

Changing Institutions in the European Union

A Public Choice Perspective

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COMMENT

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In the USA an apocryphal tale is told of a craggy Vermont shopkeeper who refused to accept either checks or credit cards at his store. When asked why, he supposedly said: 'In God we trust, all others pay cash.' While reading Tullock's chapter, I was struck for the first time by what was implicit in that Vermonter's response, to wit his apparently absolute confidence in the value of the US dollar.¹ Americans have, for at least a half-century, lived with the comforting notion that inflation levels in the USA will be sufficiently low that accepting the paper currency printed by the central bank is a completely reasonable thing to do. Even the post-oil-shock bouts with stagflation in the 1970s and 1980s didn't really affect that faith. In particular, it is still common in the USA among the cognoscenti to attribute near-mythical powers to the Chair of the Federal Reserve, at least when the occupant of that position is named Alan Greenspan. Similarly, in Europe, at least until reunification, the Bundesbank was often credited with a degree of control over the German economy that Adolf Hitler might have envied. Yet, as Gordon Tullock reminds us, when we look elsewhere in the world, we often find long periods of very high levels of inflation, and even bouts of hyperinflation, as well as many countries that appear reconciled to living with a permanent high (10 per cent plus) level of inflation. For example, looking today (early 2003) at what were, once upon a time, relatively strong economies, for example, Argentina or Venezuela, reminds us how far the mighty can fall.² Indeed, as Gordon Tullock also reminds us, the long-term record of performance of even the Federal Reserve and the Bundesbank should not be exaggerated.

A high degree of skepticism about the powers of even the best and most autonomous central banks to achieve some desired range of inflation/deflation is thus clearly called for. As my colleague A Wuffle (personal communication, 1 April 2002) puts it, 'No amount of monetary discipline can compensate for fiscal folly.' In fact, sometimes even 'necessities,' for example German reunification, can come with a very high price tag that disrupts the best-laid plans of politicians and bankers.

Still, we need to ask whether Gordon Tullock's apt and historically well-grounded deflation of the supposed anti-inflation abilities of central banks³ bears directly on the narrower question of whether to the marriage of central banks (into one big bank) one ought to admit impediments, recognizing, of course, that such a question is now largely money over the bridge.⁴ We already do have a European bank and a European currency – at least for most of Europe. (Prime Minister Tony Blair's views notwith-

standing, for the moment, England is still 'in for the pound.') Why might a single European central bank be better than a congeries of smaller central banks? Why might it be worse? Before we attempt to answer that question, we need to take a step back and ask ourselves: 'What, from a political economy standpoint, are the central tasks for a central bank?'

My answer to that last question is three-fold: (1) a central bank can print money that can be used as a directly acceptable medium of exchange throughout a wide geographic area (say within the bounds of a single nation-state, or even outside that state's boundaries), (2) a central bank can provide mechanisms – even if only reputation – that allow that currency to serve as a convertible medium of exchange throughout the world;⁵ and (3) a central bank can regulate its nation's economy by using monetary policies (controlling the amount of currency in circulation, changing interest rates on federal securities, setting the prime rate) as levers to keep the value of the currency stable (or at least not fluctuating too wildly), and to affect levels of unemployment as well as (long-run) economic growth.

In addition to these central tasks there are many other roles that a central bank might play in its nation's political economy, some good, some bad. For example, it might (1) protect political incumbents by timing economic interventions so as to benefit them, with good news coming just before an election and bad news just after; (2) it might help finance wars (via 'controlled' inflation); and (3) it might regulate the banking system to protect against risky investments that might lead to insolvencies and collapse of consumer confidence. Now, we can turn to consider some of the more important of the positives and negatives of a single currency/single central bank.

On the plus side: (1) the larger the area of direct acceptance for a currency, the lower the transaction costs to users; moreover, if other currencies are forced out of existence, transaction costs are lowered still more; (2) a single central bank will be more resistant to political pressures, since it will be subject to more competing (national and other) pressures, and a single central bank will be able to use the strength of the strongest members to discipline the weaker members of the EMU and prevent them from engaging in inflationary ways. Thus we expect a single central bank to be better able to generate stable economic growth; and (3) a single currency is an important 'psychological' sign of a unified Europe and reinforces the stability of the EU.

On the minus side: (1) we already had easy convertibility of currencies within (Western) Europe; shifting to a single currency presumably does not gain us that much, especially since convertibility is more and more being handled by credit card companies as an incidental cost of doing business. Mastercard and Visa, not the euro, or even the dollar, are increasingly the

'true' international media of exchange;⁶ (2) if we have a single central bank and something goes wrong with its policies, the consequences will be severe, and there will no longer be separate systems operating under different rules that can step in to help repair and contain the damage; and, perhaps most importantly, (3) attitudes toward the relative costs of inflation and unemployment are fundamentally political and we cannot expect that identical values will be held by each of the national governments (since some countries might have center-right governments and others center-left, for example); thus a single central bank will inevitably make decisions about interest rates that some countries will wish to resist. Thus a single central bank can be a destabilizing force.

I do not really know how to balance off these pluses and minuses. Both sides of the argument can find support within the public choice literature. What can be said, with some confidence, however, is that the most extreme scare scenarios about the euro haven't yet materialized. In particular, despite some (essentially unsubstantiated) claims that shopowners used the conversion from the local currency as an excuse to raise prices, throughout Europe the euro won immediate acceptance among the public as well as the business community as a medium of exchange.⁷ While euro-denominated transactions are still often supplemented by values expressed in the older currency, that seems to me to be clearly a transitional phenomenon. Moreover, concerns that the euro would crash in value relative to the dollar also seem misguided. While the euro initially fell relative to the dollar, it later rebounded, and the currency range in which it is fluctuating seems no greater (and perhaps less) than the historical ranges of variation against the dollar of currencies such as the German, the British and the Japanese.

In any case, while you may wish to call me a 'cock-eyed optimist,' let me close this comment with a toast: 'Long live the euro – and the Europe for which she stands!'⁸

NOTES

1. Our hypothetical shopkeeper might have insisted on being paid via barter or in 'precious' minerals.
2. As a recent Latin American example also shows, even tying your currency to the dollar is no panacea.
3. I will not try to comment on his argument that a little inflation is not just a bad thing other than to note that, once you accept some inflation as desirable, it may become harder to keep it in check.
4. Here the pun, on the design of the euro, is indeed, intended.
5. Note that to achieve these first two ends, at minimum, the currency must be seen as (relatively) non-counterfeitable.
6. Here I might note that my colleague, A Wuffle (based on his experiences in Italy and France), has argued that the true international currency of Europe is Nutella.

7. In this context it is useful to recall the remarks of one of the Italian scholars at the conference – a member of the Italian Parliament – who expressed his fears about the possibility of ordinary Italians refusing to accept the euro.
8. Cognoscenti will recognize this as a paraphrase of language from the US 'pledge of allegiance' recited by schoolchildren.