Lecture session 10

11. Alternative Exchange Rate Regimes and Optimal Currency Areas

- 11.1 Range of alternatives for exchange regimes
  - 11.1.1 Flexible: pure float to dirty float
  - 11.1.2 Mixed regimes: fixing to a basket, currency band, crawling peg
  - 11.1.3 Fixed: fixed to one foreign currency, currency board, dollarization, monetary union
    - [1] Implications of a strict fix for macroeconomic policy
    - [2] Implications of a strict fix for institutions, transparency and credibility
- 11.2 Optimal currency areas (OCA): theoretical considerations
  - 11.2.1 Optimality depends on cost vs benefits of fixed E over the integrated area
    - [1] Costs are primarily macroeconomic (loss of macro policy)
    - [2] Benefits are mostly microeconomic (price efficiency, market integration)
  - 11.2.2 Necessary theoretical conditions (criteria for benefits to exceed costs)
    - [1] Trade (in goods and services) are liberalized over the integrated area
    - [2] Capital and labor markets are integrated over the integrated area
    - [3] External shocks have the similar (symmetric) effects over the integrated area
    - [4] Fiscal stabilization (transfers) over the integrated area
  - 11.2.3 Implications of the necessary theoretical conditions
    - [1] Trade: convergence criteria for prices at micro level, inflation at macro level
    - [2] Capital and labor market integration: convergence criteria for returns, micro/macro
    - [3] Any relationship between symmetry in shocks and degree of integration?
    - [4] When [1]-[3] do not hold, fiscal transfers may be required
  - 11.2.4 Simple models for how OCA should work in theory: response to asymmetric shock
    - [1] Two-country/region trade model: shocks affect supply differently in each region
    - [2] Two-country/region model: L,K mkts adjust to shock affecting AS or AD
    - [3] Two-country/region model: shock affects supply requiring fiscal stabilization

12. Monetary Union

- 12.1. Case study of European monetary union (4 freedoms): optimality criteria in practice
  - 12.1.1 Intra-EU trade and extra-EU trade and trade balances
  - 12.1.2 Labor and capital mobility within the EU and flexibility in returns
  - 12.1.3 Fiscal stabilization
- 12.2. Pre-crisis shortcomings – 1991 Maastricht Treaty
  - 12.2.1 Focus on convergence criteria; weak enforcement of fiscal criteria
  - 12.2.2 Institutional weaknesses: on macro imbalances, exiting euro; managing debt
  - 12.2.3 ECB's limitations: on acting as lender of last resort; bank supervision/resolution
- 12.3. The euro crisis: background
  - 12.3.1 Macro problems in Greece and Ireland masks bigger financial problems
  - 12.3.2 Implications of slow response to banking crisis
    - [1] Too slow to boost bank capital and increase liquidity; ECB's power limited
    - [2] Gov'ts were unable to borrow cheaply; lacked credibility to backstop their banks
    - [3] Fiscal austerity worsened internal devaluation
  - 12.3.3 Contrast with US responses
- 12.4. Chronology of the response
  - 12.4.1 ECB only institution able to react to banking crisis and to act in short run
    - [1] 2007: increased liquidity beyond price stabilization (small-scale credit easing)
    - [2] 2010: initiates securities market program (purchase of national debt); bailouts
  - 12.4.2 EU creates EFSF and ESM – private agencies charged with providing liquidity
    - [1] 2010: European Financial Stabilization Facility – temporary with limited funds
    - [2] 2012: European Stabilization Mechanism – permanent, still limited capacity
  - 12.4.3 Longer-term response by ECB: LTRO increased liquidity to increase credit (QE)
    - [1] 2011-12: Long-term refinancing operation – unlimited funds in 3-year loans
    - [2] 2014: Targeted LTRO expands LTRO – fear of recession and deflation
    - [3] 2014-15: QE begins in earnest – ECB insists it will save euro
  - 12.4.4 Longer-term measures and proposed institutional changes
    - [1] Eurobond – idea to mutualize some national debt among Eurozone countries
    - [2] 2012: Fiscal union – Treaty on Stability, Coordination and Governance
    - [3] 2014: Banking union – single supervisor, single resolution authority, joint deposit-Insurance scheme

Study questions: Why might a mixed exchange regime be an improvement over a "corner solution", e.g., a flexible exchange rate or hard fixed exchange rate? What does it mean for an exchange regime to be considered a "hard fix"? How do such regimes differ from a fix of the local currency to one foreign currency? What does internal devaluation mean and imply for the macroeconomy of a country? How doe internal devaluation differ from external devaluation? What does the theory of an optimal currency area suggest about the choice of a fixed or flexible regime? What are the costs and benefits behind an optimal currency area? What criteria should be used to evaluate whether a common currency is optimal for an integrated area? What are symmetric and asymmetric external shocks and what is their significance for an optimal currency area? What role does trade, labor and capital mobility and fiscal transfers play in managing an optimal currency area? What factors or indicators might one look to when assessing whether an area or set of sovereign states is a good candidate for a common currency? How are fiscal and monetary policy affected by monetary union by sovereign states? How is monetary union the logical consequence of economic integration? How is political integration a logical consequence of economic integration? How do the proposed political institutions (fiscal union and banking union) help with stabilizing the macroeconomic environment of the Eurozone?