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The Curse of Being a Reserve Currency

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The European monetary system is breaking down for the same reason the gold-exchange standard in 1931 and the Bretton Woods system in 1971 collapsed: the use of domestic currencies as international reserves.

Germany inhabits within Europe today roughly the same position the U.S. did in the world of the 1950s. In the 1950s there was a lot of hand-wringing about a supposedly structural "dollar shortage." But this dollar shortage was essentially a superabundance of European currencies. Once European countries curbed the issuing of money to cover budget deficits and "hardened" their international payments in 1958, the dollar shortage turned overnight into a dollar glut.

Now theories are put forward asserting a structural shortage of deutsche marks. Some say that stable exchange rates are not possible in Europe because of the task of rebuilding eastern Germany. But they do not explain why the much larger task of rebuilding West Germany after World War II was accomplished under stable exchange rates.

Some also argue that Europe's being tied to the mark during reunification imposed "deflation" on other countries. But they do not explain how countries with inflation rates of 4% to 6% a year, like Italy and Britain, were suffering deflation. Still others argue that the European monetary system somehow requires a perverse convergence of interest rates but not inflation rates. They do not explain why, say, Italy's interest rates are seldom less than three percentage points higher than Germany's.

The Weakest Currencies

Just as with the dollar shortage of the 1950s, the apparent dearth of marks is partly a plethora of pounds (and lira and francs). The balance sheets of Europe's central banks reveal that the weakest currencies are almost invariably those whose central banks "monetize" — that is, purchase — government debt on a large scale: the lira, the pound, the peseta and even, lately, the French franc. By contrast, the mark and those currencies that have had no problem remaining tied to the mark — for example, the Belgian franc and the Dutch guilder — have central banks that don't monetize government debt in significant amounts.

Yet, also like the U.S. under Bretton Woods, Germany is still suffering from inflation caused by the rapid recent expansion of its reserve currency role. (U.S. inflation has been much higher since the

end of dollar-gold convertibility, but U.S. consumer and producer prices both doubled under Bretton Woods.)

To describe the problem simply: For other countries to increase their foreign exchange reserves, the reserve currency country must purchase more wealth abroad than it sells — i.e., run a balance-of-payments deficit. This demand for wealth without a matching supply causes inflation of either goods or securities prices — usually both in succession.

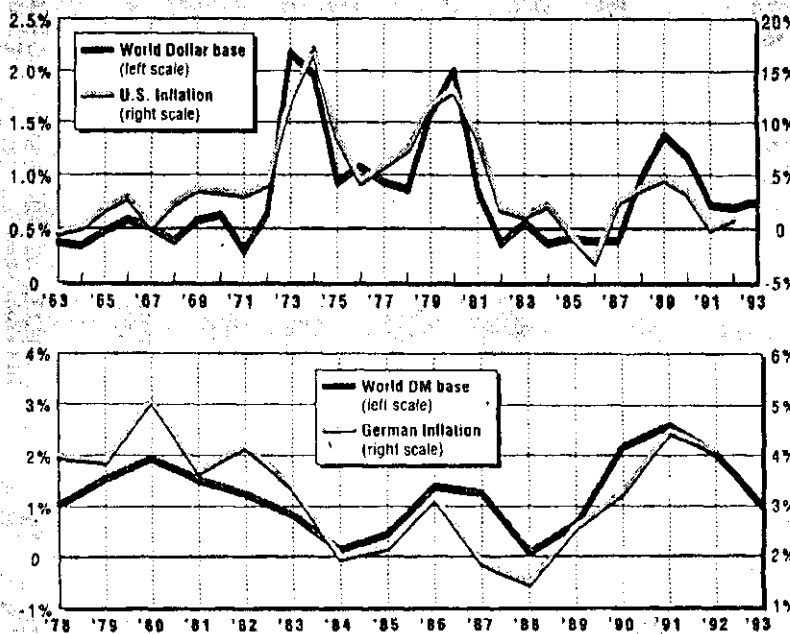
Any other country would be forced to correct such an imbalance, or else lose all of its international reserves and devalue. But the reserve currency country's loss of reserves takes the form of IOUs to foreign central banks, so its net reserves can be negative without any absolute limit. The inflationary pressure is therefore unchecked, and it quickly spreads to other countries through the reserve currency country's purchases of foreign wealth. Instead of making repeated small corrections to keep its prices, costs and payments in balance with the rest of the world, the reserve currency country piles up an ever-larger imbalance.

When the reserve currency country does apply the monetary brakes, however, the result can be a deflation potentially as large as the previous inflation (as from 1928 to 1932, when virtually all the world's official foreign exchange reserves were wiped out, and prices declined to pre-World War I levels). The only alternative is a large devaluation of the reserve currency (Britain in 1931, 1949 and 1967, and the U.S. in the 1970s and late 1980s). The danger is magnified because central banks do not track the actual inflationary or deflationary forces at work. With reserve currencies, domestic money supply growth alone gives false signals, because the inflationary or deflationary potential also includes any change in holdings of the reserve currency by foreign central banks.

Using a similar analysis, Jacques Rueff correctly warned of the collapse of the 1920s gold-exchange standard. And in the 1960s, Mr. Rueff and Robert Triffin accurately predicted the breakdown of the gold-dollar Bretton Woods system. In the past few years, we have extended the analysis to show that the waves of worldwide inflation since Bretton Woods are also

First the Dollar, then the DM Too

In the 1960s, 1970s and 1980s, dollar inflation shadowed the growth of the World Dollar Base. After the DM became a reserve currency in the early 1980s, DM inflation shadowed the growth of the world DM base. Figures for dollar and DM bases are calculated as a percentage of GNP and lagged by two years to show the correspondence to inflation.



Source: authors

largely due to the dollar's continued status as the world's chief reserve currency. For over half a century, major changes in U.S. inflation—including the 1989-91 episode—have been preceded by commensurate changes in what our firm has called the "World Dollar Base." The World Dollar Base consists of U.S. currency and bank reserves plus foreign official dollar reserves.

The same process is now at work in Germany, thanks to the mark's role as the regional reserve currency of Europe. According to the International Monetary Fund, foreign central banks held about DM200 billion at the end of 1991 — more than \$125 billion. The rapid expansion of foreign mark reserves accompanied a tremendous simultaneous expansion of credit in the German banking system, which under Europe's stable exchange rate system would otherwise have exhausted Germany's international reserves.

Comprehensive data for mark reserves do not go as far back as for dollar and sterling reserves. But they strongly indicate that what we call the World Deutsche Mark Base — the sum of German currency and bank reserves plus foreign mark reserves — has about the same impact on mark inflation as the World Dollar Base has on dollar inflation.

For the U.S., we chose the producer price index to measure inflation. For Germany, we used the gross national product index. The reason for the difference is that the World Dollar Base affects commodity inflation world-wide, because the commodity markets are conducted in dollars, while the World Deutsche Mark Base mostly affects the price of German output. Germany imports some inflation from the dollar-based commodity markets, which is not fully offset by mark appreciation against the dollar. But Germany's inflation is now higher than in the U.S. — not because of German reunification, but because reunification has been partly financed through the mark's reserve currency status.

To curb the inflation, the Bundesbank has tried to bring about, all at once, a correction of inflationary pressures that had built up for years. The adjustment has been dramatic. We know from published statistics that between the end of 1991 and

September 1992, Germany's net reserve position increased by a staggering DM94 billion (about \$60 billion) — probably much more. Yet the essence of the reserve currency system is that the net reserve increases of other countries depend on the net reserve losses and balance-of-payments deficits of the reserve currency country. Thus the \$60 billion increase in German net reserves in nine months was necessarily mirrored by equal net reserve losses — and balance-of-payments deficits — of other countries. This put impossible strains on the exchange rate mechanism.

The fault does not lie with the Bundesbank, but with the reserve currency system, which was chosen by the other central banks. Faced with a domestic recession after its earlier boom, the Bundesbank has begun to lower interest rates. Continuing to do so would also allow other European countries to cut interest rates and rebuild their foreign exchange reserves. But a renewed increase in mark reserves would renew the German balance-of-payments deficit and restart domestic German inflation. There is no way, within the current system, to escape this dilemma. Either Germany must get used to chronic inflation — punctuated by Draconian yet ultimately futile interest-rate hikes to bring it under control — or else the mark must stop being a reserve currency.

Some will say that all this is a good argument for a European central bank. The proposed Federal Reserve System of Europe would forbid the monetization of national budget deficits and end the reserve currency role of national currencies like the mark. But have proponents of a European central bank thought far enough? Since a new European currency would be used as a reserve currency by other countries, all of Europe would suffer the same reserve-currency inflation we have seen in the U.S. and now in Germany. This would be true even if the European central bank did not compound the problem by monetizing the deficits of a Federal European government.

Moreover, Europe will still import some commodity inflation from the dollar area as long as the dollar's world-wide reserve currency role continues. And there is another world-wide problem. With infla-

tion down for now, or coming down, as the result of past monetary squeezing, how do we deal with the burden of debt built up during the period of inflation? Trying to "stimulate" the economy with still more debt or more inflation would be self-defeating, because it would require a still larger adjustment later on. What is needed is to make the world financial system more liquid — to increase the ratio of money to debt — without triggering significant inflation or deflation.

The Most Effective Solution

An effective solution would need to cover a number of details, but the essential condition is clear: International money must be one country's asset without being another country's liability. Central banks already have such an asset: gold. The simplest and most effective solution would be one proposed but not adopted in the 1920s and 1960s. Central banks should revalue their gold reserves from the still-official price of \$42.22 an ounce, and use the resulting increase in monetary reserves — which would be augmented by private dishoarding and new gold production — to replace foreign exchange as official international reserves. (Some foreign currency reserves could be retired by swaps of offsetting claims or amortized with government-to-government debt.)

The two requirements of a modern international gold standard — ending the monetization of government debt and reserve currencies — are the same as for any country joining the proposed European currency union. But only such a reform, by sharply increasing the net reserves of the world as a whole, would also sharply lower interest rates, stimulate investment, increase employment, and facilitate the repayment of existing debt — without engendering significant inflation or deflation. Absent such a plan it's clear that, while improvements can be made in individual countries, there will be no lasting economic stability in Europe — or anywhere else — as long as the international monetary system is based on reserve currencies.

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