

# Europe's Monetary Union: The Case Against EMU

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Martin Feldstein--professor of economics at Harvard University, head of America's National Bureau of Economic Research and former chairman of the Council of Economic Advisors--is one of America's most distinguished economists. In this article he argues that the European Community should abandon its plans for monetary union. Government officials and opinion leaders throughout Europe are beginning to ask questions about EMU that might better have been raised before the Maastricht conference. Those who question the advisability of adopting a single currency and a federal structure for Europe are asking: "Are the economic benefits great enough to outweigh the political disadvantages of the federal structure for Europe that would follow the adoption of a single currency?"

That gets the key question exactly backwards. As an economist who watches the debate from across the ocean, my judgment is that a single currency for Europe would be an economic liability. The proper question therefore is: "Would the political advantages of adopting a single currency outweigh the economic disadvantages?"

The question is worth asking despite the claim that the Maastricht agreement made monetary union inevitable. The economic conditions for joining the monetary union are now satisfied by only three countries and may never be satisfied by all 12. In addition, although Britain alone explicitly reserved the right in the Maastricht treaty not to proceed to a single currency, political leaders in several countries have recently indicated that their national parliaments also retain that right.

More importantly, the Danish referendum rejecting the Maastricht treaty may force a fundamental renegotiation of the agreement. It will certainly cause governments and members of national parliaments to ask themselves whether their constituents really support a move to monetary and political union. History teaches time and again that major nations cannot be forced to accept treaty obligations that they regard as contrary to their own interests. As national governments and their publics look more carefully at the implications of the proposed monetary union, dissatisfaction is likely to increase.

## ONE MARKET, ONE MONEY?

Advocates of a monetary union imply that the adoption of a single currency is necessary to perfect the single market's free trade in goods and services. The European Commission has summarised this official view in the title of its publication. "One Market, One Money".

I am an enthusiastic supporter of the current attempt to achieve a single European market for goods and services. Although such a free-trade zone, even if it involves no increases in external tariffs, could in theory have trade-diverting effects that decrease world welfare, I believe that the weight of the

evidence points clearly to a net positive effect from trade creation and from decreased government intervention in domestic markets.

But the creation of a single market for goods and services does not require a monetary union. It is possible to have all the benefits of free trade without a common currency. Indeed, the shift to a common currency could actually diminish trade within Europe. It is also likely to reduce economic well-being by raising future unemployment and increasing the cyclical volatility of activity within individual countries. And it could cause a higher rate of inflation than the current monetary arrangements.

Events in North America are instructive. The United States recently established a free-trade agreement with Canada that will soon include Mexico. Yet nobody seriously suggests that the United States, Canada and Mexico should form a currency union.

I believe that this difference does not reflect the economic requirements for efficient free-trade zones in Europe or North America. Instead, it reflects different political goals. EMU is sought by those who want to move to a political union among the current members of the European Community. They seek a common currency both as a public symbol of super-nationhood and as an effective way to shift decisions on monetary and eventually fiscal policy from national capitals to Brussels.

The case for linking monetary union to the creation of the single market is based on the notion that eliminating currency fluctuations within Europe would increase trade among members of the Community. Those who hold this view argue that currency fluctuations inhibit businessmen from expanding their sales in other countries and from buying from foreign producers, because fluctuations in exchange rates can more than wipe out the normal profits from individual transactions.

It is not clear, however, whether this matters in practice. Statistical studies that measured the effect of exchange-rate volatility on trade in Europe have failed to find any impact. Moreover, if businesses really care about exchange-rate risk, they can hedge in the market for foreign-exchange futures. Medium-and long-term futures markets have become much deeper and more efficient in recent years. It is true that businessmen often complain that such hedging is "expensive", but I suspect that they are confusing the very low cost of avoiding uncertainty by buying or selling currency futures with the discount or premium that prevails when the market expects the currency's value to change.

Further evidence that currency volatility does not inhibit trade is the sharp increase in the volume of American imports during the 1980s when the dollar gyrated sharply (see chart 1). (Chart 1 omitted) 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 may in some cases even be an obstacle to expanded trade. Consider a manufacturer in Britain who contemplates expanding his marketing efforts in France, where he will compete with producers from the United States. If the dollar falls relative to the franc, the American producers will gain an advantage. If the pound were free to adjust, it might fall in line with the dollar,

thus helping to maintain British exports. But if the exchange rate of the British pound is fixed vis-a-vis the French franc and other EC currencies, such devaluation would not be possible. For such a British manufacturer, developing a market in France is less attractive when the sterling-franc exchange rate is fixed.

Fewer resources may therefore go into the manufacture of tradable goods and more into the production of services and goods for the local market. In short, although a world in which all exchange rates were fixed might increase trade, fixing exchange rates for a subset of currencies might actually discourage trade.

A single currency may reduce intra-European trade for another reason. A single tariff-free market should encourage nations to specialise in producing those products for which they have a comparative advantage. But such specialisation makes a country more vulnerable to fluctuations in demand caused by temporary changes in tastes or market conditions. Domestic monetary policy can offset these fluctuations if the country maintains its own currency but not otherwise. The use of a single currency therefore makes product specialisation less attractive: a single currency would reduce the potential gains from trade.

Proponents of monetary union also claim that a single currency can in principle help to create a larger financial market by lowering the transactions costs. This may be a reason for very small countries to tie their currencies to a larger currency, but it is irrelevant for countries as large as Britain, France, Germany and Italy. Sophisticated hedging can now eliminate the currency risks associated with international portfolio investments and other financial transactions among the European markets.

#### FAREWELL, MONETARY POLICY

Against the uncertain advantages of a currency union must be set the disadvantage of losing an independent national monetary policy. If the demand for the products of a country falls, it will suffer lower employment and output unless wages and prices fall immediately. In practice, wages and prices adjust only slowly, so output and employment suffer.

This could be mitigated with lower domestic interest rates--but that will be impossible if the country shares a single currency with a larger economic area. Moreover, when the exchange rate is flexible the favourable expansionary effect of low domestic interest rates is reinforced by the induced decline of the currency's value. This too is lost when a country no longer has its own currency.

It is worthwhile for a group of independent countries to adopt a single currency when (a) the economic shocks that hit the individual countries are similar and (b) labour is highly mobile among the countries. If the shocks are similar, the appropriate monetary policy is generally the same everywhere; little is to be gained by changing real exchange rates within the proposed currency area. A highly mobile labour force means that, to the extent that there are different shocks in different parts of the currency area,

workers will move from regions of declining demand to regions of stronger demand, making different local monetary policies unnecessary.

Just how similar the shocks, and how mobile the labour force, must be to justify a currency union depends on the potential gains from such a union. A move to a single currency is economically justified if the gains (lower transactions costs and an expanded financial market) are large enough to outweigh the losses (the loss of domestic interest rates and the nominal exchange rate as policy instruments).

It is hard to argue that the European Community satisfies the two requirements of an optimal currency area. Individual countries suffer substantially different shocks because of differences in the mix of the products they produce, in their dependence on imported oil, and in the foreign markets to which they sell.

The greater specialisation of production that should result from the completion of the single market should increase these differences. Labour mobility among European nations will inevitably remain limited by differences in language and by a culture that, unlike that of the United States, regards geographic mobility with suspicion. Expanding the current group of 12 countries to include the EFTA nations and the countries of Eastern Europe would further exacerbate both of these problems.

#### STAYING COMPETITIVE

The case for maintaining an independent currency goes beyond the ability of a nation to have a countercyclical domestic monetary policy. Equally important is that an independent currency can shift the real exchange rate without a corresponding change in the level of domestic prices.

Changes in equilibrium real exchange rates are inevitable, an important part of the economic environment. For example, a substantial increase in the world price of energy calls for a currency appreciation in the energy-exporting countries and a decline in the real exchange rate of countries that import energy. Alternatively, the equilibrium exchange rate of a country may shift gradually over time because of trends in productivity or tastes.

The Japanese yen appreciated in real terms in the 1960s and 1970s to offset rapid productivity growth in Japan's export sector. Big structural changes in equilibrium real exchange rates can be expected, especially for some of Europe's poorer countries, during the next two decades.

A currency union means, of course, that nominal exchange rates cannot adjust to achieve a needed change in the real exchange rate. The local price level must, therefore, adjust to bring about the change in the real exchange rate. Thus a 10% fall in the real value of a currency can be achieved either by a 10% fall in the nominal exchange rate or by a 10% fall in local wages and prices.

Either form of adjustment can bring the real exchange rate to its equilibrium value, but a decline in domestic prices is likely to require a period of increased unemployment. It would therefore certainly be better to have a decline in the nominal exchange rate. The shift to a single currency in Europe would preclude such nominal exchange-rate adjustments and force real exchange-rate reductions to be achieved through lower local wages and prices.

Not everyone appears to understand this. Proponents of the shift to a single currency sometimes argue incorrectly that the issue of changes in exchange rates among regions is meaningless once a single currency is accepted for the entire area. Once a single market and a single currency are established, the argument goes, no one ever looks at the balance of trade among the component regions. Who, they ask, even knows what happens to the balance of payments between New England and the rest of the United States?

#### LESSONS FROM NEW ENGLAND

To see why that argument is specious we need only look at what has actually been happening recently in New England. During the 1980s the New England economy benefited from a strong national demand for the products and services in which it specialises, particularly computers, military equipment and financial services. The increased demand for these "exports" from New England to the rest of the United States caused a rise in their prices and in the relative level of New England wages and salaries. During the decade of the 1980s, real incomes per head grew twice as fast in Massachusetts as in the rest of the country.

But now the demand for computers, for military equipment and for financial services has declined. Until there is a relative decline in New England wages and in the prices of New England's "exports" to the rest of the country, the level of unemployment in New England will be abnormally high. Massachusetts has the second-highest unemployment rate among the industrial states, topped only by Michigan. To shrink that unemployment, Massachusetts wages will have to decline relative to wages elsewhere in the nation (see chart 2). (Chart 2 omitted)

Slowing the growth of wages is a painful process, accompanied by a high level of unemployment, declining property values and the widespread failure of New England banks. New England could deal with the transition in a much less painful way if there were a flexible "New England dollar" that could be allowed to decline in value relative to the currencies of America's other regions.

Although this experience within the American economy shows one of the high costs of having a single currency, nobody seriously suggests that the dollar should be abandoned for a set of regional currencies. Why not? What is so special about the dollar that does not apply equally to the proposed European currency?

One important difference is that the dollar has already existed as a currency for more than 200 years. Although there have been periods of inflation and deflation, the dollar has acquired a reputation as a relatively reliable store of value and stable unit of account.

The proposed European currency has none of the virtues as a store of value and unit of account that only experience can bring. It would start with no reputation and with an untried European central bank. Shifting to it would involve abandoning some currencies that have acquired a reputation for stability and soundness, like the D-mark, as well as other currencies with a less solid but nevertheless positive reputation.

A further reason for a single United States currency is that the American fiscal system provides an alternative source of regional stabilisation, making regional monetary policy less important. Each dollar decline in America's real GNP reduces taxes by about 30 cents and increases transfer payments by about 5 cents. These national fiscal responses are paralleled at the state and regional levels.

When the Massachusetts economy turns down, the residents of Massachusetts send fewer tax dollars to Washington and receive more in transfers from the federal government. To the extent that the Massachusetts downturn is greater than the downturn in the nation as a whole, the result of this fiscal structure is a permanent transfer to Massachusetts. Thus even though Massachusetts lacks an independent monetary policy, a decline in the state's economy automatically triggers a stabilising shift in fiscal policy.

Nothing comparable to America's fiscal system exists in Europe, where virtually all taxes are paid to national and local governments. There is no fiscal transfer from the EC as a whole to countries that experience a relative cyclical decline. Without such a centralised fiscal system, shocks to aggregate demand that are geographically focused, or shifts in the real equilibrium values of national exchange rates, have a bigger impact on regional income and employment.

If a single currency is accepted, national governments might soon have to decide whether to accept the greater volatility of employment and incomes that comes from abandoning an independent monetary policy and flexible exchange rate, or accept instead the loss of national sovereignty over taxes and spending.

## THE POLITICS OF INFLATION

I think it is clear that economic analysis does not provide support for a shift to a single European currency: it is not necessary to facilitate trade and, by eliminating the possibility of independent monetary policies and adjustments of nominal exchange rates, it is likely to add to the cyclical instability of incomes and employment. Why then are so many in Europe calling for EMU? There are, I think, several distinct political reasons.

First, some see a single currency and a European central bank as a way to restrict the ability of national governments to pursue inflationary monetary policies. In particular, those European central bankers 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.

In effect, they argue that although each government could by itself pursue a non-inflationary monetary policy, it is politically easier for Europe to do so collectively. 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 in principle accept a much restricted scope for good monetary policy by each national central bank in order to reduce the political temptations for bad national policy. Quite apart from the question that this raises about the making of monetary policy in a democratic society, it implies a potentially very large sacrifice of potentially good monetary policy.

The practical significance of this argument is, however, put in doubt by the Maastricht treaty's ideas about a European central bank. Those proposals raise doubts about the independence of its decisions from the political influence of national capitals. The voting members of the central bank's governing board would be appointed by the member governments and would be eligible for subsequent political appointments by their own governments.

Equally worrying is the decision to have national finance ministers and the European central bank share responsibility for the exchange-rate policy of the EC as a whole. Recent experience and many studies confirm that exchange-rate policy cannot be separated from monetary policy. The only way to change the exchange rate between the new European currency and the dollar or yen would be to change European monetary policy. The designers of the Maastricht treaty either do not understand the role of monetary policy in determining the EC's exchange rate or they want to undermine any possible independence of the central bank.

Of course it might in principle be desirable to establish an independent central bank that is capable of pursuing a sound monetary policy (if it were not for the adverse aspects of losing control of the national interest rate and no longer having flexible nominal exchange rates). But, as a practical matter, the anti-inflation argument for a European central bank is very much weakened by the success of the current European monetary system (EMS).

Under these arrangements, German hegemony has induced other countries over the past decade to pursue a German-style anti-inflationary policy. Inflation in countries like France and Italy has come down sharply during the past ten years, converging towards the low inflation rate in Germany. Why accept a monetary union that would force every country to give up the possibility of countercyclical domestic monetary adjustments and flexible nominal exchange rates in order to prevent inflationary policies by their own central banks that may in any case be only hypothetical?

But it is the very 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 favour 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.

The reasons for wanting to replace the Bundesbank with a European central bank go beyond national pride and the wishes of European central bankers to have a more active role in the shaping of monetary policy. 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. French officials in particular have frequently emphasised that they regard monetary policy as currently too tight but are constrained by the EMS to follow Germany's lead.

It is ironic that while some advocates of a single currency and a European central bank argue that they want these things in order to reduce the risk of inflation, others see it as a way of relaxing the tough German anti-inflationary policy now implicitly imposed on others by the Bundesbank.

All of which reinforces my belief that the strong advocacy of 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 European Community. Those who most fervently advocate monetary union do so for a third reason--because they see it as a means to a political union, and a particular type of political union, at that.

A single currency would undoubtedly give the people of Europe more of 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 would expect that limits on national fiscal policies and enhanced centralised taxation would follow quickly.

Although there are examples of small countries that use a foreign currency as legal tender and provide no currency of their own, there is no sizeable country that does not have its own currency. Perhaps this is the most obvious explanation of the enthusiasm for monetary union among its most ardent supporters. Monetary union and a single currency would be the strongest possible signal that the European Community is on its way to becoming a single state.

THINK AGAIN

Let me conclude by reiterating my principal point. Monetary union is not needed to achieve the advantages of a free-trade zone. On the contrary, an artificially contrived economic and 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.



I can understand, however, that there are those who are willing to accept these adverse economic effects in order to achieve a federalist political union that they favour for other non-economic reasons. What I cannot understand are those who advocate monetary union but reject any movement towards a federalist political structure for Europe. That is a formula for economic costs without any of the supposed political benefits.

Moreover, although monetary union in Europe would almost certainly accelerate the formation of a federalist political union among its members, those countries that are not part of the monetary union would be political outsiders. The consequences of this for the future peace and stability of Europe, while difficult to contemplate with any certainty, may well be unfavourable.