Comments on *Optimal Currency Areas*

by Alesina, Barro, and Tenreyro

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An Interesting Paper

- Asks: Which Currency (Union) should aspiring members join?
- Use a variety of metrics indicated by Alesina-Barro theory
  - Patterns of International Trade (trade benefit)
  - Inflationary history (commitment benefit)
  - Co-movements of prices and output (stabilization cost)

The Terms of the "Bi-Polar" Debate are Shifting

- Argentina's currency board is now "mid-way approach"

- At least debatable that currency union enhances trade

Empirical Results (the value-added)

- Find well-defined \$ and € zones, but no clear ¥ zone.
    - Results mostly seem plausible and reasonable
        - Asians had accurate expectations about Japanese monetary policy
- Some progress on endogeneity issues

What's the Question of Interest?

- Usually the issue is not *who* to join but *whether* to join.
    - Examples: Denmark, Sweden, UK, in €-land
    - Argentina, Canada, Mexico in $-zone

Is a Large Country Necessary?

- A number of multilateral currency unions exist (ECCA, CFA) without any clear center country (though both are "moored" externally).
- Why not handle OCAs that do not involve any of the G-3?
    - Kenichi Ohmae's "Triad Power" or Thurow's "Head to Head" competition?

Excluding the G-3 is an Important Issue in Practice

- Benefits of regional currency unions likely to be at least as high in trade integration, price and output co-movements
- Would monetary commitment be lower for multilateral CUs (as opposed to unilateral CUs which exclude the G-3)?
    - In practice, inflation for ECCA and CFA averages 6.7% (1960-1996), while inflation for unilateral CU joiners is significantly higher (8.9%).

Other Potentially Important (Deliberate) Omissions

- Financial Integration (Argentina and dollarization)
    - Over half the papers in the 2001 *JMCB* symposium
- Monetary Sovereignty as Fiscal Policy of last resort
    - Goodhart and “C-form” money

The Empirics

- Mostly believable, though could be more accessible
  - Some key equations and descriptions currently missing
    - Is IV correlated with CU?
  - Data set?
  - Why stop endogeneity after one round?

Some Data Issues

- 138 seems like a lot of countries, but is not for this literature
    - CUs tend to be small and/or poor, so the action is in the bottom tail (I use up to 217)
- Selection Bias: a number of CUs are so tightly integrated that no data is available (Luxembourg, San Marino, Monaco, …)

Using the Ratio of Trade to GDP

- "Solves" problem though using trade level trade in numerator
  - But imposes unity on GDP product on gravity (rejected)
  - Can test for appropriateness with Box-Cox transformation of $(y^{\lambda} - 1)/\lambda$, which nests linear, natural log, and inverse
    - Find $\lambda \approx 0$ (.09), so log transform looks good
    - Both log and Box-Cox optimum deliver big positive CU effects

Estimation: Some Issues

- Coefficient on real GDP imposed to be unity (usually rejected)
- No explicit panel aspect (e.g., fixed or random effects, though year effects included and clustered standard errors)
- No real GDP per capita term (usually very significant)

Room for sensitivity analysis

Sensitivity Analysis: Effect of Currency Union on Trade

	γ (se)
Default	.046 (.057)
Fixed Effects	.030 (.011)
Box-Cox Transform	.29 (.10)
Unrestricted Gravity	.063 (.057)

The Instrumental Variable

- Requires "… bilateral trade between countries i and j depends on bilateral gravity variables for i and j but not on gravity variables involving third countries …"
- Is *Remoteness* an Issue?
  - Remoteness as (inverse of) distance-weighted GDP
    - E.g., Head ("Gravity for Beginners" 2000)

Political Incorrectness

- Greece is a “member state participating in the Euro since Jan 1 2001”
- Guinea-Bissau is part of the CFA (joined May 1, 1997)

Minutiae

- The CIA currently shows 160 currencies
- The CFA is not in currency union with France/€; they're just pegged (at 655.957) and devalued in the 1990s (from 50 to 100 per ₣ (except for Comoros).
- The ECCA is not in currency union with the US; they're just pegged at 2.7 (4.8 per pound before 1976).