

Depreciation Within A Currency Union

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When real wages in an economy no longer reflect productivity, normally devaluations of the currency restore international price-competitiveness via imported inflation that reduces real wages. This instrument is not available in a currency union. The job has to be done by reductions in nominal wages that are felt as more severe pain than inflation-induced reductions in real wages. To ease this pain a special currency split is proposed: ACT takes over the function as a medium of exchange i.e. for flows but not for stocks. Thus ACT can devalue while all stocks are not devaluated. When international price-competitiveness is restored and no further devaluation is needed, the currency split ends. (JEL: E58, E69, F13, F33, F34, F41, F42, G15)

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1. Introduction

There are a lot of reasons why economies can be endangered to fail: poor economic policy and external shocks, to name just two prominent ones. In 1944 the creators of the Bretton Woods system were aware of this and founded some institutions that not only survived the breakdown of the system in 1973 but even gained more importance since. Among these the International Monetary Fund (IMF) is the most prominent. Whenever one of its members got into trouble (usually too high to sustain debt) the IMF offered its help to get the economy back on track.

The core of the usual deal is money against an economic program for recreation that is supervised by the IMF. An important part of this program in most cases is a devaluation of the currency that helps the economy to become more competitive. But what to do, if the ailing economy is part of a currency union, which other economies are in sane condition? This problem arose especially when some small members of the Euro came into trouble in the aftermath of the financial crisis and the Great Recession 2007 – 2009.

The core intention of this paper is to introduce an unconventional idea to enable a currency-devaluation even within a currency union. First¹, we sketch the traditional programs for highly indebted economies (section 2) and alternative measures to improve the competitiveness of an ailing economy (section 3). Section 4 is devoted to our unconventional proposal: the Auxiliary Currency for Transactions (ACT). Concluding remarks close the paper.

2. Traditional programs for highly indebted economies

Getting into trouble usually means that the economy is highly indebted and that it is no longer able to raise money abroad to finance actual deficits and/or serve its foreign debt. This is signalled by rating agencies (most prominent are Standard & Poors, Moody's and Fitch) which check the credit worthiness of companies and countries. The higher the rating, the lower the interest-rates a country has to pay for its bonds. But if the rating is too low, the country gets into trouble.

The underlying reason usually is, that compared with other countries, real wages are too high in relation to productivity. As long as a country is on its own, the currency will depreciate (in a flex-rate regime) or be depreciated (in a fix-rate regime). In history (1973 – 1995) Italy is a prominent example for such developments.

In a currency union problems arise, when the central bank holds down inflation within the whole currency union, but real wages in one country rise stronger than its workers productivity. Its competitiveness is reduced, imports rise and exports fall. At last the current account deficit gets unsustainable. If in addition expansive fiscal policy tries to prop up the economy, the public deficit will rise along and the end may be an unsustainable twin deficit.

The common way to rescue is to knock on the doors of the IMF that offers some kind of credit in exchange for the implementation of a program it develops to put the economy back on track. Usually the credit is divided into tranches and before the next tranche is disbursed a team of the IMF checks whether the agreed-on measures and intermediate targets have been met.

¹ Scientific papers normally review the relevant literature. To do so, this and the necessary references (which the interested reader knows anyway) would consume more space than the core-text of the paper – according to the economic principle that is not efficient.

As the intention of the IMF is to bring back the economy on a sustainable growth-path (not just short-run emergency-help), the core of the offered program usually are measures to get real wages and productivity in line. Measures are taken to improve the flexibility of goods- and labour-markets and to reduce the state's claim. These structural changes aim at stimulating growth in productivity, but take time to have an effect in the sense that the economy becomes more internationally competitive.

An effective additional measure targeting to improve the short-run price-competitiveness is a devaluation of the currency. Exports get cheaper abroad and imports more expensive. Rising import-prices feed into higher producer-prices and consumer-prices and thus raise inflation. Real wages decrease and employment rises.

The improvement of the price-competitiveness makes the country's exports rise and imports fall so that the current account improves and an export-induced multiplier supports GDP-growth.

3. What to do if you cannot devalue the currency?

If you are a member in a currency union, you cannot devalue the currency unions' currency (CUC) to regain price-competitiveness. So you have to look for alternatives. The traditional instruments widely discussed are internal devaluation and fiscal devaluation.

3.1. Internal devaluation

Most production-costs are similar for all currency union members: raw materials, interest rates and imports from third countries. The only substantial component of costs that can be changed within a country is labour costs. To inflate by rises in the nominal wage does not reduce real wages. This is not the way out.

An alternative way to get real wages in line with productivity is the reduction of nominal wages or at least to let nominal wages rise more slowly than productivity. Normally it hits people much more when they see their nominal wages cut than when nominal wages are constant or even rise slowly and inflation does the job to cut real wages. This is felt much less harming. Thus, the reduction of nominal wages is the very stony way for the people.

3.2. Fiscal devaluation

Another possibility discussed, is a so-called fiscal devaluation. In this case the job is done by additional taxes on imports and tax-credits on exports. This helps exports directly (makes them cheaper abroad) and triggers inflation at home via rising import-prices that reduces real wages. So the long-run effect of improving price-competitiveness is reached.

But this strategy has strong problems. The most important one is, that the process leading to a currency union usually starts with a customs union and the creation of internal markets at least for goods. Typically there are no tariffs within the union, but at best with third countries (if any at all in times of multilateral agreements on tariffs and trade). Such a back-step of reintroducing customs within the union is unacceptable; exactly like selective tariffs with third countries (the quantitative effect of these would probably be minor, anyway).

4. An unconventional proposal: ACT

As traditional programs are not (completely) available and alternative measures do the job only with strongly felt harm to the people, innovative ideas are urgently needed. It is not the economists' task to educate people by punishing them for the mistakes their former governments made, but to show governments how to ease the pain for the people during necessary reconstruction processes.

The idea² is to make some kind of depreciation possible, without leaving the currency union. It starts with the functions of money: money is a medium of exchange, a store of value and a unit of account. The basic idea of ACT is to split these functions. This split is done using the distinction of stocks and flows. With the introduction of ACT all flows have to be denominated in ACT, while all stocks are still denominated in CUC.

4.1. What is ACT?

ACT is an acronym for "Auxiliary Currency for Transactions". It is a currency that is introduced additionally to CUC. As it is assigned to flows, one function of money is completely transferred to it: its function as a medium of exchange, i.e. to make transactions. The function as a store of value stays at CUC and both have the function of unit of account.

To introduce ACT, normally a law will have to be enacted, that declares it the only legal tender. This means that all prices and wages have to be declared in ACT and no longer in CUC. All sales-contracts, wage-contracts etc. have to be transformed to ACT. All transactions are accounted in ACT. During transactions from one bank-account to another the sum is converted from CUC to ACT, because the sum paid is a flow, and reconverted to CUC on the target bank-account, because this is a stock.

In modern, computerized economies with widespread use of credit-cards, ec-cash and money-cards, there is no necessity to introduce coins and bank notes for ACT. People may store CUC cash, but they cannot withdraw additional CUC from their bank-accounts and expend it for transactions. As long as ACT prevails, all monetary transactions in the economy are entirely cashless.

Important is that ACT is convertible to all currencies in the exchange market. Exports and imports are flows, so at home they are denominated in ACT. ACT can depreciate against CUC and all other currencies in the world.

4.2. The role of the central bank

The central bank of the currency area is responsible for CUC and ACT. It still performs the monetary policy in the whole currency area. And it executes the exchange-rate policy for both, CUC and ACT. Usually CUC floats to all third-country currencies and so will ACT. When ACT depreciates, it does so against all other currencies, including CUC. The central bank has the power to intervene and steer the exchange rate of ACT according to its targets.

² This idea was first published in: Stark-Veltel, Gerd, Thinking about the Euro at Night (September 4, 2012). Available at SSRN: <https://ssrn.com/abstract=2141304> or <http://dx.doi.org/10.2139/ssrn.2141304>

4.3. How does ACT work?

With the introduction of ACT all prices have to be converted from CUC to ACT. Here there are two possibilities: (1) The conversion may be done one by one, so that nothing changes over night. But as time goes by, in the exchange market ACT will depreciate, import prices in ACT will rise and so will inflation, causing a further depreciation and so on. In this process real wages are reduced, and price-competitiveness improves. This process will end when real wages reflect the workers' productivity and the economy is internationally competitive again.

(2) As productivity is lower than in other countries, the initial value of ACT may not be set in parity with CUC, but lower according to the productivity disparities. This instantly helps local exporters on the world market. At home, consumers face higher prices and wages. Real wages are not affected instantly, but only when higher import prices feed through the economy. Again the process will end when real wages reflect the workers' productivity.

As all stocks are still denominated in CUC and not devaluated, undesired side-effects of inflation (apart from the intended reduction of real wages) are circumvented: there is no distortion in allocation, debtors do not win while creditors lose and there is no incentive to spend the money instead of saving it.

4.4. External effects

There are some desirable external effects of the cashless economy³. As all transactions are carried out via bank-accounts, the possibility to evade taxes related to transactions (e.g. value-added tax) is minimized. The same applies to criminal transactions (dealing with narcotics, weapons etc.), which usually involve the use of cash⁴.

4.5. When to start and when to end ACT

The introduction of ACT is an additional instrument for institutions like the IMF. As the motivation of ACT is to cushion the hardship of reconstruction programs for the people, it makes sense to start ACT at the beginning of that program. Take the example of Greece since 2010. ACT might have been useful to introduce when the so-called troika of IMF, European Central Bank and European Commission started to redevelop the Greek economy. Today, as the Greek people already has suffered most of the hardship and the economy starts to recover, ACT will have no use. But it can be added to the instrument-box for future cases.

The point of time to end ACT has come when the international price-competitiveness is restored. That will be indicated by a stable exchange-rat of ACT to CUC, i.e. when no further depreciation is necessary. To return to CUC the law that has enacted ACT has to be withdrawn.

5. Concluding remarks

Economists cannot test their new ideas in laboratories or sandboxes. Even simulations with empirical models have only limited use⁵ – especially when the use of new instruments is tried.

³ Agarwal and Kimball propose a dual currency not along the stock-flow line, but along the paper money – electronic money line. Their purpose is to eliminate the zero lower bound for interest rates.

⁴ Rogoff proposes the abolition of paper money to prevent tax evasion, corruption, terrorism, drug trade, human trafficking and underground economy.

⁵ See the Lucas-critique.

Only applying to reality in a proper situation can prove the usefulness of an instrument and reveal unforeseen side-effects.

When economies are on the edge of failure, normally measures that put pain on the people have to be taken. Some pain is felt more harshly than other. Reductions in nominal wages belong to this category. Reductions in real wages via inflation with the same effect on international price competitiveness usually are felt less harshly.

As it is not the economists' task to educate people by punishing them for the mistakes their former governments made, but to show governments how to ease the pain for the people during necessary reconstruction processes, sometimes innovative ideas are needed. This is the case in currency unions, when one country is on the edge of failure, while the others are in good condition (as Greece in 2010 in the Euro-area). Here a depreciation to cushion the pain of reducing real wages is not available.

The task of the proposed ACT is exactly this cushion of pain. As the pain felt is reduced, it may also speed up the reconstruction process, because perhaps some necessary measures may be taken less cautious. And nobody is against a reduced duration of pain.

References:

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