Comment on David Laidler's "Concerning Currency Unions"

By Pascal Salin*

In his paper *David Laidler* recalls some basic ideas about currency unification — conceived as the fixing of exchange rates — the first one being that exchange rate changes are of a nominal nature. From that point of view it is not essential to choose fixed or flexible rates and the currency union issue is mostly irrelevant. In other words, there are no special costs of a system of fixed rates, but no precise reason for choosing them, except for the saving made in the use of money, which — as *David Laidler* says — may be of a second order of importance. This relative unimportance of choosing an exchange system is, for instance, expressed in the following terms in the OPTICA 75 report: "Monetary union would be an institutional organization among countries aiming at economic union, such as to minimize the inefficiencies inherent in the use and control of money within the union." Such an interpretation of monetary unification sets the basic for the parallel currency approach.

From a theoretical point of view, therefore, the costs and benefits from currency unification — defined as the fixing of exchange rates — are of a second order of importance.

However, although *David Laidler* accepts the monetarist view, according to which a country ought to decide a monetary rule, he refuses to go one step further and to admit that, once a country has accepted a monetary rule, it does not bear any additional cost by joining a currency union and abandoning the right to determine its own monetary rule and its own rate of inflation.

In fact the choice between fixed and flexible rates is mainly an empirical problem. Flexibility means independence in the conduct of monetary policy, but one can make a bad use of independence. Thus, the case for or against currency unification often shifts back to a guess about the behavior of monetary authorities and markets.

David Laidler's criterion for choosing an exchange regime is the relative speed of adjustment, for instance between money wages changes

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and exchange rate changes. In the same way, *M. Friedman* (1953) argued, a long time ago, that it was easier to change the price of a currency in terms of another than to change all nominal prices in terms of a currency. *W. Fellner* (1973) brought an important element into this discussion, based on the assumption that individuals are rational: if adjustment implies a decrease in real wages (or, at least, a slowing down of their rate of growth), it can be better obtained through a depreciation of the exchange rate than by an incomes policy, even if there is no exchange rate illusion, contrary to what is usually said. In fact, adjustment through the exchange rate implies that everyone bears the adjustment cost at the same time, in the form of a decrease or a slowing down of the purchasing power of his income; whereas nobody accepts this same result through an incomes policy, since he fears that he might be the only one to bear this cost if others succeed in defeating the incomes policy.

David Laidler's opinion is similar. However it seems somewhat excessive first because he considers the case of a need for an absolute decrease in real wages and not only a slowing down in their rate of growth. Although this can happen — the real transfer to oil-producers, when the price of oil increases and a country cannot spread out the effects of the price rise over time by borrowing, is an example of such a case — it is a rather rare situation. In most cases a country only has to face the necessity of slowing down the increase in real wages. It can thus be assumed that wage-earners refuse an absolute real wage cut, but not a change in the rate of growth of real wages so that the process of adjustment through wages would not be slower than the process of adjustment through exchange rates. If wage-earners refuse the needed slowing down of their wages there is no solution, whatever the policy adopted and the exchange regimes.

Second, *David Laidler* assumes that the exchange market adjusts more quickly than the labor market. A more important question would be the following: which market is the more stabilizing? From this point of view it could be argued that speculators may have a destabilizing role and recent experiences with floating exchange rates could reinforce this opinion. Expectations of a further depreciation of the currency induce speculators to cause an actual depreciation, which causes price increases, higher wage claims, etc...

In this chain of causality between exchange rates, wages and prices, who is the most responsible for instability? Wage-earners? Speculators?

The truth is that expectations can be destabilizing only if monetary authorities validate them: speculation on the exchange market is not destabilizing in itself, but only as far as it may induce destabilizing monetary policy, the monetary authorities being unable or unwilling to resist the exchange depreciating — and inflationary pressures stemming from the speculators' behavior.

If it is then assumed that the money supply is perfectly or highly elastic and validates inflationary pressures it is important to compare the formation of expectations on the exchange market and the labor market: recent experiences would not be in favor of *David Laidler's* opinion, since the exchange rate has been much more volatile than the wage rate in most countries. The reason could be attributed to "dirty floating", but, also, to other factors, for instance the lack of speculation.[1] In such a case the adjustment process would be more costly by relying upon exchange rate changes than upon changes in the rate of growth of wages.

Third, *David Laidler* believes that "wage adjustment" implies unemployment. But adjustment could also be effected through labor mobility. Such a process could have long-run effects in the form of resulting allocation of activities. What is the difference in this respect between fixed and flexible rates? Let us assume — as was done in "traditional" literature on currency unification — that there is a shift in demand away from the goods in which a country previously specialized. Nominal wages being inflexible, unemployment appears under fixed rates. Real wages decrease under flexible rates. In any case, adjustment implies that factors of production move to other activities in the country or move to other countries. Will labor mobility respond more to unemployment or to the decrease in real wages? The answer can only be empirical, and there is no *a priori* reason to think that the adjustment is faster or less costly with one or the other exchange regime.

Therefore one could disagree with the following assertions by *David Laidler:* "the average level of unemployment over time will, for a similar pattern of shocks be higher in a country which belongs to a currency union"; or "The maintenance of monetary independence by individual countries would lead to smaller short-term fluctuations in output and employment". One reason for disaggreement is the one we just stressed, namely that the necessary factor mobility is not necessarily higher under one or the other system. Another reason is the following: it cannot be denied that a country's policy is independent under flexible rates, but this does not mean that the country's policy is more stabilizing. Let us just imagine that a country uses its monetary independence to embark upon a very restrictive monetary policy: real shocks implying real wage cuts will create unemployment. What would have happened under fixed rates? One cannot answer without knowing the behavior of the "common monetary authorities": one possibility would be that the

[1] Cf. *R. I. McKinnon* (1976).

union adopts the same rate of inflation as the country would have done under floating rates.

Another possibility would be that the "common rate of inflation" is higher, in which case the short-run rate of unemployment would be smaller. Or the rate of inflation could be lower in the union, especially if the country concerned is small so that it cannot have much influence on the decisions taken by the "common authorities" and if it is relatively more affected by the assumed real shocks. The issue may thus depend on the distribution of power in the union and on the distribution of shocks. In some sense, *David Laidler* makes a plea in favor of inflation and not a plea in favor of floating rates. The plea in favor of inflation is based on the assumption of some short-run trade-off between unemployment and inflation and the relative social costs of both and we have not to discuss it as such. The only point we want to stress is the following: even if one agrees that inflation has to be preferred to unemployment in the short-run and there is no risk of continuing inflation, it is not theoretically true that monetary unification — defined as a regime of fixed rates — is relatively anti-inflation-biased, so that floating rates would be better.

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