Niels Thygesen
February 14, 1989

Suggested amendment to p. 6 of chapter II:

.... external shocks.

The most visible consequence to national governments of establishing a monetary union is that the exchange rate can no longer serve as an instrument for adjusting economic imbalances among member countries. This entails both costs and benefits.

Costs. To the extent that market mechanisms do not perform an adequate equilibrating role, other policies, such as income, fiscal and structural policies, will have to be used more intensively to bring about the corrections in cost and price trends that used to be obtained from time to time by realignments of exchange rate parities. For this reason the implementation of a monetary union must be accompanied by parallel progress in creating or strengthening effective alternative adjustment mechanisms, such as those discussed in the next section. Moreover, while the freezing of exchange rate relationships will not eliminate the possibility of imbalances between the supply of and demand for economic resources in individual Community countries, the statistical measurement and the economic interpretation of such imbalances may become more difficult in a fully integrated market since balance-of-payments disequilibria would essentially assume the meaning of regional imbalances. As a consequence, balance-of-payments figures, which are currently a highly visible and sensitive indicator of economic disequilibria, would no longer be able to play a significant role as guidepost for policy-making. Moreover, with parities irrevocably fixed, foreign exchange markets would cease to provide a source of pressure for policy corrections when economic disequilibria developed and persisted.

Benefits. The availability of an important instrument of economic policy, such as the ability of a government to change the external value of its currency, creates expectations that it will sometime be used. Some probability that a currency will be devalued prompts agents in financial markets to ask for a risk premium when holding assets denominated in that currency and it encourages wage- and price-setters

to raise costs and prices faster, so as not to be pre-empted by a sudden devaluation by the government. The latter can gradually, by pursuing a stable exchange rate objective and non-inflationary policies generally, build up its reputation for stability orientation. But doubts will persist, as the EMS experience has shown, with respect to the continuation of such policies, and they will leave interest rates higher and cost and price inflation more rapid than justified by any recent exchange-rate performance; and this will in term create pressures on the government to devalue. Only the irrevocable fixing of exchange rates in a monetary union will create a fully credible pre-commitment by a government to objectives similar to those elsewhere in the union.

The balance between the economic benefits and costs of exchage rate fixity will become more and more favourable as the Community develops into an optimum currency area. In order to tilt the balance in this direction it is essential that the move towards monetary union should be coupled with measures designed to strengthen the mobility of factors of production and a close co-ordination of non-monetary policies.