EUROPEAN CENTRAL BANK

EUROSYSTEM

Deciding to Enter a Monetary Union:

The Role of Trade and Financial Linkages

By Ruy Lama and Paul Rabanal (IMF)

Discussion by Francesco Paolo Mongelli (ECB)

This sophisticated and well-written paper is welcome in that it provides a rich estimated DSGE framework with which to assess the merit of adopting the euro.

- ❑ This may be useful for the UK, but perhaps also for other countries?
- ❑ Although many stress how unlikely UK entry into the euro area is at the moment, or even in the medium term.
- ❑ In fact, some think that an exit from the EU – however unlikely and unfortunate it might be -- is still likelier than entry in the euro area.

Be as it might, Lama and Rabanal cite in rapid succession the optimum currency area (OCA) theory, the Costs & Benefits analysis, and the "5-UK Councellor Tests".

In my discussion I provide some comments about:

- ❑ conceptual framework behind the paper
- ❑ 5-Tests and choice of specific Benefits and Costs examined
- ❑ Similarity of economic structures and exchange rate as a policy instrument
- ❑ The choice of estimation period
- ❑ Then make a few suggestions for extending this line of inquiry.

The crisis has represented a massive disruption, and the response to the crisis is huge a discontinuity. In my view a new regime in a new environment is taking shape.

1^{st} Comment: About the conceptual framework

At its most basic level the optimum currency area theory is about openness, flexibility and correlation. Euro area countries need to be:

- ❑ **“open” vis-à-vis each other** in terms of trade in goods and services, as well as financial integration. This reduces the usefulness of national exchange rates;
- ❑ **“flexible” in terms of domestic prices and costs** of production, but also labour markets. Flexibility is enhanced by “sound” labour market institutions, participation, R&D and innovation, and fiscal room for manoeuvre; and
- ❑ **“correlated” with each other →** implies absence of persistent and irremediable divergence. It is promoted by low and similar inflation rates, diversified production and consumption, high openness and flexibility, and broadly similar policy preferences.

Despite its popularity the OCA theory is rather complex.

- There is no unifying framework
- Its difficult to draw normative implications

2nd Comment Heterogeneous 5 Tests (HMT 2007):

Test 1. **Are business cycles and economic structures compatible so that we and others could live comfortably with the euro interest rates on a permanent basis?**
→ This is an OCA question

Test 2. **If problems emerge is there sufficient flexibility to deal with them?**
→ This is also an OCA question

Test 3. **Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?**
→ Yes, in post-crisis new EMU with new political economy and governance.

Test 4. **What impact would entry into EMU have on the competitive position of the U.K.'s financial services industry, particularly the City's wholesale markets?**
→ It depends, as I will argue next…

Test 5. **In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs? → It depends, as I will argue next…**

Tests 3, 4 and 5 are more about the Benefits & Costs of joining a monetary union: which is a more pragmatic and nuanced field. ***Says who?***

3rd Comment. "…if the pros outweigh the cons…."

In an old IMF Staff Paper, Ishiyama (1975) postulated that each country should evaluate the benefits versus the costs (B vs C) of participating in a monetary union from the point of view of its own self-interest and welfare ***("…if the pros outweigh the cons….")*.**

Yet, there is no all-inclusive welfare analysis to estimate the net benefits from sharing a single currency. Rather, a variety of tools is employed to gauge partial views.

According to conventional wisdom, the B vs C analysis is rather straightforward:

- Macroeconomic costs of losing influence over macroeconomic stabilisation, due to the loss of direct control over monetary policy and the exchange rate, is set against
- Gains in terms of improved microeconomic efficiency and trade deepening.

❑ Lama and Rabanal add to these two factors a financial stability dimension.
❑ They add financial stress as reflected by corporate risk premia under two scenarios:
  - halving of volatility versus
  - financial turbulence → see my next comments.

In reality, Benefits & Costs are more varied, and sometime complex, than that: let me briefly show that picking the above 3 doesn't exhaust the list.

Among main expected benefits from Monetary Union:

B.1 Improvements in microeconomic efficiency

- an increased usefulness of money due to network externality
- **Greater price transparency and possibly competition and efficiency**
- Disappearance of nominal ER uncertainty with positive effects on trade
- **Supports deeper financial integration**

B.2 Improvements in macroeconomic stability (once out of the crisis and with new political economy)

- Anchored inflation expectations
- **Resilience to external developments and shocks: now also with ESM & SSM/SRM**
- **Financial market based risk-sharing (once out of crisis)**

B.3 Benefits from the international role of the euro.

- Benefits from the worldwide circulation and use of the euro

Lesson from crisis: net benefits & costs also hinge on the solidity of EMU's new institutional framework.

Among main expected costs:

C.1 Deterioration in microeconomic efficiency.

- various changeover costs
- losing control over the "inflation tax".
- Psychological costs from a new numeraire

C.2 Costs from decreased control over macroeconomic stabilization.

- **Loss of direct control over monetary policy and exchange rate.**
- Common fiscal restraints/rules (challenging even in the best of times!)
- Risks of financial crisis and spillover effects and contagion are higher without a federal budget, but now there are backstops
- EMU can withstand significant gains and losses in competitiveness

C.3 Costs from adverse external effects.

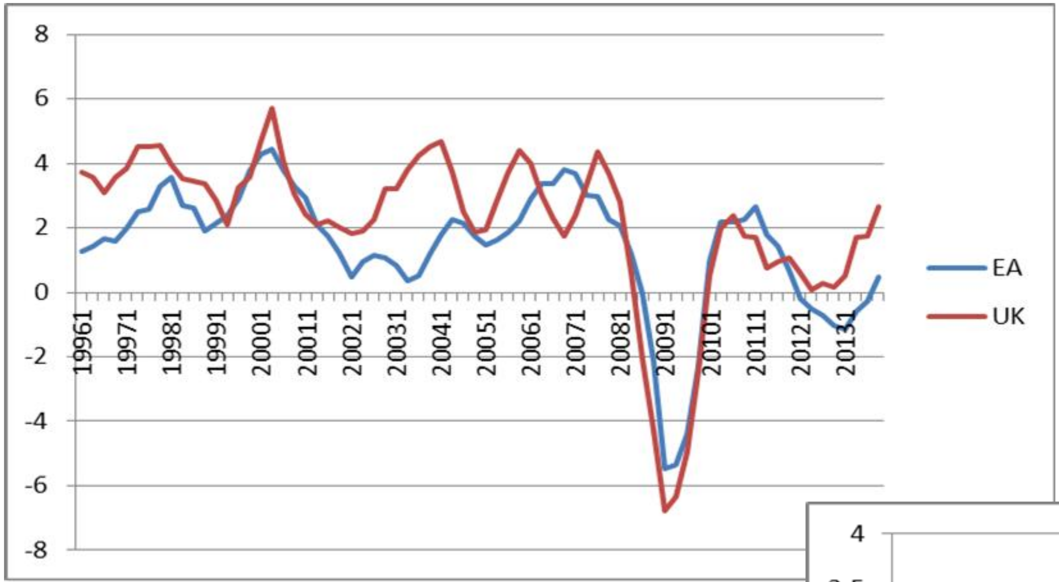
- Pecuniary externalities if other euro area partner countries run persistent and sizeable CA deficits or surpluses, and exchange rate appreciates or depreciates unduly
- loss of direct control of shares of national foreign exchange reserves

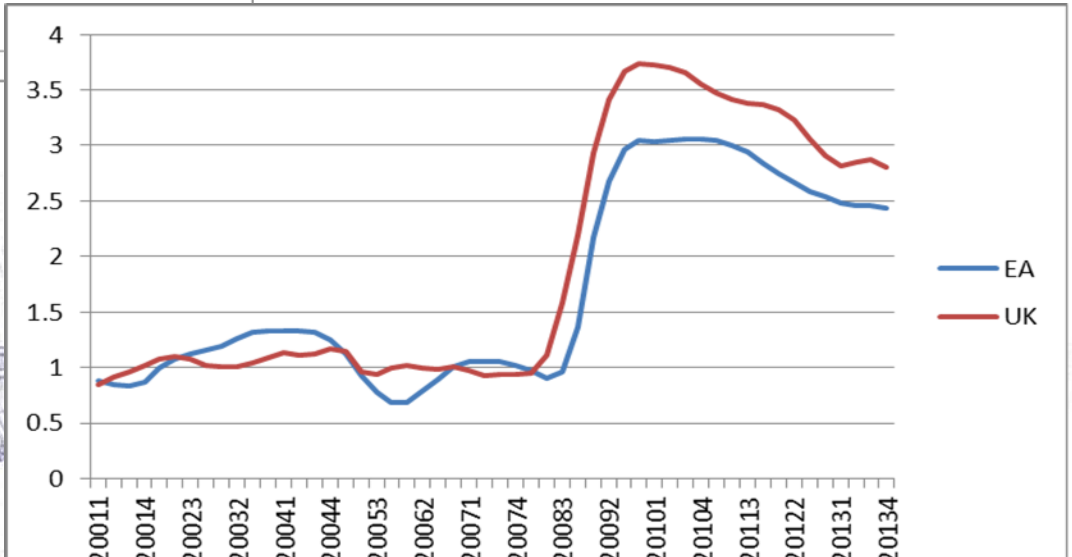
Thus, when judging upon UK entry we may want to look at more stuff.

Lesson: when future financial crisis or adverse shocks occur, the "EMU-framework" should permit them to be absorbed and managed with as little financial stress – and contagion - as possible.

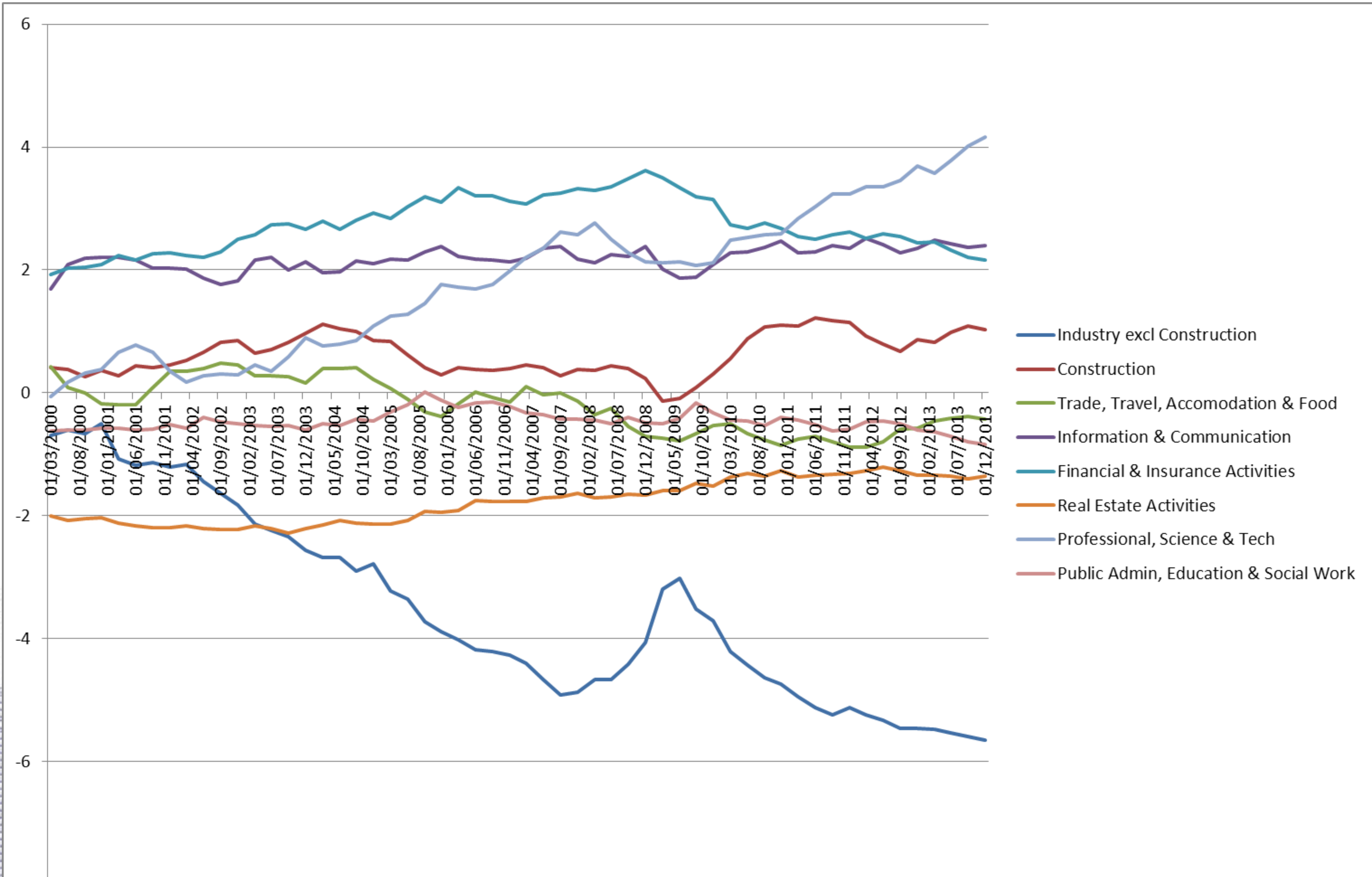
4th Comment. How similar are economic structures?

- You suggest that *"… parameter estimates are not so different across UK and euro area, suggesting that economic structures are quite similar".*
  - Yet what do we see?
  - Relative business cycle synchronization, but also higher volatility.



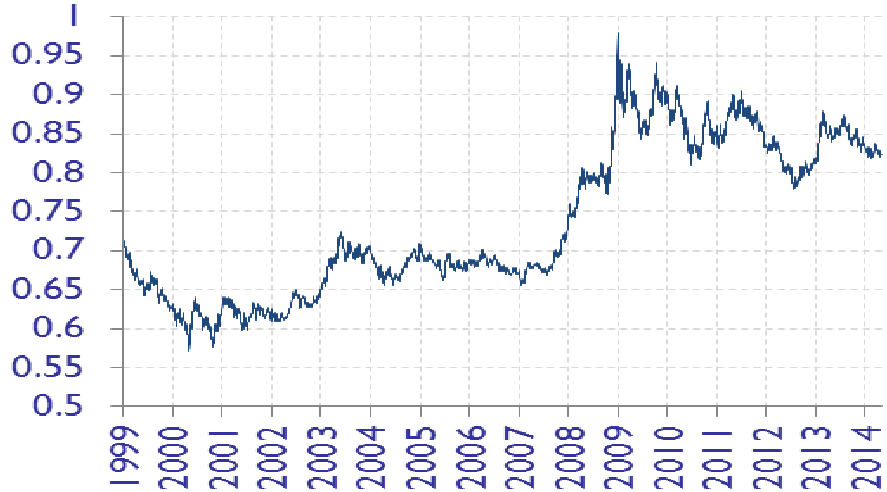


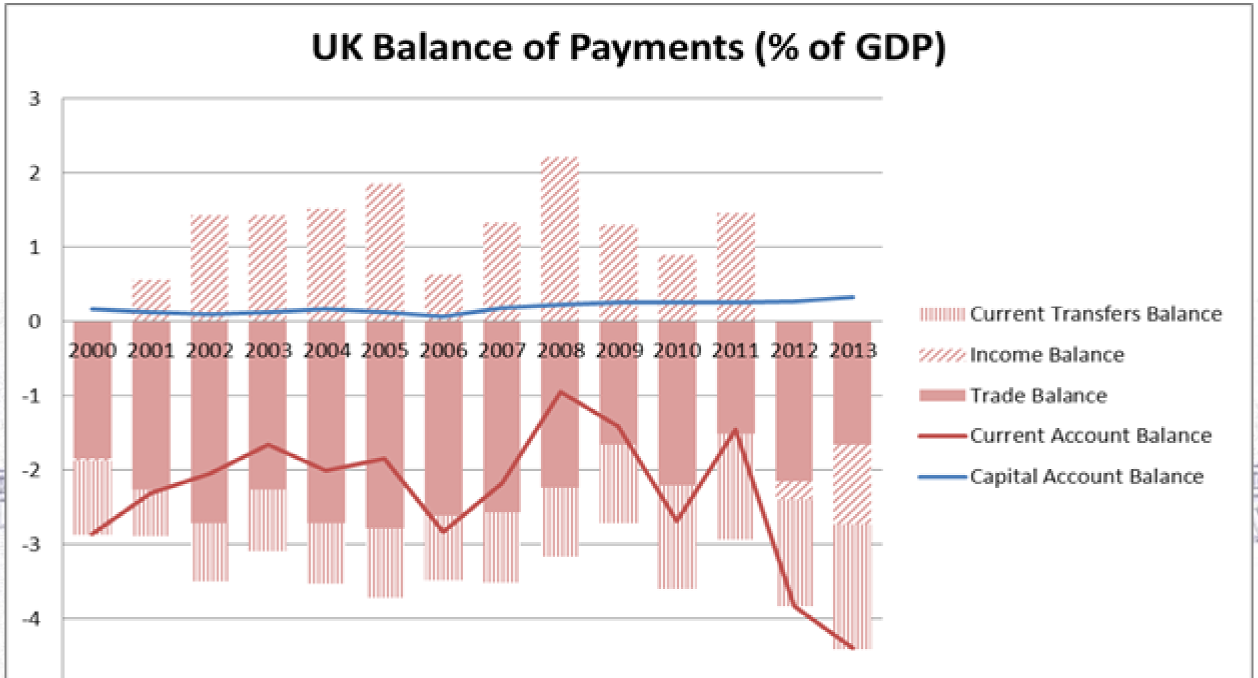
May be higher UK volatility is not that relevant because euro area data are averages across many countries: thus let's go a step further and look at sectors.



5^{th} Comment. What's the exchange rate doing?

What is happening? The UK is becoming a service economy, and despite exchange rate depreciation it is running substantial and persistent CA deficits





6^{th} Comment. Some comparisons are difficult.

- UK running substantial ***Twin-Deficits*** (also a budget deficit of around 5.0-5.5% of GDP),
- Its economy is less differentiated and, ceteris paribus, may be subject to different shock than average euro area because of specialization.
- Instead, euro area suffers from heavy legacy from crisis, still high leverage and low growth, but is reforming itself. Financial spreads are narrowing, there is stabilisation although we are not out of the crisis.

- So at best we are dealing with 2 convalescing patients that are not yet on their feet
- In my view, comparing a scenario of long-term trade gains with an exceptional financial crisis in the euro area seems not very intuitive at this point: remember the discontinuity?

- Moreover, if there were to be a financial crisis originating in the UK (due to Twin-Deficits), then might the UK be hit by a recession whether it’s in the euro area or not?
  - Yet, if we project ourselves 5-10 years from today, could we even imagine a situations where both the UK and the euro area would benefit from UK entry?
  - There would need to be a lot of financial market based risk-sharing: remember Yosha and Soerensen?

7th Comment. Looking at historical spreads not useful

Corollary. Given changes in economic and financial structures and EMU's institutional framework: looking today at historical spreads isn't necessarily helpful:

- In any case, difficult to say what would have happened to UK risk premia during the sovereign debt crisis had it been in the EA;
- many were predicting a collapse of UK bond prices during the crisis due to the weak public debt dynamics, but this never happened; and
- depth and some institutional features of the UK gilt market are unique in the EU, and thus it isn't clear whether UK risk premia would be hurt in the EA or not.

I also have a qualm about the Bayesian estimation.

- Model is estimated using quarterly data for the UK & euro area between 1984 and 1998.
- This period captures diverse financial crisis and in particular the exchange rate devaluation of 1992/1993.
- There is no acknowledgement of that in the paper.

A few additional experiments?

About trade related stuff:

- Which scenario could be devised vis-à-vis a continuing or stabilising hollowing out of manufacturing?
- Would “iceberg shipping costs” still be meaningful
- How can we model non-tradeable prices?

About financial market stuff

- Can we add financial market discipline?
- Households should be investing in government bonds which are not substitte of deposits
- About domestic financial intermediaries: upon UK-entry there will be an integrated banking system in which banks can engage in cross-border investment activities or deposit.

About macro-prudential policies

- What happens if shares of retained profits by bankers λ is tamed by supervisors/NCAs?
- Similarly with the θ leverage ratio