Does One Market Require One Money?

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Much of the current European discussion about monetary union, especially the discussion in official circles, assumes that the adoption of a single currency is necessary to perfect the free trade in goods and services that is called for in the European Community's 1992 plan. The European Commission has summarized this official view in the title of its publication ***One Market, One Money.***

In contrast, no one seriously suggests that the United States, Canada, and Mexico should form a currency union as part of the process of establishing a North American Free Trade Area.

I believe that this difference does not reflect anything about the economic requirements for efficient free trade zones or the potential usefulness of a single currency in Europe or North America. Instead, it reflects very different political goals in Europe and in North America.

European monetary union is sought by those who want to move to a political union among the current members of the European Community (EC). They seek a common currency both as a public symbol of super-nationhood and as an effective way to shift government decisions on monetary and eventually fiscal policy from national capitals to Brussels or some other single European location.

Although I shall have more to say today about the political motivations that are driving the European move toward a single currency, I think it is important for economists to evaluate the economic case for a European currency union. Political officials and voters who must make the decisions about future steps toward monetary union should understand whether a monetary union really is important for economic reasons.

In my judgment, the economic case for a currency union is not persuasive. Although there may be some economic advantages to adopting a single currency, the disadvantages are likely to outweigh the advantages. A single currency is certainly not necessary to obtain the advantages of free trade within Europe and may be counterproductive. The loss of independence in the management of monetary policy at the national level and of potential exchange rate flexibility within Europe may have more serious adverse consequences than the trade-promoting benefits that are claimed for establishing a single currency.

To support this conclusion, I will begin by reviewing the economic arguments advanced in favor of any monetary union and will then consider the associated economic costs that weigh in the opposite direction. I will then discuss whether Europe as such is an appropriate unit for a currency area. After this review of the economic case, I will look at the political motivations that, in my opinion, explain why some Europeans are so eager for the establishment of a monetary union and a single currency. Here too there are costs and benefits that should be identified in the interest of informed decision-making.

The economics of monetary union

The primary economic case for moving to a single currency is that elimination of currency fluctuations within Europe would increase trade among members of the community. Those who hold this view argue that currency fluctuations inhibit businessmen from developing markets in other countries and from buying from foreign producers because the fluctuations in exchange rates can more than wipe out the normal profits from individual transactions. More generally, in an environment of fluctuating exchange rates, international transactions involve an uncertainty that is not present in domestic transactions.

It is not clear, however, whether this is of any importance in practice. The several econometric studies that have tried to measure the effect of exchange rate volatility on trade in Europe have failed to find any impact. If businesses really care about the exchange rate risk, they can hedge future outlays and receipts in the market for foreign exchange futures. Although businessmen often complain that such hedging is "expensive," I suspect that they are confusing what is really a very low cost of avoiding uncertainty by buying or selling currency futures with the discount on forward sales or premium on forward purchases that prevails when the market expects the value of the currency to change. After all, it is when the value of a currency is expected to fall that businessmen are most eager to protect themselves and it is then that they find that forward sales of that currency are "costly".

Further evidence that currency volatility may not inhibit trade is the very sharp increase in the volume of exports to the United States during the decade of the 1980s when the dollar gyrated sharply. And certainly the Japanese have not found that the fluctuations of the yen relative to the dollar and the European currencies have been a serious barrier to their ability to increase exports.

A fixed exchange rate zone may in some cases even be an obstacle to expanded trade. Consider a manufacturer in England who contemplates expanding his marketing efforts in France. He knows that he will compete in that market with producers from the United States as well as from France. If the dollar falls relative to the franc, the American producers will gain an advantage! Since this will be a problem for all British exporters, the British government might respond by devaluing the pound in line with the dollar if it is free to do so in order to maintain British exports. With a fixed exchange rate vis-à-vis the French franc and other EC currencies, such devaluation would not be possible. For a British manufacturer, the idea of developing a market in France is in this way less attractive when the U.K.-French exchange rate is fixed than when it is flexible. Fewer resources may therefore go into the manufacture of tradeable goods and more into the production of services and goods for the local market. In short, while a world in which all exchange rates are fixed may encourage trade, fixing the exchange rates among a subset of currencies may actually discourage trade.

Quite apart from its effect on trade, the shift to a single currency can be helpful in creating a larger financial market. There is a simple convenience when more of the people with whom you deal use the same currency. In addition, with more securities and transactions quoted in a particular currency, it may be less costly to make financial transactions. This may be a reason for very small countries to tie their currencies together or to a larger currency but it is not relevant for countries as large as Britain, France, Germany, and Italy.

Against these possible but uncertain advantages of a currency union must be set the disadvantage of losing an independent national monetary policy—that is, losing the ability to respond to changes in the demand for local products by changing interest rates and the exchange rate. If the demand for the products of a country falls, it will suffer a decline of employment and output unless money wages and prices are completely flexible. Although this adverse effect on employment and output could be mitigated by a reduction of domestic interest rates, such a local interest rate reduction is not possible when there is a single currency or an absolutely fixed exchange rate. With multiple currencies and flexible exchange rates, the favorable offsetting expansionary effect of an easier monetary policy on interest rates is reinforced by the decline of the exchange rate that the lower interest rate induces.

For the past thirty years economists have considered these issues in the context of a theory of optimal currency areas first proposed by Robert Mundell. The basic idea is that it is worthwhile for a group of independent "countries" to adopt a single currency when the demand shocks that hit the countries are similar and when labor is highly mobile among the countries in the area. The similarity of the demand shocks means that there is little to be gained by changes in real exchange rates within the proposed currency area and that the appropriate monetary policy is the same for all of the countries. A highly mobile labor force among the countries in the proposed currency area means that to the extent that there are different shocks in different parts of the currency area, the workers will move from regions of declining demand to regions of stronger demand. Just how similar the shocks must be and how mobile the labor must be to justify a currency union depends on the potential gains, usually thought of in ,terms of the convenience of transactions and the increased size of the market for financial dealings.

It is hard to argue that the European Community satisfies either of the two requirements of an optimal currency area to any appreciable extent. The individual countries suffer substantially different shocks because of differences in the mix of the products that they produce, in their dependence on imported oil, and in the foreign markets to which they sell. (Barry Eichengreen has recently shown that the real exchange rate changes in the 1970s and 1980s have been far greater among the countries of Europe than among the major regions of the United States, a reflection that the shocks have differed more among European countries than among U.S. regions.) Labor mobility among European nations will inevitably be limited for a very long time to come by differences in language and by a culture that, unlike that of the United States, regards geographic mobility with suspicion.

The politics of monetary union

If economic analysis does not provide support for a shift to a single European currency, why are there such strong voices in Europe calling for a monetary union that will replace national currencies with a single European currency? There are, I think, three distinct political reasons behind this advocacy.

First, there are those who see a single currency and a European central bank as a way of restricting the ability of national governments to pursue inflationary monetary policies. European central bankers in particular who must now answer to their finance ministers see the move to a single currency and a European central bank as a chance to make monetary policy with much less political interference. They argue that although each government could by itself pursue a noninflationary monetary policy, it is politically easier for a European collective to do so than it is for individual governments. Although a European central bank would still be accountable to some political body like the European parliament, distance from national capitals and national parliaments is assumed to reduce the pressure of domestic electoral politics on monetary policy.

They and others who make this argument would accept a much restricted scope for good monetary policy in each nation in order to reduce the political temptations for bad national policies. Quite apart from the question that this raises about the making of monetary policy in democratic states, it implies a possibly very large sacrifice of potentially good monetary policy in order to reduce the risk of a bad policy being chosen.

Moreover, although this argument is logically sound, as a practical matter it is very much weakened by the success of the current EMS arrangement in which German hegemony has encouraged other countries to pursue a German-style anti-inflationary policy. Why force every country to give up the possibility of stabilizing monetary adjustments in order to prevent inflationary policies that are only hypothetical?

Indeed it is the success of the German hegemony that creates the second of the political motivations for European monetary union. Put simply, nobody but the Germans is fully in favor of letting the Bundesbank make monetary policy for all of Europe. For many non-Germans, the creation of a European central bank that manages a European currency is a matter of national pride. For non-German central bankers, it is an opportunity to play an active role in the making of monetary policy.

But the reasons for wanting to replace the Bundesbank with a European central bank goes beyond national pride and the wishes of European central bankers. Not everyone shares Germany's strong anti-inflationary preferences. A European central bank might today adopt a more expansionary monetary policy that accepts permanently higher inflation to avoid a period of slow growth in the 1990s.

It is ironic that while some advocates of a single currency and a

European central bank argue that they want this to reduce the risk of inflation, others see it as a way of relaxing the very tough German anti-inflationary policy now "forced" on Europe by the Bundesbank.

All of which reinforces my belief that the strong advocacy of European monetary union does not reflect the political economy of monetary policy any more than it does a technical belief in the ability of monetary union to enhance trade within the community. Those who fervently advocate monetary union do so because they see it as a step toward a political union, and a particular type of political union at that.

Those who want to see Europe evolve into a political union see a monetary union as a helpful point along the way. A single currency would give the people of Europe a sense that they are part of a single country even though they speak different languages and remember different national histories. A single currency and European central bank would transfer substantial power away from national governments and to the nascent European central government. Many expect that this would be followed by limits on national fiscal policies and by enhanced centralized taxation.

The events in Eastern Europe have complicated this scenario. The economic costs of a single currency union for all of Europe increase as the number of countries with their different economic situations increases. As a practical matter, the single currency and the European central bank would not include many of those nations that are not currently in the EC. Although there is much talk about a single all-encompassing European Community that would welcome the countries of Eastern Europe, the move to a European monetary union now would create a two-class Europe in which those countries excluded from the proposed monetary union would be second class Europeans. With the Eastern Europeans and probably some of the northern countries excluded, Germany would be on the edge of the primary European Community and France would be in the center.

Let me end by reiterating my principal conclusion that monetary union is not needed to achieve the advantages of a free trade zone.

On the contrary, an artificially contrived European monetary union might actually reduce the volume of trade among the member countries and would almost certainly increase the average level of unemployment over time.

Although a European monetary union will accelerate the formation of a federalist political union among its members, those countries that are not part of the monetary union will be political outsiders. The consequences of this for the future stability of Europe, while difficult to contemplate with any certainty, may well not be favorable.