What Should Academics Tell Policy-Makers About Monetary Union?

Discussion of Coleman and Wyplosz

Andrew K. Rose

U.C. Berkeley, NBER and CEPR

Haas School of Business, University of California

Berkeley, CA USA 94720-1900

Tel (510) 642-6609; Fax (510) 642-4700

E-mail arose@haas.berkeley.edu; URL haas.Berkeley.edu/~arose

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Introduction

When I began to work on monetary unions a few years ago[1] it was rare for academics outside Europe to be interested in the subject, and highly unusual to find advocates of monetary union outside a few continental Europeans. Now it is almost the majority view. Accordingly, I find myself in a difficult position, since I agree with almost all of what Coleman and Wyplosz write. In particular, I agree with Coleman that monetary union for New Zealand makes a lot of sense, and I agree with Wyplosz that any broad monetary union for Asia is and should be a long way off.

Currently there seems to be an emerging consensus in favour of monetary union, at least for many small open economies. What are its roots? At a broad level, there are two: 1) the benefits of floating exchange rates have been over-stated, and 2) the benefits

[1] Quite a few, actually.

of monetary union have been understated. In my discussion, I will touch very briefly on the first, and review some of the most striking evidence for the second.

But I want to push the argument further. The academic arguments in favour of monetary union have remained … academic. Outside continental Europe and a few places in Central and South America, the political benefits of national monetary sovereignty are perceived to be high simply because the suggestion of abandoning the national money is usually met by the public with superficial scorn and mindless ridicule. At this point, academics should be persuading policy-makers to lower the perceived political benefits of a national money. Any debate on monetary union must leave the ivory tower of the academy; policy-makers must raise it publicly if the discussion is to be serious. Succinctly, academics should be trying to get policy-makers to raise monetary union to the level of national debate.

The Benefits of Floating Exchange Rates are Lower than usually Perceived

Floating exchange rates are said to provide insulation, and to be an additional tool of monetary policy. In practice, they just as often introduce shocks that have to be offset through other tools of economic policy. Rather than being part of the solution, they are frequently part of the problem. That's why so many countries seem to have a "fear of floating" in the memorable phrase of Calvo and Reinhart.

No one knows why floating exchange rates seem to be so volatile. Indeed, it is accurate to describe this problem as possibly the most important problem in international finance. But no one denies it. Exchange rates – at least of those low-inflation developed countries – seem to fluctuate in a way that is disconnected from macroeconomic "fundamentals" (money, income, prices, etc.) for significant periods of time; this is the famous finding of Meese and Rogoff (1983). Further, when the exchange rate is fixed – especially in a hard fix – this volatility vanishes from the exchange rate and does not reappear elsewhere in macroeconomic fundamentals, as Flood and I have shown. That is, eliminating exchange rate volatility seems almost to be a free lunch, a topic I have pursued in my work with Jeanne (2002). As a result, thinking about the exchange rate as an extra tool for macro management is starting to seem unworldly. There are exceptions of course; everyone knows how depreciation allowed Australia and Canada to stave off most effects of the Asian crisis. But those cases are … exceptions.

The Benefits of Monetary Union are Higher than usually Perceived

Much work has been done on monetary unions, usually from a theoretical viewpoint. Alesina and Barro (2000) are the latest word in the area, and apply a model that combines the best elements of Mundell's celebrated Optimum Currency Area criteria and more recent work on monetary discipline. From this long literature, one gets the reasonable view that monetary unions have both costs and benefits, but are usually inappropriate for most countries because of the imperfect synchronization of business cycles or inadequate adjustment mechanisms (sticky prices and wages, few risk-sharing mechanisms and so forth).

Three things are new. First, many view the standard criteria as inappropriate. Wyplosz convincingly shows that the standard optimum currency area criteria were essentially irrelevant for EMU. I prefer more generally to think that data such as the degree of business cycle synchronization are almost irrelevant, since they are based on historical data that would be irrelevant in the case of monetary union and the changes it induces, a subject I pursued in my work with Frankel.

Second and more importantly, the literature is now more empirical. It uses data on actual monetary unions to get some sense of their effects. For instance, in my (2000) paper I found that a pair of countries in a monetary union seems to have substantially higher bilateral trade, holding a host of other factors constant. The magnitude of this effect is interesting for two reasons: a) it is robust; and b) it is astonishingly high. As a result of such work – the final innovation – monetary unions are now viewed under a much more favourable light. Since monetary union seems to be associated with greater trade, but insignificantly different macroeconomic volatility, the case for monetary union seems stronger than it did a few years ago.

Attention is usually focused with an example. Before 1967 the New Zealand pound had been in a long-term 1:1 very hard fix with the UK which I will treat as a *de facto* monetary union for international commerce. This ended in 1967 when New Zealand abandoned the pound upon decimalization. As figure 1 shows, New Zealand's bilateral trade with the UK started to decline around 1967. In particular, the figure shows that the natural logarithm of NZ-UK bilateral trade (adjusted for inflation) had fluctuated around a constant level for the twenty years before 1967. However, the establishment of the NZ dollar and the associated exchange rate volatility vis-à-vis the pound coincided with the beginning of a long-term trend decline in trade between New Zealand and the UK.[2]

[2] This ocular result can be made more rigorous with simple regression techniques; the decline in UK-NZ trade is a statistically significant 3.7% per year after 1967 though no significant decline is present before 1967. Adjusting the log of trade through the "gravity model" of bilateral trade still results in a significant downward trend of 2.9% per year after 1967.

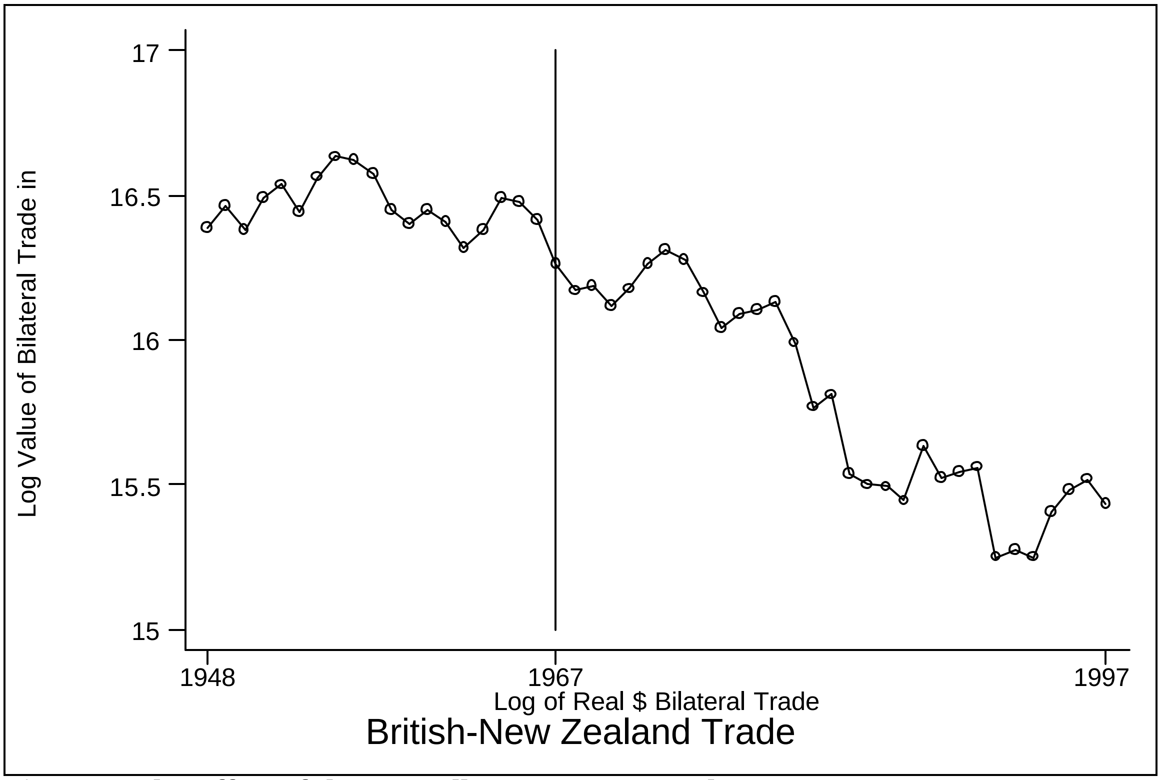

Figure 1: The Effect of the NZ Dollar on NZ-UK Trade

An accident? Hardly. My recent work with Reuven Glick exploits the 130 exits from currency unions in the 1948-1997 period using a large panel of IMF bilateral trade data.[3] Using only data on the countries that left or joined currency unions, we find that pair of countries that dissolve a currency union experience a halving of trade. This is true even after controlling for a number of other things such as preferential trade agreements and income which also affect trade. My work with Jeffrey Frankel shows that the trade boost associated with monetary union seems to have a large effect on real income.

There is of course a caveat associated with this work. It is based on actual currency unions that typically involve small and/or poor countries; thus any extrapolation

[3] The paper and associated data sets are freely available at my website.

to large rich countries is … extrapolation. EMU and the recent dollarizations in Ecuador, El Salvador and Guatemala will eventually enable us to quantify the effects of currency union more effectively. Still the debate is slowing shifting the onus proof towards the doubters of the benefits of monetary union.

De-mystifying the Concept of Monetary Sovereignty

Which brings me to my last point. Suppose the effects of EMU and dollarization turn out on net to be positive from an economic point of view. We as economists – whether academics or policymakers – will then have an obligation to contemplate the policy option of monetary union. The main problem at that point will almost surely be the mass hysteria that is associated with any suggestion that a country should surrender its monetary sovereignty. To say that most people find the thought of relinquishing the national money unpalatable is a gross understatement. One only need read a British tabloid, or count the number of European referenda on monetary union to realize how difficult it is to discuss monetary union sensibly on the national stage. The exceptions to the rule are just that; exceptions.

There are costs and benefits of monetary union. Coleman has provided us with a careful economic analysis as to whether it is in New Zealand's own interests to retain monetary sovereignty. Evidence like his may one day convince technocrats of the desirability of an ANZ monetary union. But even that very important step will mean little without proper preparation in the political sphere. It is time to try to begin educating the public so that any future discussion by the public on monetary union can be sober and thoughtful. Thinking the once unthinkable is a long slow process, as Wyplosz has shown. It is time in Asia to begin.

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