

# **Fixed exchange rates – the way forward for international cooperation and trade?**

## Introduction

One of the few things that economists agree about is the benefits from international trade. Free trade and the extension of the international division of labor are almost universally hailed as good things, as they increase the productivity and hence the real wealth and incomes of all countries (Krugman 1997).

Yet international economic integration is predicated on the existence of a stable monetary system (Salerno 2015). If economic actors cannot count on payment in money of a reasonably stable purchasing power and that is easily transferable or exchangeable into their own currency, trade and international investment becomes very costly if not altogether impossible.

In this paper, we will examine the question of what monetary systems are best for international trade and cooperation. The literature on the subject is vast, even if we restrict ourselves to that emanating from the Austrian school. The classic text dealing with the modern system of national fiat money systems is Hayek's 1937 *Monetary Nationalism and International Stability*, (Hayek 1937) where Hayek showed how flexible exchange rates distorted the international allocation of resources. More recently, economists have argued for cooperation between monetary authorities on the grounds that it is at least less bad than purely national fiat money, and agreements on international cooperation like the EMU has been called a proxy for the gold standard (Huerta de Soto 2012; and, with qualifications, Hoffmann 2013). On the other hand, Nikolay Gertchev has argued that attempts at solving the problems created by nationalized monetary systems by international cooperation between monetary authorities is in fact monetary imperialism (Gertchev 2013, also 2002, dealing in detail with currency boards) and will lead to a centralized cartel of money producers, leading to even more inflation in the long term.

We will in this paper attempt to argue that fixed exchange rate regimes – both apparent and when disguised as cooperation between central banks – is not a good institution for protecting and advancing international cooperation and the international division of labor, as it spreads and intensifies the bad effects of fiat money. Three aspects of fixed-exchange regimes will be discussed:

1. They cause what we may call over-integration between the two countries. The natural state of affairs is that production tends to relocate to the most profitable sites according to the law of comparative advantage. With a currency peg, however, the costs of trade with one country – the one to which the peg is maintained – are unnaturally low, or, rather, the costs of trade with the

rest of the world are unnaturally high. This causes the integration between the two countries and their specialization to advance beyond what is economically optimal and leads to what we may term over- or hyper-specialization. That is, they each specialize to a degree and in spheres of production that would not be viable in the absence of the fixed exchange rate that favors their mutual trade. This is reinforced by the second problem:

2. The importation of inflation. While it is historically most usual for a highly inflationary state to peg its currency to a less inflationary, in part to combat domestic inflation, this needs not always be the case. Central bank policies change, and usually for the worse, that is, in an inflationary direction. A fixed exchange rate therefore means that the state pegging its currency will have to mirror the inflationary policies of the other country, thereby in effect “importing” inflation with all the consequences that stem from an inflationary policy. In addition, the tendency to over-integration between the two countries is reinforced, since trade between the two can continue undisturbed, while foreign traders will have to take account of the risks of inflation and currency fluctuations with the fixed-exchange “currency bloc.”
3. The third problem is the integration of financial systems. While such integration is *per se* beneficial and harmless, this is only so long as the financial systems in question are sound or “natural.” However, when national financial systems create fiat financial claims, international integration can be positively harmful. This is so since financial contagion may spread, banks may become bigger and more fragile, more financial firms that are “too big to fail” are created and credit cycles become more serious and spread and synchronize across nations.

Finally, we will argue that if such cooperation is limited or even abolished, market exchanges will tend to develop institutions to overcome the problems created by the existence of national fiat moneys. Such institutions may take the form of an international gold standard or another international commodity money, or it might take the form of specialized hedging firms and institutions to mitigate the risks caused by national fiat money and the currency fluctuations caused by inflationary policies. The seemingly paradoxical conclusion is, then, that national, uncoordinated fiat money production is more conducive to international trade and division of labor in the long-term, while international cooperation between fiat money producers and fiat financial institutions may seem beneficial to general international economic integration, but in reality causes distortions and mis-allocation of resources and exacerbates the pernicious effects of fiat money. Absence of cooperation between fiat money producers

might then, in the international sphere, lead to the evolution of money of higher quality and a return to market-based commodity money.

Before we can go on to examine the question of cooperation in this world of fiat money, it is useful to recall the foundations of the theory of trade and money, following Hayek's dictum, that before we can examine why things go wrong, we must first examine how they can ever go right.

## Exchange and money in the free market

A person A may desire consumer good x but possess y, and a person B may desire consumer good y but possess x. In this situation, when the two persons meet and exchange, the benefit is immediately clear: once A owns x and B y, they are able to satisfy the want highest on their respective value-scale and both their welfare is enhanced.

The benefit from exchanging producer goods is initially analogous: a person may increase his productivity or shift to a higher-valued branch of production by exchanging the goods he initially owns for goods he thinks are better fitted to his production plans. But the benefits to trade do not stop there: the greater productivity of production under the division of labor means that a person who have an absolute superiority over his fellows in all branches of production can still benefit from trade, and a person absolutely inferior in all branches of production can still contribute and benefit his fellows. All that is necessary is that people engage in the production and subsequent exchange of those goods in whose production they have the relatively greatest superiority (or least inferiority). This is what Mises called the Ricardian law of association (Mises 1998) and is also known as the law of comparative advantage. While international trade is more complicated than this stylized representation, it is not essentially different. Questions of risk and transport costs may be more important to the international trader than the local peddler, but this depends entirely on the circumstances of time and place, circumstances that do not challenge the law of association.

By engaging in trade, specialization and division of labor man can thus greatly enhance his welfare and productivity. But in the absence of money, he would quickly arrive at an impasse, namely the problem of the double coincidence of wants. The goods he has for sale may not find any buyers who has goods for sale that he wants in return, or he does not have the goods demanded in exchange for what he wants. In order to overcome this obstacle to exchange, men discovered the possibility of indirect exchange (Menger 2007, 2009): not all goods are in equal demand in the market; some are demanded

daily all year round, while others are only demanded infrequently, or only seasonally. Therefore, the man who comes to market with not very marketable goods can improve his prospects for successful exchange by exchanging them for goods he does not himself want, but which in turn he believes to be more easily marketable. Among these more marketable goods in turn, those that are in demand across a greater area and which do not physically deteriorate emerge as the preferred media of exchange, until, finally, a few highly valued goods or only one good are established as universally recognized and accepted media of exchange – what we call money.<sup>1</sup> This commodity money may then be enhanced and perfected with the addition of certification services: mints and banks may certify the quality and amount of the monetary commodities (J. G. Hülsmann 2008). This leads to competition and exchange rates not only between different commodities vying for the role of primary medium of exchange, but also between different forms of the same commodity money. Money substitutes in the form of money certificates physically disconnected from money but nonetheless fully backed by money may also arise. The case of fiduciary media in a free market, money certificates not so backed, will be discussed below.

As money becomes established, then, economic life is fundamentally changed. In the state of barter man can only plan his life and production based on his technological knowledge and his own subjective values. He may engage in occasional interpersonal exchanges, but his production is still fundamentally autistic, focused on his own household. But with the emergence of money, production becomes focused on the market, and the individual producer can now plan his production rationally by referring his plans to the prices established on the market. Profit and loss calculation is now possible and not dependent on purely subjective feeling. All of economic life is integrated in the cash nexus and the division of labor is extended to all the members of society, greatly increasing their productivity.

It should be emphasized that there are no geographical limits to the monetary economy. Once it has first been established in a society it is extended gradually as that society comes into contact with new, economically more primitive societies. These are apt to simply adopt the monetary institutions of the more advanced society wholesale – that is, while money may not be adopted overnight, the time the process takes is significantly shortened and, what is more, the fact that one commodity is already in use as money means that it is much easier to extend this use to the new territory. But this is not a form of monetary imperialism, on the contrary, the primitive societies are aided enormously by contact with

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1 It may be noted that the emergence of money is a prime example of the creative work of entrepreneurs: chasing profit opportunities they realize gains for themselves and their partners and create more profit opportunities in turn, as the market expands, more people are drawn into economic association and the division of labor is extended (Huerta de Soto 2010).

commercial civilization as they, just like the more advanced society, gain from the extension of trade and the international division of labor.

The only questions of exchange rates in the pure market economy are about interlocal exchange rates, already dealt with by Cantillon (Cantillon 2010; cf. also Rothbard 2009, 818ff), and about exchange rates between different commodity money. Both of these are pure market phenomena and are dealt with through speculation and free price movement. The first are determined by variations in local demand for money and the costs of transporting it and will tend towards the equalization of the purchasing power of money throughout the economy, the second is simply the price of one money expressed in another. Some areas may prefer one money to another and its use will therefore be more prevalent in those areas, as was for instance the case with the Austrian Maria Theresa Thaler in the Arab world. The use of various money and the exchange rates between them under a pure commodity standard, therefore, may have a superficial resemblance to the modern world of geographical monopolies of fiat money. But the resemblance is only superficial: the latter case is caused by sustained interventions in the sphere of money by the governments of the world, while the former is caused by the preferences of men freely expressed on the market.

### *Credit expansion in a world of commodity money*

It is possible that in an otherwise pure market economy based on property rights and contractual relations, fiduciary media, i.e., money certificates not fully backed by money reserves, come into use. How will this affect the monetary system? The ability of banks to issue fiduciary media in the first place will be limited by the extent of their client base and their clients' trust in the bank: the more clients they have who are willing to use their money substitutes, the greater will be an issuer's ability to expand the money supply by issuing fiduciary media.<sup>2</sup>

The acceptance of fiduciary media will therefore be limited. Should they come into the hands of people who do not trust the issuer, or who have to deal with people who do not accept money substitutes, they will be returned to the bank in exchange for money.

We may call an area in which a certain form of fiduciary media are widely accepted a country and we may call trade between such areas international trade. What happens when the amount of fiduciary media in circulation is increased? At first the new media circulate domestically, but as soon as they

<sup>2</sup> The question of whether or not fiduciary media are acceptable in a free economy need not detain us here. See on this e.g. Hoppe (2006), Huerta de Soto (2009), and finally Hülsmann (2014) for a general account of fiat financial claims contrasted with real or natural financial claims.

come into the hands of foreigners, these will demand repayment in specie. Commodity money will begin to flow out of the country with the expanding use of fiduciary media, and the position of the domestic banks will quickly erode as their reserves drain away. Soon, they will have to restrict their issues, if their own domestic customers are not to lose confidence in them and stop accepting their money substitutes. The situation will then reverse, as commodity money flows back into the country to replace the disused fiduciary media.

This is just a short sketch of the workings of the classical gold standard: international commodity money with domestic fractional reserve banking. Much more should be said to give an accurate picture of its working, but for our purposes the important thing is this: the gold standard acts to limit the use of fiduciary media to one country only, and the international economic community are, in effect, insulated from most of the ill effects of the credit expansion. Exporters to the country currently experiencing a credit expansion may share in the boom, as their sales increase, and this is then off-set by a slump in their sales as credit expansion and boom is inevitably turned to bust and credit contraction.

We now turn from the harmonious workings of trade and money absent government interference to our present system of many national fiat money regimes and to the question of cooperation between monetary authorities.

## International trade and fiat money

Before we can examine the problems of cooperation between fiat money issuers, let us first briefly sketch the problems of international trade under a regime of fluctuating fiat currencies. When money is nationalized and monopolized trade between countries becomes more complicated. There now is an additional source of potential loss, as traders will have to take the actions of the monetary authorities into account in making their plans. Before the production of money was determined exclusively by market forces: the rate of money production was determined by the profitability and opportunity cost of such production. Now there are no rational determinants of monetary policy (J. G. Hülsmann 2003), which becomes a question of political demands and the various inflationist ideologies and economic ideas controlling the national issuers of money. These will necessarily differ from country to country, and so the value of the national monies will also differ. A country whose supply of fiat money expands more than its neighbors' will, other things equal, suffer a falling exchange rate accompanying internal inflation. This will temporarily make its exports cheaper and its imports more expensive, but only until

prices have adjusted to the larger supply of money. Expansion of the money supply may in this way be a short-term means of aiding export industries, but only at the expense of importers and only by making the whole economy suffer the bad effects of inflation: wealth and incomes are redistributed, prices are disturbed, accumulated savings and capital are eroded and the calculations of entrepreneurs are to some extent falsified.

All these disturbances are mirrored in the world of foreign exchange, as entrepreneurs continually try to estimate the changing values of all the national moneys. As rates of inflation in the different countries change and the exchange rates fluctuate, international trade becomes more difficult and more costly. To alleviate this problem, monetary authorities try to stabilize the exchange rates between their own money and that of the country's main trading partners. This may in extreme cases take the form of dollarization when the national money is completely disbanded in favor of a foreign money. In this case the national monetary authority completely abandons control of money creation, or becomes the junior partner of the foreign country whose money is adopted and on top of which it can create its own money substitutes (Gertchev 2002). Less extreme outcomes are when one country, usually smaller and more inflationary, pegs its currency to that of a larger trading partner. This stabilizes exchange rates between the two countries and eases trade relations between them. A more loose agreement, allowing for fluctuations of the exchange rate within a narrow band, can also be seen as an attempt at alleviating the problems and costs of national fiat money production.

That is the theory: currency pegs and international cooperation are meant to solve the problems for international relations introduced by the rise of national fiat money. But does it work?

### Problem no. 1: Over-Integration

The natural state of affairs is that production tends to relocate to the most profitable sites according to the law of comparative advantage. With a currency peg or similar arrangement, however, the costs of trade with one country – the one to which the peg is maintained – are unnaturally low, or, rather, the costs of trade with the rest of the world are unnaturally high. This causes the integration between the two countries and their specialization to advance beyond what is economically optimal and leads to what we may term over- or hyper-specialization. That is, they each specialize to a degree and in spheres of production that would not be viable in the absence of the fixed exchange rate that favors their mutual trade.

Capital goods and labor are always allocated to secure the most profitable output. In a country with a fluctuating money, production is determined by what entrepreneurs expect can fetch the highest price on the world market, costs of foreign-exchange dealings included. Now, however, the monetary authority in the country decides to peg its currency to that of a larger, neighboring country. This means that trade with that country becomes cheaper and consequently that exports to that country become more profitable. This change in the data may mean that the industries that before flourished by supplying the world market stagnate as they are displaced by industries focused on exporting to the market made cheaper and more accessible by monetary policy. Trade with that country consequently expands, but to some degree at the expense of trade with the rest of the world.

Now, there may be some allied benefits to establishing a currency peg. It may a way to resist the pressures of a (more) inflationary ideology at home and thus ease the pressures on the market economy. But such benefits are entirely accidental and not very certain – after all, the country to whose currency one country pegs its own may now decide to embark on a more inflationary policy, seeing how they have a larger market for their own money, precisely because of the currency peg. The effect on international trade is, in any case, to redirect trade from those areas and sectors that would be integrated according to the law of comparative costs into those sectors and areas favored by the new monetary regime.

This leads on to the second problem:

## 2. The importation of inflation

Once currency pegs and fixed-exchange agreements are concluded, the dominant money producer has a greater incentive to inflation. It makes initially more sense for more inflationary countries to peg their currencies to that of a less inflationary one. This not only stabilizes exchange rates, it also increases confidence and reduces inflationary expectations. But once the currency pegs are established, the dominant money producer will not face as many obstacles to increasing his rate of inflation. There is always a great incentive to increase the supply of money – after all, creating fiat money is a business with a nearly 100% rate of return and no risk of loss – and once its junior partners have adjusted to the fixed exchange rate, they are virtually captive customers of the dominant producer. To maintain the exchange rates, they will have to adjust their own monetary policies, buying up a portion of the new money issued as it is offered against their own medium of exchange on the foreign exchange market, or

else see their own currency suddenly appreciate. This means that they will have to increase the rate of inflation of their own moneys, mirroring the now more inflationary dominant money producer.

This reinforces the distortion of trade away from its natural channels and into what is now a currency bloc. The uncertainty of dealing in currencies other than those of the bloc increases relatively to dealing within the currency bloc, as foreign traders will have to take the risks of currency fluctuations into account.

### Problem 3: integration of financial systems

In itself, the integration of financial systems is beneficial. It leads to more efficient, more certain allocation of capital across all markets. But this benefit is counterbalanced by the problems that arise when the systems integrating are fiat financial systems resting on the ability to issue fiduciary media and when financial institutions benefit from privileges, e.g., when implied or real promises of bailouts in case of financial problems lead to moral hazard.

In such an environment, banks and other financial institutions may find it easier to expand across the currency bloc and benefit from economies of scale in their operations. In itself, this is a benefit to society as well as to the banks themselves. But when the financial system is fragile, such expansion may exacerbate any crises that may arise and spread them across the currency bloc.

One major problem is when one country expands its money supply by issuing additional fiduciary media. Under the gold standard, this expansion was limited to the country initiating the expansion by the outflow of gold. When another country is committed to maintaining a fixed exchange rate, it has to buy up money and fiduciary media issued by the expanding system – just like above in the case of a simple monetary inflation. But when the central bank maintaining the peg is itself in charge of a fractional reserve system, credit expansion in one country may trigger a credit expansion in the next.

Financial institutions in the country maintaining the peg can use claims from the expanding system to lay the basis for their own credit expansion. They present these claims at their own central bank in return for reserves and can then expand their own lending on the basis of these claims. In this way, the inflation and credit cycles of the countries in the currency bloc are increasingly linked up and synchronized. This does not simply mean that the boom-bust cycle is synchronized across a large area, the boom can also last longer, since the external drain, in the form of a worsening position on the

foreign exchange markets, is not as acutely felt. The larger the economy is across which a financial system is linked up, the greater the apparent boom and the deeper the resulting crash.

## Fluctuating exchange rates – the least bad solution?

International cooperation between monetary authorities is thus not simply a boon. While it leads to easier trade relations between cooperating countries, it does this at the expense of a more natural international division of labor and it loosens the restrictions on a more inflationary policy. The more central banks cooperate, the easier it is for them to engage in inflationary and to them profitable practices. Might fluctuating exchange rates then, paradoxically, be better for international trade?

Consider first this quote from Mises (1998, 455–56):

“The dealers on this special market [that is, the foreign exchange market] are quicker than the rest of the people in anticipating future changes. Consequently the price structure of the market for foreign exchange reflects the new money relation sooner than the prices of many commodities and services. As soon as the domestic inflation begins to affect the prices of some commodities, at any rate long before it has exhausted all its effects upon the greater part of the prices of commodities and services, the price of foreign exchange tends to rise to the point corresponding to the final state of domestic prices and wage rates.”

The speculators in foreign exchange, in other words, work to limit the effects of an inflation to the country in which it originates. They thereby perform essentially the same function under a fiat system as gold flows perform under the gold standard, but they can only do this if the central bank do not act to maintain a fixed exchange rate with the country inflating its money supply. When it does this, instead of limiting the ill effects of the inflation, it imports it into its own country. It may be that it thereby makes it easier to conduct the day-to-day business of mutual trade, but only at the cost of introducing all the disarranging effects of inflation into its own country. The costs of national fiat money are still there, but they are diffused across the entire economy instead of being isolated and dealt with on the market of foreign exchange.

If currency pegs and other forms of central bank cooperation act to limit the market of foreign exchange, the market of foreign exchange in turn, if allowed to function, will act to minimize the costs arising from the existence of national fiat money. Changes in the price ratios of the various currencies will reflect changes in their respective purchasing power, and if we accept Mises’ description of the

foreign-exchange market, it will establish the real relation between the currencies long before the inflationary process is complete. This is why inflation may give a momentary boost to exports: it is simply the consequences of domestic inflation, anticipated by speculators, that leads to a short-term disturbance of the relative profitability of export- and import-industries. There is no need for other central banks to follow a country into an inflationary spiral to counteract the effects on exports by successive devaluations.

By abstaining from currency pegs and agreements, central banks can also limit the spread of the boom-bust cycle. While additions of fiduciary media may lower the domestic interest rate, their effect internationally will be to devalue the currency. The speculators act to profit from correctly estimating the purchasing power of all currencies and are consequently not interested in apparent abundance of credit in a given country.

Other institutions may arise on the market to limit the risks of international trade: currency swaps, hedging firms and gold clauses in contracts are examples of this. Ultimately, however, the only real solution to problems of nationalized money is an international standard. Gold clauses in contracts may be a first step toward reaching this for international trade.

This does not mean that we reject Hayek's (1937) analysis of monetary nationalism. Rather, while we fully agree with him on the distorting effects of nationalized money production, we think the market's ability to overcome these effects should not be underestimated. By rigorously limiting international cooperation of central banks, the market in foreign exchange will act to limit the spread of inflation and may even in time lead to the emergence of an international commodity standard.

Ultimately, the effects of monetary nationalism cannot be eliminated unless fiat money itself is abolished. International cooperation in monetary matters is not the way to do this, however. Reforms should be national and do not depend on the international cooperation. A banking system operating with 100 per cent reserve requirements, for instance, will be much better suited to withstand the shocks of devaluations and other sudden changes on the currency market. Fundamental banking reform (Gertchev 2013), not international cooperation, might then be a good place to start in reforming the monetary systems of the world.

## Conclusion

We have tried here to argue that, given the world of multiple fiat currencies we live in, the way back to sound money does not go through international cooperation between central banks. Rather, such cooperation has its own ill effects, as it distorts the pattern of trade and spreads and intensifies inflation.

By abstaining from such cooperation, central banks would let the market find solution to overcome the problems of fluctuating exchange rates. Coupled with national banking reform, moving from fractional reserve banking prone to credit expansion to banking based on full reserves, this would go far to solve the problems created by fiat money.

We have not touched on problems involved with international fiat money such as the euro. It is in light of the arguments presented here certainly questionable whether setting up such a scheme was a step in the right direction. Now that it exists, however, returning to national moneys is not clearly the right way to go in reforming the monetary system. A much better reform, here as in the case of national fiat money, would be to replace it with a commodity money and 100 per cent reserve banking.

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