Common Currency

Economic convergence is presented as a necessary first step towards a single European currency. The Maastricht agreement set a number of convergence criteria, relating to relative inflation rates, exchange rate stability and long-term interest rates, to be met over a qualifying period. There are also target ceilings for government borrowing (PSBR) and National Debt. The former (the borrowing ratio) is to be around 3% of GDP while the latter (the debt ratio) must not exceed 60% of GDP. These two ratios are inter-linked: for example, if economic growth exceeds the value obtained by dividing the PSBR by the National Debt, the latter must fall. Table 1 shows some illustrative values.

For many, these criteria are daunting. Italy, for example, has borrowing and debt ratios in excess of 10% and 100%. As the Table indicates, annual real GDP growth for the Italian economy would have to exceed 10% for convergence to begin!

How long it might take to reach the 3% and 60% targets depends not only upon the initial starting position and the extent of public expenditure cuts and tax increases, but also upon the level of interest rates. With interest rates at (say) 5%, a borrowing ratio of 3% is required to service a debt ratio of 60%. Under such circumstances, expenditure cuts and/or tax increases would be necessary simply to remain within convergence ceilings.

So, the bad news for some is that the Maastricht targets are impractical. However, the good news for all is that these particular targets are largely irrelevant (except, perhaps, to give pseudo-substance to any claim that the time is not yet ripe!). Economic convergence

Table 1: Annual growth rates (per cent) which would leave the debt ratio unchanged

The Borrowing Ratio	The Debt Ratio 10%	20%	30%	40%	50%	60%	100%
1·0%	10·0	5·0	3·3	2·5	2·0	1·7	1·0
1·5%	15·0	7·5	5·0	3·8	3·0	2·5	1·5
2·0%	20·0	10·0	6·7	5·0	4·0	3·3	2·0
2·5%	25·0	12·5	8·3	6·3	5·0	4·2	2·5
3·0%	30·0	15·0	10·0	7·5	6·0	5·0	3·0
10·0%	100·0	50·0	33·3	25·0	20·0	16·7	10·0

is not a prerequisite for a single currency.

The volume of public sector borrowing and accumulated borrowing (the Maastricht criteria) have little bearing upon the diverse monetary policies of EU states. Inflation rates and interest rates are determined not by borrowing, but by the means by which it is financed. It is the differential use of central bank credit which causes inflation rates and nominal interest rates to diverge.

The present flexibility of the EMS – wide currency bands and periodic currency re-alignments – allows member states to act independently. This feature is attractive to both the Conservative right and the Labour left. Respectively, these pressure groups anticipate lax and tight monetary policy régimes from a central European authority. This is a measure of the confusion still to be resolved regarding the objectives of a single monetary authority.

Eddie George, the Governor of the Bank of England, has argued that devaluation is a more realistic alternative to wage reductions in high unemployment areas. This and his reference to 'divergent domestic monetary policy needs' illustrates the pernicious legacy of Keynesian demand management. Devaluation reduces the purchasing power of wages through an upward adjustment of retail prices (the pound in your pocket *is* devalued). This adjustment process was recommended by Keynes in the 1930s. It is deceptively attractive. Instead of requiring prices and incomes to fall in high unemployment sectors, exchange rate depreciation forces up a great many other domestic prices and incomes. These adjustment costs are more extensive and damaging given the protracted distortions caused by inflation. Furthermore, although the inflationary process may postpone, it cannot avoid, the need for living standards to fall in sectors which are unable to compete.

Although structural disparities across Europe are not addressed by the Maastricht convergence criteria, this should cause no concern. Monetary stability and market-determined interest rates are equally beneficial to the more and less advanced economies of the EU. Monetary policy should aspire only to this. Monetary policy cannot re-equip the unemployed with saleable skills; it cannot bring cheap credit to industries which are unable to compete for funds; it cannot bring affluence to a poor region. These were empty promises of Keynes's demand management which many are still ready to trust. While central bankers continue to believe that with the 'inflexibility of nominal wages it cannot be ruled out that there will be a continuing need for exchange rate adjustment', there will be no progress towards a single currency.

The conclusion to emerge from Bretton Woods, and each subsequent attempt to manage currencies without tackling the issue of independent monetary authorities, is that fixed exchange rates are not the pre-condition for a single currency. Only one criterion defines the route to a single currency. A consensus must be reached regarding both the objectives and the means of a unified monetary policy. If this consensus is focused upon demand management, monetary union will remain an elusive goal; but if price stability is recognised as the sole objective, the route becomes clearly defined. By its statute the European Central Bank is required to act to maintain price stability; that objective would be reached by its acquiring absolute authority to administer monetary policy throughout the EU. Only when this becomes politically feasible will a single currency emerge. Whether existing currencies then continue to circulate at irrevocably fixed rates, or whether there is a single currency, is purely a cosmetic consideration.

■ **G.R. Steele**
Department of Economics, The Management School, Lancaster University

COMING SOON FROM THE IEA

a completely revised version of Hermione Parker's *The Moral Hazard of Social Benefits* (RM 37).