

A Market-Based View of European Monetary Union

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Conference on
The European Monetary System:
Its Consequences for the Unity
of Europe and for the
International Monetary System

Organized by the Instituto de
Economía de Mercado
Avila, Spain
March 31-April 1, 1989

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by

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April 1, 1989

Relatively slow growth and high unemployment over the past 10 years suggest that the European Economic Community 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 within Europe. One might view Europe's renewed commitment to policy coordination, with its interest in eventual economic integration, as tacit acknowledgment of a problem.

Policy coordination, however, is a two-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 remove restraints on the free flow of products, labor, and capital within the EEC is the most important goal. Subject to certain caveats

about policy coordination, the single European market promises exchange, production, and employment opportunities that are more consistent with Europe's potential. These gains stem from free markets and trade, with or without a monetary union. Nevertheless, a monetary union could supplement the single market by providing further efficiencies in the use of money.

Unfortunately, a well-known conflict exists between monetary union and existing European institutions. Fixed exchange rates (as under the exchange-rate mechanism), free capital movements (as under a single market) and national monetary sovereignty are incompatible. The EEC must then make a choice: sacrifice one of these three to protect the other two. My task is to offer the observations of an outsider about this choice, about the alternatives this dilemma presents, and about its implications for both the European Monetary System and the international financial community.

As many European leaders have noted, Europe will not soon achieve the high degree of political, social, and cultural integration necessary to relinquish monetary sovereignty and effect a full monetary union. Under these circumstances, floating 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.

Markets, Real Resources, and Efficiency

Ultimately, we will judge the success of any monetary union in Europe by the long-term real growth and employment that it fosters. As I will argue, these depend more on the extent to which Europe liberalizes its product, labor, and capital markets than on the advantages of monetary union.

The European Economic Community is initiating some 300 actions to remove physical, technical, and fiscal barriers to freer markets. The removal of these barriers to the free flow of products, services, labor, and capital promises enormous gains from specialization, competition, and economies of scale. Already firms in Europe are consolidating and investing to take advantage of wider markets. Nevertheless, the removal of barriers among member states is not enough in itself to guarantee overall efficiency gains. These require that the EEC go beyond the removal of barriers among its individual members and adopt more general policies that liberalize markets and that allow prices to convey information about relative scarcities. Two widely discussed concerns along these lines have to do with the "leveling up" of regulation and the creation of barriers to external trade.

Many observers, especially the British, have expressed concern that, in the drive toward a unified Europe, a pattern of supranational regulation and subsidization will supplant the concept of a single liberalized market. Instead of breaking down barriers, restrictions, and controls, the European Community could "level them up," creating a new bureaucracy and competition-stifling patronage within the community.¹ 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 European Community 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 overall level of import restraint might not be higher now than 40 years ago, trade restraints remain an important feature of European and worldwide trade. Moreover, these restraints have become more sophisticated, more discretionary, less visible, and even less responsive to market forces than the traditional tariffs that they replaced.

All current rhetoric aside, the trading world lacks firm commitment to the principles of free trade. We live in a neo-mercantilist environment where market access often is more a function of bilateral, product-specific negotiating skills 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.² Inflation itself involves costs in terms of misallocated resources. It adds "noise" to prices, which distorts the information about relative scarcities conveyed through price changes. Through 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.

Inflation also leads to the creation of socially inefficient institutions, designed to protect individuals against inflation-induced losses on money and financial assets. We would see far fewer transactions in futures markets for exchange rates and interest rates in an inflation-free world.

Finally, 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 longer-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 efficiencies in the use of money, and a single internal market could strengthen a commitment to price stability throughout Europe. Of these 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 heads of state charged the Delors Commission with the arduous task of examining and proposing steps toward a common monetary policy in Europe. The Commission will report its findings in June 1989. One can appreciate the importance and the urgency of the Commission's work by considering the dilemma that a single European market poses under existing European institutions. As many economists have noted, the objectives of free capital movements as sought by the single market, of relatively fixed exchange rates as provided through

the existing exchange-rate mechanism (ERM), and of monetary independence among sovereign nations are mutually incompatible. History suggests that capital flows usually bear the burden of resolving this incompatibility.

Will the individual member countries of the EEC give up their national sovereignty over monetary policy? My guess is not in the foreseeable future. What then are the alternatives for the European Economic Community?

Can Europe Afford the EMS?

One alternative is to go forward with the EMS. However, the present EMS policy of attempting to maintain fixed central exchange rates with limited flexibility around them 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 incur a balance-of-payments deficit and will tend to lose reserves. Countries with relatively low inflation rates will tend to gain reserves. 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 Bretton Woods fixed-rate system, many countries--notably Germany and France--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 fixed exchange-rate mechanisms sustainable.

Most observers would agree that European policymakers do not give similar weight to inflation in formulating their monetary policies. Overall, Germany strives for a lower rate of inflation than most other European governments. Although inflation differentials among the European countries have narrowed since the early 1980s, this development does not represent a convergence among European policymakers to a similar emphasis on inflation. Incompatible inflation objectives often contribute to substantial capital flows among ERM participants and to realignments of the ERM. Moreover, inflation differentials seem to prevent more European countries from joining the ERM.

Attempts to resolve this incompatibility between liberal capital movements, national monetary sovereignty, and fixed exchange rates through more policy coordination can add to market distortions that lower employment and output. The desire to limit exchange-rate fluctuations and simultaneously to maintain monetary independence, for example, historically has encouraged countries to restrict the cross-border movements of capital. Capital controls played an integral role in the functioning of the Bretton Woods exchange-rate system; in fact, the IMF encouraged their use in cases of temporary balance-of-payments problems. Similarly, capital controls have been important for the operation of the European Community's ERM and its predecessor, the "snake." One recent study credits the stability of exchange rates under the ERM primarily to the use of capital controls, rather than to the coordination of monetary policies.³ These capital controls introduce many distortions: they raise the costs of investment capital to firms, reduce hedging possibilities, lower returns to savers, induce undesirable changes in nations' financial structures, and encourage rent-seeking.⁴

Countries also have resorted to exchange-market intervention as a possible way to resolve the problems that fixed exchange rates pose. In theory, nations could achieve fixed exchange rates, capital mobility, and monetary autonomy if they had additional independent policy instruments, but of course they do not. In practice, countries have used exchange-market intervention believing that it affords--at least temporarily--an extra degree of freedom. 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. Intervention can alter exchange rates, if it is not sterilized, but such intervention implies some subjugation of inflation goals to exchange-rate objectives. Some observers even contend that intervention creates uncertainty in the market to the extent that it raises doubts about the future course of monetary policies or that it attempts to offset market fundamentals.

The ability to realign central parities allows a possible solution to the dilemma that capital mobility and national sovereignty pose, but it also can introduce new problems to the system. Realignment of fixed exchange rates imply that countries know the correct, or equilibrium, values at which to peg. Usually the ERM members have resorted to realignments broadly designed to correct for existing inflation differentials. Unfortunately, economists have enjoyed little success in specifying the relationship between the so-called market fundamentals (including inflation differentials, real interest-rate differentials, and current accounts) and spot exchange rates.⁵ On occasion--most notably in January 1987--the realignments seemed to be the

product of intensive negotiations, especially between France and Germany, rather than the result of an "arm's 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 protectionist measures against trade and capital flows come down, does the temptation to protect home markets through monetary manipulations not grow stronger? Under a commitment to maintain a peg, countries with relatively low inflation rates might accumulate the currency of high-inflation countries. Obviously, low-inflation countries limit the extent to which they will do this, since inflation erodes the purchasing power of these reserves. At some point, countries accumulating reserves will exchange them back with the more inflationary countries, resulting in either a change in policy within the more inflationary countries or an alteration of exchange rates.

My point, however, is that such a system--unlike floating exchange rates--does not embody any smooth or automatic mechanisms to assure adjustment. At least in the interim period, the coordinated efforts to fix exchange rates will insulate exchange rates from reflecting underlying market pressures and, instead of bottling up inflation within the more inflationary countries, will transmit it to others. Under these circumstances, fixed exchange rates protect the claims of high-inflation countries to world resources through imports. Because it prevents an automatic depreciation of the inflating countries' currency, maintaining the peg keeps foreign goods artificially cheap. The result, at least for some time, is a disruption of trade and

investment across countries from what the market otherwise would have produced.

Consequently, any economic community that wishes to benefit from free trade and capital movements can maintain policy independence only if it allows the adjustments to occur through exchange rates. If Germany and France adopt policies that create a 10 percentage-point differential between their inflation rates, the ERM must allow for exchange-rate adjustments of comparable magnitude. Barring this, the EMS has the potential to impose real costs that the Community cannot afford.

Flexible Rates and the Question of Volatility

Another alternative, as implied above, is to move to a system of more flexible exchange rates, or to a regime of floating exchange rates. This alternative reduces the potential disruptions to market-driven outcomes and therefore seems more compatible with the single-market goal.

Critics of floating (or more flexible) exchange rates, however, argue that the resulting exchange-rate volatility reduces the free flow of resources among different countries in a single market. They contend that exchange-rate volatility creates uncertainty. Greater uncertainty raises the costs of doing business and the required return for undertaking risky investments. The higher costs and riskiness of business reduce international trade, investment, and employment.

This criticism seems flawed. First, exchange rates are endogenous variables, which are ultimately responsive to nations' 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 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.⁶

On National Sovereignty and a European Central Bank

As the last alternative, I wish to observe that 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 Germany. The dominant-currency 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. Under fixed exchange rates, currencies compete. Those with the most stable values tends to dominate and extend a discipline on inflating countries, assuming again that the inflation-prone countries adhere to the rules of the game. Typically, however, the rules are broken.

Inflation-prone countries alter exchange rates and restrict the free flow of capital to avoid adjustments. Moreover, experience suggests that the world tends to view the rapid depreciation of a country's currency as an indicator

of inappropriate policy. Consequently, to the extent that world opinion ever constrains the economic policies of sovereign states, inflation discipline can exist under floating exchange rates.

"Adjustment asymmetries" are another source of European reluctance to tie to a dominant currency. Fixed rates--if maintained without capital controls--would force high-inflation countries to adjust to the lower inflation rates of their trading partners. This often proves politically difficult, which is why inflation-prone countries do not adopt them to begin with. Fears that these so-called adjustment asymmetries 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 relinquish their sovereignty over monetary policy, but that each would maintain a voice in establishing a common European monetary policy. Some weighted-average inflation preference would prevail. Such compromises in the pursuit of economic policy coordination are the essence of politics, but the bane of economic efficiency and stability.

I do not wish to argue that a European central bank--or any central bank for that matter--could not successfully maximize 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. A large body of research strongly suggests that governments spend too much, particularly relative to their ability to tax. The reasons relate to the nature of publicly supplied goods, to the incentives within bureaucracies, and to the nature of political compromise. The benefits

of government expenditures tend to be concentrated on indentifiable, politically astute groups, while the costs are diffused throughout the public at large. 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. Governments often demand too much of monetary policy. I have already referred to problems of attempting to stabilize exchange rates and conduct domestic monetary policy. A more common, yet less recognized, problem occurs when countries attempt to stabilize the business cycle. Sometimes policymakers balk at eliminating inflation because they believe that a trade-off exists between inflation and unemployment. The theoretical basis for such 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.

Under conditions of autonomy and price stability, a European central bank could be a useful and natural extension of the single European market. As many European leaders have pointed out, however, monetary union presupposes a complete economic and political integration of Europe. Europe is not likely

to achieve such a close degree of integration in the near future. Perhaps the long run holds more promise, if Lord Keynes' famous dictum does not trap us first.

Europe and the International Financial Community

I have previously expressed concerns about attempts by the G7 countries to coordinate macroeconomic policy and to create exchange-rate target zones for the mark-dollar and yen-dollar exchange rates.⁷ 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. The sharp differences among economists about the true state of the economy, and about the interrelationships among policy levers and economic variables, are almost legendary. If economists cannot agree on how the economy works, can we expect governments to agree on and implement coordinated, effective macroeconomic policies? One also might wonder about the outcome if the world cooperated, but adopted the wrong model of how the world works. This of course is a problem 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.⁸

Many of these proposals call for a detailed harmonization--a fine tuning on a grand scale--of monetary, fiscal and regulatory powers. It reminds me of policymakers' efforts at "fine tuning" in the 1960s and 1970s, when they attempted to achieve many targets simultaneously. The thrust of policies shifted frequently, and those policies generally missed on all accounts. The

markets' mistrust of policymakers was reflected in an inflationary psychology that complicated and extended the fight against inflation. If we now subordinate domestic objectives to international targets and events, economic agents once again could lose confidence in the willingness and the ability of policymakers to pursue important domestic goals.

Conclusion

Policy coordination must play an essential role in process of European unification. In developing proposals for a single market and for a monetary union, I 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 strive to supplant markets and limit their discipline. We simply cannot afford them.

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 Arena?"

² See William T. Gavin and Alan C. Stockman, "The Case for Zero Inflation," Economic Commentary, Federal Reserve Bank of Cleveland, September 15, 1988.

³ Michele Fratianni, "The European Monetary System: How Well Has It Worked?" The Cato Journal, Vol.8, No.2 (Fall 1988): 477-501. See especially page 483.

⁴ See Jacob A. Frenkel and Morris Goldstein, "The International Monetary System: Developments and Prospects," The Cato Journal, Vol.8, No.2 (Fall 1988):285-306.

⁵ See Richard A. Meese and Kenneth Rogoff, "Empirical Exchange Rate Models of the Seventies: Do They Fit Out of Sample?" Journal of International Economics 14 (1983): 3-24.

⁶ See "Exchange Rate Volatility and World Trade," A Study by the Research Department of the International Monetary Fund, Occasional Papers No.28, July 1984.

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

⁸ See Jeffery A. Frankel and Katherine Rockett, "International Macroeconomic Policy Coordination When Policymakers Do Not Agree on the True Model," American Economic Review, Vol.78, No.3 (June 1988):318-40.