

# One Market, One Money? Well, Maybe . . . Sometimes . . .

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The slogan "One Market, One Money" is European. It summarizes the view that, as the European Community (EC) evolves into a single supranational economic union, the adoption of a single currency should be an integral, indeed natural, element in that evolution. But North America is developing into a supranational free trade area. An agreement between the United States and Canada is already in place, and one including Mexico is soon to be negotiated. Nor should we rule out the possibility of 'similar arrangements coming into being with other countries in the Western Hemisphere. If the Americans are emulating Europe in the matter of trade arrangements, should they not also be reconsidering the matter of monetary arrangements? Does not the evolution of a single market in goods and services also point to the desirability of some sort of monetary union: if not initially to a single currency, then at least to a system of fixed exchange rates?

I shall argue here that the foregoing conclusion does not follow, at least not yet, and probably not in the foreseeable future either. The "one market" of Western Europe, and that of North America, are very different entities, and the differences between them are, not altogether coincidentally, particularly relevant to the question of monetary unification: To put it simply, perhaps over-simply, the one European market is part of a broader, albeit as yet quite loose, political union, and the one North American market shows no sign of developing in such a direction. Monetary union, however, is at

least as much a political as an economic matter: It may be an appropriate aim for the EC—though I am not well enough informed to take a firm position here—but it is not an **appropriate** aim for North America. In what follows I shall discuss in the abstract the pros and cons of the maintenance of separate national currencies, and then I shall attempt to weigh these with reference to the above mentioned similarities and differences between the European and' North **American** cases.

The nation is a political, not an economic, entity, and if there was any general and always compelling argument that it is economically desirable for a nation to maintain its own currency, and reserve the right to have its exchange rate against other currencies fluctuate, then that argument should be applicable to other political entities too. Why should states or provinces not each, have their own currencies, and if states, why not cities and counties, or wards within cities, and so on? This *reductio ad absurdam*, which could be carried to the ultimate silliness of asking why each agent should not issue his or her own **personalized** money, forcefully draws attention to the, fact that the social purpose of money in the first place is to act as a common means of exchange and unit of account in order to facilitate market activity.

It would be ridiculous for city wards to have their own monies because city wards are extremely open economies whose inhabitants trade extensively across their borders. The information and transactions costs, not to mention exchange rate risks, agents would face in the presence of a multiplicity of city ward monies would be prohibitive. **But** trade does not stop at national boundaries, and agents engaged in international trade do face information and transactions costs and exchange rate risk. Why not, then, set the boundaries of a single currency at the boundaries of the area over which a substantial amount of trade takes place, at the economic borders of the market, rather than at the political borders of the nation-state? Or, failing that, why not at least minimize the costs generated by the existence of national currencies by maintaining fixed exchange rates within the market area? What, in short, does a nation-state get out of having its own currency, and what does it get out of permitting the exchange rate of **that** currency to fluctuate? **The** standard answers to these

questions are well known.

To begin with, within the typical nation-state, some symbolic importance is still attached to the maintenance of a distinct national currency, which is a traditional trapping of national sovereignty. Economics does not help us to understand this matter, but it should not, for that reason, be ignored. I suspect, for example, that much popular suspicion within the United Kingdom of a common European currency stems from this source. Curiously, however, in debates currently going on in Canada, the advocates of Quebec sovereignty seem to find no attraction in a separate currency. Be that as it may, this advantage of a separate national money is to be had under a rigidly fixed exchange rate. So, too, is the ability which a separate national money confers upon the government to raise revenue through seigniorage. This is not necessarily a trivial matter, **even** in conditions of reasonable price stability. If the non-interest-bearing monetary base amounts to one month's income, and the nominal interest rate is equal to, say, 6 percent, then this source will raise revenue at a rate equal to a little less than 0.05 percent of national income. Only to the extent that foreign exchange reserves are held in non-interest-bearing form, as they would be, for example under a commodity standard, is this source of revenue shut off by a fixed exchange rate.

The ability to vary seigniorage income' by varying the 'domestic inflation rate is, of course, limited by a fixed exchange rate; and quite apart from this aspect of the matter, the ability to control inflation is of political significance. Here indeed lies the very core of the case for maintaining separate national currencies linked by flexible exchange rates. Though I believe neither that the inflation tax is an efficient source of revenue, nor that any long-term inflation-unemployment **tradeoff** exists, I do believe that the inflation rate is a legitimate and important matter of political concern and debate, and that those who control it, namely the monetary authorities, should be accountable to the general public for their performance.' So long as the political institutions through which such accountability can be ensured exist only at the level of the nation-state, this consideration argues strongly in favor of maintaining a national currency, and an exchange rate regime that gives the monetary authorities the neces-

sary room to maneuver.

The final element in the traditional case for a separate national currency also requires a flexible exchange rate. I refer to the help which such an arrangement gives to an economy which faces so-called real shocks, either changes in the terms of trade, or variations in capital flows, that require adjustment of domestic real factor incomes relative to those ruling abroad. To the extent that money incomes, particularly wages, are sticky—and downward **stickiness** is usually regarded as being particularly relevant here—then exchange rate movements brought about by market forces can help with such adjustments and mitigate adverse employment consequences.

A number of comments on this argument are in order. To begin with, the very same money-wage-price **stickiness** which makes a flexible exchange rate desirable in the face of real shocks underlies the mechanisms that lead exchange rate fluctuations to amplify the consequences of monetary shocks. Thus, to deploy wage-price **stickiness** in defense of a flexible exchange rate is to imply a certain empirical judgment about the relative frequency and seriousness of the shocks to which the economy is vulnerable. It might, therefore, be a valid element in the special case for a particular country to maintain a flexible exchange rate, but it cannot be part of any blanket defense of the general superiority of such a regime. Second, one cannot help but wonder whether the degree of wage-price **stickiness** which characterizes an economy is going to be completely independent either of its exchange rate regime or of the shocks to which it is normally subjected. Finally, a flexible exchange rate can be used as a policy instrument by a central bank intent on fine tuning the economy. All the usual arguments against fine tuning apply here, and the opportunity to indulge in it conferred by a flexible exchange rate is not an advantage.

Terms of trade changes and capital flow fluctuations take place within, as well as across, national boundaries, and so the above argument about smoother adjustment can be advanced (and in the case of western Canada sometimes is advanced) to support the proposition that the boundaries of currency areas might be drawn more narrowly than those of nations. The usual counter to this point,

that the opportunities for labor mobility and the capacity for inter-regional fiscal transfers that exist within a nation-state provide alternative means of cushioning the impact of real shocks, has obvious relevance to the question of the desirability of any supranational monetary union. If the union is part of a broader economic union, with provision for ensuring international labor mobility, and the implementation of international fiscal transfers, it is more likely to be viable.

In the light of the above arguments, then, is it desirable that the one European market should have one money, and that the one North American market should emulate it, at least to the extent of moving to fixed exchange rates? The reader will forgive me if I do not come to definite conclusions about all aspects of these questions. Suffice it to say that it is easier to make the case for a single money for Europe than for North America, and that I am extremely dubious that it can be made at all in the latter case. From the outset, the EC was a common market, and it became an economic community. A common market, by definition, maintains a common external tariff. In the European case it has also maintained a common agricultural policy, along with some capacity to make fiscal transfers to depressed regions. The administration of these arrangements has required the existence of a marketwide bureaucracy, and has led to the creation of a European parliament too, albeit with very limited powers, to oversee the substantial budget involved. The EC has a common passport, and few legal or administrative restrictions on labor mobility within the community for its holders.

In North America we have a free trade area (FTA) from which several important sectors—for example, agriculture—are exempted. The extent of the supranational institutions created by the **Canada-U.S. FTA** goes no further than *ad hoc* dispute settlement panels, and an agreement to negotiate a common policy on what constitutes subsidies. National rules, made by national governments, still govern trade across national borders. The FTA has left immigration laws untouched—apart from making the transborder provision of professional services a little easier—and surely the desire to reduce cross border labor mobility is not altogether absent as Canada and the United States seek to include Mexico in a broader agreement.

The point of all this is, first, that there exist in Europe, but not in North America, alternative mechanisms of adjustment to real shocks which can, in principle, take the place of exchange rate flexibility. Even within Europe, the existence of such mechanisms was insufficient to persuade Britain, a large oil producer and center of an important capital market and hence a potential recipient of differential real shocks, to give up a flexible exchange rate until very recently. Why should Canada whose terms of trade *vis-à-vis* the United States can be volatile, and for whom transborder capital movements are extremely important, give up the exchange rate adjustment mechanism in the absence of any alternative?

More generally, and more important, European countries have already surrendered a certain amount of political sovereignty to Brussels and Strasbourg, and the institutions already exist through which, perhaps, the seigniorage generated by a European central bank might be collected and allocated, and through which the bank might be held accountable for its performance. Moreover, it should be noted explicitly that, during the 1970s, the EC encountered **serious difficulties** in maintaining its CAP in the face of large and frequent exchange rate fluctuations among the currencies, of members. Much is often made of the discipline which the European Monetary System (EMS) has imposed on members in the 1980s, but surely some of the discipline needed to keep the EMS in place and to move the system toward a closer union has come from a deeper desire to protect the CAP which, if not quite the EC's *raison d'être*, is its most important single institution. No comparable institutions exist in North America.

A new common currency for North America seems beyond the bounds of possibility, therefore, though fixed exchange rates on the U.S. dollar for both Canada and/or Mexico are not. If, however, the exchange rate were rigidly and perpetually fixed, the dominant size of the U.S. market and currency area would involve either or both of the others in surrendering control of inflation, a matter of domestic political concern, to a central bank responsible to another electorate. It is hard to believe that this would be politically acceptable in either country, or that the alternative, namely permitting foreign representation in the policymaking bodies of the Federal Reserve System

would be acceptable in the United States.

What about a potentially adjustable peg, then? Such an arrangement certainly **would** meet the above political objections, but the trouble here is that all of those traditional arguments to the effect that an adjustable peg brings with it the worst features of a fixed rate, and of a flexible rate too, have to be faced. Argument from the example of the EMS **seems** barely relevant to the case of North America. The same worries about terms of trade and capital account fluctuations that kept Britain out of the **ERM** for so long, are, as I have argued, present in the North American economy; and crucially, the verdict is **by no means** in yet as to whether Britain was wise to change her policy last year. If that verdict should in the end be favorable, that will, in part, stem from the coincidence of Britain's entry with the monetary disturbances associated with German reunification, but also in more important part, from the possibility that entering the mechanism will appear to have been a step toward catching up **with** an altogether more broadly based movement toward economic and political integration. There is no counterpart to this movement discernible in North America.

Be all that as it may, voices are now being heard in Canada that urge the adoption of a fixed exchange rate, partly at least because the appreciation which the Canadian dollar has undergone since the signing of the free trade agreement has swamped the gains that Canadian producers hoped to obtain from easier access to U.S. markets. These arguments should, I believe, be treated with suspicion: To begin with, no one in Canada is urging that the exchange rate be fixed at its current level—though U.S. beneficiaries of the free trade agreement might find such a measure attractive! Canadian advocates of a fixed rate are arguing for a deliberate devaluation. Though I am as puzzled as anyone about the current level of the exchange rate, I nevertheless believe that a deliberate policy of trying to reduce it would be inflationary, and hence would not restore the competitive position its advocates are hoping **for**.<sup>2</sup> Some of them would like to accompany devaluation with "effective" wage and price controls; but they ignore two issues, namely how to ensure that such controls would indeed be effective; and, if that hurdle for once is cleared, how to prevent their success breathing

new, and in these circumstances unwelcome, life into negotiations about what does and does not constitute a subsidy! I cannot imagine U.S. legislators failing to react if Canada were to attempt to gain competitive advantages through a policy of devaluation and wage-price controls.

But for all that, the more transborder trade in goods, services, and capital takes place, the greater are the transactions costs and the exchange rate risks to which agents are exposed. Absent the political institutions that could make a common currency or rigidly fixed exchange rate regime viable, more exchange rate stability would still be better than less. Stability, however, is not the same thing as fixity, and there are certain market mechanisms tending to produce it anyway, though I have no idea how important they are in practice. I refer to the phenomenon of currency substitution. Though national currencies predominate in domestic transactions as a result of custom, reinforced perhaps by legal restrictions, agents engaged in international transactions have a choice of which currency to use. If stability in purchasing power is important, and I would not want to dispute that for a moment, then a more stable currency will be preferred to a less stable alternative. This very fact gives an incentive to national authorities on both sides of any border to deliver stability in the purchasing power of the money for which they are responsible, and if they respond to those incentives, then apart from the effects of real shocks, exchange rate stability should result. The market for the means of exchange, that is to say, is contestable at the national frontier, and the fewer restrictions there are on transborder transactions, the more likely is it that competitive mechanisms will deliver, if not one money for the whole market, then at least rather stable exchange rates between the currencies circulating in various parts of it.

To sum up: it is certainly the case that there are benefits, in terms of lowering transactions costs, to be had from using one money in one market; but it is also true that certain political factors, involving the management of inflation and, less important, the economy's response to real shocks, argue in favor of maintaining separate national currencies, even when countries are deeply involved in mutually beneficial and only lightly regulated international trade in

