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Notes on Paul Krugman's "Currencies and Crises"

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by

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Paul Krugman has the uncanny ability to take a complex, highly technical subject and lay out the issues fairly and insightfully for nonspecialists—as if they were reading *The New Yorker*, or even *The New York Times*. But make no mistake, his own theoretical contributions on the causes and consequences of currency crises predominate in the technical literature as well. His compendium, *Currencies and Crises* (1992), contains several by-now-classic academic references to the crisis problem.

Krugman's recent writings on his web site and in conference volumes keep abreast or ahead of attempts to analyze each new major crisis. Unfortunately, each new crisis poses its own analytical problems that differ somewhat from the earlier ones. Thus the literature now refers to first, second, and third generation models of currency crises. Who knows, perhaps Argentina's current plight will require a fourth!

Eschewing pure theory in his second Tanner lecture, Krugman's opening stanza of the "gold bug variations" neatly analyzes currency crises in historical perspective. For governments to manage national monies and exchange rates, he points out an interesting historical parallel between the 19th century fetish of "respectable" governments pegging their currencies to gold to the current fetish of governments in most developing countries pegging to the dollar—or at least tracking the dollar even when they claim to be floating. For the modern period, two authors, Guillermo Calvo and Carmen Reinhart, call this phenomenon of informal dollar pegging "fear of floating". Proponents of freely floating exchange rates (including many in the International Monetary Fund today although not 40 years ago) dislike both gold bugs and dollar bugs. After all, the IMF argues, by pegging you make yourself more vulnerable to attack. So why do it?

The Gold Bug Variations Replayed

The heyday of the gold standard lasted from the mid-19th century to August 1914 (the end of the 19th century!) This "high" gold standard unified the world's capital markets and trading mechanisms in a way not seen before or since. But it was also crisis

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prone. Because the supply of a metallic monetary base is relatively unyielding to short-run fluctuations increases in the demand for it, liquidity crises and periods of quite sharp deflation—usually accompanied by bank runs—punctuated the 19th century experience.

Nevertheless, the high gold standard provided most of the world with surprisingly robust long-term price-level *and* exchange-rate stability. In consequence, much of the huge flow of international lending—mainly through London—was fixed-interest long-term bond finance of 5, 10, to 20 years maturity. At that time, a debtor country was less vulnerable than is the case today to a complete currency collapse. After getting into some political or economic imbroglio, of which there were many, a 19th century debtor had more breathing room to rearrange its financial affairs without having to repay its foreign debts immediately.

Using a term coined by Ricardo Hausmann, Krugman laments today's problem of "original sin": long- and medium-term private bond markets are virtually absent in developing countries. Except for some marginal equities markets, finance today is bank-based and very short term—and international debts are denominated in somebody else's currency—usually dollars. Thus institutions in developing countries are highly vulnerable to exchange rate risk and term-structure mismatches so that their financial systems are often very fragile. So whatever the high gold standard's other faults, original sin was not one of them: long-term finance was readily available to countries perceived to be good credit risks. And because the finance was long term, this improved their credit standing: a virtuous circle.

During World War 1, all this changed. The belligerent countries suspended their gold parities and fought the war by borrowing from their central banks and inflating. Then, after the war, Winston Churchill got bad advice from the Bank of England and attempted to restore the gold standard by fixing the value of the pound at its pre-war gold parities. This proved disastrous. At the inflated postwar price levels prevailing in the 1920s, there was a shortage of (the gold) monetary base. This deflationary pressure threw Britain into depression and provoked the general strike of 1926, and ended Churchill's tenure as Chancellor of the Exchequer. More generally as Krugman notes, the European and American governments also held on to their gold parities for too long. By the 1930s, the deflation had become quite general and resulted in worldwide depression.

Thus, except for a few unrepentant gold bugs who sometimes write for *The Wall Street Journal* but certainly never for *The New York Times*, the gold standard in particular—and even pegged exchange rates in general—have a bad name. But the gold standard's having lost her name in the 1920s and 1930s should not lead one to forget her 19th century virtues: long term price-level stability common to participating countries, minimal long-term exchange risk, and a thriving long-term international bond market. Of course, these long-run virtues were inseparable. So in reforming international financial architecture (a pompous phrase I dislike as much as Paul does), can these lost long-term virtues be retrieved *without* the world again being in thrall to the barbarous relic?

Good Devaluations, Bad Devaluations

Not so long as a country retains the right to change unilaterally the value of its currency relative to those of its neighbors. Consider Krugman's distinction between "good" and "bad" devaluations.

We most nearly agree on what constitutes a bad devaluation. In tapping the international capital market, suppose a victim of original sin (OS) has little choice but to borrow at short term in some other country's currency—probably dollars. But our OS country has otherwise managed its fiscal and monetary affairs with some probity so its exchange rate is close to purchasing power parity with its trading partners and competitors. Then a (forced) devaluation is an unnecessary calamity. Domestic debtors with assets whose returns are in the domestic currency can no longer service their foreign currency (dollar) debts—and among other things, the domestic banking system likely will crash. Most importantly, neighboring countries can be affected adversely. For example, in the crisis of 1997-98, the East Asian debtor countries were suddenly forced into bad devaluations—bad from their individual points of view but also bad for their neighbors.

But when is a "good" devaluation really good? Krugman blesses the British for providing us with two nice textbook examples of good devaluations. The first was the devaluation of 1931 associated with Britain leaving the gold standard, but when Britain did not have external debts denominated in foreign currencies. The net effect was then favorable for Britain. Export competitiveness was greatly improved so that Britain avoided the worst of the great depression—at least it was no worse off than in the 1920s. Krugman opines (possibly correctly) that Britain thereby avoided some revolutionary upheaval that could have resulted in importing some nasty political or economic regime like those then sweeping continental Europe.

So how then can one possibly quibble with the British devaluation of 1931? The problem is spillover effects to neighboring countries. Britain is certainly an island, but not one onto itself. The British devaluation of 1931 was one of a chain of sometimes inadvertent "beggar-thy-neighbor" devaluations that contributed to the collapse of the world's trading mechanism in the 1930s. The chain probably began with the Poincaré devaluation and then stabilization of the French franc in 1926 that made France "too" competitive and drained gold from the beleaguered British. The 1931 British devaluation then worsened the competitive positions of the United States and Germany—and so quickened the onslaught of the great depression in these two countries. After the United States devalued and left the gold standard in 1933, the pressure returned full circle to haunt France who was now uncompetitive and finally forced off the gold standard with a devaluation in 1936.

So what is the lesson here? Sitting where they were with all the calamitous events around them, the British were probably correct in seeing the need to devalue in 1931—although it worsened the situation in other countries. However, this need to devalue unilaterally was just a manifestation of how badly flawed the international financial architecture had become. The industrial countries were so shaken by this interwar

experience of beggar-thy-neighbor devaluations that they resolved “never again”. Whence the political momentum to secure official exchange rate parities at Bretton Woods in 1945. For each member country, the International Monetary Fund became the collective arbiter of any change in its exchange rate. In the case of higher inflation, a member country could apply to the IMF for permission to devalue. In the 1950s and 1960s, substantial real depreciations and adverse neighborhood effects were successfully avoided.

Similarly, the devaluation of sterling against the D-Mark in 1992, and the parallel devaluations of the lire, peseta, escudo, drachma, and so on, were “good” in the sense of the second generation crisis models Krugman discusses. But, France (and even Germany) which did not devalue, was highly distressed and provided a lot political momentum to ensure that such changes could not happen again. Whence the birth of the euro and the end of good or bad devaluations among the highly integrated continental European countries.

The lesson here is that unilateral “good” or “bad” devaluations, or more gentle downward floats, that adversely impact a country’s neighbors reflect overall system failure. In an integrated world economy, the choice of an exchange rate regime—and thus the common price level—should not be left to an individual country. The spillover effects are so high that it should be a matter of collective choice. This point is obvious. But much of the academic literature on fixed versus floating exchange rates focuses on the circumstances facing just one country—as if it was the sovereign right of that country alone to make the choice.

The IMF’s Real Failure in Argentina

Although the biggest cheer leaders for the currency board were Argentines themselves, Paul Krugman neatly reminds us of the great enthusiasm of most academics and IMF officials for the currency board from 1991 into 1997 when the economy seemed to be doing well. Decades of experience with high and variable inflation seemed to have been vanquished—and substantial real economic growth seemed well begun. So the recent breakdown in the exchange rate regime and calamitous economic slump are surprising—and it is certainly hard to identify who in Argentina was truly culpable.

With the benefit of hindsight, it seems that foreigners were culpable—if only inadvertently. Exchange rate and output shocks from other countries derailed Argentina’s once promising experiment. Let us focus on exchange rates of competitor countries. In the 1997-98 Asian crisis, Australia also let its exchange rate drift down to insulate itself from the worst of the crisis, Russia devalued in 1998, Brazil in 1999, and the Chilean peso drifted down from 500 per dollar in mid 1999 to 700 per dollar in mid 2001—a huge but little noticed depreciation. (All of these countries are primary products producers with some similarity to Argentina.) At the point Argentina’s currency board collapsed at the end of 2001, the yen and euro seemed slightly undervalued as well.

We know that “everybody” can’t successfully devalue—as Paul has forcefully reminded us. But Argentina had the singular misfortune of virtually everybody devaluing against it except the United States. This is precisely the kind of collective impasse that the IMF in 1945 was set up to avoid. But the IMF seems to have charged off in the opposite direction. In 1976, the IMF formally voided its mandate to return to official exchange parities—perhaps only recognizing the exchange rate chaos of the 1970s. Aside from currency boards or dollarization experiments, more recently the IMF’s mantra has been to nudge countries move away from informally pegging to the dollar in East Asia, Latin America, and in other developing countries, in order to float “freely” (as in Chile?)

Clearly, at a bare minimum, the IMF should be supporting collective exchange rate agreements at the regional level—as within East Asia or within Latin America. Even though a return to worldwide dollar parities is more problematic, the United States itself may have the most to gain. Now that Argentina has collapsed, the U.S. remains the one country that can’t devalue. And American mercantile interests are now feeling much pain from the almighty dollar. A properly organized system of exchange rate parities to prevent “unwarranted” beggar-thy-neighbor devaluations could, in the decades to come, leave the center country as its biggest beneficiary.