European Monetary Integration

By

Charles Goodhart

SPECIAL PAPER 73

September 1995

FINANCIAL MARKETS GROUP
AN ESRC RESEARCH CENTRE

LONDON SCHOOL OF ECONOMICS

E·S·R·C ECONOMIC & SOCIAL RESEARCH COUNCIL

ISSN 1359-9151-73

European Monetary Integration

Professor C.A.E. Goodhart
Financial Markets Group
London School of Economics

A. Introduction

European Monetary Union (EMU) will involve a currency union spanning a set of sovereign states with relatively little federal centralisation of either political powers or of fiscal competences. This will distinguish it from other federal countries such as Australia, Brazil, the USA, or the former USSR. In this respect it will be unique in modern times.

It is sometimes argued that there are previous analogies to EMU in the 19th century in the guise of the gold standard or the silver-based Latin Union. I shall start by claiming that such analogies have to be used extremely cautiously.

Even in its hey-day the gold standard was subject to strains and frictions, especially at the periphery; and in the inter-war years a variety of adverse circumstances, e.g. political tensions and reparations; structural disturbances caused by the previous war; economic and fiscal rigidities; and global misdistribution of international gold reserves, to name but a few, made the gold standard itself part of the problem, helping to cause the disaster then (see Eichengreen 1992, and Glasner 1989). I shall argue that attempting to fix even more rigid, and supposedly irrevocable, currency linkages in advance of, and in the absence of, political and fiscal cohesion among the member states, is also a dangerous exercise. This will be my second main subject.

One of the reasons for embarking on this whole exercise is that some participants, both politicians and economists, often our French colleagues, claim that a single currency is necessary to preserve the benefits of a single market (see Padoa-Schioppa 1994). This issue has currently become highly topical with the realisation that there is likely to be a division within Europe between those member EU countries joining EMU at the outset in 1999 and those not doing so. The question of what should be the relationship, with what mutual supervision or understanding, between those EU members inside, and those outside, has started to exercise the minds both of officials at EMI and in the EC, and of politicians, with this topic being likely to be on the agenda for the next European Council in Madrid in December. This is my third main subject.

There has been considerable interest whether, and which, European countries represent an optimal currency area. I do not find this theory particularly helpful (also see Melitz 1995). All separate nation states that are larger than Panama, Liberia or Liechtenstein have a single currency. Are they all really optimal currency areas? Is Western Australia really part of an optimal currency area with Victoria, or Alberta with Quebec? No sovereign countries allow more than one currency as legal tender within their borders, and only a few tiny countries share a currency with a larger neighbour or trading partner. As is self-evident when formerly federal states, such as the USSR and Yugoslavia, break up, the now divided nation states rapidly move to their own separate currencies. What is clear is that currency union is essentially a function of political cohesion. One crucial component of political cohesion is the centralisation of fiscal competences, with causation going in both directions. While the influence, such as it may be, of fiscal federalism on the viability of a single currency within the same boundaries has become a reasonably widely discussed issue, I want to concentrate in my fourth and final topic on causation going in the other direction, on the influence of currency union in enhancing the acceptability of greater fiscal federalism.

B. Are there any Lessons from the Gold Standard for European Monetary Union?

M. Pani_ recently (1992) wrote a book on the subject of what lessons might be drawn for EMU from the experience of the gold standard. He concluded that "Many of the steps either taken or planned by the European Community go well beyond anything attempted under the gold standard", p. 133.

Let me detail some five respects in which this is so:

(1) Under the gold standard each country pegged its own national currency to gold. There was no single currency. Consequently each country could, and some did, adjust or revoke its peg to gold. Although the respective pegs meant that there was a bilateral mint parity in each case, insurance and transport costs caused there to be a band between the mint parity and the gold points. Moreover, central banks had various stratagems for manipulating the gold points. Consequently there remained some considerable degree of independent national control over domestic monetary policies. Short term interest rates in member countries did move together, positively correlated, (Morgenstern 1959), but this correlation was significantly below unity. There was no single monetary policy under the gold standard.

(2) The gold standard was not a free trade area, far less a single market. Under the gold standard,

as Pani_ notes, p. 112, "Duties were increased sharply in Sweden and Germany, remained very high in the United States and declined slightly in Denmark.... There was, obviously, no pressure on sovereign nation states during the classical gold standard to harmonise their commercial policies", p. 112. If member countries felt that their own domestic interests required it, they could adjust to external competitive pressures by changes in their tariffs and duties.

(3) Expectations of the electorate about the capacity, and duty, of governments to use macro-economic policies to maintain employment and standards of living were much less pronounced, though even then the beginnings of the welfare state were being established in some continental European countries, e.g. in Germany. Governments were not held responsible for preventing depressions. Consequently when a recession occurred, it was generally perceived as resulting from natural forces, (not from ill-chosen macro-economic policies), and private sector agents recognized the need for adjustment, however painful, (rather than looking to government policies for salvation).

(4) Trade unions only emerged towards the end of this period. In general, wage/price flexibility was probably rather greater in the 19th than in the 20th century. What is much easier to document exactly is that labour migration between members of the gold standard, especially from Europe to the Americas and the Antipodes, was vastly greater before 1914, than is observed, expected or intended within the European Union. As Pani_ notes, p. 149, "although various measures have been taken to ensure free movement of labour within the EC, the intention has never really been to generate large-scale migration of people within the area. As the [European] Commission's [1990] report on regional policy points out, this is undesirable for the simple reason that it would create congestion and social problems on a scale that no country would be prepared to tolerate."

In contrast, periods of severe economic and social pressures in many European countries during the 19th century, e.g. in Ireland, Germany, Sweden and Italy, were greatly alleviated by the safety valve of mass migration to the new world. That safety valve can only take a small amount of pressure within the present European Union.

(5) Although the generally successful operation of the gold standard led to the desirability of its maintenance being treated almost as an article of faith in some of the central countries of the system, (notably Britain), by the early 20th century, many, perhaps most participants,

certainly those at the periphery, regarded their continuing adherence to the gold standard as a matter of national choice, dependent on perceived national advantage. For most participants, membership of the gold standard was not seen as an irrevocable commitment. Each country decided independently. There was no international treaty.

Thus Pani_, p. 156, quotes Lindert on Sweden who noted that "Sweden, like almost all countries before and after 1914, observed the gold standard orthodoxy..... when it made no difference to the domestic economy, but abandoned it [in 1931] as soon as it began to bind..... Sweden stayed on the gold standard peacefully because she grew rapidly, and not vice versa." Similarly, he quotes Fratianni and Spinelli (1984) on Italy, that "the gold standard was not a sufficient condition for stability. Politicians had no difficulty in throwing off the straitjacket of the gold standard [in the early 1890s] when it stood in the way of financing large budget deficits". The experience of the USA in the 1890s (Friedman and Schwartz) and Argentina (Ford), and other Latin American countries, will also be familiar.

Moreover, as Laidler (1991, especially Chapter 6) shows, academic opinion was generally critical of the gold standard. In the earlier part of the period there were many conferences on alternative, though usually still metallic, systems. Only, perhaps, in the early 20th century was the gold standard perceived as a likely permanent and natural system. But the main point is that for most countries adherence to it was seen as a, potentially reversible, national decision, not as an irrevocable, treaty-determined, regime.

C. The Danger of Fixing an Inappropriate Exchange Rate

Some thirty years ago when I was first learning economics, one of the most glaring policy errors of all times was held up to us as having been the UK's decision to return to the gold standard in 1925 at an overvalued exchange rate. Moreover, the extent of that overvaluation has generally been held to have been not much more than about 10%. In the last few years real, and nominal, effective exchange rates have frequently varied by more than 10% in a year. Although noone has a precise idea of the fundamental equilibrium effective exchange rates, their continuing volatility must imply that many countries are often some long way from their FEERs.

The belief that exchange rates could easily become misaligned led to the incorporation within the Bretton Woods system of the capacity of countries to realign their exchange rates. This escape route is not open within single currency areas, and one important question is what are the relative weights that one should put on the various remaining safety valves, such as relative wage flexibility, labour mobility, capital mobility or fiscal transfers, while noting that cases of persistent regional depression within currency areas do exist. The obvious problem with EMU is that most of these safety valves, notably labour mobility and fiscal transfers, will be much less in evidence than in other single currency areas. The example of German reunification should also warn us that moving to a single currency is as likely to impede, as it is to encourage, relative wage flexibility; and whether EMU will lead to capital flows into, or out of, depressed areas is anybody's guess.

Thus we can hardly claim that factor mobility, or other quasi-automatic adjustment mechanisms, are so effective that we could move to irrevocably fixed rates without any great concern. There is, however, a reasonable case that some of the core countries of north-west Europe are so alike in structure, facing similar shocks, with inter-twined economies, that a single central policy would closely mimic their preferred national policies. But that is hardly the case for the peripheral countries in Europe.

The argument that is often made instead is that the option to realign is ineffective in practice, because real wage rigidity will rapidly transform the nominal exchange rate depreciation into higher wages and prices with, in the longer run, little effect on real wages or real exchange rates. Thus the claim is made that the ability of the UK to devalue, in 1949, 1967 and 1992, or to allow its exchange rate to float downwards, has led in the longer term to greater inflation, a higher risk premium on our interest rates, without any observable benefit to long term growth rates.

I am prepared to believe, though far from certain, that that judgment may be correct, but only in the very long term. The problem is that in this very long term the responsible politicians are either dead, or at the very least voted out of office. The electorate is impatient, and if it believes that it has been crucified on a cross of gold, or racked on the ecu, it is likely to take out its wrath on those who led it down that path. It is difficult, both at the time and with hindsight, to see how a £ at 4.80 to the $ in 1949 or 2.95 to the Dm in 1992 was consistent with a concurrently vibrant domestic economy in the UK. Under the eye of eternity, a more disciplined approach to wage and price increases, enforced by massive unemployment, might have been preferable in both those cases. But that was just not politically practicable. My key point is that it will <u>remain</u> politically impractical to force large scale, continuing depression on the UK economy for the purpose of maintaining a single European currency. Meanwhile the increasing tension in France between the perceived need to do something to help unemployment there and the desire to maintain the franc fort is fascinating for the outsider to observe. Within the UK that tension would already have been resolved by abandoning the currency link. I am not claiming that this would have been either right or good, just that that is, in current circumstances, the political reality.

D. <u>Does a Single Market require a Single Currency</u>?

In some part the tension within France between maintaining the franc fort and the adoption of more expansionary policies is perceived as having been exacerbated by the comparative devaluation of some of its trading neighbours, Italy, Spain and the UK. This reinforces the view of some continental economists, and many such politicians, that a single currency is ultimately necessary to sustain a single market. Otherwise those feeling aggrieved by movements in relative exchange rates may seek to even the score by re-erecting tariff barriers, (see Padoa-Schioppa 1994). This issue is also topical because it will arise in the discussions on the nature of the exchange rate relationships between those who have participated in Stage 3 of EMU in 1999 and those member states which have not done so. This is, I believe, to be discussed at the forthcoming Madrid council meeting at the end of this year.

There is no question in my mind that a single currency does strengthen a single market. One enormous boon is that it makes the calculation of (accurate) regional balance of payments statistics almost impossible. Without such data one cannot seek to reach conclusions whether a region's balance of trade with any other particular geographical grouping is improving or worsening. Balance of payments data almost force one to concentrate on the well-being of that sub-entity whose balance is under consideration. Without them, the focus of attention will shift to the larger whole grouping.

Since the welfare of the whole group, though not necessarily of narrower sub-groups, will be improved by free trade within the group, single currency areas are internally almost invariably free trade and usually single market areas. Conversely separate currencies tend to lead to separate commercial policies and trade barriers of some kind or another.

This latter is not, however, necessarily so. There is a marked division here between North American economic thought and practice, and that in Continental Europe. While the Europeans are concerned how to control exchange rate relationships within the single market, the North Americans have concluded NAFTA, the North American Free Trade Area; in these negotiations there were many tricky cognate issues, such as the netting of porpoises, but concern over relative exchange rates was conspicuously absent. There is no side agreement in NAFTA about exchange rates.

One reason for this difference of viewpoint is that there is an associated disagreement over the determinants and merits of having the exchange rate determined by market forces. The Americans have more faith in market fundamentals, and therefore see a floating exchange rate as likely to play a positive equilibrating role between economies. The Continental Europeans have tended to stress its susceptibility to speculative forces, which may cause severe disturbances and distortions for long enough to be economically and politically significant.

Perhaps even more important, there is also a difference between the American and Continental European viewpoint about what the objectives of independent domestic monetary policies are likely to be. In both Mexico and Canada monetary policy has been aimed primarily at achieving domestic price stability. Indeed this led, until the end of 1994, to a serious excess real appreciation in the peso. So long as the constituent monetary authorities in a free trade area/single market are sincerely following domestic objectives for some aggregate nominal variable, they cannot also at the same time be manipulating their exchange rate for competitive reasons. Nevertheless some Continental European commentators often see a beggar-thy-neighbour competitive mentality lying behind monetary policy measures in other countries.

What one fears may result from a future European summit on this subject is that exchange rate relationships between those in EMU and those initially outside will be subject to some form of mutual agreement, or even worse, pegged. What one hopes will result will be an understanding that those outside EMU must announce a (quantified) final nominal objective for monetary policy, preferably to be achieved by an independent central bank. Then the ESCB should be charged with monitoring, and commenting on, those monetary policy decisions of member central banks not in

EMU that seem inconsistent with those countries' own stated objectives, especially if these appeared to be connected with any significant exchange rate depreciation.

Such criticisms have, however, failed to grasp that the main purpose of our proposal lies in the field of political economy. If the European Union is unable to point to the overt provision of any financial support to a country, or region, in particular difficulties, how can it expect to counter the siren cries of politicians seeking to blame depression on EMU, and advocating revoking the irrevocable? Almost inevitably, EMU will be perceived in due course as seriously damaging the economic interests of some large part of some member country. When that does happen, just what do you think will keep that country willing to remain within EMU? The costs of withdrawing from a single currency, and re-establishing a separate currency, are not in reality so great. When the central political cement disintegrates, as in Austro-Hungary after World War I, or the USSR, Yugoslavia or Czechoslovakia more recently, the costs of

moving from a single, to multiple currencies, are of second-order importance.

One must ask the larger question whether countries which do not feel sufficient cohesion to agree a larger transfer of fiscal competences to the federal centre are sufficiently cohesive to maintain a single currency. It is, however, partly a chicken and egg problem. Once we do have a single currency, and no balance of payments data, it will, happily, become considerably harder to estimate the net costs, or benefits, to any constituent nation of any fiscal measure. If each county in the UK had its separate currency, could assess the effect on itself of every UK fiscal proposal, and veto those that adversely affecting itself, <u>nothing</u> would ever get done at Westminster.

While some may, indeed, see merits in that, and the whole subject of fiscal federalism, or subsidiarity, is intellectually fascinating, my point is only that the very existence of a single currency could help to erode national selfishness in a manner that would facilitate the subsequent transfer of suitable fiscal competences to the federal centre. Such a transfer could then further serve to support the single currency. But how can we get through the early years when a single currency is in place without either overwhelming political support or the mutual benefit of a sizeable or well-designed federal budget? It will be an extremely dangerous corner to turn. I question whether the transition route has been well designed.

Bibliography

Eichengreen, Barry, (1992), Golden Fetters: The Gold Standard and the Great Depression, 1919-1939, National Bureau of Economic Research, (Oxford University Press: Oxford, England).

European Commission, (1990), The Regions in the 1990s, (EC, Brussels).

Ford, A.G., (1962), The Gold Standard 1880-1914: Britain and Argentina, (Clarendon Press: Oxford).

Fratianni, Michele and Spinelli, Francesco, (1984), `Italy in the Gold Standard Period, 1861-1914', in Michael Bordo and Anna Schwartz (eds): A Retrospective on the Classical Gold Standard, 1821-1931, (Chicago University Press: Chicago).

Friedman, Milton and Schwartz, Anna, (1963), A Monetary History of the United States, 1867-1960, National Bureau of Economic Research, (Princeton University Press, Princeton, N.J.)

Glasner, David, (1989), Free Banking and Monetary Reform, (Cambridge University Press: Cambridge, U.K.).

Goodhart, Charles and Smith, Stephen, (1993), `Stabilization' in Section V on `Macro-stabilization and shock absorption', of Reports and Studies on The Economics of Community Public Finance, European Economy, No. 5, pp 417-456.

Laidler, David, (1991), The Golden Age of the Quantity Theory, (Philip Allen: London).

Lindert, Peter, (1984), `Comments' in Michael Bordo and Anna Schwartz (eds): A Retrospective on the Classical Gold Standard, 1821-1931, (Chicago University Press: Chicago).

MacDougall Report, (1977), `Report of the study group on the role of public finance in European integration', chaired by Sir Donald MacDougall, Commission of the European Communities, Economic and Financial Series, No. A13, Brussels, April.

Melitz, Jacques, (1994), `Is There a Need for Community-wide Insurance against Cyclical Disparities?', Economic and Monetary Union. Economic et Statistique, Special Issue, pp 99-106.

Melitz, Jacques, (1995), `The current impasse in research on optimum currency areas', European Economic Review, 39, pp 492-500.

Melitz, Jacques and Vori, Silvia, (1992), `National Insurance Against Unevenly Distributed Shocks in a European Monetary Union', manuscript.

Morgenstern, Oskar, (1959), International Financial Transactions and Business Cycles, National Bureau of Economic Research, (Princeton University Press: Princeton, N.J.).

Padoa-Schioppa, Tommaso, (1994), The Road to Monetary Union in Europe, (Clarendon Press, Oxford).

Pani_, Milivoje, (1992), European Monetary Union: Lessons from the Classical Gold Standard, (Macmillan Press Ltd: London).

Sachs, Jeffrey and Sala-i-Martin, Xavier, (1991), `Federal fiscal policy and optimum currency areas - Evidence for Europe from the United States', NBER Working Paper, No. 3855.

Von Hagen, Jurgen, (1991), `Fiscal arrangements in a monetary union. Evidence from the US', Indiana University School of Business, Discussion Paper 58.

Von Hagen, Jurgen and Hammond, George, (1995), `Regional Insurance Against Asymmetric Shocks. An Empirical Study for the European Community', Centre for Economic Policy Research, Discussion Paper No. 1170 (May).