

THE MISSING LINK IN THE DEBATE ON MONETARY REGULATION



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Fixed exchange rates don't actually impose severe restrictions on governments. In fact, they are usually accompanied by a set of redistributive policies and institutions whose main purpose is to delay or even prevent economic adjustment within currency unions. The virtue of a system of competing flexible rates is that the competition they provide gives producers, investors and ordinary taxpayers a choice of which money and/or jurisdiction they wish to favour.

Les taux de change fixes n'imposent aux gouvernements aucune restriction vraiment rigoureuse. En fait, ils s'accompagnent généralement d'une série de politiques de redistribution et d'institutions dont le but premier consiste à reporter sinon à empêcher tout ajustement économique au sein des unions monétaires. Le grand avantage d'un système de taux de change flexibles réside dans la concurrence qu'il induit, celle-ci permettant aux producteurs, aux investisseurs et à l'ensemble des contribuables de privilégier la devise ou la juridiction de leur choix.

In the words of University of Chicago economist Arnold Harberger, "It seems that we will never finish debating the issue" of fixed versus flexible exchange rates. Different kinds of fixed rate regimes are already in place or proposed in various places of the world, while one world coordination agency (the IMF) actively encourages flexible rates. In their debate, Professors Friedman and Mundell touch only indirectly on one essential dimension of the discussion, namely the politics of monetary regulation. One key question is not explicitly discussed: What international structure is likely to yield the most efficient regulatory outcomes in the presence of rent-seeking? Public decisions are politicized. This is true both under existing national constitutional rules and under rules foreseeable within coordinated-regulation regimes. Neither national governments nor any hypothetical collective agency, such as the EU or the IMF, are constitutionally constrained regarding the range of policies they may choose to adopt.

As another Nobel laureate, James Buchanan, has pointedly reminded us, the efficiency ranking of political institutions depends on the political/legal rules governing the behavior of agents in those institutions. Arrangements clas-

sified as efficient in one legal setting will be ranked differently under alternative rules. When monetary arrangements are evaluated in conventional discussions, normative economists prescribe actions as if the national state or the collective agency under harmonized regulation is necessarily benevolent. Prescriptions are offered on the assumption that politics does not matter and that regulatory agencies always seek efficiency in policies. If that assumption is false, however, then the ordering of the regulatory arrangements that emerge may be misleading.

In practice, politics means handouts. One prime instrument available to existing *supra*-national monetary agencies is to combine monetary regulation with compensatory payments to national governments or transfers, whether to businesses or ordinary citizens, in countries experiencing economic shocks or slack labor demand. It is argued that greater stability will follow if some *supra*-national fiscal mechanism, improperly called fiscal federalism, is available to carry out international fiscal transfers.

The rule governing the European Union and the IMF provides for fiscal transfers to absorb economic shocks in

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national economies. These may include explicit bailouts, unemployment outlays, regional tax credits, development grants, equalization payments and shared-cost arrangements, all instruments familiar to analysts of traditional national federations with domestic currency unions. Producers, investors and residents in subsidized territories are encouraged to stay in their less productive employment by what has become in effect a public service cartel. For their part, resources in prosperous areas burdened by their higher share of the subsidy or tax cost now face incentives to move away from productive territories. Only a central authority possesses the monopoly power necessary to practise such discrimination. If past actions by the central governments of existing federations are any guide, a collective regulatory authority such as the IMF will use its monopoly power to balkanize the world economy by erecting the equivalent of trade barriers between economies.

Viewed in this light, monetary integration combined with handouts acts as a source of dissociation between national prices and national costs. Despite what is commonly thought, monetary integration, whether inside single countries or in Europe and America, does *not* suppress the cost of inconsistent policies. A currency union or a collective agency combined with compensatory payments merely shifts the cost of adjustment to the more conservative and prosperous regions. At the time of the debate on the European Common Market, generous subsidies were offered to secure the political support of Ireland, whose economy was less buoyant.

Similarly, the Maritime provinces can pursue costly policies within the Canadian currency union only because they are subsidized to the tune of billions of dollars for their failure to adjust. Downward pressure exerted on the Canadian dollar by secessionist threats worsens our terms of trade, raises interest rates and reduces the living standards of all Canadians. The adjustment cost is shifted to other Canadian provinces by the action of the central monetary monopoly.

By contrast, a system of freely floating currencies circulating together in an area governed by reasonably free trade is nothing more nor less than competitive federalism applied to monetary matters. Individuals and businesses can hold assets in any currency they choose. National authorities face incentives to deliver the kind of performance people want. Irresponsible micro-

and macro-economic policies cause dissatisfied individuals to switch to other currencies, as costly policies make the economy less attractive.

In a genuine federalist structure, violation of the true price-cost ratio across regions of a trading area causes the mobility process to be set in motion. Nation-states that devalue their currencies to stimulate exports or raise taxes to subsidize declining activities soon find out, as Canada now is, that resources are repelled from their territory. Whether they adjust or not, they bear the cost of their decision.

A fixed rate is a harder constraint on politicians only in the abstract. A coordinated currency regime with compensatory payments neither facilitates adjustment nor delivers the benefits of greater economic stability. It merely shifts the adjustment cost from irresponsible and inefficient countries to more conservative ones. The coordinated transfer mechanism implemented neutralizes adjustment forces.

A true common market requires neither a common currency nor coordination arrangements, any more than it calls for a common social policy or a common language. Since there is no way of knowing in advance the optimal size of a currency area, we can only rely on the market process of discovery to determine it for us. If the advantages of a single European or North American currency as a way of minimizing transactions costs are so overwhelming, such a system will spontaneously evolve as the choice of Europeans and North Americans. In the meantime, free competition in currencies offers individuals at least some protection against irresponsible national policies.

Political rent-seeking must be viewed as a permanent institutional feature of government decision-making. Redistributionism between the states of a collectively-managed area will characterize politics for as long as constraints are not constitutionally imposed on the discretion of the central authority. In turn, assuming the same permanent lack of constitutional constraints on national governments, less redistributionism and more discipline are likely to characterize regulatory action by national authorities. At the level of the nation, decentralized regulatory decisions are to be preferred in a democracy because the very structure through which political decisions are made prevents the attainment of the type of regulatory policy that might be defined as optimal.

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