Monetary Union: Benefits, Costs and a Better Alternative

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The European Monetary Union (EMU) died quietly in September when Germany’s finance minister, Theo Waigel told a committee of the Bundestag that Germany will insist on all countries following the requirements for public debt and budget deficits set out in the Maastricht treaty. In October, the European Union accepted the German position but continued to plan for the union.

Few observers expected Greece, Portugal or Spain to meet the requirements for entering EMU. Waigel’s statement also ruled out Italy, Sweden, Belgium and possibly France. Since a main purpose of monetary union is to bind France and Germany to common policies, a union without France is pointless. The current D-mark bloc would be preferable for all of its current members.

The advantages of EMU are real. Members would trade at permanently fixed exchange rates. They would gain from the opportunity to invest over a larger region and to specialize production within a region. They would face lower transaction costs and would save on the resources used to make exchanges and keep records.

There are also costs of moving to EMU and of maintaining it. Two of the largest costs arise from (1) the unavoidable uncertainty about how EMU will be managed and (2) the elimination of exchange rate changes as a
means of adjusting to country specific shocks. Introduction of EMU sacrifices the anti-inflationary reputation of the Bundesbank for a new institution to be managed by a committee. Although the mandate for price stability is clear, it is apparent already that there are differences of opinion about how the mandate will be carried out.

In a common monetary area without exchange controls and restrictions, adjustment to regional or country-specific shocks requires either resource mobility between regions, adjustment of prices and wages, or fiscal transfers. As is well-known, labor mobility is relatively low within many European countries and even lower between countries. The high barriers to labor mobility may become smaller in the future, but rapid change is unlikely. Large-scale migration is unwelcome in many parts of the Union. Welfare state policies reduce flexibility of money wages, so money wages and prices respond slowly to changes in demand. The likely result is an increase in the average rate of unemployment partly offset, perhaps, by fiscal transfers. This is a costly outcome.

Further, the social welfare programs protected by the European Social Charter impose relatively heavy costs on European producers. These costs affect the use of resources within the Union and the level of unemployment. To maintain the welfare state, with the Union, countries may choose to keep high trade barriers against non-members or allow the new currency to devalue against North American and Asian currencies. Here, too, there is uncertainty about how the new monetary system will perform and there are high costs of maintaining the union.
Net Benefits?

The net economic gain or loss from a monetary union depends on the balance of these (and other) costs and benefits. The gain from a union increases with the size of the trading area within the union. The larger the union, the larger is the share of trade and investment with other members of the union; the benefits of the common currency area apply to more of a country's trade and investment. Conversely, if intra-union trade is a small part of total trade, a country will be free of the uncertainty about exchange rates on only a small part of its trade and investment.

If the EMU included the fifteen countries in the European Union, the share of exports to member countries would be 50% to 75% in all member countries. If EMU membership is restricted to the D-mark bloc -- Austria, Belgium, Denmark, France, Germany, Luxembourg, and Netherlands -- nearly two-thirds of the exports from Denmark, France and Germany would be outside the EMU area. Hence, they would be subject to changes in exchange rates. And, as noted, some of the countries in the D-mark bloc are not likely to meet the fiscal criteria for membership.

Since gains from a common currency increase with trade volume, support for monetary union should be greatest in countries that do most of their trade within the bloc and weakest in countries that do most of their trade outside the bloc. EMU is very popular in Luxembourg and unpopular in the U.K. More generally, there is a significant correlation between export share and the popularity of EMU in the 15 countries of the European Union.

Economic considerations are important, but they may not be decisive. Particularly in France and Germany, political arguments are often more important than strictly economic costs and benefits. Both the
history and costs of European wars in the 19th and 20th centuries, and the gains during the relatively peaceful fifty years following the Second World War, suggest that the proponents of union are right to keep these costs in mind. They err, however, in not making them explicit.

Despite many statements about common purposes, France and Germany have some different objectives for the European Union. Germany seems more interested than France in expanding the Union to the east, while France is more concerned about relations with its former colonies in North Africa. Expansion to the east raises issues about the Common Agricultural Policy (CAP) and the restoration of prewar German ties to Central Europe. Restricting the CAP would reduce transfers to French farmers, lower the Union’s spending, and reduce its appeal to France. Satisfying French concerns in North Africa would increase spending and budget transfers. Hence, there is uncertainty about how policies will change and how policy will affect the value of the new monetary unit. These uncertainties are likely to persist. The May 1995 Green Paper on the arrangements for introduction of a single currency does not clarify issues about monetary control. That report, like much other official discussion, presumes that the new system will produce low inflation, small deficits, and a strong currency.

A Better Alternative

The proponents of monetary union recognize correctly that countries can benefit from use of a common currency that retains its internal and external value. No country acting alone can achieve both price stability and exchange rate stability. There are gains to each country and to all
from a cooperative monetary arrangement.

The benefits of price and exchange rate stability are too large to be ignored, but EMU is too small to realize most of these benefits. This is especially true if the monetary union is limited to a few countries in northern Europe. A much more desirable arrangement for Europe and the world would be a largely voluntary, non-bureaucratic, decentralized arrangement covering more of the world’s trade. Countries would be free to join or remain outside.

There are three types of countries to consider. The largest countries -- the United States, Germany, and Japan -- would follow a common monetary rule to maintain zero inflation in each of these countries. All three are now close to zero inflation, so the adjustment would be small. Bilateral exchange rates between these three countries would fluctuate freely so exchange rates could adjust to real shocks and cyclical changes. Since expected inflation would be zero in each country, monetary effects on exchange rates would be small or non-existent; hence, volatility of exchange rates would be much lower than under current arrangements. All other countries could fix their exchange rates to one of the major currencies. They would have the benefit of a zero or lower inflation rate on average and a fixed exchange rate over a large trading area.

The central bank of a very small country can do much harm but has little prospect of improving on a fixed exchange rate, low inflation solution. Very small countries should eliminate the monetary operations of their central banks by establishing a currency board or a permanently fixed exchange rate and, to enforce their commitment, these countries
should permit their citizens to use a non-inflating foreign currency as a medium of exchange or parallel currency.

Mid-sized countries can choose between the advantages of a fixed exchange rate in a world of zero inflation or an independent monetary policy to prevent domestic inflation. Any other choice would fail to provide the benefits that countries can expect to gain from a stable world monetary order and more effective monetary policies. It is up to each country to decide whether it is small or medium-sized and whether it wishes to join the club of stability or undertake its own policy actions. Although others may choose to do so, only the three largest countries should be restricted by a common commitment to a rule that maintains zero expected inflation and provides public benefits for them and for any country that accepts the requisite monetary discipline.

The three large countries would gain from zero expected inflation and from the opportunity to trade at fixed exchange rates with countries that accept the rule-based arrangement. Coordination would not require international action. Each of the three countries would announce the procedures or rules it intended to follow. Actions would be monitored by markets around the world. Departures from the rule that produced excessive money growth would be recognized promptly. Traders would cause the currency to depreciate and interest rates and prices to rise, so any advantage would be modest and short-lived. Market action would encourage the large countries to follow consistent policies of low inflation. A fixed exchange rate policy would bind other countries. Efforts to cheat would be punished by traders and speculators.

The proponents of EMU are correct in seeing the opportunities for
improvement in the monetary system. They are wrong to believe that EMU is the solution. A much better solution for them, and for the rest of the world, can be realized by voluntary arrangements that benefit all countries without fiscal transfers or a world or regional central bank.