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Optimum Currency Areas and the European Experience

by

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Eastern and Middle European countries applying to join the European Union (EU), and perhaps ultimately the European Monetary Union (EMU), may well be inhibited by the “standard” theory of optimum currency areas. Indeed, prior to EMU, the vigorous debate on whether the collectivity of countries of continental Western Europe was an optimum currency area (OCA) saw more economists opposed than in favor. If a monetary union (or a regime of fixed exchange rates) were to succeed, standard OCA theory emphasized the importance of free labor mobility and the absence of asymmetric macroeconomic shocks. That is, business cycles across countries within an “optimum” currency area should not be out of phase.

Clearly, any individual Eastern or Middle European country would seem to face the same doubts about the net advantage of giving up national monetary independence. Migration of people and workers is not free. And each country seems to have its own peculiar economic problems with differing national industrial structures. Thus, a review of the current state of theorizing on optimum currency areas would seem to be in order.

Introduction

Forty years after Robert Mundell put forth his celebrated theory of optimum currency areas, the analytical consensus based on his celebrated 1961 paper has disintegrated. Part of the problem stems from a seeming contradiction in Robert Mundell’s own work. For offsetting asymmetrical macroeconomic shocks, his 1961 article leans toward making currency areas smaller and more homogeneous rather than larger and more heterogeneous. However, in a little-known article published in 1973, “Uncommon Arguments for Common Currencies”, Mundell argued that asset holding for international risk sharing is better served by a common currency spanning a wide area—within which countries or regions could be, and perhaps best be, quite different.

After reviewing both approaches, I will focus on extending Mundell’s argument for international risk sharing against supply-side shocks—shocks to productivity, to the international terms of trade, and so on. For specific classes of financial assets—money, bonds, and equities—I examine how the nature of the exchange rate regime, and associated currency risk, affect ex ante the incentives for international portfolio diversification.

Across nations or regions, my discussion of OCA theory will proceed on at least four levels:

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- (1) The long-standing debate on the optimum domain of fixed exchange rates in comparison to keeping them flexible when all currencies are treated symmetrically.
- (2) The asymmetrical role of a key currency in securing exchange rate stability within an optimum currency area.
- (3) The subordinate debate on whether one needs complete monetary union (as in continental Europe) to secure an optimum currency area's internal domain.
- (4) Even more subordinate is the important issue of whether a group of economies with close trade ties (as in East Asia) gain by collectively pegging to an outside currency such as the U.S. dollar.

To encompass all four levels of analysis, a general algebraic model is devoutly to be wished. For a noble attempt to provide one, see Devereux and Ching [2000a and 2000b]. Short of this, my paper addresses issues on each level—and provides a taxonomic analytical framework to show how they are inter-related. But first, let us re-examine the two Mundell models.

The Earlier Mundell with Stationary Expectations

Like most macroeconomists in the postwar period who had a Keynesian mind set, Mundell in 1961 believed that national monetary and fiscal policies could successfully manipulate aggregate demand to offset private sector shocks on the supply or demand sides—what Willem Buiter [1999, p. 49] called the “fine tuning fallacy”. Underpinning this belief was the assumption of stationary expectations. As a modeling strategy, he assumed that people behaved as if the current domestic price level, interest rate, and exchange rate (even when the exchange rate was floating) would hold indefinitely. Not only in his theory of optimum currency areas but in the standard textbook Mundell-Fleming model [Mundell 1963], stationary expectations underlay how monetary and fiscal policy work themselves out in an open economy. In several of his influential essays collected up to 1968, Mundell showed how the principle of effective market classification could optimally assign monetary, fiscal, or exchange rate instruments to maintain full employment while balancing international payments. He presumed that agents in the private sector did not try to anticipate future movements in the price level, interest rates, the exchange rate, or in government policy itself.

In addition to stationary expectations, Mundell [1961] posited that labor mobility was restricted to fairly small national, or even regional, domains. And these smallish domains could well experience macroeconomic shocks differentially—“asymmetrically” in the jargon of the current literature—from their neighbors. In these special circumstances, Mundell illustrated the advantages of exchange rate flexibility in what has now become the standard textbook paradigm:

Consider a simple model of two entities (regions or countries), initially in full employment and balance of payments equilibrium, and see what happens when the equilibrium is disturbed by a shift in demand from the goods in entity B to the goods in entity A. Assume that money wages and prices cannot be reduced in the short run without causing unemployment, and that monetary authorities act to prevent inflation.....

The existence of more than one (optimum) currency area in the world implies variable exchange rates..... If demand shifts from the products of country B to the products of country A, a depreciation by country B or an appreciation by country A would correct the external imbalance and also relieve unemployment in country B and restrain inflation in country A. This is the most favorable case for flexible exchange rates based on national currencies.

[Robert Mundell, 1961. pp. 510-11]

True, Mundell carefully hedged his argument by giving examples of countries that were not optimum currency areas—as when the main shocks in the terms of trade occurred across regions within a single country—rather than between countries. And he also worried about monetary “balkanization” into numerous small currency domains which might destroy the liquidity properties of the monies involved. Nevertheless, the economics profession enthusiastically embraced the above delightfully simple paradigm, often without Mundell’s own caveats. Textbooks took existing nation-states as natural currency areas, and argued that a one-size-fits-all monetary policy across nation states can’t be optimal when (1) labor markets are somewhat segmented internationally, and (2) when the composition of output varies from one country to the next, leading countries to experience terms-of-trade shocks differentially.

Following Mundell, McKinnon [1963] hypothesized that “openness” with potential currency-area trading partners would militate toward having a fixed exchange rate between them. He argued that the more open the economy, the less tenable would be the Keynesian assumption of sticky domestic prices *and* wages in response to exchange rate fluctuations. For a small open economy, he also worried that the liquidity value of the domestic money would be impaired if its exchange rate, and thus its purchasing power over a broad basket of world goods, fluctuated. He *should* also have made the case that the more open economies are to each other, the less asynchronous would be their output fluctuations arising from demand shocks—a case made empirically, and very neatly, in a recent article by Frankel and Rose [1998].

Also operating within Mundell’s 1961 framework, Peter Kenen [1969] looked at the conditions under which asynchronous macroeconomic shocks across countries would become less likely. If output were more diversified, Kenen concluded that the country in question would be a better candidate to have fixed exchange rates with its neighbors because shocks focused on this or that industry would offset each other in the aggregate—the law of large numbers. He concluded that

The principal developed countries should perhaps adhere to the Bretton Woods regime, rarely resorting to changes in exchange rates. The less developed

countries, being less diversified and less-well equipped with policy instruments, should make more frequent changes or perhaps resort to full flexibility.

Kenen [1969, p. 4]

Kenen's conclusion, that relatively undiversified less developed countries—often with just one or two dominant export products—should retain exchange flexibility, is consistent with the earlier Keynesian Mundell, who stressed asymmetric shocks in the face of internal price and wage rigidities. However, as we shall see, Kenen's conclusion is quite inconsistent with the later “forward-looking” Mundell [1973a] who emphasized the need to promote asset diversification for international risk sharing.

In the 1960s, Mundell—and almost all other economists—presumed that a flexible exchange rate would be a smoothly adjusting variable for stabilizing the domestic economy. At the time, this presumption was also shared by monetarists, such as Milton Friedman [1953] or Harry Johnson [1972], who were not macro fine tuners but who wanted domestic monetary independence in order to better secure the domestic price level. Whatever policy a central bank chose, they believed a flexible exchange rate would depreciate smoothly if the bank pursued easy money, and appreciate smoothly if the bank pursued tight money. (Because economists had very little experience—except for Canada—with floating exchange rates in the 1950s and 1960s, the great volatility in generally floating exchange rates after 1971 was unanticipated.)

Thus, in the 1960s, Mundell's “Optimum Currency Areas” appealed both to Monetarists and Keynesians, although for somewhat different reasons. As such, it became enormously influential as the analytical basis for much of open-economy macroeconomics, and for scholarly doubts as to whether Western Europe—with its diverse national economies and relatively immobile labor forces—was ready for a one-size-fits-all monetary policy.

In the 1990s, the outstanding scholarly skeptic of European Monetary Union (EMU) was Barry Eichengreen—whose many articles (with several co-authors) were consolidated in his book *European Monetary Unification* [1997]. He acknowledged Mundell's influence thus:

The theory of optimum currency areas, initiated by Robert Mundell (1961), is the organizing framework for the analysis. In Mundell's paradigm, policymakers balance the saving in transactions costs from the creation of a single money against the consequences of diminished policy autonomy. The diminution of autonomy follows from the loss of the exchange rate and of an independent monetary policy as instruments of adjustment. That loss will be more costly when macroeconomic shocks are more “asymmetric” (for present purposes, more region- or country- specific), when monetary policy is a more powerful instrument for offsetting them, and when other adjustment mechanisms like relative wages and labor mobility are less effective.

Eichengreen [1997, pp.1-2].

Eichengreen and Bayoumi [1993] had used an elaborate econometric analysis to show this asymmetry. “A strong distinction emerges between the supply shocks affecting

the countries at the center of the European Community—Germany, France, the Netherlands, and Denmark—and the very different supply shocks affecting other EC members—the United Kingdom, Italy, Spain, Portugal, Ireland and Greece.”(page 104, as reprinted in Eichengreen, *op.cit.*) Even today, the British press and many economists still argue that a one-size-fits-all monetary policy run from Frankfurt can’t be optimal for both continental Europe and Britain. After all, aren’t business cycle conditions in Britain sufficiently different to warrant a separate countercyclical response from an independent Bank of England? But whether sophisticated or not, writers in this vein—more recently Martin Feldstein [2000] in “Europe Can’t Handle the Euro”—are definitely in thrall to the earlier Mundell.

The Later Mundell and International Risk Sharing

In a not-much-later incarnation, Robert Mundell [1973a] jettisoned his earlier presumption of stationary expectations to focus on how future exchange rate uncertainty could disrupt the capital market by inhibiting international portfolio diversification and risk sharing. At a 1970 conference in Madrid on optimum currency areas, he presented two prescient papers on the advantages of common currencies. Perhaps in part because the conference proceedings were not published until 1973, these papers have been overshadowed by his 1960s masterpieces.

The first of these later papers, “Uncommon Arguments for Common Currencies”, is of great intrinsic interest because very early it emphasized the forward-looking nature of the foreign exchange market—which was then worked out in more analytical detail by his students: see, for example, Frenkel and Mussa [1980]. As such, it counters the earlier Mundell idea that asymmetric shocks—i.e., those where an unexpected disturbance to national output affects one country differently from another—undermine the case for a common currency.

Instead, Mundell [1973a] showed how having a common currency across countries can mitigate such shocks by better reserve pooling and portfolio diversification. Under a common currency, a country suffering an adverse shock can better share the loss with a trading partner because both countries hold claims on each other’s output. Whereas, under a flexible exchange rate without such portfolio diversification, a country facing an adverse shock and devaluing finds that its domestic-currency assets buy less on world markets. The cost of the shock is now more bottled up in the country where the shock originated. As the later Mundell puts it.

A harvest failure, strikes, or war, in one of the countries causes a loss of real income, but the use of a common currency (or foreign exchange reserves) allows the country to run down its currency holdings and cushion the impact of the loss, drawing on the resources of the other country until the cost of the adjustment has been efficiently spread over the future. If, on the other hand, the two countries use separate monies with flexible exchange rates, the whole loss has to be borne alone; the common currency cannot serve as a shock absorber for the nation as a whole except insofar as the dumping of inconvertible currencies on foreign markets attracts a speculative capital inflow in favor of the depreciating currency.

[Mundell, 1973a, p.115].

Mundell's second Madrid paper, "A Plan for a European Currency" [1973b], makes clear his early enthusiasm for the great European experiment. With the formal advent of the euro on January 1, 1999, the forward-looking Mundell of the Madrid papers "triumphed" over his earlier Keynesian incarnation as the originator of the theory of optimum currency areas. But he is intellectual father to both sides of the debate.

Updating Mundell's Risk-Sharing Argument: An Axiomatic Approach

In developing his formal model of risk sharing, Mundell [1973a] made no distinction among money, bonds, or equities. Indeed, his analysis proceeded as if the only financial asset was some form of money. And, he considered risks arising only on the supply side, i.e., where supply shocks affected national outputs differentially. In this context, the above risk-sharing argument is deceptively simple. However, as we shall see, if money is the only financial asset, i.e., no bonds or stocks, then risk sharing between two countries will still be incomplete—even when they are joined together by a common currency.

First, however, let us ask whether "full" international risk sharing from differential supply shocks—across regions or countries—is ever possible. Purely theoretically, one could imagine an Arrow-Debreu economy with a complete set of *cross-country* contingent claims, i.e., insurance contracts all specified in real terms. If country A experienced a shortfall in output from some specified natural disaster, then it would be compensated by country B—and vice versa. Similarly, if output increased fortuitously in country A, a contract would exist requiring its surplus to be shared with country B.

However, an Arrow-Debreu economy can't actually exist. Besides being inhibited by overwhelming complexity in writing such contingent contracts, any contracts actually negotiated would be fraught with moral hazard. In Arrow-Debreu insurance contracts, the precise meaning of every state of nature requiring a particular payoff would have to be prespecified. Otherwise, countries (the people in them) would slacken their work effort, reduce output, and try to exercise some (false) insurance claim on a neighbor.

Be that as it may, suppose these problems of complexity and moral hazard in writing such forward contracts could be overcome. That is, a full set of such state-contingent claims on real resources was actually negotiable both within the domestic economy and for trade with neighboring countries. Then money itself would become redundant! There would be no point in carrying cash reserves forward, whether in domestic or foreign currency. Nominal exchange rate arrangements, whether fixed or floating, wouldn't matter. In this complete Arrow-Debreu model, all current and future "real" resources would have been fully bartered in the first negotiating period.

Instead, the nature of financial assets available for sharing risk among nations needs to be carefully restricted. To maintain empirical relevance, let me propose the following set of three restrictive axioms that every model should satisfy.

- (1) *No claims contingent on states of nature*: Although private insurance markets exist at the microeconomic level, individual risks can largely be diversified away. Not so at the macroeconomic level when large supply shocks affect nations differentially.
- (2) *All financial assets are nominal*: That is, their only intrinsic value is monetary. There are no “real” (or indexed) bonds, national or international.
- (3) *Stable fiat money*: Monetary authorities strive—perhaps imperfectly—to stabilize the purchasing power of each domestic money in terms of a broad basket of consumable goods and services. In undiversified economies with just one or two major outputs, the authorities would look to a broad basket of importables as their price-level target.

These axioms are symbiotically related. As per Arrow and Debreu, stable money isn’t necessary if there are “real” bonds or a complete set of contingent claims on real output. We know, however, that in practice virtually no state-contingent bonds are actually issued, and that there are no private issues of indexed “real” bonds.

In contrast, broad markets for *non-contingent* nominal bonds, those whose payoffs are fixed in monetary terms without regard to states of nature, exist on a large scale—but only because buyers and sellers believe that the national monetary authority is committed to stable money. A holder of a fixed-interest nominal bond needs to be reassured *ex ante* that the bond’s purchasing power at face value is known—at least approximately. Otherwise, broad and deep long-term bond markets can’t exist.

Finally, theoretical models of open economies with just one, two, or even three goods naturally violate the stable money axiom. In such models, the domestic-currency prices of these few goods—often just one domestic good—vary substantially in response to some supply shock or exchange rate change. But that is inconsistent with having a determinate demand for each domestic money. People will only hold money if there exists a broad diversity of goods produced at home or abroad whose average price defines money’s purchasing power. (Obviously, I am ruling out highly inflationary economies as candidates for joining any kind of cooperative fixed exchange rate regime.) In a literal one-good economy, people would have no incentive to hold money.

Of course, our stable money axiom doesn’t rule out the possibility of major changes in the *relative* domestic prices of particular goods, or in international terms of trade, or (limited) exchange rate flexibility. But large discrete changes, or jumps, in the purchasing power of foreign or domestic money are ruled out.

Under these three restrictive axioms limiting the potential array of financial assets available (in comparison to the unlimited array in an Arrow-Debreu economy), what can be said about the possibilities for international risk sharing against supply side shocks under alternative exchange rate arrangements? To simplify the discussion, consider capital markets as if they contained just one financial asset at a time. I will consider money, bonds, and equities in turn.

Money and Official Exchange Reserves.

In the face of imperfectly correlated supply shocks, Mundell's original (1973a) theoretical argument—where “money” is the only financial asset—still holds. If two countries share a common currency, Mundell reasoned that the full stock of privately held money in country A could be exercised as a claim on country B's resources should A be hit with a sudden decrease in output—and vice versa. Under flexible exchange rates, however, privately held money in one country would not be an automatic claim on the resources of the other—at least not at par value.

In the absence of a common currency, however, governments could only ensure that the stock of privately held national domestic money would be fully convertible into foreign money at a fixed exchange rate by holding official exchange reserves—possibly on a large scale. Then, issues of national money would be fully backed by foreign-currency assets—as when one of them adopts a currency board.

But even if the domestic stock of narrow money, say M1, is fully backed by foreign exchange, it is simply not “big” enough for substantial international risk sharing. Ching and Devereux (2000a) derive this result more formally in the context of a model where money is the only asset in countries forming a monetary union. But it is intuitively obvious. The amount of narrow money individual firms and households wish to hold as domestic means of payment is small relative to their total stocks of bonds and equities—and even small relative to the economy's total stock of short-term liquidity. In the United States the stock of M1, currency and checking accounts, is less than one fifth of the total stock of private sector liquid assets (M3)—which also includes money market mutual funds, commercial paper, and short-term Treasury securities. And, narrower still, the American monetary base—currency and commercial bank reserves held with the Federal Reserve—is less than one half of M1 or only 5.4 percent of American GNP.

Clearly for financially sophisticated economies, a broader range of financial assets as vehicles for international portfolio diversification needs to be considered.

International Diversification in Bond Holdings and the Principal-Agent Problem

Let us define fixed-interest “bonds” very broadly to include virtually all financial assets that are neither narrow money (M1) nor equities. (Because their payoffs are variable, common stocks might be considered natural financial instruments for international risk sharing—and I shall consider them separately below.) Hence, our definition of a bond includes time deposits in banks and commercial bills as well as mortgages and corporate or government bonds.

A key aspect of the bond market is that most of the “bonds” held by households are not primary claims on ultimate borrowers. Instead, most of these claims are indirect claims intermediated through financial institutions—banks, money market funds, pension funds, insurance companies, and so on. And the size of these holdings is extremely large relative to narrow money. Under this broad definition, direct and indirect bond holdings are about 200 percent of GNP in the United States. Thus, if different regions (nations)

suffer from asymmetrical supply shocks to regional outputs, default risk in the bond market is potentially substantial.

In principle, however, much of this default risk can be shared through portfolio diversification across diverse regions. Indeed, in regions with just one or two products, uninhibited portfolio diversification by financial intermediaries representing domestic households would result in *most* of their bond-type domestic assets being claims on foreigners. But this need not result in a net outflow of capital. Foreigners would happily own most of the domestic bonds issued by any (small) single-product economy as long as the rest of their portfolios were well diversified outside of the economy in question—thus leading to compensating capital inflows. Indeed, the less diversified the local economy is in its output structure, the more it has to gain in risk reduction by being plugged into a broader bond market encompassing economies very different from itself.

However, there is trouble in this potential paradise. Unless these diverse economics units are securely connected by a common money, exchange rate uncertainty—i.e., currency risk—will inhibit the international sharing of default risks.

At first glance, it is not obvious why the presence of currency risk should inhibit international portfolio diversification by households and nonfinancial firms. On the contrary, isn't currency risk just another risk that domestic bondholders could diversify away? Indeed, if the future purchasing powers of various national monies were (symmetrically) uncertain, wouldn't risk-averse households in any one country be given additional incentive (beyond their concern for limiting default risks) to hold bonds denominated in foreign currencies?

But for international or even domestic risk diversification, households could hardly manage their own bond portfolios directly. They would lose all the well-known economies of scale, including expert information collection, associated with risk pooling by financial intermediaries. Thus, a household would prefer to hold general claims with a fixed monetary pay out which are, say, an indirect claim on a bank's loan portfolio. Similarly, households seeking insurance would prefer an annuity fixed in nominal terms rather than directly holding some pro rata share of the insurance company's assets.

Reflecting this strong empirical regularity, let us assume that all the holdings of "bonds" by households are indirect, i.e., general claims on a financial intermediary. Then the resulting *principal-agent problem* becomes the key to understanding why we observe so little international diversification in bond holdings across countries not joined by a common money. The household (the principal) cannot possibly monitor or control the individual investment decisions made by the financial intermediary (the agent). So it buys claims on the financial intermediary—such as a certificate of deposit—whose face value is fixed in monetary terms. And, in non-inflationary economies where foreign monies do not circulate in parallel with the domestic one, the simplest way of establishing the face value of the pay out, i.e., the intermediary's liability, is to choose the domestic money as the sole numéraire. Thus I hypothesize that *the fixed face value of bonds held by domestic nationals the world over is largely denominated in the local (national) currency.*

But households' demand to have their noncontingent assets fixed in the national currency poses problems for the financial intermediaries, who must eventually make good on these claims. Within the limited domain defined by the domestic currency, risk-averse intermediaries can freely strive to diversify their own asset portfolios to limit default risk. However, if they cross currency boundaries in making loans, they then find themselves in the uncomfortable position of having liabilities with fixed face values denominated in the domestic currency when (some of) their assets are denominated in foreign currencies. Thus, in the foreign exchange markets, if the domestic currency was suddenly to appreciate against all others, such a financial intermediary could easily go bankrupt. Whence various regulatory rules of thumb, especially for banks, that force them to hedge in order to limit the extent of their net foreign exchange exposure. Although short-term foreign exchange risk can be hedged at some cost, long-term holdings of foreign bonds are less amenable to being hedged. A British retirement pension fund with long-term annuity liabilities fixed in sterling would lean strongly to holding fixed-yield sterling assets at a similar long term to maturity.

The bottom line is that the presence of currency risk inhibits international portfolio diversification in bond markets designed to share default risks arising out of asymmetric supply shocks. Insofar as smallish regions are more specialized in what they produce and thus subject to idiosyncratic output shocks, they would suffer more from allowing their exchange rates to float. Under flexible exchange rates, the inability of a small region to diversify away its default risks could lead to a higher risk domestic risk premium in the whole structure of its interest rates.

But much of the literature on optimum currency areas has argued just the opposite. Besides Peter Kenen quoted above, other authors have questioned whether regions or nations that are highly specialized in production should give up control over their own monetary policy and exchange rates. As Jeffrey Frankel (1999) has pointed out, Barry Eichengreen [1992] and Paul Krugman [1993] have gone one step further and worried that even a successful monetary and economic union may become less of an optimum currency area through time as its regions naturally become more specialized in what they produce. Eichengreen and Krugman point out that industrial production is now much more specialized across American states than across European nation states—and that the latter will become more specialized as a result of the very success of European Economic Union. As reported by Frankel [1999], Eichengreen and Krugman are essentially claiming that an economic entity might fail the criteria to be an OCA *ex post*, even if they had passed *ex ante*. Indeed, Krugman suggests that

Theory and the experience of the of the United States suggest that EC regions will become increasingly specialized, and that as they become more specialized, they will become more vulnerable to region-specific shocks. Regions will, of course, be unable to respond with counter-cyclical monetary or exchange rate policy.

[1993, p. 60]

Clearly, Eichengreen and Krugman were (are?) still in thrall to the 1961 Mundell and the fine-tuning fallacy. But once risk-sharing through portfolio diversification in bond holding is properly weighed, the case for a monetary union becomes even stronger as the constituent parts of the underlying economic union become more specialized in

what they produce. Presumably, the productivity gain from greater regional specialization is one of the major benefits of having an economic cum monetary union in the first place!

Currency Asymmetry: The Center and its Periphery

Because some countries are small and thus naturally more specialized in what they produce, we hypothesized that they have more to gain from economic specialization if complemented by the uninhibited two-way portfolio diversification made possible by a large currency area. Among diverse countries, risk in each country could thereby be reduced. In line with past theorizing on optimum currency areas, we made no further distinctions between “strong” and “weak” currencies.

However, size and degree of specialization are not everything. Within any international monetary system with a *mélange* of national currencies, a natural asymmetry will develop. One national money becomes the vehicle or Nth currency for facilitating international exchange and reducing inter bank transactions costs among the other N currencies (Mundell 1968, McKinnon 1979). In the aftermath of World War II, the U.S. dollar played, and still plays, this facilitating role in the world economy at large. (Now, the major exception is the quasi independent monetary domain of the newly created euro—including its periphery of small economies to the east.) Once established in this facilitating role, economies of scale and network effects are sufficiently strong to preserve the Nth country’s central position “indefinitely”.

This currency asymmetry may involve more than simply facilitating foreign exchange transactions among banks. Because this Nth currency will also be widely used in invoicing foreign commodity trade, the other N–1 countries will attempt to anchor their own price levels by pegging to the central currency if its purchasing power is stable, i.e., the center country has succeeded in stabilizing its own price level. Having this common *nominal anchor* is also a way of establishing mutual exchange rate stability in any region where trade with neighboring countries is important. In the 1950s and 1960s, the dollar played this anchoring role in Europe and elsewhere. But, because the dollar’s purchasing power depreciated (dollar price inflation was high) in the 1970s into the 1980s, within the EU this central anchoring role shifted to the deutsche mark—whose purchasing power was then more stable than the dollar’s.

Is this key-currency approach to fixing exchange rates a satisfactory way of implementing an optimum currency area? Having the EU be a deutsche mark zone was all well good for imparting greater domestic price-level and exchange-rate stability among its members. However, this key-currency approach has a serious drawback. The distinction between a strong central currency and weaker ones on the periphery is aggravated beyond what the underlying “fundamentals”, e.g. lower previous inflation in Germany than in Italy, would warrant. The asymmetry in the exchange rate arrangements themselves magnifies (aggravates?) the distinction between a strong central money and weaker ones on its periphery—whether within pre-euro Europe with the old deutsche mark, or in the rest of the world today with the dollar.

Because the central money becomes the definitive (or ultimate) means of payment in the system, it also takes on the quality of being the safe haven asset into which people fly when macroeconomic equilibrium in any of the peripheral countries is disturbed. This currency asymmetry means that, other things being equal, risk premia on bonds denominated in any of the peripheral currencies issued by non creditor countries will be higher—and likely the term structure of finance will be shorter—then for bonds denominated in the currency of the central country. And this asymmetry naturally reinforces itself. Because periodic capital flight into the center country destabilizes the demand for any peripheral country’s currency, macroeconomic management on the periphery is more difficult. Forced devaluation is an ever-present threat.

Conversely, macroeconomic management in the center country itself becomes easier. When there is trouble at home, domestic nationals see no more fundamental asset into which they want to fly. If its authorities make mistakes or are confronted with some unexpected macroeconomic upheaval, they have a much longer line of credit with the rest of the world that relieves pressure to devalue the currency. For example, to help finance the huge fiscal deficits arising from German reunification in 1991, Germany could automatically draw on a long line of credit from other European countries because they were all part of a deutsche mark zone.

Indeed, bonds issued by the center country—such as U.S. Treasuries for the dollar zone, i.e., everywhere but Europe—are widely accepted as the “risk free” asset in the international capital markets. Sovereign and private bond issues from countries outside the United States are rated, by Moody’s or Standard & Poor, relative to U.S. Treasuries. Concomitantly, risk premia in medium and long-term interest rates are measured against those on U.S. Treasuries as the benchmark. Risk premia on shorter term financial instruments are measured against the London interbank offer rate (LIBOR) on dollars. Thus the United States collectively can, if it so chooses, sell dollar denominated claims on itself to foreigners on a net basis almost indefinitely—as per the ongoing American current account deficit of the last 20 years (McKinnon 2001b).

In contrast, any heavily indebted “peripheral” country typically cannot borrow internationally in its own currency without paying a high risk premium in its interest rates. And any build up of foreign currency liabilities (usually in the key currency, i.e., dollars) must be finite. Otherwise, if repayment of these dollar liabilities comes into doubt, the peripheral country will find its own currency under attack.

The upshot is that the relative ease with which the country issuing the key or central currency can borrow in international capital markets makes it easier to maintain price stability at home. This then strengthens its reputation as a safe haven relative to its periphery—thus completing a virtuous circle. But currency asymmetry for the system as a whole is exacerbated. The peripheral countries are left with residual exchange rate uncertainty and higher interest rates. Thus, in an optimum currency area using a key currency to fix exchange rates, international portfolio diversification in the capital market—particularly the bond market—is still impeded—albeit less so than if exchange rates fluctuated freely.

EMU and the Euro-denominated Bond Market

Systematically testing these ideas empirically is a major task far beyond the scope of the present paper. However, the great natural experiment—the abolition of 11 national currencies in Europe in favor of the euro on January 1, 1999—is very revealing.

Within Euroland, private euro-denominated bond issues grew explosively after January 1, 1999. Overall euro bond issues in the first half of 1999 were 80 percent higher than a tabulation of all bond issues in the old legacy currencies for the first six months of 1998 (Capital Data, 1999). Most strikingly, issues of euro-denominated *corporate* bonds were almost four times as high in 1999 as compared to 1998. Why the startling difference?

In the pre-euro regime, the D-mark was king—the central or safe-haven European currency for the group. In effect, Europe was on a common monetary standard based on a key currency where other European countries tried, with some uncertainty, to maintain exchange rate stability against the mark. Thus, private corporations in European countries on Germany's financial periphery—such as Italy, Portugal, and Spain, which mainly issued bonds in lire, escudos, and pesetas respectively—suffered currency risk relative to German issuers of mark-denominated bonds. The resulting risk premia, i.e., higher interest rates particularly at longer term in these “club-med” countries kept finance short term and largely bank based. For example, in the early to mid 1990s, interest rates on Italian lire-denominated bonds were as much as five percentage points higher than those on German mark-denominated bonds.

After 1 January 1999, the extinction of these risky “peripheral” currencies has allowed previously hobbled Italian, Portuguese, Spanish (and even French?) firms to lengthen the term structure of their debts by issuing euro-denominated bonds at much lower interest rates—now close to those paid by German firms—while escaping from the clutches of their bankers. European banks, in turn, are madly consolidating—although unfortunately only at the national level. Even the highly indebted governments of the club-med countries, albeit under the constraint of the Maastricht Agreement, can roll over their large government debts (now denominated in euros) at interest rates within a half a percentage point or so of those paid by the German Federal Government.

The *demand* for longer-term euro denominated bonds also increased. European insurance companies and pension funds as well as banks had been confined to keeping the bulk of their assets denominated in the home or domestic currency in order to match their domestic-currency liabilities. But with the move to a common, and for the formerly peripheral countries, a stronger currency, these financial institutions became free to diversify and acquire euro-denominated assets on a Western Europe-wide basis—and from foreigners who are willing to sell euro-denominated bonds in the newly created market. Thus is the term structure of corporate finance in Western Europe being lengthened with the lower interest rates reflecting lowered overall portfolio risk.

In summary, in encouraging risk sharing through portfolio diversification in international bond markets, preliminary evidence from the great Western European experiment suggests that—on both the demand and the supply sides—a common

currency may be considerably better than a common monetary standard based on a key currency. In middle and eastern Europe, countries now use the euro itself as a key currency for securing exchange stability. Although the greater price-level stability and mutual exchange rate security from such a policy are still substantial, the full benefits of international bond-market diversification will have to wait until these countries become part of Euroland.

Stock Markets and Home Bias

An enduring empirical puzzle in the finance literature is why owners of common stock appear to diversify much less internationally than what a proper risk-return trade off based on the capital-asset pricing model (CAPM) would predict. Karen Lewis [1999] nicely reviews this huge literature. But what is striking, at least to this author, is how little emphasis was given to currency risk per se in explaining home bias.

In computing historical means, variances, and covariances of returns to holding foreign stocks in comparison to American, authors typically translate everything into dollar terms at the exchange rate prevailing during the period over which the foreign returns were calculated. In these econometric studies (often quite elaborate), industry risks are thereby completely melded with exchange rate risks.

However, absent currency risk *within* a country like the United States, the stock market ideally distributes capital across industries according to their expected returns and risks vis-a-vis the general market. Highly paid analysts specialize in particular industries to estimate the future risk and return of industry X against the general market, and then disaggregate further to pick winning firms within that industry. In the absence of stock market bubbles and crashes, all this is well and good for increasing industrial efficiency.

Now take such a group of domestic industry specialists and broaden their range to study the same industries in a foreign country, with its own monetary regime, as well as those at that home. In picking winners abroad compared to at home, exchange rate risk now tends to reduce the effective expertise of our industry analysts. Noise is introduced into the information set within which they normally work because their profit projections have to be translated back into dollars through the uncertain exchange rate.

And this noise problem is not easily resolved by hiring foreign exchange specialists to project the future course of the exchange rate. Because a floating exchange rate between any pair of industrial economies moves like a random walk, the rate can't be predicted with any accuracy.

The upshot is that expert industry analysts and portfolio managers tend to pull in their horns and recommend, for any one industry, lesser holdings of those common stocks denominated in foreign currencies than in the domestic currency. In the aggregate across all industries, therefore, holdings of foreign stocks will be less than a purely mechanical application of an international CAPM model would project. This loss-of-technical-expertise argument is probably not the only reason for home bias in international equity holdings, but it is a leading candidate.

Considering money, bonds, and equities together, what can we conclude about asset diversification to deal with asymmetric supply shocks across regions or countries? Clearly, under floating exchange rates, currency risk will undermine international risk sharing and diminish cross-holdings of all three financial assets. But even a credibly fixed exchange rate between any pair of countries will still leave a residual currency risk because of the “natural” currency asymmetry that develops. Full asset diversification by risk-averse financial intermediaries with narrow profit margins will still be inhibited. Only a common money will convince financial intermediaries to diversify as freely across national boundaries as they do across regions in the same country—as what the later Mundell (1973a) wanted.

Aggregate Demand Shocks: A Further Taxonomy

The earlier and more Keynesian Mundell (1961) focused on asymmetric demand shocks and the need for counter cyclical macroeconomic policies: “Suppose demand shifts from the products of country B to the products of country A.....with the need to allow an appreciation of B’s currency to restrain aggregate demand in B—and a depreciation of A’s currency to stimulate it in A”. But under what circumstances are such asymmetrical demand shocks likely to occur?

Diversified Industrial Economies: Suppose A and B were highly diversified industrial economies, say, Germany and France, each producing thousands of goods with a huge overlap in product lines. Could consumer preferences suddenly shift in the way the quotation from Mundell implies? It is difficult to imagine that consumer preferences would suddenly shift en masse away from thousands of French goods in favor of thousands of German goods. The law of large numbers in product diversification would be overturned. One could, perhaps, imagine a narrower demand shift away from autos toward motor cycles—but this would not be particularly country specific. Thus, for diversified economies, the need for exchange rate flexibility to offset volatility in consumption preferences is negligible.

Apart from pure shifts in consumer preferences, there is another kind of “demand” shock which economists, e.g., Harry Johnson [1972], used to believe would warrant an exchange rate adjustment. Suppose country A began to inflate aggregate demand so as to create incipient (or actual) inflation. An ongoing depreciation of A’s currency could accommodate this to avoid a loss in A’s international competitiveness while obviating the need for domestic disinflation and a possible rise in unemployment. But, with the death of the Philips Curve, we now know that such accommodation would violate the principle of time consistency in policy making—and simply lead to further instability. Unless the country in question has a chronic need for revenue from the inflation tax, better that it be forced to disinflate to maintain the exchange rate.

This dilemma, to deflate or not to deflate to maintain economic competitiveness with one’s trading partners, only arises because they have separate monetary regimes. Under a common currency, differential rates of inflation could not persist.

Undiversified Economies: Particularly for primary products producers with unstable terms of trade, the argument is often made [see Kenen 1969] that countries retain exchange rate flexibility—devalue when the terms of trade turn against you—in order to ameliorate the resulting income fluctuations. But this view has several problems.

First, tying the exchange rate to the fortunes of one or two primary products would undermine private portfolio diversification and international risk sharing—as described above. Foreigners would not want to hold financial claims on the domestic economy if they knew the exchange rate was volatile. And this reluctance would make it difficult for domestic nationals to hold financial claims on foreigners without the economy as a whole running (an expensive) current account surplus, i.e., allowing net capital flight.

Second, the liquidity value of the domestic money itself could be impaired. If only one product was produced domestically—say, coffee—and the purchasing power of domestic money was tied to the price of coffee, people would opt to hold foreign currencies for domestic transacting. In an economy producing one or two exports but importing a broad basket of goods of all kinds, the natural way of satisfying our stable money axiom is to peg your currency to that of a highly diversified trading partner. Otherwise workers would be reluctant to accept wages specified in term of domestic rather than foreign money.

The Endogeneity of the OCA Criteria. The presence of asynchronous demand shocks, or asynchronous income fluctuations more generally, could well diminish as trade integration increases. Of course, under a common currency, asynchronous demand shocks would be quite minor because of the disappearance of separate national monetary policies. As Jeffrey Frankel [1999 p. 24] puts it for nascent monetary unions “The OCA criterion might be satisfied ex post even if not ex ante”.

But short of adopting the rather draconian solution of forming a monetary union, Frankel and Rose [1998] show that trade integration itself reduces the extent to which income fluctuations are uncorrelated, i.e., are asynchronous. For 21 industrial countries from 1959 to 1993, they first computed correlations of income changes between every pair of countries. They then regress these correlation coefficients on a measure of trade integration for each pair. Across their 21 countries, higher trade linkages are associated with higher correlations in income fluctuations. In effect, globalization, in the form of greater trade integration, seems to be pushing the world towards being potentially one giant optimum currency area with, ideally, a single common money. But see below.

Summing Up

There are only two good reasons why any country *not* be on a common-currency regime or a common monetary standard with its trading partners. (A common monetary standard is one of highly credible fixed exchange rates but national monies remain in circulation. The late 19th century gold standard is a good example—as are the key-currency regimes described above.)

First, a country could not participate in either a common-currency regime or a common monetary standard if its own public finances were too weak. If its government needs to retain control over issuing its own currency in order to extract more monetary seigniorage from the financial system—possibly through inflation—than a common-currency regime would permit, then no fixed exchange rate regime is feasible or advisable. More subtly, by owning its own central bank, the government becomes the preferred borrower in the national capital markets. Because the government alone owns the means settlement on interest-bearing debt denominated in the domestic currency, it can float public debt at the lowest interest rates in the domestic capital market [McKinnon, 1997]. This preferred access to the domestic bond market also allows the national central bank to act as a “lender-of-last resort” for domestic commercial banks.

Clearly, several Eastern and Middle European countries do not yet have sufficient fiscal and financial control domestically to allow them to give up their national central banks in order to join a broader monetary union. And, as Mario Nuti (2000) suggests, adopting a currency board may not be a satisfactory half way house: the country loses control over its national central bank without yet gaining access to the discount window of the central bank for the broader monetary union.

Second, no sufficiently stable monetary standard exists in the rest of the world. Natural trading partners, by the OCA criteria, are themselves not stable in a monetary sense. The now 12 members of Euroland took several decades of intense bargaining over economic integration and mutual fiscal constraints before the stage was set for the European Central Bank (ECB) to credibly issue a common currency. However, because the euro is now firmly established as a stable European monetary standard, the much smaller Eastern and Middle European countries now have more incentive to join it.

At the present time, the political will for full-scale economic and monetary integration with neighboring countries simply doesn't exist elsewhere. With less demanding political requirements, however, a common monetary standard based on a key currency might be able to achieve much—although not all—of the benefits of a common currency [McKinnon 1996]. A successful common monetary standard requires two key interrelated conditions

- (1) Over a long future time horizon, there exists some credible anchoring mechanism so that countries which attach themselves to the standard succeed in stabilizing the purchasing powers of their national monies; and
- (2) most countries, particularly close trading partners, attach themselves convincingly to the same standard.

The gold standard's great advantage was that it was international. By the late 1870s, most economies that were significant international traders had adopted it. Moreover, it provided a credible anchoring mechanism for national price levels until interrupted by World War I in August 1914. This lack of persistent inflation and the gold standard's universality meant that exchange rates were credibly fixed and capital markets were remarkably well integrated from the 1870s to 1914. The gold standard's great drawback, of course, was recurrent liquidity crises from runs on gold—which was a principal reason for the advent of the Great Depression of the 1930s.

In the modern period, the U.S. dollar serves as a (quasi) monetary anchor for most countries outside of Europe. It has the great advantage over the 19th century gold standard of being a fiat managed currency—and, in the modern period, not itself subject to runs or liquidity crises. However, the dollar standard has major drawbacks.

First, although informal pegging to the dollar is widespread in Asia, the Americas, and much of Africa in the short run [Calvo and Reinhart, forthcoming], these exchange rate pegs are “soft” and lack credibility—particularly over the long term. In contrast, gold mint parities in the 19th century were highly credible on a long-term basis—although occasional short-term suspensions could occur. But it is the long-term credibility in exchange rate parities which was the key to the remarkable integration of capital (mainly bond) markets in the late 19th century [McKinnon, 1996].

Second, the modern dollar standard is not universal enough in securing stable exchange rates. Argentina pegs strongly to the dollar, but other members of Mercosur do not. So even if one considered Mercosur to be an OCA, Argentina can still be upset by Brazil suddenly devaluing. Similarly, in the increasingly integrated East Asian economies before the 1997 crisis, all countries except Japan had been informally pegged to the dollar. However, because of weak or non-existent commitments to maintain their dollar exchange rates in the long run, they were all vulnerable to inadvertent “beggar-thy-neighbor” devaluations. But the desire for a common monetary standard in East Asia remains strong. After the 1997-98 crisis, most East Asian countries resumed informal dollar pegging in 1999 and 2000 [McKinnon, 2001a].

In conclusion, outside of Euroland and the drive for “euro-isation” in Middle and Eastern Europe, the best interim hope for regional OCAs like East Asia or Latin America is to recognize the inevitability of dollar predominance and work toward rationalizing the rules of the dollar-standard game [McKinnon 1996 and 2001a]. But that is a story for another time.

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