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Commentary

The Case for the Euro--I

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Do we really need another case for the euro? I made a case (using the name "europa" rather than "euro") as long ago as 1969. At that time the Hague Summit was setting up the Werner Committee to develop a plan for an economic and monetary union. Tomorrow at a press conference in Frankfurt, the European Monetary Institute will list countries eligible for membership, pending a final decision by European Union heads of state at a summit in London on May 1. A single-currency European Monetary Union is set to go next year.

Why the need for another case?

One reason is that three important countries--Britain, Denmark and Sweden--have serious doubts and have decided not to go ahead in the first round. Another reason is that there is considerable academic opposition to the idea of monetary union. It comes not just from Keynesians but from monetarists such as Milton Friedman, Henry Kaufman and Martin Feldstein, and even--surprise--a supply-sider, Arthur Laffer. The Keynesians fear the removal of devaluation as a weapon of policy. The monetarists' reasons range all the way from the threat that the euro might bring the dollar to its knees to the political possibility that it will create civil war in Europe! By contrast, Mr. Laffer thinks that a European currency might be a good idea in principle but that the Europeans will make a botch of it.

Even some European economists are worried about the impact of monetary union on their economies. They see the great advantages of a single currency in reducing information and transaction costs and in creating a large currency bloc that would be a counterpart to the dollar. They also see the need for monetary union in order to "complete" the movement toward a full-fledged common market such as exists within the U.S. A single market needs a single currency. Nevertheless, there is concern about the costs of throwing away the weapon of exchange rate policy.

Asymmetric Shocks

The problem is best illustrated by asymmetric shocks, economic changes that affect the members of the potential union differently. The usual argument centers on real shocks--as opposed to easily manageable monetary shocks. Real shocks are associated with shifts of excess demand from one group of commodities to another.

A shift of demand from the goods of region A onto the goods of region B will threaten unemployment in A and create inflationary pressure in B. Expansionary monetary policy might help to relieve unemployment in A but it would worsen inflationary pressure in B; contractionary monetary policy would be equally bad for opposite reasons. In this case, opponents of monetary union argue, exchange rate changes would be a superior mechanism of adjustment. Assuming A and B have different currencies, a depreciation of A's currency relative to B's would simultaneously reduce unemployment in A and inflationary pressure in B.

A monetary union rules out this solution, and that constitutes a major argument against it. Because of asymmetric shocks, the case against monetary union runs, one country or region might be unlucky enough to get saddled with a long and dreary period of excessive unemployment that it could have avoided had it stayed out of the monetary union.

At the outset it should be acknowledged that a monetary union cannot insulate its component parts from real shocks. Such shifts of demand normally lower the real income in one region at the expense of another. But if the critics of monetary union are right in asserting that a monetary union cannot insulate a region from shocks to demand, they are wrong in thinking that exchange rates can do any better. There is no exchange rate policy that can insulate an economy from the changes in real income arising from real shocks.

Optimum Currency Areas

I suppose I bear part of the blame for the argument, because it figured prominently in my exposition of the theory of optimum currency areas in my 1961 article introducing the subject. In the example I used, a hypothetical North America was divided into two regions--the East, producing cars, and the West, producing lumber. If there is a shift of demand from cars to lumber, flexible exchange rates between Canada and the U.S. would not solve the problem. Assuming the academic arguments for flexible exchange rates were valid (and I argue they are not), the flexible exchange rate solution would work only if currencies were reorganized into Eastern and Western jurisdictions.

I had no intention, of course, of proposing anything as silly as a redistribution of monetary areas in North America. My point was rather to show that if the argument for flexible exchange rates is valid at all, it is only valid for single-region countries. Flexible exchange rates will not help solve British regional unemployment problems in Wales or Scotland, or Italian problems in the Mezzogiorno, or U.S. problems in the Appalachians, or German problems east of the Elbe, or Canadian problems in the Maritimes. If the argument for devaluation were valid, it could be applied to every state or subregion in any country, with a proliferation of new currencies so they could be devalued!

The U.S. is not unfamiliar with asymmetric regional shocks. The oil price spikes in the 1970s made huge fortunes in oil-exporting regions in the Southwest but a basket case out of oil-importing regions like New England. Doubtless many Harvard or MIT Ph.D.s wished at that time that New England had a separate currency so they could devalue it. But all that New England would have got out of it would have been a higher price level and higher interest rates associated with expectations of future devaluations. No new resources are brought to a region by devaluation.

The middle 1980s saw the turn of the screw when oil prices collapsed, causing euphoria in Massachusetts and despair in Texas. Had Texas had a separate currency, doubtless some economists would have recommended its devaluation. But again there would not have been any sharing of the aggregate burden of the terms of trade collapse. Devaluation of a hypothetical Texas dollar would have imposed a higher price level and higher interest rates.

The case against devaluation and inflation as a way of correcting employment is amplified when account is taken of progressive income taxes. Devaluation causes "bracket creep" and fiscal tightness, increasing rather than diminishing unemployment. The great inflations of the 1970s were associated with rising not falling unemployment.

To be sure, after a long period of price stability, devaluation, like a sudden burst of money acceleration, can have real effects due to rigidities and money illusion. It can create a sense of euphoria arising from brisk demand, higher profits and temporary employment increases in the short run when wage rigidities can be relied on. This has long been the Keynesian argument for devaluation. Provided wage rates are not indexed to prices, a surprise devaluation can be a temporary spur to the economy for the duration of existing wage contracts. It can also shift wealth from creditors to debtors and reduce the burden of the national debt, easing problems of fiscal management.

There is no free lunch, however. There is the moral problem that policies relying on money illusion hurt workers and others on fixed incomes, as well as bond holders, and the financial authorities have to engage in deception to maintain surprise. More important from a practical standpoint, the crucial elements of money illusion and surprise are no longer present. Since the breakdown of the Bretton Woods arrangements, trade union leaders and investors have become fully aware of the link between currency depreciation and inflation, and have learned how to protect themselves against it. Wages now quickly adapt to inflation forecasts, leaving as a residue higher prices without any employment gains. In fact wage demands, by anticipating future

devaluations, can actually increase unemployment. High inflation and currency depreciation have not helped Spain escape the highest unemployment rates in Europe.

This does not mean, however, that careful attention should not be paid to the exchange rate at which a country enters a monetary union. If a country's price level at current exchange rates is out of line with other prices inside the union, it would be a poor bargain to endure the painful deflation needed to bring domestic prices into line. Britain chose an inopportune time to enter EMU in October 1990, because of the impending German fiscal expansion following reunification, and because capital inflows associated with financial services reform had pushed the pound to the peak of its cycle against the mark. When Britain had to leave the Exchange Rate Mechanism in the latter's crisis of 1992, many in Britain were soured on EMU, blaming the Bundesbank, Margaret Thatcher's advisers or even the whole idea of monetary integration in Europe for what was considered a fiasco. Even so, the episode helped Britain break inflationary expectations.

Britain, with the value of the pound again near the peak of its cycle against the mark, has now chosen to delay entry into EMU. Though its fiscal and debt position is more sound than any other member of the EU (laying aside tiny Luxembourg), the political decision has been put off until the next election. In the meantime, Britain can make use of the interval to harmonize its policy with that of the new European central bank. The signal that the market believes the pound has reached its long-run equilibrium against the euro will be when British interest rates have come down to those on the continent.

A good exchange rate is an old exchange rate. After countries have been in a currency area for a long time, wages, prices and interest rates become harmonized to a common level. In the ERM crisis, newcomers like Britain had to leave in the face of shocks. But the experience of the Benelux countries and Austria was completely different. Despite the asymmetric shock of unification in the anchor economy, these smaller economies were able to maintain their parities by continuing to let their monetary policies be governed by the balance of payments. In the monetary union, a self-adjusting monetary policy will be automatic rather than a matter of central bank discretion.

Monetary union will not eliminate the unemployment problems of Europe, which are due to excessively high tax rates, overregulation of the labor market, and social safety net provisions that have overshot the bounds of allocation efficiency and fiscal solvency. Nevertheless, the single currency will work in the direction of reducing unemployment. Without the supposed weapon of exchange rate policy, governments will in future have to stress reform of the microeconomic provisions that have protected the employed partly at the expense of the unemployed. Equally important, there will be direct effects arising from the increase in transparency of pricing in the labor market, which will foster increased awareness of Europewide labor market conditions, increase labor mobility and create pressures for convergence in pensions, unemployment benefits and taxes on labor.

The changeover to a new currency is never a simple process. The hard part is the mental transformation on the part of the public. Accustomed to valuing and reckoning in national currencies, each of the 375 million people in the European Union will have to learn a new way of comparing and thinking about prices. There is also an emotional transformation. The love affair that people in some countries have with their national money will come to an abrupt end, an emotional trauma akin to the loss of national heritage. Aggravating the emotional loss will be lingering regret associated with the loss, or sharing, of monetary sovereignty that has always been a key component of political sovereignty.

Compound Savings

These costs cannot be swept under the rug. But against them must be set the greater power of the euro. Instead of a currency that is legal tender in a small transactions area, Europeans will gain a currency that spans a continent. The benefits will derive from transparency of pricing, stability of expectations and lower transactions costs, as well as a common monetary policy run by the best minds that Europe can muster. These gains will gradually earn the euro the respect, perhaps grudging at first, that should more than compensate for the loss. Because the costs are paid but once, while the savings compound indefinitely, it is highly probable that the capitalized value of the latter considerably exceeds that of the former.

Monetary union will do much to integrate Europe's commodity, factor and capital markets. It will increase

Europewide competition and revolutionize financial markets. It will spur rationalization, mergers and takeovers in the European banking industry and commercial firms. Perhaps most important of all, EMU will change the way Europeans think about themselves and about a multiregional continental market that has become the largest in the world.

Next: The international implications.

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