Kaleidic Economics

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Imagining an "Optimal Language Area"

It is widely acknowledged that money is an example of a spontaneous order – a cultural phenomena that humans have developed to facilitate exchange. To be sure states can and do affect the evolution of money, but it would still exist without them. In this regard, an analogy is often drawn between money and other examples of spontaneous orders – such as language. But we can extend this analogy further, since money is what people use as a means of communication.

Imagine visiting the French Mediterranean coast, and deciding to take a day trip to Spain. At the border, you are required to demonstrate proficiency in Spanish. You mentally cast away all the French words you know, and try to remember the Spanish ones. And when you return, you get frustrated by the fact that Spanish words come to mind when you really need the French. Then, one day, it is announced that to simplify things the new national language of both France and Spain will be Danish! Out go the French and Spanish vocab, and you learn Danish instead. Minor inconveniencies aside, the transition is a smooth one. But then problems begin to develop. Perhaps the Danish language is less homogeneous than people thought, as it adapts to local dialects. Maybe this "one size fits all" isn't suitable in places that have different needs. Without belabouring the analogy too much, the obvious costs of multiple languages shouldn't obscure the more nuanced benefits of evolution.

What if the French and Spanish governments said, "officially, we want you to speak in Danish, but it's really up to you". Perhaps then those in rural Burgundy will go back to French, and those in Murcia speak Spanish. If the Basque's want to speak Basque, and the Catalan's Catalan, then that's fine too. It's up to you – as a visitor – to decide which of these languages, and to what extent, you should learn. We would expect places close to borders, or large cities, to exhibit multiple languages. This may appear confusing, but people tend to know more languages than they realise (computer programming, mathematics, are all "languages" in this sense). We might expect globalisation and multi culturalism to lead towards fewer languages (but this can't be taken for granted, if people attach close value to their cultural heritage). The bottom line is that language *is* a spontaneous order and people are constantly making choices about how best to communicate with people they wish to interact with. If it turns out that Danish has flaws, no worry, we shift to something else.

There is no study of "Optimal Language Areas" precisely because people recognise how spontaneous this process is. We might give examples of how the Welsh language would have died out were it not for government support, but theses cases are the exception. The borders of a language are reasonably free, and the emergent outcome of this process seems to work. Indeed if anything European governments tend to encourage multilingualism as parts of integration efforts. We do need our state to tell us how to communicate with others.

By contrast, "Optimal Currency Areas" generate a lot of academic attention. Which seems pointless, given that most economists accept that the Eurozone is *not* an optimal currency area, and then politicians adopted one regardless. But they did, and we are now hearing about its impending break up. This report seeks to discuss some of the main scenarios for how a break up may occur.

Why has the Euro survived this long?

Kaleidic Economics takes scenario analysis as part of our founding mission, and to some extent it is heartening to see the rise of their use. As an example, Aviva Investors provided an estimate of the costs of three different scenarios regarding a Greek exit: staying in, leaving, and ejection (see figure 1).[1]

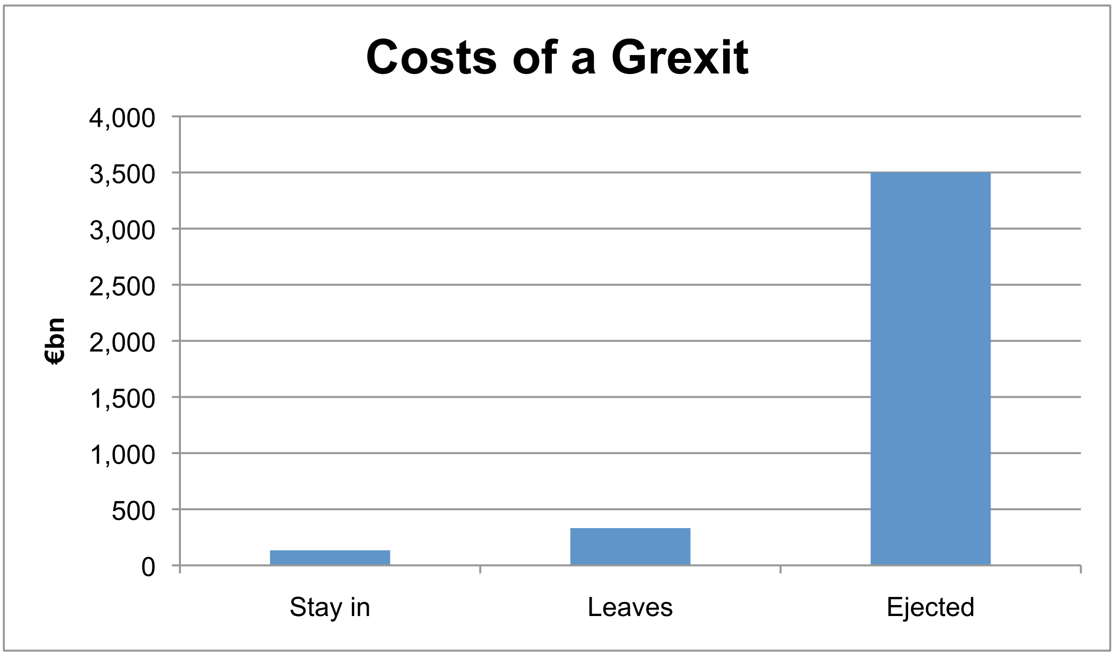
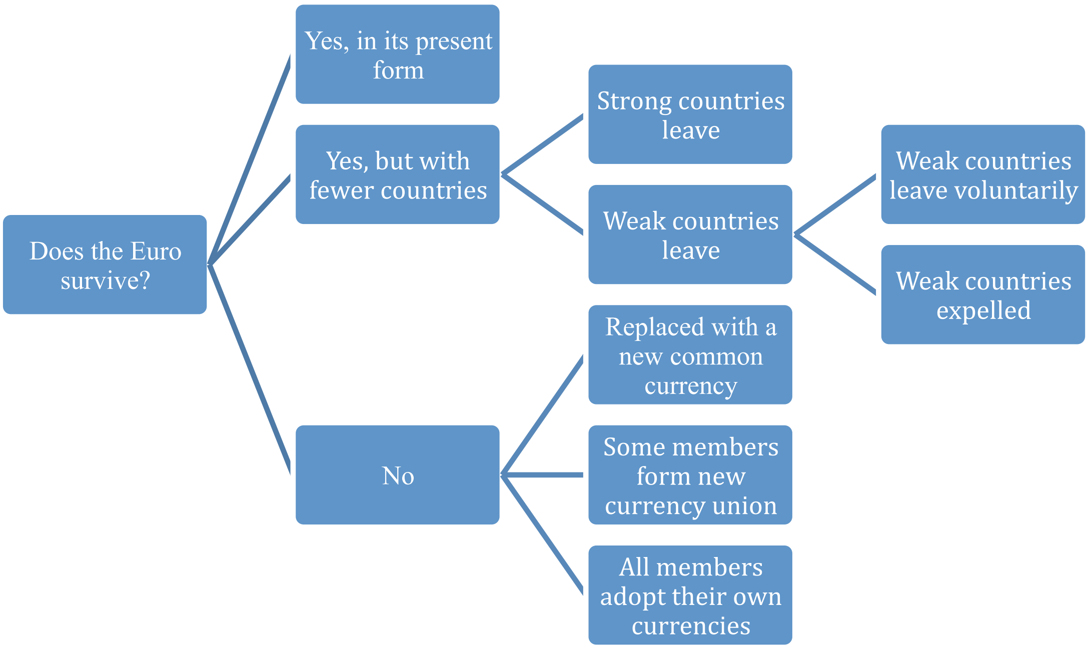


Figure 1 Costs of a Grexit, Source: Aviva Investors

The problem is that these three alternatives aren't exhaustive. Indeed many scenarios being discussed are incomplete. As a way of indicating this (as opposed to correcting for it) consider the diagram below.

[1] See Jill Treanor, "Greek euro exit: some scenarios" *The Guardian*, 15th June 2012



There are a number of critical uncertainties here, and we've focused on the endgame rather than a potential timescale. But it incorporates three major debating points: whether weaker members or stronger members leave; the extent of consensual agreement; and what comes after exit.

One advantage of thinking about potential end games, rather than a sequence of policy choices, is that it places less relevance on policymakers. *The Economist* provided a list of the possible ways to deal with the Greek debt problem, which includes the following:[2]

- Fiscal transfers (giving money)
- Bailout loans (lending money)
- Vienna initiative (roll over Greek holdings)
- Soft restructuring (voluntarily extend maturities)
- Hard restructuring (forced haircuts)

But there is a temptation to believe that the crisis will be resolved by elected officials, behind closed doors, coming up with definitive plans. Two things we *do* know about present EU leadership is that (i) it's pretty weak; (ii) there is virtually no appetite to preside over a failing Euro. Therefore our attention shifts to the "Euro survives" scenario, and an ad hoc hodge podge of alternative ways to paper over the cracks.

We may well be in for several years of economic stagnation. U.S. based economist Steve Horwitz has called it "the BBQ economy" – i.e. low and slow. Politicians just keep kicking the can down the road, hoping that moderate growth and moderate inflation gradually shave off the debt burden. Once you pierce through the rhetoric, this is what the UK government are betting on happening. *The Economist*

[2] "The worlds worst menu" *The Economist*, May 28th 2011

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has an interactive tool that allows you to see the impact of alternative scenarios on debt levels.[3] Users plug in potential growth rates of GDP growth, fiscal deficit, interest rates (that government pays on their debt), and inflation, and a chart shows the point at which it exceeds the 60% level that Reinhert & Rogoff identified as being a warning sign of unsustainability. The plan is to keep the pig on the fire, monitor it closely, and pray that neither the flames go out nor a fireball catches.

So one reason Greece haven't exited the Euro yet, is because they haven't had to. Possibly this is also driven by fear about what would happen next. There are very few historical instances where a new currency union has been dissolved. Indeed this is one reason why scenario analysis (imaging the future) beats historical studies. But this leads us to another potential reason why Greece hasn't left yet. Perhaps they can't.

Is a Grexit legally possible?

The whole point of the single currency was a credible commitment mechanism, and the inability to leave was hard wired into the founding agreements. Article 50 of the Lisbon Treaty allows member states to leave the *EU*, so perhaps this is one mechanism by which they might leave the Euro. Alternatively, the existence of Great Britain, Denmark, Romania etc. as members of the EU but not the Euro, suggests that there is scope for countries like Greece to join them. But the notion that Greece could simply "go back" to the drachma seems a massive oversimplification.

In their Wolfson Prize winning proposal, *Capital Economics* (led by Roger Bootle)[4] runs through the possibly mechanisms of a Greek exit. It points to "Lex monatae", which refers to a government's sovereign right to determine a national currency. But (as they point out) this principle does not apply if debt obligations are governed by the law of a foreign jurisdiction. Any agreement under the International Swaps and Derivatives "Master Agreement", for example, would still be enforceable in Euros. Whilst *The Economist* reports that €30tn of such Euro denominated contracts exist[5], this is an overstatement (because it includes debt that's being rolled over separately). *Capital Economics* report that only 1% of EU mortgages are held cross border, and even if – say – a Greek person held a Euro denominated bank loan with a German bank, provided that bank had a presence within Greece it would fall under Greek law and *Lex Monatae* would apply (p.78). But this seems to assume a certain level of acquiescence amongst German banks. Focusing on the legal ability for a government to make a declaration ignores the diplomatic and retaliatory considerations. As Hal Scott said (back in 1998!)

> "Any break-up accompanied by re-denomination of existing euro obligations, including government bonds, will create great legal uncertainty and costly litigation. There are no

[3] "The maths behind the madness", *The Economist*, November 19h 2011
[4] "Leaving the Euro: a practical guide" *Capital Economics* (Submission for Wolfson Economics Prize 2012).
[5] "Currency discussion" *The Economist*, 7th April 2012

> continuity of contract rules for exiting EMU [a currency union] equivalent to those for entering… [this will] require cooperative and deliberative solutions and will be difficult and costly to solve".[6]

So whether we under or overestimate the difficulty, what we do know is that for one or more countries to exit a currency union that remains in existence, is possibly without precedent.

Neither devaluation nor deflation

A proposal by Philip Booth and Alberto Mingardi, published by the *Wall Street Journal*, helps to avoid this problem.[7] They advocate Greece reinstating the Drachma as a **competing currency** to the Euro. This means that the currency problem is kept completely separate from the debt one, and because existing contracts would remain, explicit default would be necessary. For many economists, this transparency would be a good thing. Existing debt would essentially become like the foreign currency debt held by a defaulting Latin American currency coming off a peg. And it is worth a reminder that when Uruguay defaulted on sovereign debt in 2003, they were borrowing again within 5 months. Confronting problems directly are not politically beneficial, but economically they are the sensible thing to do.

There are some who think the solution to the Eurozone crisis is reasonably simple, and two phenomena are offered as a panacea:

- **Devaluation:** if countries had their own currencies, they could simply inflate their way out of debt
- **Deflation:** if countries allow prices to adjust downwards they can simply go through bankruptcy procedures under a falling price level

Competing currencies is a policy solution that takes an intermediate position. Like the *Capital Economics* plan it rests on an assumption of nominal downward wage inflexibility, and real wage flexibility (p.10-11). It takes the view that the transaction costs of one relative price change (i.e. the value of one currency relative to another) can be smaller than the transaction costs of *all* relative price changes. It takes seriously the price frictions that result from money being non-neutral.

The main argument of the Euro was that it took monetary authority away from individual countries, but it has emerged into a fiscal commons whereby countries simply guarantee each other's debt. The "discipline" that was supposed to prevent over borrowing, is the harsh economic reality of over indebtedness. You could argue that this is a "chickens coming home to roost" story, but this takes the amount of economic pain as given, ignoring the fact that bad government policy (such as overly tight

[6] Scott, H.S., (1998) "When the Euro falls apart" *International Finance*, 1:2, pp. 207-228
[7] "No more monopoly money for Europe", by Philip Booth and Alberto Mingardi, *Wall Street Journal*, 18th January 2011

monetary policy or inflexible labour markets) have the potential to make that pain even worse. *Given* the fact that labour markets aren't perfectly flexible, wage deflation is possibly better pursued through currency devaluation rather than nominal wage cuts. Casting a generation of people onto the economic scrapheap to pay for the sins of their rulers, may not be the best options. And therefore neither devaluation nor deflation are saviours. Unfortunately.

Radical opportunities

In any scenario that requires a country to leave the Euro, there is a massive obstacle to overcome. According to *Capital Economics*, it takes around 6 months to mint and print the requisite coins and notes for a fully operational cash economy. Assuming that this cannot be done in secret, there have been some ingenious suggestions put forward. But historical cases of stamping (or indeed using defining characteristics of Greek-issues Euros such as images on coins, or serial numbers on notes) are subject to Gresham's Law since the Euro would be continuing to function as a currency elsewhere. *Capital Economics* list several ways to deal without cash:

- Use bank cheques, or credit or debit cards
- Use (increasingly popular) contact less payment technology
- Use trade credit
- Use Euros

Note that their final option brings us close to a Booth/Mingardi competing currency regime, but also note the scope they give for spontaneous orders to "solve" the problem. They essentially argue that the state *cannot* solve this problem because it cannot mobilise quickly enough. Therefore we need to simply hope the people find an alternative. Might we "permit" commodity money to step in, if people wish to use it? And if such solutions emerge, why in 6 months time should the boot of the monetary authority return with it's tardy, monopolised currency? Is the window open not only to *competing* currencies, but competing *private* currencies?

Kaleidic Economics is a business roundtable that meets each quarter in London. For more information: http://kaleidic.org

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