Forming a Currency Zone: Some Economic Considerations

Florin Aftalion
Professor Emeritus, ESSEC Business School, Paris

Issues

- What economic theories or observations can guide the decision to join the Euro Zone?
  - Optimum Currency Areas
  - Problems with differential inflation rates
  - Sovereign debt fiasco
- Costs/benefits for a small, less developed economy.

Optimal Currency Areas (OCA)

- The theory was introduced by Robert Mundell (1961) in order to make the case for fixed exchange rates
- In 1970 Mundell presented “A Plan for a European Currency”
- OCA theory was further developed by Ronald McKinnon (1963), and Peter Kenen (1969)
- Robert Mundell: Nobel award in 1999.
- When countries come together to form a currency union there are:

Benefits

- Elimination of transactions costs and exchange rate risk (between participating countries) should increase trade and investments between them
- Price transparency should benefit consumers and increase competition
- (Member countries will sell their debt in foreign markets at lower rates)

Costs

- No independent monetary policy
- Exchange rates cannot be used as a policy tool
- Consequences of Asymmetric shocks: inflation and unemployment cannot be treated by a unique monetary policy
- The larger the total economy the higher the probability of Asymmetric shocks

- The loss of independent monetary and exchange rate policies is considered to be the most important cost in joining a monetary union
- Increased intra-industry trade and further economic integration should reduce country differences which cause asymmetric shocks.

Adjustments to asymmetric shocks

- Costs of adjustments in a monetary union will be lower if labor markets and wages are flexible and if labor mobility is high.
  - Regional unemployment can be offset by labor moving to another region, and would not require direct policy intervention.
- The expected costs of forming a union would also be lower if the budgetary process is centralized, and the monetary union is vested with fiscal powers (i.e., a centralized budget).
  - This would allow the union to direct loans or aid to countries or regions suffering asymmetric shocks.

Is the Monetary European Union an OCA?

- Labor immobility
- Wage rigidity
- No fiscal centralization
- Differences in industrial structures (and no convergence)
- When the MU was launched it was hoped that industrial structures would converge

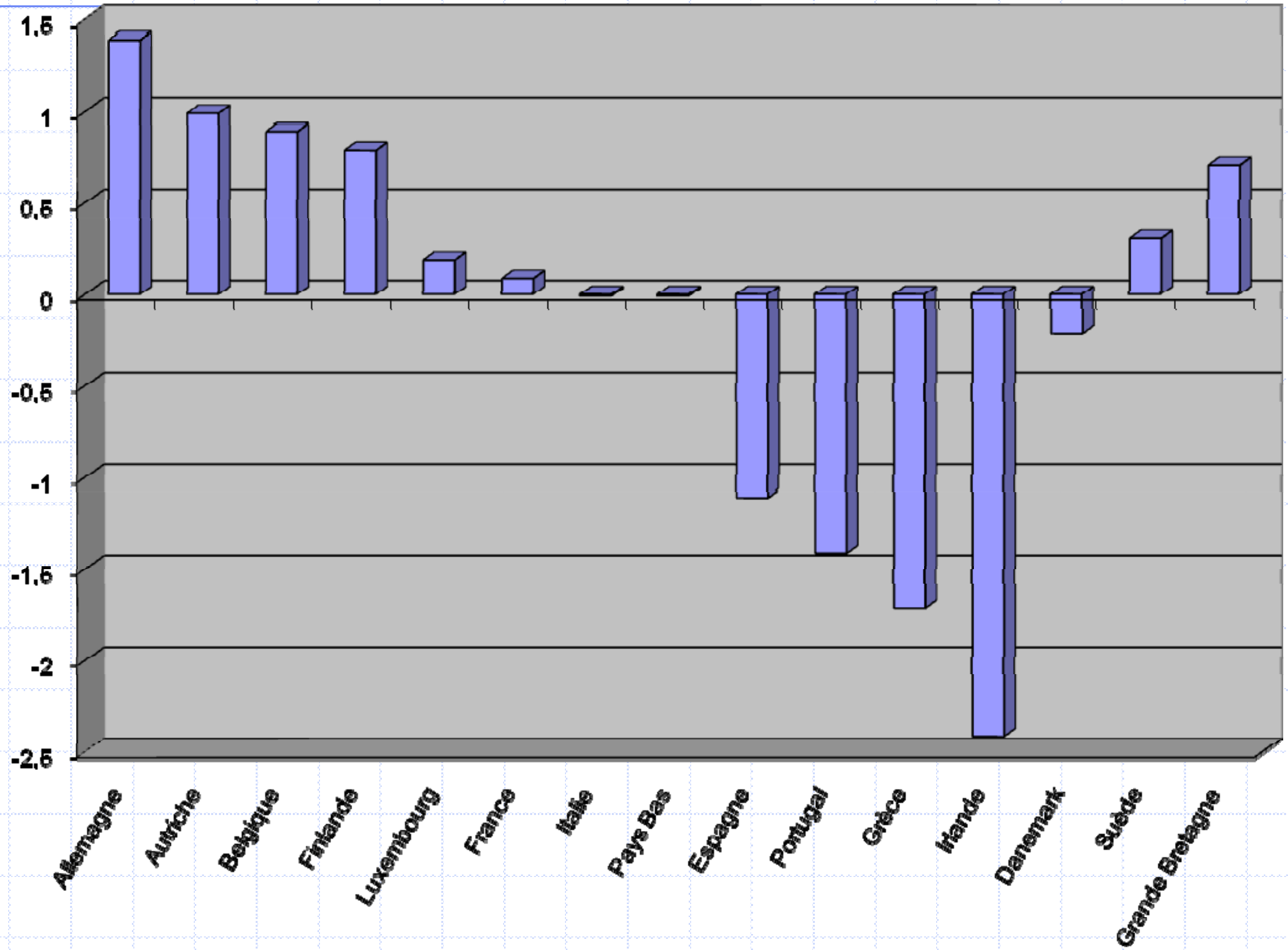
Differential Inflation Impact

- Consumer price levels in wealthier countries are higher than in LDCs (the Balassa-Samuelson effect)
- **In the EU, as LDCs grow their price levels increase (relatively).** Relative prices of exchangeable goods remain constant. But: higher inflation in wages and real estate.
- Inflation differentials generate differences in **real interest rates**

Inflation in MU countries 2001-2008

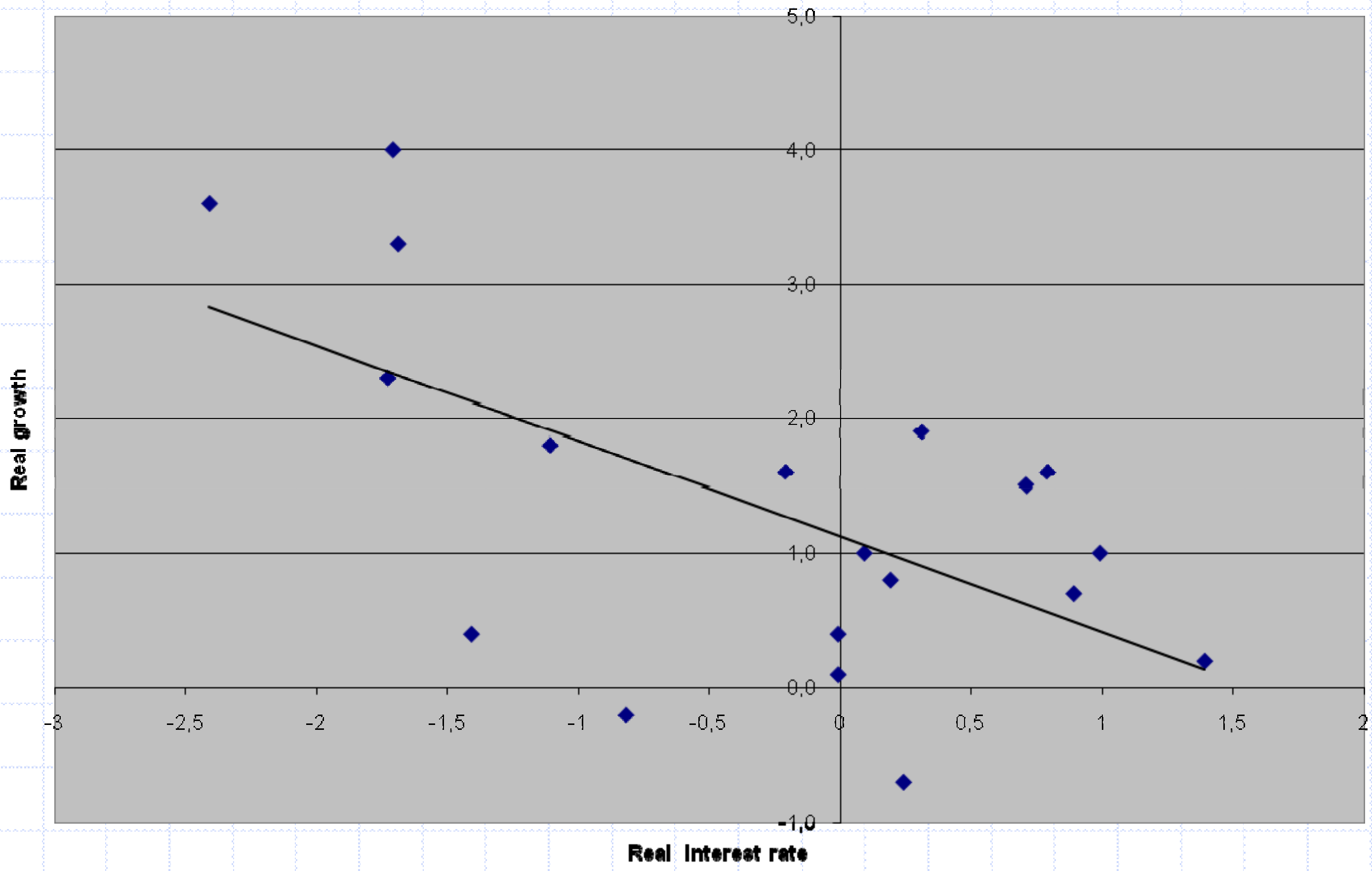
	Average inflation %	Accumulated inflation differential with Germany %
Austria	2,1	2,4%
Belgium	2,3	4,1%
Finland	1,7	-0,8%
France	1,9	0,8%
Germany	1,8	0,0%
Greece	3,4	13,5%
Ireland	3,8	17,2%
Italy	2,4	4,9%
Luxembourg	2,5	5,7%
Netherland	2,2	3,2%
Portugal	3,0	10,0%
Spain	3,3	12,6%

Real Interest Rates MU in 2003



Real growth in 19 countries

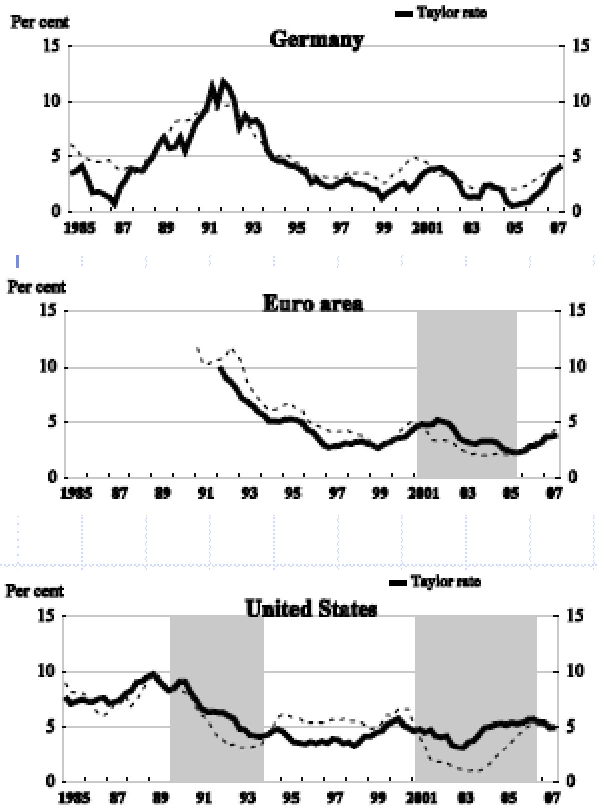
BS windfall effect

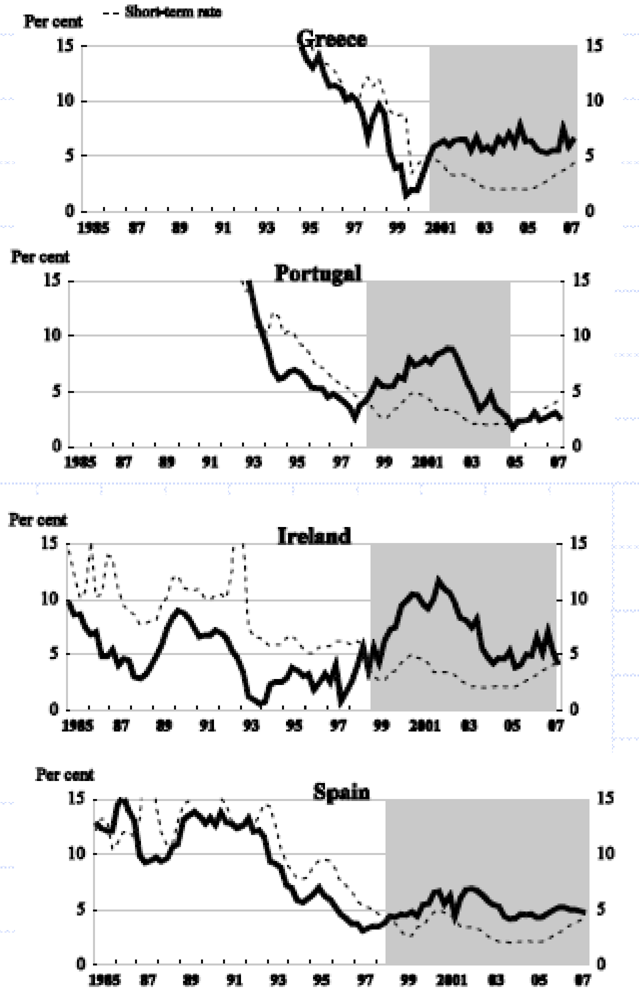


Consequences

- Inflation differentials especially in non exchangeable goods (real estate)
- Growth differentials
- Non sustainable wage differentials between EuroZone countries

Taylor Rule and Real Interest Rates





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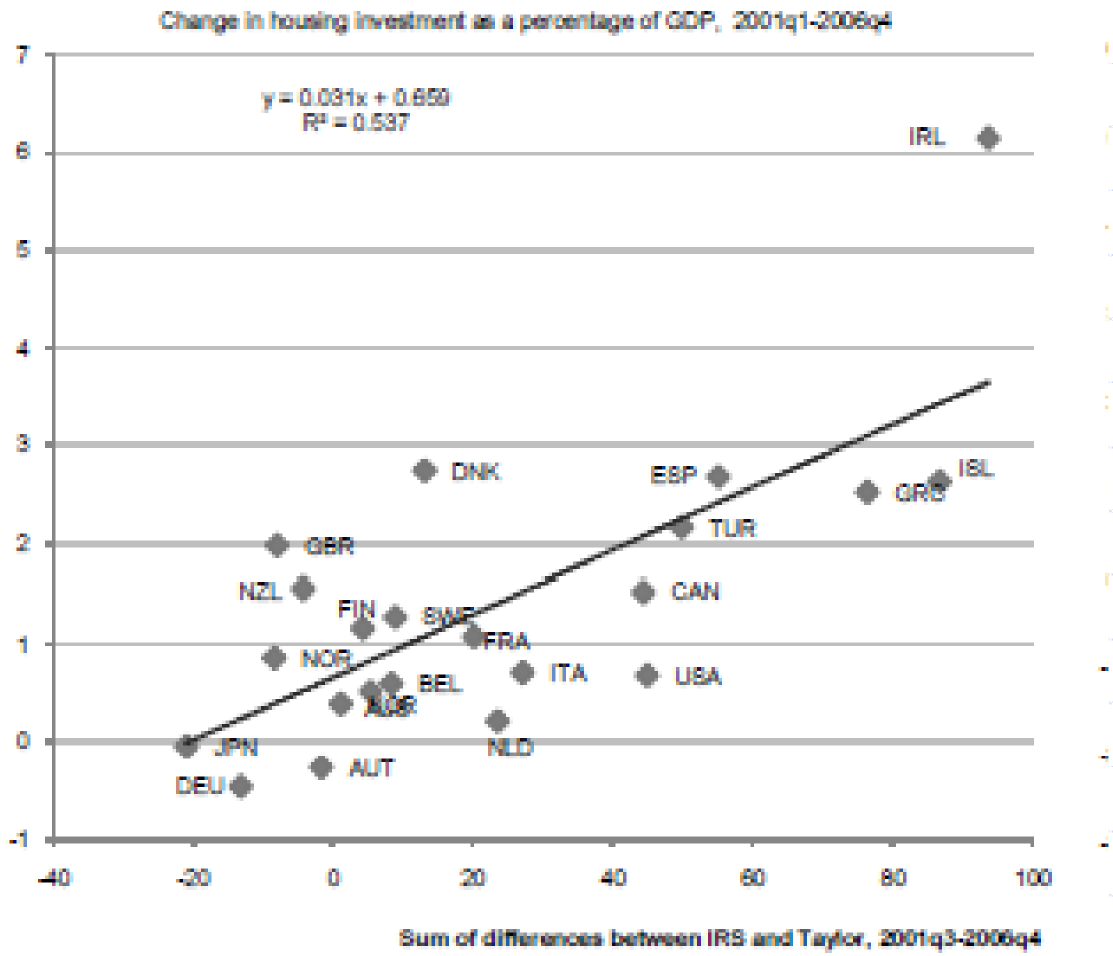
Housing Investment versus deviation from Taylor Rule



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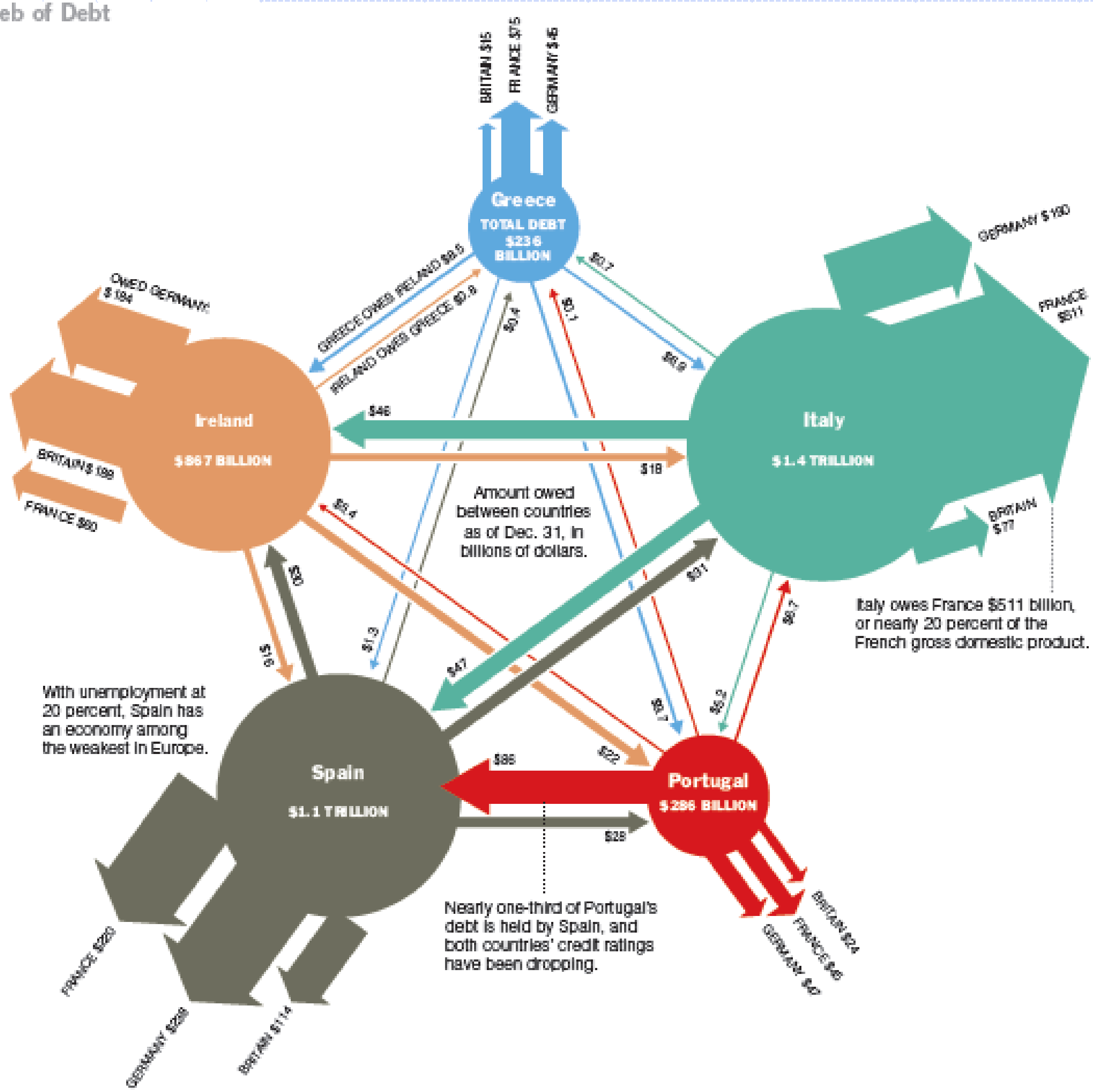
Greece Credit Default Swap

Greece credit default swap represents the annual cost, in basis points, to insure against a default of Greek sovereign debt over the term of a 5-year swap agreement. Source: Bloomberg, FMRCo (MARE) as of 5/28/10.

Sovereign Debt Interest Rates

Chart 1: Europe's Web of Debt



Source: Bank for International Settlements.

The Case for a LDC Joining the EuroZone

Costs

- No independent monetary policy
- No devaluation to increase exports
- BS-Inflation control

➢ Benefits conditional on the hardening of the Maastricht criteria

Benefits

- More investments from abroad
- Increased inter-community exports
- Cheaper Government borrowing
- Or, if problems, bailout by the Union

Intra-union exports of EU countries (% of GDP) in 2005

Belgium/Luxembourg	66,7
Slovakia	58,9
Czech Republic	54,1
Netherlands	51,1
Estonia	45,6
Hungary	43,7
Slovenia	37,3
Ireland	34,7
Lithuania	30,1
Austria	28,1
Latvia	24,6
Denkmark	23,1
Poland	23,1
Germany	22,0
Sweden	21,2
Malta	21,0
Finland	19,1
Portugal	16,6
France	13,7
Italy	12,2
Spain	12,0
United Kingdom	9,8
Cyprus	6,1
Greece	4,0

- Large differences in openness of EU countries with the rest of the Union
- For countries with a small degree of openness (UK and Greece), it is less clear that they belong to an optimal currency area with the rest of the EU
- Cost-benefit analysis is likely to show net benefits of being in EMU for Benelux, and small central European countries

Source: De Grauwe

The End