

WORLD MONETARY POLICY AFTER THE EURO

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The Hayekian View

How will the appearance of the euro influence monetary policy throughout the world? Euroskeptics, drawing upon F. A. Hayek's arguments in *Choice in Currency* (1976), see the move from independent European national currencies to the euro as a move from (limited) currency competition to a European currency monopoly. According to this view, the less competition there is to restrain them, the greater the temptation for remaining central banks, and the European Central Bank (ECB) especially, to inflate. They may inflate to try to exploit the short-run Philips Curve, or to enhance their seignorage revenues. In the language of industrial organization theory, less competition means that each supplier faces a less elastic demand curve for its product, so that each is more capable of profiting by reducing its product's quality. According to this pessimistic, Hayekian view, the euro means more inflation worldwide, and especially in Europe itself.

Two Types of Currency Markets

The Hayekian view has some merit: the ECB was, after all, mainly promoted by the French and other nations that were unhappy with the strict discipline imposed by Germany's tight money policy in conjunction with the ERM. But a straightforward Hayekian view seems overly simplistic, not because it cynically treats central bankers as maximizers (the theory only requires that unemployment or seignorage be among the considerations guiding central bank policy), but because it is based on an incomplete view of the market for currency. It overlooks the fact that the market for currency is actually a combination of two different types of markets. There are, first of all,

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many *domestic* currency markets, where currency is employed as a medium of exchange for intra-national transactions. Then there is the *international* currency market, where currency serves as a medium of exchange for international transactions and as an asset (other than domestic currency) in individual and bank investment portfolios.

The two kinds of currency markets differ in one important respect. In domestic currency markets, where currency serves mainly as a local medium of exchange, opportunities for currency substitution are limited, and the demand for the domestic central bank's currency is relatively *inelastic*. In the international currency market, where portfolio managers and international traders are freer to switch currencies, the demand for any particular currency is relatively *elastic*. One reason for this difference is that a domestic medium of exchange is subject to stronger network effects than an international medium of exchange. Once a dominant medium of exchange is established in a region, network effects make it difficult for any one user to abandon it and the network based upon it. Thus, a Russian citizen would find it hard to conduct business in Russia in the near future using anything other than rubles or dollars as a domestic medium of exchange. Yet the same citizen might well consider employing euros instead of either dollars or rubles as a medium of exchange in foreign trade. A European trading partner will be happy to quote a better price in euros, because payment in euros saves him the transactions costs involved in currency conversion. This argument suggests that, the more extensive a domestic currency area's involvement in foreign trade, the greater the prospects for that currency to be adopted as an international exchange medium.

A second difference between markets for domestic exchange media and the international currency market is that, where domestic banks are terrible, as in Russia, an international currency may be hoarded as a savings vehicle or store of value. Because the store of value function of money is not subject to network effects, this source of demand for international currency also makes that demand relatively elastic.

Implications for Central Bank Behavior

What bearing does the existence of two different kinds of currency markets have on the likely behavior of the European Central Bank and of other monetary authorities? It means that the ECB can either focus exclusively on supplying an exchange medium to the European market, a market that is already effectively locked into the euro medium of exchange network, or it can attempt to supply an exchange medium and store of value to meet the needs of the international

currency market, a market that is relatively free to accept or reject euros based on their quality (and especially their relative rate of appreciation) compared to that of the leading international currency, the dollar. Other national currencies have little hope in the foreseeable future of capturing any significant part of the international currency market, either because they have poor rates of return or because their domestic holders engage in too few international transactions to make them an obvious option for use in international trade.

Were the ECB only concerned with supplying the European market with exchange media, it might take advantage of its monopoly in that market to pursue a relatively inflationary policy, just as any good Hayekian might predict. But the euro has a fighting chance of becoming a serious rival to the dollar as an international currency. Because the international currency market is large even relative to the European market for domestic exchange media, even an ECB exclusively concerned with earning seignorage (which could be used to fund Europe's welfare state) might see advantages to pursuing a low-inflation policy, in order that it might capture some significant share of the larger but contested market. A low euro inflation rate (even mild *deflation* is consistent with positive seignorage earnings if the real demand for euros grows rapidly enough) might be fully or more than fully offset in the long run by the increased worldwide demand for euros. In the language of public finance, the ECB might maximize the revenue from its inflation tax by setting a low taxation rate in order to build a large taxation base. The long-run Laffer Curve, showing the relation between the inflation tax rate and tax revenue, takes account of the euro's ability to establish itself as an international currency and reaches its highest point at a rate of inflation well below the revenue-maximizing rate implied by the short-run Laffer Curve.

Thus, revenue or seignorage considerations alone might make the euro a hard currency, as good as or better than the dollar, notwithstanding apparently reduced overall opportunities for choice in currency.

An Historical Precedent

In medieval times (when government mints were more obviously concerned with maximizing revenue), mints produced both soft and hard currencies. The former were debased or lightened relatively frequently but the latter maintained their precious metal contents for many decades. The different types of currency were distinguished by the markets they served. Soft monies were for local use; hard ones were for the international market. The reason was simple: in inter-

national transactions, national legal tender laws were difficult to enforce, while network effects were relatively weak, so that opportunities for currency substitution were substantially greater than in domestic exchange. While a few mints (like that of Venice) produced coins exclusively for the international market, others (those of Spain come to mind) produced shoddy coins for home use along with solid ones for use abroad.

The High Road or the Low Road?

With rare exceptions (China for many years was one), governments in modern times produce only one brand of currency, and therefore must decide whether to take the high road of endeavoring to supply the international currency market, as the United States and Germany have done in recent years, or the low road of exploiting their domestic markets only, which generally means greater inflation.¹

Which road will the ECB take? For the moment, it is not obvious. Although the European Union is clearly anxious that the euro should maintain its value relative to the dollar in the short run, this may simply be part of a “time inconsistent” strategy aimed at allowing it to temporarily boost employment or to extract more revenue from its citizens once the euro becomes established. But it may be the case that the ECB intends the euro to be a serious rival to the dollar. If the latter view is correct, we can expect low inflation policies to persist for a while both in Europe and in the United States, as the euro establishes itself as a worthy successor to the mark. Should the euro fail to earn this status, however, the consequences will not be limited to higher European inflation. The dollar would once again reign unchallenged in the market for international currency, opening the door for the Federal Reserve to return to its inflationary ways of the 1960s and 1970s.

Reference

Hayek, F.A. (1976) *Choice in Currency*. Occasional Paper 48. London: Institute of Economic Affairs.

¹That Germany has in recent years been a source of competitive pressure against the U.S. dollar in the international currency market has been due largely to devices, including the “snake” and later the “exchange rate mechanism,” designed to make the German mark compatible with other European currencies by creating a system of quasi-fixed European currency exchange rates. The compatibility of the mark with other European currencies added to the effective size of the mark’s European network, making marks an attractive option for use in European foreign trade. The preference of European traders for marks over other European currencies reflected their expectation that any realignment of intra-European exchange rates would likely favor the mark.