

“Why Europe Can’t Afford the Euro.” *Times* (London), 19 November 1997.

A common currency is an excellent monetary arrangement under some circumstances, a poor one under others. Whether it is good or bad depends primarily on the adjustment mechanisms that are available to absorb the economic shocks and dislocations that impinge on the entities considering such a currency.

Flexible exchange rates are a powerful adjustment mechanism for shocks that affect the entities differently. It is worth dispensing with this mechanism to gain the advantage of lower transaction costs and external discipline only if there are adequate alternatives.

The United States is an example of a situation that is favourable to a common currency. Although composed of 50 states, its residents overwhelmingly speak the same language, listen to the same television programmes, see the same movies, can and do move freely from one part of the country to another. Goods and capital move freely from state to state, wages and prices are moderately flexible, and the national Government raises in taxes and spends roughly twice as much as state and local governments. Fiscal policies differ from state to state, but the differences are minor compared with the common national policy.

Unexpected shocks may well affect one part of the United States more than others — as, for example, the Middle East embargo on oil did in the 1970s, creating an increased demand for labour and boom conditions in some states, such as Texas, and unemployment and depressed conditions in others, such as the oil-importing states of the industrial Midwest. The different short-run effects were soon mediated by movements of people and goods, by offsetting financial flows from the national to the state and local governments, and by adjustments in prices and wages.

In contrast, Europe exemplifies a situation unfavourable to a common currency. It is composed of separate nations, speaking different languages, with different customs, and

having citizens feeling far greater loyalty and attachment to their own country than to a common market or to the idea of “Europe”. Despite being a free-trade area, goods and capital move less freely than in the United States.

The European Commission based in Brussels, indeed, spends only a fraction of the total spent by national governments in the member countries. They, not the European bureaucracies, are the important political entities.

Moreover, regulation of industry and employment is more extensive than in the United States, and differs far more from country to country than between American states. As a result, wages and prices in Europe are more rigid, and labour less mobile. In those circumstances, flexible exchange rates provide an extremely useful adjustment mechanism.

If one country is affected by negative shocks that call for, say, lower wages relative to other countries, that can be achieved by a change in one price, the exchange rate, rather than by requiring changes in thousands on thousands of separate wage rates, or the emigration of labour. The hardships imposed on France by its “*franc fort*” policy illustrate the cost of a politically inspired determination not to use the exchange rate to adjust to the impact of German unification. Britain’s economic growth after it abandoned the exchange-rate mechanism a few years ago to refloat the pound illustrates the effectiveness of the exchange rate as an adjustment mechanism.

Proponents of the euro often cite the gold standard era from 1879 to 1914 as demonstrating the benefits of a common currency. But the gold standard also had its costs. The period was characterised by declining prices from 1879 to 1896, rising prices thereafter, and sharp fluctuations within each period.

The standard was viable only because governments were small (spending about 10 per cent of the national income, rather than 50 per cent or more, as now), prices and wages were highly flexible and the public was willing to tolerate, or had no way to moderate, wide swings

in output and employment. Take away the rose-coloured glasses and it was hardly a system to emulate.

As of today, a subgroup of the European Union — perhaps Germany, the Benelux countries and Austria — come closer to satisfying the conditions favourable to a common currency than does the union as a whole. And they also have the equivalent of a common currency.

Austria and the Benelux three have, to all intents and purposes, linked their currencies to the mark. However, these countries retain their central banks and hence can break the link at will. Any country that wishes to link to the mark more firmly can do so on its own, simply by replacing its central bank with a currency board, as some countries (such as Estonia) outside the EU have done.

The drive for the euro has been motivated by politics, not economics. The aim has been to link Germany and France so closely as to make a future European war impossible, and to set the stage for a federal United States of Europe. I believe that adoption of the euro would have the opposite effect.

It would exacerbate political tensions by converting divergent shocks that could have been readily accommodated by exchange-rate changes into divisive political issues. Political unity can pave the way for monetary unity. Monetary unity imposed under unfavourable conditions will prove a barrier to the achievement of political unity.