Currencies: The Rules of the Game applied to Germany and Greece

Keith Rankin, 2 July 2015

This week's financial default of Greece's government reminds us that we should understand how exchange rate systems are meant to work, and why, more often than not, they don't work for both technical and political reasons.

"The Rules of the Game" is an expression that relates particularly to the 'gold standard' era of the decades before World War 1, and the late 1920s. The fixed exchange rate gold-standard system had been postulated by Scottish philosopher David Hume – in the 1750s – as a fully automatic system of correcting financial imbalances (understood as trade imbalances) between countries. The key idea was that the amount of money a country had was a simple multiple of the amount of coinable gold (and/or silver) held by a country's banks and Treasury. A country with trade surpluses, it was assumed, would experience a surfeit of money and hence inflation. A country with trade deficits, on the other hand, would experience a shortage of money and hence deflation. The inflation would erode the trade surpluses, and the deflation would correct the trade deficits.

The theory does not work for two reasons. The first is that the presumed direct link between money and prices does not really exist. The second is that the mechanism was spiked by all the governing authorities for two separate reasons, one applying to deficit countries and the other applying to surplus countries.

The Eurozone was meant to work just like this. It's a fixed currency zone, and did indeed operate in 2001-08 as if it was a self-contained multi-national economy, with balanced trade with the rest of the world. So what should have happened between 2001 and 2008?

Greece and other mainly southern countries came to run trade deficits, and Germany and other mainly northern countries came to run trade surpluses. If the Euro mechanism had worked in an automatic way, Greece would have experienced resulting deflation, and Germany would have experienced resulting inflation. The result of these opposing flations should have meant a trade correction, with Greece exporting more and Germany exporting less, and the Euro financial crisis would never have happened.

The policymakers in Europe might be naïve, but are not that naïve. In the 1920s (and well before), central bankers understood that they had to operate the mechanism manually. (Instead of automatic adjustment, surplus countries lent to deficit countries, disabling the mechanism.) This meant that the central banks had to apply the 'rules of the game', from the manual. The idea was that, if this was the 1920s, the Greek Reserve Bank would run a restrictive deflationary monetary policy, and the German Reserve Bank would run a loose inflationary policy. The resulting deflation and inflation, it was believed, would correct the trade imbalances.

The Eurozone was not well set up for this, because there was a European Central Bank that could hardly apply opposing monetary policies simultaneously to different Euro national economies. Thus it was left to the national governments to try to achieve opposing flations through diametrically opposed fiscal policies. Hence the austerity imposed on Greece's government. That's the rule of this uniquely twenty-first century variant of the fixed-currency game.

The immediate and obvious problem, however, is that the rules apply equally to the surplus countries, of which Germany is the most important. By the set of rules applied to Greece, Germany was required to do the opposite. Germany was required to run an overtly inflationary policy, to counter the deflationary policy imposed on Greece. Greece followed the rules for five long years. But Germany did not even contemplate following the counter-austerity rules that just might have made the Euro-currency system work.

Why the reluctance to follow the rules? There are two reasons, both of which are well known to macroeconomic historians.

The first reason is that deflation is an ugly beast – as the Greek people have discovered – in that it aggravates rather than heals debt problems. Debts inflate when prices deflate. Unemployment becomes

rampant as a result of deflation-induced private sector austerity as well as public sector austerity, creating a debt-deflationary spiral, converting recession into depression.

The second reason is that governments have almost never pursued inflationary policies when under these circumstances. (Japan and Switzerland pursue ineffective inflationary policies today, but under quite different political circumstances to Germany.) There are two main reasons. First, many countries like running trade surpluses, even though the long-run logic of trade surpluses is that you are effectively giving your exports away. These countries simply see persistent trade surpluses as a measure of national economic success, and not as a cause of multi-national systemic instability.

These beliefs that countries should run indefinite trade surpluses rather than pursue balanced trade are given a name: 'mercantilism'. And this name describes the preferred financial policies (for centuries) in many northern European and Asian countries. Anyway, it is because of these strong mercantilist beliefs that Germany could not contemplate running any 'uncompetitiveness' policy designed to create a German trade deficit. Further, inflation is a process that exonerates debt and depreciates middle class saving. Therefore, because German culture emphasises the virtue of saving and the sinfulness of debt, any policy that is intended to achieve inflation, no matter how appropriate that policy might be, is just one step too far for (especially) Lutheran and Calvinist sensibilities.

The rules of the game do not work in the technical sense that monetary conditions do not determine inflation or deflation, as supposed, and unbalanced trade is not a simple consequence of national price levels. But, if they are to be applied, they need to apply even-handedly to all the players of the game. Germany is required to pursue counter-austerity policies at least as much as Greece is required to pursue austerity policies. Further, the rules of the game do work if applied with intuition and imagination. All countries benefit when their people and governments act to prevent the long-run accumulation of both trade deficits and trade surpluses. Indeed the emergence in Europe of negative interest rates is the most hopeful sign of this happening.

Germany has an out, because the Euro system is not a global monetary system, unlike the gold standards of 90 and 110 years ago. This out is for the Eurozone as a whole to become a mercantilist state (a Greater Germany), running indefinite trade surpluses with the rest of the world, in direct competition with China as an exporting state. It means that the Anglo-Latin-African world (rest of the world except Asia) must run ongoing trade deficits, and end up, eventually, something like Greece today.

The rest of the world has one major protection, however, the system of floating exchange rates. This is also a game with its own sets of rules; rules that are routinely broken by the Reserve Banks (central banks) of the world. In this game, countries like New Zealand with persistent external deficits are required to follow monetary policies that will facilitate a depreciation of their currencies. Under these rules, economies with persistent surpluses like China and Singapore and Saudi Arabia and now the Eurozone are required to run monetary policies that will facilitate an exchange rate appreciation. (And internal welfare transfers for less fruitful provinces such as Sichuan, Greece and East Germany.) These are financially balancing policies.

The biggest problem here is that most central banks have been asked to play a different game by their governments; the game of keeping inflation at about two percent. There's a direct conflict between competing monetary policy objectives. But, even if there was no conflict, the mercantilist countries, for whom the priority is 'making money' rather than 'balanced trade', would still not follow the rules.

The IMF (International Monetary Fund) itself discusses, on its website, "the broader consequences for the international financial system when some countries run large and persistent current account deficits and others accumulate big surpluses".

The games political economists believed in are often nice in conception but flawed in practice. If we are going to expect the rules of such games to be followed by some, and especially with the intensity that Greece is being forced to follow the deflation rule, then the rules of the game should be followed by all. The principle of balance is an important one. The rules to achieve balance can be adjusted where necessary, rather than ignored by some and imposed rigidly on others.