

The United States as a monetary union

EMU study



HM TREASURY

EXECUTIVE SUMMARY

1 The United States (US) is a monetary union occupying a huge geographical area – significantly larger than Western Europe. As the world’s largest economy (in terms of its level of GDP) it provides a working example of how different regions – quite disparate in terms of their geography, climate, industry and heritage – develop within a monetary union.

2 The US is frequently cited as providing evidence that different regions can prosper within a monetary union and can adjust to unanticipated economic disturbances, or ‘shocks’, in the absence of an independent monetary policy or nominal exchange rate. It is often suggested that a single currency has had a significant impact on US economic performance, in terms of both macroeconomic stability and the microeconomic benefits of greater trade and competition.

3 Monetary union formally began in the US with the ratification of the Constitution in 1788. But the US only assumed many of the characteristics of a full monetary union, such as an independent central bank and a single currency, over the following 150 years. The institutions of monetary union in the US have tended to evolve in response to specific needs or difficulties, rather than according to a pre-planned framework.

4 Different aspects of the evolution and operation of the US as a monetary union have been extensively analysed in a wide range of academic studies. This study presents a comprehensive overview, drawing on the analytical framework explained in the EMU study by HM Treasury *The five tests framework*. It examines the adjustment mechanisms which have operated in the US and the likely benefits that monetary union has delivered. This study informs a number of other EMU studies and is relevant to each of the Government’s five economic tests for EMU entry, in particular the fifth test on growth, stability and jobs.

The implications of US monetary union

5 The first sections of the study consider the key implications of monetary union for regions within the US. They focus on the extent to which the regions within a monetary union are subject to region-specific shocks, and the ability of regions to adjust to such shocks without an independent monetary policy or nominal exchange rate:

- supply and demand shocks have varied widely in their incidence and impact on the regions of the US. Similarly, analysis of business cycles suggests that some regions have displayed highly idiosyncratic business cycles. It cannot be concluded that the US regions all follow a common business cycle;
- this suggests that a monetary union can survive (and prosper) with quite varied business cycles and in the presence of asymmetric shocks, i.e. shocks which affect some regions or sectors more than others;
- theories of endogenous convergence suggest reasons why a single currency might foster similarity in regional business cycles. There is limited evidence to indicate that this may have occurred in the US, but it is not clear whether this is due to the deepening of the monetary union or wider structural factors;

- various adjustment mechanisms appear to play a part in helping US regions to adjust to asymmetric shocks. Labour markets are thought to provide important adjustment mechanisms (in terms of employment flexibility and labour mobility), apparently playing a greater role than in many other countries. There is also some (though imperfect) risk sharing in financial markets – a potentially important mechanism whereby agents from one region spread investments across other regions of the economy;
- US federal fiscal policy plays a far greater role in assisting regional adjustment than does EU-level fiscal policy in Europe. But in Europe, national fiscal policy assists regional adjustment much more than state level policy does in the US. Some US states run budget deficits and surpluses, but these do not seem to be directed at cyclical stabilisation, or at offsetting regional shocks. Overall, fiscal policy appears to provide as much, if not more, assistance to regional adjustment in Europe than in the US; and
- there is no single optimal means of adjustment to shocks. Different adjustment mechanisms will be most appropriate, depending on the country or region, the specific circumstances and the nature of the shock. But the US clearly benefits from having a high degree of flexibility. In particular, labour market adjustment mechanisms facilitate a relatively rapid reallocation of resources when US regions experience region-specific shocks. High flexibility alleviates the effect of such shocks on the overall performance of the economy.

Fiscal policy institutions 6 Individual US states are not prevented by any formal institutional framework from running fiscal deficits. Nor is there any harmonisation of state income, corporate, sales or excise taxes in the US. The evidence suggests that even with highly mobile capital, states retain some flexibility to run independent fiscal policies – although in practice almost all US states choose to follow a form of balanced budget rule on an annual basis. Annex B discusses fiscal federalism – the allocation of fiscal policy authority among different levels of government.

Identifying the benefits of the US monetary union... 7 The benefits of monetary union are difficult to identify in the absence of a counterfactual illustrating the likely economic performance of the US states or regions without a single currency. Nevertheless, the evidence of the size and strength of the US economy and single market makes it difficult to believe that the monetary union has not delivered benefits.

...at the macroeconomic level 8 At a macroeconomic level, there is evidence to suggest that US monetary union has contributed to greater consumption stability. Consumption has tended to be more stable in the US than in other major industrialised economies in the last twenty years, even though output has not been noticeably more stable. The large single market, well-integrated financial markets and trade integration may have helped the US to stabilise consumption both over time and between regions.

...and at the microeconomic level 9 There are a number of channels through which monetary union in the US appears to have had a positive microeconomic impact:

- trade: an absence of comprehensive data on inter-state trade makes it difficult to compare the level of trade within the US with that between countries. Recent work suggests that trade between US states is over 40 per cent higher than trade between US states and Canadian provinces (although this may reflect factors other than the single currency). The balance of evidence suggests that the single currency in the US has helped to stimulate inter-state trade;

- investment: through the 1990s, the US experienced high rates of investment growth accompanied by high rates of productivity growth. This suggests that the US has an efficient financial market, in terms of allocating investment to high productivity areas;
- competition: a more relevant measure of the integration of the US economy may be provided by estimates of competitive pressures in the US. Evidence suggests that price competition is greater in the US than in major European countries. This is likely partly to result from the greater price transparency and integration provided by the single currency. But this cannot be separated from other factors such as a common language and culture, and the federal regulation of commerce. The evidence suggests that competitive pressure, in turn, has been the major driving force behind recent strong US productivity performance;
- specialisation: at a high level of industrial aggregation, US regions are less specialised than the EU economies. But on more disaggregated measures, the US is more specialised, which allows for agglomeration effects and for US firms to gain scale economies;
- financial markets: a large single currency area and a large, diverse single market, may have helped the development of US financial markets. This is despite the US having a relatively complex and decentralised regulatory structure; and
- US monetary union does not appear to have influenced the location of financial markets to any significant degree. Established patterns of business, often related to first-mover advantage and regional specialisms from the 19th century, appear to survive even today. In the North East, major equity investment and trading takes place in cities geographically closer than London and Frankfurt in Europe.

I0 The evidence suggests that monetary union has facilitated greater competition and integration between regions and states of the US, along with deep and liquid financial markets. It has also required the existence of an integrated single market and a high degree of confidence that, should difficulties occur, the institutional and economic structures are able to evolve and meet emerging challenges.

II This evolutionary aspect of the US monetary union is a recurring theme when examining how the US has successfully adapted to economic change and the needs of monetary union. Several examples of institutional change are identified, including:

- the creation of the Federal Reserve Bank in the early 20th century, providing an independent monetary authority for the US – a direct response to banking crises;
- evolution of the Federal Reserve structures in response to weaknesses in its original form;
- the adoption by individual states of balanced budget rules to encourage fiscal responsibility at a sub-federal level;
- the integration of the trans-continental US economy, with increasing capital mobility among regions;

- the pooling by the states of authority over tax and benefit systems at the federal level; and
- labour mobility between the North and South, which increased significantly in response to demand and supply shocks in the mid 20th century.

Conclusions 12 The study does not draw direct conclusions for EMU or the question of possible UK entry. A direct comparison between the US and euro area is difficult for several reasons, most notably that the institutions and policy frameworks of the US monetary union have evolved over a significant period of time in response to economic need, and not according to an *ex ante* design as in the euro area.

13 Moreover, the political context for the two monetary unions is very different. Ultimately the US states chose federal structures for fiscal policy to underpin political union – based on the principle of fiscal federalism. In the EU, fiscal policy is the responsibility of Member States as set out in the Stability and Growth Pact, and subject to the provisions of the EC Treaty.

14 This suggests that perhaps the most important lesson from the US experience is that a key feature of a successful monetary union is a high degree of confidence that, should difficulties occur, both the economic and institutional structures of the monetary union have the capacity to evolve and meet emerging challenges.

15 The study provides valuable evidence for the assessment of each of the Government's five economic tests for EMU entry, in particular the fifth test on growth, stability and jobs.