The Choice of Currency in a Single European Market

Pascal Salin

A "unique market" for commodities and factors of production ought to exist in Europe in 1993, and the great majority of people believe that all possible efforts must be made to move toward the unique currency that is deemed necessary to implement such a market. "A unique market, a unique currency, a unique central bank"—that is the fashionable slogan.

I do not share this view for reasons that are drawn from economic theory and are explained in this paper. I will begin with a discussion of concepts, such as "unique market" and "economic integration," and show why a unique market does not imply the existence of a unique currency. It will be made clear that Europe's present monetary problems have not been caused by an excessive number of currencies but by institutional characteristics of both the existing national monetary systems and the European Monetary System. Therefore, the priority ought to be given to institutional changes—mainly by reintroducing decentralized responsibility—and not to establishing a unique currency and a unique central bank. The paper concludes with a discussion of the practical aspects of a competitive approach to European monetary integration, as regards both competition between currencies and competition between monetary systems.

The Unique Market and Monetary Integration

The unique market that has been promised to Europeans in 1993 is an ambiguous concept. Moreover, there is no logical link between economic integration and monetary unification. There may be reasons for reducing the number of currencies in Europe, but these

---

Cato Journal, Vol. 10, No. 2 (Fall 1990). Copyright © Cato Institute. All rights reserved.

The author is Professor of Economics at University Paris-IX-Dauphine. He thanks Lawrence H. White for useful comments on an earlier version of the paper.

reasons are independent from the possible creation of a unique market.

A Unique Market: What Does It Mean?

The evolution of the European process of integration since the creation of the European Economic Community (EEC) has been characterized by a progressive shift of emphasis from the initial—and satisfactory—concept of a common market to that of a set of common and harmonized policies, which may even be opposite to the initial aim. Will the "unique market," which has been promised for 1993, consist of a return to the initial impulse, or will it be something different?

The shift in policy directions has been reinforced by a semantic confusion between two meanings of "integration": "integration of markets" and "integration of producers." A market can be considered "integrated" as far as there are no "artificial" obstacles to the free choice of producers and consumers. The aim of the common market was to make it possible for Europeans to buy and sell goods all over Europe without having to be concerned about the nationality of trading partners.

Free trade, which is implied by a common market, does not mean free markets. It means only the suppression of *specific* obstacles (such as tariffs), which are applied whenever trade occurs between different (national) areas. When there is free trade, traders have the *right* to trade. Free trade does not mean that markets are free from public interventions over the entire free-trade area. Specific taxes, subsidies, or regulations may exist on some portions of this area, for example, in different countries.

From this point of view, the integration of markets aims at reinforcing competition among producers. Competition does not necessarily lead to the homogenization of commodities, contrary to what is suggested by the traditional theory of competition. In reality, the consequences and the merits of competition stem from each producer's incentive to differentiate his production in order to do better than his present and potential competitors. In some cases, competition may lead to a smaller diversification of products; but as a general principle, increasing competition increases diversification. Therefore, we may suspect at this point that there is a contradiction between the reinforcement of the "common market" and the emphasis on "harmonization."

In fact, integration is generally understood as "integration of producers," which more or less means cartelization and not competition. The aim is either to replace existing producers by a small number of

producers or to impose the same environment on all producers. But *common policies* may avoid or limit free competition. European authorities have skillfully created and maintained the confusion between the two meanings of "integration." Thus, they meet an obscure feeling of public opinion according to which any agreement, any cooperation, any "harmonization" is desirable.

This confusion in language is very close to another confusion that exists between "competition" and "the harmonization of the conditions of production." Most people believe that competition is "unfair" when producers are not placed in the same productive environment, which explains the present efforts toward the harmonization of regulations or taxes.

Competition implies freedom of choice, by producers as well as consumers, specifically the freedom of entry. But it does not imply that all producers should operate in the same environment and should be subject to the same "competitive conditions." Economic theory—particularly the theory of international specialization—brings the fundamental lesson that producers of the same product operating under different conditions have the responsibility, in combining various factors of production, to make allowance for the particular constraints they are subject to in order to make their products competitive. Because integration is usually interpreted in terms of production and not markets, the claim for harmonizing "competitive conditions" has been translated, in every sector, into a search for common European policies and harmonization of taxes and regulations.

The "unique market" is thus interpreted as necessarily including the harmonization of production conditions. To be sure, one does not try, for the time being, to harmonize everything, and the principle of mutual recognition of norms is an interesting example of officially accepted differentiation. The general direction, however, is toward harmonization. The concept of the "unique market" thus seems to mix the notion of a common market—that is, free trade—and the notion of a constructivist effort in favor of the harmonization of the conditions of production. In that sense, the "unique market" rests on a fundamental intellectual error. Before focusing on the specific case of monetary arrangements, let us consider the field in which efforts toward harmonization have been the most explicit, namely, taxation.

To make the "unique market" possible in 1993, the EEC Commission, supported by most officials and commentators, defends the idea that fair competition is impossible without harmonizing VAT rates and some other taxes. The core of my argument is this (see Salin

1988, 1989): Some taxes—for instance, the VAT—do not affect relative prices and, therefore, the conditions of international specialization, so that there is no need for harmonization. In cases where taxes introduce specific distortions among countries, competition in tax systems is better than harmonization. It may introduce incentives for governments to suppress these distortions.

With free trade, the price of a given commodity tends to be the same in different countries, but it is likely that the structure of costs is not the same in all countries. Two producers can be "competitive" on a market even if their conditions of production are different. For example, a Spanish tomato grower and a Dutch tomato grower use very different production techniques because they work in different environments. The Spaniard enjoys much more free sunshine, but the Dutch tomato grower can be competitive with greenhouses heated by natural gas. Under such conditions, it would be absurd to call for the "harmonization of competitive conditions," that is, to pretend to offer more sunshine to the Dutch growers, to subsidize the use of natural gas by the Spaniards, or to oblige Spanish producers to cover their plants with a canvas in order to protect Dutch producers from the "unfair competition" from sunbeams. The only important thing is to secure competition on the markets for commodities and factors of production.

It is absurd to try to "harmonize the conditions of production" in a free market economy, so that all producers could produce with exactly the same structure of costs. I do not see any difference between the (impossible) harmonization of sunshining conditions and the harmonization of tax conditions. Taxation is only one characteristic of the environment to which producers have to adjust, and there is no more justification for harmonizing one tax than any other part of production costs.

The main problem is not harmonization but "optimal taxation and expenditures." We shall see that in the monetary field the problem is not harmonizing money production and monetary systems, but providing for "optimal money." But, there is no rationale for harmonization per se: Why, for instance, should we harmonize toward a possible standard of over-taxation and spoliation? Similarly, why should we direct monetary integration toward a possible standard of over-production of money?

When aiming at tax harmonization, the EEC Commission and its administration, the national governments and the medias that support them, are wasting their efforts to reach targets that have no meaning. There is nothing to add to the common market in order to have a unique market. *The "unique market" already exists.* If there

is no justification for shifting from a common market to the "unique market," then another direction ought to be taken, namely, shifting from a common market to free, or deregulated, markets. This deregulation can be obtained through either an explicit and centralized process of public decisions or a more competitive process. The "unique market" would not be made *unique* because of harmonization and centralization, but it would be closer to a *market* if it were deregulated. The emphasis must be put on "market" and not on "unique." This shift of emphasis applies perfectly to monetary integration.

A Unique Market without a Unique Currency?

It is widely thought that a unique market needs a unique currency and, therefore, a unique central bank. This opinion reflects the more general idea according to which European integration consists of creating a super-nation on the model of existing nations. The traditional slogan, "one nation, one state, one currency," is merely translated into European terms, and the possibility of disconnecting the national zone and the monetary zone is considered an absurdity.

In fact, we must apply to money the same reasoning that we applied to the production and circulation of commodities. A single market for money is not necessarily a market in which production is cartelized by force or in which the conditions of production are harmonized. A single market or an integrated market exists in a given area as far as there is freedom of choice for producers and money-users.

A unique market for commodities and production factors does not imply the creation of a unique currency, because the differentiation of currencies is not an obstacle to the free movements of goods, currencies, and financial assets. Modern economies are complex social systems, founded on individual specialization and exchange, because they are monetary economies. To play its role as a means of indirect exchange and reserve of value, money need not be a homogeneous product; it needs to be a *good currency*. Similarly, an exchange economy relies on systems of communication and telecommunication, but not necessarily a unique communication or telecommunication system. Only in a centrally planned economy might it be easier to use a unique currency. The claim for a unique currency may be a consequence of the confusion between a single market and a centrally regulated economy, which seems to be the aim of many Europeans.

Although the creation of a unique market—whatever we understand it to be—does not justify the existence of a unique currency in Europe (or, at least, a system of perfectly substitutable currencies,

that is, a system of fixed exchange rates), there may be other reasons to limit the number of currencies. The aim of any monetary arrangement ought to be the production of a "good" currency, which plays its role as an "undifferentiated purchasing power." The moneyness of a monetary unit depends on its ability to be exchanged against any other good, at any time, and with anybody. The liquidity of money has two components: the stability of its purchasing power and the dimension of the zone in which it is circulating.

We more or less know what a noninflationary currency is, but we do not know the optimal dimension of the monetary zone, which may have to be discovered from experience. It is obvious that gains might be realized by increasing the dimension of a monetary area, as far as there are economies of scale, externalities, or economies of scope in the production of money. However, the optimal dimension does not necessarily correspond to a unique currency in Europe (or in the world). There may be a dimension—narrower than Europe—beyond which the marginal gain from enlarging the zone is negligible.

Thus, the specific characteristics of money production imply that the differentiation of currencies be limited, contrary to my argument that competition normally creates differentiation. This does not mean, however, that the process of competition must be controlled in order to avoid excessive differentiation. Quite the contrary. If gains can be obtained by limiting the number of currencies, then competition is the best way to reveal such a situation, because there are always people in a free system to extract potential gains. It is, therefore, likely that, if currency competition was ever to prevail in Europe, the market would select a more limited number of currencies than there are currently, and possibly only one of them. Even if the spontaneous working of the market were to select a unique currency, however, it would not be necessary—and not even desirable—to have a unique central bank in Europe.

Rather than imposing a limited number of currencies or a unique currency in Europe, it is important to think about the institutional structures that would make "good" currencies (or a good unique currency) possible in Europe. The problem with the present monetary organization in Europe is not that there is an excessive number of currencies. The problem is that there are institutional flaws, both regarding the organization of national systems and the organization of the European system of central banks.

The European Monetary System: Present Reality and Future Prospects

Modern monetary systems are founded on *institutional irresponsibilities*. This is the case with the European Monetary System and plans for the future—for instance, the proposals included in the Delors Report—do not bring any remedy to this feature.

If we consider the great number of possible monetary systems, it is striking that all modern monetary systems are built on the same pattern. The likely reason is that these systems are the product of public design and not of a spontaneous process of evolution. To better evaluate the working of modern monetary systems, and specifically of the European Monetary System, we should consider a different system that might develop under free banking: a nonhierarchical system with convertibility guarantees in terms of an "external" asset, such as gold.[1]

Each member bank in such a monetary cartel[2] gives two convertibility guarantees, one in terms of gold ("external guarantee") and one in terms of the currencies issued by the other member banks ("internal guarantee"). If a bank issues too much money, then it loses gold (because some customers want to exchange that currency against gold). It has an incentive to adopt a more restrictive monetary policy in order to avoid a loss of customers and a possible failure because of a crisis in confidence. The adjustment process may also be reinforced by the pressure put on it by other member banks. In such a system, each bank is responsible for its own convertibility guarantees—both external and internal—and its adjustment process. Bad management—that is, the provision of a bad currency—is sanctioned.

This example demonstrates that a well-functioning monetary system with a unique currency—the currency issued by the monetary cartel—is perfectly compatible with a multiplicity of banks and decision centers. All decentralized decision centers adhere only to coherent rules of the game.

Moreover, as far as freedom of entry is maintained, so that several (actual or potential) monetary cartels exist, external competition prevents a member of a monetary cartel from trying to obtain a monopoly

[1]See, for example, White (1984), Selgin (1988), and Salin (1990).

[2]The use of the term "cartel" may be disputed, since a cartel is usually defined as an organization whose members collude to offer their products at the same price. I adopt a more extensive definition of the term here, however, as meaning actions taken by producers to suppress the differentiation of their products. It is the case with banks that make their currencies perfectly substitutable, even though this result may not be obtained by an explicit "cartel" agreement but by isolated and convergent decisions of banks.

position and from issuing a depreciating currency. Thus, decentralized responsibility inside the cartel and competition outside are efficient ways to discipline monetary production.

Present national monetary systems are designed according to a hierarchical model. The commercial banks—or second-rank banks—still give formal convertibility guarantees in terms of the central bank's currency and the central bank occasionally gives external guarantees, if the system is some sort of a (pseudo-) gold standard or a fixed-rate system. But the central bank is indirectly in charge of giving "internal" guarantees (between currencies issued by the member banks), because commercial banks can issue unlimited amounts of money if the central bank is not inclined to adopt a tight monetary policy. The role of the central bank as a lender of last resort can be interpreted as a (partial) transfer of responsibility (regarding "internal guarantees") between commercial banks and the central bank. Contrary to what happens in a decentralized system, banks have no incentive to limit money creation. Each bank participating in such a monetary cartel has an interest in trying to widen its market share, and there is constant pressure in favor of money creation. Instead of being a self-regulating system—as is the case with decentralized guarantees—there is a command system, especially if the central bank uses discretionary monetary instruments to limit money creation. The inflationary bias of modern monetary systems stems from this institutional characteristic. This transfer of responsibility between banks, however, would not be possible if central banks were issuing convertible currencies at fixed prices.

Institutional irresponsibility is reinforced by two other characteristics. First, the central bank as a public institution is entitled to act in a discretionary manner. For instance, if the central bank is ever supposed to give an "external" convertibility guarantee (fixed rates in terms of gold or a foreign currency), it considers it normal to change the guaranteed price on a discretionary basis. The possibility that a currency may be devalued weakens the external discipline of convertibility. Second, monetary authorities can more or less isolate the national system from external competition by enforcing legal tender laws or exchange controls. Thus, modern monetary systems are inflation prone because there is a lack of self-adjusting incentives inside the system and a lack of competition outside. This situation is certainly true of the European Monetary System, which may be one of the worst solutions to international monetary organization. It can be analyzed as an *international cartel of national cartels.* The national cartels are organized according to the scheme we just outlined: They are hierarchical, public, and compulsory. The international cartel is

a European cartel of public central banks. It is symmetrical but with no external convertibility guarantees, which would limit the incentives to create money in a decentralized fashion.

The usual proposals concerning European monetary integration do not solve these problems, and they may even reinforce institutional irresponsibility. Thus, the Delors Report has proposed a pooling of official reserves in the second stage of the integration process. As a consequence, if a central bank adopts an excessively expansionary monetary policy, then the loss of reserves—which presently plays the role of a decentralized signal—would be "collectivized" and the incentive to correct the policy would be greatly reduced.

In the longer run, the creation of a unique currency and a unique central bank would not cure present problems in that they would not diminish institutional irresponsibility. As in present national systems, there would be a lack of decentralized incentives to limit money creation and possibly a lack of external competition. The cartel managed by the European super-state would probably use discretionary monetary management and could enforce exchange controls and other harmful devices under the pretext of protecting the European balance of payments. The very nature of the European Monetary System would not be modified by substituting a hierarchical discretionary system to the present European cartel of national cartels.

A Competitive Approach to Monetary Integration

A competitive process of integration is better than a centralized and constructivist process, not only because it leaves to the market the choice of the unique currency but also because it creates competition in monetary systems—that is, competing institutional arrangements—possibly producing the same currencies or the unique currency. Beyond that, it allows competition for the production of all sorts of monetary and financial services in which gains from cartelization may be different. This is important since, as we have just seen, the main problem of modern monetary systems and specifically of the European Monetary System is not that there is no unique currency within a large monetary area—for instance, in Europe—but that the systems are founded on institutional irresponsibility. Therefore, monetary systems must be designed so that this irresponsibility is diminished or suppressed or the market must be allowed to select the best monetary system.

Currency Competition

There are solutions that correspond to a more competitive approach than the one that is generally adopted. A system of free

banking, in which anyone is free to supply and use a currency, is the best approach because it would increase the responsibility of individual banks. Free banking may not be acceptable for the time being, however, so it may be advisable to discuss other options.

The first possibility is to favor competition between *existing* currencies, which means substituting free-floating rates for the present European Monetary System. In much the same way that norms are mutually recognized, there would be a mutual recognition of currencies. As previously stressed, the flexibility of prices does not mean that there is no unique market; in fact, there would be a "common market in currencies." It is quite true that the diversification of currencies imposes various costs on money-holders (for instance, transaction, information, and risk costs), but this is the case with all sorts of commodities for which we accept such costs. Diminishing the diversification of goods would decrease these costs, but it would also limit freedom of choice for consumers and incentives to innovate for producers. Transaction costs can thus be considered as equivalent to investment costs: Investing in differentiation makes freedom of choice possible. This is true for currencies.

With currency competition, it is expected that, little by little, a currency or a limited number of currencies will be selected by the market as "common currencies." Although we suspect that most monetary areas in Europe are too small to extract all possible gains from large-scale production or economies of standardization, we do not know to what extent this is true. We also do not know beyond what size significant marginal gains can no longer be obtained by decreasing the differentiation of currencies. A competitive process would allow the market to determine the optimal monetary areas, and it would put pressure on central banks to hold back inflation in order to avoid a decreasing role for their currencies. From this point of view, responsibility for monetary management would be distributed among central banks in a more decentralized way, and each bank would be responsible for its own currency. If central banks had incentives to produce a good currency, then inflation rates could be low and exchange rate fluctuations could be limited, so that it would be largely equivalent for money-holders to hold one or the other currency. In such a case, the costs of differentiation would be minimized, and if ever a unique currency were to replace existing currencies, the process would be gradual and better accepted. From a practical point of view, such a competitive system implies the definitive disappearance of exchange controls or legal tender laws. It also implies possible changes in the organization of monetary systems.

In today's world, a central bank has jurisdiction over commercial banks located in its national area, and it can impose any regulation or try to influence their reserve positions. Let us assume that Europeans are free to use any currency for any activity, but that national monetary monopolies still exist, in the sense that a bank would be obliged to issue only the national currency. As the worst currencies would be less and less used, banks issuing these currencies would have to leave the market.

Happily enough, banks are increasingly allowed to accept deposits in other European currencies. In this way, monetary competition is developing within Europe, although the European Monetary System is an attempt to cartelization. In a system of freely floating rates and freedom for banks to issue any European currency, there is an apparent difficulty if, for instance, a central bank in country A can impose reserve requirements on the banks in its national system, while the banks in other European countries are allowed to issue the currency of country A without having to bear the same requirements. There are some possible ways to overcome this "difficulty."

First, each central bank could be entitled to regulate the activities of all European banks as far as their currency is concerned. Thus, the central bank of country A could oblige all European banks to hold reserves in currency A in proportion to their deposits in the same currency. Second, there could be more deregulation, making each commercial bank responsible for guaranteeing the convertibility of the deposits it accepts in any currency. In this way, each bank would participate in different cartels (and possibly new ones, if freedom of issuance is accepted). In such a decentralized system, each bank would be responsible for ensuring that it is able to transfer deposits in terms of any European currency.

As Lawrence H. White has suggested, this question might not be considered a "difficulty" but a competitive solution. There would be several competing processes to produce the same currency, as is the case with the Euro-dollar. In a system that lacks self-regulatory mechanisms, however, as is the case in present systems, competition between banks could result in more money creation. Limits to creating money in present systems depend on the regulatory powers of the central banks, and they may be lightened by competition—not among different monetary systems, but inside each monetary system.

There is another alternative to a free banking system. Some European politicians may see the necessity for a symbolic move in the monetary field. For a long time I have considered the creation of a European parallel currency to be more than a symbolic step ("A Currency for Europe" 1975), but I am certainly less convinced of it

now and I do believe that less-visible steps could be more important. The parallel currency approach, however, presents great advantages in comparison with the usual approach (exchange rate fixity with the final target of a unique currency and a unique central bank). In fact, it does not constitute an absolutely constructivist approach, and it leaves to the spontaneous working of the market the choice of relatively more desirable currencies. Freedom of choice exists, at least within a limited domain.

Competition in Monetary Systems

A common market—that is, free trade and free choice—does not necessarily produce completely free markets. In the field of taxation, for instance, I have argued that the harmonization of taxes was not necessary because it did not prevent free trade. Different systems of taxation and public expenditures, however, may be propitious to economic activity, and competition between tax systems might help to select those that better meet the needs of citizens. The same is probably true regarding money.

Competition between currencies—existing currencies, new public currencies (parallel currency), or private currencies—does not imply a forced harmonization of monetary regulations. But we can expect less-regulated monetary systems to be able to issue a more desirable currency or to issue a given currency more efficiently, so that it can lead to deregulation of monetary and financial systems. On the contrary, a unique European central bank would probably be endowed with regulatory powers based on the model of existing national central banks. This would make it more difficult to experiment with various means of monetary management, and the process of deregulation would probably be slowed down. There would be free trade, but no completely free markets.

To a large extent the modern bank is a product of regulations. In a deregulated world, the present roles of a bank—as money-issuer, financial intermediary, and producer of monetary and financial services—would be scattered among many different firms. Some would be specialized in a very specific job, some would link activities that are mainly separated for the time being (for instance, insurance and deposit management), and so forth.

To be sure, even with a unique currency, it is not necessary to have a unique decision center. In a deregulated and decentralized system, each producer gives convertibility guarantees, but he is responsible for them. Let us imagine, for instance, that two banks issue the same currency in that they give mutual guarantees of convertibility. But we can view a currency as a complex good or—

according to the "new theory of consumption" (Lancaster 1966)—a bundle of characteristics. Currencies are claims on different firms that are managed differently (in a deregulated world), so that the confidence we have in the banks' capacity to maintain their convertibility guarantees may be different. In other words, although the claims on two banks benefit from the same convertibility guarantees and are formally considered substitutable, they are different goods, being claims on different firms. In a deregulated world, continuous efforts would be made to find the best combination of diversity and homogeneity. As perfectly exchangeable means of payments, monetary units have to be as homogeneous as possible, a process that occurs because of convertibility guarantees and cartel arrangements. We also know, however, that there are different ways of producing a given good. In a cartel, each participant may try either to be more efficient than the other ones (that is, to adopt different production processes) or to give his product different characteristics.

For example, assume that bank A and bank B belong to a monetary cartel and that their currencies benefit from convertibility guarantees. Bank A gives a positive return on demand deposits but no insurance against the risk of failure; bank B gives no positive return but a reliable insurance. From this point of view both currencies, although they are convertible one into the other at a fixed price, are not perfect substitutes from the point of view of consumers. Money-users do not just demand a convertible currency, they demand currencies with a bundle of characteristics. In this diversified system of free banking, each of them buys the currency that has the combination of characteristics he prefers. In return, the producers must find the precise combination of characteristics that will make it possible for them to give their currencies convertibility guarantees and to obtain the highest possible profitability. In such a world, we discover the "optimal" combination of diversity and homogenization.

We can imagine a centralized process of deregulation in Europe, but competition in regulations and between deregulated systems is still preferable. This may imply that banks would be free to choose their desired reserve ratios, interest rates on deposits and credits, means of insuring deposits, and so forth. In order to avoid fears about such a process of competition and deregulation, a completely free sector could be introduced along with existing ones, allowing consumers to choose one or the other. Thus, the process of integration in Europe would be based not only on a "common market for currencies" (currency competition) but even more on a "common market for monetary and financial systems." I am convinced that thinking

about possible changes in monetary systems is far more important than enforcing the present view in favor of centralization.

There is no logical link between a unique market—whatever it may be—and a unique currency. A unique market, therefore, is perfectly compatible with a multiplicity of currencies and monetary systems, and there are reasons to prefer competitive approaches to monetary integration. But it is also true that there is no reason for limiting monetary integration to the borders of Europe. The optimal size of monetary and financial areas may be larger than Europe for some activities and smaller for others, and we must be cautious about the possible risks of Europe becoming a monetary fortress. The time may be here for new initiatives in favor of a worldwide approach, including competition and deregulation.

References

"A Currency for Europe—The All Saints' Day Manifesto for European Monetary Union." (Manifesto signed by nine European economists.) *The Economist*, 1 November 1975.

Lancaster, Kelvin T. "A New Approach to Consumer Theory." *Journal of Political Economy* 74 (March/April 1966): 132–57.

Salin, Pascal. "Le mythe de l'harmonisation fiscale." *Revue francaise d'économie* 3(3) (1988): 135–58.

Salin, Pascal. "The Case Against Tax Harmonization." Report for the Conference on Global Disequilibrium, Montreal, McGill University, 17–19 May 1989.

Salin, Pascal. *La vérité sur la monnaie.* Paris: Odile Jacob, 1990.

Selgin, George A. *The Theory of Free Banking.* Washington, D.C.: Rowan & Littlefield, 1988.

White, Lawrence H. *Free Banking in Britain: Theory, Experience, and Debate, 1800–1845.* New York: Cambridge University Press, 1984.

Competition or Cartelization among European Currencies?

Lawrence H. White

There is little to criticize in Pascal Salin's very effective presentation of the case against a cartelization of European currencies under the aegis of a European central bank. Two points will perhaps bear amplification.

Harmonization of Seignorage Harms Money-Users

As Salin emphasizes, uniformity of tax, regulatory, or monetary policies across borders is not a virtue per se. Harmonized policies may be uniformly illiberal and anti-competitive. They *will* be anti-competitive when the motive for harmonization is the desire of each government to shelter certain domestic producers from the competition of less-regulated or less-taxed producers in other jurisdictions.

Monetary competition, like tax competition, is better than illiberal harmonization. In fact, monetary policy is not just *like* a tax policy; it *is* a tax policy in the sense that the seignorage revenue from monopolistically supplying base money is a tax revenue. Expanding the stock of a base money levies a tax on the holders of the existing stock, as the value of their money balances is diluted. The idea of seignorage as a tax on holdings of base money is of course quite familiar to monetary economists,[1] and the idea is relevant to the discussion of a European central bank.

A major part of the "tax base" for the collection of seignorage is the stock of base-money reserves that banks are required by law to hold against their deposits. Among Western European nations, seignorage is most important as a source of tax revenue (making up 6 to 12 percent of total tax revenue) in Italy, Spain, Greece, and

---

Cato Journal, Vol. 10, No. 2 (Fall 1990). Copyright © Cato Institute. All rights reserved.

The author is Associate Professor of Economics at the University of Georgia.

[1]For an elementary exposition, see McCulloch (1982, chap. 5).

Portugal, primarily because reserve requirements are highest there (Drazen 1989, pp. 13–14). Greater freedom for trans-European branch banking competition, beginning in 1992, could significantly erode the seignorage tax base in these countries by allowing depositors to switch more easily from the deposits issued by highly taxed domestic banks to the better-yielding deposits issued by lightly taxed foreign banks. The tax authorities would suffer, but depositors would clearly benefit. Ultimately, the integration of capital markets will compel reductions in high reserve requirements in order to maintain the competitiveness of domestic banks (Drazen 1989, p. 15; Grilli 1989, p. 71).

If reserve requirements (and, therefore, the seignorage tax base) are to fall, the rate of monetary expansion (the tax rate) must increase in order to generate the same seignorage. But the rate of monetary expansion in any member of the European Monetary System is constrained, given the commitments to free capital mobility and fixed exchange rates, by the expansion rates of the less expansive members. Inconsistent rates of monetary expansion would create inflation-rate differences that are inconsistent with fixed exchange rates (absent restrictions on capital flows). If the governments with the largest appetites for seignorage are enthusiastic about forming a European central bank, it may be because they anticipate that its rate of monetary expansion—and, hence, their share of its seignorage—will be greater than the seignorage they can extract on their own as members of the EMS, once 1992 arrives.

The hypothesis that at least some European governments are concerned about their seignorage is supported by the observation that when Italy had to disinflate upon joining the EMS, it simultaneously increased its reserve requirements so as to preserve its seignorage (see Drazen 1989, p. 15, citing Giavazzi 1988). The hypothesis is also supported for several countries (France, Ireland, Italy, Germany, and Greece) by evidence of cointegration between times series for seignorage and total government expenditures (Grilli 1989).

Optimal Currency Communities Can Emerge Spontaneously

A single market does not require a single currency, as Salin correctly insists, just as it does not require a single language (or a single system of weights and measures). Still less does a single market require centralized imposition of a particular currency, language, or measurement system. The competitive process can and should be

allowed to reveal how many and which currencies best serve their users.

But are there not benefits to others when an individual chooses to use a common currency? Yes, there are. His potential trading partners can transact with him at lower cost. Is not collective guidance through political means then needed to ensure that we have a common currency to "internalize" these potential external benefits? No, it is not. An individual who chooses to use a particular currency *shares* the benefits of that choice with his trading partners. The simple fact that trade is two-sided implies that he saves transactions costs just as they do. Consequently, there is no divergence between the privately best and the socially best choice of currency by any individual. "Optimal" currency communities will spontaneously develop as economies of standardization make themselves felt.[2] It is a needless exercise of paternalism to limit individuals' choices among currencies (the same argument applies to languages and measurement systems). Governments should neither hinder, nor accelerate, nor attempt to short-circuit entirely the market convergence process toward a common currency. We need competition as a discovery procedure in the currency market, just as we need it in the computer market (where common standards also emerge). No one knows in advance the size or composition of the optimal currency community or the most preferred monetary policy among members of such a community.

What about the launching of a new currency (or unit of account)? Is not a collective commitment to use a proposed new currency necessary to overcome the very tendency for everyone to use what is currently the most popular currency among his or her trading partners, which makes each individual reluctant to go first in using the new? Is not the decision to switch to a new currency, therefore, a public good, just like the decision to switch from driving on the left to driving on the right? Well, a synchronized switch to a new currency may need to be public, but it is not necessarily a good. It will be a public *bad* if its users find that the new currency is worse than the old, particularly if the inflation rate is higher or more variable. Thus, the character of the proposed arrangements for controlling the supply and purchasing power of the new currency have to be carefully considered. Salin is right when he says that "rather than imposing a limited number of currencies or a unique currency in Europe, it is important to think about the institutional structures that would make 'good' currencies possible." As far as I can see there is no guarantee,

[2]The issue in optimal currency communities is not one of economies of scale in production, contrary to what Salin's terminology suggests.

and virtually no likelihood, that a European central bank currency produced monopolistically by a cartel of nation-states would prove to be less inflationary than the best of the existing national currencies now competing in Europe.

The switch to a new currency, furthermore, does not need to be synchronized. A superior currency, in principle, can displace an inferior currency gradually, provided that government does not block it. The "dollarization" of high-inflation economies (Mexico, Argentina, Israel) in recent decades, despite legislated obstacles, is a familiar example of this phenomenon. In an earlier era, gold displaced less suitable commodity monies. There are transactors at the margin of any currency community, such as multinational firms, who will choose to switch to a superior currency unit as a transactions and accounting medium when the benefits exceed the costs. Under deregulated and modern conditions, the costs may be low enough that some transactors may switch out of their accustomed currency even for a modest inflation differential. From the marginal users the superior currency can spread to their domestic trading partners, for whom the benefits of switching will have risen.

The establishment of a parallel European currency unit, both allowed and required to compete for its customers, is therefore a defensible idea. No one who distrusted such a currency would be forced to use it. The opposite would be true of a compulsory and monopolistic European central bank currency.

The more competition there is among fiat currencies, as Salin rightly concludes, the more discipline there will be on their issuers and the better the outcome for currency users. But competition will not eliminate discretion for the national monetary authorities, except in the limiting case where demand for each currency is perfectly elastic with respect to the rate of monetary expansion. Constitutional limits on monetary expansion, therefore, would still be useful.

References

Drazen, Allan. "Monetary Policy, Capital Controls, and Seignorage in an Open Economy." In *A European Central Bank?* Edited by Marcello de Cecco and Alberto Giovannini. Cambridge: Cambridge University Press, 1989.

Giavazzi, Francesco. "The Exchange-Rate Question in Europe." Working paper, Universitá di Bologna, 1988.

Grilli, Vittorio. "Seignorage in Europe." In *A European Central Bank?* Edited by Marcello de Cecco and Alberto Giovannini. Cambridge: Cambridge University Press, 1989.

McCulloch, J. Huston. *Money and Inflation.* 2d ed. New York: Academic Press, 1982.

Currency Competition and European Monetary Performance

Geoffrey E. Wood

The title of Pascal Salin's paper is well chosen, for it directs attention to two key issues in discussion of European Monetary Union. First, is there any necessary connection between EMU and the single market program? Second, should a currency be imposed on Europe or should there be free choice of currency? Salin analyzes these issues with great skill and reaches the following conclusions. The single market program does *not* require the creation of a single currency. Despite that conclusion, there are deficiencies in present European monetary arrangements. The deficiencies are not the result of there being too many moneys, but of these moneys having deficiencies. Finally, Salin argues that these deficiencies are more likely to be remedied by letting currencies compete than by imposing a single currency on the European Economic Community. All of these conclusions seem to me to be correct, but there are some important arguments in their favor that Salin does not deploy and some criticisms of his conclusions that he does not confront. In these comments, I will set out these arguments and consider these criticisms.

Single Market and Single Currency?

As Salin observes, it is frequently claimed that the Single Market Program requires more than the abolition of all government-created barriers to the movement of goods, labor, and capital. It also, it is said, requires "harmonization of production conditions" to ensure "fair competition." As part of this harmonization, the argument runs, we need to create as single currency to ensure common monetary conditions.

Cato Journal, Vol. 10, No. 2 (Fall 1990). Copyright © Cato Institute. All rights reserved.

The author is Professor of Economics at the City University Business School in London.

There is most certainly a case for a free, competitive market within Europe—and, indeed, worldwide. The case can be made in two distinct ways, and both show that gains come in such a situation because production conditions are *different* between firms and locations. Harmonization of production conditions would certainly restrict and could eliminate these gains.

One approach can readily be traced back to Adam Smith. This approach describes the process, characterized by Smith ([1776] 1937) as the workings of an "invisible hand" that guides a market economy, uncoordinated by any central planner, to its best possible allocation of resources. This is essentially the neoclassical general equilibrium analysis of an economy.[1] That analysis demonstrates that residents in an economy can gain by two types of trade. First, they trade goods and services so that what they consume is better aligned with their tastes than was the set of goods they started with. Second, they gain by getting more goods than they initially had as *differences* in production conditions are exploited. These differences are exploited by factors of production moving to take advantage of the fact that different production conditions across industries mean that industries make the best use of *different* combinations of factors. These output gains accrue because of diversity of production conditions; and if production conditions were "harmonized," the gains would be lost. This neoclassical approach shows that difference, not harmonization, is the source of gain.[2]

The second line of argument has become known as the Austrian approach to the analysis of a competitive economy. It sees competition as leading not to a stable, efficient equilibrium but rather as a continuous *process*, where firms with different techniques, knowledge, and views of the future continually compete against one another. This creates what Schumpeter (1956, p. 84) called a "perennial gale of creative destruction"—a gale that brings to consumers new goods, better goods, and cheaper goods. Note the one point in common with the neoclassical analysis; gains come because of differences in production conditions. Neither approach can justify the harmonization of production conditions and the imposition of a common currency as part of that process of harmonization.[3]

[1]A lucid exposition of this analysis can be found in Bator (1957).

[2]Samuelson (1949) showed that if two economies are identical in every respect except that in one relative factor intensities differ across industries while in the other they do not, then the former can produce more of every good than can the latter. The differentiated economy's production possibility frontier is everywhere outside that of the undifferentiated economy.

[3]Another argument for a common currency is considered below. See note 6.

Criticisms of the EMS

In essence, the EMS is a system of the same type as Bretton Woods, the monetary arrangement of the West from 1946 to about 1970. It suffers, therefore, from the same defects as that system did. Three of those defects are particularly noteworthy. First, exchange rates are politicized: Deciding whether or not to change a rate is political. This introduces an additional form of uncertainty, and one against which it is hard for participants in the foreign exchange markets to protect themselves. It is a different kind of system from either free-floating or rigidly fixed rates; it is *not* a halfway house. Second, claims that EMS membership has either reduced inflation or reduced the output costs of doing so are not based on strong evidence. Third, the system has *not* delivered reasonably stable prices (defined as inflation as measured by the CPI running at 2 percent per annum or below, a rate consistent with price stability because these indices generally make inadequate allowance for quality change. Indeed, over the past two years, inflation has started to drift up again in the principal ERM countries. What monetary system can do better? Here we come to Salin's third main point.

Currency Competition

Salin argues that currency competition, rather than the imposition of a common money, will improve monetary performance in Europe. At this point, it is important to eliminate a possible misunderstanding. By currency competition, Salin does not mean several currencies circulating together. It is better described as monetary policy competition, a situation where individuals can hold assets, including bank deposits and cash, denominated in any currency they wish and anywhere they wish. In such circumstances, monetary authorities would have the incentive to deliver the kind of monetary performance people want, and individuals dissatisfied with or fearful of one authority's performance could switch to the currency of another. Monetary authorities would be constrained by potential competition.[4]

Salin advances two reasons for relying on such competition. First, we have no way of knowing the optimum domain of a currency; we

[4]Samuel Brittain has raised a most interesting question touching on this point. British residents have been free in the way described here since 1979. What, he asked, have been the beneficial effects? Surely the answer is that the authorities have acted much more rapidly to correct their mistakes. Monetary policy was tightened substantially by the end of 1989 in response to the policy failures of 1987 and 1988, when inflation had reached less than one-third the rate it attained under the last, pre-exchange control abolition, conservative administration.

can find it only by relying on the market process of discovery. Second, competing monetary policies give monetary authorities the incentive, which they otherwise lack, to deliver stable money.[5] Incentive is recognized as important in every other aspect of life. Why neglect it in this one? And, of course, the incentive need not be purely financial; prestige may also be important.

These arguments are both clear and persuasive. Nevertheless, there have recently been criticisms of them. Because Salin does not consider these criticisms, I will discuss them here.[6]

Criticisms of Competing Monetary Policies

Guido Carli (1990), Italy's treasury minister, recently observed that holding exchange rates fixed required coordination, not competition, among monetary policies. Carli used the word "coordination" in a peculiar way, but he is nevertheless correct. If exchange rates are to be held fixed between countries, then every country but one must subordinate its monetary policy to that of the leading country. ("Subordination" is a more accurate term than "coordination," although it is certainly understandable that Carli, a treasury minister whose country is not the policy leader, chose to use "coordination.") Without such "coordination," the set of fixed rates would not hold, as inflation rates would diverge and drive exchange rates apart.

But Carli's criticism is beside the point, for competition explicitly requires either floating or very wide bands. Only then could the benefits of a well-conducted monetary policy show up in better monetary performance; otherwise, it would be dissipated across the region or offset by the failures of others. Carli is correct in what he says, but what he says is not relevant for a regime of competing currencies.

[5]Basic price theory helps reinforce this point. If there is a monopoly issuer of a currency, he can increase his revenue (to a certain point) by inflating. For the classic discussion of how inflation provides revenue for a monopoly supplier of money, see Bailey (1956). If there is monetary competition, however, profits can be increased only by gaining market share—by shifting the demand curve for the money to the right. This can be done only by supplying the kind of money people want.

[6]Some may object that monetary policy competition would not lead to a single European currency, a desirable goal since a single money would economize on transactions costs. Both points are probably correct. But note first that if we did have a single money, the beneficial effects of competition would be absent, for what would constrain the supplier of that money to a satisfactory performance? Second, if we did discover a way of constraining such a monopolist, it would be easier to move to a single money if every country had a low and stable inflation rate. Hence, competing currencies make a single money more attainable, although not necessarily desirable.

It is useful next to turn to Allsop and Chrystal (1989). Their comments are much more interesting. They argue first that if competition drives out one currency, then the process of driving out that currency will involve hyperinflation. The currency's value will collapse as people flee from it with haste. That *may* happen. But if we look at the competitive process in markets for goods, we rarely observe a firm's market share collapsing in response to a small difference in quality or price. Rather, market shares erode gradually; then firms seek to respond, improve products or cut price, and win back their position or at least put an end to its further erosion. Why should not the same be true, in general, for currencies? Surely Allsop and Chrystal's point is a warning, not against allowing competing currencies in Europe, but against allowing competition between currencies when one is already substantially inferior to another in its stability.

Allsop and Chrystal address their second criticism to an aspect of the competing currencies proposal advanced by the British government (H. M. Treasury 1989). That proposal contained the suggestion that every EC currency should be legal tender in every EC country. Allsop and Chrystal are scornful. Would shopkeepers have to maintain a till for every currency, they ask? In expressing this scorn, however, they miss a more substantial point.

By making all currencies legal tender, governments would have passed a law mandating that all currencies are perfect substitutes, one for another, in settlement of debt. Such a law would imply that the price of any currency relative to any other was fixed; that is, it would imply fixed exchange rates. Hence, making the currencies legal tender seems to rule out currency competition. In this respect, the British government's proposal is internally inconsistent. A better approach to the question of legal tender is, as Salin suggests, to abolish legal tender laws and simply make contracts enforceable in whatever currency the parties had originally agreed.

Banking Stability

We sometimes hear the fear expressed that the banking system would be less stable in a world of competing currencies, on the grounds that it would not be clear which central bank had responsibility for which commercial banks if these banks were doing business in several currencies. This concern reveals a fundamental confusion. Central banks need not—should not—be responsible for commercial banks. A central bank's duty to maintain stability concerns the money stock, *not* an individual bank. In a time of panic, it does not lend to a bank and does not engage in bailouts. It lends *to the market.* That

is, a central bank lends on security to whoever brings in the security. Doing so prevents monetary collapse following a banking panic, and that is the purpose of lender-of-last-resort action (see Gilbert and Wood 1986).

If central banks behaved in this manner, then commercial banks doing business in a currency would ensure that they had assets, denominated in that currency, that could be rediscounted at the relevant central bank. If they did not, they might fail; but the system is protected as long as the central banks act as lender of last resort. The central bank's lender-of-last-resort role, therefore, does not conflict in any way with currency competition.

What about supervision and regulation? There is little evidence that these activities benefit consumers or enhance the stability of the banking system (see Benston 1990). But aside from that, if central banks decided to regulate, they could regulate those banks with headquarters in their country. Central banks could then offer different degrees of regulation, allowing both suppliers and consumers of banking services to choose the regulatory framework they wished and thereby increasing welfare by expanding choice. The outcome could be little regulation, much regulation, or somewhere in between, or some countries would offer one type of regime and others another. In any event, it would reflect consumer choice and thus increase welfare as compared to the present situation. Hence, just as the lender-of-last-resort role causes no problems for competing currencies, neither does the much less-important task of supervision and regulation.

Conclusion

In his fascinating paper, Salin made three main points: (1) We do not need a common currency as part of the EEC's single-market program; (2) the present problems of the EMS result from the nature, not the number, of its member currencies; and (3) currency competition would improve monetary performance in Europe. All of these points are correct. My only criticism of Salin's paper is that there are some arguments in favor of his conclusions that he has not deployed, and that is not a criticism I would press strongly.

References

Allsop, Christopher, and Chrystal, K. Alec. "Exchange Rate Policy in the 1990s." *Oxford Review of Economic Policy* 5(3) (1989): 1–23.

Bailey, Martin J. "The Welfare Cost of Inflationary Finance." *Journal of Political Economy* 64 (April 1956): 93–110.

Bator, Francis M. "The Simple Analytics of Welfare Maximization." *American Economic Review* 47 (March 1957): 22–39.

Benston, George J. "Does Regulation Produce Stability?" In *Unregulated Banking: Chaos or Order?* Edited by Forrest H. Capie and Geoffrey E. Wood. London: Macmillan, 1990.

Carli, Guido, "Co-ordination Not Competition." *Financial Times*, 17 January 1990, p. 25.

Gilbert, Alton, and Wood, Geoffrey E. "Coping with Bank Failures." Federal Reserve Bank of St. Louis *Review* 68 (December 1986): 5–14.

H. M. Treasury. *An Evolutionary Approach to Economic and Marketing Union*. London: H. M. Treasury, November 1989.

Samuelson, Paul A. "International Factor Price Equalization Once Again." *Economic Journal* 9 (June 1949): 181–97.

Schumpeter, Joseph A. *"Capitalism, Socialism, and Democracy."* London: Allen and Unwin, 1956.

Smith, Adam. *The Wealth of Nations* [1776]. Edited by Edwin Cannan. New York: The Modern Library, Random House, 1937.