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.

  o Examples: Denmark, Sweden, UK, in €-land
  
  o 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
  o But imposes unity on GDP product on gravity (rejected)
  o 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**

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<td><strong>Unrestricted Gravity</strong></td>
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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 F (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).