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Kenen, Peter B
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COMMON CURRENCIES VERSUS CURRENCY AREAS

Preferences, Domains, and Sustainability

By PETER B. KENEN*

I will define a currency area as a group of countries that undertake to contain their bilateral exchange rates within narrow bands, defined in respect of agreed central rates which they cannot change unilaterally. The Bretton Woods System was meant to meet this definition but fell short in practice, because the International Monetary Fund could not control effectively its members' exchange-rate policies. The European Monetary System (EMS) met the definition closely until 1993, when the exchange-rate band was widened to 15 percent, and has met it fairly well since 1993, as members have made little use of the wider band.

How does a currency area differ from a monetary union? In a currency area, each member retains its own currency and central bank. It has the right to pursue an independent monetary policy, the right to propose a change in its exchange rate, and the ability, if not the right, to alter its rate unilaterally. In a monetary union, there is one money, one central bank, and thus one monetary policy. The national currencies have disappeared, and no country can change its exchange rate without quitting the union and reintroducing its currency.

Yet the two regimes differ in practice less than they do in principle. Although members of a currency area have the right to pursue their own monetary policies, they cannot exercise that right without jeopardizing their exchange-rate pegs. This is true for all currency areas in the long run. Under the Bretton Woods System, no country could let its inflation rate exceed the U.S. inflation rate persistently; otherwise, it would have to devalue eventually. Hence, U.S. monetary policy constrained the policies of all other countries.

* Department of Economics, Fisher Hall, Princeton University, Princeton, NJ 08544.

When capital mobility is high, moreover, the constraint on monetary independence holds in the short run as well and has two dimensions. No country can reduce its interest rate below rates prevailing elsewhere in the area without risking a very large capital outflow, and no country can even contemplate an exchange-rate change without running the same risk. This double constraint began to bind in Europe in the 1980's, as EMS countries abolished their capital controls. Monetary autonomy was reduced, and the Bundesbank's monetary policy came to be the policy of the whole EMS. Governments came to believe that they could not undertake exchange-rate realignments without unleashing market forces that might destabilize the whole system.

Recognize the consequence of my definitions. Any seemingly general comparison of currency areas and monetary unions becomes a comparison of two special cases: the EMS and the proposed European monetary union (EMU). But most of the recent literature also deals with those cases, and there may be no others ahead. Narrow-band currency areas are not viable when capital mobility is high. Monetary unions are feasible only among countries with well-developed decision-making processes like those of the European Union (EU).

It should be equally clear that the theory of optimum currency areas cannot be used to compare currency areas and monetary unions. It is concerned with the choice between floating and fixed exchange rates, not between narrowly pegged rates and a common currency. Rarely have so many good papers been written about the wrong question—although they do say useful things about the problems facing Europe in the years ahead.

What, then, are the real differences between a currency area and a monetary union? First, monetary policy will be conducted differently under the two regimes. Second, exchange rates

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will disappear completely in a monetary union.

With high capital mobility, a currency area will have a single monetary policy, but it will reflect the preferences and circumstances of the largest strong-currency country. This was true under the Bretton Woods System and even more obviously true under the EMS. In fact, it was deemed to be the main virtue of the EMS when disinflation was the order of the day. But the dark side of the same asymmetry became painfully evident in the early 1990's, when the Bundesbank had to combat inflationary pressures stemming from German unification, and the rest of Europe was in deep recession.

The basic issue was posed incisively by critics of the EMS, even before it arose acutely in the 1990's: If Europe must have a single monetary policy, should it be made by the Bundesbank or by a European institution responsive to the needs of Europe as a whole? Unfortunately, this formulation was often taken to imply that German policy preferences are different from those of other EU countries, and that possibility was worrisome to Germans. It is indeed still worrisome. It explains why Germany has insisted on a stability pact to limit budget deficits and why it wants EMU to start with a small core of countries whose histories affirm their commitment to price stability.

Under the Maastricht treaty, however, the future European Central Bank (ECB) will be required to pursue price stability and will be independent. Hence, there may be no difference between the observable preferences of those who lead the Bundesbank and those who will lead the ECB. Yet their domains will be different. The Bundesbank pursues price stability in Germany and must combat inflationary pressures whenever they emerge in Germany. The ECB will pursue price stability in the EMU countries as a group, not in any single country. It will have a European domain, which means that its policies will usually mitigate asymmetric shocks, not aggravate them, as the Bundesbank did a few years ago (see Kenen, 1995).

There are four ways in which members of a monetary union can expect to gain from suppressing exchange rates:

(i) Transactions costs will disappear—which is another way to say that the real resources employed in foreign-exchange trading can be shifted to other productive activities.

(ii) Members of a monetary union, having no exchange rates, cannot be forced to defend them by raising their interest rates to astronomical heights. This is, in effect, the quid pro quo for the formal abdication of monetary autonomy.

(iii) A monetary union reduces exchange-rate risk and banishes that risk completely if the union is seen to be permanent. Exchange-rate risk does not appear to have large effects on trade or capital formation. Most studies of the issue, however, have looked at the wrong sort of risk. They have asked whether short-term exchange-rate volatility depresses trade or investment, and there are ways to hedge against that sort of risk. It is more difficult (but more important) to measure the effects of uncertainty about long-term exchange-rate changes, because it is harder to hedge against them. If a firm could predict its future foreign-currency receipts, it could sell them forward. But it cannot predict its receipts when the volume of trade itself depends on future exchange rates.

(iv) A monetary union can be expected to extend the domain of the typical firm by taking the foreignness out of foreign trade. Canada and the United States belong to a free-trade area and speak the same language (apart from Quebec). But John McCallum (1995) has shown that cross-border trade is far smaller than one would expect, given the amounts of trade between Canadian provinces or between U.S. states.

I conclude with two more questions. Will EMU happen? Will it last?

Yes, it will happen. Not because the key countries, France and Germany, will meet the convergence criteria, but because they do not have to meet them exactly. In early 1998, the European Commission and European Monetary Institute (EMI) will assess the degree of convergence achieved by each EU country, us-

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ing the convergence criteria in the Maastricht Treaty. Then, the Council of Ministers, acting on a recommendation by the Commission and in light of the findings by the Commission and EMI, will decide which countries meet the "necessary conditions for the adoption of a single currency." But the treaty never says that the convergence criteria are the "necessary conditions" for adopting a single currency. Much attention has been paid to phrases in the treaty which impart flexibility to the convergence criteria. More attention should be paid to the flexibility that the Council will enjoy when deciding what weight to give the criteria themselves.

Will EMU last? I will distinguish between its long-run economic viability and its short-run political viability.

If Europe is not an optimum currency area, because labor is not mobile enough, wages are not flexible enough, and so on, the costs of EMU may become unacceptably high. This risk was stressed by Paul Krugman (1993), who warned that further integration, due partly to EMU itself, may intensify specialization and make individual countries more vulnerable to industry-specific shocks. But Jeffrey Frankel and Andrew Rose (1996) raise a different possibility. The tighter integration of EU countries will tend to synchronize business cycles and thus reduce the most important asymmetric shocks.

There is a near-term problem, however. The cost of defecting from EMU will rise sharply in 2002, when the Euro replaces the national currencies. Before that, a country can defect without having to reintroduce its currency. Defection may become attractive if, in the interim, EU countries continue to cut their budget deficits, pursuant to the stability pact, while the ECB seeks to acquire credibility by pursuing a tight monetary policy.

Some economists believe that the ECB will offset the demand-depressing effects of the stability pact; it may even allow the Euro to depreciate vis-à-vis the dollar. In its quest for quick credibility, however, and the need to convince the German public that the Euro will be just as good as the deutsche mark, it may compound the deflationary pressures imposed by the stability pact. In that case, unemployment will not fall, and politicians of the left and right may gang up on EMU. One can only hope that the ECB will not try to achieve credibility in ways that put EMU itself at risk.

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