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A trio of trilemmas

The gold standard holds worrying lessons for the single currency

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EUROPEAN leaders have enjoyed a period of respite from financial turmoil since last summer. But the euro remains vulnerable. Portuguese bond yields soared this week as the ruling coalition fractured. Ireland's economy has contracted for three quarters in a row. A proper banking union is a long way off. The euro's fragility is underlined by a new study (http://www.nber.org/papers/w19112.pdf) by Michael Bordo of Rutgers University and Harold James of Princeton University. The two economic historians look at the flaws in another supposedly impregnable international monetary regime, the gold standard, and find reasons to fret about the single currency.

The parallels between the euro and the gold standard are not exact. The single currency is a monetary union with the European Central Bank (ECB) at its apex; the gold standard had no such institution. The euro floats against other currencies such as the dollar, and the ECB is obliged to maintain price stability rather than convertibility into gold. But for the 17 states that now share the single currency, it represents a new gold standard in that their exchange rates with each other are fixed.

That observation is not new, but the authors' analysis of the tensions that eventually scuppered the gold standard is fresh. Those tensions, they argue, emerged from a trio of "trilemmas", each a set of three choices of which any two options together are feasible but not all three. One of the three trilemmas is familiar to economists: the "impossible trinity" of fixed rates, free movement of capital and an independent monetary policy. This means that when currencies are locked and capital can flow freely, countries surrender their ability to conduct their own monetary policy. But Messrs Bordo and James reckon that countries in regimes like the euro and the gold standard may not just be sacrificing their ability to set interest rates; they may also be forsaking financial stability and even undermining democracy.

Start with monetary independence. By throwing away the key of exchange rates, countries must alter their relative domestic prices and wages when they become misaligned. In its heyday before the first world war the gold standard worked well. It generated pressures on both surplus and deficit countries when they respectively gained or lost competitiveness. States with surpluses acquired gold, pushing up the money supply, raising prices and making them less competitive. States with deficits lost gold, which caused the money supply to shrink, pushing prices down and sharpening their edge against rivals.

Unfortunately the euro resembles the flawed interwar version of the gold standard rather than the classical pre-war model. After the gold standard was restored in the 1920s, central banks in surplus states like France (which had rejoined it at an undervalued exchange rate) sterilised the monetary effects of gold inflows so that prices did not rise. That put all the pressure to adjust on countries like Britain, which rejoined the gold standard in 1925 at an overvalued rate. A similarly harsh deflationary process is now under way in peripheral euro-zone countries like Greece. Their adjustment would be much less draconian if the core states were prepared to tolerate considerably higher inflation than the euro-zone average. But Germany fiercely resists this.

The second of the authors' trilemmas is the incompatibility of fixed exchange rates and capital mobility with financial stability. When countries joined the gold standard, it bestowed a seal of approval that prompted a big influx of foreign money. That pumped up credit, driving an expansion of domestic banks that often ended in grief. Under the gold standard a strong state could support wobbly banks and investors; in pre-war Russia, for example, the central bank was called the "Red Cross of the bourse". But a weak state could easily forfeit investors' confidence, as happened to Argentina in its 1890 debt-and-banking crisis. That same story has been repeated in the brief history of the euro. Money cascaded into peripheral Europe, causing banking booms and housing bubbles. In the bust that followed, the task of recapitalising banks has caused both the Irish and Spanish states to buckle.

The third trilemma is the most worrying: the potential incompatibility of fixed exchange rates and free movement of capital with democracy. Germany was able to rejoin the gold standard after the first world war thanks to the confidence-boosting Dawes Plan in 1924 dealing with reparation payments. But the harsh fiscal medicine administered during the Depression in its effort to stay on gold contributed to the rise of the Nazis. Britain left gold in 1931, presaging the end of the gold standard, because the austerity it required had become unbearable.

Demos and the demos

The potential for a similar backlash against the economic and fiscal requirements of Europe's monetary union is clear. Although southern Europeans still want to keep the euro, not least because the cost of exit is harsher than that of leaving the gold standard, disenchantment grows. Italian voters said *basta* to austerity in February; Portugal's government is fraying in the face of public hostility to tax rises and spending cuts. Northern Europeans are also unhappy. Popular opposition to paying for euro-zone rescues constrains Angela Merkel, the German chancellor, from spelling out the sacrifices voters must make to sustain the euro.

None of this means an explosion is imminent. Political pressures can simmer for a long time before they boil over. The euro-zone recession has to end at some point. Progress towards institutional reform may accelerate after the German election in September. But if the long-term viability of the single currency is secured, the Europeans will be bucking history.

* "The European Crisis in the Context of the History of Previous Financial Crises", NBER Working Paper 19112, June 2013

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