The Single Currency – Will it Work and Should We Join?

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Introduction

There must by now be a greater spillage of words on this topic than once there was of the Torrey Canyon’s oil in the English Channel. But on we must go, so compelling does the issue still remain. In this piece I have gathered my thoughts in two main sections. First, I review the economic pros and cons of monetary union. The second section considers the likely developments given that the EMU project has been pressed on with on the continent transparently and primarily as a political project. Then finally should and will the UK join?

The Economic Principle of the Single Currency

A good starting point for discussing the advantages of a common currency is the report of the European Commission (1990) who made a heroic attempt to measure them. They speculate that the efficiency gain from removing currency uncertainty and exchange costs may be worth as much as 10 per cent of EEC GNP. Virtually all of this comes from the effect of a supposed reduction in the risk premium on the cost of capital. Various other gains are adduced from the common currency: increased price stability (including through enhanced credibility), more disciplined public finance and greater macroeconomic stability.

To begin with price stability, on which the report places much emphasis, this is attainable with or without EMU, as is credibility. Whether EMU makes them more easily attainable is a matter of political economy, which is not tackled by the EC’s report: what will the European central bank’s powers and incentives be, and what legitimacy conferred on it
by the 15 democratic peoples of the EEC? These questions are under­standably not addressed in the EC report but merely assumed away.

Yet even if they were convincingly answered, there would still be the alternative of pursuing price stability credibly by domestic means. Domestic means of commitment exist, and are effectively achieved in many OECD economies such as Germany, the US and Japan: essentially they involve some form of domestic nominal target, whether the money supply or nominal income or simply price behaviour, with the commitment penalties supplied by the political process. To put it crudely, governments that fail to deliver acceptable price performance lose votes – ultimately this must be the only effective penalty in a sovereign democracy.

This domestic commitment process highlights the difficulties inherent in designing a Europe-wide commitment process for monetary policy. As the Germans have persistently pointed out there is a 'democratic deficit' in the European 'union'. Without democratic political union there would indeed be a lack of democratic legitimacy for a European central bank imposing tough monetary policies on many different national regions of Europe, some of which may well be suffering from severe recession in spite of an EEC-wide inflation. This lack would also fatally undermine credibility.

If we turn to public finance the report envisages greater discipline arising from the inability of a national government to raise taxation through printing money ('seigniorage' or the 'inflation tax'); this inability is reinforced by the Maastricht fiscal criteria, designed to limit the risks of country bail-outs. Here a virtue is made of what in the literature is regarded as a problem, making optimal taxation more difficult. However, the EC report offers no mechanisms, only pious hopes and peer country pressure, for achieving movement to fiscal balance under EMU. No seigniorage and no alternative fiscal mechanism: there is a serious fiscal vacuum.

The large efficiency gain speculated on in the EC report comes from removing the transaction costs of currency exchange and the hedging costs of guarding against currency uncertainty. There are two arguments which suggest its estimate is likely to be well on the high side:

1 Currency risk is diversifiable in a world of many currencies and investment vehicles whose risks are variously correlated with currency risk. Such diversifiability means that the cost of hedging should essentially disappear.

2 A transaction involving currency exchange should not, on the face of it (given the negligible cost of keying in electronic orders), cost