Hong kongs lessons for the world

ASSIGN BUSTER

paper: Hong Kongs Lessons for the Worldpaper?: The Greek crisis has many lessons not only for the Greek people but for all of us who use money.

We could hardly have asked for a more dramatic way of teaching us those lessons than the failure of a member of the European Monetary Union in the train of the Great Recession of 2007-2010. One lesson is that our monetary arrangements are defective, not only those of Greece and the EU, but those of the world as a whole; another, that the conditions for a well-functioning monetary system have been ignored by authorities, who never leave money alone; and finally, that the job of a central banker is an impossible one. Since my conclusions are decidedly unorthodox, I must declare the grounds of my reasoning: I believe that money is too important an institution to be left to central bankers. I can show that allowing a currency to devalue solves nothing much, since after devaluation the country must fulfil the same severe conditions that were needed to avoid devaluation. Given the record of unrelenting depreciation of state monies, I would like to propose ways to give ordinary people the choice of a solid currency for their savings and investments. Three monetary systemsLet me start by classifying monetary systems in logical order. Monetary arrangements can be divided into three sets.

1 The first set includes the currencies whose exchange rate is fixed to a physical standard or pegged to another currency. The second set includes the countries that allow their currency to float against the other currencies, as is the case for sterling or the euro itself. The float could be free and left to the market but very few of the group of oligopolistic central banks of the world refrain from intervening in the exchange markets, with the pretext of

keeping the rate at a value they consider more conducive to the general welfare. Some of us think that central bankers cannot be trusted with our money, either when they more or less successfully fix it or when they more or less cleanly float it. In that case there is a third possibility: to allow full monetary competition.

In fact, all currencies more or less willingly compete but there is the possibility to allow people to choose the money they wish to use, for transactions, or as the measure of prices, or as a reserve of value. Only a few nations actively encourage their citizens to hold and deal in foreign currency beside the national one. Monetary choice has recently widened with the creation of digital moneys thanks to the new Information Technologies. I am not only alluding to bitcoin but also to many other experiments in private monies, which can be found conveniently analysed by Kevin Dowd (2008) in a pamphlet from the Institute of Economic Affairs. 2 In my view, it is possible that some of these private moneys may soon successfully link to gold as a way to guarantee the holders against continuous and uneven loss of value.

The hard discipline of fixed exchangesHong Kong is one of the best examples of a solid peg. In the case of a fixed exchange rate, six rules have to be obeyed if it is to hold. 1. The monetary authority of Hong Kong must keep a reserve of US$ in excess3 of the total amount of HK dollars in existence. 2. Capital and its yields must be free to enter and leave the country without hindrance. 3.

The monetary authority does not fix the discount rate nor does it require banks to keep a reserve against deposits. 4. The state budget must always be in surplus and the state refrain from adding to the public debt. 5.

No failing bank or firm must be bailed out by the monetary authority or the government. 6. Society at large will accept internal devaluation (of which more anon) when balance of payments deficits need correcting. In sum, in Hong Kong there is no monetary policy other than maintaining the currency board, no other fiscal policy than balancing the budget without increasing taxes, in the case of a fall of exports, no other macro policy than cutting public expenditure. Let me point out something of importance for my conclusions: that these are the conditions of the classical gold standard. So, whatever comes, Hong Kong takes it on the chin" all to keep its currency out of the hands of politicians and central bankers.

It is not as if Hong Kong has not prospered under a currency board. There is no need to view these prescriptions as religious commandments: even these commandments we poor sinners sometimes disobey. Giving way here and there may not lead to inevitable decay and fall as long as the peg holds firmly. Hong Kong does have a policy of social housing. Primary and secondary education is supplied free of charge to a large proportion of the youth. There is subsidised health care for the citizens of Hong Kong. Immigration policy is too strict and is endangering economic growth (as in many other countries). It was to be expected that one of the demands of the pro-democracy movement would be that trade unions be recognised, collective agreements permitted and a minimum wage imposed by law.

However, capital flight and a weakening currency will give warning signals if the drift towards democratic socialism quickens. These conditions are immediately applicable to any country that has adopted an outside currency as its own, as have the members of the Eurozone. This in effect is an ultra-currency-board. The most important condition it must fulfil to stay in the monetary union is readiness to carry out an internal devaluation.

You need a very flexible economy and society to accept doing all that follows in short order. Instead of trying to cheapen ones exports by devaluing the currency externally, the country must reduce its costs internally, especially social security entitlements and labour costs. Demanding that in the Eurozone as in Hong Kong there be no unemployment benefit to keep people at work may be too hard a medicine; and no living wage either, as it causes unemployment among the very poor. Charges should be introduced for health services and education, for reasons of efficiency as much as economy. Maybe it is politically too costly to make pensions private and fully capitalised, but the retirement age can be adapted to the longer life expectation. Trade unions are still too powerful there and labour laws too protective. The prohibition of budget deficits should be enforced without delay.

If the cost reduction and budget consolidation are resisted, the cure will take longer and be harder, which is what has happened in Greece, where the painful adaptation is lasting more than five years. Is a flexible exchange rate better than internal devaluation? Leaving aside the mountain of private and public debt accumulated, which can and will be reduced with the well-tried procedures of the “ Club de Paris” and the “ London Club”, why submit any

country of the Eurozone to such torture as Greece has suffered these last five years? The critics of the euro insist that all this pain need not have been caused if Greece had been able to devalue its currency. I accept that an external devaluation is politically easier than internal devaluation.

It takes the population by stealth and is believed to affect only foreigners. However, a devaluation: (a) depreciates the value of assets denominated in the devaluing currency and thus impoverishes the local population; (b) impoverishes them for a second time by increasing the local price of imports; and (c) thirdly, pushes up the price of the goods and services now newly exported. In sum, a devaluation is equivalent to a once-and-for-all hike in the price level. 4 The re-equilibrating effect of a devaluation on the balance of payments can be quickly frittered away if those price increases become persistent, i. e.

, they become inflation because of the pressure applied by interest groups on the government, and of the government on the central bank to compensate their losses. There is need for devaluation after-care or accompanying measures, as we prudishly called them at the Bank of Spain where I lived through three devaluations: a large increase in the interest rate to rein in the money supply; higher taxes together with a sharp reduction in public expenditure to rebalance the budget; a determined resistance against trade union and civil service demands for higher wages; the hope that shops will not take advantage of the higher cost of imports to increase their prices across the board. In other words it must be followed by the same sorts of measures that should have been applied to forestall devaluation. Devaluing the currency offsets past mistakes but the effect will be lost unless ordinary

people are fooled into believing that there has been no devaluation” or forced to act as if. The question remains: if external devaluation is easier to put in practice than internal devaluation and in the end amounts to the same thing, why insist on keeping a fixed exchange rate? The answer is that a peg ties the hands of central bankers and governments.

Fiat money and how to control itThe expression fiat money is very telling. It designs paper money created out of thin air, so to speak, in contrast with money fixed to an easily realisable outside good. The government of a country and its central bank can say fiat, let it be, and print as much national money as they think fit. All is not bad with modern paper money and its companion commercial bank money: they greatly reduce transaction costs in the performance of contracts and play a useful role in the financing of families and firms. Additionally, paper and bank money have the advantage that their costs of production seem minimal if hedging costs against depreciation are not taken into account.

The trouble with printing money at will is that in the end it can feed inflation. Since the last thing we want is to have our long term plans upset by sudden changes in the value of money, we should pay special attention to the mechanisms that stop the monetary authorities from playing political games with the currency. There is a peremptory need to control the freely issued monies of the present day. Different ways of exercising that control have been devised over time.

One way we have just seen when looking at Hong Kong: pegging the currency. 5If the rate of exchange is flexible, one needs to impose a rule on

the central bank to stop it from reducing the internal or the external value of the currency at will. Different rules are used to make central bankers behave. Firstly, more and more central banks around the world are proclaimed to be independent of the government. Then, a growing number set themselves an inflation target. Such is the case of the Bank of England or the European Central Bank (ECB): they must keep the rate of inflation as measured by the Consumer Price Index (CPI) at or just below 2 per cent one year with another. 6 When the target is not met the Bank of England is required to explain, in an open letter to the Chancellor of the Exchequer, why and what will be done to make it good.

The discipline for the Board of Governors of the ECB consists in calculating the inflation target for the Eurozone as a whole and not for any nation in particular. See " Whats Wrong With the Taylor Rule?", by Jeffrey Rogers Hummel. Library of Economics and Liberty, Nov. 3, 2014, and the John Taylors EconTalk podcast episodes. For years controversy raged between the economists who thought it best that central bankers should react to unwanted levels of inflation and low production discretionally and those who think they should be made to obey a rule.

In the end, the defenders of rule-bound central banking have prevailed in theory, mainly because a fully informed public will adapt its expectations to reality with greater speed and less cost than one kept in the dark by the monetary authorities. 7 In practice, however, the worlds principal currencies are nothing but discretionally floating currencies managed by a panel of bureaucrats. The result is that the world monetary system is far from delivering good money. Friedmans plea for floating exchange ratesFor more

on these topics, see A Conversation with Milton Friedman. EconVideos, Library of Economics and Liberty.

See also Money Supply, by Anna Schwartz, and Gold Standard, by Michael Bordo in the Concise Encyclopedia of Economics. It was Milton Friedman who first defined an ideal for the management of fiat money: to keep the growth of base money8 at the same rate as the secular growth of real GDP (for which nominal GDP would be a proxy if prices are stable). Money for Friedman was a very powerful instrument in setting the economy on a growth path and later in making prices rise. A well-managed currency allows us to calculate prices, and helps us set aside value for a future need, and very considerably helps production. Increasing money excessively as compared with real production ends in price increases. Milton Friedman thought that the creation of the Federal Reserve had not been a good idea. As a distinguished historian of money, he argued that the creation of a central bank had notably increased the volatility of the American economy.

Since the Fed was there, however, the best solution was to deprive it of discretionary powers or, if I may put it so, have central bankers wear a chastity belt in the form of a strictly defined rule. In my view, Friedman defended flexible exchange rates on the assumption that a well behaved central bank would keep the increase in money supply hand in hand with the secular growth of real production. Thus the rate of exchange can look after itself if the quantity of money is increased in an orderly fashion at the same speed as output. In that case, the exchange rate would simply act as a buffer for bumps and potholes on the road, not as a weapon in exchange rate wars.” The existing oligopoly of far from independent central banks paddling

in a sea of dirty float cannot be expected to produce the desired good money.” But it is not a matter of the right person heading an independent central bank and applying the proper monetary policy. The existing oligopoly of far from independent central banks paddling in a sea of dirty float cannot be expected to produce the desired good money. The combination of fiat money with budget deficits and an indebted welfare state inevitably makes for a secular drift downwards of the value of currencies, whoever may be the President or the Governor of the bank.

It is not so long ago that the dollar was worth 4. 2 Swiss dollars; it now is worth 1. Perhaps it is because Switzerland does not really have a central state. Again, sound-money-Switzerland seems not to have done badly at all with regard to growth and prosperity.

Two social regularitiesSee Rational Expectations, by Thomas Sargent in the Concise Encyclopedia of Economics. A. The quantity theory Whatever the monetary system chosen, two social laws or regularities govern the management of money: the quantity theory of money and the theory of rational expectations. Today no serious economist doubts that in the end an increase in the supply of money will lead to a corresponding increase in prices or loss of the purchasing power of money, both at home and abroad. I know that John Maynard Keynes said that “ in the long run we are all dead,” but we who have children and grandchildren have a longer time horizon than that. The best way to get the import of this quantity theory of money is to formulate it with Milton Friedman along the same lines as Irving Fisher: M?·V = P?·QThis roughly means that an increase in the quantity of money times the percentage of their income people do not wish to keep in the form of

money is equal to the increase of either prices or of output or both in some proportion. When people want to keep a greater percentage of their income in the form of ready money, velocity falls, as it did in 2008-2010.

But let us assume for a moment that velocity is constant. In that case, an increase in the quantity of money will either lead to higher prices or to more output. By producing more money, central bankers aim at increasing output and employment. What Milton Friedman wanted to underline when adopting this formula is that in the long run all new money goes into prices. Remember, " Inflation is always and everywhere a monetary phenomenon..

." That is a very good reason for keeping an eye on politicised central bankers. B. Rational expectations I know the phrase rational expectations rubs peoples fur the wrong way.

It is mistakenly believed to predict that we humans are moved exclusively by a level-headed rational estimation of what the future lays in store. Rational expectations does not mean that we make no mistakes or that there are no bubbles. Regarding the money market, it suggests that no historical prices can help predict tomorrows prices, unless there is inside information on the part of some traders, which is precisely the case with central bankers. Central bankers have a temporary asymmetrical advantage as to the effects on the money supply, because information about monetary measures does not get into prices all that quickly. But in the end it reaches the general public. 9A lack of general information about the possible effects of monetary measures is compounded with the tendency, observed in laboratory experiments, for bubbles to occur in markets where assets are traded mainly

for resale, such as the stock exchange and property markets. 10 In the laboratory these bubbles become bigger with increases in the money supply or debt finance.

As Jerry Jordan (2011) has noted happens in the real world, Asset price increases need not be accompanied by debt increases, but when they are then the subsequent decline in asset prices has much broader implications. So this only tells us that sooner or later we ordinary people realise that what we took for a real increase in the prices that we are personally quoted or the prices we can charge for what we sell may simply be a monetary mirage. Monetary authorities can only deal in nominal prices or nominal exchange rates" those that appear on the labels of our grocery goods or the front pages of international newspapers. They may control inflation but they do not and cannot control real values, which in the end are decided in the market. In the end the monetary injection will turn into price inflation or into burst bubbles. One thing authorities do know: paradoxically the monetary measures they take will be more effective the more they succeed in fooling ordinary people. Authorities can count on people suffering from money illusion and exchange rate illusion. They know that, when they promise that higher inflation will reduce unemployment, or that a lower discount rate at the central bank will increase investment, or that a nominal depreciation of the currency will boost exports, the desired effects will follow, but only if people are taken by surprise.

Sound moneyThe six conditions for a successful peg (above) indicate that a currency fixed to an outside value may be the best method to keep its own value from deteriorating over time. A peg is a method of guaranteeing that

politicians or central bankers cannot play games with the national money. The founders of the European Monetary Union, especially Germany, wanted to create a solid, stable currency, governed by an independent central bank and free from political abuse.

Critics of the euro miss its fundamental point: that the euro was devised precisely to stop member states using the depreciation of the currency to avoid tackling the underlying problems of the economy. This is what the Greeks could not live up to. The mistake was not so much devising a stable euro as imposing it on nations unready to forsake the magic wand of monetary policy for short term advantage. In that case it would have been better to allow ordinary people a choice of currencies: in the case of Greece the use of the drachma and the euro in parallel. I have pointed out a lesson often forgotten: that, whatever the system chosen" fixed, floating, parallel currencies" the conditions of sound money are always the same: if you peg you currency you must apply the six Hong Kong conditions; if you prefer the comfort of a flexible exchange rate you in the end must apply the same kind of measures in the form of devaluation after-care" as the British, who prefer a flexible-exchange-pound, have discovered. Monetary and budget austerity is always advisable, whatever the exchange rate system, but sound money is not easy, for it delivers the goods only in the long term. We economists should never have accepted the name of austerity for the measures needed to rescue currencies from short-sighted political interference. An obese smoker who also drinks is sure to complain of the doctor who imposes austerity on him, though he knows he will feel immeasurably the better for it.

This is now clear from the work of Alberto Alesina and Silvia Ardagna, among others, well analysed by Tim Congdon in his “ In Praise of Expansionary Fiscal Contraction” (2015): cuts in public expenditure rather than Keynesian expansionism is what puts an ailing economy back on the path to growth. A monetary anchor for large countriesBut pegged to what? A small country may peg to the dollar. How do we guarantee the dollar, the euro, the yen or any other big currency does not continue on a secular slide? The large central banks want to use “ the wondrous tool of money to maintain full employment, price stability and moderate interest rates”, all at one go. At the same time they want to “ satisfy an array of interest groups”” voters who want free education for their children, free health care for their families, a generous state pension; exporters, importers, bankers, agriculturists and other producers; creditors, debtors, among which especially the government. They want their countries to be like Greece while eroding the currency to avoid paying the price. I ask again, what will happen to our savings and investments, to our progress, to our freedom, if the dollar, the euro and the other world currencies continue to misbehave? Two possibilities should be explored. One is private currencies, the other a return to the classical gold standard.

Friedrich Hayek was the first front rank economist who argued in favour of private monies, much to the amusement of the cognoscenti. The year was 1976 and it was a time when privatisation of national industries was being mooted by friends of the future prime minister Margaret Thatcher. Milton Friedman summed up the general criticism by alleging a contradiction in Hayeks thought: though a defender of spontaneous order, here was Hayek

proposing a designed reconstruction of money. But here, I am afraid, Friedman was wrong. Hayek had in fact written what amounted to a business proposal for private firms launching a new currency for profit, which the advances in technology today have made increasingly workable. Many failed attempts will be made before decentralised private monies become widely used, but state monies are so defective that I dare predict we shall soon see private currencies accepted by many of us. 11If private monies are a red rag to managed money bulls even more so is the gold standard to the welfare establishment. Keynes called gold a barbaric relic in his Tract on Monetary Reform (1925); but in the same breath admitted that the price stability of a century had contributed to the wondrous economic growth of the world from the end of the Napoleonic wars to WWI.

12Many an illustrious economist will reject the idea of returning to the classical gold standard out of hand. I think this is so because it is not well understood how it would function. There is no need for gold coins to circulate. Convertibility of notes and deposits into gold would be enough, 13 together with the participating nations forsaking all attempts to sterilise gold inflows and outflows. The cost of the gold system could turn out to be not be much higher than fiat paper if people hedging possible depreciation by investing in gold is taken into account. 14ConclusionIt is inexcusable for the economics profession to play along with the vote buyers. We know society is not as the populists paint it.

Growth does not flow from monetary trickery and income redistribution. The sources of economic growth are population and capital, of course, but more so, transformative technology, the spread of knowledge, and better

institutions. The central banker simply cannot deliver the goods she pretends are within her grasp: sound money, full employment, moderate interest rates, a smoothly functioning financial system. The central bankers lot is not a happy one. Keynes spoke of the euthanasia of the rentier. Dare I speak of the euthanasia of the central banker as in Hong Kong?;,?