One world, one money

A global currency is not a new idea, but it may soon get a new lease of life

IN DIFFICULT times, people are allowed, even encouraged, to think the unthinkable. Some of the economists who propose capital controls as a remedy for recession in Asia claim to be doing this—but they are flattering themselves. Unthinkable? Malaysia just did it. Dozens of countries still use capital-account restrictions. And it is a cliché of the orthodox “sequencing” literature that a variety of such controls should be retained until other reforms are complete. Really, to think the unthinkable, you have to be bolder than this.

So here is an idea: global currency union. Let nobody call it boringly feasible, or politically expedient. Yet, like all the best unthinkable ideas, it has more going for it than you might think—in principle, at least. The idea is not new. Richard Cooper of Harvard University proposed a single world currency in Foreign Affairs in 1984, and he was not the first to think of it. It seemed an outlandish idea, and still does. But much has happened lately to make it worth a moment’s thought.

The usual way to ask whether countries would be better off sharing a single currency—that is, whether they constitute an “optimal currency area”—is to examine the following trade-off. On one side is the undoubted convenience of a single money as a lubricant for trade and cross-border investment. On the other is the loss of the exchange rate as a shock-absorber for times when one or more of the countries face pressures (an abrupt fall in demand for their exports, say, or a sudden rise in labour costs) that the others are spared—a so-called “asymmetric shock”.

In setting cost against benefit, again according to the standard view, the crucial factors are openness to trade and freedom of movement of factors of production. A small open economy has more to gain from the convenience provided by a single currency. On the other hand, if labour (especially) is reluctant to migrate, the need for the exchange-rate shock-absorber is all the greater. Weighing all this, most economists conclude that the 11 countries that are about to adopt the euro are not in fact an optimal currency area. The world as a whole is not even close.

So what has changed? The main thing is the current global emergency. This is so serious a crisis that it is likely to prove a paradigm-shifting event, though straws were in the wind already. The emerging-market disaster poses the question, How is the world to live with globally integrated finance? In addition, it casts doubt on what once seemed a good answer: that floating exchange rates are the best way to stabilise the world economy.

Shockingly unstable

According to the traditional model, a country with unduly high labour costs, and therefore a troublesome current-account deficit, could expect to see its currency depreciate; this would cut real wages, making imports dearer and exports cheaper, thus neatly restoring the economy to equilibrium. But in a world where international flows of capital overwhelm international flows of trade, this does not work. Floating exchange rates destabilise trade and investment by wrenching relative prices away from their fundamental values (that is, from the values that would put the corresponding exchange rates at purchasing-power parity).

In the emerging-markets crisis that currently threatens the world economy, exchange-rate movements have not been absorbers of shocks but amplifiers and even creators of them.

Governments of small open economies have long known that it is not an option to “leave the exchange rate to the market”. Monetary policy must always keep at least one eye on the currency. But governments have also learnt, in a second big change, that intermediate exchange-rate regimes do not work either. That was the lesson of the European Monetary Sys-