Scottish Affairs, no.45, autumn 2003

COMPETING CURRENCIES: A USER-FRIENDLY PATH TO THE EURO

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The British approach to European Monetary Union appears to have got bogged down in Gordon Brown's famous Five Tests. Had the Government adopted instead the alternative Five Tests proposed by the **Financial Times**[1], they might have fared rather better. These were that Britain should only join EMU when the other member states agreed to (1) Denominate the Currency in Pounds, Shillings and Pence, (2) Give Up the Metric System, (3) Measure Temperature in Fahrenheit, (4) Eat British Beef, and (5) Drive on the Left. Whatever their other shortcomings, these criteria have the advantage of being less ambiguous than Brown's, and are no less well-grounded in economic theory.

Once the Government have extricated themselves from these difficulties of their own creation, they will be faced with the task of negotiating terms of entry with the present member states of EMU. Apart from the difficulty of knowing what is the 'right' rate of exchange at which to enter (and Mervyn King has acknowledged that it would take many years to find this out econometrically), there is the problem of the Maastricht criteria. These require a country which wishes to be admitted to EMU to first spend a probationary period of two years in the ERM 'waiting-room' while its credentials in terms of exchange rate and interest rate stability are checked. The British Government has already made it clear that they do not wish to repeat this experiment in view of the unfortunate experience last time.[2] They

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[1] ***Financial Times**, 17/8/99, p. 16.*

[2] *It is interesting to note that those principally responsible for the conduct of monetary policy in Britain today, viz. the Chancellor of the Exchequer, the new*

have a point. While allowing sterling to float or abolishing it altogether may be acceptable ways of coping with short-term flows of speculative capital, trying to maintain a fixed rate looks like a recipe for instability.

Smaller states applying to join EMU, and nine out of the ten new members of the EU are small states, are also likely to experience some difficulties if they are required to comply with the formal steps for EMU membership laid down at Maastricht. Estonia, for example, whose currency has at present a fixed link with the euro through a currency board, would have to take a step backwards, allowing its currency to fluctuate against the euro within specified limits.

This paper proposes an alternative approach to acquiring the euro as a domestic currency, one which may be thought appropriate for the circumstances in which Scotland finds itself today. It would give Scotland the benefits of using the euro without the political and economic traumas involved in becoming a member of EMU. If membership of EMU were thought to be desirable for political reasons, that could follow at a later date. The paper falls into two parts. The first part sets the scene, the context in which contemporary monetary arrangements operate. The second part considers what would happen if the euro were allowed to circulate in Scotland, competing on equal regulatory terms with other currencies.

1. Setting The Scene

At the present time, the Scottish economy is an integral part of the sterling currency area, with all the advantages and disadvantages which that entails. The advantages include permanent fixity of the exchange rate with the country's principal trading partner, England, and the complete integration of the capital markets of the two countries. Perhaps the most important advantage which Scotland derives from participation in the sterling area is that the usefulness of the currency to its citizens is enhanced, since the usefulness of money generally increases with the size of the domain over which it is used. A common currency is also a public good which provides several forms of positive externality. One of those beneficial externalities is

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Governor of the Bank of England, and the Permanent Secretary of the Treasury, all supported Britain's membership of the ERM eleven years ago.

that whenever an inter-regional payments imbalance arises it is immediately accommodated by a flow of financial transactions enabling the deficit country to draw on the resources of the surplus country until the adjustment cost is sufficiently spread out over time. The use of a common currency eliminates the risk of future exchange rate fluctuations and maximises the gains from trade and specialisation (Kawai 1992).

The disadvantages for Scotland of using sterling as a currency are principally two. As a political entity, Scotland has very limited influence over monetary policy. As it makes up less than 10% of the UK population, it is not surprising that this should be so. Secondly, sterling is a currency in which there is unusual scope for substantial speculative capital movements, and therefore for recurring or even persistent misalignments with other major currencies. This leads to distortions in external trade and in domestic production and consequently to significant real costs both of misallocation and of maladjustment. Therefore, if Scotland were to replace sterling with the euro as its currency, and if the euro proved to have a less volatile external value than sterling, that would represent a gain. There would be an additional gain if there were a reduction in the risk premium on the currency. And if it is true that the usefulness of money rises with the size of the domain over which it is used, then there would be a further gain.

The UK economy is itself part of a much wider, albeit informal, economic area composed of the advanced or industrialised economies of the world, an area which can loosely be identified with the OECD countries. The external boundaries of this area are rather fuzzy; at the same time they are steadily expanding as the process of globalisation continues. Within this area, there is a substantial degree of freedom of trade for non-agricultural goods and for services and almost complete freedom of capital movement. There is also a variety of currency areas and exchange-rate regimes. However, with unrestricted freedom of capital movement the scope for an autonomous monetary policy within each economy is significantly limited, especially among smaller economies. Nevertheless, a marginal amount of room for manoeuvre may be offered to a country by the pursuit of an independent monetary policy, as the experiences of Switzerland and Norway illustrate.

This advanced economic area of the world is at the present time undergoing a rapid evolution in ways which are relevant to the choice of monetary and exchange rate arrangements. Not only are the remaining restrictions on capital movements within the area being eased, but the development of electronic media of exchange are making an identification of 'the' national money supply increasingly difficult, and hence its control by national central banks increasingly tenuous. Furthermore, there is an observable tendency in most of the OECD economies for both prices and wages to become more flexible. This is perhaps the leading factor explaining the recent phenomenon of sustained growth in the advanced economies unaccompanied by the inflationary pressures of the early post-War period.

This last point has a bearing on the choice of exchange rate regimes. The case for flexible exchange rates rested largely on their capacity for compensating for embedded price and wage rigidities. The latter were widespread throughout many of the OECD countries in the first three post-War decades. Since then, an increasing flexibility of prices and wages has strengthened the case for fixed exchange-rate regimes. The weakness of such regimes has perhaps been exaggerated. If an economy has completely flexible prices, including nominal wages, then a flexible external exchange rate is unnecessary. But if a country's problem is with real rigidities, e.g. sclerotic labour markets or persistently high real wages, then the choice of exchange rate regime is irrelevant. A loss of exchange rate flexibility only matters to the extent that there are nominal price rigidities in the country concerned.

Generally speaking, those economists who are in favour of a country's membership of EMU argue that either or both of floating exchange rates and independent national monetary policies are a source of instability in practice. Those on the other side of the debate emphasise the theoretical principles suggesting that these arrangements should work in an accommodating fashion to cushion 'shocks' which would otherwise be destabilising.

In both cases, however, we are talking about short-run adjustments to change. In the long run, the choice of particular monetary arrangements is generally thought not to be decisive from the point of view of the actual evolution of a market economy. It is true that even in the long run a greater risk of monetary laxity may mean an increased risk premium and hence a higher cost of capital. But most economists today would tend to agree that real factors such as culture, institutions, the aptitudes of the labour force, the stock of capital, and access to technology and markets are the principal determinants of the rate of growth of an economic system. This belief is founded on the observed historical experience of developed countries.

2. COMPETING CURRENCIES

Competing currencies, for so long a *curiosum* of monetary theory, are now a fact of everyday life throughout most of the world. The dollar circulates alongside domestic currencies from Russia through parts of Asia to Latin America. This has come about largely as a result of advances in technology, accompanied by the increasing integration of the OECD economies through trade and capital movements, in particular movements of financial capital. And the development of electronic payments systems means that the real cost of exchanging currencies has fallen significantly in recent years. The use of electronic media such as the internet also means the creation of new forms of money co-existing with the old. Internet currencies like Beenz illustrate the almost forgotten proposition that currencies do not have to be issued by governments in order to be acceptable.

The case for allowing two or more currencies to circulate within a single country is founded on two principles:

- First, the elementary proposition that two people exchanging commodities are better off if they are left to choose the terms of their transaction themselves, including their choice of a mutually preferred currency. They are deemed to be the best judges of where their own interests lie.[3] The contending proposition, namely that the state should have monopoly rights over the issue of currency in a particular country, although widely accepted, is quite difficult to justify. One argument is that there are economies of scale in commercial banking so that unregulated competition between banks would lead inevitably to a private banking monopoly.[4] But even if it were true, this argument would not apply to competition between different national currencies.

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[3] *This is not the place to debate the proposition which says that, especially in financial markets, people are often too poorly informed to be able to know where their true interests lie. In the present case, people who felt inadequately informed would continue to be able to use the traditional currency with which they were familiar.*

[4] *It is curious that supporters of the principle of a state currency monopoly include some, such as Milton Friedman and Tim Congdon, who are amongst the most vociferous critics of state monopolies everywhere else in the economy.*

- The second principle justifying competing currencies is that competition between currencies normally operates to support price stability (Girton and Roper 1981). Competition should ensure that that currency which was perceived as being most likely to maintain its purchasing power over time would be the one in greatest demand.[5] It is possible to construct models in which currency competition does not guarantee that the currency of the monetarily 'virtuous' region will emerge as the nominal anchor (Woodford 1991), but such results usually depend on highly particular and implausible assumptions (e.g. no transactions costs).

The case for competing currencies received an elegant restatement with the publication in 1976 of Hayek's paper on 'The Denationalisation of Money'. Hayek argued that national governments could not be trusted to keep the purchasing power of the money they issued stable. An excessive rate of growth of public expenditure would tend to undermine the value of the currency. This argument gained some sympathy following the experiences of the 1970s and the 1980s. But in the 1990s the talk amongst Western finance ministers has been of little else but prudence in the pursuit of price stability (Issing 2000). However, the present climate of opinion which believes that low inflation is a necessary condition for sustained economic growth may not last forever. It would surely not survive a deep or prolonged recession. In the long run competing currencies might therefore be a safer bet.

In any given country or region there can be competition among internal currencies or among external currencies or among both. Internal currency competition occurs when the domestic commercial banks issue notes which are in competition with each other. This is what happened in Scotland between 1810 and 1845. The arrangement came to an end when the Bank Charter Act of 1844 effectively imposed a currency board system on Scotland. In a carefully researched and well-argued paper published in 1985, Michael Fry showed what regulatory changes would be required to restore competing internal currencies to contemporary Scotland. They amounted to

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[5] *At first sight, this proposition appears to contradict Gresham's Law about bad money driving out good. But it should be remembered that Gresham's Law applies only to those different kinds of money between which a fixed rate of exchange is enforced by law (Hayek 1976, pp.41-43).*

little more than the repeal of the Bank Notes (Scotland) Act of 1845 and the amendment of the Banking Act 1979 so that it ceased to apply to Scotland (Fry 1985). Eighteen years ago, Fry's proposal fell on deaf ears. This was largely because it was presented as part of an agenda for the re-invigoration of the Scottish economy through a revival of capitalism at a time when political opinion in Scotland maintained a lingering hostility toward any manifestation of capitalism whatsoever.

Eighteen years on, the world has changed and opinion has evolved, as Fry anticipated it might (Fry 1985, p.60). Not only are all but the very smallest businesses capable of handling multiple currencies, but individual citizens do so too with the help of their credit cards. With the integration of financial markets it has become much easier for ordinary people to hold deposits in different currencies. So it is not at all difficult to envisage a scenario in which the protected status of sterling is withdrawn and the pound and the euro circulate in Scotland in competition with one another, each currency enjoying equal legitimacy. Other national currencies, for example the dollar, might also circulate. These currencies could be joined by currencies issued by one or more of the Scottish banks, by other private banks and by electronic currencies. Businesses and many individuals would probably wish to maintain accounts in more than one currency and would be free to choose which currency they used in particular transactions. The great attraction of this proposal, apart from widening the range of choice for the individual, is its simplicity. It represents a quite small evolution of the present situation that could be brought about with minimal regulatory change. In particular, it need not wait upon further constitutional change.

For all currencies to compete on an equal footing, it would only be necessary to withdraw the statutory privileges currently enjoyed by sterling. Some instruments of monetary control at present employed by the Bank of England, notably reserve requirements, special deposits, interest rates and the custom of the Government maintaining its balances at the Bank of England would be suspended. The effect of these measures would be to loosen rather than to abolish the influence of the Bank of England on monetary conditions in Scotland. Since it would still be acting as a central bank south of the border, the Bank's influence would continue to be felt in Scotland, albeit indirectly. So long as the Scottish banks continued to keep their reserves in London, their ultimate source of liquidity would continue to be the City's money markets. The position of the Scottish banks with respect to the Bank of England in this scenario would then become analogous to that of the Irish banks up to 1979 (Fry 1985, pp.49-55). But to the extent that the share of sterling in trading and asset-holding in Scotland should give way over time to other currencies, then the influence of English monetary policy on the Scottish economy would gradually diminish.

Should this happen, i.e. should the usage of sterling in Scotland be gradually displaced by the euro or the dollar, it would only be as a result of an accumulation of individual personal and commercial choices. It would not be the result of an aggregate political choice. Individuals would continue to use whichever currency they wished. Indeed, it is precisely individual and corporate choices which are bringing into existence a de facto regime of competing currencies in contemporary Scotland without waiting on political decisions. Internet shopping sites in Europe price predominantly in euros. The euro should therefore become the preferred currency for e-commerce throughout Europe. The net consultant **E-Insight** forecasts online purchases by UK consumers from euro-priced sites reaching 3.5 billion euros by the end of this year.

A major benefit of allowing competing currencies in Scotland will be to achieve a stable monetary framework appropriate for the participation of a small country in a global economy, free from external or internal political influence. There will be other benefits. Not the least among these is that Scottish-based banks, insurance companies and other financial institutions will be able to compete in international markets on equal terms. Once they have cast off the shackles of the present UK regulatory regime for retail financial services, (surely one of the worst in the developed world), they will be able to deploy their traditional competitive advantages. Their probity and trustworthiness have at present little commercial value in a tightly regulated market, but in the unregulated global market of the future made possible by the internet, these advantages will once again come into their own.

Within a regime of competing currencies which currency should government contracts be written in, state salaries and pensions paid ? In principle, this should be a matter of choice for the payees. Individuals should also be free to choose the currency in which their tax payments are made. If this choice were not allowed, governments would be able to continue to exercise an undue influence over one currency, a temptation which they would find difficult to resist.

Where governments entered into contracts with an intertemporal dimension then, like private financial institutions, they would have to take care to match their future liabilities with similarly denominated assets, or to avail themselves of the facilities offered by the options and futures markets. Some people will feel that to do this means introducing unnecessary complications, and that a state-backed monopoly currency would be much simpler to administer. Perhaps, but not safer. Without the ability to issue their own currency, governments will be less tempted to run up large unfunded pensions liabilities, making promises to future pensioners which their successors will be unable to keep.

A regime of competing currencies may finally dispel the illusion that a modern economy needs something called 'legal tender'. As it happens, none of the paper money circulating in Scotland today is legal tender. Designating one particular currency as 'legal tender' merely enshrines the privileges of that currency as a compulsory unit of account. All that a law of legal tender does is to provide a means by which a government can force people to accept a standard of payment of its own, thereby opening the way for inflation and debasement of the currency.

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July 2003