A Market-Based View of European Monetary Union

by W. Lee Hoskins

Slow economic growth and high unemployment over the past 10 years suggest that the European Economic Community (EEC) has not grown at its true potential. Many observers attribute this shortfall—at least in part—to restrictions, regulations, subsidies, and income guarantees that distort markets and produce inefficiencies. One might view Europe's renewed drive toward eventual economic integration, through the creation of a single internal market by 1992 and with the EEC's interest in monetary policy coordination, as tacit acknowledgment of a problem.

Policy coordination, however, is a double-edged sword. It can cut through the web of restraints in which we have tied world markets, freeing them to pursue the most efficient allocation of resources. Or, it can sever the incentive and information processes that markets uniquely possess, killing any hope of maximizing production, employment, and exchange. Europe must choose how it will wield this sword.

The drive to create a unified Europe includes a single-market objective and a monetary-union initiative. The single-market objective would remove restraints on the free flow of goods, services, labor, and capital by 1992. Freer markets and expanded opportunities for trade promise enormous gains from increased efficiency and economies of scale.

Through a monetary union, many Europeans hope to coordinate monetary policy with an eye toward maintaining exchange-rate stability. Although monetary union could supplement the single market by providing further efficiencies in the use of money, a monetary union is of secondary importance in pushing Europe toward its economic potential. Most of the gains stem from free markets and free trade, not from monetary arrangements.

This is fortunate, because monetary union faces a formidable challenge from existing European institutions. Most economists recognize the mutual incompatibility of fixed exchange rates as maintained under the current European Monetary System (EMS), free capital mobility as sought by the single-market objective, and national monetary sovereignty. The EEC will face a choice: sacrifice one of these three to protect the other two.

Only one choice seems feasible, at least for the near term. Many European leaders have noted that Europe will not soon achieve the high degree of political, social, and cultural integration necessary for it to relinquish monetary sovereignty and effect a full monetary union. Of the remaining alternatives, more-flexible exchange rates offer the best means of maximizing the efficiency gains from a single market and free capital movements. Moreover, floating rates do not preclude an eventual monetary union.

The European Economic Community will benefit enormously from the creation of a single internal market by 1992. Nevertheless, the free movement of financial capital could force Europe to choose between fixed exchange rates and monetary independence. This Commentary discusses the alternatives involved with this choice, one of which is the creation of a European monetary union.

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Concerns along these lines have to do with creation of barriers to external trade. Inflation itself involves costs in terms of misallocated resources. It adds “wages” to prices, which distorts the information about relative scarcities conveyed by price changes. Through its interactions with tax systems, inflation can affect firms’ investment and financial decisions. While these costs are greatest when inflation is high and variable and difficult to predict, they are present at the moderate levels observed in the United States and the EEC today.

Evidence from a large set of countries, with very different institutions and economic conditions, indicates that persistent inflation erodes long-term economic growth. The inefficiencies and distortions associated with inflation reduce resources available for capital formation and encourage investments that have quick payback periods, rather than long-term growth potential.

The creation of a single European market, together with a more general acceptance of a liberal-market philosophy and a commitment to zero inflation, will confer substantial gains on Europe, with or without a monetary union. To be sure, however, a symbiotic relationship exists between a single internal market and a monetary union. A monetary union could enhance the benefits of a single internal market by providing efficiency gains in the use of money, and a single internal market could strengthen a commitment to price stability throughout Europe. Of the two, the creation of a single internal market undoubtedly is the more important. Beyond the efficiency gains that I have described, it is the sine qua non of monetary union.

Identifying the potential gains from monetary union is easy, but achieving them—if they are at all achievable—is quite a different matter. The EEC has made progress on the Delors Committee’s report, but the key question remains: how far can European policymakers go in these new efforts to improve price-level stability? The EEC could enhance the gains from a single market if its members adopted a stable-price policy. Inflation itself involves costs, both in terms of misallocated resources and in terms of distortions in the information about relative scarcities conveyed by price changes. Through its interactions with tax systems, inflation can affect firms’ investment and financial decisions. While these costs are greatest when inflation is high and variable and difficult to predict, they are present at the moderate levels observed in the United States and the EEC today.

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The overall efficiency. The EEC must avoid taking actions that could offset the gains from a single internal market. Two widely discussed concerns along these lines have to do with market. Two widely discussed concerns along these lines have to do with changing barriers, restrictions, and controls, the EEC could “level them up,” creating a new bureaucracy and competition-stifling protectionism within the Community. This kind of policy coordination would limit potential gains in production, employment, and exchange opportunities in Europe. Replacing 12 individual markets with a single market does not, in itself, diminish rent-seeking, as we have seen with Europe’s Common Agricultural Policy.

Similarly, some of us from outside the EEC wonder whether the Community will restrict external competition. Over the past 40 years, the trading world—often led by the EEC—has lowered tariffs and removed quotas. But after substantial gains during the 1950s and 1960s, the progress slowed. Although the EEC’s protective tariffs were more modest than before, they might not be better than 40 years ago, trade restrictions remain an important feature of European and world-wide trade. Moreover, these restrictions have become more discretion ary, even less visible, and even less responsive to market pressures than the traditional tariffs that they replaced.

The fact is that the trading world lacks firms commitment to the principles of free trade. We live in a neomercantilist environment where market access is more often a function of bilateral, production-specific negotiations than the result of competitive strengths. Such types of policy coordination have enormous costs.

A further concern, which has not received enough attention, focuses on price-level stability. The EEC could enhance the gains from a single market if its members adopted a stable-price policy. Inflation itself involves costs in terms of misallocated resources. It adds “waste” to prices, which distorts the information about relative scarcities conveyed by price changes. Through its interactions with tax systems, inflation can affect firms’ investment and financial decisions. While these costs are greatest when inflation is high and variable and difficult to predict, they are present at the moderate levels observed in the United States and the EEC today.

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Identifying the potential gains from monetary union is easy, but achieving them—if they are at all achievable—is quite a different matter. The EEC’s heads of state have changed the Delem Committee with the sudden task of examining and proposing steps toward a common monetary policy in Europe. The Committee’s report, published this month, will be debated at the EEC summit in Madrid in late June. One can anticipate the importance and the urgency of the Committee’s work by considering alternative strategies for resolving the incompatibility of a single European market, fixed exchange rates, and national monetary sovereignty.

Can Europe Afford the EMS?

One alternative is to maintain the present exchange-rate mechanism (ERM) of the European Monetary System. However, the current policy of allowing exchange rates to move within a narrow band around fixed central exchange rates will prove more difficult as Europe liberalizes capital flows.

Theory tells us that individual countries cannot conduct independent monetary policies under a system of rigidly held exchange rates with free capital mobility. Countries that inflate their economies above the average level of their trading partners will suffer a balance-of-payments deficit and will tend to lose reserves. Countries with relatively low inflation rates will tend to gain reserves. Eventually, the inflation-prone countries will experience a subsequent monetary contraction, while the latter will experience a monetary expansion.

Also, as this discussion suggests, a system with mobile capital and fixed exchange rates leaves countries vulnerable to external monetary shocks. Under the ERM’s fixed-rate system, many countries—notably West Germany and France—have complained about importing inflation from the United States during the late 1960s and early 1970s. Only as long as member countries have similar preferences for inflation are exchange-rate mechanisms sustainable.

Most observers would agree that European policymakers do not give similar weight to inflation in formulating their monetary policies. Outside West Germany, the EEC’s interest rate policy is determined by central banks, and the EEC’s inflation policy is determined by national administrations. Each EEC country faces its own interest rate policy, and it is the relative strength of lira and the German mark that determines the future of the EMS.

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Unfortunately, available research strongly suggests that sterilized intervention (that is, intervention with no monetary consequences) does not provide countries with an additional policy lever through which to pursue an exchange-rate target. It is not sterilized, intervention can alter exchange rates, but this introduces a substitution of inflation goals to exchange-rate objectives. Some observers even contend that intervention creates uncertainty in the market and thus prevents members from adjusting to the fundamentals of a situation.

The ability to realign central banks allows a possible solution to the dilemma that capital mobility and national monetary sovereignty pose, but it also can introduce new problems into the system. Realignments of fixed exchange rates imply that countries know the correct, or equilibrium, values at which to peg. Usually the ERM member have resorted to realignments broadly designed to correct for existing inflation differentials. However, economists have enjoyed little success in specifying the relationship between the so-called market fundamentals (including inflation differentials, real interest-rate differentials, and current account) and spot exchange rates. On occasion—most notably in January 1987—the realignments seemed to be the product of intensive negotiations, especially between France and West Germany. Rather than the result of an “arms-length” reading of market fundamentals. Because such renegotiations cannot promise to produce a market equilibrium value for exchange rates, they can introduce real-resource costs.

In addition, a commitment to defend exchange rates risks the danger of what I call monetary protectionism. As nations lower protectionist barriers against trade, they may also spread the temptation to protect home markets through monetary manipulations not grow stronger! A commitment to maintain a peg, countries with relatively low inflation rates might accumulate the currency of high-inflation countries. Ob-
tend that exchange-rate volatility creates uncertainty, which raises the costs of doing business and the required return for undertaking risky investments. The higher costs and riskiness of business, in turn, reduce international trade, investment, and employment.

This criticism seems flawed. First, exchange-rate movements respond to changes in other economic variables and, ultimately, to changes in monetary and fiscal policies. Much of the volatility of exchange rates reflects the volatility and incompatibility of underlying policies. Uncertainty created on this account is a by-product of policy and would exist under fixed exchange rates. Nevertheless, many economists regard exchange-rate volatility as excessive—the result of overshooting, bubbles, and destabilizing speculation. Although volatility may create some inefficiencies, these inefficiencies pale in comparison to the market distortions that could result from an attempt to peg at an inappropriate exchange rate, or from attempts to maintain fixed exchange rates through capital controls. Markets for other assets exhibit similar volatility, yet we do not peg their prices.

Second, volatility is not synonymous with uncertainty, although observers often use the terms interchangeably. Under floating exchange rates, firms can hedge, although not completely, against the risks imposed by this volatility. Under fixed exchange rates, the market can become uncertain of the magnitude and timing of adjustments when it judges existing rates to be inappropriate. These risks seem more difficult to hedge against and can result in inefficient resource allocations. Ironically, speculators usually are more certain about the direction of change and are often assured of profits. Finally, I am aware of no concrete evidence that links exchange-rate volatility, as I have described it, with a reduction in trade, investment, or employment.9

On National Sovereignty and a European Central Bank

As the last alternative, the European Economic Community could maintain the current ERM structure with an increased liberalization of capital flows, if individual countries gave up their national monetary sovereignty. One way to achieve this requires all countries to peg their currencies to a dominant-currency country, such as West Germany. This country then would determine the overall inflation rate through its monetary policy, and the other countries would maintain the exchange-rate pegs through their monetary policies. I doubt, however, that the EEC participants would acquiesce to such a commitment, at least in the near future.

Some countries could benefit from such an arrangement. For small, open economies that are heavily dependent on trade with the dominant country, such an arrangement might create more stability in trade volumes and prices. It could reduce their vulnerability to speculation and limit the need for forward cover. All of this assumes, however, a strict adherence to the rules of the game and a willingness to accept the monetary policy of the dominant country.

Many observers argue that a fixed-exchange-rate system exercises a discipline on inflation-prone countries and enhances the credibility of their disinflation efforts. This discipline often proves difficult to maintain politically, which is why inflation-prone countries do not adopt disinflation policies to begin with. Often the discipline is avoided through capital restraints or through parity adjustments.

Fears that the discipline effects of fixed exchange rates will become more pronounced as the EEC loosens capital restraints have prompted calls for the creation of a European currency issued through a European central bank. Such a central bank implies that all governments would relinquish their sovereignty over monetary policy, but that each would maintain a voice in establishing a common European monetary policy. Some weighted-average infla-

I do not wish to argue that a European central bank—or any central bank, for that matter—could not successfully enhance production and employment opportunities, but its ability to do so rests on the attainment of two conditions. First, the EEC must give its central bank complete autonomy from financing the fiscal policies of the individual European states and of the Community in general. By financing expenditures through the sale of their debt to central banks, governments can reduce the real value of their outstanding debts through subsequent inflation. This inflation tax, although highly inefficient and distortional, nevertheless is relatively invisible to the electorate; hence its attractiveness.

The second condition for the successful creation of a European central bank requires that it maintain the value of its currency by promoting price stability. I have already referred to problems of attempting to stabilize exchange rates while attempting to conduct an independent domestic monetary policy. A more common, yet less recognized, problem occurs when countries attempt to stabilize the business cycle.

Policymakers sometimes balk at eliminating inflation because they believe that a trade-off exists between inflation and unemployment. The theoretical basis for such a policy and the evidence supporting its effectiveness are weak. Nevertheless, even granting that more inflation could lead to a temporary increase in employment, there seems to be a tendency for such policies to ratchet inflation upward. In the 1970s, the rate of inflation at the business-cycle trough tended to rise with each cycle. The resulting reductions in long-term growth probably outweighed any short-term gains in employment.
Europe and the International Financial Community

I have previously expressed concerns about the attempts of the G7 countries to coordinate macroeconomic policy and to create exchange-rate target zones for the mark-dollar and yen-dollar exchange rates. The creation of a European monetary union could have the unfortunate consequence of increasing support for these policies. Even when sovereign countries want to coordinate policies, they might not be able to do so effectively.

Despite advances in economics and statistics, our knowledge remains limited about the true state of the economy, about the interrelationships among policy levers and economic variables, and about the weights society attaches to specific economic problems. These uncertainties greatly reduce the chances that policy coordination will enhance economic welfare.

Many of these proposals for international policy coordination call for a detailed harmonization of monetary, fiscal, and regulatory powers. If nations compromise domestic objectives—particularly price stability—because of international targets and events, they risk the loss of public confidence in their willingness and ability to achieve those objectives.

These, of course, are problems at the national level, but the costs of an error increase sharply as we extend the scope of coordination to Europe and to the international financial community in general.

Conclusion

Policy coordination must play an essential role in the process of European unification. In developing proposals for a single market and for a monetary union, we urge coordination of efforts to free markets and to expand exchange and production opportunities. That these markets extend across European boundaries only serves to enhance the gains from such coordinated policies.

We should similarly explore opportunities for international coordination that enhance the performance of free, competitive markets. I caution, however, against forms of policy coordination, both in Europe and throughout the international community, that serve to supplant markets and to limit their discipline. We simply cannot afford them.

Footnotes

1. This view is found in Nigel Lawson's speech at the Royal Institute for International Affairs on January 25, 1989, entitled "What Sort of European Financial Area?"


7. See W. Lee Hoskins, "International Policy Coordination: Can We Afford It?" Economic Commentary, Federal Reserve Bank of Cleveland, January 1, 1989.


W. Lee Hoskins is president of the Federal Reserve Bank of Cleveland. The material in this Economic Commentary is based on a speech presented on March 31, 1989, in Avila, Spain, at the Conference on the European Monetary System: Its Consequences for the Unity of Europe and for the International Monetary System, organized by the Instituto de Economia Mercades.

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