The Political Economy of Currency Unions

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ESCB Research Cluster II workshop, Bank of Greece, September 2022

The views expressed on the slides are my own and do not necessarily represent those of the ECB.

Summary

How to sustain a monetary union (MU) when member countries can, and—in some states of the world—may want to leave the union?

- Two-country model with country-specific technology shocks (Cole-Obstfeld specs)
- Benefit of MU: reduced trade costs; cost of MU: no national monetary policy
- Country exits MU (once and for all) when expected discounted value of cost exceeds expected discounted value of benefit

Summary c'td

- Monetary policy may alleviate cost, by putting more weight on stabilization objectives of member country that has incentive to leave the union
- In so doing, it has to make sure that the participation constraint of the other member country is not violated
- Paper finds that common interest rate policy is a rather blunt tool to maintain MU. Cross-country fiscal transfers are a more effective instrument.

Two instructive polar cases

1) Perfect positive correlation of shocks

- Interest rate policy of common central bank coincides with counterfactual policies of national CBs
- No incentive to leave the MU, and no need for policy to favor a member country

2) Perfect negative correlation of shocks

- If country 1 wants to leave MU, country 2 wants to leave as well
- Common monetary policy unable to sustain MU. But cross-country fiscal transfers remain a potent instrument (?)

Comments

- Topical paper
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- Topical paper
- I like the paper's approach, making simplifying assumptions in order to obtain sharp results, ...
- but I wonder whether the paper may underestimate the benefits MU membership in practice

Economic and political union

- Europe's MU is part of an (incomplete) economic and political union
- As such, it is likely that a disintegration of MU would also lead to a (partial) disintegration of the economic and political union
- Likewise, MU might foster (beneficial) economic integration
- Paper focuses on benefits of MU related to trade of consumption goods. In practice, labor markets, financial markets, production networks etc. would also be affected by disintegration of MU

Transition costs, and set of policy instruments

- Paper abstracts from transition costs of leaving a MU. These costs are likely to be non-negligible, and higher than those of leaving an exchange rate peg
- Paper considers two instruments—common interest rate policy and cross-country fiscal transfers—to sustain MU
- What about other instruments like central bank asset purchases, and national fiscal stabilization policies (which may be more effective in MU)?
- Is it nessecary to make *quasi-permanent* adjustments to monetary policy objective / fiscal arrangement in order to fight *temporary* incentive to leave MU?

Conclusion

- Very interesting paper on a policy-relevant topic
- Substantial sensitivity analysis
- I'm looking forward to the next draft