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Considerations on the Costs and Benefits of Economic and Monetary Union

1. Introduction

The Cecchini studies evaluated the potential gains that can be achieved by the completion of the internal market, and the table in the annex summarises the main results. It was found that the 1992 programme would add between 4 1/2 and 7 per cent to Community GNP, with a diminution of the price level by as much as 6 per cent.

This note analyses additional costs and benefits of the creation of a full economic and monetary union compared to the 1992 programme alone. It compares the following two scenarios:-

1992: Successful completion of the internal market programme with the EMS in its present form, reinforced only to the extent necessary to avoid speculative attacks on exchange rates after the abolition of capital controls in 1990.

"1992 plus": Successful completion of the internal market programme plus fixed exchange rates without margins of fluctuation and a credible commitment not to change parities (i.e. MU), significant structural funds, effective coordination of demand policies, oversight of budgetary policies and Community policies in a number of specific sectors.

The note is organised as follows. Section two discusses the costs and benefits of monetary union. Section three then discusses the costs and benefits of a coordination of demand policies and oversight of budget policies; and finally section four goes into supply-side areas of Community policies.

The purpose is to identify the strictly economic rationale for actions in these areas so that the net welfare gain can be identified. Wider social and political considerations are not taken into account and no attempt is made to quantify the gain, but the conclusion is that the potential is substantial.

2. Costs and benefits of a Monetary Union

The main perceived cost from a monetary union (MU) is that the irrevocable fixing of exchange rates eliminates an instrument that might be needed to offset the effects of shocks. Such shocks might require adjustments in real exchange rates inside the Union.

The surrender of the nominal exchange rate as a policy instrument may or may not make the needed change in real exchange rate more costly. Much depends on the extent that nominal wages are rigid or that there is "money illusion" in general. For example it is often argued that the nominal exchange rate is important because a real shock, e.g. and increase in oil prices, would require that in some countries real wages decline relative to those of other countries. This decline would be difficult to achieve by a reduction in nominal wages at a constant nominal exchange rate, but might be easier to achieve at constant nominal wages through a devaluation of the nominal exchange rate.

In both cases real wages would eventually have to decine by the same amount. The argument that the same reduction in real wages is more easily achieved by a devaluation than by a reduction in nominal wages must therefore rest on the assumption that either nominal wages are fixed by law or through contract ("rigid nominal wages") or that wage earners do not realize their loss of purchasing power when it occurs through the rise in prices that comes with a devaluation ("money illusion").

The validity of argument that changes in nominal exchange rates are needed for adjustment also depends upon the existence of shocks that affect entire countries and not just specific regions or industries. Many shocks, especially in more advanced economies, are however industry specific (shifts in technology and tastes) and most industries are present throughout the Community. The nominal exchange rate is hence a less important instrument for adjustment than is generally thought.

The main types of benefit from a MU include: the elimination of exchange rate uncertainty; the reduction in transaction costs; and the increased transparency of prices that comes from the irrevocable fixing of exchange rates.

The nature of the first two types of benefits is evident. They have always been widely used in support of efforts to reduce exchange rate variability. The EMS has already done much to reduce the costs of exchange rate uncertainty. Transactions costs however, especially for companies operating over a number of countries and hence using many currencies remain significant. However some of these costs would remain in a MU which did not have a single currency. They would be decreased by irrevocably fixed rates but might not be completely eliminated. As there would still be a number of national currencies, banks would still incur the costs of multiple accounting systems and cash holdings.

The third type of benefit implies that this small step, from low to zero exchange rate variability, might have important indirect effects. For example, in assessing the benefits from the 1992 internal market programme it is usually assumed that after 1992 the Community will constitute a single unified market. However, as long as firms set prices in national currencies the transparency of prices is not total. Firms therefore have more scope for price discrimination across national markets. In the "Cost of Non-Europe" study it was found that the welfare gains that can be expected from 1992 differ considerably depending on whether one assumes that 1992 just leads to an area without internal frontiers but where firms can practice price discrimination between markets, or that 1992 implies a really unified market inside which price discrimination by national markets is impossible. The upper bound of the range of benefits found in the Cecchini report would correspond to the second hypothesis.

For financial markets the elimination of a residual degree of exchange rate variability might also be important. A comparison of interest rates on DM and HFL assets shows that, over the last five years, HFL interest rates have been almost 1 percentage point higher than DM interest rates although the HFL/DM exchange rate has been stable. With completely and credibly fixed exchange rates interest differentials of this type can be expected to disappear.

The creation of a MU would also eliminate the possibility for the monetary authorities of the regions of the MU to use (unanticipated) monetary policy to affect employment or the real interest rate paid on public debt. For some countries this discipline coming from a MU could be beneficial because it might lead to a reduction of the real interest rate paid on public debt. With debt to GDP ratios exceeding 100% in some countries, a reduction in the risk premium of 1 percentage point would permit the government to reduce the deficit by 1% of GDP.

Other benefits from a MU include:-

- A MU would be an answer to the stability problem. The existence of (i) fixed exchange rates, (ii) integrated capital markets, (iii) autonomy for national monetary policy and (iv) a high degree of trade integration threatens the stability which has been achieved under the EMS, which in turn would put the entire 1992 programme in jeopardy. The speedy creation of a MU, or more precisely, abandoning the desire to preserve autonomy for national monetary policy, would therefore be necessary to preserve the EMS and the entire 1992 programme.

- the creation of a MU would diminish the exposure of the member economies to shocks coming from outside.

- the creation of a MU would give Europe a "monetary identity" and would increase the weight of Europe in the rest of the world.

In conclusion therefore it appears that for the Community the benefits from a monetary union outweigh the costs because it is a highly integrated area. This is confirmed by the literature which suggests that areas inside which trade is intense, factors of production are mobile and for which most shocks do not affect entire regions but rather industries or sectors distributed over the whole area are likely to form an "optimum currency area".

3. Costs and benefits of the Demand and Budgetary Policy Exchange

This section discusses the costs and benefits from the coordination of demand policies and oversight of budgetary policy. Such coordination is necessary to the functioning of the union, and can be justified on that ground alone, but it can also bring a welfare gain to the extent that economic policies have external effects, that is if action by one state or private agent affects directly the welfare of others.

The management of aggregate demand over the cycle is often assumed to imply external effects because a change in the fiscal stance in one country affects demand and inflation in other countries, but this beneficial side effect is not taken into account by the country that undertakes to change its fiscal stance for domestic reasons. Since expansionary policies are perceived to lead to a cost in terms of deteriorating external accounts, it has been argued that in a fixed exchange rate system an insufficient coordination of fiscal policies leads to a deflationary bias because each individual country ignores the effects of its action on the system and operates an excessively tight fiscal policy. This example could be changed by taking into account the effects of the fiscal stance on inflation which might result in an inflationary bias instead of a deflationary one. However, whatever the signs of the external effect of fiscal policy, the general principle is that coordination of fiscal policies would have the aim of ensuring that all member countries set their fiscal policy taking account, not only of their own interests, but also of the interests of the entire system. Although each individual member country might feel that fiscal policy coordination imposes a cost on it, participation by all might lead to better demand management and hence a benefit in terms of overall economic welfare.

Community control over public sector deficits and public debt might also yield benefits if deficits or debts become large enough to threaten the credibility of national authorities. If a perception develops in the market that the authorities of a certain country might experience difficulties in servicing their debt, or might be induced to devalue their currency to reduce the real burden of the debt, interest rates on the debt of these countries would increase. A lack for credibility acts like a tax or any other distortion, removal of this distortion through Community control would increase economic welfare.

4. Supply-side Areas for Community Policies.

This section considers some additional areas in which Community policies can have net benefits on strictly economic welfare grounds. In most cases this is because there are market imperfections that operate on a Community-wide scale and can therefore not be dealt with at a national level.

- Information is a good that is difficult to trade in private markets because its value cannot be evaluated without it being revealed. Private markets in information may therefore be underdeveloped and some public intervention may be required. A strong Community policy in the field of research and development can therefore be justified on economic grounds, not only to avoid duplication efforts, but also to help to create the appropriate framework that makes sure that private agents perceive the appropriate social value of research and development. Given that most research and development will be valuable throughout Europe, action by Member States individually is not sufficient to provide the right incentives.

- Community oversight of national industrial policy will increase welfare in those sectors in which there is only a small number of firms which make high profits. Each individual member state might try to attract these industries using different types of intervention because this would be beneficial from a national welfare point of view. However, if all member states do this, their efforts will of course neutralize each other and a waste of resources will result.

- Finally similar reasoning can be used to establish the need for a Community policy in all sectors producing international public goods such as infrastructure for transportation, environment and long distance energy transmission.

The economic benefits of increased investment by structural funds are based on considerations of market imperfections. If the infrastructures and other investments financed by the Community yield a net benefit they would also have been undertaken by the regional or national authorities as long as these regional or national authorities had access to financing. If the Community regional policy is limited to financing economically viable investment its main impact would therefore come through the fact that the financing of the investment is borne by the entire Community instead of the specific region or nation in which it takes place. However, this is an income redistribution aspect.

The above result relies on the assumption that national or regional authorities have free access to international capital markets. It appears difficult to decide a priori whether member countries do have such access. The current LDC debt crisis shows that entire groups of countries can be excluded from these markets. The reason is that in capital markets information about the solvency of the debtor is the critical variable and it is difficult for creditors to assess the solvency of sovereign borrowers. Once the solvency of a debtor is in doubt, it is often not in the interest of creditors to simply raise the interest rate to reflect this risk because a higher interest rate in itself raises the probability of that debtor becoming insolvent. Moreover, higher interest rates eliminate the good credit risks from the markets. Under these circumstances credit to bad credit risks is often rationed. It may be argued that no member country has so far been rationed and hence that the LDC debtor parallel is inappropriate. Yet, although no member country has up to now encountered difficulties in obtaining credit in international capital markets, some national authorities have reduced their investment programme before attaining the point at which they might be openly rationed.