suggests that during the era of the gold standard, substantially lower rates of inflation were registered than in the period following World War II. There was also greater variability of real per capita increase in income.

Schwartz also notes that a shift to a true gold standard would be a shift to a monetary regime that would find few supporters. Moreover, even if the United States, for instance, adopted a gold standard monetary regime, it is not certain that prices would be more predictable than under alternative regimes (Schwartz discusses why in the aforementioned study.)

The gold standard monetary regime was abandoned when conversion of domestic money into gold ceased. In the post-World War II period, fixed exchange rates under the Bretton Woods system evolved into adjustable pegged exchange rates. When confidence in American gold-dollar convertibility and its role as the dominant reserve currency eroded in the 1970s, the Bretton Woods system, in effect, collapsed. Gold ceased to play a monetary role.

Thereafter, the world embarked on a discretionary fiat monetary regime with "managed flexible rates." The results have not been altogether satisfactory. Indeed, in some countries the results have been high and variable inflation and interest rates, low productivity growth, and unstable exchange rates, prompting discussion of returning to the gold standard and fixed exchange rates as a way of improving performance.[4]

Any discussion of a return to a gold standard must confront the reluctance of countries to give up discretionary authority over monetary affairs. This is also a problem for a fiat money regime governed by a rule for the growth of the money supply.[5] The failure, moreover, of the U.S. Gold Commission in 1982 to endorse a larger role for gold in contemporary monetary affairs puts to rest its serious consideration.[6] Nevertheless, the gold standard regime continues its appeal for many people—witness the continued price quotation for gold on the world's stock exchanges.

NOTES

This paper draws on my current and past research including George Macesich, *Political Economy of Money: Emerging Fiat Monetary Regime* (Westport, Connecticut and London: Praeger Publishers, 1999); George Macesich, *Issues in Money and Banking* (Westport, Connecticut and London): Praeger Publishers, 2000); George Macesich, *Money and Monetary Regimes* (Westport, Connecticut and London: Praeger Publishers, 2002).

[1] See, for instance, Milton Friedman *Money Mischief: Episodes in Monetary History* (San Diego, New York, London: A Harvest Book Harcourt Brace and Company, 1994) especially chapter 10, "Monetary Policy in a Fiat World."

[2] See Robert A. Mundell, "A Theory of Optimal Currency Areas," *American Economic Review*, September 1961, pp. 657-664; and Ronald I. McKinnon, "Optimum Currency Areas," *American Economic Review*, September 1963, pp. 717-725.

[3] See Anna J. Schwartz, "Alternative Monetary Regimes: The Gold Standard," in *Alternative Monetary Regimes*, ed. Colin D. Campbell and William R. Dougan (Baltimore and London: The Johns Hopkins University Press, 1986), pp. 44-72, Anna J. Schwartz, "Introduction," in *A Retrospective of the Classical Standard, 1821-1931*, ed. Michael D. Bordo and Anna J. Schwartz (Chicago: University of Chicago Press, 1984), pp. 1-20.

[4] Anna J. Schwartz, "Alternative Monetary Regimes: The Gold Standard," *opcit.*, pp. 69-71.

[5] *Ibid.*

[6] *Ibid.*