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Subir Gokarn: The crumple zone

The Greek experience demonstrates the value of floating exchange rates as shock absorbers

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It is just over five years ago that the situation in Greece first threatened global financial stability. Over this period, a number of major initiatives in which European institutions and the International Monetary Fund combined forces to try and mitigate this threat were taken. However, as things stand today, it appears that their impact has been limited. While there are clear differences between the situations in 2010 and today, the bottom line is that the prospect of Greece's exit from the euro zone is still in prospect and the risks of this spilling over into broader financial instability should still be high up on global policymakers' priority lists.

I had written earlier on the pros and cons of exit from the Greek perspective, but as things come to a head in Europe, it would be useful to reflect on the overall institutional framework within which this crisis precipitated and explore its implications for more effective macroeconomic management.

In my view, by far, the most important lesson from this long and complex story is the criticality of the exchange rate regime and its alignment with domestic conditions. In essence, the euro arrangement attempted to recreate the Bretton Woods currency arrangement that existed between 1945 and 1971 and formally ended in 1973. The benefits of a dollar-based fixed exchange rate regime were visible during the earlier years of this arrangement, as macroeconomic policies in participating countries were aligned and the absence of exchange rate risk encouraged trade between participating economies, many of which were reconstructing after World War II. However, during the 1960s, the United States saw inflationary pressures intensify for a variety of reasons and the arrangement transmitted these pressures to other participating economies. This contributed to its eventual termination.

As Europe transited out of this arrangement, it wanted to preserve the benefits of fixed rates for regional trade, while ensuring that policy decisions by any one country did not spill over with adverse impacts on others. The solution was to centralise the monetary function while committing participating countries to tight fiscal rules. In an ideal situation, this would have resulted in a single fiscal authority for the entire arrangement, but that was clearly too much to ask. As it happened, it worked reasonably well until the financial crisis of 2008-09, after which, despite the efforts of regional and global institutions, no enduring solution has been found.

In a sense, the breakdown of the euro arrangement is further and enormously costly evidence that fixed exchange rate mechanisms do not work. Or, to put it another way, the conditions under which they might work are so onerous that there is always a high risk of their failing. For Greece in particular, the consequences of it staying on in the euro zone have been five years of negative gross domestic product (GDP) growth, massive chronic unemployment and attrition in public services. An appropriate counterfactual question is: what if it had a floating exchange rate?

We tend to use automotive metaphors quite regularly in analysing the economy: acceleration, braking, sudden stops and so on. Shock absorbers are also sometimes invoked. Let me take this a little further. Car bodies have something called a crumple zone, which allows the body to collapse into itself when a collision takes place.

While this wrecks the car, it prevents the shock from being transmitted through to the people inside. Older car designs, which did not have crumple zones, left the car relatively undamaged but caused serious injury to passengers. In fact, it was the learning from this pattern that led to design innovations based on the crumple zone.

In a way, the exchange rate can function like a crumple zone, or the absence of one, for the macroeconomy. In a floating rate system, an external shock is, typically, immediately reflected in sharp movements in the exchange rate. Yes, there are real consequences to the domestic economy, particularly for stakeholders unhedged against exchange rate volatility. But both self-correcting forces and policy responses are activated by sharp currency movements, which can stabilise the situation without too much disruption.

On the other hand, in a fixed rate system, like in cars without crumple zones, the entire shock is transmitted to the domestic economy. Since the fixed rate does not allow the self-correcting forces to materialise, the entire burden of adjustment falls on processes with significant political economy dimensions - wage declines and fiscal compression, for example. The impact of these on growth and welfare is enormous. The outcomes that the Greek economy has manifested over the past five years are a concrete example of how much damage the absence of exchange rate flexibility - the crumple zone - can do to the domestic economy.

With hindsight, one could argue that there were significant and widespread welfare benefits of the European customs union, which allowed for virtually unrestricted movement of goods, services, capital and people within the region. But the benefits from the currency union, as things stand today, are more ambiguous and, certainly, more unevenly distributed. The relative performance economies that are part of the first but not of the second - particularly the more recent entrants from East Europe - strongly support this inference.

Of course, it is one thing to question the rationale of an existing framework and quite another to recommend that an alternative must be put in place. The costs of transition must also be given due consideration. For the euro zone, the critical question is whether the benefits from preserving the arrangement justify a collective resource transfer to Greece and, possibly, other economies that risk destabilising it. If this is so, then national governments have to try and persuade domestic constituencies that such transfers are actually in their interests. Clearly, this is getting harder and harder to do, but it is the only way to go.

For other countries and groupings, the lesson is clearly in the severe limitations imposed on collective institutions by national institutions, capabilities and aspirations. As in Europe, the benefits of open trading arrangements are, by and large, demonstrable, even if they are unevenly distributed. But, beyond this, reach seems to exceed grasp. Most importantly, every country must find its own crumple zone to buffer it from external shocks. High exchange rate volatility may look and feel messy and uncomfortable, but better to have a smashed-up car than smashed-up passengers.

The writer is director of research, Brookings India, and former deputy governor, RBI. These views are his own