# Political and Institutional Commitment to a Common Currency

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A stroll along the first floor corridor at the International Monetary Fund's Washington headquarters reveals the fundamental and indisputable fact that political considerations, rather than purely economic concerns, are the predominant practical determinants of the domain of operation of currency regimes. Despite the theory of optimum currency areas which might suggest alternative outcomes, with few exceptions, the empirical regularity is one country, one money. Even the exceptions help to prove the rule. The common currencies of the African franc zone reflect a still strong political, as well as economic, linkage to the former colonial power. The use of the U.S. dollar as the circulating medium in Panama (and Liberia) also reflects present or past political relationships.

Moreover, the political theory of currency areas is not merely a statement of static facts; it has predictive power. The common currency that Rome imposed throughout its empire did not survive the decline and fall of that empire. Similarly, the states that emerged from the breakups of the Austro-Hungarian and Ottoman empires after World War I rapidly moved to separate currencies. When the Soviet Union collapsed at the end of 1991, some misguidedly thought that a ruble zone could and should be preserved; but reality prevailed, and the 15 sovereign republics of the former Soviet Union all now have independent national currencies. Conversely, when the Founding Fathers sought to construct "a more perfect union" in the U.S. Constitution of 1787, the power "to coin money and regulate the value thereof" was transferred from the states to the new federal government. The objective was not only to improve the monetary basis for commerce and finance within and between the states, but also thereby to strengthen their political union. In Europe today, the drive to construct a European Monetary Union (EMU) has been justified primarily on the prospective economic benefits of a common currency. However, such a proposal would have been literally unthinkable, whatever its possible economic benefits, with the political divisions that characterized Europe until relatively recent years. And, still today, the strongest advocates of EMU tend to be those who see monetary union not only as a beneficial economic mechanism, but also as substantively and symbolically important for strengthening the political dimension of European union. Conversely, those who are skeptical about stronger political union in Europe also tend to be skeptical about EMU.

In view of the centrality of political considerations in determining monetary arrangements, it seems essential to ask how these considerations affect the differences between currency areas and currency unions, most importantly in the effort to transform European monetary arrangements from a currency area into EMU.

A currency area is an arrangement for a group of countries to peg exchange rates among distinct national currencies. In some cases, exchange rates may be rigidly pegged, but more usually they are allowed to fluctuate within narrow bands. Members retain their own central banks, although with serious constraints on the independence of national monetary policies. A currency union involves a much stronger political and institutional commitment to fix exchange rates absolutely through a single money that functions as the monetary standard for a group of countries. The supporting institutional structure also includes a common monetary authority for all the countries of the union which determines monetary policy on a union-wide basis.

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Once formed, a currency union implies a substantially stronger commitment not only to fixed exchange-rate relationships, but also to membership of the group, than does a currency area. In particular, in the currency area defined by the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS), not only have exchange-rate parities occasionally been adjusted, but some countries have entered, left, and subsequently reentered the ERM. In contrast, while the Maastricht Treaty makes provision for some countries to remain members of the European Union (EU) while opting out of EMU, and for delayed entry into EMU of EU members that fail initially to meet the convergence criteria, it makes no provision for countries to leave EMU once they have joined. For a monetary union, "What the Lord hath joined together, let no man put asunder."

From the perspective of economic analysis, it is not immediately clear how to model formally the differences between a currency union and a reasonably firm currency area. Theoretically, they share the key economic characteristic, relative to floating exchange rates, of strong assurance that exchange-rate fluctuations will generally be quite limited. Indeed, a few years ago I argued that there would be little economic difference between continuing with the ERM (of which the United Kingdom was then a member) and proceeding to EMU. Some would have gone further to argue that a currency area like the ERM was superior to a monetary union like EMU since it provides the general assurance of a high degree of exchange-rate stability but retains the escape hatch of parity changes if conditions become too difficult.

Now, after the experience of the past five years, I have somewhat altered my opinion. Some pegging arrangements have exhibited longer-run stability when smaller countries follow a dominant leader, such as the United States in the Bretton Woods System or Germany vis-à-vis several smaller European countries. But such arrangements have worked less well among countries of more comparable economic size and will probably be even less viable with independent national central banks charged primarily with responsibility for domestic economic and financial stability. Moreover, recent experience does not support the view that the ERM has behaved like a currency area where markets have had reasonable confidence in the fixity of exchange-rate parities and conferred the economic benefits to be expected from such confidence. Rather, on a number of occasions since the initial crisis in the summer of 1992, exchange-rate parities came under intense market pressures to an extent that seems much greater than in the earlier history of the ERM when economic convergence among participating countries was clearly less than it has been recently. In many cases, the market appears to have got it mainly right. However, in the key case of the French franc, it is more difficult to see the economic fundamentals that called into question the central parity and necessitated prolonged periods with substantial premia of French short-term interest rates over comparable German rates. If the possibility of movement in the exchange rate between the French franc and the deutsche mark had been eliminated through monetary union, these interest-rate premia would presumably not have emerged, and the relatively weak performance of the French economy would have been somewhat enhanced.

Of course, this point should not be overemphasized. During the ERM crises in the early 1990's, the market never questioned the exchange-rate parity between the Dutch guilder and the deutsche mark or the unilateral peg of the Austrian shilling to the deutsche mark; and these countries did not pay a price in terms of significant interest premia relative to Germany in order to maintain their exchange-rate pegs. Nevertheless, the general point remains that the very firm political and institutional commitment to exchange-rate fixity implied by monetary union can have practically important economic benefits over a currency area—benefits that I had earlier underestimated. These underestimated benefits are additional to the convenience advantages from having a single unit of account and medium of exchange over a wide economic area.

Moreover, the desire of several countries to be solid members of the ERM and, more recently, to be founding participants in EMU has provided political leverage to improve national economic policies. During the past decade, this has been reflected in the convergence of inflation rates in most European countries down toward the German standard. More recently, it is apparent in the fiscal consolidation efforts of some countries that have been at least partially motivated by the desire to meet the Maastricht deficit criterion. Looking forward, the desire to secure implementation of EMU has motivated agreement on mechanisms that will help to guard against the recurrence of undesirably large fiscal deficits.

So much for the good side. What about the traditional concerns that Europe does not ideally fit the economic criteria for a currency area and, even more so, for a currency union that lacks the ultimate escape hatch of exchange-rate changes? These concerns remain relevant. Recent experience with the European economic impact of German unification and earlier with the oil price surges in the 1970's illustrates the possibility of asymmetric shocks that can have significantly different effects on different European economies. And sharp regional differences over desirable monetary policy can be a source of political divisiveness rather than a stimulus to closer political union. This is, after all, the centenary of William Jennings Bryan's proclamation of Southern and Western discontent with the prevailing national monetary standard, "You shall not press down upon the brow of labor this crown of thorns; you shall not crucify mankind upon this cross of gold." Here in New Orleans, at the site of his great military victory, we might also recall how Andrew Jackson resolved an earlier regional controversy over monetary policy by killing off the Second Bank of the United States, thereby initiating eight decades of the ultimate in central-bank independence: no central bank whatsoever.

However, the additional difficulties that might arise from EMU in dealing with regionally asymmetric disturbances should not be exaggerated. Disturbances that have asymmetric regional effects within national economies will not be any more difficult to deal with under EMU. The relative lack of labor mobility within and between different economies (especially in comparison with the United States) and the more general lack of economic flexibility already impair performance and contribute to high levels of unemployment, even without EMU. With EMU, it is possible that these problems will be somewhat ameliorated because the incentives for painful adjustments to changes in economic circumstances and the willingness to undertake such adjustments may be enhanced when it is known that exchange-rate changes are no longer an option. Also, for many disturbances that have broadly similar effects across different European countries, the exchange-rate adjustments that are absolutely precluded by EMU would not be helpful. This includes, for example, the need for all of the present members of the European Union to adjust to expanding trade with central and eastern Europe.

Indeed, it is clear that the key economic policy challenges facing individual European countries now and for years to come are broadly similar. Social welfare programs that provide extensive retirement and health-care benefits, as well as generous support to the disadvantaged and unemployed, have already helped to push up government spending in most of Europe to 50 percent of GDP or even higher. With the aging of populations over the next 2–3 decades, social spending under current policies will rise significantly further, implying crushing tax burdens for the working population and severe disincentives for economic growth.

EMU, of course, did not create this problem; and it will not resolve it. However, the political leverage that has helped to improve economic policies in recent years in several European countries could work in reverse if EMU gets the political blame for the scaling back of popular social welfare programs that is necessary all across Europe. To some extent, this is probably inevitable, partly because EMU is inextricably tied up in the popular mind with the Maastricht convergence criteria, with specific efforts to reduce fiscal deficits in individual countries, and with the "stability pact" for future fiscal discipline. But this problem should not be made worse. Once it is formed, the European Central Bank (ECB), like any central bank, will periodically face the unpopular task of tightening monetary policy and slowing economic growth in order to contain inflationary risks, sometimes with potentially divisive asymmetric effects on different EMU participants. As a European institution without an established and particularly solid political base, the ECB will not be well-positioned to carry the extra and very heavy political burden of necessary reform of social welfare programs. Failure of EMU would surely have economic and especially political costs far beyond those of parity changes and other adjustments of the ERM. If European Monetary Union is to be assured a reasonable chance for success, the national authorities whose policies have generated the social welfare problem need to step forward to take full responsibility for the necessary reform.