Contemporary Issues in Finance
Foreign exchange and currency unions

Martin Upton

Let us now turn to the subject of foreign exchange and currency unions. I want to ask the question about the prospects for countries within the eurozone, as the zone itself expands. Marcus?

Marcus Davidson

The concept of a currency union is not new. I think it's important to get straight at the outset exactly what is and is not new about the single currency area. A major issue which always comes up in arguments about the single currency is the fact that, with a single currency, the countries which belong to the currency union have to sacrifice control of interest rates, exchange rates and monetary policy to some kind of super-national body. And the argument is whether the one size fits all feature of this policy ultimately is bad for everybody. It results in interest rates being too high for the laggards. At the time of we're speaking, which is June, 2006, Italy, for instance, is an economy in the doldrums and arguably could do with lower interest rates to stimulate it; other countries show signs of overheating and maybe they could do with slightly higher interest rates. Now, there's nothing about this which is new, as such. In the United Kingdom we have had for many years of double-divide. We have a north-south divide between a reasonably depressed north and chronically booming south. Arguably, the application of a single interest rate and exchange rate to both of those sectors of the economy is bad for both. We have another divide which is also very deep seated in our economy, which is the divide between manufacturing and services. Manufacturing always screams when interest rates go up; services keep quite quiet because their cash piles just earn more interest.

Another very well known example of a currency union, of course, is the United States of America which is a very large and a very diverse economy. Now, one way in which those two unions differ from the European union is, of course, that they are also each of them a political union – in other words a political union and a currency union are co-terminous with each other. The European union is not a political union and the very idea of a political union is probably the single most controversial aspect of the whole arrangement. The problem is going to get even more serious potentially when new members join. The new entrants are really on a fast track – some of them think they're on a fast track – to join the currency and, when you look at their contribution in terms of GDP to the enlarged pool, enlarged economy of the eurozone, it is very small. So, they're going to be very much at the mercy of the larger members of the union – in particular, of course, France and Germany.

Martin Upton

Graham, what's your angle on the question?

Graham Honeybourne

I think Marcus has done a very good analysis there. I don't disagree with anything he said other than I would reinforce that, until we get a more centralisation of the political systems, the desegregation that he's talking about, in terms of some economies being upset, is just going to increase. Some people will suffer and others will have massive asset price inflation and wage inflation.